Fiscal Federalism: Scotland

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Lots of fiscal ..... 

.... not much federalism
The Timeline

• 16th September 2014 – The “Vow” - "permanent and extensive new powers for the parliament will be delivered by the process and to the timetable agreed and announced by our three parties starting on 19th September."

• 18th September 2014 - Referendum

• 19th September 2014 - “And I can announce today that Lord Smith of ... has agreed to oversee the process to take forward the devolution commitments, with powers over tax, spending and welfare all agreed by November and draft legislation published by January. “ (David Cameron)

• 27th November 2014 - Smith Commission reports detailing Heads of Agreement on further devolution of powers to the Scottish Parliament

• 22nd January 2015 - Draft legislation to deliver more powers to the Scottish Parliament published

• 28th May 2015 - Bill presented to Parliament

• Bill has now completed Committee stage and will be considered at Report and Third Reading stages over one day, on a date yet to be announced
The Proposals

• Tax
  – Income Tax

“Within this [UK-wide] framework, the Scottish Parliament will have the power to set the rates of Income Tax and the thresholds at which these are paid for the non-savings and non-dividend income of Scottish taxpayers (as defined by the Scotland Acts).”

“As part of this, there will be no restrictions on the thresholds or rates the Scottish Parliament can set. All other aspects of Income Tax will remain reserved to the UK Parliament, including the imposition of the annual charge to Income Tax, the personal allowance, the taxation of savings and dividend income, the ability to introduce and amend tax reliefs and the definition of income.”
The Proposals

• Tax
  – VAT

“The receipts raised in Scotland by the first 10 percentage points of the standard rate of Value Added Tax (VAT) will be assigned to the Scottish Government’s budget. These receipts should be calculated on a verified basis, to be agreed between the UK and Scottish Governments, with a corresponding adjustment to the block grant received from the UK Government”

– Air Passenger Duty

“The power to charge tax on air passengers leaving Scottish airports will be devolved to the Scottish Parliament. The Scottish Government will be free to make its own arrangements with regard to the design and collection of any replacement tax, including consideration of the environmental impact.”
The Proposals

• Tax
  – Aggregates Levy

“Once the current legal issues in relation to Aggregates Levy have been resolved, the power to charge tax on the commercial exploitation of aggregate in Scotland will be devolved to the Scottish Parliament. The Scottish Government will be free to make its own arrangements with regard to the design and collection of any replacement tax.”
The Proposals

• Welfare benefits to be devolved to the Scottish Parliament

  – Benefits for carers, disabled people and those who are ill:

    Attendance Allowance, Carer’s Allowance, Disability Living Allowance (DLA), Personal Independence Payment (PIP), Industrial Injuries Disablement Allowance and Severe Disablement Allowance.

  – Benefits which currently comprise the Regulated Social Fund:

    Cold Weather Payment, Funeral Payment, Sure Start Maternity Grant and Winter Fuel Payment.

  – Discretionary Housing Payments
Further issues

- The parties agree that the Scottish and UK Governments should incorporate the following aspects into Scotland’s fiscal and funding framework:

  - **Barnett Formula**: the block grant from the UK Government to Scotland will continue to be determined via the operation of the Barnett Formula.

  - **Economic Responsibility**: the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure.

  - **No detriment** as a result of the decision to devolve further power: the Scottish and UK Governments’ budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.
The “No Detriment” Clause – From the Decision to Devolve

• No detriment as a result of the decision to devolve further power

  – The initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately

  – Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK Government, including any identified administrative savings arising to the UK Government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved

  – Future growth in the addition to the block grant should be indexed appropriately
The “No Detriment” Clause – From post-devolution decisions

- No detriment as a result of UK Government or Scottish Government policy decisions post-devolution

- Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments.

- Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.
Other Issues

• Borrowing Powers
  – *Scotland’s fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework.*
  – *The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework.*

• Implementable and Sustainable
  – *Once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation.*

• Independent Fiscal Scrutiny:
  – *the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland’s public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process*
Some tax powers exist/are coming. The Scotland Act 2012

- Landfill Tax
- Land and Buildings Transaction Tax
- Scottish Rate of Income Tax (SRIT)
- Council Tax
- Non-domestic rates

- 2015-16 revenue estimates:
  - Landfill tax £0.1bn
  - Land and Buildings Transaction Tax £0.4bn
  - SRIT £4.7bn
  - Council Tax £2.0bn
  - Non- Domestic Rates £2.8bn

  • Total £10bn

(Out of total budget of approx. £30bn)
Scottish Rate of Income Tax (SRIT)

Vertical tax competition within shared tax base?

Horizontal tax competition over mobile tax base?

Scottish Government

HM Government

= £4.7bn

£10k  £42k  £52k  £100k

Income Tax Rate

10p  15p  20p  40p  50p
Scottish Lorentz Curve
Challenge for Scottish Government!?
Division of Taxes Raised in Scotland between Holyrood and Westminster

After Smith Commission Implemented

- National insurance contributions
- Corporation tax (excl North Sea)
- Fuel duties
- Income tax
- Council tax
- Non-domestic rates
- Stamp duties
- Tax on capital gains
- Vehicle excise duty
- Other taxes, royalties and adjustments
- Other taxes on income and wealth
- Inheritance tax
- UK VAT
- Tobacco duties
- Scottish VAT

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Welfare Benefits to be Transferred
Smith Proposals: International Comparison

Decentralisation ratios in OECD countries

![Graph showing decentralisation ratios in OECD countries]
The Block Grant Adjustment – How will it work?

The Indexed Deduction Method

Year 1

Reduced Block Grant: size of reduction determined by growth in UK tax base/revenue?

Shortfall if Scottish tax base/revenue not growing as fast as UK tax base/revenue

Year 2

Scottish Income Tax Revenue

£30bn

<£30bn?

No detriment 1

Adjust for changes in population?
Welfare Fund Adjustment – How will it work?

Year 1

A

£2.5bn

Increase in grant to pay for welfare benefits

Year 2

A*

<£2.5bn?

No detriment 1

Indexed on: population at risk, disability, inflation etc
Draft Legislation – Fiscal Framework

- **Fiscal rules** – these are designed to constrain fiscal policy, typically by setting limits on borrowing and/or debt over a defined period, in order to ensure fiscal responsibility and debt sustainability; and

- **Fiscal institutions** – these are non-governmental bodies responsible for overseeing fiscal policy decisions of the Government. In the UK this role is performed by the Office for Budget Responsibility (OBR), which also produces official economic and fiscal forecasts.
Draft Legislation – Fiscal Framework

• “the fiscal framework should apply at all levels of government”

• “An outcome which requires the citizens of one part of the UK to make a greater contribution to fiscal consolidation as a result of the actions of devolved government would be contrary to the ‘no detriment’ principles set out in the Smith Commission Agreement. Therefore the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government across devolved and reserved areas.”
Hypothecation

- Scottish government revenues around £17.7 billion
- What would this pay for?
  - Health Service, Justice and Welfare Benefits allocated to Scotland
  - Leaving Education, Transport, Local Government, remainder of Welfare (including the state pension)
  - And shared services – Defence, International Aid, Debt Interest etc.
- To be paid by rUK taxpayers and by other Scottish tax revenues
What do Scots want in relation to tax and welfare powers?
Preferences for taxes and benefits among those who wish powers moved to Holyrood
Post-Smith Process

• Horse-trading rather than guiding principles
  – e.g. failure to make the case for risk pooling

• In contrast:
  “the government and Parliament of Canada “are committed to the
  principle of making equalization payments to ensure that provincial
governments have sufficient revenues to provide reasonably comparable
levels of public services at reasonably comparable levels of taxation.”
  Constitution Act, 1982

• Secretive process
  Even further reduces the likelihood of general acceptance – fertile ground
  for conspiracy theorists

• At end of which voters likely to be even more confused on the
  linkage between taxation and spending in Scotland
Conclusion

- Smith proposals conceived in haste with no clear rationale or narrative around shared risks
- No general understanding of the risks implied by the new powers
- Continuation of Barnett alongside new tax and welfare powers along with “no detriment” principles is unlikely to be stable and will probably have to be revisited
- Not clear that there is a substantial appetite for policy variation between Scotland and rUK – even though there is a demand for more powers to be held at Holyrood.
Thanks!

John A McDonald cairn in Rogart, Sutherland, unveiled in 1968 by John Diefenbaker