Working Paper Series: No. 1, December 2015

IFS report provides inadequate basis for fiscal settlement negotiations

Jim Cuthbert

1. Introduction

Following the result of the referendum in September 2014, the Smith Commission was established, to suggest a package of increased powers for the Scottish Parliament. Many of the Smith Commission proposals were embodied, (sometimes in modified form), in the Scotland Bill which is currently going through the parliamentary process. However, important details of the fiscal arrangements of the reforms were not spelled out – either in the Smith report, or in the Scotland Bill. Instead, the details of the so called fiscal settlement were left to be agreed in negotiation between the Westminster and Scottish governments.

Although we still know nothing about what is happening in these secret negotiations, nevertheless, in the latter part of November the whole question of the fiscal settlement suddenly achieved a very high public profile. In large part, this was due to the publication of the report of the House of Lords Economic Affairs Committee on 20th November (HOL 2015) which highlighted the potential very serious effects for Scotland if wrong decisions were made about the fiscal settlement, and argued that it was impossible to scrutinise the provisions of the current Scotland Bill properly until the details of the proposed settlement were known. About the same time, a report was published by the Institute for Fiscal Studies (IFS) looking at options for adjusting Scotland's block grant in the light of Scotland's new tax and welfare powers (IFS 2015). Since the question of block grant adjustment will be at the very heart of the fiscal settlement, one might naturally expect that the IFS report will prove influential in the current negotiations.

What will be argued in this critique of the IFS report is that it represents a flawed assessment of the options for adjusting the Scottish government block grant: and that there are significant dangers for Scotland of falling into a fiscal trap if the current negotiations take the IFS report as a basis.

At first sight, this might seem a surprising argument to put forward. After all, the IFS report does not recommend any specific method for adjusting the block grant. Quite the reverse, it correctly identifies the difficulty of implementing the 'no-detriment' principles set down by Smith, while at the same time maintaining the existing Barnett formula. And the IFS report concludes by saying that resolving all the issues it identifies would require a fundamental re-assessment of the funding regime of the UK's devolved governments – a statement with which one can only wholeheartedly agree.

The problem is that, despite this apparent agnosticism, the authors of the IFS report nevertheless make certain key decisions and assumptions about the characteristics of the block grant adjustment process: and these decisions and assumptions are sometimes being made on the basis of flawed or limited analysis.

To give one example: a key area in the adjustment process is the decision on what basis the abatement to the block grant for devolved tax revenues should be indexed through time. There are a number of possibilities – it could be done in line with the growth in tax revenues, the growth in the underlying tax base, or using some other metric. And yet, on the basis of very limited justification, the IFS concentrate on just one of these choices: the three examples which the IFS report analyses in detail, and the fourth option which they put forward as a possible alternative, all use a method based on tax revenue indexation. But the decision to use tax revenues has profound implications for the types of risk to which the Scottish government's revenues would be exposed, and for the way in which Smith's second no-detriment principle will impact on the freedom of action of the Scottish government. The upshot is that, if the IFS report was taken as the starting point from which to negotiate the fiscal settlement, the decision to index on revenue, rather than tax base or some other approach, would have already been taken – effectively by default.

Other aspects which the IFS report either ignores, or to which it pays inadequate attention are:

- What effect does the Scottish government's lack of economic powers have in affecting the balance between risk and potential reward in the eventual fiscal settlement.
- What are the limitations, and risks, of trying to run a monetary union on the basis of a largely formulaic approach to distributing resources.

These issues are discussed in more detail in the succeeding sections. The overall conclusion of this report is that the IFS study in effect represents a distorted assessment of the options for the post-Smith fiscal settlement. There are therefore grave dangers for Scotland if the IFS report were taken as the basis on which the fiscal settlement negotiations are conducted.

2. Background

This section looks at various topics which provide useful background for the discussion in later sections

Background 1: The Smith Report Principles for the Fiscal Settlement

Paragraph 95 of the Smith Commission Report, (Smith, 2014), sets out various principles which the Commission agreed should govern Scotland's fiscal settlement. Annex 1 reproduces the relevant part of the Smith report.

Background 2: The Block Grant adjustment mechanisms considered in detail in the IFS report

For each of the taxes which are devolved or assigned to Scotland, there will be an abatement to the Scottish government's block grant, to compensate Westminster for the revenues it will have foregone. Determining the initial size of this abatement should pose no problem: in line with principle (3b) of Smith, (see Annex 1), the initial abatement will be set at the amount of revenue raised in Scotland by the devolved tax at the then current UK tax rate and structure. The difficult problem that then arises is how this abatement should be increased, i.e., indexed, in subsequent years.

The following are the block grant adjustment methods considered in detail in the IFS report. For more detail, see that report, particularly sections 4, 5 and 7.

The Indexed Deduction (ID) Method
Under this method, the initial block grant deduction is increased in line with the subsequent change in tax revenues from the equivalent taxes in rUK. An approach along these lines was originally suggested by Gerald Holtham: so methods of this broad type are sometimes referred to as Holtham indexation.

The Per Capita Indexed Deduction (PCID) Method
Under this approach, instead of indexing to the aggregate percentage change in tax revenues, (as in the ID approach), indexation is linked to the percentage change in revenues per person. More formally, this approach involves dividing the indexation factor used in the ID approach by the relative rate of population growth between rUK and Scotland over the relevant period.

The Levels Deduction (LD) Method
Under this approach, the block grant abatement is increased each year by adding a population share of the change in comparable revenues in rUK.

The IFS report spends a lot of time analysing how these different approaches perform, particularly with respect to the first 'no detriment' principle, that no government should lose from the decision to devolve power: and with respect to the second 'no detriment' principle, that there should be no detriment from subsequent policy decisions of the other government. Their conclusion is that none of the methods satisfies both principles: the ID and PCID methods, (particularly the PCID one), seem more consistent with the former principle, but less consistent with the second. On the other hand, the LD method satisfies the second principle, but is less consistent with the first.

This inherent tension between the first and second no detriment principles led the IFS report to note that it could be resolved if the Barnett formula itself were modified. Under this approach, which they denoted the <u>Percentage Per Capita, (PPC),</u> method, the Barnett formula would be modified so that it delivered equal percentage changes in per capita public expenditure, (rather than equal absolute changes). Under this PPC approach, the PCID method would be used to index the abatements to the block grant. While the IFS note the possibility of using this PPC approach, they do not analyse it in detail, and do not specifically advocate it.

A key thing to be noted about the three methods the IFS analyse in detail, (namely, the ID, PCID and LD methods), and also their PPC method, is that all of these methods, in the particular forms used by the IFS, involve relating changes to the block grant abatement to changes in rUK tax revenues. It is this fact, the use of tax revenues, which will be of particular significance from the point of view of this paper: rather than the detailed characteristics of the individual methods.

<u>Background 3: Tax Revenue and Tax Base</u>

It is important to be clear that the use of tax revenue as the basis for indexing the abatement to the block grant is not pre-ordained by anything that is written in the Smith report: or indeed, in the more detailed proposals for implementing Smith set out by the then Westminster coalition government in Cm8990: indeed, rather the opposite.

The Smith Commission did not specify an indexation mechanism: their principle (3c) simply recommended that some appropriate basis of indexation should be used. Nor did Cm8990 recommend a specific option, indicating the final method would need to be arrived at after negotiation between the Westminster and Scottish governments, (para 2.4.8 of Cm 8990). But the wording of para 2.4.8 suggests that, for the most important abatement, that relating to income tax, the starting point for the discussions should be the corresponding arrangement for the Scottish Rate of Income Tax, (SRIT), which is being introduced following the Scotland Act 2012. What is proposed for the SRIT abatement is indexation according to growth in the UK income tax base. Here the tax base, for income tax, is specifically defined as the aggregate of all taxable incomes, after taxable allowances, reliefs, etc (see Cm 8990 page 29, footnote 3).

So one option for indexing the income tax abatement is indexation in relation to the tax base. But another option, and the one which, as noted above, the IFS report concentrates on, is indexation in relation to the change in tax revenues. Tax revenues vary with the size of the tax base: with variations in the tax richness of the base: and also with variations in the relevant tax rate. So indexing in relation to tax revenues raises quite different issues as compared with indexing in relation to tax base. These issues will be of great importance to the following discussion in this paper.

Background 4: The Cm 8990 approach towards achieving the 'taxpayer fairness' principle

Smith's principle (4b) states that changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK, and vice versa. This is often referred to as the principle of 'taxpayer fairness'. This seems an entirely unexceptionable principle: but, critically, there is no detail in Smith as to how this principle should actually be achieved in practice.

Cm 8990 accepts the principle: but then goes further, by specifying the mechanism by which the principle should be achieved. Specifically, it states that, where changes in rest of UK, (rUK), income tax rates cause changes in public expenditure in Scotland, there should be an adjustment to the block grant abatement to offset these. It is worth quoting in full from para 2.4.14(ii) of Cm 8990, which deals with the case of an increase in rUK income tax: '… similarly, if the UK government spends this extra funding on reserved areas (such as pensions, benefits, defence, debt interest, etc.) then this would be spent UK wide, including Scotland, despite the 'rest of UK' income tax not applying in Scotland. The tax deduction element of the funding model therefore needs to work alongside the Barnett Formula to ensure that increases in 'rest of UK' tax do not fund higher spending in Scotland.'

This approach to implementing the taxpayer fairness principle has profound implications. In particular, it means that, if the Westminster government uses changes in rUK tax rates to alter spending on reserved services, then this will impact on the size of the Scottish government's block grant – so the Scottish government will either have to change devolved services in Scotland, or make an adjustment to Scottish tax rates to compensate: (and the required compensatory change in the Scottish tax rate could, in fact, be larger than the original change in rUK tax rates.) One crucial consequence is that the Cm8990 method of implementing the taxpayer fairness principle means that the Scottish government loses a large part of the control over income tax which it thought it was getting under Smith. But the second important point to note is that this implication is a result of the particular way of implementing taxpayer fairness chosen in Cm 8990: the effect is by no means implicit in the taxpayer fairness principle itself. This distinction, between the principle itself, and the Cm 8990 way of implementing it, is of considerable importance.

3. <u>The IFS choice to use tax revenue as the basis for indexation: a problematic approach.</u>

Probably the most significant passage in the whole IFS report is the first paragraph of section 4. This paragraph includes the following statement: ‘*In this section we assess a number of specific BGA indexation approaches that share one thing in common: in each, the BGA is linked in some way to what happens to equivalent tax revenues in the rest of the UK (rUK). We focus on such approaches because they offer a relatively automatic way of ensuring that the UK Government continues to manage fiscal risks that affect the whole of the UK.’* (In this quote BGA is the IFS shorthand for Block Grant Adjustment.)

This short passage has profound, and many would argue, unacceptable, implications for all of the adjustment options which the IFS goes on to consider. The purpose of this section is to explain why.

Let us see first of all why the IFS claim that indexing on tax revenue has the property of automatically ensuring that the UK government continues to manage fiscal risks that affect the whole of the UK. There is a fuller description of this in the IFS section 4. But briefly, if the UK economy as a whole suffers an adverse economic shock, then overall UK tax revenues will suffer. The resulting pressure on public expenditure on devolved services in rUK will lead to cuts, (or a reduced rate of growth), in the Barnett formula block grant element of the Scottish government’s finances. But since the abatement to the block grant is indexed to tax revenues, there will be a cut, (or a corresponding reduced rate of growth), in the abatement. The effect is to somewhat smooth the Scottish government’s budget. If Westminster then wants to protect its services by increasing borrowing, Scotland will benefit from the Barnett consequentials, without having to increase its own borrowing.

So the IFS are correct in their claim about the effects of indexation on the management of UK wide shocks. But note that indexation on tax base also achieves a similar effect. So the IFS did not need to choose to index on tax revenues to achieve this particular outcome.

However, indexing on revenues does automatically achieve something else: it automatically delivers the Smith Commission’s taxpayer fairness principle. Let’s see how this happens: (again, the mechanism is described in more detail in section 4 of the IFS report.)

Suppose that the Westminster government increases the rate of income tax, and then spends the resulting increased revenues on ‘devolved’ services. Then the Scottish government block grant will increase because of the Barnett formula consequentials of the increased spend on devolved services: but the abatement will increase because the increase in income tax revenues will increase the abatement factor – and the two effects will, more or less, cancel out. (Whether they will cancel out exactly depends on the specific variant of the adjustment method being used: and the IFS report devotes a lot of energy to discussing the different effects under the different variants. But for present purposes, the differences between the possible variants of the revenue indexation approach are second order effects.)

Suppose, on the other hand, Westminster increases the rate of income tax, but spends the revenues on increasing expenditure on reserved services. Then since public expenditure on devolved services has not changed, there will be no Barnett formula consequentials on the block grant element of the Scottish government's funding. But because the indexation factor will have increased with the increase in tax revenues, the abatement to the block grant will have gone up: so, overall, the Scottish government's abated block grant will have gone down. But Scotland will have benefited from a share of the increased expenditure on reserved services. So again, roughly speaking, overall public expenditure in Scotland will not have changed.

So tax revenue indexation does indeed automatically deliver Smith's principle of taxpayer fairness. But it does this by putting in place an automated version of the specific mechanism for achieving taxpayer fairness set out in Cm 8990. And, as was noted in the previous section, this mechanism comes at a significant cost, (a cost which does not attach to the principle itself): namely, it means that the Scottish government effectively loses control of its own full discretion over the income tax rates it wishes to set.

It is important to note that the taxpayer fairness principle could be achieved without putting in place the Cm 8990 mechanism. This would indeed be a non-trivial step, but eminently feasible. For example, one way of doing this would be to have an rUK block grant, with expenditure on 'devolved' services, like health and education, funded out of the aggregate of the block grant plus rUK income tax receipts. Moreover, unless this change is to be purely cosmetic, the block grant for rUK has to be settled independently of the setting of the rUK income tax rate, and of determining spending priorities for rUK devolved services. If the same body is setting the block grant for rUK as is deciding the rUK income tax rate, then rUK block grant is just a residual and we are back with the kind of unacceptable results which have already been explored. So what is required is some form of quasi-federal system.

It might be argued that this involves fundamental constitutional change which goes beyond what was envisaged in Smith. This, however, should be no bar to the possibility being on the table in the current negotiations. After all, EVEL involved fundamental constitutional change going far beyond Smith – and this was implemented without even proper parliamentary scrutiny.

But, returning to the main thread, there is another very significant cost which attaches to the decision to index on tax revenue. The size of the income tax base is, (by the standard definition, and as repeated in Cm 8990), the aggregate of taxable incomes, (net of personal allowances, etc.) The amount of tax revenue will clearly vary with the size of the tax base, and in line with variations in tax rates. But it will also vary with another important factor – which one might call the tax richness of the tax base. To give an extreme example: the same growth in tax base, (say £1billion), could be achieved either by an increase in taxable incomes in the 40p tax band: or at the 20p band. But in the former case, the resulting growth in tax revenues would be £400 million: double the growth in tax revenues in the latter case. So very significant variations in tax revenues could take place which are entirely due to variations in tax richness, over and above any effect of changes in the size of the tax base, or of variations in the tax rate itself.

Indexing the block grant adjustment on tax revenues, therefore, means that Scotland is exposed to a whole new element of risk, as compared to an indexation approach based on tax base – namely, the risk of differential variations in the tax richness of the tax base. Moreover, there are good reasons for anticipating that such differential movements might well occur in practice:

a) the fact that the tax base which is being devolved excludes dividend income means that not just Scotland's overall tax base, but specifically the upper end of the tax base, is vulnerable if self employed high earners opt to take a higher proportion of their earnings in dividends.

b) there is some evidence that high income earners are in any event more likely to relocate in response to higher marginal rates of tax – or the threat of higher marginal rates.

The fact that the IFS has chosen to concentrate on indexation methods based on tax revenue therefore means that the methods of block grant adjustment which they illustrate all have the effect of exposing Scotland to a completely new class of risk, (the risk of adverse movements in the differential richness of the tax base), over and above risks attaching to differential movements in the size of the tax base itself.

In summary, there are three important points to be taken from the discussion in this section:

i) IFS's stated grounds for concentrating on indexation methods based on tax revenue is that this offers a relatively automatic way of ensuring that the UK government continues to manage fiscal risks which affect the whole of the UK. This argument does not stack up: indexing on revenues does indeed have this effect – but so does indexing on the size of the tax base.

ii) Indexing on revenues does automatically deliver the taxpayer fairness principle. But it does so by automatically enshrining the needlessly strong Cm 8990 delivery mechanism – which means that the Scottish government effectively loses control of its own income tax rate, whenever Westminster changes income tax to fund reserved services.

iii) And indexing on revenue comes at the huge cost of exposing Scotland to a completely new class of risk, (as compared with indexation on tax base): namely, the risk of differential movements in the tax richness of the tax base.

4. <u>Other areas where the IFS report is inadequate</u>

The asymmetry of risk and reward implicit in Scotland's lack of economic powers

The whole thrust of the Smith reforms is to set up a system of risk balanced by potential reward: where the Scottish government is exposed to financial risk if, by imprudent actions or bad luck, it fails to meet certain implicit targets – but, conversely, reaps reward if, by successful policies, or good luck, it overachieves the implicit targets. Setting up such a system has to involve an assessment of whether the Scottish government has a realistic chance of meeting the relevant targets, given the policy levers at its disposal.

The options which the IFS consider in their report, which are all based upon some variant or other of tax revenue indexation, expose Scotland to the full risk of relative economic underperformance as compared to rUK. The targets are challenging. (To be neutral initially, under the PCID variant Scotland's income tax revenues per head have to grow at the same rate as rUK's: under the ID variant they have to grow at about 1.0035 times the rUK rate: and for the LD variant Scotland's income tax revenues have to grow about 1.14 times the rUK rate. Here neutrality is defined as obtaining the same funding as would have been delivered by the original Barnett formula.) Moreover, the penalties if Scotland fails to meet these targets are very severe. In the long run, if Scotland's per capita tax receipts chronically grew less fast than those in rUK, then Scotland's public expenditure would ultimately turn negative under the ID variant: and would be reduced to probably around half rUK levels under the other two variants. (For proof in relation to the ID and PCID approaches, see Cuthbert, 2015b: the discussion there is couched in terms of tax base indexation, but the argument also holds for tax revenue indexation.)

It is thus extremely important, before setting up any such system, to consider the economic tools and levers available to the Scottish government. These tools have to be adequate to give the Scottish government a sporting chance, not just of meeting the implied targets in normal times: but also of breaking out of any progressive spiral of decline if such were to be instituted by, say, an adverse economic shock (see Cuthbert, 2015a for a discussion of the adverse dynamics potentially implicit in the kinds of variant being considered by IFS.)

The Scottish government will, in fact, lack many of the important economic powers. As a reminder of just how limited the Scottish government's powers will be, its worth remembering that it will, of course, have no control over monetary policy; it will have limited ability to devise a flexible package of taxation, since it will have control of only a single major tax, income tax; it will have restricted borrowing powers; and it lacks control of competition policy, international trade development, licensing of North Sea oil, utility regulation, and a number of labour market responsibilities.

Given this lack of powers, setting up any system where the Scottish government's implicit target is to match economic growth in rUK will imply a substantial asymmetry between risk and reward: the chances of falling short, and being penalised, will far outweigh the chances of exceeding the implicit target, and being able to reap rewards. It is a striking lapse in the IFS report that they concentrate on indexation arrangements, (based on tax revenue indexation), which imply such strong implicit targets, without examining or acknowledging the resulting asymmetry between risk and potential reward, given Scotland's limited economic powers.

To what extent is it possible to rely on rule based systems?

The sixth point in the Smith Commission's principles for Scotland's fiscal framework states that the arrangements should not require frequent ongoing negotiations: but should be subject to periodic review. This has clearly been interpreted by the IFS as a requirement that the arrangements should be largely formulaic: there is a brief discussion on page 45 of the IFS report of the possibility of having ongoing needs assessments, but this is largely dismissed on the grounds that it would tend to weaken the incentives on the Scottish government.

However, the assumption that the required arrangements should be largely formulaic involves glossing over a major issue. It is extremely difficult to design formulae which will operate satisfactorily over extended periods. (The Barnett formula is often put forward as an example of a formula which was fairly successful in this respect: but during the period for which the Barnett formula operated, something like £150 billion worth of oil revenues were quietly transferred out of Scotland, over and above the relatively higher levels of public expenditure which were maintained in Scotland, and after making full allowance for Scotland's share of reserved services and historic debt interest: this was certainly not a satisfactory outcome as far as Scotland is concerned.) In addition, the UK is, of course, a monetary union: and it is now widely recognised that monetary unions cannot operate successfully without periodic adjustments to intra union fiscal transfers. As experience in the Eurozone indicates, it is extremely difficult to adjust such transfers automatically, using a formula based system.

For the above reasons, there are good grounds for arguing that it is a mistake to opt for a system which is overly formulaic. A less sophisticated formula, accompanied by regular adjustments at the periodic reviews envisaged by Smith, might be better than a very sophisticated formula intended to operate for long periods. Discussion of this type of option is missing from the IFS report.

The interpretation of Principle 8 on UK economic shocks

As has been noted in section 3 above, the IFS used Smith's eighth principle (that the UK government should continue to manage risks and economic shocks that affect the whole of the UK), as their justification for concentrating on tax revenue based indexation. Not merely is this argument wrong – a similar effect is achieved by tax base indexation. But in addition, it effectively pushes the IFS into a misinterpretation of principle 8 itself.

While the principle says that the UK government should be responsible for UK economic shocks, it does not say that Scotland should be responsible for all other risks and shocks. Indeed, such a strong interpretation of principle 8 would be quite inconsistent with the concept of a well-functioning monetary union, (which involves pooling of resources against asymmetric within-union shocks and trends.) It would also be inconsistent with the kind of rhetoric that was bandied about in the referendum campaign, about the advantages of the union. And yet, in concentrating on options which put all the risks of differential economic performance on Scotland, the IFS came close to an interpretation of principle 8 which one might characterise as 'if it affects the whole of the UK, its up to the UK government: if it differentially affects Scotland,(other than relative population change, under the PCID and ID approaches), it's up to you'.

Overall, the discussion in this and the preceding section prompts the question: how did the IFS report end up in this unsatisfactory position, particularly given the expertise of the authors in this area? It is possible that the fascinating complexity of this area might have led them to concentrate unduly on what are essentially technical issues: and that, in doing so, they missed part of the broader picture.

5. Implications

The IFS report is quite right in identifying the difficulty of simultaneously satisfying all of the principles which Smith identified for the fiscal framework. What this means is that, in arriving at the final fiscal settlement, the Smith principles will inevitably have to be modified in some respects. There will need to be a process of agreeing which principles are vital: and what others can be relaxed, and by how much.

The problem with the IFS report is that it did not embark on this process in a judicious and even-handed fashion. Instead it plunged in, giving certain principles primacy on arbitrary or ill-considered grounds, while entirely neglecting other important issues.

The result is that, if one were to take the IFS report as the starting point in determining the fiscal settlement, one would find oneself working in one narrow part of the overall space of possible decisions – a part of the space with some very specific properties. The eventual fiscal settlement which would result would be one which involved indexing the block grant adjustments using some form of indexation based upon tax revenues. It would therefore expose Scotland to the whole risk of differential economic performance, (including the risk of differential changes in the tax richness of the tax base, as well as in the size of the base) – a position which is totally unacceptable in the light of the limited economic powers the Scottish government possesses. It would involve the strong Cm 8990 mechanism for delivering the principle of taxpayer fairness – which has the inevitable drawback of meaning the Scottish government loses control of its own tax rates whenever Westminster changes income tax to fund reserved services. It would involve an unjustifiably narrow interpretation of Smith's principle 8 on UK economic shocks. And it would be a rigid, rule based system, quite unable to deliver the flexibility required in running a successful monetary union.

None of these effects is essential, far less desirable. A proper negotiation of the fiscal settlement should start with a much broader canvas.

There is no need to index on the basis of tax revenues in order to achieve the eighth Smith principle, on UK economic shocks. In fact, there is no necessity even to index on tax base to achieve the principle. A system of indexing on a percentage increment which is fixed in real terms, (as advocated in Cuthbert 2015b), coupled with a flexible review process which would be triggered in the event of a major UK shock, could cope adequately.

There is no need to adopt the harsh Cm8990 mechanism in order to achieve Smith's taxpayer fairness principle. In order to achieve taxpayer fairness, the primary requirement is that changes in rUK income tax rates should be separated from decisions to change spending on reserved services. This would indeed imply some form of quasi-federal working at UK level, and would be a significant constitutional step. But EVEL has shown that significant constitutional change, over and above Smith, is perfectly feasible.

The second requirement for achieving taxpayer fairness is that the block grant abatement has to be adjusted to cancel out the Barnett formula consequentials of the effect of rUK tax changes on devolved services. But there is no need to attempt to automate this step by indexing on revenues. No tax changes are ever undertaken without a careful estimate being made of the revenue consequences: and this estimate could be used as the basis for the required offsetting change to the abatement – with a subsequent adjustment if necessary if the outturn revenue consequences of the rUK tax change turned out to be very different from the estimate.

Full account should be taken in the negotiation of the asymmetry which arises between risk, and potential reward, if Scotland is set a target of matching rUK economic performance, but is handicapped by the limited set of economic powers which it currently possesses.

There should be a recognition of the advantages which a regular system of review would offer, (under agreed ground rules, to avoid moral hazard.) This would give the flexibility required for the operation of a successful monetary union – a flexibility lacking under any over-formulaic system. Regular review also means it would be possible to operate successfully on the basis of a less sophisticated indexation system.

It is not the purpose of this paper to push any particular solution to the fiscal framework problem. (Though the author does have a personal preference, which is the operation of indexation based on a fixed, and low, real indexation factor – together with flexible arrangements for review: see Cuthbert 2015b.)

Instead, the primary purpose of this paper is to argue that the IFS report presents a narrow and distorted view of the options for the fiscal framework: and that, if the IFS paper is taken as the starting point for the negotiations, an unacceptable framework will result. There is a potential fiscal trap for Scotland of massive proportions if the current negotiations are bungled, and Scotland ends up having to match rUK on economic performance, while at the same time being handicapped by its lack of economic powers. Unfortunately, the way the IFS have set their parameters for a solution leads straight into the trap. If the negotiations take the IFS report as a starting point that is where we will end up.

References

Cm 8990 'Scotland in the United Kingdom: An Enduring Settlement': HM Government, January 2015.

Cuthbert, J. R., (2015a) 'The Barnett formula under the Smith reforms': *Fraser of Allander Institute Economic Commentary*, Vol (39)1, June 2015.

Cuthbert J. R., (2015b) 'Note for House of Lords Economic Affairs Committee following evidence session on 9 September': accessible at http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/economic-affairs-committee/the-devolution-of-public-finances-in-the-united-kingdom/written/21826.pdf

House of Lords, (2015) 'A Fracturing Union: The implications of Financial Devolution to Scotland': Select Committee on Economic Affairs. 1st Report of Session 2015-16: HL Paper 55.

Institute for Fiscal Studies, (2015) 'Adjusting Scotland's Block Grant for Tax and welfare Powers; Assessing the Options': by D. Bell, D. Eiser and D. Phillips: November.

Smith, (2014) 'Report of the Smith Commission for Further Devolution of Powers to the Scottish Parliament': 27 November.

Annex 1: Smith Commission Fiscal Framework Principles

The following principles are reproduced from paragraph 95 of the Smith Commission Report.

(1) Barnett Formula: the block grant from the UK Government to Scotland will continue to be determined via the operation of the Barnett Formula.

(2) Economic Responsibility: the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure.

(3) No detriment as a result of the decision to devolve further power: the Scottish and UK Governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

(a) This means that the initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately.
(b) Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK Government, including any identified administrative savings arising to the UK Government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved, sufficient to support the functions being transferred, at the point of transfer.
(c) The future growth in the addition to the block grant should be indexed appropriately.

(4) No detriment as a result of UK Government or Scottish Government policy decisions post-devolution

(a) Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments.
(b) Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.

(5) Borrowing Powers: to reflect the additional economic risks, including volatility of tax revenues, that the Scottish Government will have to manage when further

financial responsibilities are devolved, Scotland's fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework.

(a) The Scottish Government's borrowing powers should be agreed by the Scottish and UK Governments, and their operation should be kept under review in conjunction with agreement on the mechanism to adjust the block grant to accommodate the transfer of taxation and spending powers.

(b) Borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.

(6) Implementable and Sustainable: once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

(7) Independent Fiscal Scrutiny: the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process.

(8) UK Economic Shocks: the UK Government should continue to manage risks and economic shocks that affect the whole of the UK. The fiscal framework should therefore ensure that the UK Government retains the levers to do that, and that the automatic stabilisers continue to work across the UK. The UK Parliament would continue to have a reserved power to levy an additional UK-wide tax if it felt it was in the UK national interest.

(9) Implementation: the Scottish and UK Governments should jointly work via the Joint Exchequer Committee to agree a revised fiscal and funding framework for Scotland based on the above principles. The two governments should provide updates to the Scottish and UK Parliaments, including through the laying of annual update reports, setting out the changes agreed to Scotland's fiscal framework.