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VIA VERITAS VITA

The Scotland Bill (2016) and the Fiscal Framework

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INSPIRING PEOPLE

What’s in a Fiscal Framework?

- Block Grant Adjustment
- The interpretation of ‘no detriment’ in Smith Commission Agreement
- Capital and Revenue Borrowing and Flexibility
- VAT assignment
- Inter-governmental scrutiny of Fiscal Matters and Governance of Fiscal Framework
- Other issues (Tax administration costs; crown estate; employability programme funding)

Block Grant adjustment

- Setting initial baseline should be relatively straightforward
- After that, indexation is more complicated.
- Three main indexation methods have been suggested
- They have different implications and justifications
- Ultimately the choice depends on the principles agreed as part of the SCA (can they all be satisfied?) and the main risks facing Scotland’s budget

Block Grant adjustment methods

1. Levels Deduction (see Bell and Eiser, 2014). Block Grant Adjustment (BGA) is updated by adding population share of comparable (devolved) rUK tax revenues

$BGA_1=(POP^S/POP^{rUK})_0*(T_1^{rUK} – T_0^{rUK})$

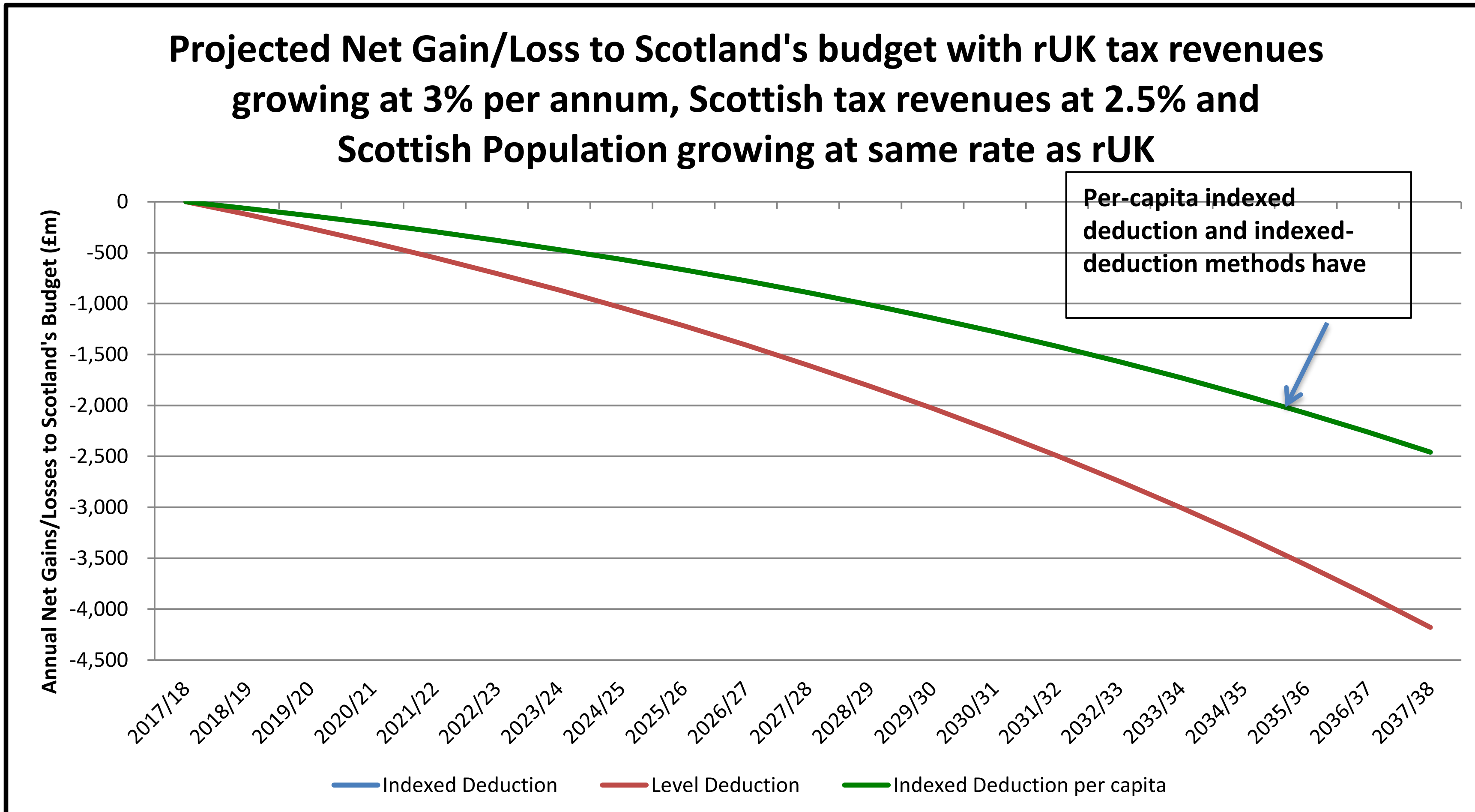
2. Indexed Deduction (see Holtham, 2010). The BGA is updated by the percentage change in comparable (devolved) rUK tax revenues

$BGA_1=(T_1^{rUK}/T_0^{rUK})*BGA_0$

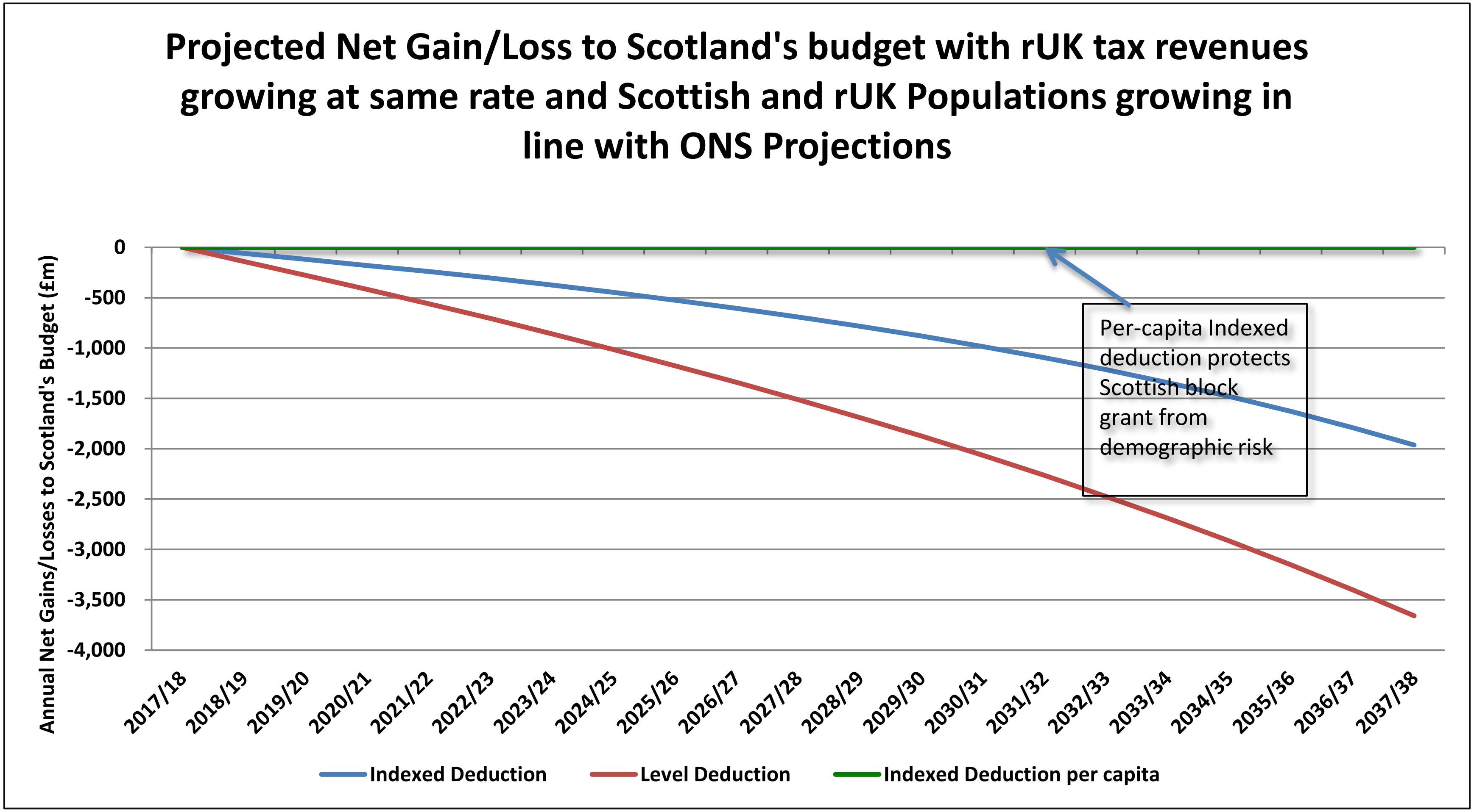
3. Per-capita indexed deduction adjusts the index deduction method by relative population growth in Scotland and rUK to allow for the fact that population in the two areas grows at different rates

$BGA_1=[(POP^S{}_1/POP^S{}_0)/(POP^{rUK}{}_1/POP^{rUK}{}_0)]* (T_1^{rUK}/T_0^{rUK})*BGA_0$

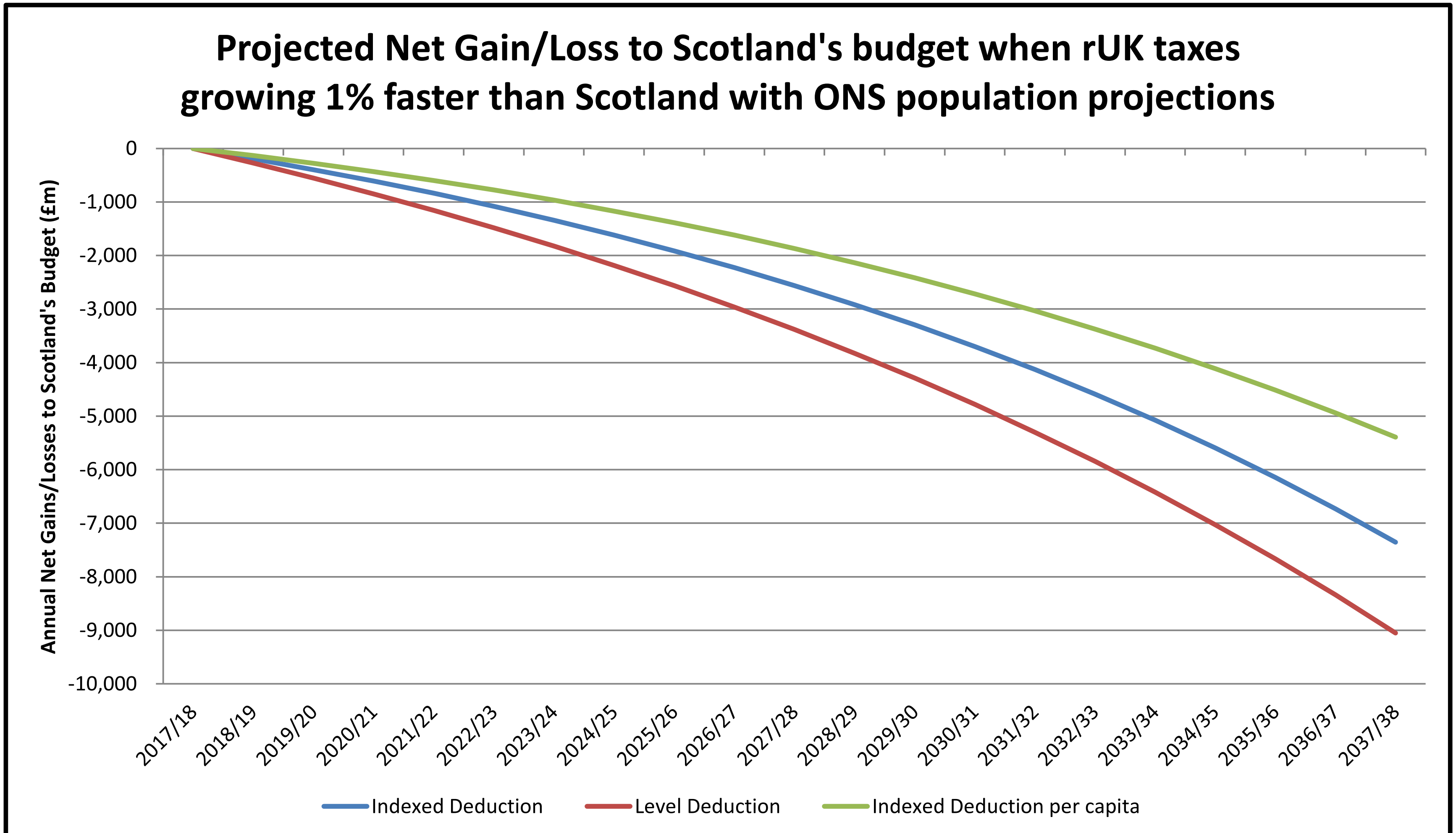
The three methods if rUK and Scottish comparable tax revenues rise at different rates



The three methods if rUK and Scottish populations grow at different rates



The three methods if tax revenues in rUK grow faster than Scotland and population follows ONS projections



Which is the best adjustment method?

- I’ve suggested, as have STUC and Cuthbert (2015) that the per-capita indexation method is better.
- Bell, Eiser and Phillips (2015) suggest that none of the three methods satisfies the two non-detriment principles set out in the SCA:
  - 1st non detriment principle: ‘no detriment from the decision to devolve’ and
  - 2nd non detriment principle: ‘no detriment from subsequent policy decisions of the other government’
- LD satisfies the 2nd but not the first, whilst PCID/ID satisfies the 1st but not the second, and PCID additionally protects from demographic shocks.

Why is per-capita-indexation better?

1. Smith Commission Agreement put Barnett formula as a cornerstone. The other methods would in essence work against Barnett, potentially driving spending per head in Scotland inexorably lower. Politically, the first no-detriment principle is likely to be very important.
2. The 2^{nd} no-detriment principle around ‘tax-payer fairness’ is almost impossible to satisfy. It will be violated in any case because of complex interactions between of UK government actions on reserved and devolved taxes and tax-payer behaviour (e.g. CGT and income tax) and between devolved taxes and reserved spending.
3. Although a balanced budget fiscal expansion by UK government might breach the 2^{nd} no-detriment principle under per capita indexed deduction, there is an asymmetry in the relationship between central and devolved government. UK government has a much broader range of economic tools to deal with a deviation from the second principle. Scotland and the other devolved governments do not have the same range of tax powers as the Central government to offset any deviations from that principle.
4. Scotland arguably does not have all the tools to counteract demographic trends, so it is reasonable to protect devolved governments from additional demographic risk. Scotland is already exposed to demographic risks through Barnett.

The Governance of the Fiscal Framework

The complexity of the BGA issues suggest that transparency, asymmetry of power between the two government in disputes and stability of the framework over time are important.

- Transparency – the BGA is difficult to understand and may counteract the additional accountability which the Scotland Bill is due to generate (see the work of the expert group I chaired re the Calman Commission). It is difficult to explain some of the potential impacts to the general public: e.g. if the rUK government raises income tax to spend on devolved areas this might advantage Scotland depending on the BGA method. If rUK government raises income tax this automatically disadvantages Scotland through the BGA. So it may be best to keep the system as straightforward as possible.

- Asymmetry of Power Should there be independent oversight of the framework as the Treasury is both a party to the agreement and a referee in the process? Trying to adjudicate on Barnett formula bypass as well as no detriment might be easier if there is an arbitration mechanism. A fiscal arbitration mechanism would not be impossible to design and would not be expensive to set up.

- Stability – The framework will need to evolve over time as the structure of taxation and spend and demographics change over time. No simple formula will work for ever. Again, a fiscal arbitrator might be able to make recommendations to the two governments for changes in the BGA formula, and review the formula in the future in the light of experience.

Other issues

- Block grant adjustment regarding welfare
- VAT assignment – How does one accurately identify how much VAT is raised in Scotland? Living Cost and Food survey limited in scope and might not capture positive effects of tourism on Scottish VAT receipts
- Borrowing – symmetric and asymmetric shocks in rUK and Scotland and implications for Scotland regarding revenue borrowing. On capital borrowing there is the issue of caps. Also implications for fiscal adjustments/fiscal rules at overall UK level (‘shared effort’ on revenue spend works through Barnett and block-grant adjustment via devolved taxes). Again, a fiscal arbitrator might be helpful here if one wants to create a ‘Federal’ model with symmetric power.
- Other issues (Tax administration costs; crown estate; employability programme funding)