Introduction

The Institute for Government is currently engaged in a research project entitled ‘Governing after the referendum’. In keeping with the overall charitable mission of the Institute, our research focus is on improving the effectiveness of the UK’s changing devolution arrangements and the relationships between the UK and devolved governments.

As such we do not advocate particular reforms to the devolution settlements nor a particular vision of how the country’s territorial constitution should be designed. We are, however, closely following and engaging in the constitutional reform debate and are pleased to have the opportunity to contribute evidence to this Finance Committee inquiry. In this short paper, completed just after the publication of the report of the Smith Commission, we address four of the questions posed by the committee in its call for evidence.

What general principles should apply to the devolution of further financial powers to the Scottish parliament?

The process of devolution can sometimes appear to be driven more by political pressures and calculations than by a clear set of principles. We welcome the approach adopted by the Smith Commission that the next phase of devolution should be guided by a ‘principles-led approach’ on the grounds that ‘arriving at clear principles for the devolution of more powers will be vital to finding a sustainable and lasting settlement and meeting the country’s expectation for significant change’.

The Institute for Government’s position is that the next phase of fiscal devolution should be managed with a view to the impact on government effectiveness and to the implementability of any new settlement. Specific principles to take into account should therefore include: the impact of fiscal devolution on the accountability of the Scottish Government, the administrative costs and challenges associated with creating and operating a more devolved tax system, and the ‘policy relevance’ of powers devolved, meaning the extent to which new tax levers complement other powers controlled at the devolved level.

A general point to make would be that an overall devolution package that reduces rather than increases the ‘jagged edges’ between policy under reserved and devolved control is more likely to produce an effective settlement and to reduce conflict between the UK and Scottish governments.

1 Further details on our research can be found at: http://www.instituteforgovernment.org.uk/our-work/parliament-and-political-process/governing-after-referendum
To what extent could the Scottish Government be constrained in how it uses new tax powers given the interaction with fiscal decisions at a UK level?

The Smith Commission report announced cross-party agreement for the devolution of control of all income tax rates and bands. However, this will not amount to ‘full control’ of all aspects of the income tax system since Westminster is expected to retain the power to: define ‘income’; set rates on investments, dividends and savings; and set uniform allowances and reliefs across the whole of the UK. Consequently, there will continue to be a UK-wide income tax system within which Scotland will gain significant but not unconstrained policy flexibility.

A further potential constraint relates to borrowing capacity. The Scotland Act 2012 gave the Scottish Government the ability to borrow up to £500m to even out fluctuations in tax receipts (so-called ‘revenue borrowing’, as distinct from ‘capital borrowing’ for infrastructure investment). The Smith Commission recognises that an extension of Scotland’s power to raise its own revenue via taxation will therefore necessitate an extension of these borrowing powers. Any such extended borrowing facility will need to be agreed with and overseen by the Treasury.

What are the implications of further fiscal devolution for the block grant?

Under the provisions of the Scotland Act 2012, the block grant will be reduced to compensate for increased revenue from the Scottish rate of income tax and the two fully devolved taxes – the Land and Buildings Transaction Tax and Scottish Landfill Tax. Even for this fairly small-scale fiscal devolution, negotiations between the two governments over these adjustments and how the adjustments should be indexed have proven somewhat difficult, particularly for the two smaller fully devolved taxes.

With more extensive powers to vary income tax as well as control of other revenue-raising powers (such as Air Passenger Duty and the Aggregates Levy) and the assignment of half of the VAT revenue raised in Scotland, agreeing the block grant adjustment and indexation will become a more complicated process, although to some extent the existing methodology could be extended. Agreeing upon a fair grant adjustment methodology will also be more challenging the more volatile is the tax base being devolved. The Smith report sets out some principles for how Scotland’s new fiscal framework should work, but on some key points there is little detail – e.g. it is simply stated that the adjustment to Scotland’s block grant “should be indexed appropriately”.

In theory, the process of fiscal devolution could one day reach the point where instead of having to adjust a block grant paid by the Treasury to Scotland, Scotland controls such significant revenue-raising capacity that it would need to make a payment to the rest of the UK for those services that remain UK-wide. At that point (a ‘full fiscal autonomy’ system) there would be a need for further negotiation as to how such a reverse block grant system would work.

What are the implications of further financial powers for the role of Revenue Scotland?
Under the Scotland Act 2012, the Scottish rate of income tax is to be managed and collected by HMRC. Revenue Scotland has responsibility for the two fully devolved smaller taxes. The Smith Commission report builds on this approach of having parallel tax administration systems in Scotland. The plan is for HMRC to continue to collect all income tax in Scotland (although rates and bands could differ), while Air Passenger Duty and Aggregates Levy will be fully devolved – and seem likely to become the responsibility of Revenue Scotland. This may require an expansion of the size and capacity of Revenue Scotland, which is a small organisation of a few dozen staff at present, in which case it may well recruit from the 9,000 or so HMRC staff currently located in Scotland.

The Smith Commission report also emphasises the need for coordination between the two governments on issues such as avoidance of double taxation, and the development and operation of a separate fiscal framework for Scotland – operating within the wider UK fiscal framework. Revenue Scotland would no doubt be closely involved in such processes.

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