



**The Jimmy Reid  
Foundation**

**Submission to the Smith Commission  
regarding increased powers for the  
Scottish Parliament**

**Jim and Margaret Cuthbert**

### **About the authors**

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## Executive Summary

1. This is a submission by the Jimmy Reid Foundation in response to the public invitation by the Smith Commission to submit views on the powers to be offered to Scotland in the aftermath of the Scottish referendum.

2. The submission deals almost exclusively with fiscal and economic issues. It develops five criteria against which proposals for increased fiscal responsibility for the Scottish Parliament should be judged: these are

- *Is there an appropriate balance between incentives to grow the tax base, and the operation of fiscal transfers within a monetary union?*
- *Tax responsibility must relate to a suitable choice of tax: and must be accompanied by appropriate powers for growing that tax base. Is a suitable balance being struck?*
- *Are there technical/ feasibility problems with what is proposed: and if such problems are being assumed away by an implicit model of how the economy works, then are the assumptions involved in such a model being made overt?*
- *Does the proposed solution have a reasonable chance of agreement: and is there sufficient clarity about the proposal, on those aspects which are critical for agreement?*
- *Does the proposal measure up to the promises made in the run up to the referendum?*

Since it is clear that issues relating to income tax are going to be at the core of the reform discussions, we have devoted a lot of time to income tax. The way this has been approached has been to look in detail at the Conservative proposals, which involve Scotland having almost full responsibility over income tax: and then looking in detail at the Labour proposals, which involve partial responsibility for income tax under an extension to the Calman proposals.

3. As regards both sets of proposals, there is, in general terms, insufficient clarity about how key aspects of the proposals would operate: there are important technical issues, which are identified, which need to be addressed: and there appear to be implicit economic assumptions underlying the proposals, (e.g., that the UK is a largely self-regulating optimal currency area: or that the best way of achieving economic growth is by reducing taxes): which need to be made explicit. In the absence of more detail on points like these, neither the Conservative or Labour proposals can presently be regarded as serious or credible attempts at reform.

4. However, what is required is not just greater clarity and tinkering with details of the proposals. There is enough evidence available in relation to both sets of proposals to identify what appear to be fundamental flaws and unacceptable risks. In particular,

a) Income tax is an inappropriate and risky choice as the primary basis for giving the Scottish Parliament fiscal responsibility within the union. There are a number of

aspects to this. Income tax receipts are inherently volatile and difficult to predict, (as the current problems the OBR is having in forecasting income tax receipts for the UK as a whole demonstrate): and yet no consideration is given to appropriate shock absorbers for the Scottish government. Further, if Scottish income tax were less buoyant than receipts for the UK as a whole, and if the indexation method for the abatement to the Scottish Block grant uses the Holtham approach, (as seems likely, though this is not spelled out in any of the proposals), then this would chronically penalise Scotland's public finances.

b) Critically, neither of the proposals gives the Scottish Parliament sufficient economic powers to be sure of being able to grow its income tax base. It should be a fundamental principle underlying proposals to increase fiscal responsibility that not merely is an appropriate tax chosen but that equal weight should be given to devolving adequate economic powers to grow the relevant tax base. This principle has been ignored.

5. On a more detailed technical point, in the case of the Labour proposals, (which involve a modified form of Calman tax arrangement), consideration should be given to the proposal that is made in the submission for adjusting the Holtham indexation arrangements.

6. There are further technical issues, with both sets of proposals, which would need to be addressed.

For the Conservative proposals, these include: the need to specify exactly how the operation of the Barnett formula would be adjusted, to avoid the adverse effects of Holtham indexation: the decision as to whether the Scottish government's income tax revenue should be net or gross of those tax credits which are regarded as negative tax: and the need for an increased shock absorber to allow the Scottish government to cope with the increased volatility of its revenues.

Similar technical issues arise in relation to the Labour proposals. In addition, because Labour is proposing a modification of the Calman income tax approach, the technical issues associated with that approach also arise. In particular, the adverse effects of fiscal drag on Scottish revenues under Calman will be accentuated by the Labour proposal to extend the basic Scottish rate of tax to 15p. This is also likely to interact with the ability for the Scottish government to increase higher band tax rates, to build in a ratchet effect increasing Scottish higher band tax rates. And there are issues about Tax Incremental Funding which would need to be addressed.

7. Our suggestions for both taxes and economic powers which should be devolved are as follows:

- The two areas we recommend for increased tax responsibility are national insurance, and taxation of land.
- In terms of powers, the critical thing is that, in those areas where the exercise of reserved powers is currently failing Scotland, powers should either be

transferred, or appropriate steps taken to ensure that the relevant powers are exercised properly, in the joint interests of Scotland and the union. Candidates for direct transfer of powers, we suggest, are fisheries, the crown estate, and aspects of representation in Europe. In other areas, what is required is something like a micro-federal solution, where power is shared between Scotland and Westminster, but in a quasi-federal manner which means that the numerical preponderance of England does not simply dominate: these areas include monetary policy, oil and gas policy and taxation, utilities regulation, corporation tax, competition policy, and research and development and support for innovative industries.

# Submission to the Smith Commission from the Jimmy Reid Foundation

## Introduction

1. This is a submission by the Jimmy Reid Foundation in response to the public invitation by the Smith Commission to submit views on the powers to be offered to Scotland in the aftermath of the Scottish referendum. It should be made clear at the outset that, while the authors, Jim and Margaret Cuthbert, are avowed supporters of independence, they have approached this submission firmly within what one might call the spirit of the Smith Commission: that is, the concern here is how best to arrive at additional powers for Scotland, which will work for the benefit of Scotland, and the rest of the UK, within the existing union.

2. In this submission, we deal almost exclusively with fiscal and economic issues. Even within this constraint, we have not attempted a comprehensive review of the detail of all the proposals currently on the table. Limitations, primarily of time, but also of space, prevent this. The fact that we have not dealt in the same detail with the proposals submitted by all the parties implies no disrespect. But since it is clear that issues relating to income tax are going to be at the core of the reform discussions, we devote a lot of time to income tax. The way we have approached this is to look in detail at the Conservative proposals, which involve Scotland having almost full responsibility over income tax: and then looking in detail at the Labour proposals, which involve partial responsibility for income tax under an extension to the Calman proposals.

3. The structure of this submission is as follows:

Section 1 sets out, and justifies, the appropriate criteria for judging reform proposals.

Section 2 gives relevant background on the current state of the UK and Scottish economies: this background is important, because it is only in the light of this type of information that the likely performance of the different reform proposals can be judged.

Sections 3 and 4 look respectively at the Conservatives proposals, which involve almost full responsibility for income tax, and at the Labour proposals, which involve partial responsibility.

Section 5 covers assorted issues arising with other proposals.

Section 6 sets out proposals from us on what taxes might be considered, and on what further economic powers might be transferred for the Commission to consider.

Section 7 is our summary and conclusions.

4. The overall conclusion we come to is that neither of the proposals put forward for full or partial responsibility for income tax comes close to meeting the criteria for satisfactory reform. The reason for this is not because such reform is impossible: however, satisfactory reform has to address a large number of complex issues, and these issues have not been adequately addressed in the various submissions from the political parties. This puts the Commission in a difficult position: the basic material it is being asked to work with from the political parties is inadequate: in effect, it cannot come up with a satisfactory solution from the existing political party submissions.

5. As regards the content of the specific proposals which are eventually implemented, our main recommendations are:

- That income tax is, in several respects, an inappropriate tax to provide a main funding mechanism for the Scottish Parliament, in the context of the union.
- Any proposal which extends to the Scottish Parliament responsibility for funding a significant part of its budget through a particular tax has to be accompanied by appropriate economic powers, which would give the Scottish government a fair chance of successfully growing the relevant tax base.
- Hence, other taxes should be considered in addition to income tax: specifically, we recommend national insurance, and taxes on land.
- As regards economic powers, we suggest direct transfer of powers in relation to fisheries, the crown estate, and aspects of representation in Europe. In other areas, what we suggest is required is something like a micro-federal solution, where power is shared between Scotland and Westminster, but in a quasi-federal manner which means that the numerical preponderance of England does not simply dominate: these areas include monetary policy, oil and gas policy and taxation, utilities regulation, corporation tax, competition policy, and research and development and support for innovative industries.

## 1. The Appropriate Criteria for Assessing Reform Proposals

1. In this section we set out, and justify, appropriate criteria which should be used to assess any proposal for extending the taxation and other powers of the Scottish Parliament, within the framework of the existing UK union.

Criterion 1: *The issue of achieving an appropriate balance between incentives to grow the tax base, and the operation of fiscal transfers within a monetary union, has to be specifically addressed.*

2. It is widely recognised that an essential feature of a successful monetary union is the existence of a mechanism for making fiscal transfers between different parts of the union as and when the need arises. It is also widely recognised that, if a country or region within a monetary union receives part of its funding from a local tax base, then the system should be designed in such a way that the country has a positive incentive to grow that tax base: (whether it has powers to grow that tax base is another issue, which we return to below).

3. The problem is that there is an inherent tension between these two requirements: and it is in fact very difficult to set up a system which achieves both. Realistically, what is required is some carefully worked out compromise between the two requirements. We regard it as an essential pre-requisite of any proposal for a major extension of fiscal powers to a country within a monetary union that the question of the tension between the mechanism for fiscal transfers, and adequate incentives for growing the local tax base, is specifically addressed.

Criterion 2: *Tax responsibility must relate to a suitable choice of tax: and must be accompanied by appropriate powers for growing that tax base.*

4. Let us suppose that criterion 1 has been met, and that a system has been designed which involves a reasonable blend of a mechanism for determining fiscal transfers together with reasonable incentives for the country in question to grow its tax base. This implies that the country in question will benefit, in terms of funding for public expenditure, if its tax base grows relative to the average for the whole of the monetary union: but conversely, that it will suffer if its tax base declines in relative terms. In this situation, two things are vital. First of all, that the tax in question is appropriate: if, for example, the tax chosen is inherently and chronically less buoyant in the country in question, as compared with the union average, then this condemns that country to a future of chronic relative decline in public spending. Secondly, even if the tax chosen is in principle quite appropriate, it is essential that the country in question has the appropriate powers to grow its tax base. Since tax bases depend, ultimately, on economic growth, this implies that tax responsibility has to be accompanied by responsibility for the control of major economic levers. The questions of economic powers and tax responsibility are of equal weight, and inseparable.



*Criterion 3: Are there technical/ feasibility problems with what is proposed: and if such problems are being assumed away by an implicit model of how the economy works, then the assumptions involved in such a model should be made overt.*

5 Any significant change to tax or other powers may have unlooked for consequences: so it is, of course, important that a good deal of attention should be paid in advance to identifying and correcting as many of these as possible. Will the change, for example, build in perverse incentives on government behaviour: could it give rise to undue instability in the revenues being generated, and are there adequate means of coping with this: will it result in unproductive “beggar thy neighbour” behaviour: how consistent is it with EU regulations: and so on. It might be thought that no change would be implemented unless all such issues had been thoroughly thought through: but in fact, the UK’s record on this is very poor. To give an example, the Calman proposals on tax are actually being implemented, even though they are badly thought through proposals which build in perverse incentives to raise tax rates, and have an interaction with fiscal drag which will adversely affect Scottish government revenues, (Cuthbert and Cuthbert, 2011).

6. It may be, of course, that the proponents of any particular change have a view of how the world works, which means that from their point of view a specific technical issue may be ignored. A classic example was the introduction of the euro, where it was the view of euro proponents that once sufficient economic convergence had been achieved, and assuming the individual euro members had sufficient self discipline, then the eurozone would constitute a stable and self-regulating optimal currency area, so that the need for a mechanism for fiscal transfers could largely be sidestepped. This view can now be seen to be wrong. But the example illustrates why it is essential, if the advocates of a particular change are ignoring potential technical difficulties because they ascribe to a specific economic model, then the assumptions implicit in that model should be clearly brought out for scrutiny.

*Criterion 4: Any proposed solution should have a reasonable chance of agreement: and should be clear about the areas that are critical for agreement.*

7. To be implemented, any proposal must command support from the major UK parties, be capable of being passed by the House of Commons, and, since government is ultimately by consent, must enjoy majority support from the people of Scotland. This in itself is a truism. But what is important is that proposals are spelled out in sufficient detail that the potential areas of disagreement are identified. To give an example: when the leaders of the UK political parties gave a vow to maintain the Barnett formula, what does this actually mean? The vow was widely interpreted in Scotland as an implicit pledge to protect the relatively high current levels of public expenditure per head in Scotland for the foreseeable future. Did the vow actually mean this: and if so, what are the chances of this being acceptable to a majority in the House of Commons?

Criterion 5: Does the proposal measure up to the promises made in the run up to the referendum.

8. On 15 September, the leaders of the main UK parties jointly made a vow which stated, among other things, that “permanent and extensive new powers for the Parliament will be delivered” and “because of the continuation of the Barnett allocation for resources, and the powers of the Scottish Parliament to raise revenue, we can say that the final say on how much is spent on the NHS will be a matter for the Scottish Parliament.” In a speech in Loanhead on 8<sup>th</sup> September, Gordon Brown promised “nothing less than a modern form of Scottish Home Rule”: this speech, significantly, was welcomed both by David Cameron and Ed Miliband. Gordon Brown also stated “We are going to be within a year or two, as close to a federal state as you can be in a country where one nation is 85 percent of the population”: (“Progress”: 5 September, 2014). Any proposal for reform needs to be assessed as to whether it matches up to these promises.

## 2 State of the Union

1. This section looks at a number of indicators for the UK and Scotland relevant to the later discussion. Fuller information can be found in the relevant references.

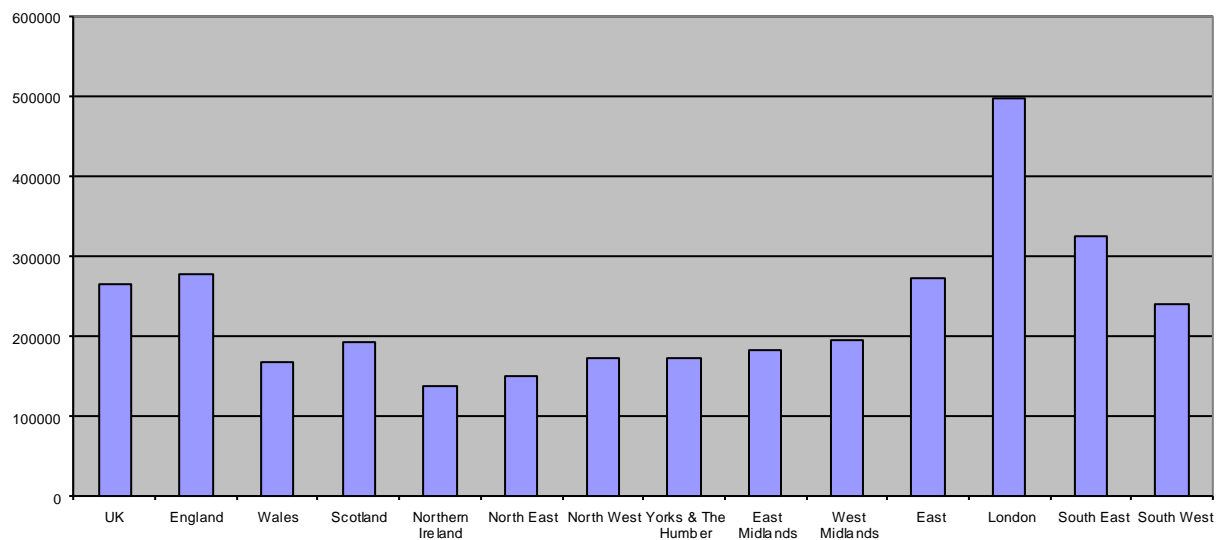
### 2. *Is the UK a Convergent Optimal Currency Area?*

An optimal currency area is defined as the geographic area in which a single currency would create the greatest economic benefit. There are benefits in, for example, trade, but there are also costs – in loss of ability to influence monetary and fiscal policies.

Conventional wisdom would be that, within an optimal currency area, what would be expected through time would be deepening economic convergence between the different parts of the currency area. Let's look at some indicators illustrating the degree of economic convergence within the UK.

House prices first: Chart 1 shows average house prices in the countries and regions of the UK in June 2014.

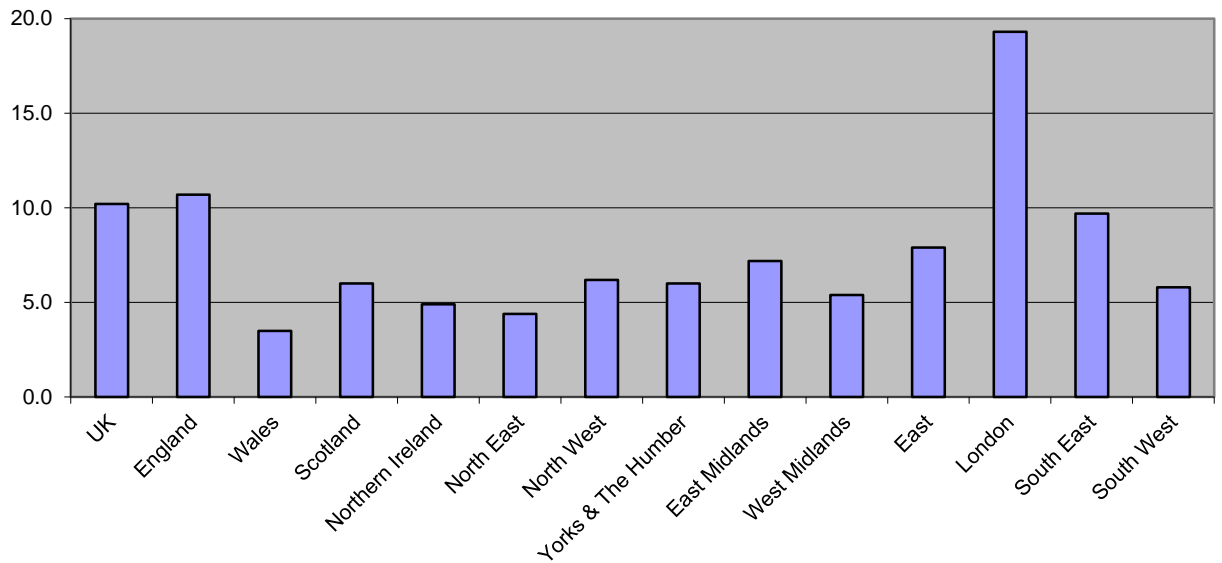
**Chart 1: Average house prices £, UK June 2014**



Source: ONS

And Chart 2 shows the annual rate of change of house prices in each of these areas.

**Chart 2: Annual House Price Rates of Change  
UK June 2014**

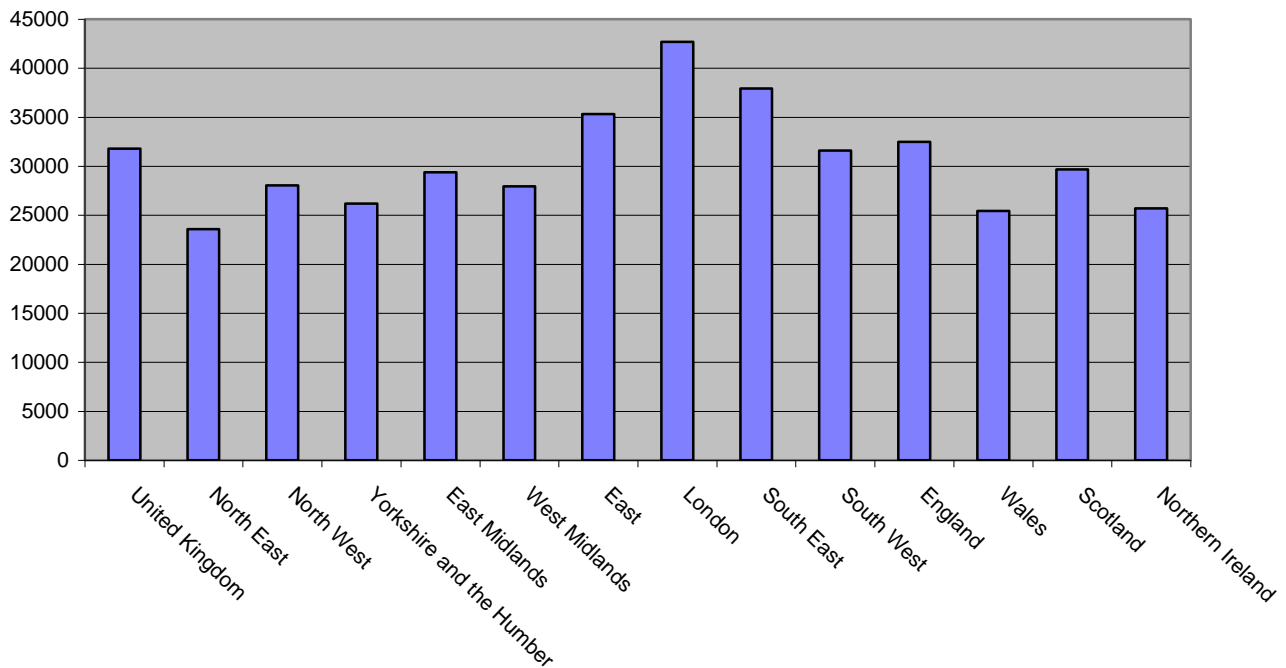


Source: ONS

What the charts illustrate is how there are marked differences in property prices through the UK, with prices very much higher, and rising much faster, in the South East. This is symptomatic of the well known imbalance in the UK economy, with pressure cooker conditions, particularly in London, but also in the South East, which are not reflected elsewhere.

Another relevant indicator is the level of average gross annual household income. Here we look at this excluding social security benefits.

Chart 3: Average gross annual household income in £s excluding social security benefits  
UK 2010-2012



Source: ONS

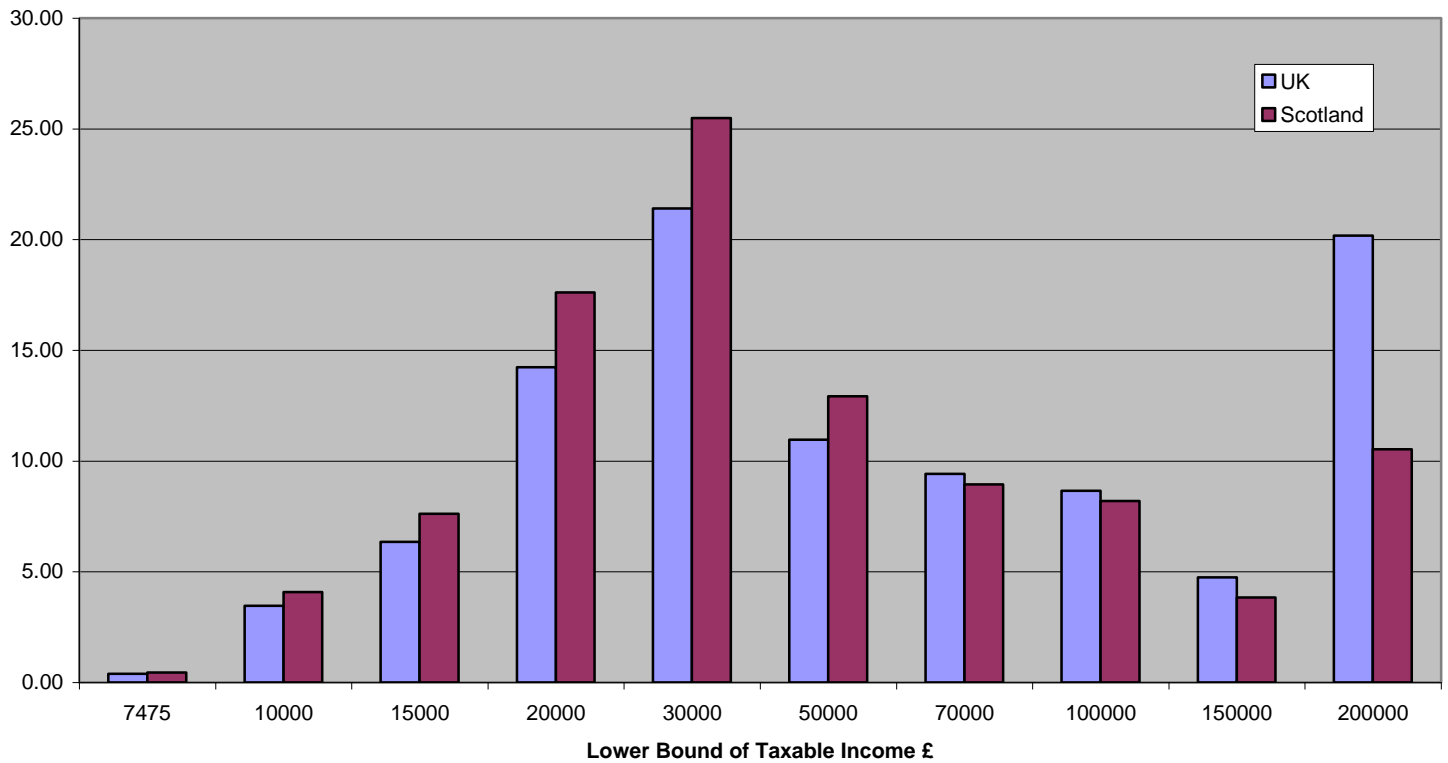
What this illustrates is marked variations in income between different areas, with the lowest average income (North East) being just over half that in the highest income area (London).

These are selected indicators only, but they amply illustrate that in the UK there is very far from being the convergence between different areas that would be expected in a well functioning optimal currency area. A much fuller discussion and illustrations can be found in M. Cuthbert, (2013). This lack of convergence in the UK, with a financially dominated South East, and many other areas struggling to keep up, has important implications for our later discussion.

### 3. *Distribution of Taxable Income*

These marked imbalances between different parts of the UK are reflected in corresponding differences in the distribution of taxable incomes between different areas, and hence in the distribution of the amount of tax collected from different income bands. This is illustrated in Chart 4 by comparing, for the UK and Scotland, the percentage of total tax take coming from different income bands.

**Chart 4: Percentage of total tax raised coming from different income bands: UK, Scotland, 2011-12**



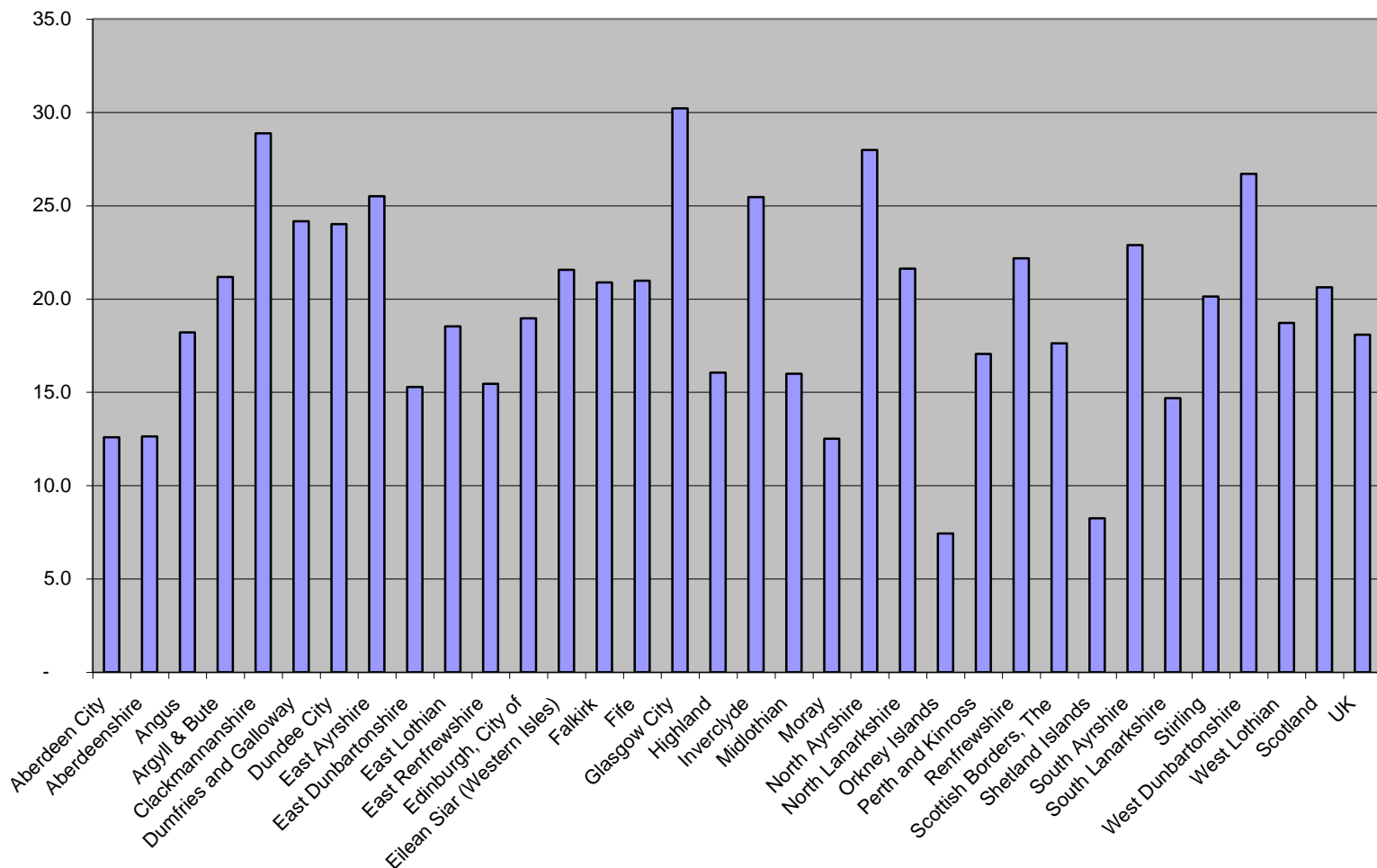
Source: HMRC

What we see is quite striking, particularly at the high income end. Those who have a taxable income of more than £200,000 account for 20% of the total tax raised in the UK: however, in Scotland those earning over £200,000 account for much less of the total Scottish income tax take, at just over 10%. This disparity, we will argue later, has very important implications for proposals to use income tax as the primary means of giving Scotland greater fiscal responsibility.

#### 4. *Within Scotland Disparities*

This picture of marked UK imbalances is reflected in a similar picture of imbalances between different areas within Scotland. To illustrate this, the following chart shows the percentage of workless households across local authorities in Scotland in 2012.

**Chart 5: Workless Households as Percent of all Households, 2012**



Source: ONS

There are marked variations across Scotland. The percentage of workless households in Glasgow is over 30%, and Clackmannanshire, East Ayrshire, Inverclyde, North Ayrshire, and West Dunbartonshire, all have percentages over 25% in 2012, compared to the Scottish average of 20.6%.

Further details of disparities in economic activity between different areas in Scotland can be found at [http://www.cuthbert1.pwp.blueyonder.co.uk/new\\_page\\_12.htm](http://www.cuthbert1.pwp.blueyonder.co.uk/new_page_12.htm). Such disparities are a long standing feature of the Scottish economy, and are extremely relevant when it comes to considering the economic powers required by the Scottish Parliament.

## 5. *Competition Policy*

Mergers and acquisitions are two important areas for the City: and as a result, the UK has adopted a competition policy at the more *laissez-faire* end of EU policy. As a result of this policy, Scotland has suffered from the loss of several high profile companies – either through loss of control and HQ functions, or in some cases through complete loss of major employment. Examples are Scottish and Newcastle, Distillers, Bank of Scotland, Scottish Power. But in addition to these high profile takeovers, we suffer very badly from takeovers of high growth, high tech SMEs. Examples include Wolfson Microelectronics, ProStrakan, and Shield.

While clearly some individual Scottish companies have benefited from acquisitions, it is widely recognised that the extent of the mergers and acquisitions of Scottish companies has had an effect in inhibiting the growth of the Scottish economy. This is relevant to the questions of whether current *laissez-faire* UK competition policy is optimal for Scotland, and of how competition policy is administered in Scotland.



### 3. Full Control of Income Tax (almost)

1. The Conservative proposals for further powers for the Scottish Parliament are set out in the Strathclyde Commission report of May 2014. For present purposes, the main proposal is that the Scottish government would be responsible for setting the rates and bands of income tax in Scotland: (but this would exclude responsibility for the definition of income for tax purposes: for taxation of dividends, investments, and savings: and for setting the personal allowance.)

2. We now assess this proposal against the criteria set out in Section 1.

3. As regards criterion 1, while there is the commitment in the 15<sup>th</sup> September vow to retain Barnett, there is no discussion at all in the Conservative proposals on the critical issue of how Barnett would be modified in the light of the Scottish government being partly self financing through income tax, (and possibly VAT). We assume, (though the Conservative proposal should be explicit on the point), that a similar approach will be adopted as is being implemented in relation to the Scotland Act. That is, that the adjustment to the Block Grant because of the Scottish government's own resources will be indexed by the Holtham method: that is, in line with the overall growth of the UK's non-saving, non-dividend tax base. If this is the approach the Conservatives propose to adopt, it would mean that the Scottish government would indeed have an incentive to grow Scotland's income tax base. But the Holtham indexation approach comes with a serious collateral risk: namely, that Scotland's finances will suffer if the Scottish income tax base is not as inherently buoyant as the UK as a whole. This risk was recognised by Holtham in the context of the original Calman reforms : in evidence to the Finance Committee, Holtham said that his model *"might not be in Scotland's interests if (the Scottish) tax base grows more slowly than that of the UK"*, (Scottish Parliament Official Report, 17 April 2013). And the risk will be proportionately greater under the Conservative proposals, given that much more of the income tax base is being transferred.

4. Criterion 2 is concerned with whether the tax chosen is suitable, and whether tax responsibility is balanced by appropriate powers to grow the tax base. Chart 4 in Section 2 indicates how the income tax base in Scotland has very different characteristics from the average tax base for the UK as a whole – with much less of the tax base in Scotland falling into the category of very high earners. Because of the way the UK has been heavily dominated by the financial sector over the past thirty or so years, there has been a great expansion in the very high salaries earned in the City. As pointed out by OBR in its latest forecasting report, *"Wages tend to be more tax rich if they are taken home by a smaller number of higher paid workers, than if they are earned by a larger number of lower paid workers."* So if the dominance of the UK economy by the South East financial sector continues, then the income tax base in Scotland could be chronically less buoyant than income tax receipts for the UK as a whole. Hence, giving a form of tax responsibility to Scotland which is largely based on income tax, (particularly if the Conservative proposals do indeed assume implementation of Holtham indexation), could condemn Scotland to a long period of

relative public expenditure decline. This calls into question the appropriateness of the Conservatives' choice of income tax.

5. Further, still looking at criterion 2, the economic powers to be transferred under the Conservative proposals are very limited: the main exception being the power to vary income tax rates itself. Presumably, implicit in the model underlying the Conservative proposals is the view that the way to grow the income tax base in Scotland, and to achieve ultimate public expenditure benefits, is to stimulate the economy by reducing tax rates, (while undergoing, at least in the short term, corresponding reductions in public expenditure). If this is the implicit view underlying the Conservative proposals then this should be made explicit.

6. Criterion 3 is concerned with whether technical issues concerning the proposals have been adequately addressed. One important technical issue, which we have already touched upon, is the question of how the Barnett formula will be adjusted, and, if this is indeed to be by Holtham indexation, the potentially adverse implications of this. These important issues have not been addressed at all in the Conservative submission.

7. A further technical point concerns the interaction of income tax with the system of tax credits. Tax credits which have the effect of reducing the amount of tax an individual pays are regarded as negative tax: whereas tax credits which are not paid out of tax are public expenditure. One issue which has to be decided is whether the income tax for which fiscal responsibility will be given to the Scottish government is net or gross of those tax credits which are treated as negative tax. If the income tax which a Scottish government will receive is net of these tax credits, then this is likely to contribute significantly to the volatility of the Scottish government's tax receipts: as well as implying that the Scottish government is, in effect, being required to finance an important part of the benefits system, over which it has no control. There are therefore good arguments for taking the definition of Scottish tax as being gross of tax credits. The important point, however, is that this is a technical issue which needs to be addressed, and is not addressed at all in the Conservative proposals. There will also need to be consideration of the implications of the introduction of Universal Credit.

8. Another technical issue relates to the need for flexibility in the financing arrangements for the Scottish government, given that greater fiscal responsibility will be accompanied by greater revenue volatility. This issue was recognised in the implementation of the Calman tax proposals, when the Scottish government was given limited borrowing powers, to cope with the difficulty of predicting the receipts from the Scottish rate of income tax. However, the fluctuations in the finances of the Scottish government are likely to be proportionately much greater, if it is relying on the whole of the Scottish income tax take, as compared with the revenues of the Scottish rate of income tax under Calman. Further, the Strathclyde Commission proposal that Scotland might also have a proportion of Scottish VAT revenues would increase the potential for fluctuations in the Scottish government's finances. There is therefore the need for some kind of shock absorber, potentially much larger than

that brought in by the revenue borrowing powers and cash reserve introduced under the Scotland Act. The issue of how this should be achieved is not addressed at all in the Conservatives' proposals. It may be that what is required is a significant extension of the Scottish government's ability to borrow: but this is not necessarily the appropriate solution, since it will be difficult to distinguish temporary fluctuations in revenue, in relation to which the required borrowing will be self-correcting, from secular trends in the Scottish government's finances. What is clear is that there are difficult, and critically important, issues here which have not been addressed at all in the current proposals.

9. It may be, of course, that underlying the Conservatives' proposals is the view that the UK economy is close to being an Optimal Currency Area: and that, provided the Scottish government operates with a balanced budget, and keeps its tax rates in line with, or below, the rest of the UK, then the whole UK economy will operate in a stable and convergent fashion with no need for larger shock absorbers to cope with fluctuations in Scottish government funding. Such a view seems, to us, to be wildly optimistic – particularly given the clear evidence in section 2 that the UK is far from being a convergent optimal currency area. If this is the view underlying the Conservative proposals it should be made overt, and justified. If not, it is vital that the issue of how to cope with fluctuations in Scottish government revenues is addressed.

10. Criterion 4 is concerned with whether the proposal has a reasonable chance of agreement: and whether the areas which are essential for agreement are clearly enough identified. Certain aspects of the Conservative proposal are currently unclear. For example, (a) does the vow on Barnett given by the Party leaders imply a pledge to protect the relatively high levels of public expenditure in Scotland for the foreseeable future? (Or indeed, the higher levels which might be implied by the interaction of Barnett with the relatively slower rate of population growth experienced by Scotland: see our evidence to the Finance Committee, (Cuthbert and Cuthbert, 2014)). If so, this could well not be acceptable to a majority in the House of Commons. (b) is the Conservative model only workable under the conditions where a Scottish government implements a low tax regime, and under the belief that the UK economy will then operate as a convergent Optimum Currency Area, where all will benefit from resulting economic growth. Such a model is unlikely to be regarded as either feasible or desirable by a majority in Scotland. These examples illustrate how there are important aspects of the Conservative proposal, and how it is meant to operate, which need to be clarified.

11. Finally, criterion 5 asks whether the proposal measures up to the promises made in the run up to the referendum. One thing that is striking about the proposals is the extent to which, on a careful reading, they imply restrictions on Scottish powers as well as extensions. The increased volatility implied by greater tax responsibility, without adequate shock absorbers, would force the Scottish government to adopt an extremely cautious fiscal regime. The establishment of an independent commission to undertake fiscal forecasts would further inhibit the Scottish government's freedom of action. Above all, David Cameron's proposal of

EVEL would turn Scottish MPs into second class parliamentarians. This is far from being “as close to a federal system as it is possible to get”.

12 Our conclusion is that the Conservative proposals fail badly on all of the criteria set out in Section 1: and that the issues identified under each of these criteria need to be addressed in much greater detail. Our overall view on the Conservative proposals, however, is that there are fundamental problems, which go beyond the need for greater clarity, and some tinkering at the edges. The basic problem is putting primary reliance for fiscal responsibility on income tax, a tax for which, given the unbalanced nature of the UK’s finance-driven economy, Scotland’s share of receipts is likely to be volatile, and chronically less buoyant. A Scottish government operating under the Conservative proposals would have two options. It could go for a low tax strategy, with immediate cuts in public expenditure, hoping in the long run to reap the benefits of a growing economy: but the success of such a strategy is doubtful, given the inherently unbalanced nature of the UK economy. If it raises taxes, to protect public services in the face of tax volatility, it condemns Scotland to a future of relative decline. Either way, the choice of an inappropriate tax, and the Scottish government’s lack of economic powers to tackle basic economic problems, makes a favourable outcome extremely unlikely.

#### 4. Partial extension of income tax powers: the Labour Party proposals

1. Labour's proposals were published in the report of Scottish Labour's Devolution Committee, published in March 2014. For present purposes, the main relevant proposals are:

- The Calman income tax changes being implemented under the Scotland Act would be extended, raising the width of the tax band over which the Scottish government has control from 10p to 15p.
- In addition, the Scottish government would be able to increase the tax rates on higher income tax bands, (but not reduce them below rest of UK levels).

In addition, just before the referendum, Gordon Brown indicated that Scotland might be allocated a proportion of VAT receipts in Scotland.

2. We now assess these proposals against the criteria in Section 1. Where similar issues arise as have already been discussed in relation to the Conservative proposals, we will note this, but not repeat the discussion in detail.

3. In relation to criterion 1, while there is a continued commitment to Barnett, there is no discussion of the issue of the adjustment that would be made to Barnett in the light of the other sources of revenue. As with the Conservative proposals, we assume that what is proposed is a system based on Holtham indexation. If so, this raises similar grave risks for Scotland's public finances if Scotland's income tax base were less buoyant.

4. As regards criterion 2, since the primary vehicle for delivering fiscal responsibility under the Labour proposals is income tax, similar issues arise as under the Conservative proposals as regards the inappropriateness of this choice. Because Labour is proposing to transfer a smaller proportion of income tax, some of the problems posed by potential volatility may be less severe: but on the other hand, specific technical problems arising with Calman are likely to increase volatility, (as will be seen in the discussion under criterion 3), so the overall effect is unclear. The economic powers transferred under the Labour proposals are fairly limited, and mainly relate to increasing certain local authority powers. The effectiveness of at least one of their proposals, namely the extension of Tax Incremental Funding (TIF), is likely to be limited by technical problems with TIF, (as will also be discussed further below in section 5). Overall, it does not appear that sufficient powers are being transferred to grow the income tax base effectively.

5. Criterion 3 is concerned with technical issues. As with the Conservative proposals, none of the important issues of the detail of the adjustment to Barnett, the relationship with tax credits, or of the need for a shock absorber mechanism in the light of revenue volatility, has been addressed. In addition, there are some further technical issues specific to the Labour proposals.

6. The first relates to the Holtham indexation which, we assume, would be employed to adjust the abatement to the Block grant. We have already identified the risk this implies to Scottish finances if the Scottish income tax base were less

buoyant than that of the UK as a whole. In the case of the Labour proposal, since what they are proposing is a modification of Calman, it would be worth considering whether a specific technical adjustment might reduce the problem. Instead of indexing the abatement to the block grant in line with UK non-saving, non-dividend tax receipts, why not calculate the product of a Calman basic tax rate (15p under the Labour proposals) for the UK as a whole, and then index the block grant abatement in line with this? Clearly, the feasibility of doing this would need to be examined in detail – and it would be necessary to check by detailed investigation that there were no unlooked for consequences. But at first sight, this idea seems to achieve the basic goals of indexation, while at the same time removing the worst effects of potential instability in the UK tax base due to high earnings. If this idea has merit, then it should also be considered as an adjustment to the arrangements that are currently being introduced under the Scotland Act.

7. A further, recognised, problem with the existing Calman tax proposals arises through the effect of fiscal drag: (fiscal drag is the tendency for an increasing proportion of the overall income tax take through time to come from the higher rate bands, as thresholds are not updated fully in line with inflation.) Because the Scottish portion of income tax represents a smaller proportion of the tax raised from the higher tax bands, the effect of fiscal drag will mean that, for a given Scottish tax rate, the amount of revenue raised will decrease through time as a proportion of the total income tax take in Scotland. To compensate, a Scottish government would be under pressure to increase its tax rate through time.

A change in the Calman threshold, (that is the amount of the income tax rate over which the Scottish government has control), has an effect on this mechanism. In fact, as the Calman tax threshold is increased, the effect of fiscal drag on the Scottish tax take increases proportionately with the level of the Calman threshold. The Labour proposal to increase the Calman threshold by 50% will therefore make the adverse effect of fiscal drag interacting with Calman 50% worse. In a prolonged period of fiscal drag, the Scottish government would therefore be under strong pressure to increase tax rates to compensate.

8. The problems which arise through Calman and fiscal drag are likely to be compounded by another aspect of the Labour proposals: the ability which the Scottish government would have to increase higher band tax rates. Of course, it would be perfectly legitimate if a Scottish government chose to increase higher band tax rates for what were perceived to be generally accepted reasons of social justice. But in practice, a Scottish government would be under strong pressure to increase its higher band tax rates, not for reasons of social justice, but to compensate for the deficiencies in Calman. Suppose that a Scottish government had introduced neutral tax rates, so that the Scottish basic and higher rates were the same as the rest of the UK: but if it found that its revenues were being eroded because of the fiscal drag problem, then there would be a strong temptation for the Scottish government to increase the proportion of tax it took from the higher bands by increasing the Scottish rate of high band tax. In other words, the fiscal drag problem in Calman,

interacting with the Scottish government's power to increase higher rate taxes, might build in a kind of ratchet, pushing up Scotland's high band tax rates.

9. As regards criterion 4, one main point to be clarified about the Labour proposals is what is actually implied by the vow to retain Barnett. Similar issues arise here as under the discussion of this point in relation to the Conservative proposals.

10. Finally, criterion 5 is concerned with whether the proposal measures up to the pre-referendum promises. There are two important respects in which this is doubtful. First, the Labour proposals are in many ways the most limited of all the proposals on the table from the political parties: they appear to fall very short of Gordon Brown's promise of being very close to federalism. Secondly, Gordon Brown made an explicit promise that the NHS in Scotland would not be under a threat of privatisation following a "no" vote. This is inconsistent with retaining the Barnett formula as the main source of funding for the Scottish Parliament. A significant move towards the private financing of health provision in England would have knock-on effects in reducing the size of the English public expenditure health budget – and, through Barnett, would reduce the size of Scottish block funding from Westminster. Given the fairly limited financial resources under the direct control of a Scottish government, it would not, realistically, have the option of increasing taxes in Scotland to compensate. So a major move towards the privatisation of health funding in England would inevitably force corresponding changes in Scotland.

11. Overall, the Labour proposals fail on each of our five criteria, in much the same way as the Conservative proposals. The Labour proposals are potentially less sensitive to fluctuations in the income tax base, given that there is a smaller portion of the tax base being transferred: but on the other hand, they involve more technical problems, largely because they are based on the flawed Calman model. (However, we suggest for consideration a potential adjustment to Holtham indexation, which could reduce some of the adverse effects.) But overall, what is required is not just a question of greater clarity, and of tinkering with detail, but of being more transparent about what underlying view is implicit in the proposals about how the economy operates. There are remarkably few details on this in the Labour document itself: but there are clues in another document, produced after the referendum by Jim Gallagher, a Labour party adviser and one of the academic consultants to the Labour Devolution Commission. Two comments by Gallagher stand out. First is the claim that the UK is an optimal currency area. Second is the statement that the choice facing Scotland is "*Do we want to have higher taxes, and higher public expenditure than the rest of the UK, or for that matter, lower taxes.*" (Gallagher, 2014.) These two statements imply a rather simplistic, and flawed, dichotomy. They neglect the inherent risks of being part of a UK which is far from being a largely self-regulating optimal currency area. The statements also neglect the realistic option which the people of Scotland would surely prefer if the choice was spelt out: namely, of having, as well as fiscal responsibility for suitable taxes, the right economic powers for delivering growth in the Scottish economy, and hence of achieving both acceptable tax rates, and whatever levels of public expenditure the Scottish people deem as appropriate.

## 5. Other issues

1. Under Labour proposals, local authorities would be given increased scope to influence local development: one specific proposal is extending Tax Incremental Funding (TIF). While TIF can work successfully, experience elsewhere indicates that there are two major difficulties. One is that it works best in areas which are in any event economically buoyant or successful: so it can distort investment priorities away from areas where regeneration is really needed. But the most important problem with TIF is the danger that the economic activity that it encourages may largely be displacement, rather than genuinely additional activity. And since TIF involves ring fencing a part of the Scottish government's non-domestic rate tax base, then if what happens under TIF is displacement rather than new activity, this will damage the overall finances of the Scottish government. Heavy reliance on TIF is therefore in many respects a risky strategy: (Cuthbert and Cuthbert, 2012).

2. As regards the SNP proposals, we do not comment in detail, but there is an important issue as to how they relate to our criterion 4. That is, is there a reasonable chance of agreement and have those aspects which are critical for agreement clearly enough identified. As regards the latter aspect, the SNP proposals do not discuss whether the degree of fiscal autonomy envisaged would be feasible if Scotland was carrying a population share of UK debt interest. There needs to be greater clarity about what share of UK debt is implicit in the financial contributions which Scotland would make to the rest of the UK under the SNP proposals.



## 6. Transfer of Powers

1. In this paper we have argued that income tax as the main tax is not the appropriate choice for delivering fiscal responsibility to Scotland within the union: particularly since current proposals would mean that Scotland has very limited economic powers which it could use to grow the income tax base. Implementing the present proposals of either the Conservative or Labour parties is likely to lead to a self-reinforcing cycle, where the Scottish government will be under strong pressure to raise Scottish tax rates to compensate for a less buoyant tax base, leading to further relevant economic decline, further relative shrinkage of the tax base, and so on.

2. To counter this, what is required is a different, or extended, tax base for the Scottish budget, combined with significantly increased economic powers for the Scottish Parliament. We do not have a fully worked out package of proposals: but we do have suggestions about additional taxes which should be considered and about extra economic powers for the Scottish Parliament.

3. The first tax we suggest for consideration is National Insurance, (including both employee and employer contributions). National insurance has been rejected as a possible candidate in most of the current unionist party proposals, largely because of the perceived links between national insurance contributions and payments of certain welfare benefits, and the view that the welfare system is a common glue that should bind the union together. The perceived links with welfare are not, however, strong reasons for rejecting national insurance because:

a) The UK welfare system is not a funded system. National insurance payments are just like any other tax, they do not fund welfare payments directly. This means that there is no reason why the qualification function of national insurance contributions, (the fact that an individual's entitlements depend on his/her NI payments record), cannot be regarded as being completely separate from the questions of who sets NI rates and who receives NI revenues.

b) In any event, the importance of NI as a qualification for benefit entitlements is being much reduced, due to current changes in the benefits system. (For example, there is the movement to flat benefits in state pensions: and in relation to both the jobseekers' allowance and the employment support allowance, the time period has been reduced before the recipient moves on to means tested benefits).

c) Further, a flat benefit system applied to the whole of a very disparate country like the UK cannot be regarded as an equitable and fair spreading of the glue. A benefit which may be perfectly adequate to tide a recipient over a period of unemployment in a dynamic area such as the South East may come nowhere near enough to assist someone in the Welsh valleys.

d) And lastly as far as a country wide glue is concerned, the proposal by the Conservatives that Scotland should be allowed to top up benefits payments already strikes at the NI system should be uniform across the UK.

4. The usual arguments against NI are therefore weak. On the other hand, there are strong arguments in its favour. It is a tax which raises a large amount of revenue: receipts are much more stable than income tax: and growth in revenues is closely related to economic growth, so that there would be a strong incentive for the Scottish government to grow the tax base, (assuming adequate powers). Moreover, (although there may be issues about what would be possible within EU rules which would need to be further explored), there would be great benefits if the Scottish government were able to vary NI rates. For example, if it were able to vary employers' NI rates for activities like research and development, or for employment in specific geographical areas like Enterprise Zones, this could provide a powerful tool for stimulating useful economic activity which would be beneficial not just to Scotland but to the whole union. One of the points that comes out of the charts in section 2 is the need for tools to address area disparities in economic activity: this proposal could fit the bill.

5. The second tax base which we argue should be considered is land. For one thing, land is in many ways the ideal candidate for local taxation: it cannot run away: and title has to be registered, so a system could be put in place to establish ownership. Moreover, misuse and under-use of land is one of the great scandals of modern Scotland under the union – with an extremely concentrated pattern of land ownership: absentee landlords: large areas under used: and an increasing loss of agricultural land to lifestyle and horsiculture. A sensibly designed Scottish system of land taxation would yield revenue and would do much to counter these abuses and foster a sustainable environment.

6. As regards areas where the Scottish Parliament needs powers, a useful starting point is to consider where the current exercise of reserved powers has failed Scotland, and why. We give the following examples:

*Fisheries:* Given up as a bargaining chip by the Heath administration in EU entry negotiations: a classic example where Scottish interest barely registered at Westminster. We still lack adequate representation.

*Monetary Policy:* administered primarily in the interests of the City, and the South East's economic interests, which, as illustrated in Section 2, are very different from Scotland's. In 1998 Eddie George, when he was Governor of the Bank of England, was reported as saying that lost jobs in the North were an "*acceptable price to pay to curb inflation in the South*", (Independent, 24 October 1998): this encapsulates the problem.

*Oil and Gas Policy and Taxation:* there have been particularly egregious failures here. Examples are the original Westminster decision to downplay the significance of this resource: (witness the suppression of the McCrone report, and the following

quotation from the minutes of the Cabinet meeting of 15th December, 1977: “Above all, the creation of an oil fund would play into the hands of the Scottish Nationalists, for whom it would become a major political target”.) The primary failing was the use of what should have been regarded as a capital resource primarily to fund the UK’s current deficit, and to cover up the UK’s deteriorating trading position: (see J.R. Cuthbert, 2013). And then there has been, whether wittingly or unwittingly, a consistent attempt to downplay the transfer of revenues out of Scotland, and the extent to which Scotland has subsidised the rest of the union. Witness the following astounding quotation from the Strathclyde Commission itself: “Whilst we know that even at its height North Sea revenue did not even cover the Scottish Welfare Bill”, (Strathclyde report, page 7): or the following from Robert Peston of the BBC: “The big question about the Prime Minister’s plan to hand more control over taxes, spending and welfare to the four nations is how far this would end the subsidy of Scotland, Wales and Northern Ireland by England, and especially by London and the South East’ (19 September 2014). These statements were made in the face of the fact that, on a very conservative basis of calculation, the rest of the UK benefited by £150 billion or more from Scottish oil revenues, (Cuthbert, 2014b). Note that this is the residual sum after fully allowing for Scotland’s total public expenditure including welfare, and defence.

*Utilities Regulation:* The reserved function of regulating the privatised utilities has seen the implementation of a charging model for utilities’ capital investment based on a flawed form of current cost accounting. The effect has been significant extra cost for customers, and windfall profits for utilities companies: (see Cuthbert, 2014a). Given Scotland’s geographical location, this has particularly adverse effects in relation to areas like rail fares, and electricity transmission costs.

*Corporation Tax:* The amount raised in Scotland is relatively small: but it is actually far smaller than it ought to be, given the amount of tax avoidance, which Scotland can do nothing about. (For example, for tax reasons, brand registration of certain major Scottish whiskies has been transferred to the Netherlands: as a result very little UK corporation tax is paid, even though the product is made here.) In addition, corporation tax could be used much more imaginatively, with adjustments being made to tax reliefs in order to encourage activities like R and D, particularly in SMEs.

*Competition Policy:* The *laissez-faire* attitude attaching to mergers and takeovers underlying UK competition policy has served Scotland particularly badly, with loss of control, and in many cases, loss of actual firms in several strategically important areas: see section 2 for examples.

*Crown Estate:* The Scottish Affairs Committee of the House of Commons did an extensive review of the operation of the Crown Estate Commissioners in Scotland and reported that substantial changes needed to be made, primarily due to inadequate attention being paid to local interest and development needs throughout Scotland. To give an example, (not reported in the Scottish Affairs report), the Crown Estate does not include the potential effect on the local economy in its criteria for determining offshore wind farm developments.

*European Representation:* Scotland has often been badly let down by its lack of direct representation in Europe. This is not only in obvious examples like fisheries and agriculture, but also more subtly because Scotland is not directly involved at the critical early stages where initiatives like research programmes and general policies are being developed. By contrast, an area like Flanders directly represents its people in Europe in the formulation of relevant parts of policy and their implementation.

*Research and Development and Support for Innovative Industries:* R&D is essential to improving productivity and competitiveness. The EU target is for 3% of GDP to be spent on R&D. Scotland's spending is very low at 1.6%, with the UK little better. In business R&D in Scotland is only 0.6% of GDP, (in contrast to, for example, Finland, at 2.4%). Current UK tax credit policies are not effective for that group of SMEs which is so important to develop in Scotland, namely technologically innovative companies. This is because many such companies are not at the stage where they are generating the profits which they need to benefit from tax credits, given the way tax credits are currently designed: and also because they often do not own all of the intellectual property, which is a particular problem for spin-outs from Scotland's strong academic research base.

7. Since we are operating here firmly within the spirit of the Smith Commission, we refrain from suggesting that relevant powers should simply be transferred to Scotland in all, or most of these areas: even though, as supporters of independence, we, (the authors), would regard that as being the cleanest and most efficient approach. But within the context of the union, unless Scotland achieves greater powers in these areas, or unless power is exercised much more effectively in these areas on Scotland's behalf, then there is little or no chance of Scotland growing its tax base, and hence increased fiscal responsibility is likely to be a disaster.

8. The appropriate way to achieve improvement in each of these areas will vary from area to area. In some cases, direct transfer of the relevant powers to Scotland within the union would be perfectly appropriate: for example, crown estate: responsibility for Scottish fisheries policy and negotiations: and direct representation of Scotland in Europe on the Flanders model.

9. But in other cases, there might be strong arguments from the perspective of preserving the unity of the union against transfer of powers: or transfer to Scotland might be meaningless within the union, (e.g., monetary policy). The challenge for the Smith Commission, and the broader reform process within which it is embedded, is to come up with a new approach in such cases, which will bridge the gap between the failure of Westminster responsibility, and full transfer of powers to Scotland. In each of these areas, what is required is something like a micro-federal solution, where power is shared between Scotland and Westminster, but in a quasi-federal manner which means that the numerical preponderance of England does not simply dominate. (We note that in their submission, the Liberal Democrats identified a similar gap as regards the exercise of devolved and reserved powers, and were advocating the development of some form of partnership working.)

## 7. Summary and Conclusions

1. In this paper, we have developed five criteria against which proposals for increased fiscal responsibility for the Scottish Parliament should be judged: these are

- *Is there an appropriate balance between incentives to grow the tax base, and the operation of fiscal transfers within a monetary union?*
- *Tax responsibility must relate to a suitable choice of tax: and must be accompanied by appropriate powers for growing that tax base. Is a suitable balance being struck?*
- *Are there technical/ feasibility problems with what is proposed: and if such problems are being assumed away by an implicit model of how the economy works, then are the assumptions involved in such a model being made overt?*
- *Does the proposed solution have a reasonable chance of agreement: and is there sufficient clarity about the proposal, on those aspects which are critical for agreement?*
- *Does the proposal measure up to the promises made in the run up to the referendum?*

Since it is clear that issues relating to income tax are going to be at the core of the reform discussions, we have devoted a lot of time to income tax. The way we have approached this is to look in detail at the Conservative proposals, which involve Scotland having almost full responsibility over income tax: and then looking in detail at the Labour proposals, which involve partial responsibility for income tax under an extension to the Calman proposals.

2. As regards both sets of proposals, there is, in general terms, insufficient clarity about how key aspects of the proposals would operate: there are important technical issues, which we identify, which need to be addressed: and there appear to be implicit economic assumptions underlying the proposals, (e.g., that the UK is a largely self-regulating optimal currency area: or that the best way of achieving economic growth is by reducing taxes): which need to be made explicit. In the absence of more detail on points like these, neither the Conservative or Labour proposals can presently be regarded as serious or credible attempts at reform.

3. However, what is required is not just greater clarity and tinkering with details of the proposals. There is enough evidence available in relation to both sets of proposals to identify what appear to be fundamental flaws and unacceptable risks. In particular:

a) Income tax is an inappropriate and risky choice as the primary basis for giving the Scottish Parliament fiscal responsibility within the union. There are a number of

aspects to this. Income tax receipts are inherently volatile and difficult to predict, (as the current problems the OBR is having in forecasting income tax receipts for the UK as a whole demonstrate): and yet no consideration is given to appropriate shock absorbers for the Scottish government. Further, if Scottish income tax were less buoyant than receipts for the UK as a whole, and if the indexation method for the abatement to the Scottish Block grant uses the Holtham approach, (as seems likely, though this is not spelled out in any of the proposals), then this would chronically penalise Scotland's public finances.

b) Critically, neither of the proposals gives the Scottish Parliament sufficient economic powers to be sure of being able to grow its income tax base. It should be a fundamental principle underlying proposals to increase fiscal responsibility that not merely is an appropriate tax chosen but that equal weight should be given to devolving adequate economic powers to grow the relevant tax base. This principle has been ignored.

4. On a more detailed technical point, in the case of the Labour proposals, (which involve a modified form of Calman tax arrangement), consideration should be given to the following proposal we make for adjusting the Holtham indexation arrangements. This adjustment would involve indexing the abatement to the Scottish Block grant not by the growth in the overall UK non savings non dividends tax base, but in relation to the growth in the tax revenue which would be produced if the basic Calman rate of tax, (15p under Labour proposals) were applied to the UK tax base. This suggestion would have to be examined in greater detail for feasibility and unlooked for side effects: but it might mitigate one of the significant risks with the current Labour proposal.

5. There are further technical issues, with both sets of proposals, which would need to be addressed.

For the Conservative proposals, these include: the need to specify exactly how the operation of the Barnett formula would be adjusted, to avoid the adverse effects of Holtham indexation: the decision as to whether the Scottish government's income tax revenue should be net or gross of those tax credits which are regarded as negative tax: and the need for an increased shock absorber to allow the Scottish government to cope with the increased volatility of its revenues.

Similar technical issues arise in relation to the Labour proposals. In addition, because Labour is proposing a modification of the Calman income tax approach, the technical issues associated with that approach also arise. In particular, the adverse effects of fiscal drag on Scottish revenues under Calman will be accentuated by the Labour proposal to extend the basic Scottish rate of tax to 15p. This is also likely to interact with the ability for the Scottish government to increase higher band tax rates, to build in a ratchet effect increasing Scottish higher band tax rates. And there are issues about Tax Incremental Funding which would need to be addressed.

6. Our suggestions for both taxes and economic powers which should be devolved are as follows.

- The two areas we recommend for increased tax responsibility are national insurance, and taxation of land.
- In terms of powers, the critical thing is that, in those areas where the exercise of reserved powers is currently failing Scotland, powers should either be transferred, or appropriate steps taken to ensure that the relevant powers are exercised properly, in the joint interests of Scotland and the union. Candidates for direct transfer of powers, we suggest, are fisheries, the crown estate, and aspects of representation in Europe. In other areas, what we suggest is required is something like a micro-federal solution, where power is shared between Scotland and Westminster, but in a quasi-federal manner which means that the numerical preponderance of England does not simply dominate: these areas include monetary policy, oil and gas policy and taxation, utilities regulation, corporation tax, competition policy, and research and development and support for innovative industries.

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