

The UK Government's proposals for the future financing of  
devolved government in Scotland: an economic assessment

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## Executive Summary

- This paper offers a critical appraisal of the proposals published by the UK Government in November 2009 to reform the arrangements for funding the devolved administration in Scotland. The proposals follow on from the fiscal policy recommendations made by the Calman Commission report;
- Like the Calman Commission recommendations, the UK Government proposes to create a Scottish income tax to be set initially at 10p and applying to both basic and higher rates of income tax. The yield from this tax will be a new, “own source”, element in Scotland’s budgetary revenue and the block grant will be reduced proportionately to reflect this;
- While acknowledging that these proposals will increase the financial accountability of the Scottish Parliament, we demonstrate that they are defective in economic terms, and if implemented are likely to create key instabilities in the budgetary arrangements of Scotland’s government that have significant ramifications for the delivery of public goods and services and, consequently, for Scotland’s economic prospects;
- Rather than using actual income tax receipts generated in Scotland as the basis of the adjustment, the yield to be attributed from the Scottish tax will, in the first instance, be based entirely on a Treasury forecast. The “own source” element of the prospective financing regime will therefore be the product of a contestable non-transparent regime, it will constitute a non-verifiable amount, and it is non-negotiable;
- Economic forecasts are entirely dependent on the underlying assumptions of the economic model generating the forecast. The “own source” revenue effects of a change in the Scottish rate of income tax will thus depend solely on the assumptions used in the Treasury forecasting model. As public spending decisions will be driven in part by these forecasts, and because Treasury forecasts are neither reliable nor uncontested by other forecasters, inter-governmental disputes over funding are all but unavoidable;
- We estimate that the trajectory of funding implicit in the new proposals would have resulted in a significant shortfall of revenues available to the Scottish administration had it been in place since 1999 by an amount in excess of £1.2 billion. Making good this revenue deficit would have required an increase in the Scottish rate of income tax by approximately 1p every 5 years just to retain the same level of public services;
- The UK Proposals create new uncertainties facing the financing of Scotland’s public spending. Any government whose expenditures are (in part or in total) funded by current tax receipts must have suitable borrowing powers to ensure that unexpected revenue shortfalls can be covered by borrowing. The UK Government explicitly rejects granting borrowing powers to the Scottish Government and Parliament to “smooth” current spending. The prospective financing regime therefore increases the likelihood of instabilities to

Scotland's public spending which may have adverse consequences for the performance of the Scottish economy;

- New borrowing powers that are proposed to finance capital programmes. These are defective and are likely to lead to an under investment in Scotland's capital stock. This is because of the conditions attaching to this new borrowing facility, chiefly that the tax burden on today's taxpayers must increase immediately to finance and repay loans whose benefits will accrue to future generations;
- While the prospective regime might increase the fiscal accountability, we regard this to be an extremely modest gain compared to the losses that will result if the proposal is implemented. And although it can be argued that the aim is not to increase the leverage of the Scottish Government over economic policy, but simply to enhance the accountability of its parliament, it is an unavoidable fact that any decisions over the rate of income tax and the manner in which public spending is financed will have significant economic effects. We do not consider that the UK Government proposal has taken sufficient account of the likely economic effects of its proposals. Instead, it seems to be a piecemeal attempt to enhance the financial accountability of Parliament in a manner that is informed by political expediency in the context of the current Scottish political debate rather than by sound economic analysis.
- We argue that the proposal could and should be revised in the following ways:
  - to permit sensible borrowing for non-capital purposes, with rules to prevent excessive borrowing, and allow capital borrowing against future tax revenues rather than against higher tax rates;
  - to remove the constraints that make the Scottish Parliament de facto accountable to Whitehall (e.g. let the taxes raised by the Scottish tax rate be collected directly in Scotland; and provide a reconciliation between actual revenues received and their earlier forecasts);
  - to allow Scotland to keep and enjoy the benefits of any extra revenues created (at present actual revenue improvements go to London);
  - to increase the range of tax autonomy in order to increase political (Parliamentary) accountability, to diversify the revenue sources, and to provide some revenue smoothing; and
  - to allow the Scottish Parliament to at least supervise the calculations upon which the funding consequences of their own tax decisions will be based.

## **1. Introduction**

This short paper offers a critical appraisal of the proposals published by the UK Government in November 2009 to reform the arrangements for funding the devolved administration in Scotland. It is, of course, in the nature of White Papers that much of the detail that will be included in any subsequent legislative proposal is absent. Nonetheless the White Paper ‘Scotland’s future in the United Kingdom: Building on ten years of Scottish devolution’<sup>1</sup> announcing the parameters of the prospective reform to the current arrangements provides a clear sense of what is being proposed. As we argue in some detail below, our opinion is that the proposal is defective in a number of important ways, and if implemented is likely create key instabilities in the budgetary arrangements of Scotland’s government with significant ramifications for the delivery of public goods and services and, consequently, for Scotland’s economic prospects.

In presenting this critique we are not advocating that the current Barnett regime should continue to be the basis for financing devolved government – in Scotland or elsewhere. There is a near unanimous consensus that the Barnett system is no longer an appropriate mechanism for this purpose, and that a fundamental overhaul is needed. We entirely concur with this view. Indeed the Government’s White Paper of November acknowledges also accepts this, and proposes to shift the funding model to one more closely reflective of the “needs” of the devolved territories and, perhaps, the regions of England. So while we agree that reform is needed, we do not consider the current proposals are either viable or desirable in economic terms. And while we advocate a considerably more radical shift towards fiscal autonomy for Scotland, that approach is explicitly *not* the benchmark against which we are assessing the current proposals. Rather we examine these proposals strictly in terms of their economic and economic policy properties. In our concluding section we offer our thoughts on how the current proposals might be amended in order to address the defects we identify.

## **2. Background**

In June 2009 the Calman Commission published the conclusions of its inquiry into the powers of the Scottish Parliament in the light of ten years’ experience of devolution. That Commission had been established by the opposition parties in the Scottish Parliament and was widely regarded as a reaction to the “National Conversation” that the SNP launched to engage the Scottish electorate in a discussion about Scotland’s constitutional future.

While the Commission focused on a wide range of issues, one of the major themes it addressed was how best to improve the financial accountability of the Scottish Parliament for monies that it spends annually across the range of devolved competences. The Commission’s view was that this would best be achieved by devolving a limited degree of tax autonomy to the Scottish Parliament. Specifically the Commission proposed that the UK rate of income tax applied in Scotland should be reduced by 10p (at each tax band) and that the block grant be reduced by an amount equivalent to the tax yield this produced. It would then be for the Scottish

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<sup>1</sup> Cm 7738, November 2009

Parliament to levy the “Scottish income tax” at whatever rate it wished – if the aim was to restore the whole amount of the lost revenue then it would simply reinstate the 10p rate. However the Parliament would be able to lower or raise the Scottish rate of income tax according to whether it wished to reduce or increase the revenue it had available to finance devolved policies. The upshot would be that the grant element in devolved spending will be reduced by a significant amount – estimated to be 15% - and it will require the Parliament annually to set the rate at which the Scottish segment of income tax is to be levied. The Calman Commission also recommended that Scottish Ministers should be given an additional borrowing powers to increase *capital* investment in any one year; no new powers to borrow to finance current spending was proposed.

Following the publication of the report of the Calman Commission we, along with a number of colleagues, criticised its fiscal recommendations on two substantive grounds. First we pointed out that a fiscal regime in which expenditure in any one year was in part dependent upon income tax revenues collected in that year was inherently unstable for two reasons. The first problem is that any unanticipated change in the level of economic activity in Scotland would be bound to impact on the income tax yield now used to finance part of Scottish public spending. If economic activity unexpectedly declined this would produce a shortfall of planned (tax) revenue over planned expenditure and force the Government to make immediate cuts in its spending programmes. If economic activity increased unexpectedly then of course revenues will rise and supplementary spending could be financed. The economic problem in both cases is that the impact on public spending is pro-cyclical and, consequently, likely to amplify either the unexpected economic downswing or upswing, rather than reduce it. The second problem was simply that no authoritative data on income tax revenues collected in any year is available until 2 years later. This means that the true revenue effects of a tax decision will not be known until well after the year in which that decision was taken and, presumably, the spending implications budgeted for. Even if the ultimate revenue effects of any tax change were properly calculated, contemporaneous data for income tax receipts will not show this and planned spending will have to be revised accordingly. The outcomes may be even worse affected because decision, parliamentary and implementation lags mean that the decisions will actually be calculated on imperfect data from two years before and have effects that are not clear for two years after.

As we indicated at the time the only way to tackle these well know problems of fiscal regimes is for governments to have access to a facility for “smoothing” such unexpected variations in revenues, typically through borrowing powers. However this was deemed not to be necessary by the Calman Commission, and this rejection of proposing Scottish Government be given enhanced borrowing powers was our second substantive criticism of the Calman report. It is entirely unclear why the Commission came to its position. Although recognising that this “smoothing” problem arises when current spending relies on current tax revenues, the scale to which Scotland’s public spending would be dependent on these revenues has been decreed to be below some (non-defined) critical threshold at which this would create problems for funding public spending programmes. No explanation was offered as to the route by which this judgement, which we regard as fundamentally ill-informed, was made.

It is against this background that we now have an opportunity to consider the reforms to Scotland's fiscal arrangements set out in the UK Government's White Paper. Needless to say these proposals are important both from an economic and a constitutional perspective. We will focus only on the economic and economic policy aspects of the proposals since it is those effects (rather than constitutional effects) that ultimately will determine the impact of the new arrangements on the people of Scotland. Accordingly, while enhanced parliamentary budgetary accountability is one criterion against which to assess the proposals, they must also be assessed in terms of their likely impact on Scotland's economy and on the capacity of Scotland's government to manage the Scottish economy. Against this measure we conclude that the proposals are highly problematic.

### **3. The Proposals**

Unsurprisingly the White Paper broadly endorses the Calman Commission proposal to establish a Scottish rate of income tax which the Scottish Parliament will have the power to set. The base rate for this new Scottish tax will be 10p and will apply to the basic and higher rates of income tax. To facilitate this new tax the rates of income tax applied by the UK Government in Scotland will be reduced by 10p. It will be incumbent on the Scottish Parliament to set the Scottish segment of income tax annually as part of the normal budgetary process. The devolved authorities will be able to raise or lower Scotland's income tax rate as it wishes. The receipts generated by the application of the Scottish rate of income tax will be deemed Scotland's "own sources" revenue, and will replace part of the annual block grant. The White Paper does not put a figure on the tax receipts accruing from the application of the Scottish tax, although estimates put this at approximately 15% of Scotland's current block grant. The block grant will be "proportionately reduced" (i.e. by, say, 15%) in the first year of the new regime to take account of this new source of revenue, and in subsequent years the annual Barnett cash uplift will be applied only to this "proportionately reduced" block grant. If the sum of the block grant plus revenue from the application of the Scottish segment of income tax is inadequate to meet the expenditure aspirations of a Scottish Parliament, Parliament has the power to raise the Scottish rate in order to cover the budget deficit. And, of course, the Scottish rate of income tax could be reduced in the event of a budget surplus being projected.

The White Paper makes no provision to establish powers to permit the Scottish Government to borrow to finance current expenditure. Accordingly current spending must be financed by current revenue. This borrowing question had been considered by the Calman Commission and it had reached the same conclusion, despite the fact that the Commission did acknowledge that this model of tax devolution would expose public spending in Scotland to potential "cash flow management" problems. In the event it concluded that the degree of this exposure was insufficient to warrant the creation of new borrowing powers. As we discuss in detail below in the context of the tax devolution proposals this absence of borrowing powers to finance current spending is one of the major weaknesses of the UK Government's proposals. Finally the UK Government White Paper endorses the recommendation by the Calman Commission that a new power to finance capital spending in Scotland should be introduced. However as we discuss below the conditions attaching to this new competence are both highly restrictive and very unlikely to generate an economically efficient level of capital investment.

#### **4. Tax setting, uncertainty and revenue flows**

Although similar to the recommendations made by the Calman Commission, a key feature which distinguishes the UK Government's proposals from that original model is that the "own source" component of Scotland's revenue will be determined, in the foreseeable future, on the basis of a Treasury *forecast* of the yield from the application of the Scottish rate of income tax, and not the *actual* taxes collected in Scotland. In other words there will be no calculation of the income tax revenue actually collected in Scotland, the result being that the "forecast" and "actual" tax yields will never be reconciled, nor the appropriate financial adjustments made. While this does address one defect in the Calman model of tax devolution, the implication of this proposal is that something like 15% of Scotland's revenues will depend on a Treasury forecast of Scotland's income tax receipts, with no compensation for errors. One does not have to be an economic historian to appreciate the limitations of economic forecasts, far less those undertaken by the Treasury. Moreover managing this "virtual" revenue system will become highly problematic should the Scottish Government's forecast of the level of Scottish economic activity – and so income tax receipts – be out of line with the Treasury forecast. Given what is at stake – i.e. the total revenue available to finance public spending in Scotland – inter-governmental disputes over economic forecasts probably are inevitable.

It is straightforward to explain why. Under the prospective scheme in each year the block grant will be reduced by the Treasury's calculation of the tax yield in Scotland on the basis of a 10p (Scottish) rate of income tax. The adjusted block grant will then be augmented by the Treasury estimate of the yield given the actual Scottish rate. If the Scottish income tax is set at 10p then these adjustments will be identical. But, of course, this adjustment might not be accurate, and it might not be agreed. And this is important for two reasons. First if the Treasury overestimates Scotland's income tax yield, as it has done on average for its own revenues in the past, this will result in a corresponding over-reduction in the block grant which will have an adverse effect on the base upon which the Barnett formula is subsequently applied. Second if the Treasury underestimates Scotland's tax yield then the entire amount of the tax revenue dividend associated with improved economic performance in Scotland will accrue to the UK Treasury. Accordingly one might reasonably expect the forecast on which the tax revenue element of the new funding arrangement to be contested, at least some of the time. There are many independent forecasters (at least four for Scotland), and the forecasts made for the UK by the Treasury have frequently been disputed and have often been proved wrong. At the very least all forecasts are subject to revision. Which body, if any, will be established to arbitrate inter-governmental disputes arising from competing expectations of Scotland's economic performance? And if there is to be no arbitration between competing forecasts, then the UK Government could lay itself open to accusations that the Treasury is manipulating its forecasts as a means of controlling public spending in Scotland.

Even at first glance, therefore, this "own source" element of the proposed financing arrangement appears to be defective in three senses. First it is not transparent. The Treasury alone will determine this element of Scotland's revenue and its forecast tax revenue might, or might not, be the product of the correct model of Scotland's economy. Second whether or not the Treasury estimate of Scotland's share of income

tax revenues was correct for any particular year is not verifiable because no provision is made to compare actual against forecast income tax receipts generated in Scotland. Should the Treasury's forecasts be inaccurate – and by definition this has to be the case – then conceivably Scotland could continue to receive the “wrong” amount of tax revenue indefinitely. As we note below, even minor errors can add up to significant amounts over the longer term. Third this proposal will confront the devolved administration with considerable underlying uncertainty with respect to the scale of its future revenues – uncertainty about the outcomes, and uncertainty of what the forecasts will say.

However a more problematic issue arises should the Scottish Parliament decide to use its new tax power – for instance in order to raise Scotland's rate of growth. An example best illustrates the difficulties this could create. Suppose that Scotland's parliament decides to reduce the Scottish rate of income tax on the grounds that this will attract business and increase work effort – and hence increase total income tax receipts generated in Scotland. After all, with lower rates of income tax the level of disposable incomes – and so demand – in Scotland will increase, businesses can expand output and new workers enter the labour force thereby lowering unemployment. Moreover the competitiveness of Scotland's firms will increase if labour productivity rises as employees work harder because, with a lower income tax rate, they will now take home a higher share of their wages. On that basis total income tax receipts in Scotland are likely to rise fairly quickly, with one-half of this rise being available to finance higher Scottish public spending or finance a subsequent income tax cut (the UK Government would receive the other half). But what happens if the Treasury economists are working under a completely different set of modelling assumptions – namely that a cut in Scotland's rate of income tax would permanently *reduce* Scotland's tax receipts and so her “own source” revenue? This could happen. In addition to the immediate fall in revenue when the rate of income tax rate is cut, the Treasury might insist that Scotland's output and employment will actually decline since workers can now work *less* hard and still take home the same pay as they had before. Instead of labour productivity rising, under this assumption the opposite will be the case and businesses will be forced to raise prices in order to cover costs. In this scenario a vicious, rather than a virtuous, economic circle will ensue, and the fall in employment will produce lower tax revenues necessarily leading to cuts in public spending. (Of course if it then turns out that the Scottish government was right, *all the extra* revenues generated by the Scottish tax cut would accrue to the UK, and not to Scotland, since the UK gets the actual revenues while Scotland is allocated the *forecast* without any subsequent reconciliation.)

So, depending on the assumptions built into the economic model, one can produce two quite different forecasts of future income tax receipts arising from the same tax change. This is a well known problem. In technical terms getting the “right” forecast in the above scenario requires that Treasury economists actually know whether, in Scotland, the income effect in the income-leisure trade off dominates the substitution effect; or whether the substitution effect dominates the income effect. One can be pretty sure that they do not know this, at least not for Scotland, since the detailed (Scottish) national accounts data needed to make the relevant calculations simply do not exist.

This reveals a fundamental flaw in the “own source” proposal as set out in the UK Government White Paper. It will lead to the somewhat bizarre situation in which a Scottish Government would only sensibly utilise its new powers to propose a change in the Scottish rate of income tax *after* it had taken instruction from the UK Treasury of the impact *its* economic model predicts this would have on Scotland’s income tax yield. This is, to say the least, an unsatisfactory state of affairs. Indeed, under this arrangement the Treasury will have considerable influence over the rate at which Scottish income tax is set given that it will be for the Treasury to decide the impact that any tax change will have on the revenue subsequently accruing to the Scottish Government. This seems to undermine entirely the UK Government’s assertion that the proposed financial regime will enable the Scottish Parliament to determine its own tax rate according to its spending preferences.

Consequently a Scottish Government seeking to use its income tax powers to boost growth is that it will have to first convince the Treasury that its underlying economic assumptions are correct. Under such conditions, it would be highly unlikely (and potentially irresponsible) in our view for any Scottish Government to use its new tax powers unless it has prior knowledge of the Treasury’s determination of the impact of the prospective tax change on tax revenues. To minimise the risk of losing income because Treasury assumptions dictate that that will be the result of your tax change, or of giving it to someone else if Scottish assumptions should prove to be correct, the best strategy is simply to avoid changing the Scottish rate of income tax, or to do so only with the express permission of the UK Treasury in the knowledge of the revenue consequences. In other words, the unused 3p variable rate available under current legislation is being replaced with an equally unusable 10p variable rate.

## **5. What will happen to the budget?**

It is also worth considering what the new arrangements might mean for future revenue flows to the Scottish Parliament. It is, of course, impossible to provide any definitive forecast of future revenue flows. However it is possible to estimate, in general terms, what might have happened had the proposed arrangements been in place since 1999. There is no doubt that the trajectory of revenue flows to the Scottish administration would have been different under the proposed regime than under the present funding model. If the new (own source) tax revenues are to fill the gap created by the (proportionate) reduction in the block grant, then the condition for identical growth under the “old” and “new” regimes is that Scottish incomes (which determine her income tax revenues) must grow at least as fast as UK public spending (which is what determines the annual uplift to the block grant). In fact this has not been the case for a long time. Over the period 2000-2008, data on the rate of growth of UK public spending and Scotland’s GDP show that public spending growth in the UK has outstripped the growth in Scottish incomes by an average of 0.21% per year. This implies the proposed financing regime would have created a funding gap had it been in place over the period 2000-2008: a gap which gets *larger* by an additional £81m each year of revenues lost to the Scottish government, summing to £1.2bn lost after 5 years<sup>2</sup>. This means that had the proposed funding arrangement been in place over the period since devolution we estimate that a Scottish Government would have been

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<sup>2</sup> This is likely to be an under-estimate in that data suggests that the scale of this “funding gap” increased significantly in later years.

forced to raise the Scottish rate of income tax *every year* by 0.21p in the pound, or by 1p every 5 years, in order that the rate of growth of public spending in Scotland kept pace with the growth of public spending in the rest of the UK.<sup>3</sup> In all likelihood this would have had an adverse impact on business conditions in Scotland, on living standards and on the ability of the Scottish economy to grow and create jobs. In our view, therefore, the UK Government's funding proposals therefore come at a potentially high cost, particularly in the provision of frontline public services and, we suggest, the potential growth rate of the economy as a whole. So while it is true that the proposed funding scheme increases modestly the fiscal accountability of the Scottish Parliament, our estimates suggest this comes with a fairly high price tag.

Given the emphasis that both the Calman Commission and the UK Government have placed on ensuring good relations between the UK and Scottish governments, it is worth stressing what we consider to be the inherent defects of the UK Governments proposals in terms of good governance. It seems to us that the lack of transparency and verifiability in the tax revenue element of prospective new funding regime is bound to create additional (not less) tensions between a Scottish Government (or Parliament) seeking to use its new income tax powers, and the UK Government which ultimately will decide the assumed revenue consequences that result from changes to the Scottish rate of income tax. Needless to say such a regime lends itself to political opportunism (from both sides of the border) if UK Government's estimate of the revenue consequences of a change in the Scottish rate of tax is contested by the government in Scotland. This is especially important if one accepts that had the proposed regime been in operation during the years since devolution began then less funding would have been made available to the Scottish administration to finance devolved policies than actually was provided.

## **6. Borrowing powers**

As noted above, the White Paper proposals endorse the Calman Commission's views with respect to the borrowing powers of the Scottish Government. As recommended by the Commission, borrowing will not be permitted to finance current spending. A new power to borrow to finance capital spending is to be introduced however, but with conditions. First any such borrowing has to be agreed upon by the Treasury; second, the interest rate has to be reset each year; third, it has to be accompanied by an (immediate) increase in the Scottish rate of income tax to generate the amount required to finance and repay the loan. Whilst welcoming the recognition that borrowing for capital investment purposes is a sensible power to grant the Scottish administration, the requirement that any loans raised under these provisions have to be financed out of an increase in *current* taxation is simply nonsensical in economic terms.

While it is of course the case that all public sector borrowing has to be serviced and, ultimately, repaid from tax receipts, it is certainly not the case that it is either necessary or efficient to impose this requirement on the current generation of tax payers, as opposed to paying back out of the extra revenues subsequently generated by the investment, as any business or government elsewhere would do. In that way the

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<sup>3</sup> If the starting date is later, say 2003, the forecasting errors are larger meaning that the potential cuts to public spending would have been greater, or the required increase in the Scottish tax rate higher.

burden of the debt properly is levied on those who gain from the increased revenue flow from the capital investment financed by the initial borrowing. Capital projects create economic benefits that accrue both to current and future generations. In efficiency terms the burden of servicing and repaying borrowings to finance such projects should therefore be distributed between current and future generations according to the corresponding flow of benefits and not imposed entirely on the current generation as the UK Government proposes. This is why all governments manage their public debt with an appropriate mix of repayment and refinancing. Requiring today's tax payers to repay a loan which principally benefits future generations is virtually certain to *reduce* the Government's capital investment programme below that which is economically efficient. It is difficult to see any sensible government borrowing for investment purposes under such conditions, and that is likely to mean that investment in capital and future infrastructure projects will be restricted below what is economically desirable.

A second set of borrowing conditions is also foreseen. Any borrowing for capital spending will be limited to one year at a time, and can only be undertaken at interest rates set by the Treasury. Even if those rates are set at market rates, this is not much help as most capital spending by governments involves multi-year projects. Uncertainty over what the future funding costs are likely to be, and over whether the project will be funded beyond the current one year limit, is almost certain to mean that governments will be very reluctant to borrow or to commit resources to the constant renegotiations needed to ensure that existing projects remain funded. As a result, Scotland's capital and infrastructure projects are likely to remain significantly underfunded under this new regime.

As has become very clear in the course of the current economic recession, it is desirable that any government reliant on tax revenues to finance any part of its spending programmes has access to borrowing in order to "smooth" its public finances should the economy be subject to unexpected economic shocks. The proposal to make some element of Scotland's public spending dependent on forecasts of tax revenues implies that complementary borrowing powers are an essential accompaniment in order to fulfil this "smoothing" function. It is also worth noting that in no other devolved administration, nor English region, will public spending programmes be exposed in this manner.

## **7. Intra-budget borrowing**

In practice the Treasury's income tax forecasts (for the UK) have been remarkably inaccurate, over-predicting those revenues in the downturn and under-predicting them in the recovery. So this is a realistic and legitimate concern. There is a small provision in the Scotland Act for the Scottish government to borrow up to £500m within any one funding year to cover cash shortfalls within the current financial year (the White Paper does not say if this facility would also be cut along with the block grant). But that is very small: first because it must be paid back the following year before any further borrowing can be undertaken, and second because it would be too small to make a difference in the kind of recessions we are likely to encounter.

For example, we would need to borrow £500m if there were a 5% shock to incomes in a recession that lasted two years or more. In the current recession, incomes have fallen

by 6% to 7% for longer than two years. What would happen then? Cuts in public spending, not matched by cuts elsewhere in the UK, would become unavoidable. Moreover those cuts would be a multiple of the original shortfall in revenues. The UK government has had to borrow 14% of national income to counter falls in income of 5-6%. Translating that to Scottish conditions, in the absence of noncapital borrowing, public spending on services, schools, and health would have to be cut immediately. But those spending cuts will drive a further decline in incomes and hence tax revenues, requiring a second round of cuts and/or tax rises. Ultimately, in order to restore spending, tax rates would have to rise to make up the shortfall, provoking yet a third decline in disposable incomes and hence revenues and spending.

This cycle of revenue declines, followed by spending cuts and then tax increases, is unavoidable because one cannot increase taxes immediately to avoid the spending cuts. It takes two years: one year to pass the budget change through Parliament, and then one year for the changes to be implemented through the tax code and bring the higher revenues in. This problem is a direct consequence of linking current government spending to *current* tax receipts under a regime in which the annual budget must be in balance – i.e. outgoings (expenditure) have to be matched by income (revenue) year by year. If businesses cannot be expected to do this, it is certainly unrealistic to expect governments to be able to do so.

Again these arrangements seem an unlikely way to strengthen the economic and social union in the UK, the overriding objective of both the Calman Commission report and the UK Government's White Paper.

## **8. Changes in the long term**

The White Paper also sets out the UK Government's proposals with respect to the longer term arrangements for funding Scotland's government. This foresees a transition to a devolved tax regime much similar to the original Calman proposals – i.e. where it will be *actual* (and not estimated) income tax revenue collected in Scotland that will augment the revised block grant. Moreover the block grant system itself will be reviewed in order to ensure that financial transfers bear some relationship to need. For this transition to occur requires both that a new agency is created to which income taxes collected in Scotland are remitted (or at least calculated), and that a comprehensive UK-wide needs assessment is undertaken to determine the scale of the block grant assigned to each of the devolved administrations and, perhaps, the regions of England.<sup>4</sup>

As long as the Scottish Government is not permitted to undertake borrowing in order to “smooth” unexpected variations in its revenue, then the tax revenue element of the prospective funding arrangement will continue to create problems in the delivery of public goods and services on the part of Scotland's government. And while the switch from “forecast” to “actual” data will ensure that revenue accruing from the application of the Scottish rate of income tax *ultimately* will be reliable, because it takes at least 2 years before accurate data on tax receipts becomes available the Scottish Government

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<sup>4</sup> In this context it is somewhat surprising that immediately prior to the publication of the White Paper, the Scotland Office published a discussion paper in which it ruled out establishing a separate Scottish tax collecting authority on grounds of prohibitive collection and compliance costs. See ‘Tax Administration and Constitutional Change in Scotland’, Scotland Office, 18 November, 2009.

will have no option but to continue to rely on forecast tax receipts when planning public spending for any particular year.

There are also practical problems that render these tax proposals inappropriate, if not unworkable. What dispute resolution procedure will be invoked when it is discovered that too much grant was cut because the forecasts were wrong, or because they were correctly carried out but on data that contained errors? Second, what is to be done if incomes were thought to be higher than they turned out to be, so the underlying grant had been cut more than it should have been – causing public services to be cut more than they should have been? Third, how are disputes over jurisdiction to be resolved? How are the self-employed, partnerships, trusts, firms and persons with incomes arising on both sides of the border, and investment incomes under double taxation agreements to be allocated a jurisdiction? The opportunities for flipping addresses are nearly endless. Similarly income tax breaks for personal pension plans: will they be given at the UK rate or the combined Scottish rate, at the address of the investor or of the pension provider? Despite the hostility of the Scotland Office to creating a tax collecting agency for Scotland, we would argue this is an absolutely essential corollary to the tax devolution proposals set out in the White Paper.

In fact, compliance and collection is a problem which is not recognised by the White Paper. Yet the ability to shift income, capital and domicile status between jurisdictions is an issue that occupies nearly all the major economies, not least the UK, and will come to affect Scotland under the White Paper proposals. How important it would be in practice remains to be seen. But if the Scottish tax rate were set at 5p instead of the full 10p then a self-employed person earning £50000 would save £2500, more at the higher tax brackets, every year by registering at a Scottish address. It is not that rules cannot be introduced to prevent with all these cases. But those rules will inevitably be arbitrary and hence continually subject to challenge. They also have an obvious ability to distort and redistribute economic activity as people, and not least the policymakers, try to game the system for private or political advantage. Resources that could be better used elsewhere will inevitably get taken up in resolving disputes and enforcing the rules.

And who will pay to administer and enforce the new regime? And how much will it cost? It used to be said that the old Tartan tax would cost 1.5p per pound raised to administer. If so, to maintain spending at its current level, we will need a Scottish tax rate of 11.5p on top of the 10p UK tax rate just to stand still. That would mean an income tax rate of 21.5p, compared to 20p in the rest of the UK, for the same level of services. Although our figures might exaggerate the case, Scots would nevertheless see their tax rates rise above the rest of the UK just to stand still.

## **9. A question regarding variable tax revenues**

The official advice from the UK Treasury with respect to its own affairs is that adjusting tax rates to meet the budgetary implications of fluctuating economic circumstances should be avoided as far as is possible (if not at all costs). This is a position they have adopted forcefully in their own publications and given as a reason why it would be undesirable for the UK to join the Eurozone (where tax variations would also be required). The rationale is that tax variations, or uncertainty over future tax liabilities, distorts incentives and damages economic growth, and also introduces

all kinds of unintended redistribution effects and distortions into the markets. That is no doubt correct. But it raises a question. Why is such a regime then being imposed on Scotland, one of the weaker regions in terms of growth, without the borrowing arrangements which the UK government allows itself to smooth taxes; or without the ability to raise her own taxes more widely in order to diversify her revenue sources?

## **10. Conclusion: What might be done?**

It has not been the purpose of this paper to design a new tax settlement for Scotland, but rather to explain the economic consequences of the proposals set out in the recent UK Government White Paper. If we take the current Barnett arrangement as the comparator against which to assess the financing scheme being proposed by the UK Government, and perhaps endorsed by the other political parties who supported the conclusions of the Calman Commission, our view is that the proposed system is significantly inferior in terms of the likely economic problems to which it will give rise. Not only do we anticipate less resources will be available to a Scottish Government under the proposed scheme in comparison to the current one, it is a regime in which revenue (and so spending) instability is an inherent characteristic. Such uncertainty could easily generate significant long terms problems for the Scottish economy.

Moreover the opacity and subjectivity of the “own source” segment of proposed financing regime is such that almost certainly it will lead to potentially damaging tensions emerging between the Scottish and UK governments – all the more so when different political parties are in office in London and Edinburgh. And while it is accepted that the prospective regime will require the Scottish Parliament to set the Scottish segment of the rate of income tax, and arguably this might increase the fiscal accountability of that parliament, we regard this to be an extremely modest gain in the context of the considerable economic losses we believe could result if this proposal is implemented. And while its supporters might argue that its aim is not to increase (or decrease) the leverage that the Scottish Government has with respect to economic policy or economic outcomes, but rather to enhance the accountability of its parliament, it simply is an unavoidable fact that any, and all, decisions over the rate of income tax and the manner in which public spending is financed inevitably will have significant economic effects. We do not consider that the UK Government proposal has taken sufficient account of the likely economic effects of its proposals. Instead they seem to be a piecemeal attempt to enhance the financial accountability of Parliament in a manner that is informed more by political expediency in the context of contemporary Scottish political debate than by sound economic analysis.

Our limited aim in this paper was to critically review from an economic perspective the UK Government’s proposals to change the financing arrangements for Scotland’s devolved administration rather than offer proposals for an alternative fiscal regime. However, it would be appropriate to suggest directions in which these proposals could, and we believe should, be developed before being presented in the form of draft legislation in order to limit the damaging effects the proposals as they stand will have on the Scottish economy.

Perhaps the most obvious way to create better or more equitable economic outcomes, would be the following:

- to allow sensible borrowing for non-capital purposes, with rules to prevent excessive borrowing, and allow capital borrowing against future tax revenues rather than against higher tax rates;
- to remove the constraints that make the Scottish Parliament de facto accountable to Whitehall (e.g. let the taxes raised by the Scottish tax rate be collected directly in Scotland; and provide a reconciliation between the actual revenues of the combined taxes and their earlier forecasts);
- to allow Scotland to keep/enjoy the benefits of all extra revenues created;
- to increase the range of tax autonomy in order to increase political (Parliamentary) accountability and to diversify the revenue sources, and to provide some revenue smoothing; and
- to allow the Scottish Parliament to at least supervise the calculations upon which the funding consequences of their tax decisions will be based.