WRITTEN SUBMISSION FROM ROYAL SOCIETY OF EDINBURGH

Summary

- The RSE is concerned about the speed at which implementation of the Smith Commission recommendations for the devolution of new powers to the Scottish Parliament is proceeding. The accelerated timetable risks undermining the aim of achieving 'an enduring settlement.'

- It is crucial that the process allow sufficient time for deliberative consultation, expert and informed consideration and analysis, including Scottish and Westminster Parliamentary scrutiny, and testing, and where necessary, re-appraisal of the proposals prior to their implementation.

- There is a fundamental need to consider the underpinning principles of the constitutional structure sought. The following are, in our view, key elements of this:
  - Clearly established understanding and formal recognition of which risks and opportunities should be pooled and which of them should be devolved (in this context, it is important that the rationale for recommending particular tax and spending powers for devolution be fully developed);
  - Clear and transparent fiscal rules as part of an overarching fiscal framework;
  - Developing mechanisms to regulate the relationships between the Scottish and UK Governments;
  - The provision of fiscal data within an appropriate fiscal reporting framework;
  - Establishing fiscal institutions that can provide independent and rigorous analysis and review;
  - Developing a medium-term budgetary framework which includes rigorous and understood budgetary procedures and harmony of these across the total economy.

- With particular reference to the principle of needs-based funding, there is a requirement to re-consider the use of the Barnett Formula as the basis for determining the fiscal relationships.

- There is a pressing need for a comprehensive and independent analysis of how the principle of 'no detriment' will apply in practice. It will be particularly important to resolve the boundaries within which the 'no detriment' principle will operate.

- The RSE is firmly of the view that there is a need to establish in Scotland an independent fiscal body to provide authoritative and independent forecasts of the future fiscal revenues and budget position. It is crucial that the fiscal body be independent of government. To ensure the reputation, impartiality, credibility and impact of the fiscal body, it must be appointed independently by, and be directly accountable to, the Scottish Parliament. Beyond a forecasting role, consideration should be given to whether the independent
fiscal body would provide analytical commentary on strategically important forward-looking issues and commitments.

- Inter-governmental arrangements between the Scottish Government and UK Government should be reformed as a matter of urgency and scaled-up significantly. The scale of the complexity and challenge associated with negotiating a fiscal framework for Scotland reflects the need for a system of much closer cooperation between the Scottish and the UK Governments. We support the development of a stronger Joint Ministerial Committee (JMC) system with clearer guidelines, more regular meetings, enhanced transparency and publicity. Not only is it important to nurture cooperation and coordination at ministerial level; this needs to extend to the officials charged with developing and implementing the fiscal framework.

Introduction

1. The Royal Society of Edinburgh (RSE), Scotland’s National Academy, welcomes the opportunity to respond to the Scottish Parliament Finance Committee’s inquiry into Scotland’s Fiscal Framework. This response has been prepared by an RSE working group with expertise in economics, public finance and public policy. We would be pleased to discuss further any of the comments made in our response with members of the Finance Committee.

2. Given the related territory, the Committee might be interested in the RSE’s recent response to the House of Commons Constitution and Political Reform Committee on its scrutiny of the Draft Scotland Clauses 2015 as set out in Scotland in the United Kingdom: An Enduring Settlement. Similarly, the Committee might consider the report of a joint RSE and British Academy discussion on Further Powers for Scotland – What does the draft legislation mean in practice, which was held at the RSE on 3 March 2015.

A revised funding framework for Scotland

Implementation process

3. The RSE is concerned about the speed at which implementation of the new powers emanating from the recommendations of the Smith Commission is proceeding. Scotland in the United Kingdom: An Enduring Settlement envisages the UK Government introducing Scotland Bill legislation, alongside an agreed fiscal framework, in the first session of the next Parliament.

4. The components of a revised fiscal framework that will need to be negotiated and agreed are likely to be extremely complex. It is crucial that the process allow sufficient time for consultation, expert and informed consideration and analysis, including Scottish and Westminster Parliamentary scrutiny, and testing, and

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where necessary, re-appraisal of the proposals prior to their implementation. It would seem to us that this requires a more expansive approach than that afforded by the normal Scottish Parliamentary committee inquiry process.

**Need to consider the principles underpinning the constitutional structure**

5. In this extended process we believe that consideration needs to be given not only to how the Smith Commission recommendations will be implemented but, more fundamentally, to the rationale and underpinning principles of the constitutional structure sought. We believe that consideration of the following key elements would need to be part of this process:

- Clearly established understanding and formal recognition of which risks and opportunities should be pooled and which of them should be devolved. On this will depend the design of appropriate fiscal instruments and budgetary balances.
- Clear and transparent fiscal rules as part of an overarching fiscal framework.
- Developing mechanisms to regulate the relationships between the Scottish and UK Governments, both at the political level and between officials.
- The provision of fiscal data within an appropriate fiscal reporting framework.
- Establishing fiscal institutions that can provide independent and rigorous analysis and review.
- Developing a medium-term budgetary framework which includes rigorous and understood budgetary procedures and harmony of these across the total economy.

6. The accelerated timetable for implementing the Smith Commission recommendations risks undermining the aim of achieving ‘an enduring settlement.’ It is paramount that the legislative outcome be seen to have been reached after adequate and appropriate public and parliamentary consultation and debate.

7. In this context, it is clearly important that the rationale for recommending particular tax and spending powers for devolution be fully developed. The partial devolution of welfare and tax powers will lead to significant complexities in responsibility, the sharing of risk and the application of the ‘no detriment’ principle. This is illustrated, for example, by the proposed mix of housing provision: the delivery of social housing (and planning for housing in general) would rest with the Scottish Government while housing benefit provision would remain a reserved issue. Universal Credit is enshrined in the proposals as a reserved issue. However, it is difficult to determine on what principle all aspects of this current policy must remain reserved.

**Learning lessons from the new powers devolved under the Scotland Act 2012**

8. It will also be important to consider the devolution to the Scottish Parliament of new tax and borrowing powers under the Scotland Act 2012. These new powers are being implemented in two stages – The Land and Buildings Transaction Tax, landfill tax and new borrowing powers are now devolved (as from 1 April 2015), with devolution of the Scottish rate of income tax to follow in April 2016.
Application of these powers will need to be thoroughly reviewed, both in their own right and also for the implications they have for implementation of the further powers recommended by the Smith Commission. This approach would also allow decision makers to learn from the experiences of implementing the powers of the 2012 Act.

**Calculation of the block grant and the operation of the Barnett formula**

9. The Smith Commission Agreement recommended that the block grant from the UK Government to Scotland should continue to be determined through the operation of the Barnett Formula.

10. However, rather than accepting this premise, we believe there is a need to re-consider the use of the Barnett Formula as the basis for determining the fiscal relationships. The Finance Committee’s recent Report on Further Fiscal Devolution\(^3\) references several prominent criticisms of the Barnett Formula, including that it: takes no account of the relative spending needs across the UK; is based on policy changes in England; and lacks transparency in how it is operated by the UK Treasury.

11. The principle of needs-based funding means that revenue support should be allocated on the basis of some proper assessment of need. As we have indicated at the outset of our response, this will require a more deliberative process of consultation.

12. It is also worth noting that the adjustment to the block grant is inevitably going to become increasingly complex if new tax powers in Wales and Northern Ireland were to enter into the Treasury’s block grant calculations.

13. Should the block grant continue to be determined through the operation of the Barnett Formula (or any adaptation thereof), there must be a mechanism through which the UK and Scottish Governments can negotiate and agree on adjustments in an open and transparent manner. It is certainly not acceptable for HM Treasury, as an organ of the UK Government, to make such decisions unilaterally. This demonstrates the pressing need for strengthening of the intergovernmental arrangements on which we comment in paragraphs 29 to 33.

**The principle of ‘no detriment’**

14. The Smith Commission Agreement recognises that, on initial devolution of further powers, there should be ‘no detriment’ to the Scottish or UK Governments’ budgets. While this is sound in theory, there is a pressing need for a comprehensive and independent analysis of how it will apply in practice in relation to the powers conferred by the Scotland Act 2012 and to those proposed as a result of the recommendations of the Smith Agreement. There are many policy areas where decisions taken in one nation of the UK may impact upon one

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\(^3\) *Further Fiscal Devolution*, Scottish Parliament’s Finance Committee (4 March 2015)  
or more of the other nations. In particular, there is a need to resolve the boundaries within which the 'no detriment' principle will operate.

Statement of Funding Policy

15. We note that the Statement of Funding Policy, which sets out the arrangements governing the setting of devolved budgets based on the current Barnett formula, has not been updated since 2010. It therefore does not include any reference to the arrangements for implementing the financial powers within the Scotland Act 2012 or the further powers proposed by the Smith Commission Agreement. To date, the Statement has been produced by HM Treasury without the need for agreement by the devolved administrations. In revising the Statement it will be important to ensure that this is done in an open and transparent manner, with the input of the devolved administrations. This input could be secured by the strengthening of inter-governmental arrangements.

Independent scrutiny of Scotland’s public finances, including the development of an enhanced independent fiscal body in Scotland

Forecasting the future fiscal position

16. The Smith Commission recommended that the Scottish Parliament should seek to expand and strengthen the independent scrutiny of public finances in Scotland. As a component of an updated fiscal framework for Scotland, the RSE is firmly of the view that there is a need to establish in Scotland an independent fiscal body which is capable of providing authoritative and independent assessment of the fiscal position and general prospects for the Scottish economy within the context of UK and international developments. The RSE has previously provided comments\(^4\) to the Finance Committee on the creation of an independent fiscal body in Scotland.

17. We recognise that the Scottish Fiscal Commission was established on a non-statutory basis in June 2014 to provide an independent review of Scottish Government forecasts of receipts from devolved taxes. We also note that the Scottish Government has recently issued a consultation on legislative proposals that would place the Commission on a statutory footing. However, the Commission does not originate the forecasts; rather, it is restricted to reviewing and reporting on the Scottish Government’s forecasts.

18. The more powers that the Scottish Parliament has in relation to revenue generation and expenditure in Scotland, the more important it becomes to safeguard the sustainability of its public finances. In a recent report\(^5\), Audit Scotland stated that developing a good fiscal reporting framework is fundamental to ensuring appropriate accountability in Scotland as more powers are devolved.

\(^4\) Proposals for an independent fiscal institution in Scotland (September 2013)

\(^5\) Update on developing financial reporting; Audit Scotland (March 2015)
It also highlights the need to strengthen the link between economic activity and Scottish Government revenues and spending.

19. The International Monetary Fund (IMF) has developed a new Fiscal Transparency Code\textsuperscript{6} to support the strengthening of fiscal surveillance, support policy making, and to improve fiscal accountability. We would encourage the Scottish Government and the Parliament’s Finance Committee to consider the principles set out in the IMF’s Code in terms of strengthening the fiscal reporting framework in Scotland.

20. As with the UK’s Office for Budget Responsibility (OBR), we would expect an independent fiscal body in Scotland to be established to provide independent forecasts of the future fiscal revenues and budget position. This is in line with the ‘advanced’ practices identified by the IMF for fiscal statistics compiled by a professionally independent body. The Scottish fiscal body could be charged with: a) reviewing the fiscal outlook for the government and the public; b) forecasting the future revenues likely to be available; c) estimating current structural imbalances; and d) estimating the likely consequences of current spending and taxation plans.

Independence and accountability

21. It is crucial that the fiscal body in Scotland be independent of government influence, and be seen to be so. To ensure the reputation, impartiality, credibility and impact of an independent fiscal body, it must be appointed independently by, and be directly accountable to, the Scottish Parliament. This approach recognises the importance of ensuring the body’s freedom from political pressure while balancing this with an appropriate mechanism of accountability to assure its effectiveness and democratic legitimacy.

22. The independent fiscal body should be able to develop its own framework of analysis, data sources and methodology. It should have full access to data and any related analysis or evaluations made elsewhere. Given its independence, the fiscal body will need to exhibit a high degree of transparency. This calls for the publication of all material relevant to its work. A parliamentary committee (or committees) could be charged with receiving and considering the reports of the fiscal body and holding the Executive to account in relation to its policy and budgetary decisions.

Analytical commentary on long term strategic issues and commitments

23. The Finance Committee will be aware that the RSE has frequently raised concerns about the fact that budget setting is on a year-by-year basis. This restricts longer-term prioritisation of expenditure by failing to take account of longer term demands. Therefore, beyond a forecasting role, consideration

\textsuperscript{6} International Monetary Fund’s Fiscal Transparency Code (June 2014)
should be given to whether the independent fiscal body would provide analytical commentary on strategically important forward-looking issues and commitments. For example, this could include commenting upon the fiscal implications of demographic change.

24. This would enable independent consideration to be given to financing implications beyond the parliamentary cycle. This could be achieved without interfering with the government's preferences, priorities and targets.

25. In this context, the Finance Committee might find it instructive to consider the operation of the US Congressional Budget Office (CBO). It is strictly non-partisan and conducts objective, impartial budgetary analysis. While the CBO does not make policy recommendations, it does provide analysis of both near term and longer term budgetary and economic options.

26. The Finance Committee will need to give consideration to the most efficient arrangements for organising the proposed forecasting and strategic commentary functions. We have previously suggested that it be explored whether these proposed functions could be hosted within a consolidated body that includes SPICe. This would not negate the need for additional resource in order to deliver the forecasting and commentary functions, including the provision of staff with expertise in data analysis, statistical modelling and econometrics. We are of the view that Scotland would be able to support only one officially established independent body which is a centre of expertise in applied fiscal and economic analysis.

Borrowing powers

27. The Smith Commission recommended that the Scottish Government should have sufficient, additional borrowing powers to ensure budgetary stability and to provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. As well as providing for capital spending limits, the Scotland Act 2012 enables Scottish Ministers to borrow up to £200m annually and £500m in total to address deviations between forecast and actual revenues.

28. Borrowing-related decisions to support public spending will be dependent on there being an appropriate framework for independent forecasting and reporting of tax revenue, underpinned by the provision of sufficient data. This reinforces the points we make in the preceding section on the establishment of an independent fiscal body.

Strengthening of intergovernmental arrangements for a fiscal framework

29. Any devolved, federal or quasi-federal system needs to have mechanisms regulating the relationships between the levels of government. These have two important purposes, namely, policy co-ordination and conflict resolution.

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7 More information available from: http://www.cbo.gov/
30. The Smith Commission recommended that the current inter-governmental arrangements between the Scottish Government and UK Government, including the Joint Ministerial Committee (JMC) structures, be reformed as a matter of urgency and scaled-up significantly. Smith also indicated that the new fiscal framework should be agreed and implemented jointly by the UK Government and Scottish Government through the Joint Exchequer Committee (JEC), with suitable engagement with both the UK and Scottish Parliaments.

31. Typically, inter-governmental relations in the UK have been ad hoc, informal, and undertaken on an issue-by-issue basis with little opportunity for public scrutiny. The JMCs have met infrequently and have, in the main, had limited impact. We note that the JEC has not met since February 2013.

32. The scale of the complexity and challenge associated with negotiating a fiscal framework for Scotland reflects the need for a system of much closer-cooperation between the Scottish and the UK Governments. This not only relates to the implementation of the new powers, but to the need to manage, on an on-going basis, the interdependencies that the new settlement will create.

33. The preceding paragraphs demonstrate the need for more effective bilateral structures to resolve potential issues of conflict and to encourage joint working on areas of shared responsibilities. We support the development of a stronger JMC system with clearer guidelines, more regular meetings, enhanced transparency and publicity. Strengthening in this manner will provide incentives to agree upon policy. It is important to nurture cooperation and coordination at ministerial level, and this needs to extend, also to the officials charged with developing and implementing the fiscal framework.

Additional Information

Advice papers are produced on behalf of RSE Council by an appropriately diverse working group in whose expertise and judgement the Council has confidence. This Advice Paper has been signed off by the General Secretary.

In preparing this Advice Paper we would like to draw attention to the following RSE responses which are relevant to this subject:

- The Royal Society of Edinburgh’s response to the House of Commons Constitution and Political Reform Committee on Scotland in the United Kingdom: An Enduring Settlement – Draft Scotland Clauses 2015 (February 2015)

- The Royal Society of Edinburgh’s response to the Scottish Parliament’s Finance Committee on proposals for an independent fiscal institution in Scotland (September 2013)
The Royal Society of Edinburgh’s response to the House of Commons Scottish Affairs Committee Inquiry into Scotland and the UK: cooperation and communication between governments (November 2009)

Any enquiries about this Advice Paper should be addressed to Mr William Hardie (email: evidenceadvice@royalsoced.org.uk).

Responses are published on the RSE website (www.royalsoced.org.uk).

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