In this note, rather than focus on which particular taxes, revenues or areas of public spending might be devolved, or how far they should be devolved and what limits should be placed on their use, I wish to stress the principles and general rules of operation that need to go into the design of the devolution process.

Second, I would like the committee to recall that the Smith Commission was required to ensure that any powers selected for further devolution would i) cause no detriment to the UK or to any of its consistent parts; and ii) cause neither the UK nor the Scottish government to gain or lose financially simply as a consequence of devolving a specific power.

Obviously these restrictions cannot be taken to mean literally no effect on any other party or it would never be possible to make any changes at all. The Committee should be careful to distinguish first and second round effects of a devolved power. That will allow it to consider devolution when it is not a zero-sum game; and where it is designed to correct imbalances of the past or to create gains to parties outside government.

It would also be useful to recall that the ability to make gains was allowed in the devolved powers already granted (eg LBTT, Scottish income tax). The point is, we want to devolve powers where a tax works more efficiently at a devolved level or where it allows the UK economy to function more efficiently.

**Principles:**

1) There should be no shared taxes, including no sharing of tax bands, of tax thresholds, or of exemptions or decisions about the definition of the tax base. This is to prevent conflicts, exploitable differences, or inconsistencies or ambiguity emerging between the two authorities responsible for each part of the tax. To allow that would create problems in implementation. It would also create problems of accountability. In order to remove the possibility that inconsistencies and/or exploitable differences may emerge, you would have to ensure that either a single tax authority implemented the tax or that all definitions (tax base, bands etc) are unified – in which case little accountability is imposed on the regional tax authority while little incentive remains for using the devolved tax.

Third, a shared tax (with different tax rates) means that the devolved Scottish revenues would be driven, in part, by decisions made by another authority (the rest of the UK) despite the Scottish Parliament having given no authority for that to happen (in effect, a West London question). An example is the raising of the minimum taxable threshold by UK legislation. If the number of taxes devolved is limited, there would be no way for the Scottish Parliament to compensate for the lost revenues by raising other taxes to fill the gap. Here the loss in
accountability, responsibility and effective devolution is obvious: one tax authority becomes dependent on another unless the bands, thresholds and the tax base definition are all devolved along with tax rates.

Fourth, with shared taxes it is important that the revenues raised are fully verifiable and accounted for in the Scottish budget, and fully reconciled with any forecasts used earlier. At present this is not guaranteed under the Scotland Act’s shared income tax since the collection will be undertaken by HMRC without public verification. The result is devolution de jure, but not de facto. The tax has in effect been re-reserved.

2) There should be no assigned or apportioned taxes because such taxes are simply a grant by another name, but with political uncertainty added. There is no devolution involved since there is no policy input from the Scottish government. Assigned taxes may provide the illusion of ‘greater power’ or ‘further devolution’ by increasing the proportion of the Scottish Budget funded by ‘own-source’ revenues. But illusions of autonomy may lead to tension if nothing can be done to change those taxes should it be necessary to do so. Also the budget would become more vulnerable to fluctuations in tax revenues without an ability to respond.

An exception could be made for VAT as an apportioned tax since, by European Law, the rate charged cannot be varied from that in the rest of the UK. But it would still amount to a grant, conferring no effective devolution powers to the Scottish Parliament.

3) Since we are moving to a world with more uncertain and potentially volatile revenues, but fixed contractual costs, adequate borrowing measures need to be included in the devolution package. What adequate means in this context needs to be determined as part of the detailed negotiations, but it should certainly be sufficient for the “golden rule of public finance” (that borrowing be allowed to cover spending on public capital, but not for current spending) to operate freely and to cover normal expected fluctuations in public revenues. The golden rule is important here because it ensures adequate spending on public investment, especially on research and development, infrastructure investment, and training which are now considered by many to be the critical components for stimulating growth in a slow-growth environment. The current limits on borrowing (½% of GDP across the cycle to offset normal revenue fluctuations; and a running total of 2% of GDP for capital projects) fall well short of adequate for any measure of further devolution.

4) The Scottish Parliament should be able to draw and make public a distinction between the de jure and de facto degree of devolution in any tax that is to be devolved, with decisions to be made on the de facto measure. The reasons are obvious from point 1); if the revenues collected or allocated cannot be verified as consistent with the expected degree of devolution, it will open up an agenda for quarrelling and disagreement between governments.

An example: The income tax proposal in the Scotland Act requires forecasts of the revenues yielded by the Scottish rate to be made by the OBR in London. The difference between those forecasts and the expected yield of a standard 10p rate is then to be subtracted from the Barnett grant total. But the OBR has no model of the Scottish economy, so of necessity they will have to prorate their forecasts from UK income tax revenues – in exactly the same way
as other components of the Barnett grant are calculated by prorating expenditures planned for
the English regions. Once the public perceives that devolution has had little independent
effect, they will conclude that it has failed. As a result, there would be no incentive for any
government to use the devolved tax.

**Policies for a Purpose:**

5) Any devolution package should be required to include one or more taxes that offer genuine
levers that can be used to promote jobs and economic growth, and increase the capacity for
health and welfare support in an era of demographic change. This is a concern. Income tax
has proved to be one of the least effective instruments in that regard. Few countries use it for
these purposes, their experience being that it failed to achieve its goals. Moreover, as a source
of revenue it has grown slower than national income over the years (IMF figures). Indeed the
Treasury’s own advice is that it is a tax best left unchanged because manipulation creates
uncertainty and disincentives in the labour markets that damage growth. Instead it is best
thought of as a mechanism for redistribution.

If income tax is to be used as an instrument of redistribution, then another lever needs to be
found to boost growth and jobs: point 6) below makes some suggestions. Similarly, if income
tax alone is devolved, fluctuations in national income will have large revenue consequences
(given the size of the tax). With devolved borrowing powers constrained, the incentive to use
such powers will be limited given the risks to the budget.

6) One obvious candidate for an alternative approach would be the employers’ component of
national insurance contribution (the employees’ component is just another income tax). These
contributions impact the cost of employing someone directly, and hence boost employment if
they are reduced. They also impact unit production costs directly and can therefore be used to
lower costs/increase competitiveness and generate growth. In that sense it is a superior tax to
devolve for developing the economy.

Along with this, it might be beneficial to consider welfare devolution and the devolution of
legislation on employment conditions, both of which affect costs and hence competitiveness,
employment and growth, and possibly more flexible markets – especially for skilled workers.
The Scandinavians have had some success with this approach.

A third option might be to use corporation tax, although it offers less scope as corporation tax
rates have come down world-wide. In addition, it raises compliance problems and mostly
affects the distribution of earnings between labour and capital. This means it is less effective
as a lever for employment creation unless it is used to increase the mobility of firms (compare
the experience of Ireland and Germany). Perhaps a better way to use this option is to consider
offering tax credits for R&D expenditures. This would impact productivity directly which is a
powerful way to lower unit production costs and hence boost growth and employment. It
would also go some way to correcting the R&D and overall productivity deficits in Scotland.
R&D spending in Scotland is about half that in the rest of the UK (especially among UK
owned firms).
7) If devolution is to be partial or incomplete, it would pay to create a portfolio of smaller devolved taxes, or of larger taxes partly devolved rather than devolve one large tax. There are reasons for this. First, it will always be more effective to have a coherent set of taxes belonging to a consistent economic strategy, with coherent movements between them when you make changes. This cannot be done with a single devolved tax. Second, and probably more important, Scotland needs a diverse tax base. Since revenues from own taxes are always uncertain and subject to fluctuations (to an extent that spending patterns are not), successful risk management requires a diverse set of revenues with different patterns of volatility. In the absence of borrowing powers, or with borrowing restricted as much as in point 3) above, this is the only way to smooth public revenues.

Third, all taxes distort incentives and spending/earning patterns to some extent. Some taxes may be worse than others, but having several taxes allows the policymakers to choose a balanced package to lower, if not minimise, the worst distortions and preserve incentives.

8) Lastly, there are distinct advantages in having a multi-tax devolution package in that one can then exploit transfers and substitutions between taxes at the margin. That can be used to smooth revenues and reduce the need for borrowing as pointed out above; but also to make Scottish taxation a much more flexible instrument for supporting growth and jobs, and would enhance the degree of accountability and responsibility given to the Scottish fiscal authorities – and the degree of ownership they accept for their fiscal policies. That is not something that can be done with a single tax.

Other points:

9) Full devolution will ultimately require the devolved taxes to be collected in Scotland and then either spent directly in Scotland or remitted to London on an agreed basis. It cannot proceed on an unverifiable and less than fully transparent basis. If it does proceed on that basis, it is a recipe for quarrels and breeds distrust and pressures for further change.

Second, if the debt problem in Europe has taught us anything, it is not that Europe’s fiscal controls were too weak, but that they were never enforced. Taking ownership and accepting accountability for your fiscal programme is the first step for creating fiscal responsibility, and collecting and remitting your own revenues is a necessary component for achieving that. It is hard to see how anyone could accept responsibility for a programme that you neither collect, nor administer.