1. This memorandum is submitted by Alan Trench to the Scotland Bill Committee in the fourth Parliament, as part of the Committee’s re-consideration of the Scotland Bill following that carried out in the third Parliament. I would draw members’ attention to the memorandum I submitted to that committee, much of which bears on the issues that concern this one. Most of the issues to which I drew attention then have not been satisfactorily dealt with in the amendments proposed by the UK Government since January.

Financial and fiscal matters, generally

2. The Scottish Government was responsible for about 55 per cent of total identifiable public spending in Scotland in 2009-10, according to data from HM Treasury Public Expenditure Statistical Analyses 2011, with a total Departmental Expenditure Limit of £28,413 million. That level of spending responsibility is comparable to that of regional-level governments (states, provinces, cantons, etc) in many federal systems. However, those governments are responsible for much greater proportions of their own revenue. This is illustrated in the table below:

<table>
<thead>
<tr>
<th>Country</th>
<th>Expenditure by regional-level governments (percentage of total public spending)</th>
<th>Percentage of own spending raised by regional-level governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>46</td>
<td>55</td>
</tr>
<tr>
<td>Canada</td>
<td>63</td>
<td>80</td>
</tr>
<tr>
<td>Germany</td>
<td>63</td>
<td>56</td>
</tr>
<tr>
<td>Switzerland</td>
<td>68</td>
<td>75</td>
</tr>
<tr>
<td>Spain</td>
<td>49</td>
<td>23</td>
</tr>
<tr>
<td>United States</td>
<td>46</td>
<td>70</td>
</tr>
</tbody>
</table>

There are many reasons, practical and of principle, why it is desirable for such governments as the Scottish Government to raise significantly on revenues they generate themselves, and as the table indicates this is common practice elsewhere in the world. It is telling that the more politically centralised systems (Australia and Germany) raise less of their own spending, and that regional-level governments in the more decentralised ones are raising between 70 and 80 per cent of their spending. In a Scottish context, this would imply the Scottish Government raising in the order of £20-22 billion.

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1 This is a simplified version of table 11.3 in R. Watts ‘The United Kingdom as a federalised or regionalised union’ in A. Trench (ed.) Devolution and Power in the United Kingdom (Manchester University Press, 2007).
3. Achieving this is in a UK context is, however, far from straightforward. According to Government Expenditure and Revenue Scotland 2009-2010 (henceforth GERS), the largest source of tax revenue in Scotland was personal income tax (£10,405 million, 24.7 per cent of the total). The next largest sources are national insurance contributions (£7,997 million), VAT (£7,348 million), corporation tax (£2,597 million) fuel duties (£2,207 million), council tax (£1,960 million), non-domestic rates (£1,823 million). ‘Sin taxes’ (alcohol, tobacco and betting and gaming duties) collectively raise £1,872 million. Any scheme for extensive fiscal devolution will need to involve devolution of much of these. However, that is easier said than done. Some of these taxes are ill-suited for devolution either for legal reasons (VAT), because of the risk of tax avoidance means they may both trigger tax competition and serve as volatile sources of revenue (corporation tax, fuel duties and betting and gaming duties), or because of administrative practicalities (national insurance contributions, particularly employers’ NICS). Council tax and non-domestic rate are already in principle devolved, though the debates about a possible local income tax suggest significant constraints to that.

4. What this suggests, however, is that much more extensive devolution of personal income tax than recommended by the Calman Commission will be necessary to create a meaningful degree of fiscal responsibility for the Scottish Parliament and Government. It is worth noting that the UK Government would still also tax personal income, through the national insurance contributions paid by employees and the self-employed. In the face of these problems, I also favour hypothecation to the Scottish Consolidated Fund of a significant proportion of VAT revenue. This is unquestionably problematic because of the asymmetric risks involved, and was considered and rejected by both the Calman and Holtham Commissions, but in my view it is preferable to the alternative, which is continued heavy reliance on the block grant calculated in accordance with the Barnett formula. There is a further advantage that VAT revenues are relatively stable (they declined by 7.8 per cent between 2007-08 and 2009-10), which means that devolved public services would not be threatened so much by the swings of the economic cycle.

The block grant

5. There are two sets of issues that are important in relations to the block grant. One significant issue with the block grant is the extent to which it ties public services in Scotland to the model applying in England. The block grant and formula system allocates Scotland a proportionate share of changes in spending on ‘comparable functions’ as identified in HM Treasury’s Statement of Funding Policy. Such shares are known as ‘Barnett consequentials’. There has always been significant informal pressure to allocate such Barnett consequentials to the functions which triggered them, even though in principle devolved governments are free to allocate them as they see fit. While this may not have caused any practical problems during the long boom in public spending during the 2000s, this was also eased by a broadly shared political vision of a Labour UK Government at Westminster and Labour-dominated ones in Edinburgh and Cardiff. Now, the

UK’s various governments have very different visions not just about what policy should involve but also how much governments should tax and what the structure of the state should be. That creates very serious difficulties for the devolved governments in deciding how to exercise their autonomy when it comes to making public policy in devolved areas, a problem best illustrated when it comes to funding higher education. While the block grant mechanism was suitable for allocating funds to the Scottish, Welsh and Northern Ireland Offices before devolution, it is much less appropriate when serious political and policy differences emerge.\(^3\) When the UK Government is actively seeking to reshape the role of the state in ways that the Scottish Government (and other devolved administrations) do not support, that is all the more problematic.

6. One advantage of devolved governments having their own tax base, rather than relying so heavily on the block grant, is that this attachment to the model of public services applying in England would play much less of a role. While I would envisage redistributive grants continuing to exist and to play significant roles in the funding of devolved government in Wales and Northern Ireland, the impact of such a grant in Scotland would be much more limited.

7. As regards the proposed reduction of the block grant as a result of devolution of income tax, I consider it quite deplorable that the UK Government has still failed to outline how that cut would be calculated in the first instance or uprated in subsequent years. Given the significance of the issue, I cannot understand how the Parliament can be expected to give its legislative consent to the bill before these arrangements are proposed, and there has been sufficient time to analyse and understand their implications. I was puzzled that the bill was introduced without any clear proposal about this. A year later, there has been no visible progress on this fundamental point. It is, after all, now nearly 2½ years since the Calman Commission’s report setting out this principle was published. In that time, one would have expected this issue to be resolved.

**Devolution of corporation tax**

8. The Scottish Government has put particular emphasis on the early devolution of corporation tax. In my view, this tax is a problematic candidate for devolution for a number of reasons. First, while corporation tax may be an attractive candidate for devolution because of its potential economic effects, devolving it would risk serious difficulties for Scottish public finances and the funding of public services. Corporation tax is one of the most volatile of taxes, and one which is volatile pro-cyclically. According to GERS, non-North Sea Oil corporation tax revenues have declined from a peak of £3,465 million in 2007-08 to £2,791 million in 2008-09 and £2,597 million in 2009-10, a reduction from peak to trough of 25 per cent.\(^4\) Given that the costs of providing devolved public services in Scotland do not

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3 I have also highlighted this mis-match in A. Trench ““Devolution Plus”: What it might entail and where it might lead” *Scottish Affairs*, no. 68, summer 2009, pp. 51-70.
4 Figures from Scottish Government *Government Expenditures and Revenues Scotland* 2008, 2009 and 2010 editions, table 4.1 in each case. Note that the basis on which that is calculated relates to Scotland’s proportion of UK GDP as a whole, rather than the structure of the Scottish economy – which may increase the volatility, given Scottish reliance on the financial services sector. North Sea revenues are, according to GERS, even more volatile.
fluctuate counter-cyclically – if anything, they fluctuate pro-cyclically – devolving corporation tax would expose the Scottish Government to risk of greater shortfalls in revenue during times of recession or weak economic growth. That risk would be increased if the key taxes on which the devolved government had to rely were the proportion of income tax set out in the Scotland bill, corporation tax, and the ‘small taxes’ proposed for devolution.

9. Second, there are many practical difficulties in devolving corporation tax. The most pressing of these is identifying what the Scottish share of UK corporation tax receipts is, or should be. On this issue, the suggestion of the Holtham Commission – that these should relate to the proportion of a company’s payroll located in the area concerned, compared to the UK as a whole – has a great deal to commend it on the level of principle.\(^5\) It is worth noting that the Holtham Commission recommended that corporation tax should remain a UK tax, even if different rates were levied in relation to different parts of the UK, and the proceeds from those parts were then remitted to devolved governments. There would be strong practical reasons for that, both from the point of view of the collection agencies and to limit the administrative burden and compliance costs for companies.

10. Third, there is a major issue of principle at stake in relation to corporation tax: whether the Scottish Government should have a significant role in the management of the Scottish economy, or whether the economy should remain a matter for the UK Government. That was the framework of devolution put in place in 1998, and which was accepted by the Calman Commission. This is not necessarily an insurmountable obstacle to corporation tax devolution; but it does suggest that much more detailed consideration of the issues of principle, and its implications for the UK as a whole, is needed, before this step could be taken.

11. Even if corporation tax were to be devolved on this basis, there would be significant issues of fiscal co-ordination between the UK and Scottish Governments. The risks of unregulated tax competition would, from a UK point of view (more than a Scottish one) be severe. Such arrangements need not be statutory in nature, but would need to be robust and put in place ahead of devolution of the tax.

12. DeVolving corporation tax would be a matter with very significant implications, both for the UK economy and for the working of devolution within the United Kingdom. Devolving it would also be a complex matter. All that suggests that the Scotland bill would not be a suitable vehicle for devolving it, even if its devolution were to be considered appropriate. Resolving these issues in such a way that the necessary provision could be incorporated into the bill would delay implementation of the bill very significantly – a matter of years rather than months, in all probability. This appears to have been acknowledged by the Scottish National Party; its amendment for the devolution of corporation tax proposed during the bill’s Commons Report stage provided for this to be done by order, rather than directly through the Act. A change of this size and complexity

is not, in any case, appropriately made by secondary legislation. In my view, whatever the case for devolution of corporation tax might be, the present Scotland bill is not the appropriate vehicle to achieve it.

**Devolution of excise duty**

13. Excise duty on alcoholic drinks presents particular problems. There are good policy reasons why tax on the sale of alcoholic drinks should be in the hands of the Scottish Parliament. Alcohol is often consumed where it is sold (in pubs, bars or restaurants), or nearby (when sold in off-licences, supermarkets and so forth). Consumption of alcohol has a direct bearing on such devolved matters as health and drink-related crime and domestic violence. One obvious way of trying to address these problems is through increasing the cost, whether by taxation or regulatory measures (such as minimum pricing). Doing so by taxation is an appropriate way of doing so, as it means the tax revenues can be used to redress the consequences of excessive consumption. Against this, there is a risk that differential rates of could lead to personal importation to avoid duty, as was found in southern England following the opening of the Channel Tunnel, leading to a leakage of tax revenue (though only when the imported supplies are then sold on does this subvert the social policy goals of differential tax rates).

14. However, there are serious problems with devolving excise duty, as this is levied at the point of production or importation into the UK, not the point of sale to the consumer. That will seldom be the same part of the UK as where it is consumed, so devolving the duty would create huge problems of calculating and levying differential charges, and significant costs for both government and suppliers of alcohol. Devolving excise duty would therefore not be an effective way of tackling problems in Scotland, as it could only apply to alcohol produced in Scotland, not that brought in from other parts of the UK. This would mean Scotch whisky would become more expensive, but not gin or Irish whiskey; and likewise Tennant’s lager might be affected, but not Stella Artois or Carlsberg brewed in England. Devolving excise duty in its present form is therefore not an appropriate way of addressing the social policy problems the Scottish Government wish to tackle.

15. In the longer term, this may support a fundamental shift in how alcohol excise duties are calculated. In the shorter term, a way forward might to reduce rates of duty, and allow governments (including the Scottish Government) to charge a duty on sales of alcohol, whether for on-premises consumption or off-sales. This could be calculated and collected through a similar mechanism to VAT, but (in devolved parts of the UK) be explicitly for devolved purposes and so be set by devolved legislatures.

16. In principle, a similar approach would be one way of addressing issues of tobacco cost as well, though in Scotland regulatory measures (regarding arrangements for tobacco sales) have been preferred to date and seem to have been effective. Off-shore competition for gambling means, however, that this is less likely to be effective with regard to gambling duties.
**Enhanced borrowing powers**

17. It is clear that the borrowing provisions set out in the bill when first introduced were unduly limited. The aggregate limit proposed by the Scottish Government, of £5 billion rather than £2.2 billion, seems to me appropriate given the degree of potential volatility in tax revenues to be devolved under the Act, though its introduction and use need to be tied to the introduction of these provisions. As part of the purpose of borrowing powers is to enable the Scottish Government to manage the risks that come with fiscal devolution, further extensions would be necessary in the event further taxes were devolved.

**Institutional arrangements**

18. In my earlier evidence I noted my concerns about the weakness of the institutional arrangements for the proposed partial devolution of income tax and other taxes. It appears to me that greatly strengthened arrangements, so that HM Revenue & Customs would be formally accountable to all legislatures on whose behalf it collects taxes, is needed. I remain of the view that at least one member of the HMRC’s Board should be appointed by the Scottish Government. It also seems to me that much more robust intergovernmental machinery is needed to manage both issues concerning tax administration and practice, and tax policy. Neither the biannual meeting of Finance Ministers, nor the intergovernmental commission proposed in the November 2010 Command paper, seem to me to fit the bill. They need significantly wider remits, and to meet more frequently.

**International obligations**

19. In my earlier memorandum and oral evidence to the Committee, I noted my concerns about what was clause 23 of the bill regarding the implementation of UK international obligations. (That provision is now clause 27 of the bill as introduced into the House of Lords.) That clause seemed to me unduly wide, and to open the door to UK Government action in any devolved area where a UK international obligation existed. The proliferation of international obligations in the modern world meant this opened the door to widespread UK action in devolved matters. I remain of the view that that clause is far broader than is needed to remedy any actual problem – the more so given what the Secretary of State said about it in his evidence in February 2011 to the Commons Scottish Affairs Committee. I have discussed this matter in detail on my ‘Devolution Matters’ blog.⁶ In my view, for the reasons I set out there, the Parliament should decline to give legislative consent to this clause of the bill.

Alan Trench  
29 October 2011

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