PICKING THE RIGHT BUDGET CONSTRAINT FOR SCOTLAND

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Executive Summary

This position paper considers the devolution of further fiscal powers to the Scottish Parliament in the context of the objectives and remit of the Smith Commission. The argument builds on our discussion of fiscal decentralization made in our previous published work on this topic.

We ask what sort of budget constraint the Scottish Parliament should operate with. A soft budget constraint (SBC) allows the Scottish Parliament to spend without having to consider all of the tax and, therefore, political consequences, of that spending, which is effectively the position at the moment. The incentives to promote economic growth through fiscal policy – on both the tax and spending sides are weak to non-existent. This is what the Scotland Act, 1998, and the continuing use of the Barnett block grant, gave Scotland.

Now other budget constraints are being discussed – those of the Calman Commission (2009) and the Scotland Act (2012), as well as the ones offered in 2014 by the various political parties – Scottish Conservatives, Scottish Greens, Scottish Labour, the Scottish Liberal Democrats and the Scottish Government. There is also the budget constraint designed by the Holtham Commission (2010) for Wales that could just as well be used in Scotland.

We examine to what extent these offer the hard budget constraint (HBC) that would bring tax policy firmly into the realm of Scottish politics, asking the Scottish electorate and Parliament to consider the costs to them of increasing spending in terms of higher taxes; or the benefits to them of using public spending to grow the tax base and own-sourced taxes?

The hardest budget constraint of all is offered by independence but, as is now known, a clear majority of those who voted in the referendum did not vote for this form of budget

constraint. Rather they voted for a significant further devolution of fiscal powers while remaining within a political and monetary union with the rest of the UK, with the risk pooling and revenue sharing that this implies.

It is not surprising therefore that none of the budget constraints on offer, apart from the SNP's, come close to the HBC of independence. However, the almost 25% fall in the price of oil since the referendum, a resource stream so central to the SNP's economic policy making, underscores why there is a need for a trade off between a HBC and risk pooling and revenue sharing.

Ranked according to the desirable characteristic of offering something approaching a HBC the least desirable are those of the Calman Commission, the Scotland Act, 2012, and Scottish Labour. In all of these the 'elasticity' of the block grant in the face of failure to grow the Scottish tax base is either not defined or is very elastic – meaning that the risk of failure is shuffled off to taxpayers outside of Scotland.

The degree of HBC in the Scottish Conservative, Scottish Greens and Scottish Liberal Democrats proposals are much more desirable from an economic growth point of view, the latter even embracing the HBC proposed by the Holtham Commission that combines serious tax policy with welfare support in the long-run. We judge that the budget constraint in the SNP's proposals is too hard as it does not allow for continuation of the 'welfare union' in the UK.

We also consider that in the case of a generalized UK economic slow requiring a fiscal stimulus that the Scottish Parliament be allowed increased borrowing to be repaid in the next economic upturn.

Universities of Connecticut and Glasgow
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Opening remarks

This position paper is about choosing the right budget constraint to discipline spending by the Scottish Parliament. None of the seven proposals made by the political parties are explicit about this. However, unless the budget constraint on spending is hard, or, as hard as possible in the context of the UK, MSPs will not be required to compare the benefits of their spending decisions against the tax and other costs (such as on work incentives) of extra spending.

Designing a new fiscal regime for the Scottish Parliament of course involves many other important matters for which the Scottish political parties have stated differing positions. Not least among these is the balance between any remaining block grant and own sourced taxes; exactly which taxes should be devolved, and to what extent, how much variability the Scottish Parliament will be allowed over them.

In this position paper we do not directly address these and related matters for three reasons. First, because whatever fiscal regime – on both the spending and taxing sides – is decided the governing budget constraint has to be hard: spending decisions have to have implications for the raising of taxes in Scotland. Policy risk has to reside with the policymakers and the people who vote for them and not be shuffled off to be met by taxpayers outside of Scotland. Secondly, as this is already a long document we think that the Commission will appreciate conciseness of topic.

Thirdly, we have already written quite extensively on matters other than the budget constraint in Hallwood and MacDonald (2004, 2005, 2006a, 2006b, 2006c, and 2009).

We are aware that there is a strong sentiment to maintain what has been called the UK's 'welfare union' and we care about this too. To cope with this, while still making the budget constraint as hard as possible, we are in favour of what we call the "Holtham interlude". If

MSPs choose unsustainable levels of spending it will only be after 12-15 years (as recommended by the Holtham Committee on fiscal devolution to Wales) that super-normal adjustments to any remaining block grant can occur. Likewise, if the Scottish Parliament is successful in raising the Scottish tax base and tax collections, it can keep the extra revenues during the "Holtham interlude" before there is any downward adjustment in block grant. It would simply be unfair in a welfare union that a constituent part that was enjoying buoyant finances did not share them with its partner countries.

The balance between block grant and own-sourced taxes is an important question that is addressed in some proposals. For example, the Scottish Liberal Democrats recommend, respectively a 45-55 percent apportionment; Scottish Labour 60-40 percent, and it has been calculated that the SNP favours 40-60 percent.[1] While we leave to others what is the optimal balance between remaining block grant and own-sourced taxes, we are clear that the block grant is not elastic within the period of the "Holtham interlude". To reiterate spending by the Scottish Parliament, however it is financed, will not be properly prioritized if "policy risk" is shuffled off to the rest of the UK. The effects of decisions made by the Scottish Parliament have to be felt by the decision-makers and those that voted for them, and not by the rest of the UK, at least during the "Holtham interlude".

We also argue that careful thought has to be given to how fiscal policy in the UK can operate in the face of generalized economic downturns. Our recommendation is that Scotland and other constituent parts of the UK should be afforded loans from Westminster as part of a UK-wide stimulus package; the loans to be repaid in the following economic upturn.[2]

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[1] On the SNP figure see Peter Jones (2014).

[2] We note that Mark Carney, Governor of the Bank of England, in a speech given in January 2014 warned that in a monetary union with substantial inter-regional fiscal transfers that the share of public spending at the sub-central

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Main objective of the paper

The main objective of this position paper is to investigate the 'hardness' of the budget constraints that have recently been proposed to govern spending by the Scottish Parliament. These are, in the order we discuss them:

1) Continuation of the Barnett formula.
2) The Scotland Act, 2012.
3) Scottish Labour, 2014.
4) The Holtham Committee (2010) on Wales but could be extended to Scotland
5) Scottish Liberal Democrats, 2014.
6) Scottish Conservatives, 2014.
7) The SNP.
8) The Scottish Green Party.

The large literature on the financing of sub-central government establishes the principles that for fiscal efficiency – in both spending and taxing, as well as in accountability to the voters, the budget constraint under which political decision-makers operate is hard. This means that decisions taken by the Scottish Parliament have real costs: that increased spending means that taxes – the burden on the voters - will have to go up to finance it. In general, voters and citizens

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government level in total public spending cannot be greater than some (loosely) defined threshold, otherwise the center will have insufficient funds to stabilize spending in a region in economic difficulties. This we characterize as the "eurozone problem" where sovereign countries in strong financial positions are reluctant to lend to other sovereign countries in weak positions. However, within the sovereignty of the UK, it is rather unlikely that this inter-state reluctance would be a problem, at least as long as the Better Together mentality maintains itself across the Kingdom.

at the sub-central level have to understand that what public spending they vote for has real costs to them.

With a soft budget constraint, public sector decision-makers do not have to make hard choices trading off greater public spending with greater tax burdens on the population that gets to enjoy that greater level of public spending.

The four main principles of a hard budget constraint (HBC) on sub-central government (SCG) – such as the Scottish Parliament are that:

i) A HBC aligns policies offered by SCG with what the voters at level are willing to pay for. This is not inconsistent with equalization payments between regions of a country, but these would be expected to flow to low income per head regions.

ii) A HBC creates incentive alignment between SCG and central government (CG) – the former does not spend funds allocated to it wastefully. This is a misuse of funds, or moral hazard, issue.

iii) A HBC is time consistent, in the sense that SCG should not expect to be bailed out by CG if it mismanages the level or allocation of its spending.

iv) A HBC should prevent adverse selection by voters at the SCG level when voting for their SCG. That is, the political parties should be unable to make promises that they know, or, should know, are un-financeable in the long-run.

What we recommend

In the Scottish context we recommend a HBC and this requires:

i) Block grants from Westminster should *not* be elastic in the sense that if the Scottish Parliament cannot finance its chosen spending level out of the existing block grant and own-sourced taxes, the block grant is not automatically or quickly increased. The Holtham Commission recommended a 12 to 15 year 'waiting period' with respect to the Welsh Assembly and Government, and the Scottish Parliament should abide by rules such as these. A non-elastic block grant amounts to a 'no bailout clause' (it is time consistent). The advantages of this are:

a) SCG spending decisions have to look to whether they are financeable during this extended period of time.

b) As there is a risk in adverse circumstances that taxes at the SCG level will have to go up to maintain chosen expenditure levels, the Scottish Parliament is forced to balance the benefits of its spending choices with the cost to Scottish taxpayers. This principle is consistent with risk sharing in a 'welfare' union. But a 'sharing union' is not the same thing as an 'unlimited pocket money system' that would impose no costs at the sub-central level, simply transferring them to the rUK.

ii) Any extra taxes raised in Scotland are not shared with Westminster, or, they are not so during the extended period of non-adjustment during the 'Holtham interlude'. If it were otherwise the incentive to use tax policy to increase the Scottish tax base (size of the economy) is diluted. For example, if Scottish taxes were set to finance 40-percent of the Scottish Parliament's spending, for every extra £1 of Scottish tax revenue 60-pence would be sent to Westminster.

iii) Likewise, if the Scottish Parliament's tax policy led to a smaller tax base (a shrinking economy), it should have to live with that during the extended period of non-adjustment. If it were otherwise, a moral hazard would be imposed on the rUK, namely, that Scottish tax policy is a riskless exercise for MSPs and voters.

iv) Borrowing by the Scottish government should be:

a) Limited in amount – as several proposals suggested, with the proviso that borrowing could be increased during a generalized UK economic downturn.

b) Allowed only for capital projects (except in a generalized UK economic downturn) so that repayment is sustainable.

c) Subject to a no-bail out clause so that borrowing can be disciplined by financial markets.

We turn next to examine the several proposals listed as 1 to 8 above to see how consistent they are with creating a HBC for the Scottish Parliament properly to operate under. At the end of these examinations we restate our own recommendations.

1) The Barnett formula

The Barnett formula still governs public spending by the Scottish Parliament, and it would do so into the indefinite future in the fiscal devolution plans of the Scottish Labour Party. The Scottish Liberal Democrats also foresee the Barnett formula being used for a short while after budget reform but then they would phase it out. The SNP says that the Barnett formula should be kept in any arrangement short of complete fiscal autonomy. We also note that Prime Minister David Cameron, ex-Prime Minister Gordon Brown and shadow Chancellor Ed Balls have also stated that Barnett should be kept in a new devolution settlement. They are wrong.

The Barnett formula is an extreme example of a soft budget constraint (SBC), the very opposite of the HBC Scotland needs.

Under the Barnett formula - initiated in 1978 - Scottish Parliament spending, S, equals the difference between taxes raised in Scotland, T_S, less taxes, T_{-W}, sent to Westminster (more strictly the Consolidated Fund), plus Barnett funds, F, transferred to Scotland. Or,

$$S = T_S - T_{-W} + F. \qquad (1)$$

Thus, under Barnett all income and expenditure taxes, as well as some other taxes (such as betting tax) collected in Scotland (T_S) are transferred to the Consolidated Fund, meaning that Scottish Government spending is financed just by the Barnett block grant.

As Hallwood and MacDonald (2006a) show, it is the absence of tax issues in Scottish Parliamentary deliberations that makes Barnett a soft budget constraint. Thus,

a) With Barnett, as the Scottish Parliament does not have to be concerned with tax policy at all (save for the never used and now defunct plus/minus 3-percent 'tartan tax'), questions that are the essence of fiscal policy and tough decision-making never come up. The Scottish Parliament never has to ask:

'Is it worth raising more taxes to finance more government spending?',

or,

'Is it worth cutting Scottish public spending to be able to cut Scottish tax'?

But with a HBC these are real questions when politicians have to make decisions involving very real trade-offs between i) more spending and the political cost that comes with it - more taxing; and ii) the political benefit of less taxing with the cost of less spending.

b) With Barnett it is not in the Scottish political domain that the size of the Scottish tax-base (from which taxes are collected) matters for the long-run prosperity of Scotland and so the future levels of public spending. No thought has to be given by the Scottish polity to whether tax policy can be used to promote work-incentives or entrepreneurship. The size of the Scottish tax-base needed to finance increased spending in the future is neither here nor there.

c) With Barnett, if taxes raised in Scotland happen to fall, the Scottish polity does not have to be concerned with balancing the budget by cutting the level of public spending.

d) With Barnett, the Scottish polity does not have to risk the wrath of voters by raising tax rates (rather than cutting its spending).

e) With Barnett, the Scottish polity does not have to think about increasing its borrowing by issuing tradable securities against future tax revenues.

It is for all of these reasons under the Barnett block grant system the Scottish Parliament is most unlikely ever to have to worry about the balance of public and private spending in Scotland both in the present or over time – the size of the Scottish tax base from which tax revenues are drawn just doesn't matter to politicians that can only be elected and re-elected on what the voters think of their spending choices.

So it is that the absence of a HBC for the Scottish polity also means that there is the same absence for the voters. All the voter has to decide on is which politicians offer them the best spending policies. This is not a proper fiscal system in which politicians have to offer a combination of spending and taxing policies.

The Barnett block grant system should be eliminated to be replaced with one that does not contain automatic annual block grant increases. Also, the hardness of the budget constraint, and the advantages it brings for tax-payers across the UK, is increased the smaller is the block grant relative to own-sourced taxes. But to repeat, as we see the UK continuing as a ‘welfare union’ we are not in favor of a ‘no block grant system’, only one with a built in system of an ‘inelastic’ block grant within the period of the “Holtham interlude”.

2) The budget constraint proposed by the Calman Commission (2009) and in the Scotland Act (2012)

The Scotland Act, 2012, is clear about what it wants to achieve with respect to income taxes. Paragraph 26 (2B) says that (from April 2016): “The basic rate, higher rate and additional rate for a tax year on the non-savings income of a Scottish taxpayer is to be found as follows. Step 1 Take the basic rate, higher rate or additional rate determined [by Westminster]. Step 2 Deduct 10 percentage points. Step 3 Add the Scottish rate (if any) set by the Scottish Parliament for that year”. Then the Scottish Government obtains for its own use the taxes gathered from the Scottish income tax rate as determined by Step 3. These are “own sourced taxes” and they are expected to increase fiscal discipline as the Scottish Government’s spending is now linked to the discipline of raising taxes from Scottish taxpayers.

However, the Scotland Act, 2012 leaves undefined as to what happens to the block grant – the words, “block” and “grant” do not appear in the legislation. This is as in the Calman Commission (2009) proposals that underpinned the 2012 Act. The Calman Commission said that it was beyond its remit.

However, Recommendation 3.4 of the Calman Commission reads:

> "The block grant, as the means of financing most associated with equity [between regions in the UK], should continue to make up the remainder [i.e., 83-pecent] of the Scottish Parliament's Budget but it should be justified by need. Until such times as a proper assessment of relative spending need across the UK is carried out, the Barnett formula should continue to be used as the basis for calculating the proportionately reduced block grant."

The Office of Budget Responsibility (2012) underlines this lack of commitment to a new policy on the block grant noting that: "The eventual decision on the method for adjusting the block grant will be a matter for the UK and Scottish governments" (paragraph 1.8).[3]

It is really quite odd that, despite this lack of clarity over the future of the block grant, the Calman Commission claimed that: "we are clear that real financial accountability is achieved" (paragraph 3.181). It is odd because without pre-determining what happens to the block grant as Scottish own-sourced taxes rise or fall, it is simply unjustified to make this claim.

Thus, will fiscal failure (e.g., spending own-sourced taxes in a way that unjustifiably reduces work incentives) be rewarded by a larger block grant (apparently, yes, if the "needs" referred to in Calman don't also happen fall)? Alternatively, will fiscal success be rewarded by a smaller block grant (again, possibly, yes, if "needs" remain unchanged and Scotland is able to finance an increasing proportion of these needs out of its own-sourced taxes)?

Under these circumstances - tax policy success rewarded with a lower block grant and tax policy failure with a larger block grant - in terms of equation (1), the only difference that Scottish own-sourced taxes would make is that Scottish taxes transferred to the Consolidate Fund, T_{-W}, would be reduced alongside an equal reduction in block grant funds, F, transferred into Scotland.

[3] Office of budge Responsibility, *Forecasting Scottish Taxes*, March 2012. http://budgetresponsibility.org.uk/wordpress/docs/Forecasting-Scottish-taxes.pdf

If this was the case there is again no incentive for the Scottish Parliament to worry about tax policy or the tax costs of its spending policies. Only if the Scottish Parliament got to enjoy incremental net revenues would it have any real interest in using tax policy to benefit the Scottish economy; similarly, a HBC would require that any failure on tax policy *not* be automatically offset by a larger block grant.

3) Scottish Labour Devolution Commission proposals

The Scottish Labour Devolution Commission (2014) open by noting that it is impossible to close the fiscal gap to zero unless Scotland were independent. So they are about balancing the accountability of the Scottish Parliament to its voters so that they have a stake in the success of the Scottish economy – i.e., to get the extra revenue if it successfully grows the economy. Scots should also share in the rest of the UK resources so that all can enjoy similar levels of prosperity and be guaranteed the same rights such as free health care at the point of need. Scottish Labour proposes giving the Scottish Parliament powers to raise around £2 billion more in revenues in addition to the Scotland Act (2012), so raising about 40% of its budget from its own resources. Thus there would be 60-40 percent split between, respectively, a block grant and own-sourced taxes (pages 65-66).

The main way own-sourced taxes would be increased is by widening the variation of income tax by half (relative to what is in the Scotland Act, 2012) from 10 pence to 15 pence so that ¾ of basic rate income tax will be under the control of Scottish Parliament.

Scottish Labour also proposes introducing a Scottish progressive income tax rate in the higher income tax rate bands, but there would be no powers to reduce those rates relative to what was already set by Westminster.

Scottish Labour also says that VAT, national insurance contributions, corporation tax, alcohol, tobacco and fuel duty, climate change levy, insurance premium tax, vehicle excise duty, inheritance tax, capital gains tax and tax on oil should remain "reserved" – they would continue to be set at Westminster.

As to the block grant from rUK the Scottish Labour Devolution Commission plans to keep the Barnett formula saying:

> "As we made clear in our interim report, the Barnett formula should remain as the funding mechanism for public services in Scotland. Under our proposal, as is the case under the Scotland Act [2012], the Barnett grant will be reduced to take account of the fact that the Scottish Parliament will have a revenue stream of its own. As a result the Scottish Parliament will be funded partly by grant calculated under the Barnett formula and partly by its own resources – principally Scottish income tax payers" (p 16).

Scottish Labour argues that these proposals ensure the appropriate balance of fairness, accountability and efficiency.

Scottish Labour and the HBC

The greatest weakness in the Scottish Labour proposals is that they do not address the issue of a HBC. At best, the matter is fudged. They repeatedly (but implicitly) imply that the budget constraint would be soft (in a sense the hard budget constraint will always be overruled by the risk pooling/ revenue sharing objective): if own-sourced tax funding plus the block grant became inadequate to finance Scottish public spending it would be made good by increased funding from the rUK. For example, it is asserted that "The UK is a 'sharing union', with economic, social, and political aspects, in which risks and rewards are collectively pooled" (p. 11). Later it is asserted that "welfare benefits are the key instrument of social union" (p 136); that "Barnett … provides stability in levels of public funding, and so public services" (p 139); that a tax programme should include "constancy in fiscal-policy making and the way fiscal policy impacts the economy" (p 141); and that there is a "need to retain a shared taxation base with the UK to ensure social solidarity and a minimum level of public service provision across the country" (page 146-147).

It is easy to see that the Scottish Labour (2014) proposals are not a design for a HBC but an outline of a social programme - they say that the Scottish tax system should 'support aspirations', 'promote a green economy', and have 'flexibility to fund public expenditure' (all quotes page 141).

Nor is any consideration given to using the tax system to raise the tax base by promoting economic growth; rather it is repeatedly asserted that tax competition is a bad thing – especially in rates of corporation tax and at the higher rates of income tax.

How much difference would it make that the proposed block grant would drop from 100-percent of spending to 60-percent? Since Scottish Labour say nothing about this, especially not with respect to a HBC, here are some scenarios:

1) If Scottish Labour means what it says "the Barnett grant will be reduced to take account of the fact that the Scottish Parliament will have a revenue stream of its own", then the incentives to take measures to increase the Scottish base and increase taxes collected in Scotland are weak because each extra pound of tax revenue would be off-set by one less pound of block grant. To make the incentives sharper what is needed is a clear statement – which is not made - that each extra pound of tax revenues collected in Scotland will remain with the Scottish Government for the financing of extra spending or reduction in Scottish tax rates.
2) It is never made clear by Scottish Labour what it means when it refers to a 60-40 percent split between block grant and own-sourced taxes? If they mean that it is to hold through

time then there is a perverse incentive to increase the Scottish tax-base and taxes collected in Scotland as that would mean larger block grants! It is hard to believe that anybody would argue for that, not least because it runs against the grain of the 'welfare union' - a Scotland that anyway starts off with relatively high per capita income in the UK would be in receipt of larger and larger block grants financed by the rUK.

3) While the latter is too extreme to be realistic – it is just an example of Scottish Labour's lack of clarity, under the Barnett formula, Scotland would anyway be receiving ever larger block grants as public spending in the rUK increased. Thus, it could be that if the Scottish Government took measures successfully to increase the Scottish base and tax collections this source of public funding would be supplemented by a growing block grant. This too seems to run against the grain of a 'welfare union' for the reasons just stated. Moreover, better than risk some future less favorable block grant formula it is quite easy to imagine that Scottish Governments would not risk taking measures to raise the Scottish tax base and tax collections. That is, as under the Barnett formula, even as adjusted in the Scottish Labour document, there is a strong incentive not to introduce growth promoting fiscal policies. These are anyway risky – they may not pay off and could be politically unpopular – and if they did work, could end up being rewarded with a smaller block grant.

4) The Holtham Commission

One year after the Calman Commission made its recommendations the Holtham Commission (2010) made recommendations for tax devolution to Wales. Its deliberations are relevant to the Scottish case given that the Scotland Act, 2012, and Scottish Labour's proposals have so many unresolved issues.

Like the Calman Commission, the Holtham Commission emphasized a "needs-based funding regime" (paragraph 2.19, page 12) for the Welsh Assembly Government.

Yet the Holtham Commission also set the principle that "the Welsh budget should *not* be protected from Welsh *policy risk*, i.e. changes to the tax-base arising from decisions of Welsh Ministers should have their budgetary impact in Wales" (paragraph 5.8, page 47). This means that the Welsh Assembly Government would keep for its own purposes 100% of any extra tax revenues it generated from changes in its tax rates with no reduction in the block grant. Also, any reduction in tax revenues due to a reduction in its tax rates relative to those in England would also be borne by Wales with no increase in the block grant.

The policy of a needs based fiscal regime and Wales bearing its own policy risk are conflicting because if Welsh own-sourced taxes fell Wales would not be able to meet its "needs" – assuming them to be unchanging - out of the sum of block grant and own sourced taxes. But Holtham has a very neat answer to this – as we are about to see.

Similarly, an increase in Welsh Government Assembly revenues relative to "needs" may also be problematic because English taxpayers could well ask why they should pay the same block grant to Wales when the Welsh Government Assembly had more than sufficient revenues to meet Welsh "needs".

It is arguable therefore that the proposed policy of tax revenue changes due Welsh Government Assembly tax policy being incident on Wales is a politically non-viable. Rather, if "needs" are emphasized, lower Welsh tax revenues would be off-set by larger block grants.

In fact, the Holtham Commission brilliantly recognized that its two priorities – financing of 'needs' and the effects of Welsh tax policy being incident only on Wales - were contradictory; to have one is not necessarily to have the other. The Holtham Commission resolved this contradiction by recommending infrequent changes in the size of the Welsh block grant - every 12 or 15 years, irrespective of whether the Welsh tax-base was growing or shrinking. This is the "Holtham interlude".

Under such a regime, should Welsh own-sourced taxes fall they would not be immediately balanced by an increase in the block grant and Welsh citizens would suffer the consequences. And should Welsh own-sourced taxes increase, the block grant would not be immediately reduced and Welsh citizens would enjoy enhanced levels of public spending.

The most important aspect of this arrangement is that, at least during the 12 or 15 year interval, it amounts to a HBC with the "needs" principle effectively sacrificed to the "Welsh tax policy incident on Wales" principle. The "social solidarity" so evident in the proposals of Scottish Labour is there, but in the long-run.

5)The Scottish Liberal-Democrats Commission

The Scottish Liberal Democrats Commission (SLDC) on devolution builds on the Steel Commission (2006) report – that favourably cites our early work. They propose a version of 'Home rule' for Scotland within a reformed, federal United Kingdom. By home rule they mean that the Scottish Parliament would have control over most aspects of Scottish domestic affairs, including responsibility for raising the finance for the greater part of its own spending, but with welfare and pensions (as well as defence) provided by the Westminster.

To quote from the SLDC's document:

> "The plans would allocate permanently to the Scottish Parliament control of the rates and bands of income tax, capital gains tax, inheritance tax and air passenger duty. Together with the proceeds from corporation tax this would give the Scottish Parliament the authority over taxes on income and wealth and raise 60 per cent of what it spends" (p 7).

The SLDCs rightly see this as a radical transfer of powers in a new system of fiscal federalism within the UK; and that "The plans would keep intact the UK single market, vital for jobs, and the social welfare union, crucial for people saving for retirement. Importantly, they would open up choices to be made in Scotland about the kind of country we should be" (page 7-8).

The Scottish Liberal Democrats proposed budget constraint

Under the Scottish Liberal Democrats proposals the budget constraint faced by the Scottish parliament becomes:

$$S = T_S - T_{-W} + F + B,$$

where B is borrowing (set at a maximum aggregated limit of £1 billion) is to be used to cushion spending in a cyclical downturn, that is, to maintain S even as T_S falls. The other terms have the same meaning as before. The share of own-sourced taxes in Scottish Government spending (T_S-T_{-W})/S would be about 55-percent or so. This is a good deal higher than that of Scottish Labour set at about 40-percent. Also, fiscal transfers from Westminster, F, would ultimately change over from being set by the Barnett formula to being "needs based".

How hard is the SLDC's budget constraint, what incentives does it give to Scottish voters to elect Scottish governments committed to adopting policies to raise the Scottish tax base by promoting economic growth; and what incentives does it give to MSPs to offer such growth promoting policies?

As all income tax collected in Scotland is to be retained there and that income tax is the largest single source of tax revenue it offers a strong incentive to grow the income tax base as it could lead either to greater public spending in Scotland or to lowered income tax rates.[4] Either of these is likely to be a vote winner.

Moreover, the Scottish Liberal Democrats refer favorably to the Holtham Commission and as we have seen the latter suggests a 12-15 year HBC. That is, any adverse consequences of Scottish fiscal spending or taxing policies will not be bailed out by the rUK immediately, and SCG will have to bear the policy risk for that extended period of time.

What is not absolutely clear in the Scottish Liberal Democrat's recommendations is how the needs assessment will operate. If the rUK were to finance 100-percent of these needs that would mean that the Scottish Government would have little fiscal interest in adopting policies to reduce them – which means that the rUK would bear the policy risk for policies it was not responsible for. The important thing here is how much of its "needs" will Scotland have to finance out of its own-sourced taxes. If this a high percentage it would incentivize the Scottish government both to adopt policies aimed at reducing the "needs" as well as policies aimed at raising the tax base to make them easier to finance.

The opposite would be true if Scotland was required to finance only a small percentage of its needs, as it would not benefit fiscally from reducing them and would not have the incentive to grow its tax base to finance them. The SLDC really should have offered more detail on these matters.

(6) The Scottish Conservatives

The Scottish Conservative Commission (2014) (the Strathclyde Commission) identify a so-called fiscal gap (or vertical imbalance) and note, as others have noted, that this is large in the Scottish

[4] To be given "powers over income tax, bands and rates" (2012, page 10). Recommendation 15: Income tax paid by Scottish taxpayers should be almost entirely the responsibility of the Scottish Parliament.

context since although the Scottish Government has control over more than 60% of identifiable public spending it is only responsible for raising a small fraction of that amount. Closing the fiscal gap through fiscal devolution they argue would create a more responsible politic. Their main proposal is that the Scottish Parliament should be responsible for setting the rates and bands of personal income tax in Scotland. Income tax on investment and savings should remain in the UK to safeguard the integrity of the UK's single market in financial services. The personal allowance should be set for the whole of the UK. In the interest of brevity we footnote other Scottish Conservative proposals.[5]

The Scottish Conservatives proposed budget constraint

The proposals of the Scottish Conservatives (2014) are clearly informed by the idea that tax systems are about the revenue side of government policy while commitments to public spending programmes are on the other side of the ledger. With this clarity they call for a HBC on spending by the Scottish Government. Thus,

> "While block grant adjustments will always be complicated, we need to ensure that devolved policy choices have a direct link to the money available to the Scottish Exchequer. It must be the case that good governance and policies that drive prosperity are felt by the population that elected those decision makers. Otherwise all efforts to establish fiscal accountability are wasted. It must be a condition of any further fiscal devolution that a robust and stable long-term mechanism is devised, which will demonstrate a clear link between Scottish fiscal policy choices and expenditure in Scotland.

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[5] The Scottish Conservatives argue that a share (left undefined) of VAT should be assigned to Scotland. National Insurance (both employees and employers parts) should not be devolved if the social security system is to continue to operate at a UK wide level and provide the same benefits to all. Corporation tax should not be devolved since it relates to activity that can easily be transferred across borders and it is highly volatile and does not give a reliable yield. Capital gains and inheritance taxes are not high yielding taxes and they are seen as not being suitable for devolution.

Smaller taxes bundle such as air passenger duty; climate change levy, excise fuel and vehicle duties etc. are also considered but these total less than 10-percent of UK tax revenue. Some also relate to activities that are highly mobile (e.g., fuel duty and betting duties) and so should not be devolved. Air passenger duty should be devolved.

The Scottish Conservatives Commission note the volatility of North Sea oil revenues - £10bn in 2011/12 to £5.5bn in 2012/13 mean that this is better smoothed by the whole of the UK and so it is unsuitable for devolution.

This is coming close to a 'no bailout clause'. Scottish governments can enjoy higher tax revenues if they can create them; but if they adopt policies that denude the Scottish tax base then they will suffer the consequences. This is the nature of a HBC.

However, the Scottish Conservatives do imply that block grants could be adjusted but only after a delay during which the consequences of tax policy are felt. This idea squares with the "Holtham interlude". The Scottish Conservatives proposal has the attractive feature of combining a HBC in the medium term with maintenance of the 'welfare union'.

The Scottish Conservatives are also in agreement with the Scottish Liberal Democrats in that:

> "'Income tax paid by Scottish taxpayers should be almost entirely the responsibility of the Scottish Parliament'. The Devo Plus group has likewise stated that the Scottish Parliament should have "the freedom to set the rates across all bandings of income tax in Scotland". And the IPPR have found that 'The case for outright devolution of personal income tax … is a strong one'. We agree: the Scottish Parliament should be responsible for setting the rates and bands of personal income tax in Scotland" (2014, page 13).

Finally, pension and social security financial provisions should remain at the UK level. If Scotland wants to be more generous than that, it should finance them itself.

(7) The Scottish National Party.

The SNP's (2014) proposed fiscal powers for the Scottish Parliament are contained in four key points: The Scottish Parliament should have 'full fiscal responsibility' in that all tax revenues should be retained in Scotland unless there is a particular case for continued reservation. In their view the Scottish Parliament should have full fiscal autonomy with control over income tax, national insurance, corporation tax, capital gains tax, fuel duty, air passenger and inheritance tax. Under EU legislation, VAT and some excise duties would be reserved taxes. However, although such taxes would not be devolved, the SNP's favours 100-percent assignment of such reserved taxes.

Additionally the SNP propose that the Scottish Parliament should be responsible for all domestic expenditure, including welfare spending and would only make payments for reserved matters (defense and foreign affairs) to the UK government. They also argue that to have a sustainable framework for public finances would require the 'necessary borrowing powers'. In any agreement which falls short of full fiscal responsibility, the SNP argue that the Barnett formula should continue to be used to determine Scotland' resources during any transitional period[6] and that the formula should be adjusted 'appropriately according to the actual degree of fiscal responsibility'.

The SNP's proposed budget constraint

While the SNP's budget constraint is hardest of all - all spending is financed out of own-sourced taxes, it does not allow for a 'welfare union' because transfers from Westminster will be phased out. Moreover, as during the referendum debate it was made clear that a Scotland-within-the-sterling-area would have limited borrowing powers, that particular welfare-shock absorber would also not be available.

It is interesting to note that the SNP emphasize the macroeconomic framework in which their policy is embedded. Specifically, it will be embedded in the sterling zone monetary union with exchange rate and interest rate setting being reserved matters, and financial stability would also continue to be delivered across the United Kingdom by the Bank of England. Perhaps most tellingly they note: "Scotland would use its greater tax, spending and borrowing powers within a

[6] The SNP accept that the transition to full fiscal responsibility will take some years to complete, as implementation of the Scotland Act 2012 has demonstrated.

sustainable overall fiscal envelope guaranteed by clear rules and procedures to ensure affordability".

8) The Scottish Greens

In general terms the Scottish Green party (2014) argues that the Scottish Parliament and local authorities should have the power to design and raise the majority of their own taxes and therefore fund the majority of their own spending. More specifically, the SGP argues for the devolution of taxes which can easily be made progressive, those based on immovable assets, such as land and property, and those which are intended to achieve behavioral changes such as environmental and resource taxes. The Greens argue for the full devolution of income tax in terms of rates, bands reliefs and personal allowances. Taxes levied at a flat rate such as VAT and corporation tax should not in their view be devolved but could have a percentage of the revenue assigned. The Greens recognize the importance of the pooling and sharing of resources stressed by Better Together during the referendum campaign. They suggest the block grant should be retained and set by a yet to be agreed formula.

With respect to borrowing powers, the Scottish Greens argue that the Scottish Parliament needs the freedom to make its own borrowing decisions, 'without the need for approval given or limits set by the UK Government'. However, the latter could very well be inconsistent with macroeconomic policy set for the whole of the UK; and it would somehow have to be subject to a 'no bailout' clause so that financial markets in no way come to believe that the rUK would come to the rescue in the case of default.

Our proposals

The budget constraints offered by the Calman Commission, the Scotland Act (2012) and Scottish Labour (2014) are very weak and will impose little fiscal discipline on the Scottish Parliament because the block grant received from Westminster is too elastic. We say this not necessarily because there is no scope for a growth promoting tax policy rather that in the 'welfare union' they envisage penalties for failure are few. In these proposals it is implied that in the case of failure the UK government would smartly step in with a larger block grant. The rUK would bear the policy risk for decisions that it had no part in making.

To create a HBC for the Scottish Parliament what are needed is a high proportion of retained taxes and an inelastic block grant.

With respect to the latter, the Holtham Commission clearly sees the need to leave policy risk residing with the decision-makers at the level of sub-central government. Only after a long delay (12-15 years) would mistakes be rectified with larger block grants from the center so maintaining the 'welfare union'.

For any system of financing sub-central government, if spending and tax policies are to be disciplined – the budget constraint is hard – the consequences of fiscal policy have to reside at that level of government and that level of voter. However, there is a desire to maintain the UK as a 'welfare union', and this is the main reason for maintaining fiscal transfers from the center to sub-central government. Given these transfers, a budget constraint can still be hard so long as the transfers are not managed in a way that provides an automatic offset to policy failures at the sub-central level.

The budget constraints offered by the Scottish Liberal Democrats, the Scottish Conservatives and Scottish Greens are hard enough to be given serious consideration. They imply much less immediate transfer of policy risk away from the Scottish Parliament to the rUK. As such they will concentrate minds in Scotland – of government and voters – on what can work at the fiscal level to promote prosperity in Scotland. The fiscal proposals of the SNP are the hardest of all, but they do not allow for continuation of the welfare union.

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