

Additional Evidence on Scotland Bill and Fiscal Framework by Anton Muscatelli, University of Glasgow

Introduction.

I had been asked to provide the Committee with commentary on the Fiscal Framework, had negotiations been completed between the UK and Scottish governments. At the time of writing agreement has not been reached, although the press is reporting that the negotiations are progressing. I have therefore focused on providing some comments on what might be negotiated in the framework, as far as that is discernible from public commentary.

I will focus my attention on the block grant adjustment mechanism as this seems from press reports to have been the main, or most reported, area of dispute. However, the other aspects of the framework are also important, as I set out in my presentation to the Further Powers Committee (see

http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/Inquiries/devolution_committee_-_AM_-_Final.pdf). In particular the limits placed around borrowing for capital, the margins for revenue smoothing, the estimation of assigned VAT, the costs of administration of the additional powers, and the governance of the framework.

However, the block grant adjustment (BGA) mechanism for the devolution of additional income tax powers seems to be at the centre of much of the debate, and this has been echoed by press reports (eg see <http://www.bbc.co.uk/news/uk-scotland-scotland-politics-35522587>).

The position, as far as one can discern from public sources is the following: the Scottish Government has argued that the basis for the BGA should be the per-capita indexed deduction method (PCID). This method would give Scotland the incentive to grow its tax base relative to the rest of the U.K., but would protect Scotland against demographic risks in addition to those present through the Barnett formula. The argument is that anything other than PCID fails to meet the Smith Commission's first no-detriment principle, and would undermine the Smith commitment to maintain the Barnett formula as the cornerstone of the agreement. The U.K. Government would seem to be focusing on a levels deduction (LD) approach if one interprets what the BBC's Brian Taylor describes as 'Barnett formula for tax' (<http://www.bbc.co.uk/news/uk-scotland-35461963>) in this sense. The LD approach fits this description. The UK government's position seems to be that PCID does not meet one part of the Smith Commission's Agreement's second no-detriment principle, around 'tax-payer fairness'. This would imply, for instance, that an increase in UK government spend on devolved areas such as the English NHS, financed using devolved income taxation would unduly benefit Scotland through the Barnett formula as Scottish taxpayers would gain additional funding net of the BGA.

Slide 4 in my PowerPoint presentation

(http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/Inquiries/devolution_committee_-_AM_-_Final.pdf) sets out these two BGA methods and the Indexed Deduction (ID) method, a third method similar to PCID but which does not adjust for population changes.

I have argued in my evidence to this Committee and to the House of Commons Scottish Affairs Committee that PCID is the only method which satisfies the major aspects of the Smith Commission Agreement. The Smith Commission agreement placed Barnett at the centre of the fiscal framework. The LD (and ID) methods erode Barnett over time and violate the first no-detriment principle. They expose Scotland to additional demographic risk which we do not have the policy levers to offset as we do not control immigration policy. The current differential demographic trends between Scotland and the rest of UK as projected by the Office for National Statistics (ONS) are starkly different. As Figure 6 in my presentation shows, based on ONS population projections, the costs to Scotland of adopting LD instead of PCID would amount to a cumulative £7bn loss in real terms over the first 10 years of the Scotland Bill being enacted. Even with ID the losses would be very marked. Hence anything but PCID erodes Barnett and does not deliver Smith. Figure 5 from the paper by Bell, Eiser and Phillips 'Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options' is a good illustration of this effect. All other things

remaining equal, LD accelerates spending per capita in Scotland towards the levels in England. ID actually could erode the block grant even more. It is also important to note that PCID is not riskless for Scotland: we still have to grow our tax base as rapidly as the rest of the U.K in order to avoid an erosion of the resources available to us. But it exposes us to a risk we have levers to manage rather than demographic risk which we cannot readily manage.

Possible Compromises

Given these very different perspective what room is there to compromise in deciding on a BGA method?

The following are some possible approaches to developing a compromise.

First, as I suggested in my evidence to the House of Commons Scottish Affairs Committee one could modify PCID to address the 'tax-payer fairness' objection. (In passing, one should note that the tax-payer fairness issue is symmetric: it holds in reverse when the UK cuts taxes and spending, diverting resources towards rUK). The tax-payer fairness issue arises because Scotland's population share of the U.K. (used in Barnett) is higher than Scotland's income tax share as a proportion of the U.K. One could therefore modify PCID every time that the UK government changes income taxes to fund/reduce spending on devolved departments, such as the English NHS or schools. The block grant would be reduced by an amount additional to PCID if the UK government raised devolved taxation to increase devolved DELs (the reverse would happen if it cut taxes and spending). One could use the Barnett comparability factors to estimate the required additional reduction to the block grant. This method would be a way of modifying PCID by bringing in an element of LD, but without exposing Scotland to additional demographic risk. This modified PCID could satisfy all of the key no-detriment conditions of the Smith Commission agreement. It would be fair to both Scottish and rUK taxpayers. The only argument against it is that it adds a layer of complexity to PCID.

Second, one could use LD (or ID) but additionally set some 'insurance' or floor to the block grant if demographic risk is too high. This might be the compromise which the UK government has been suggesting judging from a recent newspaper opinion piece by the leader of the Scottish Conservatives Ruth Davidson MSP (see <http://www.thesun.co.uk/sol/homepage/feeds/NewsApp/newsapp-english/newsapp-english-scotland/6936141/Tory-leader-Ruth-finally-speaks-about-her-position-on-funding-for-Scotland.html>). In this op-ed she states that "...we could...have a transition period for a number of years where Scotland gets a guarantee that funding won't fall below a set amount...". Her suggestion is that one could then review this after a few years, which presumably corresponds to a parliamentary term or a spending review period.

A third possibility, similar to the second compromise, is that one takes an average of PCID and LD, thus exposing Scotland to some but not all the additional demographic risk. This would simply be a pragmatic political compromise, probably accompanied by an acknowledgement that the two governments cannot agree, and probably accompanied by a sunset clause which meant that this aspect of the fiscal framework would only apply for a single Holyrood parliamentary term. The fiscal framework would then be renegotiated. On current ONS population projections from Figure 6 in my presentation this might lose Scotland £250m per annum by 2021-22 if a 50-50 weight was applied to PCID and LD, or £50m per annum if a 90-10 weight was applied to PCID and LD.

In my view the first of these compromises is the most obvious choice. It corrects PCID slightly to address the UK government's concern over taxpayer fairness at a cost of a little more complexity to a spreadsheet calculation. It meets the Smith Commission agreement as closely as it possible to achieve. The second and third alternatives are problematic because they are ad hoc and they violate the first no-detriment principle in Smith. The second alternative is particularly problematic as it concedes the principle that LD or ID should be the basis for BGA at some point in the future, which undermines Barnett on which Smith is based. The third compromise, though basically just a bargain which 'splits the difference' might be acceptable if the sunset clause allows the issue to be revisited *ex novo* in the light of a fundamental disagreement between the two parties.

Obviously one can only speculate as to whether some of these possibilities have been or might yet be explored in the Joint Exchequer Committee.

In my view the first best compromise would be an agreement based around PCID, appropriately modified to account for taxpayer fairness. The second best compromise would be the third option: a political bargain for the short term, allowing a more principled evaluation of the BGA to be revisited after a period of time. The worst compromise would be to concede using LD or ID in its pure forms as the permanent cornerstone of the fiscal framework.

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