The Scottish Parliament
Pàrlamaid na h-Alba

FINANCE COMMITTEE

AGENDA

21st Meeting, 2014 (Session 4)

Wednesday 25 June 2014

The Committee will meet at 9.30 am in the James Clerk Maxwell Room (CR4).

1. **Decision on taking business in private:** The Committee will decide whether to take item 3, 4 and 5 in private.

2. **Scotland's public finances post-2014:** The Committee will take evidence from—

   Rachel Holmes;

   and then from—

   Professor David Heald, Professor of Accountancy, University of Aberdeen;

   Professor Alan Trench.

3. **Landfill Tax (Scotland) Act 2014:** The Committee will consider its approach to scrutiny of draft subordinate legislation.

4. **Air Weapons and Licensing (Scotland) Bill:** The Committee will consider its approach to the Financial Memorandum of the Bill.

5. **Welfare Funds (Scotland) Bill:** The Committee will consider its approach to the Financial Memorandum of the Bill.

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The papers for this meeting are as follows—

Agenda Item 2	
Note by the Clerk	FI/S4/14/21/1
Agenda Item 3	
PRIVATE PAPER	FI/S4/14/21/2 (P)
Agenda Item 4	
PRIVATE PAPER	FI/S4/14/21/3 (P)
Agenda Item 5	
PRIVATE PAPER	FI/S4/14/21/4 (P)

Finance Committee

21st Meeting, 2014 (Session 4), Wednesday 25 June 2014

Scotland's public finances post-2014

Purpose

1. This paper provides copies of the written submissions that have been received from the witnesses who will be providing evidence at this meeting in relation to Scotland's public finances post-2014.

2. The Committee will hear from two sets of witnesses at this meeting. The first panel will be in relation to pensions while the second panel will provide evidence in relation to the Barnett formula.

3. Regarding the session on the Barnett formula, in addition to the submissions from the Professor David Heald and Professor Alan Trench, submissions from Professor Gerald Holtham and Marius Ostrowski, Head of Research for the All Party Parliamentary Group on Taxation, are also attached.

Catherine Fergusson
Senior Assistant Clerk to the Committee

SUBMISSION FROM RACHEL HOLMES

Biography

I am a Chartered Accountant and a full time university lecturer. Before taking up lectureships with the Institute of Chartered Accountants of Scotland in 2007, and in 2010 at university in Edinburgh, I worked for seventeen years major investment companies and financial institutions in Scotland and in Luxembourg. I now lecture in accounting, taxation, corporate finance and investment management. I am currently studying for a Doctorate in the experiences of overseas Chinese students studying accountancy at a Scottish university. All views expressed in this written evidence and in committee are my own.

Pensions Policy Post 2014

There are two broad scenarios for Scotland and pensions after September 2014. Firstly, a majority yes vote in the referendum creates potential for change in pension policy in Scotland. With a no vote, pension policy will continue to be delivered by Westminster, where Scotland's democratic representation comprises less than 10% of MPs. Westminster governments are rarely decided by votes in Scotland and so there is little opportunity for change to suit the specific circumstances be they economic, demographic or social, of Scotland. With a no vote there is little further discussion to be had in terms of the Scottish Parliament because most, if not all, decisions relating to pensions will continue to be made in Westminster.

There are indeed areas that need to be resolved in Scotland on transitioning to independence should there be a yes vote. With the refusal of Westminster government to pre negotiate such areas, due to political considerations, any formal discussions surrounding the transition to the Scottish Parliament of powers relating to pension policy require to be postponed until after a yes vote. It is my view that the issues raised and frequently discussed during the lead up to the referendum can and will be resolved successfully.

Scotland need not be fearful of having control over its own pension provision and policy. Scotland, like most other European countries of similar size and, in many cases with fewer assets, is economically viable. To my knowledge, all the major UK party leaders have now agreed that, economically, Scotland has the necessary ingredients to be a successful country. Thus, while there are detailed debates round specific aspects of pensions, some of which will take time to resolve, the opportunity to take a new look at pension provision and policy in Scotland, can be embraced positively.

Nobody need believe that the current provision of public pensions by UK government is a 'gold standard'. The UK is low in rankings of countries in terms of provision for pensioners. Many countries, often those with small populations, do better. There is no reason why, in time, Scotland could not aspire to something different, where it made sense to do so.

Some key points to note with regard to the current UK pension provision and policy:

- The Office for National Statistics calculated that the UK has a total future pension liability of £5 trillion based on recent projections of government employee and state pension provision.
- Comparing the UK state pension provision to the rest of the world, the Melbourne Mercer Global Pension Index scores the UK at a C+ (alongside Chile) while smaller nations such as Denmark, Netherlands, Australia, Sweden and Switzerland are ranked above with A or B ratings.

- The Organisation for Economic Co-operation and Development indicate that under UK pension provision the average person might receive 32.6 per cent of their final salary from the state once they retire. This is the lowest proportion in Europe. The average equivalent figure for the total 34 countries measured was 40.6 per cent. Austria offers 76.6 per cent.

- This UK state pensions' liability is largely unfunded - there are few investment assets generating income to support future pensions.

- Other countries, many of them small nations like Scotland have a pool of investment assets, built up over time and which now fund pensions. The UK government does not have such a fund.

- Because there are few investment assets, pensions must be funded by working individuals funding the pensions of the retired via salary contributions (public sector employment schemes) and, NICs (the state pension).

- Tax relief for those saving into work or private pensions is available but wealthier people benefit most with tax relief at higher rate (and additional rate) and available on relatively large amounts of investment. The less well off, have no access to the higher or additional rates of tax relief. The less well-off are also unlikely to meet anywhere near the maximum amount of investment attracting tax relief in any one year.

- Scotland could, in time, consider the attractiveness or otherwise of policies of other countries, for example offering tax relief on work and private pensions contributions based on age rather than income tax banding.

- Women have been treated poorly by the UK pension regime. Employer pension schemes still remain a regime which favours those who work for one employer, full time, throughout their working life. Usually this applies to men.

- Women are also disadvantaged in terms of the state pension with disproportionately fewer women compared to men qualifying for the full basic state pension.

There is scope for Scotland to do something different. This will take time, and must not be rushed. But over the longer term there is an opportunity for Scotland to shape the pensions provision best suited to its own circumstances and to the new ways in which people live their lives. The opportunity is also there to look elsewhere and implement the best policy from other countries. Those policies will be for future

Scottish Governments, of whatever hue, to decide. Increasing incentives to save for the less well-off should, in my view, be a priority.

There will, of course, be challenges. But there are significant challenges at the moment and there is little scope, under the current arrangements, for the Scottish Parliament to meet these challenges because it lacks the powers to do so.

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WRITTEN SUBMISSION FROM PROFESSOR DAVID HEALD[1]

THE BARNETT FORMULA WITHIN THE DEVOLVED FINANCING SYSTEM

Introduction

1. I have a longstanding interest in the public finances of Scotland: in 1976 I proposed what later became the tartan tax; in 1980 I named the Barnett formula when knowledge of its existence first came into the public domain; in 1990 I contributed to the debates stimulated by the Scottish Constitutional Convention; and in 2008 I supported the Canadian-style tax-points transfer that was included in the Calman Commission Report. This personal background is relevant to the exposition below on the issues that must be addressed if extended taxation powers are to be successfully operated by a devolved Scottish Parliament. My invitation to give evidence to the Committee explicitly asked me to address the Barnett formula: there is no discussion here of Independence as there would no longer be grants from the UK Government.

2. The Referendum constitutes a critical juncture in Scottish public finances, even if the result is No. The status quo of 1999 is rarely defended, with party competition on the No side on how far-reaching tax proposals can now be. Expectations have been aroused inside Scotland for a 'better devolution deal', while – temporarily in my view – the voices outside Scotland that denounce its 'excessive privileges' are relatively subdued. Squaring the circle between 'better deal' and 'worse deal' will prove difficult, particularly in relation to (a) the practical operation of devolved tax powers, and (b) the grant system. It must also be remembered that Wales and Northern Ireland are important players, both in terms of looking enviously at Scotland and in terms of wishing to emulate Scottish constitutional and financial arrangements.

How Barnett Works

3. What is remarkable is how much misunderstanding and/or misrepresentation there is of the Barnett formula, and how that has gone uncorrected because of inadequate transparency. It is an adjustment formula, not a needs formula as is sometimes claimed. Changes in expenditure in England on services that are devolved to Scotland lead to changes – positive or negative – in the Scotland Departmental Expenditure Limit (DEL), after weighting for population ratios and comparability percentages. Because the expenditure base per capita is higher than in England and increments are equal amounts per capita, increases in public expenditure will lead to (slow) convergence towards England per capita expenditure = 100. If expenditure falls, there would be divergence. There has been much less convergence since 1979-80 than would be predicted given the mathematical properties of the formula (Heald, 1994): this is primarily a result of Scotland's *relative* population fall, but also of other factors discussed in Heald and McLeod (2005).[2]

4. There have been three emphatic advantages for Scotland. The first is the expenditure-switching discretion, originally of the Secretary of State for Scotland

[1] Professor of Accountancy at the University of Aberdeen.

[2] These included formula by-pass in the 1980s (usually beneficial to the then Territorial Departments), the transfer of functions, and classification and accounting changes.

before 1999 and of Scottish Ministers since then. The second is the protection that this adjustment mechanism gives to policy discretion within Scotland. Unlike for UK departments responsible for England, central departments like the Treasury and Cabinet Office cannot probe the detail and disallow 'undesirable-in-their-eyes' expenditure. The practical advantage to the Treasury is that a mechanical formula has allowed the expenditures of Scotland, Wales and Northern Ireland to be settled, very quickly, after decisions have been taken on the much larger English programmes. Third, the existence of the formula protected the budgets of the Devolved Administrations from Treasury 'raids', perhaps conducted without public disclosure.[3]

5. On the basis of what is in the public domain, my assessment is that the Treasury has generally abided by the spirit and letter of the funding rules.[4] Heald and McLeod (2002) set out how Barnett could be modified, in ways that might assuage concerns expressed in Wales and Northern Ireland. However, the Labour Government closed down debate on the topic at a time when public spending was increasing rapidly and modifications could have been done relatively painlessly. Criticisms of within-England distribution have been channelled against the Barnett formula, though that has no direct relevance.

6. Table 1 summarises the operation of the Barnett formula since the 2010 UK general election, with reference to the present year (2014-15). It reinforces two points. First, the Barnett formula is deeply embedded within the UK public expenditure system over which the Treasury has unchallenged power. The CSR2010 baseline for the 2014-15 Scotland DEL (£28,245 million) evolved through UK spending announcements to the 2014-15 Revised budget, net of depreciation (£28,683 million). Cumulatively the net Barnett formula consequentials (plus £113 million) were a modest component of this transition. For 2014-15, the Barnett reduction in SR2010 (£508 million) was more than offset by positive consequentials from subsequent spending announcements.

7. A much larger effect on the total DEL came from Machinery of Government changes and Baseline transfers (plus £367 million). Moreover, there is a £607 million reduction from the 2014-15 DEL (as at June 2013), reversing 'temporary' Barnett consequentials and one-offs, to reach the SR2013 baseline for 2015-16 (£27,920 million). There is no provision in the Statement of Funding Policy for such a step, nor a distinction there between 'temporary' and 'permanent' consequentials. Table 1 reinforces the point that the Treasury has much discretion. There is a transparency deficit that is undesirable now and – unless removed – would make major devolved taxes unworkable.

[3] See the *Herald* report on 3 January 2014 headed 'Thatcher minister wanted to secretly cut millions from Scotland's funding – Papers reveal row centred on saving cash and political fall-out' (Settle, 2014). The occasion was the release of documents at the National Archives under the 30-year rule.

[4] The documented exceptions are now relatively old, relating to the treatment of the Olympics and to the implementation costs of the Carter Review of Prisons. The latest *Statement of Funding Policy* (Treasury 2010) is located at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/sr2010_fundingpolicy.pdf. This was not updated at Spending Review 2013, contrary to customary practice, possibly on the argument that SR2013 (covering only 2015-16) was an extension of CSR2010.

Table 1: 2014-15 as Illustration of evolution of Scotland DEL from CSR2010 to Budget 2014

	£ million	
	2014-15	**2015-16**
Baseline for CSR2010	**28,245**	
Cumulative Barnett consequentials	113	
Machinery of Government changes and Baseline transfers	367	
Budget regime changes	12	
Forth Replacement Crossing prepayments	(52)	
Rounding error	(2)	
Revised budget, net of depreciation (March 2014)	**28,683**	
Revised 2014-15 budget, net of depreciation (June 2013)		**28,527**
SR2010 baseline adjustment		(607)
SR2013 baseline		**27,920**

Source: Successive Scottish Government responses to Freedom of Information requests

8. Second, the feast of Barnett consequentials in the early and mid 2000s reflected a surge in spending on health and education in England. Large reductions since June 2010 to English programmes were partially offset by large increases in health. During the period June 2010 to March 2014, there were ten UK spending announcements.[5] The effect on the Scotland DEL clearly depends on UK Government decisions about whether comparable or non-comparable programmes will be cut.

9. Despite all the criticism, from within Scotland about the so-called 'Barnett squeeze' and from outside Scotland of its higher per capita expenditure, the system has survived for more than 30 years because:

a) There has been no compelling support for an alternative, particularly a UK-wide needs assessment;

b) The expenditure-based financing system, with broad expenditure-switching powers, is congruent with the reality of the UK public expenditure system; the 16% of the population living in the Devolved Administrations were sufficiently marginal to UK political debates for some spending legacies and policy deviancy to be tolerated at Westminster and Whitehall; and

c) Since 1997, there has always been a Scottish MP of Cabinet rank at the Treasury and this has protected Scotland's political clout. There is generalised hostility to the Barnett formula in Whitehall and Westminster, on the basis of

[5] These ten UK spending announcements were: June 2010 Budget; CSR 2010; 2011 Budget; Autumn Statement 2011; 2012 Budget; Autumn Statement 2012; 2013 Budget; SR2013; Autumn Statement 2013; and 2014 Budget.

what is perceived as excessive levels of public expenditure in Scotland and Northern Ireland.[6]

The Implications of Extra Tax Powers

10. The continued lack of transparency post-devolution was tolerated in the context of much more money flowing down the Barnett pipeline in the early and mid-2000s. A pre-condition of the exercise of significant tax powers is that there is full transparency about the funding system. Otherwise, the tax powers will become unusable, subjected to mockery, vulnerable to gaming by the UK Government, and to disintegration of the administrative infrastructure for assessment and collection. Heald and Geaughan (1997) voiced fears of such a fate for the tartan tax, though – in the event – non-use owed much to unabsorbable increases in Barnett funding that went partly into the build-up of End-Year Flexibility.

11. There are undoubted advantages when democratically elected bodies have some of their expenditure covered by tax revenues under their control. However, this is easier to say than to sustain in a highly centralised political system such as the United Kingdom. Raising ‘own revenues’ cannot legitimately mean receiving the revenues generated in a sub-national jurisdiction through the application of a centrally-set tax rate to a centrally-prescribed tax base. This creates no political accountability: they are ‘assigned revenues’, even if not labelled as such. Moreover, without some form of revenue equalisation, there will be large variations in revenues per capita across jurisdictions, and substantial year-to-year revenue volatility. To count as own revenues, there has to be at least sub-national control of the tax rate, possibly within prescribed limits: these can legitimately be labelled as ‘own tax revenues’. Otherwise, there will be shifts in the location of fiscal risks (eg revenue oscillations) and policy risks (eg UK government changes to the tax structure to the detriment of sub-national revenues) in ways which are damaging to public expenditure management and to political accountability. Arguably the worst of all worlds is when devolved tax powers are not usable: it will not take long before the talk of ‘enhanced accountability’ is discredited. Therefore, the design of the grants system and the adopted rules about devolved borrowing and saving become decisive. Otherwise, the Barnett formula system’s high level of predictability of capacity to spend will be lost, without off-setting benefits. Since 1999 this predictability has been enhanced by periodic Spending Reviews every two or three years, rather than the pre-1998 system of annual Public Expenditure White Papers.

12. Four observations about political context are highly relevant:

a) The Devolved Administrations wish to spend more per head than does the UK Government in England, in part reflecting historical legacies and in part divergent views about the size and scope of the public sector;

[6] Commentary on spending differentials per head usually refers to the territorial analysis tables in the annual *Public Expenditure: Statistical Analyses* (Treasury 2013). However, these figures include UK Government expenditure in Scotland and are influenced by other factors than the Barnett formula. Heald (1994, pp. 170) called for the regular publication of ‘English equivalent expenditure’ (ie that expenditure that drives Barnett increases or decreases). Twenty years later this has still not happened.

b) A striking feature of the last 30 years has been the weakening of local government across Great Britain,[7] in terms of loss of functions and of discretion in local taxation. The arguments for own tax-raising no longer seem to be applied to local authorities, from which much financial discretion has been removed either by legislation or grant design;

c) Notwithstanding (a) above, much contemporary discussion relates to the possibility of taxes being lower than in England, particularly but not exclusively in relation to Corporation Tax and Airport Passenger Duty. Tax-varying powers would be more difficult to operate in Wales because of population proximity to the border with England, and Northern Ireland has the complication of a 220-mile land border with Ireland. Moreover, while Scotland and England are economically quite similar in terms of prosperity, both Wales and Northern Ireland have much lower taxable capacities, meaning that whether there is tax-base equalisation becomes salient in the way it does not for Scotland alone. The Government of Ireland Act 1920 system of financing for the Stormont Parliament disintegrated because of 'parity'. If Northern Ireland broadly followed UK taxes, then some of its resource shortfall would be non-transparently funded by Westminster; and

d) Claims that lower tax rates would be self-financing through higher economic growth should always be treated with suspicion.

13. If more extensive taxation powers are not to be mere window-dressing at substantial cost (ie parity is always maintained but the tax infrastructure must always be in place), the following issues must be addressed:

a) The administrative infrastructure must work to a very high standard and there must be effective enforcement of, for example, tax residence rules for Scottish taxpayers;[8]

b) Changes are required to the way in which the UK Government sets taxation policy. Many of these would be beneficial to the United Kingdom (Heald, 2012), but that is no guarantee that they will be forthcoming. Specifically, the discretionary timing of the UK Budget just before the beginning of the tax year on 6 April, will create difficulties for the Scottish Government which has to notify HMRC of the Calman tax rate by 30 November of the preceding year,[9] without knowledge of what will happen to UK-wide tax thresholds and tax bands or to tax rates for those UK residents who are not Scottish taxpayers. The potential for game-playing by the UK Government is self-evident;

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[7] The circumstances of Northern Ireland are different, as the removal of powers in 1973 was connected to the Troubles. Reorganisation and centralisation of key functions followed the 1970 report of the (Macrory) Review Body on Local Government in Northern Ireland.

[8] Alarmingly, the HMRC will not give priority to verifying taxpayer declarations of residence between the countries of the United Kingdom; further work would be rechargeable to the Scottish Government (Scottish Government and HM Revenue & Customs, 2013, para 3.14). This is critically important because (a) unlike the tartan tax, the Calman tax has no upper limit on liability; and (b) some of the highest-income Scottish taxpayers may have homes in more than one UK country.

[9] See Appendix B of Scottish Government and HM Revenue & Customs (2013). It stretches credulity to believe that this tax decision could be kept confidential for long after this date.

c) The grant system, which could be a Barnett-type adjustment mechanism or based on a needs assessment, must be transparent and accessible. There must be no appearance or fact of the grant being reduced as punishment for an increase or decrease in a devolved tax rate relevant to that applying in England (or the rest of the United Kingdom, as appropriate).[10] This provision is vital because a perceived constraint on the Scottish Government using the tartan tax power in a downwards direction during the expenditure feast of the early and mid-2000s was the fear that the Treasury would then open up the Barnett formula, not necessarily making those steps public;

d) For tax powers to work, there must be explicit reporting on an annual basis, with standardised updates whenever there are changes, so that devolved finances can be followed in real time; and

e) The relationship between the devolved taxation system and social security is critical, both in terms of system functioning and political credibility.

Beyond the Barnett Formula?

14. Fantasy numbers have become pervasive in the Referendum debate, with the impression being given that austerity can be forgotten. Two frightening numbers appear in Institute for Fiscal Studies briefings on UK public finances. First, at the end of 2013-14, only 49% of planned austerity had been done. Second, real-terms age-adjusted per capita NHS expenditure in England is projected to fall by 9.1% from 2010-11 to 2018-19, despite the ‘protection’ it has so far received.

15. There has been no published UK-wide needs assessment since 1979, in which year was published the 1978 exercise that predated the intended implementation of the Scotland Act 1978 and the Wales Act 1978. Some internal exercises within the UK Government have never been published. At devolution in 1999, it seemed inevitable that, sooner or later, there would be an official exercise, though circumstances led to that not happening. If there were to be one post-Referendum, the main alternatives are an Australian-type detailed needs assessment (which would be comprehensive and expensive) or a simplified one (which would use a limited number of needs indicators). The other question is whether such an exercise would be buried inside the recesses of government (eg Treasury-led, with or without Devolved Administration participation), or conducted at distance from governments by some public body (eg a UK-wide Territorial Exchequer Board).

16. One of the by-products of the Holtham Commission Report on devolution finance in Wales is the proposal by two of its three members that the Scotland budget should be cut by £4 billion (Holtham and Miles, 2010). This calculation is based on applying their ‘simple’ needs assessment formula across the United Kingdom: on that basis, Wales is underfunded whereas Scotland and Northern Ireland are overfunded. The calculated needs indexes (England = 100) were Wales (115), Scotland (105) and Northern Ireland (121) (Independent Commission for Funding & Finance for Wales, 2009). It is clear that there would have to be transitional arrangements should a new needs assessment generate such numbers.

[10] Some grant designs might have grant dependent on local tax effort: however, the issue here relates to ‘off-system’ changes to the grant made by the UK Government.

Without a formal needs assessment, one option that might appeal to a UK Government would be to fund the Devolved Administrations on the basis of the distribution formulae in use for internal distribution within England. This would embody UK priorities for England in terms of the scale and scope of public service provision, as well as importing into devolved funding the political fixes made for England. A second-round effect is likely to be that the UK Government would make reference to the implied needs weights embodied in lower-level distribution formulae used within each of the Devolved Administrations. This would possibly lead to pressure to mimic internally the needs formula underlying the block grant. In a political climate of low trust in official numbers, the scope for potential conflict is obvious: between the UK Government and the Devolved Administrations; between the Devolved Administrations themselves; and between prosperous and less prosperous parts of the devolved countries about 'pass-through' and the extent of internal equalisation.

17. More devolved taxes will mean that the block grant is smaller but its role will remain critical. If such a system is to work, there must be explicit constitutional architecture with far-reaching implications for the rest of the United Kingdom. For example: the UK budgetary timetable must be pulled forward; there has to be less opportunity for political theatre on the part of UK Chancellors of the Exchequer, necessitating constraints on Treasury power; and rules of engagement have to be devised that protect the UK Government and Devolved Administrations from gaming, probably in the form of internal fiscal rules. The Scottish Government would have to be ready for extremely tough financial negotiations.

Conclusion

18. Paradoxically, to make devolution finance work better it is not the Devolved Parliaments/Assemblies/Governments that must change most but the UK Parliament and Government. Otherwise the income tax powers are likely to lead to parity, as any change by a Devolved Administration is vulnerable to countering – whether on thresholds, bands and rates – by the UK Government. Within the context of the United Kingdom's membership of the European Union, which imposes constraints on Corporation Tax and VAT, income tax is the appropriate basis for the main devolved tax. However, without appropriate constitutional machinery on intergovernmental financial relations, it would be possible for a UK Government to subvert the financial arrangements, for example, by significantly reducing income tax rates in England while increasing VAT.

19. An important point to stress is that such reforms could also bring benefits for much of England, within which economic imbalances are severe. This can be seen in controversies about whether London and the wider South East is a fiscal ATM for other parts of the United Kingdom or whether its dominance sucks life out of elsewhere. The economic imbalances within England and the dominant size of England within the United Kingdom greatly complicate fiscal decentralisation and influence the ensuing political controversies.

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SUBMISSION FROM GERALD HOLTHAM

The Barnett Formula

The Barnett formula determines the size of increments to block grants to the devolved authorities, including the Scottish government. The size of the block grant is the result of an initial determination when the block grant was inaugurated, repeated applications of the formula and negotiations that occurred whenever additional functions were devolved, first to the Scottish office then to the Scottish Parliament. There is no particular rationale for the size of the grant; it is what it is and the major UK political parties have said they will maintain it and do not plan any changes.

The formula itself identifies activities that are devolved and calculates the increment per head in expenditures on those activities in England each year. The same absolute increase in spending per head is then added to the block grant for the devolved territories. Since expenditure per head is higher in the devolved territories than it is in England the same absolute increment implies a smaller percentage change in the total expenditures of the devolved authorities – implying the so-called Barnett squeeze. The block grant itself, as opposed to the annual increment, is not however adjusted for changes in population. A decline in population could therefore lead to increases in spending per head and this could offset the Barnett squeeze, maintaining relative expenditure per head. That appears to have happened in Scotland.

Proposals have been made to reform the block grant mechanism. These fall into two quite distinct categories reflecting a basic philosophical distinction.

One approach, reflecting the UK's history as a union state, proposes to treat the block grant in the same way as regional distributions that are made within the countries of the UK. Government revenue is centralised, except for local authority council tax, and expenditure is distributed geographically using formulae reflecting the relative needs for public expenditure. It would be consistent to treat distributions between countries in the same way as distributions within countries and determine their size on the basis of relative needs.

The alternative approach is to regard the UK as having evolved to become a de facto federation and to regard its constituent parts as having first claim on taxes raised in their area. In most federations there is some sort of equalisation mechanism whereby wealthier regions contribute to public services in the poorer regions. In the UK case no such mechanism has been agreed or even discussed. The main political parties prefer to stick with the Barnett formula rather than tackle the difficulties inherent in a reform on either philosophical basis.

From a Scottish perspective, reform on the federation basis would be more advantageous at present than a reform on the union basis. The union basis involves assessing relative needs for public services in different geographies. Actual formulae in use in Scotland, England and elsewhere measuring relative needs are complicated but work carried out by the Independent Commission on Funding and Finance for Wales (2010) showed that those complicated formulae could be modelled with 96 per cent accuracy by a simpler formula taking four factors into account: demographic structure, extent of poverty, incidence of chronic health complaints and population sparsity or dispersal. When this model was applied it suggested that Scotland received a larger grant than relative need would justify, that Northern Ireland was slightly over-funded but within error margin for the exercise and that Wales was slightly under-funded.

Since that work was carried out, there has been a period of austerity which is presumably reversing the Barnett squeeze and there have been changes to the needs formulae in use too. No updating of the work has been carried out. It was based partly on 2001 census data that have been superseded by the 2011 census and on other data that are now five or six years old. The extent of the Scots overfunding was such that it is unlikely to have been eliminated by subsequent developments, though it may well have been reduced.

On the federal approach, Scotland has an income per head very close to the UK average and its budget deficit has generally been of the same order in relation to its economy as that for the UK as a whole. In other words the net transfer between Scotland and the rest of the UK has varied in direction (depending *inter alia* on the oil price) but has generally been small. That contrasts with the situation in Wales and Northern Ireland where the public sector deficit is much larger than for the UK as a whole, implying a substantial transfer to them. Given that their income per head is over 20 per cent below that of the UK average, some such transfer would be indicated within any reasonable federal system. Scotland does not currently enjoy such a net transfer but since it is not poorer than average, it could be argued that its overall position in a federation was broadly appropriate. The federal reform would not therefore imply much change in Scotland's share of public sector spending in the UK, whereas the union reform would imply some reduction.

Since the Barnett formula is entirely arbitrary and without any reasoned justification some sort of reform would be appropriate. The political difficulties of achieving an agreed reform, however, seem likely to deter governments from attempting it as they have done since the 1970s. As the constitutional situation in the UK evolves it is unclear on which basis any future reform would be attempted anyway and it is unclear what Scotland's relative socio-economic situation might be at that time. As noted above, if the situation resembled the present one, Scotland would be likely to benefit more from a 'federal' reform rather than a 'union' one, though much would depend of course on the details of any settlement. There is a wide range of possible quantifications of 'need' and an equally wide range in the extent of equalisation transfers within a federation.

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SUBMISSION FROM MARIUS OSTROWSKI, HEAD OF RESEARCH, ALL PARTY PARLIAMENTARY GROUP ON TAXATION

REPLACING BARNETT: SOCIAL JUSTICE AND UK DEVOLUTION

Considering the principles of public expenditure

1. This submission is chiefly concerned with the principles of public expenditure. It aims to give contextual depth to the Scottish Parliament's Finance Committee's inquiry into Scotland's post-2014 public finances by outlining the norms that underpin how social justice works in practice in the UK. On the Barnett formula specifically, it compares the procedural and outcome-related aims and priorities embedded in current practice with those of alternative models for allocating public expenditure. It is less focused on the economic case for or against the Barnett Formula or its potential replacements, since these are already addressed elsewhere, and they are not the particular specialism of the All-Party Parliamentary Taxation Group.

2. Refreshing current understandings of the purpose that public expenditure serves will help the UK as a whole move towards some kind of consensus or resolution on how to change the mechanisms by which public expenditure is regionally distributed. Analysis on this issue will be extremely relevant for the (R)UK regardless of the outcome of the referendum, as both Scottish independence and further autonomy within the Union would also affect the fiscal arrangements of (at least) Wales and Northern Ireland. It is also (though clearly to a lesser extent) pertinent for Scotland in either case, since the discussion touches on its internal public expenditure arrangements and pre-independence transition arrangements, as well as the reconceptualisation of its fiscal arrangements if it stays within the Union.

3. The structure of this submission is as follows: (1) an outline of the case for replacing the Barnett formula with a new holistic model for UK public expenditure; (2) discussion of the tensions between fiscal autonomy/responsibility and universality in a partially devolved system; (3) an examination of needs-based approaches to social justice in a devolved UK; and (4) comments on what a truly national approach to fiscal equalisation would entail.

The case for holistic reform

4. There is now an acceptance that unitary Westminster rule is no longer politically possible, in the sense that the only viable direction of future constitutional reform is towards more devolution. Further, there is an acceptance that some form of constitutional change will be needed whatever the outcome of the referendum. The questions that remain concern the extent to which such change will take the form of federalisation. Without stronger regionalism within England, the relationship among the 'UK nations' will always be asymmetric. Transfers of power have so far been characterised more by particular regional 'exemptions' than by systematic top-down dispersal of powers.

5. It is not clear that this should simply continue to be the case after September 2014. The APPTG, among others, has argued for the implementation of a (R)UK-wide Constitutional Convention after the referendum, or at least a 'national conversation' about the form in which the UK should be constituted. The aim would

be to incorporate the results of the referendum and subsequent negotiations into a detailed 'national picture' of precisely where, and under whose authority, which powers are to be located in the UK state, and to shed light on what is otherwise an obscure and underdemocratic process.

6. Given such a context for re-evaluating the constitutional relationship between UK regions, the UK as a whole should also take the opportunity to completely reassess the design of UK taxation and expenditure arrangements. Of special concern in such a 'national conversation' should be the expenditure allocation and/or fiscal equalisation mechanisms that apply, firstly, between the national government and devolved authorities, and, secondly, between the economies of the devolved regions.

7. The APPTG takes the view that, whether Scotland votes to stay in the UK or to leave, expenditure allocation in the UK as a whole needs to be rethought.[1] In the case of a 'Yes' vote, the block grant from the UK government to the Scottish Parliament would obviously be discontinued, since there would be both no political will for its maintenance and a direct conflict with EU rules on state aid.[2] Yet it is worth noting that there would still need to be some form of transitional arrangements from the status quo to full discontinuation, presumably during the proposed 17-month post-'Yes' negotiations, the experience gleaned from which could profitably inform the subsequent expenditure reassessment for the UK.

8. The fundamental problem with the current expenditure allocation under the Barnett formula is the regional disproportionality, and hence asymmetric unfairness, it embeds and perpetuates in per capita expenditure outcomes. It is well established that, under current arrangements, Scotland enjoys c.120% the identifiable per capita expenditure on services relative to England, with equivalent figures of c.115% for Wales and c.130% for Northern Ireland. Briefly put, this has been a result of less-than-expected historical effectiveness of the so-called 'Barnett squeeze' in reducing the expenditure differentials between the four UK nations. It is worth noting that it is not the asymmetry per se that is seen as the grounds for the Barnett formula's questionable legitimacy, but the ad hoc and seemingly arbitrary nature of the asymmetry's origin.

9. Leaving aside questions of rectification of these historical asymmetries, the priority when rethinking future expenditure allocation must be to move away from the 'tinkering at the edges' approach that has characterised how the Barnett formula is applied. If expenditure reassessment is to be meaningful, and its allocation truly fair, it cannot just be the balance of changes to public expenditure (i.e., increases or decreases to the block grant) that are made regionally proportional. Instead, the balance of levels of public expenditure must be made proportional, based on some overarching criterion.

10. There are strong political reasons for moving away from the (increasingly Byzantine) incrementalism of Barnett formula baseline adjustments towards the (more straightforward) holistic logic of looking at public expenditure in its entirety. It

[1] All-Party Parliamentary Taxation Group, *Achieving Autonomy: What the independence referendum means for Scotland's fiscal future* (2013), §§5.26-7, 6.83, 6.85

[2] Ibid., §7.6.

must be accepted that the Barnett formula is democratically invalid, and perceived to be illegitimate by an increasing number among the population who are aware of its existence and operation. The persistent political unwillingness to make major reforms to the existing allocation mechanisms must be overcome, in the interests of averting the growing political ‘deadweight’ associated with the formula’s continued application.

11. There are clear advantages to initiating a ‘clean slate’ analysis of UK public expenditure. It gives the UK a chance to provide a more robust solution to the question of expenditure allocation than the temporary ad hoc stand-in that the Barnett formula was always intended to be. Further, it would tie in well with the holistic openness and transparency of a Constitutional Convention. Lastly, it would continue debates about regional contribution to, and benefit from, the aggregate wealth and economic activity of the UK economy as a whole, which have only been brought into the public eye as a result of the referendum campaigning on both sides.

Devolving responsibility in the Union

12. The aim of devolution is, to borrow a phrase from David Hume, for each devolved region to become (in some respects) “a kind of republic within itself”.[3] Yet this is not so much a question of simply creating a degree of autonomous constitutional status and legal authority for subnational regions. It is primarily a recognition that there is a discrete collective identity that frames the social relations which operate in these regions. It is also a recognition of the existence of a degree of autonomy in the operations in the regional economy, and the consequent need for a proportionate degree of autonomy in its management. Typically this takes the form of some regional autonomy regarding fiscal policy—i.e., some devolved responsibility for taxation and/or public expenditure.

13. In this last context, it is important to remember that there will always be expenditure (and hence taxation) for which responsibility is not devolved. For the concept of the Union to be meaningful, there must always be some institutions, policies, and procedures reserved to the UK tier that give it political and economic substance as well as a more symbolic cultural presence. In fiscal terms, this means that there must also always be at the UK tier the taxation and expenditure mechanisms needed to support these institutions. In the UK, these reserved matters comprise defence, national security, foreign and trade relations, and monetary policy, elements of employment and industry, energy, and transport policy, as well as most of welfare spending and the administration of the Civil Service. For these areas, expenditure is distributed (1) by service, and hence (2) via each service to citizens, as determined by the UK government.

14. The expenditure for which responsibility is devolved is that associated with policy areas not listed as reserve matters, including education, healthcare, justice, local government, and the environment. Here, the ‘route’ for expenditure is more indirect: it is distributed (1) by region, then (2) by service, and hence (3) via first region then service to citizens, as determined by the devolved government. Crucially, the UK government loses the ability to ensure that how devolved expenditure is

[3] David Hume, ‘Idea of a Perfect Commonwealth’, in *Essays Moral, Political, and Literary*, Eugene F. Miller (ed.) (Indianapolis, IN: Liberty Fund, 1987), p.520.

distributed to citizens matches either the practice or the implied 'national ethos' of how it distributes expenditure in reserved areas. All the UK government can do is to use the block grant to provide the required revenue to the devolved authorities to fund their overall expenditure, using some predetermined allocation mechanism.

15. One of the suggestions put forward as an alternative to the Barnett formula is a move towards full fiscal autonomy for the devolved regions. Here, the approach to fiscal responsibility would be even more extreme: expenditure would be distributed (1) by service, and hence (2) via each service to citizens, as determined by the devolved government. The UK government would have no residual control, neither over the specific distribution nor the overall level of expenditure, especially if full fiscal autonomy were not also complemented by a block grant. As a consequence, the political concern with the Barnett formula of a permanent cross-subsidy from England to the other UK nations would lapse.

16. Fiscal autonomy certainly has the independent virtue of (to a certain degree) reconnecting taxation and expenditure in a way that clarifies each one's rationale. The tendency at the moment is for a 'one big pot' approach: tax is collected in different ways from different sources for different reasons (income, VAT, excise duties &c), and expenditure is distributed in different ways for different purposes (health, education, social justice, &c). Re-establishing a 'reconnection logic' in the form of a more transparent specific-tax-to-fund-specific-expenditure process would be crucial for a more 'joined-up', holistic approach to taxation in general. It would certainly play an important part in rebalancing UK regions' relative responsibilities for taxation and expenditure (in Scotland's case, c.16% and 67% respectively), and thereby encourage them to exercise strong fiscal prudence, but is an ancillary concern here.

17. However, both fiscal devolution and full fiscal autonomy come up against one of the fundamental problems of decentralisation: despite the interposition of an intermediate authority between national government and citizens, the national government's responsibility for citizens is not thereby decreased. For instance, the policy areas not reserved to the national tier are devolved, not abandoned. There is still an expectation (even in the absence of an equivalent guarantee) that regional governments will pursue policy and expenditure in devolved policy areas in a way that tallies with the 'national ethos' of social justice. As observed by the Calman Commission, there is a constant and irreconcilable tension in any non-unitary system between the drives for (1) permitting particular variation at the sub-national level, and (2) achieving universal standards across the nation-state.[4]

18. The concern for universalisation takes two forms. Regarding the status of UK regions, the problem it addresses is that of regional asymmetry. Mitigating sub-national variation in this form becomes a question of redressing interregional (political and economic) size imbalance, and of 'preserving' minority regions by assuring them the fiscal foundations of their equal political status within the Union. Regarding the status of UK citizens, universalisation must address the problem that the fiscal aspect of the 'experience of citizenship' may be unequal across citizens depending on their region of residence. Mitigating sub-national variation thus means

[4] Commission on Scottish Devolution, *Future of Scottish Devolution within the Union: A First Report* (2008) p.64.

ensuring the "equal placement" of citizens across the UK to benefit from publicly-funded services.[5]

19. In both cases, the need to maintain the 'social Union' places a limit on the usefulness of fiscal autonomy as an alternative to the Barnett formula. This limit takes the form of accepting that universalising policy/expenditure area x across citizens y must entail equalising citizens y (to some degree) in respect of policy/expenditure area x. The implication is that any areas of spending that are supposed to exist/apply with national scope (reserved or devolved) must be funded (taxed) and distributed (spent) in such a way that the fiscal burden/benefit accrues (roughly) equally across the UK overall.

20. Separate from the need to reflect this implication in the way that expenditure reserved to the UK government is distributed, an allocation mechanism must be implemented for devolved expenditure that recognises the unity of common social interests between the different regions and/or citizens of the UK. Briefly put: 'solidarity costs'. Following the recommendation of the House of Lords Select Committee on the Barnett Formula, the APPTG has endorsed the use of a resource equalisation mechanism, whereby the block grant is used to mitigate regional differences in expenditure.[6]

21. The question is thus what form of such a mechanism would maximise the democratic and emotional validity of equalisation. In practice, this becomes a matter of choosing the criterion by which the balance of levels of public expenditure should be made proportional. The answer to this depends on one's approach to the question of what one wants to achieve with tax-and-expenditure system.

Social justice in the UK

22. Revisiting the universalisation requirement outlined above, the question arises: how 'deep' does equalisation go? If a concern for universalisation entails equalisation to some degree, is this degree extensive or basic? Extensive equalisation is an ambitious ideal, which thickens the notion of fair and equal citizenship. However, actually achieving extensive equality (of opportunity, welfare, outcomes, &c) is well beyond both the remit and capacity of equalisation mechanisms in a devolved system, since it would require a level of interventionism by the central Westminster government that is incompatible (at least in spirit, if not technically) with meaningful decentralisation of powers.

23. In theory as well as in practice, achieving universal coverage thus becomes a matter of equalisation to a basic degree. 'Basicness' is a matter of both sufficiency and priority. Equalising the 'experience of citizenship' may not require full, literal equality between individuals to be meaningful, but still depends upon a minimum level of provision. At the same time, the expenditure used to effect this provision needs to be targeted at those who fall furthest below this minimum level, in order to make its equalising effect as procedurally effective as possible. Both must be

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[5] Alan Trench, *Funding Devo More: Fiscal options for strengthening the Union* (London: IPPR, 2013), p.36.

[6] All-Party Parliamentary Taxation Group, *Achieving Autonomy*, §6.85.

satisfied using some criterion that both specifies what this minimum level consist of, and identifies those who must be targeted most urgently.

24. This criterion for this basic minimum that has been repeatedly recommended since the Treasury Committee's enquiry into the Barnett Formula in 1997-98 is needs assessment. The concept of 'need' has been defined differently in different recommendations, but the formulation that has the most currency is the variant proposed by the Holtham Commission in 2010. This definition rests on seven 'need' indicators: (1) number of children; (2) number of older people; (3) ethnicity; (4) income poverty; (5) ill health; (6) sparsity; and (7) the London weighting (obviously inapplicable elsewhere).[7] The APPTG would, however, also recommend the addition of an additional indicator based on levels of regional economic performance, such as the Gross Value Added per head used by the IPPR.[8]

25. The APPTG sees no fundamental problem with using needs assessment as the criterion to determine how expenditure should be regionally allocated within the UK. It is strongly context-sensitive, allowing expenditure to be both tailored to a particular view of the sufficiency requirements for equalised 'experience of citizenship', and targeted to specific groups who are (as a result) deemed to be a priority for fiscal help. Crucially, needs assessment is also open to the possibility that expenditure levels may vary between UK regions, which there must always be scope for in any devolved system. Yet any such variation would be derived in a wholly different way to the fortuitous outcome under the Barnett formula, and would therefore command much more stable justificatory standing and democratic legitimacy.

26. However, any planned incorporation of needs assessment must consider a series of questions which arise from the use of this particular criterion. First: whose need is of concern in determining expenditure allocations? Both the Holtham and IPPR need indicators are framed in regional terms, yet most of the 'regional needs' they stipulate deal with aspects or attributes of regional populations, derived (at least partly) from those of individuals. When allocating expenditure based on total regional need, therefore, it is doubtful to what extent the needs of a region as the unit of concern can be separated from the aggregate needs of the individuals who live in it as units of concern. This has significant implications for the level of detail in the population data, and the complexity of the calculations, that will be required to accurately assess—and hence meet—the needs of any given UK region.

27. A tentative suggestion here is that a regionalised form of the logistical mechanisms needed to implement Universal Credit and related reforms to UK tax and welfare administration could be harnessed in precisely the way needed to determine 'need' down to the individual level. The implementation of a variant of HMRC's proposed (but ultimately abandoned) proposal for modernising PAYE calculations, Centralised Deductions, which the APPTG has strongly supported, would offer an extremely capable mechanism to manage calculations that take individuals as the 'units of concern'.[9] Centralised Deductions was intended provide a

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[7] Independent Commission on Funding & Finance for Wales, *Fairness and accountability: a new funding settlement for Wales* (2010), p.20.
[8] Iain McLean, Guy Lodge, and Katie Schmuecker, *Fair Shares? Barnett and the politics of public expenditure* (London: IPPR), p.6
[9] For further details, see All-Party Parliamentary Taxation Group, *PAYE at the Crossroads* (2012).

central feed of real-time income data, and automatic reconciliation between income tax deductions and benefit entitlements, and a system along these lines would help identify (for instance) the income poverty need indicator, as well as facilitating the accurate distribution of both national and regional expenditure at an individual level.

28. A second question is: what is the regional/individual need for? A simple numerical calculation does not cover what it is that expenditure goes towards—i.e., what it is spent on. One major problem with the Barnett formula, and with the block grant approach generally, is that expenditure is allocated en bloc, not by service. Yet the need indicators are specific to very particular policy areas (welfare, healthcare, transport, &c), and thus require specific forms of expenditure to be addressed. Echoing the earlier point about the specific-tax-to-fund-specific-expenditure 'reconnection logic', the implication is that accurately targeted expenditure allocation cannot so much take the form of one block grant as of a series of smaller service-specific grants. Regional need would have to be calculated by service at the regional level, with the overall value of the grant calculated as an aggregate of the resource needs of each region in each of the expenditure areas for which it has responsibility (rather than en bloc transfer).

29. It is worth noting that a devolved social justice framework based on need does not require parity of allocation to individual services and 'sectors' of expenditure, as compared between UK regions. Enforcing a system where broadly similar proportions of each regional authority's budget is spent on health, education, welfare, &c, would undermines the point of allowing for regional variation—such as, for instance, the Scottish cross-subsidy of free higher education from its block grant. Such a requirement would also be difficult to enforce under the asymmetric approach to empowerment that currently characterises UK devolution, since the remits of regional budgets would be too dissimilar for such comparisons to be made, let alone enforced.

30. The third question (echoing the concern for universalisation earlier) is: what is the concern with regional/individual need meant to achieve? For individuals: regional and/or service-based expenditure allocation provides a 'fiscal dividend' that is designed to meet the basic requirements required for meaningful quality of life 'experience of citizenship'. The goal is civic integration and stakeholdership, primarily through the recognition and strengthening of the economic basis of political participation. For regions: expenditure allocation provides the material fundamentals required to sustain a steady rate of demographic and economic growth and development. The goal is regional prosperity, and the transformation of the Union into what Gordon Brown has labelled a "constitutional partnership of equals" in a "voluntary multinational association".[10]

A national approach to fiscal equalisation

31. Reforming the Barnett formula and establishing a needs-based resource equalisation mechanism, if it is to be done at all, must be done holistically.

[10] 'Scottish independence: Gordon Brown outlines "power-sharing" UK', *BBC News*, 10 March 2014, http://www.bbc.co.uk/news/uk-scotland-26510735; Martin Kettle, 'Gordon Brown is right: federalism is on its way if the Scots shun independence', *Guardian*, 11 June 2014, http://www.theguardian.com/commentisfree/2014/jun/11/gordon-brown-federalism-scottish-independence-westminster.

Expenditure allocation must consider not just imbalances between England and the Celtic fringe, but regional disparities within England too, especially given the radical differences between London and other English regions. Within England, this is perhaps made harder due to the absence of equivalent bodies to the Scottish, Welsh, Northern Irish, and London devolved assemblies, and the evident lack of public appetite for creating them, as well as the abolition of the Regional Development Agencies that would offer a functional alternative.

32. However, the recent trend towards the creation of city-regions and combined authorities, granted protean forms of devolved policy responsibility in the form of 'City Deals', could serve as a useful proxy in this respect. Also, a truly holistic approach to expenditure allocation would mean assessing not just individual or regional needs but local needs as well, based on the responsibilities allocated to county councils, metropolitan and London borough councils, and the other 'upper' and 'lower tier' authorities. This would address the oversimplistic nature of limiting fiscal transfers to taking place between England, Scotland, Wales, and Northern Ireland.

33. In practice, for instance in Scotland's case, this would mean that needs-based grants would not just be transferred from the UK government to the Scottish Parliament, but also (from both) to local authorities to the extent that—and for the policy areas in which—they are empowered. Given the strong localism programme that has been pursued in the RUK since 2010, this would presumably go hand-in-hand with a matched approach of 'devolution all the way down', including an appropriately greater degree of revenue-raising responsibility. This stands in direct contrast to the centralising tendencies of the Scottish Government that have been in evidence in the same period.

34. Finally, the APPTG notes that the question of where responsibility for fiscal powers should lie is more a question of normative preference than one of empirical possibility. There is extensive technical and legal capacity to devolve both taxation and expenditure control from the UK tier to local and regional authorities, so the decision of how much to devolve to a particular authority depends largely on the prevailing views on what it should be doing.[11] In other words, to a large extent, the chosen conception of the UK as a constitutional entity will decide the eventual conception of the UK as a fiscal system.

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[11] All-Party Parliamentary Taxation Group, *Achieving Autonomy*, §§2.16, 10.7.

WRITTEN SUBMISSION FROM ALAN TRENCH

1. This memorandum is intended to set out some key points to assist the Committee in advance of my oral evidence to it on 25 June. In it, I am chiefly concerned with the implications of a No vote in September's independence referendum. So far as a Yes vote is concerned, I have little to add to evidence of previous witnesses before the Committee.

2. This paper draws on my work on the Institute for Public Policy Research's 'Devo More' project, with Guy Lodge. That project has produced a number of outputs, including a detailed discussion of a workable decentralised financial system for the UK, *Funding Devo More,* published in January 2013.[1]

The purpose, form and implications of tax devolution

3. The most important issue about tax devolution is what purpose or purposes it is meant to serve. Tax devolution cannot simply be about 'autonomy', and devolution within a single state is about securing an appropriate balance between autonomy for particular units and equity across the state as a whole, and about ensuring that tax bases as well as resources relate to the functions of the respective governments. It is also about ensuring that finance ministers have reasonably controllable and predictable revenues and – given the division of functions between sub-state and central governments – an appropriate measure of control to influence the economy of that sub-state region given the ways in which that function is shared.

4. There are cases where devolved or decentralised services can best be funded by a grant. That is, however, not the case for Scotland, where devolution in 1998 not only involved the devolution of responsibility for around 65 per cent of identifiable public expenditure in Scotland, but a much wider transfer of responsibility than merely the administration of public services that were substantially common across the UK.[2] Fiscal devolution is a necessary concomitant of the sort of devolution that was enacted in 1998.

5. In the case of a devolved Scotland after a No vote, the division of functions is likely to remain substantially the same as at present, in spending terms. Devolution of some welfare functions is on the table, the most radical proposals being those set out in our *Devo More and Welfare* report.[3] This proposed devolution of Housing Benefit and Attendance Allowance, the administration of the Work Programme, and a power to supplement additional welfare. Even with these proposals, the most significant spending commitments of the Scottish Government would be for health and education functions. The costs of these functions are both inflationary and mildly anti-cyclical in nature; they tend to go up when times are good, as demand for them is essentially unlimited and general cost and wage inflation drive up costs. But there

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[1] A. Trench, *Funding Devo More: Fiscal options for strengthening the Union* (London: Institute for Public Policy Research, 2013), available at http://www.ippr.org/publications/funding-devo-more-fiscal-options-for-strengthening-the-union.

[2] See further A. Trench 'Devolution Plus': What It Might Entail and Where It Might Lead' *Scottish Affairs*, no. 68, summer 2009, pp. 51-71.

[3] G. Lodge and A. Trench *Devo More and Welfare: Devolving benefits and policy for a stronger union* (London: Institute for Public Policy Research, 2014), available at http://www.ippr.org/publications/devo-more-and-welfare.

tends to be a particular spike when times are bad; people stay in or return to education if jobs are scarce, to improve their standing in the labour market, and people under financial pressures tend to have health problems too. This means that devolving highly volatile tax bases makes little sense; it creates the risk of reducing devolved government revenues just as demand for services it provides increases. Fiscal devolution in a UK context needs first and foremost to ensure that devolved governments not only have access to substantial tax bases, but to relatively stable ones.

6. A further important issue is the burden of costs arising from tax devolution, how substantial these are and where they fall. These costs are usually categorised as administrative costs (those incurred by governments and tax agencies in administering a tax system) and compliance costs (those incurred by tax payers in submitting tax returns and paying their taxes). Governments are also concerned with how effectively they can collect taxes. The UK's systems score relatively well by international standards, particularly the Pay As You Earn system for income tax, which collects large proportions of the revenues due at modest cost for the tax collection agency and minimal complication for the taxpayer. A government that sought to disrupt these arrangements would risk reducing its own revenues, increasing the burden on taxpayers, or both.

7. Reviewing the options for tax devolution for *Funding Devo More*, I concluded that the best options were for outright devolution of personal income tax, and assignment of a substantial proportion of VAT receipts (since VAT cannot be devolved within a single state). Income tax is a substantial and highly visible source of revenue, accounting for about 23 per cent of total revenues generated in Scotland, which is not particularly volatile. Devolving would provide a power lever to shape economic and social policy as well generating revenue.

8. Assigning a portion of VAT revenues – but not devolving control of rates or incidence of the tax – is a more controversial proposition. VAT is both a relatively stable tax in the short-medium term, and a growing tax base in the longer term, so it is attractive in that respect. Moreover, retaining the receipts from the tax would give the Scottish Government both a direct interest in ensuring economic growth, and a way of reaping the fiscal rewards of doing so. That would help make a measure like universal childcare much more affordable and practicable. Assignment of the tax does present some difficulties, particularly as there is an asymmetric transfer of risk (albeit one mitigated by the relative stability of VAT revenues). However, any government would want to set a sales tax, and EU rules mandate one for any EU member, whether independent or not. Given the limited range of practicable options, assigning VAT receipts becomes more attractive than it might be if one were designing a fiscal system from scratch.

9. Land taxes should also be devolved, a process which will be well underway in April 2015 when landfill tax and stamp duty land tax are devolved. (As well as the aggregates levy, there would be a case for devolution of capital gains tax in relation to transactions in land as part of completing that process.) Devolution of duties on tobacco and (particularly) alcohol would be desirable, though EU legal constraints and indeed the Treaty of Union make that problematic, quite apart from issues of smuggling. If a further major tax base were to be devolved, the best choice would probably be employers' National Insurance Contributions. However, the relatively

limited scale of likely welfare devolution weakens the case for that move, which would be appropriate if substantial welfare functions were to be devolved but not otherwise.

10. The 'Devo More' package, with devolution of all income tax and assignment of 10 points of VAT, would provide for about half of devolved spending being covered by tax bases under the direct control of the Scottish Parliament.

11. One tax not suitable – by almost any measure – for devolution is corporation tax. It is not a major source of revenues, corporation tax receipts are highly volatile, and devolution would significantly add to compliance burdens for taxpayers, particularly small businesses, while probably also adding to administrative costs and undermining collection rates for government. Moreover, the constraints that would need to be imposed on its devolution – to ensure that the devolved tax rate and other benefits applied only to tax receipts generated in Scotland and not in other parts of the UK, and to comply with EU law on state aids – would be a further factor, both limiting the use the Scottish Government might make of it and the burdens on taxpayers.

12. Similarly, oil and gas revenues are unsuitable for either devolution or assignment. Devolving them would raise serious legal difficulties under EU law, and expose Scottish public services to the problems of volatility that they present. Particularly if some or all of these revenues were assigned (not devolved outright), there would be no control over the receipts, which are determined by such factors as the extraction rate and global oil prices, neither of which would be under the control of the devolved government. There are good public finance reasons for the UK Government, with its wider tax base and greater scale, to manage such volatility. (Indeed, as the Committee will be aware, Angus Armstrong considers the scale of such problems as so serious as to make a debt-for-oil swap desirable in the event of independence.[4])

13. All three pro-UK parties are now committed to further forms of devolution in the event of a No vote. They have strong electoral reasons to deliver that, given that it is the preferred option of Scottish voters, and clearly has been for a considerable time. The key questions concern the means and timescale by which that happens.

Grants and the Barnett formula

14. 'Protecting the Barnett formula' has acquired almost totemic status for all parties in Scotland. Certainly the Barnett formula treats Scotland generously, with a grant that exceeds any reasonable calculation of relative needs and – varying from year to year and depending on how they are calculated – tax revenues generated by Scotland.

15. The Barnett formula system has a number of virtues, apart from the generosity of the quantum of funds it allocates to Scotland. Most notably, it provides stable and predictable resources to fund services whose costs are (as noted above) somewhat

[4] A Armstrong and M Ebell *Scotland's Currency Options* National Institute of Economic and Social Research Discussion Paper No. 415 (London; October 2013)

inflationary. It therefore insulates the Scottish Government from much of the revenue risk that comes with fiscal devolution. However, it also has several downsides.

16. One is – or will be – convergence. Convergence is well known to be a property of the Barnett formula – as Scotland receives a population share of changes in spending on 'comparable functions' in England (but has a higher starting point), its funding should converge on the English level over time. The evidence suggests this has not happened, or happened to only a minimal extent.[5] The explanation appears to lie in the rate of Scottish population decline over the 1990 and much of the 2000s, even between Spending Reviews (when the population figures have been revised). During that period, the average rate of population decline was around 0.3 per cent per annum. That decline briefly reversed in the late 2000s, but has now resumed at a slower rate of around 0.1 per cent per annum, which is projected by the Office for National Statistics to be maintained for the coming ten-fifteen years. The implication of this is that Barnett convergence will start to affect Scottish public finances in the coming years.

17. A second problem is that Barnett implicitly ties the funding of Scottish public services to that prevailing in England. Scotland gets a proportion of changes in spending in England, whether those are increases or reductions. While the Scottish Government is free to allocate the block grant as it sees fit, the scale of the major spending commitments on health and education (and long-term policy commitments more generally) limit the scope for such changes, if English spending were to shift appreciably. This is a strong argument for significant fiscal devolution, to deliver Scottish aspirations to make policy for domestic matters in Scotland (in a way that may be different to policy in England) while remaining part of the United Kingdom. Tax assignment, in my view, accomplishes this objective better than the Barnett formula arrangements, even if it is less desirable than outright devolution.

18. No party has any commitment to change the Barnett formula after a No vote. Both Labour and the Liberal Democrats have been keen to emphasise that the Barnett formula should remain as the basis for calculating the overall envelope for funding devolved Scottish services. [6] The UK Government remains committed to the Barnett formula 'until the public finances are stabilised'. While there has been quite a debate about the merits of replacing the formula, there appears to me to be no political appetite to do so in the foreseeable future, as well as those clear and express commitments not to do so. Suggestions that a No vote means the abolition of the Barnett formula are no more than alarmist speculation.

19. That said, there are reasons in the longer term to seek to change the way the block grant is calculated, so that it is put on a basis that can command broad support across the UK. There are also very strong reasons to change the way the grant is administered and organised, so that fewer decisions are taken unilaterally by HM Treasury, there is greater transparency about the working of the formula and the

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[5] See House of Lords Select Committee on the Barnett Formula, *The Barnett Formula,* 1st Report of Session 2008–09, HL Paper 139 (London: The Stationery Office, 2009, Memorandum by Professor David Heald, pp. 316-24, especially section 2.

[6] Scottish Labour Devolution Commission *Powers for a purpose – Strengthening Accountability and Empowering People* (Glasgow, March 2014); Scottish Liberal Democrats *Federalism: the best future for Scotland. The report of the Home Rule and Community Rule Commission of the Scottish Liberal Democrats* (Edinburgh, October 2012).

funds allocated using it, and there is greater scope for impartial intervention and review of decisions about the formula. Chapter seven of *Funding Devo More* suggests how this might be done, drawing on the work of the Lords Select Committee on the Barnett formula and the Holtham Commission in Wales.[7]

Implementation of fiscal devolution

20. It is worth noting that these proposals amount to a programme for further devolution that would take around 15 years to implement, at least. Some steps can be implemented relatively quickly; devolution of income tax can build upon the framework being established to implement the Scotland Act 2012, and assignment of VAT receipts can be done relatively readily. Other steps would be trickier; devolution of capital gains tax would require significant legislative change to that tax, for example, and devolution of employers' National Insurance Contributions would entail a significant overhaul of how the National Insurance Fund works, as well as raising major issues about the role of contributory benefits in the welfare state more widely. Any change to the way the block grant is calculated would also raise a number of complicated issues, and it is hard to see how they could be accomplished in less than five to seven years at the very quickest, though changes to the process could be accomplished more readily.

'Full fiscal devolution'

21. It is worth being clear about a further issue. 'Full fiscal autonomy' – the idea that devolved Scottish authorities should set and collect all taxes in Scotland, and remit a contribution to the UK Government for shared services provided by the UK Government – presents profound problems. It would be incompatible with anything like the existing UK welfare state, and present grave problems particularly for old age pensions. It is incompatible with the Union in other respects as well. A referendum vote for Scotland to remain part of the UK therefore also has to be regarded as a rejection by Scottish voters of the idea of full fiscal autonomy.

22. Devolution of taxes so that devolved taxes match devolved spending presents different problems. It would be very hard to achieve, given the nature of the UK's tax system, and the already-extensive devolved spending responsibilities. There would be serious equity arguments against it as well. Even if this were desirable, it is hard to see how it could be achieved.

Borrowing

23. Fiscal devolution necessarily also implies the ability of a devolved government to borrow – not just prudentially, for capital infrastructure, but to enable it to manage the volatility necessarily introduced by fiscal devolution. There are serious hazards for the central government if sub-state governments have the power to borrow based on their own streams of tax revenue, with an implicit guarantee of a bail-out from the

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[7] House of Lords Select Committee on the Barnett Formula *The Barnett Formula,* First Report of Session 2008–09, HL Paper 139, (London: The Stationery Office, 2009); Independent Commission on Funding and Finance for Wales *Final report – Fairness and Accountability: A New Funding Settlement for Wales* (Cardiff: Welsh Assembly Government, 2010).

central government.[8] My view now is that the disadvantages of limiting borrowing to that carried out via the central government (such as a power only to borrow from the National Loans Fund) exceed the advantages, and that a devolved government in the UK should have the power to issue bonds on its own account as well as to borrow via the UK Government. However, the UK Government needs to protect its position as well. It needs to be able to limit its potential liability from such borrowing, which can be done by setting and publicising a ceiling of the maximum amount of devolved borrowing which it will indemnify. Any borrowing above that ceiling would be clearly visible as such, and lenders to the devolved government would be aware that they had no guarantee from the central government, so if they exceeded that ceiling they would bear the risk and not be able to transfer it to the UK Government.

24. I hope this helps the Committee in its deliberations.

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[8] See J. Rodden, *Hamilton's Paradox: The promise and peril of fiscal federalism* (Cambridge: Cambridge University Press, 2006).