



**FINANCE COMMITTEE**

**AGENDA**

**14th Meeting, 2014 (Session 4)**

**Wednesday 7 May 2014**

The Committee will meet at 9.30 am in the Robert Burns Room (CR1).

1. **Scotland Act 2012:** The Committee will take evidence from—

John Swinney, Cabinet Secretary for Finance, Employment and Sustainable Growth, Alistair Brown, Deputy Director, Fiscal Responsibility Division, and Alison Cumming, Head of Tax Policy, Scottish Government.

2. **Scottish Fiscal Commission:** The Committee will take evidence from—

John Swinney, Cabinet Secretary for Finance, Employment and Sustainable Growth, Alistair Brown, Deputy Director, Fiscal Responsibility Division, and Alison Cumming, Head of Tax Policy, Scottish Government.

3. **Scotland's public finances post-2014:** The Committee will take evidence from—

Professor John Kay;

Professor Gavin McCrone;

Professor Peter McGregor, University of Strathclyde.

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The papers for this meeting are as follows—

**Agenda Item 1**

Note by the Clerk

FI/S4/14/14/1

**Agenda Item 2**

Note by the Clerk

FI/S4/14/14/2

**Agenda Item 3**

Note by the Clerk

FI/S4/14/14/3

## Finance Committee

14<sup>th</sup> Meeting (Session 4), Wednesday 7 May 2014

### Scotland Act 2012

#### Purpose

1. The purpose of this paper is to provide background to the Committee's evidence session with the Cabinet Secretary for Finance, Employment and Sustainable Growth (CSFESG) in relation to the implementation of the Scotland Act 2012 ("the Act").
2. Both the Scottish and UK Governments are required to bring forward reports under section 33 of the Act which set out progress on the implementation of the financial provisions. The [Scottish Government's implementation report](#) is attached. The forward to the report explains that it "sets out in summary the main areas of progress over the last year, and identifies key steps that remain to be taken in the year ahead". It goes on to note that this "will be the last such report before the devolved financial provisions in the 2012 Act are implemented". It is understood that the UK Government's report will be published on 6 May, once the UK Parliament returns from recess.
3. The first implementation reports were published in May 2013, on which the Committee took evidence from the CSFESG, HMRC and the Chief Secretary to the Treasury. The Committee published a report in October 2013 on [the implementation of the Act](#) in which it made a number of recommendations for consideration in relation to the ongoing work on implementation. The [Scottish Government responded](#) to the Committee's report in January 2014 and this is attached.
4. In addition to the evidence session on 7 May, the Committee is due to take evidence from HMRC on 14 May and the Exchequer Secretary to the Treasury on 11 June.

#### Scottish Rate of Income Tax (SRIT)

5. In its report on the implementation of the financial provision of the Act, the Committee made a number of recommendations or sought clarification from the Scottish Government on a number of issues relating to setting SRIT, the transitional period and forecasting and reconciliation of SRIT. The Scottish Government's response to the Committee's report addressed the points that had been raised. The Committee also indicated in the report that it would continue to monitor costs for the implementation of SRIT.

#### *Transitional Period*

6. The Committee has pointed out that it is unclear how the UK will bear the risk of a deviation from the forecast receipts for SRIT during the transitional period when there will not be a reconciliation with the actual forecasts. For example, if the parliament

agrees to an 11p rate and the forecast was pessimistic. It remains unclear as to why the Scottish budget would not be disadvantaged if the actual receipts for the 11p rate were higher than forecast.

7. The Committee also sought further details regarding how the reconciliation process would work in practice. The Government response stated that the details are still under discussion with the UK Government but that reconciliation will depend on the production by HMRC of audited accounts. It is not clear from the implementation report whether there has been any progress on this issue.

#### *Forecasting SRIT*

8. The OBR have now published five Scottish tax forecasts. The figures for SRIT from the most recent three forecasts are as follows:

#### **March 2013 – SRIT**

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	4330	4240	4246	4332	4649	4976	5308

#### **December 2013 – SRIT**

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	4310	4275	4250	4377	4652	4918	5218	5551

#### **March 2014 – SRIT**

Year	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	4331	4299	4271	4449	4668	4974	5286	5607

9. The OBR states that the “2011-12 SPI [Survey of Personal Incomes] was published in January 2014 and suggests that the Scottish share was 3.08 per cent in 2011-12” and that this was “higher than the 3.03 per cent assumed for the Scottish share in 2011-12 in our December forecast”.

10. In terms of the comparison between the December 2013 and March 2014 forecasts, the OBR explains that—

“Scottish income tax liabilities are higher in each year from 2011-12 onwards, reflecting the higher Scottish share and the stronger UK forecast from 2014-15. These offset the reduction in yield from the Budget 2014 measures and an adjustment related to the treatment of gift aid repayments.”

#### *Block Grant Adjustment Mechanism*

11. The mechanism for adjustment of the block grant in relation to SRIT has been agreed by the Scottish and UK Governments. This mechanism is based on the indexed deduction Holtham methodology.

12. In its report on the Scotland Act the Committee asked whether the indexing of the block grant adjustment will take into account relative changes in population size. The CSFESG responded that he had “asked officials to give further consideration to this question” and that the details of a “no-detriment policy are also under consideration with HMT.” He stated that a further update would be provided in the annual implementation report.

#### *Implementation of SRIT*

13. The Scottish Government report highlights that one of the issues discussed and agreed between it and HMRC during the year is the approach that will be taken to advise Scottish taxpayers of the amount of SRIT that they have paid. The decision that has been taken is to provide annual information on the P60 form issues at the end of the tax year. The report states that this decision was taken by Ministers in correspondence. The report indicates states that the decision was taken after “consideration of options and their approximate costs”.

14. The report indicates that one of the options considered but ruled out was identifying the amount of SRIT on monthly or weekly payslips. The reasons for not pursuing this option are identified as—

- Relatively high costs to employers as a result of a large number of payroll systems requiring adjustment
- That this approach may not give an accurate picture of annual liability “since Scottish taxpayers’ status can change mid-year as a result of in- or out-migration or for other reasons.

15. HMRC has indicated that the overall estimated costs of implementation are likely to be below the level indicated in November 2010, “with the total cost in the region of £35 to £40 million” rather than the earlier estimate of £40 to £45 million. The Scottish Government states that costs to date amount to approximately £1 million of which £183,000 was incurred in 2012-13 and £790,393 in 2013-14. This compares with estimates in the previous report of £165,141 in 2012-13 and £1.5 million in 2014-15. The report notes that “SG officials working on the project believe that the activities giving rise to these costs were incurred on relevant project and programme work, and that the work was necessary to deliver the required outcomes”.

16. Draft Budget 2014-15 set out the following allocations for implementation of the Act—

Year	2013-14	2014-15	2015-16
Allocation (£m)	3.5	10	40

## **Block Grant Adjustment for the devolved taxes**

17. In his response to the Committee's report on the financial provisions of the Scotland Action, the CSFESG stated—

“I understand and share the Committee's concern about a lack of agreement on a method for calculating the block grant adjustment in respect of the devolved taxes. I remain committed to consulting the Committee on proposals and will do so as soon as some progress has been made between HM Treasury and the Scottish Government on this matter.”

18. When asked about the block grant adjustment for the devolved taxes at the Committee's meeting on 4 September 2013, the Chief Secretary to the Treasury stated—

“We hope to resolve the matter in the next few months. Clearly, that needs to happen because time is marching on.”

19. The Scottish Government report states that “The block grant adjustment in respect of the devolved taxes remains under discussion by Ministers”.

20. The Scottish Government observes that—

“The Scottish Government continues to believe that the position set out in the Command Paper...should be applied in a simple and transparent manner in line with the Command Paper. The UK Government believes that the initial adjustment should be subject to indexation”.

21. The Scottish Government states that it “wishes to agree the block grant adjustment as soon as possible” and that—

“We have written to HM Treasury proposing a settlement which we believe addresses the concerns of the UK Government, provides an equitable settlement for Scotland and unlike the UK Government's proposals does not amend the ratios used for the Barnett formula. We are hopeful of a successful resolution.”

## **Forecasts for the devolved taxes**

22. The forecasts for devolved tax receipts, against which the block grant adjustment will be calculated are those produced by the OBR. Issues in relation to the forecasts for LBTT and Landfill tax are considered below.

### *Forecasts – LBTT*

23. The Scottish Government has indicated that the financial impact of LBTT should be broadly financially neutral when compared with SDLT. During consideration of the

LBBT Bill a number of witnesses pointed out that the volatility of the tax may make this neutrality difficult to achieve.

24. The Committee stated in its Stage 1 report on the LBTT Bill that—

“If the block grant adjustment was calculated within six months’ time, then a five year average for the period 2010-11 to 2014-15 would need to rely on OBR forecasts for at least two, or possibly three of these years. The latest data available is for 2011-12, although 2012-13 should become available within the next 6 months. The Financial Scrutiny Unit have advised that on the basis of the currently available data and OBR forecasts, this would imply a block grant adjustment of £319.<sup>1</sup>”

25. With the outturn data for 2012-13 now available, the receipts for SDLT in Scotland for the six years up to this date are as follows—

Year	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
£ million	565	320	250	330	275	283

26. Another key consideration is the accuracy of the OBR forecasts. The changes in the forecasts in the three forecasts produced from March 2013 to March 2014 are set out below.

#### March 2013

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	323	348	372	410	456	509

#### December 2013

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	283	361	432	491	539	589	646

#### March 2014

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	283 <sup>2</sup>	367	456	500	541	580	621

27. The March 2014 forecasts a doubling of Scottish receipts from 2012-13 to 2017-18. In relation to this forecast, the OBR explain that this reflects a number of factors—

“Firstly, the expected pick up in house prices in Scotland. Secondly, although property transactions have picked up recently, they remain well below their longrun trend, providing scope for further growth. Finally, the combination of higher house prices and fixed nominal tax thresholds in the UK system will have

<sup>1</sup> <http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/61649.aspx>

<sup>2</sup> As noted in the Committee’s report on implementation of the Scotland Act 2012, this is an outturn figure.

a 'fiscal drag' effect with a higher proportion of transactions becoming subject to higher stamp duty bands."

#### *Forecasts – Scottish Landfill Tax*

28. There are no Scotland-specific figures for landfill tax revenues available from HMRC as revenue receipts are based upon reporting at a company level rather than by landfill site, and many companies operate cross the UK.

29. In its March 2014 Scottish tax forecasts, the OBR states that the DEFRA model for forecasting waste sent to landfill has recently been updated. The results of this model are provided to the OBR as part of the UK landfill tax forecast. The OBR states—

"The forecast now better captures the trend decline in local authority waste sent to landfill. This reflects less waste being generated and increases in the recycling and incineration of waste. We have incorporated the steeper decline in both the UK and Scotland forecasts."

30. However, it is not clear whether the OBR forecasts have also taken account of the Scottish Government Zero Waste Plan in relation to which, the Scottish Government has stated, "is highly likely the Scottish Government's Zero Waste Plan will see both the quality and type of material landfilled in Scotland change substantially, with far less material going to landfill and what is landfilled being largely inert materials."<sup>3</sup>

31. The three most recent OBR forecasts for Scottish landfill tax are set out below.

#### **March 2013**

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
£ million	99	95	104	105	105	108

#### **December 2013**

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	99	96	99	104	104	108	110

#### **March 2014**

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ million	100	111	117	109	100	98	101

32. For its March 2014 forecast, the OBR explains that the decline of waste going to landfill explains the fall in receipts towards the end of the forecast period but notes that near term forecasts are up compared to the December 2013 figures to reflect stronger than expected UK receipts for 2013-14. The rise in receipts in 2013-14 and 2014-15

<sup>3</sup> Scottish Government consultation on landfill tax (2012) Available at:  
<http://www.scotland.gov.uk/Publications/2012/10/3524/4>



“reflects the pre-announced rises in the standard rate of landfill tax of £8 per tonne in both years”.

33. In the Financial Memorandum of the Landfill Tax (Scotland) Bill, the Scottish Government indicated a forecast of a 74% drop in receipts, from £100 million to £26 million, between 2015-16 and 2024-25. It stated that “no allowance has been made for receipts from taxing illegal landfill at this stage”.

34. In evidence to the Committee on 2 April 2014, SEPA was asked about a possible indication of the tax yield that could be gained from new powers to tax illegal landfill. In response, SEPA gave an idea of the potential scale, stating—

“We are dealing with individual sites that might each have a seven-figure liability. It is very difficult to quantify, and it has not been quantified before because there has been no liability. However, we believe that we are talking about a multimillion-pound figure.”

## **Borrowing**

### *Capital Borrowing*

35. The Act gives Scottish Ministers a number of borrowing powers, including a power in relation to capital investment that would enable borrowing of up to 10% of the Capital DEL budget for each year with a statutory limit of £2.2 billion. The Scottish Government indicated in its Draft Budget 2014-15 that it intends to use this power to borrow £296 million in 2015-16.

36. Further to these powers, in February 2014, the Chief Secretary to the Treasury announced his intention to make an Order to allow Scottish Ministers to issue bonds, subject to the £2.2 billion limit.

37. The Scottish Government’s implementation report observes that the CST’s announcement “applied no other limitations to the quantum of borrowing” i.e. the 10% Capital DEL limit.

38. The report goes on to state—

“The Scottish Government's position is that it is happy for its borrowing to be subject to scrutiny by the Scottish Parliament and to operate within an agreed prudential borrowing regime, but that an arbitrary annual limit is not justified.

It is the view of the Scottish Government that the option of phasing borrowing - for example over a spending review - should be open to the Government. We wrote to the UK Government on 19 February 2014 seeking clarity over their current position on the annual borrowing cap and requesting it be removed.”<sup>4</sup>

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<sup>4</sup> Paragraphs 20-21

39. In addition to indicating the anticipated sum to be borrowed, Draft Budget 2014-15 assumes that: repayment of any borrowing will be over a period of 25 years, interest will be charged at a rate of 5% and repayments will cover both principal and interest from 2016-17 onwards.

40. The Committee's report on implementation sought clarification from the Scottish Government of why this period and interest rate had been assumed. In response the Government stated that—

“We will use capital borrowing powers to support investment in assets with long lifespans. By matching loan terms to the lifespan of assets, the Scottish Government will improve affordability by spreading the cost of repaying loans. The current NLF rate for borrowing over 25 years is 3.44%. However we chose to use a higher rate of 5% as a prudent estimate underpinning the projections in the draft Budget.”

41. When the CST appeared before the Committee in September 2013, the Committee sought clarification as to whether the Scottish Government and Scottish local authorities might be disadvantaged by not having access to the “project rate” which is intended to take forward particular major infrastructure projects. CST indicated that he would be happy to look at this point – as yet no clarification has been received.

#### *Parliamentary scrutiny*

42. The Cabinet Secretary wrote to the Committee in November 2013 in relation to changes to the Written Agreement and setting out details of the information that he intends to include in future draft budgets. In relation to borrowing, the Cabinet Secretary said—

“The Draft Budget would also contain information about the Government's plans for utilising the borrowing powers introduced in the Scotland Act including the purpose and rationale of borrowing and an annual update on the costs of repayment and the Scottish cash reserve.”

#### **Conclusion**

43. The Committee is invited to consider the above issues in taking evidence from the Cabinet Secretary.

**Catherine Fergusson**  
**Senior Assistant Clerk to the Committee**

**Finance Committee**

**14th Meeting, 2014 (Session 4), Wednesday 7 May 2014**

**Scottish Fiscal Commission**

1. In May 2013 the Cabinet Secretary for Finance, Employment and Sustainable Growth (CSFESG) stated his view that—

“Scotland will require an independent forecasting body that can provide independent assessment to the Government and the Parliament of what might be generated as a consequence of those taxes. I am considering how that would be established.”

2. Given this statement from the CSFESG, the Committee carried out a short inquiry from November to December 2013 into proposals for a Scottish Fiscal Commission. The Committee’s [report on this inquiry](#), in which it made a number of recommendations about the role, establishment and operation of such a body, was published in January 2014.

3. The Scottish Government provided a [response](#) to the Committee in April 2014, a copy of which is attached.

4. In his letter to the Committee of 13 November 2013, the Cabinet Secretary stated—

“A final decision has still to be taken about the precise arrangements for delivering an annual independent assessment of the Government’s forecasts as part of consideration about the role of the Scottish Fiscal Commission. However, I would envisage that such an independent assessment should be available for the Committee’s consideration each Autumn, with respect to the Draft Budget for 2015-16 onwards.”

5. The purpose of this session is to consider the Government’s response to the Committee and discuss with the CSFESG the next steps in establishing a Scottish Fiscal Commission in order to inform Draft Budget 2015-16.

**Catherine Fergusson**  
**Senior Assistant Clerk to the Committee**

**Finance Committee**

**14th Meeting, 2014 (Session 4), Wednesday 7 May 2014**

**Scotland's public finances post-2014**

**Purpose**

1. This paper provides copies of the written submissions that have been received from the witnesses who will be providing evidence at this meeting in relation to Scotland's public finances post-2014. The submissions received are attached as the Annexe to this paper.
2. The topics agreed by the Committee for these evidence sessions are—
  - taxation
  - borrowing
  - public sector debt
  - fiscal rules.
3. The Committee has also agreed to hold evidence sessions to specifically consider pensions and the Barnett formula.

**Catherine Fergusson  
Senior Assistant Clerk to the Committee**

**SUBMISSION FROM PROFESSOR JOHN KAY**

1. The idea of an independent Fiscal Policy Council, or similar body, has been under discussion in Scotland for several years now. There seems wide support for this idea, but an inability to advance it much beyond an idea. I believe it is important for Scotland, whatever the future constitutional arrangements, that some proposal of this kind should be implemented: and that the quality and credibility of any Scottish government's economic and fiscal policies would be enhanced as a result.

2. An analogy is often made between such a Fiscal Policy Council and a Monetary Policy Committee (or the similar bodies in other countries which operate under the auspices of the Central Bank) but there is more that is misleading than helpful in this analogy. A Fiscal Policy Council as I envisage it would not have any executive authority (such as the power to raise interest rates): such powers would usurp the proper role of Government and Parliament. Its purpose would, in essence, be to keep the Government honest, to provide Government and Parliament with the information and analysis needed to support capital and current expenditure decisions, and to convince lenders of the competence and integrity of Scottish government and the information about its activities which it discloses. This objective is particularly important if Scotland is to establish itself as a new borrower in international capital markets. The analogy with the Monetary Policy Committee is, however, useful insofar as it relates to the independence and status of the body and its independent analytic capability.

3. An FPC can perhaps best be seen therefore as a complement to Audit Scotland, undertaking at a macroeconomic level the work which Audit Scotland does at a microeconomic level in reviewing the propriety and value for money in individual components of public expenditure: in a sense the FPC would be the body which assured users that the government accounts taken as a whole provided a 'true and fair view'.

4. The purposes of an FPC would therefore be somewhat similar to those of the UK government's Office for Budget Responsibility. However in my view the OBR has been established too much as a body to give validation to what was formerly the forecasting operations of the UK Treasury, and too little as a body exercising the functions described in its title – the promotion of budget responsibility. It will be useful to have more systematic forecasting and analysis of the performance of the Scottish economy – and resource should be devoted both inside the Scottish government and in independent bodies to developing that capability – but this is a separate issue from the ones currently before the Committee.

5. Although there are some similarities between the requirements of public and private sector accounting, there are also important differences. The critical question is 'is the current level of public sector service provision sustainable at current levels of taxation?' Achieving an honest and comprehensive answer to this question requires analysis and answers in relation to most of the difficult issues underpinning questions of public finance, including

- are current debt and borrowing levels sustainable?

- what is the future cost of PFI and similar public sector “off balance sheet financing” exercises?
- what should be an appropriate balance between current and capital spending, and how should capital expenditure be accounted for?
- what will be the future cost implications of current pension commitments in the state scheme and to public sector employees?
- how are demographic changes likely to affect these costs? (and what will be their effect on other expenditure items which are sensitive to demographic factors, such as education and health expenditures?)
- to what extent are public sector deficits structural rather than cyclical?
- if Scotland were to receive a larger share of North Sea oil revenues, how should the budgetary impact be stabilised?
- what should be the planned maturity structure of Scottish debt?

6. If well designed and successfully operated, such an FPC could also provide a framework for better considered infrastructure planning within Scotland. In my view, there are three related problems here

- inadequate infrastructure spending in aggregate (partly due to the absence of the analytic framework described above)
- poor and piecemeal choice of projects, over influenced by lobbying, enthusiasm for pet projects, and opportunities for creative off balance sheet financing.
- poor management of large infrastructure projects.

7. Work by an FPC in these areas could complement the work of the Scottish Futures Trust, i complementing with macroeconomic analysis the microeconomic activities which are developed there. In my view, across the UK as a whole, justified dissatisfaction with the management of infrastructure has developed but the consequences have been focussed far too much on financing mechanisms and far too little on better project management.

8. On occasions like this, it is tempting to give too much attention to the design of institutions and too little to the problems these institutions are designed to solve. I hope the Committee will not treat the observations in this paper in that way. A Fiscal Policy Council should be regarded primarily as a way of identifying the issues and problems which require government and parliamentary scrutiny.

## SUBMISSION FROM PROFESSOR GAVIN MCCRONE

### **Independence and Devolution: The Economic Issues**

The following notes summarise some but by no means all the points made in my book *Scottish Independence: Weighing Up the Economics*, the second enlarged edition of which was published in March this year. I intended my book as an impartial analysis of the economic issues. The position I take is that Scotland could perfectly well manage as an independent country. It is even possible that it might eventually do better economically than remaining as a part of the UK; but this would depend on the wisdom or otherwise of the policies adopted by Government. There would however be major challenges, uncertainties and adjustments in separating from the UK. After more than 300 years of union and economic integration, it would be a mistake to assume that this could be done without cost or damage to the economy in the years following independence. There could be a loss of some key industries.

### **Taxation**

The latest edition of the Scottish Government's publication *Government Expenditure and Revenue Scotland* gives Scotland a slightly larger deficit in 2012-13 than for the UK as a whole – 8.3 per cent of GDP as against the UK's 7.3 per cent. This is including a geographical share of revenues from the North Sea and contrasts with the previous four years, when the Scottish deficit was slightly lower than that of the UK. These deficits are however unsustainable and action has to be taken to reduce them whether for the UK or for an independent Scotland. Onshore tax revenue is approximately equal to the average per head for the UK as a whole so that, with the inclusion of revenue from the North Sea, Scotland would be in surplus if it were not for its higher public expenditure, which is 11.5 per cent above the UK average per head. This difference amounted to £1,267 per head in 2012-13.

There is reason to doubt that these figures give a true indication of the scale of deficit Scotland would have if it was independent. In the first place the share of North Sea revenue would have to be settled in negotiation; and secondly the rate of interest that would have to be paid on the national debt would probably be higher with independence. This is simply because Scotland would be a new borrower on the market without the UK's default free record.

All of this points to a challenging fiscal situation with independence. In addition to this, work by the Institute of Fiscal Studies suggests that because North Sea revenues are expected gradually to decline and Scotland has the disadvantage of a population ageing more rapidly than for the UK as a whole, the years ahead could become even more difficult.

### **Public Sector Debt and Borrowing**

It is not clear at present how much of the UK's public sector debt Scotland might be expected to take on. A population share of the UK's net debt in 2014 would be about £100 billion and there have been indications that this would be acceptable to the present Scottish Government. The Scottish Government have however suggested that a much lower share of debt could be justified because of the massive oil revenues in the past, especially in the early 1980s. These, if apportioned to Scotland,

would have shown Scotland contributing substantially more than its population share of tax revenue. This, of course, raises the question why only go back to 1980? In earlier years, before revenue from the North Sea started, information is scanty, but such as there is would suggest substantial deficits, proportionately higher than for the UK as a whole, in the 1960s and 1970s. On the other hand the rUK Government after independence might press for the national debt to be divided by share of GDP. This would result in both countries having net public debt of around 80 per cent of GDP at the time of separation. Scotland would then have a larger share of the debt than if it was divided by population, since the GDP of the North Sea would raise Scottish GDP by 21 per cent and increase the share of debt accordingly.

One further point about the national debt needs to be made, since it has been largely ignored so far in the debate. Because of the Bank of England's programme of quantitative easing, the Bank now holds some 30 per cent of the UK's national debt in bonds that it has acquired simply by printing money. The interest paid on these bonds to the Bank is apparently returned by it to the Treasury. In effect this large amount of debt is costing the Government nothing. It is not clear what is to happen to this. The expectation was that when conditions improved, the Bank would gradually sell these bonds on the market. This would, of course, increase the cost to the Government, as it would no longer get the interest payments returned. Present economic conditions do not suggest any need for the Bank to sell this debt to contract the money supply. It may therefore just sit undisturbed with the Bank. It is possible that eventually a future Government may decide it is pointless paying interest on this debt only to get it back and decide that it should be written off. How this might affect Scotland's inherited share of the debt is far from clear, but this needs to be taken into account in any negotiations.

### **The Currency and Fiscal Rules**

More heat than light has been shed on the future for the currency if Scotland becomes independent. On the one hand the Scottish Government says that currency union with rUK would continue, that the Bank of England would remain the central bank for both countries; and that it would continue also to act as lender of last resort for Scotland as well as rUK. On the other, the Chancellor and spokesmen for the other two unionist parties have said categorically that this will not be acceptable. The Scottish Government's Fiscal Commission favours continuing currency union but makes it clear that agreement would be necessary.

The Scottish Government further argues that it will be easier to reach agreement after independence. Maybe. But I cannot see a future rUK Chancellor accepting an arrangement that made rUK taxpayers, in effect, guarantors of Scottish debt, whether Government debt or bank debt. Because of Scotland's much smaller size such an arrangement could not be reciprocal – Scottish taxpayers could not guarantee rUK debt. This problem would be eased but not eliminated if the major Scottish banks moved their headquarters to rUK and operated in Scotland through subsidiary companies separately regulated in Scotland, something I expect might happen anyway. Lloyds Banking Group (owner of Bank of Scotland) manages its business from London, although Bank of Scotland's office on the Mound is the official registered office. Royal Bank has the bulk of its customers in England, where



its trades principally as NatWest, and more and more it runs its business from London.

If in the end, despite all this, it were possible to reach agreement on a form of currency union, the disastrous events in the eurozone have shown that very tight constraints on fiscal policy should also be expected, as well, obviously, as no freedom in monetary policy. This would severely limit any Scottish Government's fiscal policy and the size of its deficit. I would also expect it to require avoidance of discriminatory taxation, which could affect competition for investment, such as a lower rate of corporation tax than in the rUK.

Spokesmen for the Scottish Government have suggested that if a currency union cannot be negotiated, Scotland would continue to use the pound anyway and might refuse to take a share of the national debt. This does not seem to me a plausible policy. Not many countries use the currency of another country over which they have no control. Those that do have no control at all over monetary policy, they have to run exceptionally tight fiscal policies to retain confidence and they require substantial reserves. Failure to take its share of the debt could be regarded as akin to a default, resulting in a loss of confidence in the markets. The lesson here is that, whatever Ministers may wish, the outcome will in the end be determined by the markets. It should be remembered that when Czechoslovakia split to form the Czech Republic and Slovakia, there was no referendum and it was not clear that the population of either country wanted a split. Both Governments certainly wanted to continue their currency union but lack of confidence in the markets saw substantial funds being shifted from Slovakia to the Czech Republic, which brought it to an abrupt end in less than six weeks.

My own view is that if Scotland becomes independent, it may, like Ireland in 1922, try to continue in monetary union with the rUK initially without a lender of last resort. But conditions are now very different from 1922, because of the much greater speculation and volatility in the markets. Financial institutions might find it necessary to move to rUK so that they still had the protection of the Bank of England. The situation would probably prove unsustainable before long and sooner rather than later a Scottish Government would find it necessary to set up its own central bank as lender of last resort, which would also have power to issue its own currency. This could be the restoration of the pre 1707 pound Scots, or indeed the merk, and it could be pegged against sterling initially on a one to one basis, as Ireland's currency was for a long time, which would reduce transaction costs. But its exchange value could, if necessary, be altered if economic conditions made this necessary, something that has not been possible for eurozone countries in trouble, to their great disadvantage. It would also allow some variation in monetary and fiscal policy, so long as these did not put pressure on the exchange rate for the currency.

The disadvantage of this policy would be that it could impose transaction costs on companies trading across the border, introduce risk to mortgages and pensions that were cross border and, even more serious, cause some of the companies that make up Scotland's large financial sector with over 100,000 jobs to consider whether they should move out of Scotland to where the bulk of their customers are.

## More Devolution as an Alternative

### Taxes and Welfare

In contrast to independence, where all taxes and welfare expenditure would become the responsibility of the Scottish Government and both would be likely over time to differ substantially from their counterparts in rUK, most proposals for increased devolution require a degree of alignment with policy in the UK as a whole. The issue then is how far powers can or should be transferred to the Scottish Government. Two areas of policy are particularly important – on taxation to provide greater accountability and the flexibility to vary policies more than at present; and on welfare or social security, the main area of policy so far not devolved, to satisfy perceived demands from the Scottish electorate for greater control. Welfare expenditure is not only important because it is an area of policy about which the electorate cares greatly, with surveys showing support for greater devolution, but also because it is by far the largest single category of public expenditure, greater than health and education combined.

I do not see why a large part of the responsibility for welfare should not be transferred to the Scottish Government and Parliament. So long as Scotland remains part of the UK, I do not think it would be acceptable to have different rates of old age pension or other benefits that are funded at least notionally by national insurance. I think that to have differing rates of national insurance, while possible, would raise a lot of problems and might be unacceptable to the population throughout what would still be one state. I also believe different rates for some benefits, which could encourage people to move to wherever rates might be more generous, should be avoided. But council tax benefit is already being devolved and housing benefit, which relates closely to the Scottish Government's responsibility for social housing, is an obvious candidate also, as are attendance allowance and carer's allowance, which relate to policy on health; other possibilities are TV licences for the elderly, winter fuel payments and industrial injuries benefit. Transfer of personal independence payments (the successor to disability living allowance) should also be considered. Together these items would amount to about a third of the Department of Work and Pensions expenditure on social security and, added to the expenditure for which the Scottish Government and local authorities are already responsible, would amount to over £10 billion or just under half of the total expenditure on social security in Scotland.

Devolution of power to raise taxes is probably not of so much concern to the electorate, but the absence of significant tax raising power, while having responsibility for the bulk of domestic expenditure in Scotland, gives rise to a lack of accountability for the Scottish Government and Parliament. The Scotland Act 2012, when fully implemented goes some way to remedy this. Together with the existing responsibility for business rates and council tax, it will give the Scottish Parliament responsibility for about 35 per cent of the revenue required to finance its expenditure.

This is a substantial transfer of responsibility, which, because it has not so far been implemented, has attracted little attention.

Transfer of responsibility for excise duties and fuel duties would have obvious attractions: excise duties on alcohol because of the relationship between alcohol and health, and fuel duties because a Scottish Government might want to alleviate the burden that high taxes on fuel impose on Scotland's remoter communities. But Calman, in considering this, fully explained the difficulties: excise duties are levied at point of production or import, not point of sale, and fuel duties would be difficult because the Grangemouth refinery, which supplies fuel to much, but not all, of Scotland, also supplies the north of England. Assuming the UK remains a member of the European Union there would also be difficulties under EU rules over different fuel duties within one member state. An EU derogation has been obtained that permits a lower rate of duty in the Scottish islands, but a different rate in Scotland from that in the rest of the UK would probably be ruled out for the same reason that differing rates of VAT are not permitted within one member state.

But it would still be possible to increase greatly the extent to which taxes raised in Scotland covered Scottish public expenditure. The point of devolving more tax raising power is not only to increase accountability, it should also be to make Scotland less dependent on the block grant from Westminster. Although few people probably understand it, many English commentators and MPs consider that the present Barnett formula arrangements provide a block grant that is too generous to Scotland. The Holtham Commission for Wales supported this view, while also arguing that the formula provided insufficient funding for Wales. This is likely to become an increasing source of friction between Scotland and the rest of the UK. In my book I have therefore proposed devolution of power to raise three quarters of the present income tax revenue, rather than half as in the Scotland Act; unlike some other commentators, I would not want to leave Westminster with power only over taxes that are regressive. I therefore do not support devolving the whole of income tax. I would also assign all the revenue from VAT, apart from the small percentage that goes to finance the EU budget, (VAT rates cannot be varied within one member state under EU rules). Together with transfer of stamp duty land tax, landfill tax and the other two taxes recommended by Calman but not so far implemented – aggregates levy and air passenger duty – this could give the Scottish Parliament and local authorities responsibility for raising revenue to cover well over half their expenditure, including the cost of the social security benefits referred to above.

This would involve a substantial reduction in the proportion of Scottish public expenditure financed by the block grant and would reduce the scope for friction between Scotland and the rest of the UK. The remaining grant would for the time being remain to be determined by some variant of the Barnett arrangements. Whether the formula is more generous to Scotland than is justified, when compared with other parts of the UK, can only be made clear if a proper needs assessment is carried out with a methodology that is acceptable to all parties. There are no proposals from the UK Government to do that. But increasing the proportion of the Scottish Government's expenditure funded by taxes raised in Scotland, along the lines proposed, would enable the Scottish Government to benefit from policies that

increased Scottish prosperity and also give greater flexibility in deciding those policies.

## SUBMISSION FROM PROFESSOR PETER MCGREGOR

### Scotland's Tax Policy post 2014<sup>1</sup>

#### Introduction and background

While the outcome of the referendum is, of course, uncertain it seems clear that future Scottish Governments will possess substantially enhanced tax powers relative to the current position. In fact, this is already inevitable given the Scotland Act, but all of the pro-union bodies proposals for further devolution in the event of a “no” vote that are in the public domain imply significant additional powers. Admittedly the Conservative Party’s proposals have not yet been revealed but further tax powers seem likely to be proposed (and it is at least conceivable that they could “out devolve” the Labour Party on taxation).

A “no” vote in the forthcoming referendum on Scottish Independence would immediately lay to rest one of the most controversial issues that has characterised the economic debate so far, namely the currency issue. Scotland would remain in a monetary union with the rest-of –the UK (RUK), which implies that the Scottish Parliament will have no greater influence on UK monetary policy than it does currently. However, even a “yes” vote would have similar (if less inflexible) implications, if the SNP Government’s preference for continued monetary union were satisfied, although in this case while the Bank of England would continue to set base rates the market would determine the risk premium associated with Scottish Government debt.<sup>2</sup>

What about fiscal policy, which relates to Government expenditures and revenues? Under all of the pro-union plans that are in the public domain, the Scottish Parliament would have comparatively limited influence on the overall fiscal policy stance: the difference between government revenues and expenditures (although limited borrowing powers are part of some proposals, and indeed will be a reality once the Scotland Act comes into force). Even under independence with continued membership of a monetary union with RUK, there would be significant restrictions on the aggregate fiscal stance (as the recent experience of the Eurozone suggests).

So both the **overall** monetary and fiscal policy stances will be constrained if any of the existing proposals for constitutional change are successfully implemented. Of course, the precise nature and extent of such constraints will vary among the current independence and pro-union proposals. While these differences are undoubtedly

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<sup>1</sup> This note draws liberally on joint research conducted with Patrizio Lecca, Kim Swales and Tobi Edmonds-Holley, of the Fraser of Allander Institute, Department of Economics and Strathclyde International Public Policy Institute, University of Strathclyde. The research is conducted with the support of the ESRC’s *Future of the UK and Scotland pre and post referendum* initiative, under the auspices of the *Centre for Constitutional Change*.

<sup>2</sup> I do not consider the case of a separate Scottish currency here since it is not a policy of any of the parties and Scotland. (This case also raises significant additional complications, which would require separate analysis.)

worthy of further detailed assessment, in the rest of this note I explore aspects of the proposals that constitute a kind of “**common core**”: these proposals are shared by the independence and pro-union bodies’ tax policy proposals. This common core naturally implies that the overall monetary and fiscal policy stances are effectively given.

### **The fiscal powers common to all proposals for constitutional change**

Under these circumstances is there anything interesting left for the Scottish Parliament to consider? The answer is, of course, an emphatic “yes”: there is the issue of the **level** at which **both** taxes and expenditures are set: restrictions on the overall fiscal policy stance effectively mean that taxes and expenditures have to move together.<sup>3</sup> If the Scottish Government wants to increase government expenditure, it will generally also have to increase taxes to finance the change. Similarly, any reduction in taxes would have to be matched by a reduction in government expenditure.

Of all the independence and pro-union proposals for further fiscal powers (that are so far in the public domain) the common core is in fact the Labour Party’s plans, since these are the most modest to date: all other parties propose plans that are more radical in terms of control over the income tax system as a whole and the set of taxes that will be under Scotland’s control. These plans would give the Scottish Government the ability to vary income tax rates by up to 15 percentage points on all rates across the board. (There would also be the ability to raise the higher rate to increase the degree of progressivity of the Scottish tax system.) These powers, **if used to their full extent** - of course, a big “if” - would allow tax rates to be moved together to change the current basic rate of income tax of 20% to 35%, a move significantly in the direction of the high tax/ high spend Scandinavian countries. Alternatively a basic rate of 5% could be introduced, creating a move in the direction of the low tax/ low spend Baltic countries.

In fact, the Scotland Act ensures that a significant proportion of the “common core” is currently already being implemented, since it provides for a variation in the Scottish tax rate of ten percentage points. Given that this is the only part of the core constitutional change which is absolutely certain to be implemented, it is perhaps worth exploring its likely effects further.

### **The likely impact of exercising greater fiscal powers**

Of course, no Scottish Party has yet signed up to use the new powers that they propose to effect radical change, or even to select a Scottish Rate of Income Tax (SRIT) that would result in anything other than parity with UK tax rates- the position that successive Scottish administrations have chosen to date. (This would require a

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<sup>3</sup> As we have already noted the tightness of this constraint will vary significantly among proposals.

SRIT of 10%, since the default position is a reduction in tax rates of 10 percentage points.)

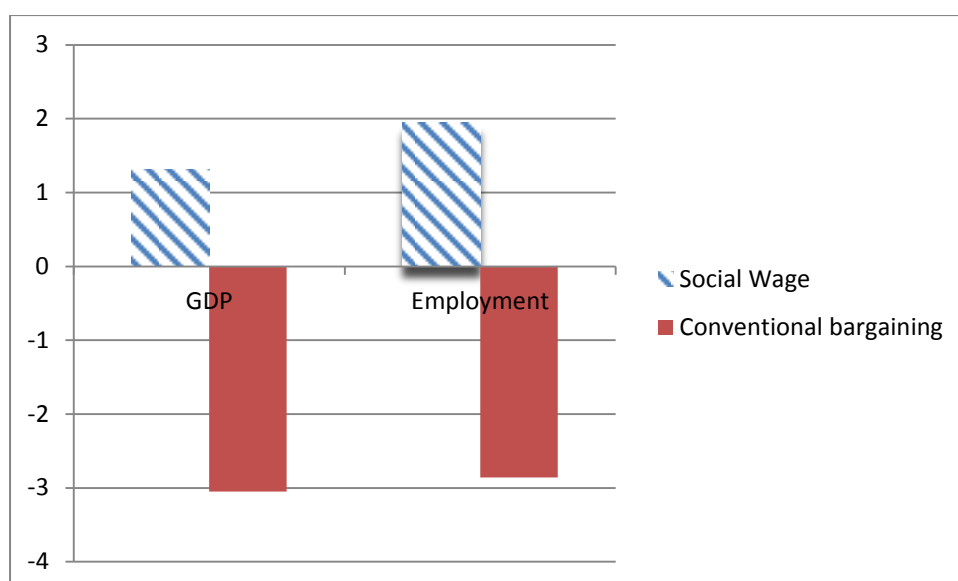
However, any Scottish Government would be wise to try to anticipate the likely **impact** of variations in taxes and expenditures on the Scottish economy, which will remain a small, open, regional economy irrespective of the extent of constitutional change. So while the Scottish Government post 2014 will have substantially increased fiscal powers, the impact of exercising those powers will depend crucially on the reactions of the Scottish people, and the residents (including Governments) of RUK and ROW.

What then are the likely impacts of using the greater fiscal powers being proposed? Our research in this area suggests that **public attitudes** towards Government expenditure matter a great deal. An illustrative analysis of the impact of setting the Scottish Rate of Income Tax (SRIT) at 15% will make the significance of this clear. In effect a SRIT of 15% implies a 5 percentage point *increase* in tax rates in Scotland, and a corresponding *increase* in government expenditure. For simplicity we assume that this is current government expenditure that has no direct supply-side impact: it acts as a pure demand stimulus.

There are two countervailing effects of such a balanced budget fiscal expansion in general. Firstly, there is a net stimulus to demand: while disposable income and therefore private consumption falls, this is more than offset by the increase in government consumption, which is less import intensive than private consumption. Secondly, there is an adverse supply shock: wages are conventionally regarded as being bargained in terms of the real (net of tax) consumption wage. So when taxes are raised workers push for a higher nominal wages in an effort to restore their real consumption wage, reducing regional competitiveness and the demand for Scottish exports.

While the net result of these two forces typically cannot be predicted, the competitiveness effect will be stronger the more open the economy. In our default model of the Scottish economy our analysis suggests that the adverse competitiveness effect predominates, and we find the balanced budget multiplier is in fact negative. Figure 1 summarises our preliminary analysis of the long-run output and employment effects of setting the SRIT at 15% under conventional bargaining (so that workers bargain for a net-of –tax real wage). The result is a 3% fall in GDP, with a slightly smaller fall in employment.

**Figure1. The impact on output and employment of a SRIT of 15%**



However, the adverse competitiveness effects can be moderated and even offset if the increase in government expenditure creates an amenity that is valued by residents and especially if this valuation is in turn reflected in a willingness of workers to accept a lower take home wage. This could happen if unions bargained over a **social wage**, in which government expenditures matter as well as private consumption (take home pay). If workers value the increased public consumption as much as their own private consumption and this is fully reflected in wage bargaining then the adverse competitiveness effects of the tax hike are eliminated. This social wage case is also illustrated in Figure 1: the balanced budget multiplier is now positive, with GDP increasing by 1.3% and employment by 1.9% (the greater stimulus to employment reflecting the decline in the real wage).

Even the direction of effects depends on public attitudes to government relative to private consumption. However, we have little relevant direct evidence on public attitudes in Scotland, though there is a presumption that Scots have a greater preference Scandinavian high tax/ high expenditure regimes than the residents of RUK. Clearly, a government that successfully persuaded Scottish workers to bargain over a social wage would be more likely to secure a positive outcome from an increase in government spending and taxation. Furthermore, the Government may maximise the probability of a positive response by targeting expenditures e.g. on health, education and child care spending more likely to exert a positive impact than defence expenditures (though a number of these expenditures would also be expected to have positive direct supply side effects).

What is clear is that the Scotland Act already gives powers to the Parliament that can have significant impacts on the Scottish economy. Indeed, under conventional bargaining (social wage) our preliminary results suggest GDP impacts that could vary by up to plus or minus 6% (minus or plus 2.5%) of GDP.



All of the current proposals for constitutional change involve substantially greater powers. However, all of the pro-union proposals for further tax devolution seem likely to add to the strains on the Barnett formula, which will inevitably come under greater scrutiny and the consequences of this may be substantial.

### **Further research issues**

Given the radical nature of all of the current proposals on taxes and spending, it seems useful to explore the likely impact of using these powers as best we can, given the limitations of available data and our understanding of individuals' behaviour. The *ESRC Future of the UK and Scotland pre and post referendum* Initiative is seeking to shed further light on public attitudes to government expenditure and we have also begun to explore some wider aspects of tax changes, for example the importance of the distinction between current and capital government expenditures and the possible impact of a Scottish-specific corporation tax rate.

In all of these cases there is interest in the extent of any spillover effects to RUK (and feedback effects to Scotland), which we are also beginning to assess. Given the strength and extent of the interdependencies between Scotland and RUK it seems likely that these results may augment the case for a degree of coordination of policies between Edinburgh and Westminster Parliaments.