Smith Commission: why the economic and fiscal arrangements need to be changed

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1. Introduction

This paper, which has been written on behalf of the Jimmy Reid Foundation, is a critique of the economic and fiscal arrangements recommended by the Smith Commission, which reported in November 2014, and of the proposals for implementing these recommendations set out in Cm8990 published in January 2015. This paper is of particular importance just now, when the new Conservative Government is putting forward its proposals and timetable for implementing the Smith recommendations: and when the SNP will be seeking to use its increased muscle at Westminster to modify the proposals to give Scotland greater powers. The debates about implementation and modification have to be informed by a proper understanding of the problems inherent in Smith, some of which are highly technical, but have profound consequences. What the present paper does is to provide a thorough analysis of the problems – as well as putting forward solutions.

The Finance Committee of the Scottish Parliament has been carrying out an enquiry into the proposed fiscal framework set out in Cm8990: and the Jimmy Reid Foundation has submitted evidence to this enquiry. The present paper builds upon that evidence, (which is attached as an annexe to this paper): but the Finance Committee was concerned with some fairly specific technical questions – and the Reid Foundation evidence restricted itself to these questions. There are, however, a number of fundamental issues which go beyond the scope of the Finance Committee questions. These issues concern, for example, the nature of the mechanisms necessary for the successful operation of a monetary union: or what sort of implicit economic model underpins the Smith proposals. The primary purpose of this paper is to go beyond the Finance Committee focus, and to discuss such wider issues.

The structure of this paper is as follows:

Section 2 briefly summarises the main economic and fiscal changes which are proposed for implementation as a result of the Smith Commission recommendations.

Section 3 identifies a number of specific problems which would arise from the implementation of these changes.

Section 4 draws conclusions as to what the impact of the Smith proposals would be, and makes recommendations.

In summary, we find that the Smith Commission proposals, and the way they are proposed for implementation through Cm 8990, involve serious flaws:

- The income tax base is very different between Scotland and the rest of the UK: which means that income tax is an unsuitable choice as the primary vehicle for giving the Scottish parliament greater fiscal responsibility.

- There is no adequate solution to what we have called the gearing problem: that is, the problem that arises when changes in the rest of the UK in a tax which is devolved to Scotland are allowed to impact on reserved services: (that is, services, like defence, which are for the UK as a whole.)

- The Scottish government is being given responsibility for living within its tax resources, without being given adequate powers to grow the economy, and hence its tax base.

- The technical arrangements surrounding the operation of the new system are unduly complex, and are unlikely to be able to be operated in an open and satisfactory fashion.

- Although much was made during the referendum campaign about the advantages of the UK monetary union, the implementation of the Smith proposals will weaken the mechanisms for determining fiscal transfers which are a necessary part of the operation of a successful monetary union.

Overall, a Scottish government operating under the proposed reforms will find itself severely constrained in its freedom of action: and there is a real danger of Scotland finding itself locked into a self-perpetuating cycle of economic decline.

In terms of solutions, we argue that the Smith Commission proposals will not be workable unless further reform is carried out in three main areas:

1. There has to be a recognition that fundamental constitutional change is required, not just in Scotland, but at Westminster. For the reasons set out in the paper, we argue that satisfactory implementation of Smith depends on implementing a properly federal system at UK level.

2. There needs to be a recognition that Scotland requires much greater powers if it is to have a chance of making a success of increased fiscal responsibility. These powers are required in three main areas:

- Scotland needs more tax powers: one major tax lever is not enough.
- Scotland needs more economic powers: growing the economy and the tax base are essential.
- And Scotland cannot be barred, as it is now, from exploiting and benefiting from its major natural resources.

3. The various technical problems which surround the implementation of the Smith proposals need to be tackled. This in itself is no simple task. At the root of these technical problems lies the very complexity of the system. It is unlikely that a satisfactory solution can be found without a radical simplification of the whole approach: but such a simplification would be possible under a proper federal approach.

2. Background Information on the Fiscal Arrangements post-Smith

2.1 The Smith Commission was set up after the Scottish Referendum to develop proposals for implementing the promises for greater powers for Scotland made by the "No" side in the referendum campaign. The Commission involved all five of the main Parties, and reported on 24th November, having deliberated for the very short time period of seven weeks. The Commission report was unanimous: which meant, inevitably, that it involved a good deal of compromise between the differing viewpoints of the Parties involved. On 21st January, the Westminster government published Cm8990 setting out its proposals for taking forward the recommendations in the Smith Commission report.

2.2 On the fiscal side, the thrust of the Smith recommendations was to give the Scottish government greater responsibility for funding its expenditure through revenues raised in Scotland, while at the same time delivering on the pledge made during the referendum campaign by the leaders of all three main UK Parties, that the Barnett formula would continue. Specifically, as regards tax, the Smith Commission recommended that the Scottish parliament should be given control of non-savings non-dividend income tax in Scotland: the Scottish parliament would be responsible for setting rates and thresholds for this tax in Scotland, (apart from the basic threshold), and the resulting revenues would come to Scotland. The Scottish government would also be given control of air passenger duty and the aggregates levy. Overall, therefore, after the implementation of the Smith reforms, the taxes under the control of the Scottish government would be council tax, non-domestic rates, income tax on non-savings non-dividend income, land and buildings transaction tax, air passenger duty, and aggregates levy. Smith also proposed that a portion of the VAT revenues raised in Scotland should be assigned to the financing of the Scottish budget: the proposals in Cm8990 in fact extended the Smith recommendation on VAT – so that about half of the VAT revenues raised in Scotland will be assigned to the Scottish budget. Scotland will not, however, have any power to set VAT rates. Overall, post-Smith, about half of the Scottish budget would consist of revenues which are either under the control of the Scottish parliament, or which are assigned to Scotland.

2.3 The revenues coming from the proposed new tax powers and assignments will interact with the existing Barnett formula in the following way:

- The Scottish government will continue to receive a Block Grant from Westminster, the starting point in the calculation of which each year will be the existing Barnett formula calculated for that year.
- There will, however, be abatements to the Barnett formula amounts to allow for the new tax revenues which in future will be raised by or assigned to the Scottish government.
- The initial size of the abatement will be calculated so that neither side either gains or loses: that is, the initial abatement in year 1 of the implementation of Smith will equal the tax revenues foregone by Westminster.

- For subsequent years, the size of the abatement will need to be indexed. As yet, the details of this indexation process have not been finally determined. But it is proposed that the abatement for income tax revenues foregone by Westminster will be indexed on the so called Holtham method: that is, in line with the growth in the overall UK income tax base.
- There will be an addition to the Block Grant in relation to the welfare programmes that are being devolved to Scotland under the Smith proposals.
- The Scottish government will have the ability to build up a cash reserve: and it will have limited borrowing powers, both to cover short term revenue fluctuations, and for capital investment. The overall limits are £500 million for current borrowing and £2.2 billion for capital.

2.4 Underlying the Smith proposals were important "no detriment" principles. The first of these was that neither side should suffer detriment as a result of the decisions to devolve further powers. That is, that Scottish and UK government budgets should be no larger or smaller simply as a result of the initial transfer of tax or spending powers.

2.5 Smith's second no detriment principle is that neither party should suffer as a result of policy decisions made by the other party post devolution. This principle was set out in paragraph 95(4) of Smith, which states:

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.

2.6 Cm8990 accepted this principle, but set out to implement it in a specific way. The relevant part of Cm8990 is paragraph 2.4.14. What this envisages is that, if the UK government makes a change to a tax in the rest of the UK, for which responsibility in Scotland is devolved: and if this change affects expenditure on reserved services, (such services are regarded as benefiting the whole of the UK), then there should be a compensating up or down change in Scotland's Block Grant, so that the overall level of public expenditure in Scotland is not affected. And if the UK government makes a change to a tax in the rest of the UK, for which responsibility in Scotland is devolved: and if this change affects expenditure on "devolved" services in the rest of the UK, then there should be an adjustment to Scotland's Block Grant, to cancel out the Barnett consequentials of the rest of the UK tax change. As we will see later, this way of attempting to implement Smith's second no detriment principle has profound consequences.

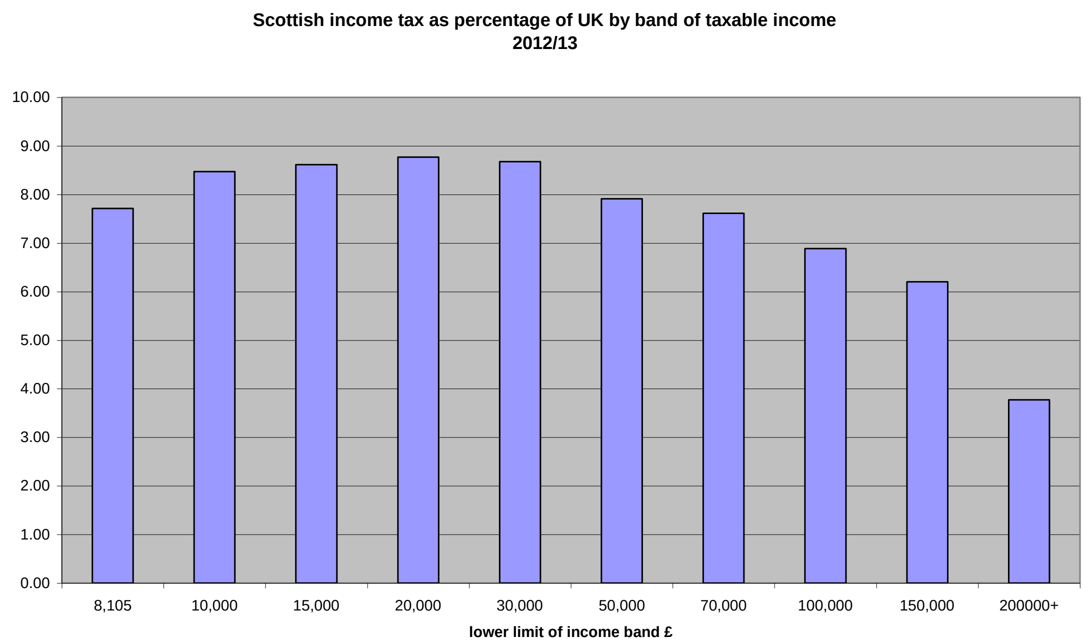
3. Issues and Problems with the Smith Proposals

3.1 In this section, we identify and discuss a number of significant issues which will arise in the operation of the Smith proposals. The devil, as always, is in the detail: and it is only in the light of consideration of the kind of detail discussed in this section that we will then be able, in the next section, to draw some overall conclusions as to how well the new system is likely to operate.

Income Tax: An Unsuitable Choice of Tax

3.2 As we have seen, the primary mechanism chosen to give the Scottish Parliament greater fiscal responsibility is control over much of income tax. Income tax, however, has severe drawbacks for this purpose: these include:

(i) There are marked differences in the tax base between Scotland and the rest of the UK. These principally relate to the fact that Scotland has proportionately far fewer taxpayers with earnings at the upper end of the income scale. For example, as regards taxpayer numbers, in the UK as a whole, HMRC statistics for 2012/13 indicate that 0.55% of taxpayers earned over £200,000: the corresponding Scottish percentage is only half this, at 0.27%.
As regards the amount of tax revenue, the chart below shows, for 2012/13, (the last year for which data is available), Scottish total income tax revenues as a percentage of UK within the different bands of taxable income. Scotland has 8.3% of the UK population. The chart shows how, for income bands from £50,000 up, the Scottish share of UK income tax falls progressively below Scotland's population share, dropping to 3.77% for the income band of over £200,000 (HMRC, based on liabilities).



(ii) Income tax receipts can be fairly volatile year to year. For example, between 2008/09 and 2009/10 income tax receipts in Scotland fell from £11,288 million to £10,610 million – a fall of over £678 million or 6%.

iii) As was pointed out by the Institute for Fiscal studies, (IFS,2014), the restriction of the Scottish rate of income tax to non-dividend income means that some tax payers could potentially respond to a higher rate of income tax in Scotland as compared to rUK by shifting their income into dividends: these would then be taxed at the UK rate. This could apply particularly, for example, to owner/managers of small companies.

These factors are likely to lead to a number of adverse consequences. First, the different structure of the Scottish income tax base from that of the UK as a whole means that there will inevitably be periods when the tax base in Scotland grows less fast than that in the UK. As we will see, this will interact with the proposed arrangements for indexing the abatement to the Scottish Block Grant in a way which will adversely affect Scotland. Secondly, the potential volatility of income tax receipts is large compared with the amount of borrowing allowed to the Scottish government to meet short term revenue fluctuations: this borrowing is limited to £200 million in any one year up to a cumulative total of £500 million. As regards the restriction of the Scottish tax to non-savings, non-dividend income, while it is not possible to quantify the effects of this, the result could be to reduce the marginal yield from any increase in the Scottish rate of income tax, particularly at the higher rates.

Responsibility without Power: the Scottish Government will lack adequate powers to make the system work.

3.3 Although the Smith Commission proposals were intended to mark a very significant transfer of powers to the Scottish government, in practice the actual powers which the Scottish government will be able to exercise will be severely constrained. This arises for two main reasons.

3.4 First, there is the problem that if there is only one major tax lever to control, and that tax bears upon a mobile resource like labour, then it will not be possible in practice for any Scottish government to implement a rate of income tax in Scotland which is significantly higher than the income tax rate in the rest of the UK (rUK). If it did attempt to do this, then there would be an outflow of labour, particularly skilled labour, and the Scottish economy would face the danger of relative decline. Note that this danger would be much less if the Scottish government had a range of major tax levers under its control. In such circumstances, it would be able to design an overall tax package, with higher taxes on some tax instruments and lower on others, which would be constructed to achieve different objectives from the rUK tax package, but which would not necessarily be any less attractive to the taxpayer. This option is not open if only a single major tax lever is available.

3.5 Secondly, the Scottish government lacks many of the most important economic powers which would be necessary to optimise Scotland's economic performance. Without adequate powers, the Scottish government will be in the position of having greatly increased responsibility for living within its tax resources, without the power to take really effective action to grow the Scottish economy, and hence the tax base. (As we will see below, the situation is made even worse because of the particular method which Westminster intends to implement for indexing the abatement to the Scottish government's block grant).

3.6 As well as wider tax powers, areas in which important economic powers are reserved are:

- Employment policy
- Industrial policy
- Competition policy
- Representation in Europe
- Licensing (of industries like whisky and oil)
- Utility Pricing

3.7 There was a detailed discussion in our earlier Jimmy Reid Foundation/Options for Scotland paper (Cuthbert and Cuthbert 2013), showing how in most of these areas, power has not been exercised by Westminster in a way which has been to Scotland's advantage. For example, under Westminster's direction of competition policy, Scotland has lost control of some of its major industries like whisky. That earlier paper also showed how, with greater autonomy in these areas, Scotland could use its powers to increase economic and social well being. We will not repeat that detailed discussion here: but the important point to make is that there is much that a Scottish government could do with increased economic powers to grow Scotland's economy and tax base – but under Smith, it lacks the necessary powers.

3.8 One specific area which should be mentioned however, because it was not covered in that earlier paper, is the Transatlantic Trade and Investment Partnership, (TTIP), which is currently being negotiated between the US and the EU. The risk that TTIP poses a threat to the NHS in Scotland has received considerable publicity, although the reassurances that have been given that health will be protected are not very convincing. A subject that has not received as much publicity is the potential threat under TTIP to the public ownership of Scottish Water. This again highlights the need for the Scottish government to be part of the negotiations on TTIP and similar treaties.

The Gearing Problem Not Satisfactorily Addressed

3.9 The Smith Commission proposals on income tax raise problems which are a good deal more complex than the Calman tax proposals to give Scotland control over a 10p share of income tax rates. One particular difficulty which arises under Smith occurs if changes in income tax in rUK are allowed to affect not just "devolved" services in rUK but also reserved services for the whole of the UK. It is remarkable that this particular problem has attracted little attention to date, because it has fundamental implications. Perhaps the reason for this lack of attention has been that there is no convenient name to describe the problem: which is why we have given a name to it, calling it the "gearing problem".

3.10 The nature and implications of the gearing problem are discussed at length in the Jimmy Reid Foundation evidence to the Finance Committee: see the answer to Question 1 in the Annex to this paper. We will not repeat that detailed discussion here, but the main points are as follows.

3.11 In its purest form, the gearing problem would arise if a cut in rUK income tax was being funded wholly or partly by a cut in "reserved" services. To prevent damage to the economy which would occur if Scotland's tax rates got badly out of line, the Scottish government would have to match the cut in rUK income tax, and hence the Scottish government would have to cut services under its control: but since the spending cut in Scotland would be spread over a narrower base, there would be a disproportionate, or geared, effect relative to the cut, if any, in "devolved" services in rUK. While the Smith Commission report did not specifically spell out this gearing problem, the Commission was clearly aware of it: and one of Smith's no detriment principles would, if it were possible to implement it, have the effect of removing the problem. However, the way that Cm8990 proposes to implement this no detriment principle is flawed. As pointed out in the Annex, the effect of the Cm8990 approach would be that, if the Westminster government chose to use rUK income tax to fund an increase in reserved services, then the Scottish government would have to increase its tax rate, or cut its services, or both.

3.12 Overall, it is difficult, if not impossible, to see how a satisfactory solution to the gearing problem could be arrived at without having a specific rUK Block Grant, together with an rUK chamber which would set rUK income tax, and decide how "devolved" services in rUK would be run, and funded from the rUK Block Grant plus rUK income tax. There would also need to be a separate, overarching UK chamber, responsible for setting the Block Grants for the different countries of the UK. That is, a satisfactory solution to the gearing problem would require something akin to a proper federal system for the UK.

Technical difficulties of indexing the abatements to the Scottish Block Grant

3.13 Again, a fuller discussion of these specific issues can be found in the Annex, in the answer to question 3. But to summarise:

a) The proposed approach to indexing the abatement to the Block Grant for the income tax revenues foregone by Westminster is the so called "Holtham" method, which involves indexation in line with the overall increase in the UK income tax base. This means that Scotland stands to gain if the Scottish tax base increases faster than that for the UK as a whole: but conversely, Scotland will be penalised if the Scottish tax base grows more slowly. This puts at a premium the need for Scotland to be able to grow its economy, and hence its income tax base. However, the lack of important economic powers means that Scotland is, in effect, not merely being forced to engage in this particular battle, but to do so without adequate weapons – and hence is unlikely to succeed. The problem is exacerbated by the differences, which we have already noted, between the tax bases in Scotland and the rest of the UK, which are likely to mean that there will be periods when the Scottish tax base grows less fast. There is a particular danger that any such period might institute a self reinforcing cycle of higher income tax rates in Scotland, relative economic decline, reduced resources, and so on.

b) There has been a long standing tendency for the population of Scotland to decline relative to the rest of the UK. As noted in the Annex, for Holtham indexation to be neutral, Scotland would have to grow its per capita tax base at the rate of growth of the per capita tax base in the UK as a whole, multiplied by the relative rate of population growth in the UK as compared to Scotland. In other words, Scotland would have to grow its per capita tax base faster than the rest of the UK, just to stand still. There is thus a strong case for making a specific adjustment to the Holtham indexation approach, so that indexation is carried out not in relation to the growth in the total UK tax base, but in relation to relative growth in the UK per capita tax base.

Technical difficulties in relation to the operation of the Smith "no detriment" principle.

3.14 This too is covered in the Annex: (in answer to question 5). To summarise:

as already noted, the implementation of the Smith no detriment principle as set out in Cm8990 does not provide a satisfactory solution to the gearing problem. But even leaving this difficulty aside, there will be significant technical difficulties about operating this proposed approach. What paragraph 2.4.14 of Cm8990 implies is that there would be ongoing adjustments to the Scottish Block Grant, for example, to cancel out the Barnett formula implications of a decision to change rUK income tax rates. However, there is much scope for confusion, and argument, about what would actually constitute such a change in rUK tax. For example, would a decision to uprate income tax thresholds to counteract fiscal drag be such a change? Or indeed, would the failure to uprate tax thresholds in a given year for inflation in itself be such a change? Moreover, these no detriment adjustments would have to be appropriately indexed. Holtham indexation would not be suitable for this: and it is actually very difficult to see how an appropriate indexation method could be arrived at which would be self-cancelling if a given tax change was reversed.

Problems with VAT assignment

3.15 Although the Scottish government will have no powers whatsoever to alter VAT rates, Cm8990 actually extends what was proposed by the Smith Commission, so that about half of estimated Scottish VAT revenues will be allocated to the Scottish government. There are a number of potential problems with this.

a) Estimated Scottish VAT revenues can be relatively volatile. The following table shows Scottish VAT revenues as a percentage of UK, as estimated by HMRC over the period.

VAT Receipts: £ million

Year	UK	Scotland	Scotland/UK%
1999-00	56,779	4,633	8.2%
2000-01	58,622	4,787	8.2%
2001-02	61,026	5,047	8.3%
2002-03	63,451	5,235	8.3%
2003-04	69,075	5,671	8.2%
2004-05	73,026	5,958	8.2%
2005-06	72,856	6,044	8.3%
2006-07	77,360	6,685	8.6%
2007-08	80,599	7,033	8.7%
2008-09	78,439	6,882	8.8%
2009-10	70,160	6,169	8.8%
2010-11	83,502	7,264	8.7%
2011-12	98,292	8,275	8.4%
2012-13	100,572	8,317	8.3%
2013-14	104,718	8,654	8.3%

Source: HMRC

As can be seen, Scotland's estimated share of VAT revenues increased from 8.2% to 8.8% before decreasing again. A fluctuation of this magnitude in the share of VAT revenues coming to Scotland would represent about £314 million in the Scottish Budget. Moreover, it is not at all clear that this fluctuation did in fact reflect any real underlying change in the Scottish economy. The allocation of VAT receipts to the different countries of the UK is carried out on the basis of patterns of household consumption as estimated by the Living Costs and Food Survey, (which draws a sample of 5,665 households per year in the UK). There was a significant change in the methodology of this survey around 2006: it is not known whether this change affected the estimated apportionment of VAT receipts to Scotland.

b) According to HMRC published sources, there is a particularly large gap for VAT between expected payments and actual payments: actual payments run about 10% below expected payments. There is absolutely no information as to whether the size of this gap varies between different parts of the UK. This contributes another significant element of uncertainty to the notional assignment of VAT revenues to Scotland.

c) The need to index the abatement to the Scottish Block Grant for VAT revenues foregone by Westminster will raise similar indexation problems as already discussed above in relation to income tax.

Overall, it is difficult to see that Scotland gains anything from the proposals to hypothecate to Scotland a share of VAT revenues. Scotland gains absolutely no extra powers: but is exposed both to the short term fluctuations, and the long run indexation risk, which will be associated with this tax. And given the large element of uncertainty about the assignment of VAT receipts to Scotland, it is difficult to see that it adds much to the principle of fiscal responsibility.

Monitoring and openness problems

3.16 It will be very important, once the Smith proposals are operational, that the system should be seen to be operating openly and fairly. This is actually going to be extremely difficult to achieve. There are a number of different aspects to this.

a) First of all, the proposed changes graft on to the existing Barnett formula a complicated system of abatements and ongoing adjustments, all of which will, in turn, need to be appropriately indexed. This overall process is so complex that it is difficult to see how it can be performed openly and fairly.

b) The situation is made much worse because of the operation of the underlying Barnett formula. There is some discussion of this in the Annex in answer to question 3. But to give one example, because the Treasury Funding Statement and PESA databases are not aligned, it is not possible to work out what the outturn expenditure has been for England, on those services which are devolved to Scotland. In other words, it is not possible to say, without some fairly crude estimation, to what extent the existing Barnett formula is actually bringing about convergence of per capita spending levels between Scotland and England.

c) There are still important deficiencies in the government's estimation of what the level of public expenditure attributed to Scotland actually is. The basic data source here is PESA, produced by the Treasury in an annual exercise jointly with government departments. Periodic improvements have been made to PESA: however, examination of the detailed data indicates that there is further work to be done. Areas requiring attention include expenditure on research and development by the UK research councils: and expenditure by the Whitehall Department of Business, Investment, and Skills on important matters such as trade promotion, and inward investment.

d) As we have already noted, there are problems with the estimation of VAT receipts for Scotland. Unless this methodology can be demonstrated to be very robust, any fluctuations in estimated VAT receipts are liable to be challenged.

Danger of policy bias because of separation of powers

3.17 On a broader scale, there is a real danger that the separation of powers implicit in devolution, and even more so after the implementation of Smith, will lead to a damaging form of policy bias. The Scottish government will, naturally, focus its efforts on those powers it possesses. Conversely, Westminster, and public opinion in general in rUK, is likely to take the view that Scotland should be left to get on with things, particularly since there seems to be a widespread opinion that Scotland will have something approaching home rule. The result is that Westminster is unlikely to factor Scottish interest fully into the development of policy in vitally important reserved areas. This effect can already be seen at work – with recent Westminster science projects virtually ignoring Scotland. The likely outcome is that Scottish economic (and social) problems will not benefit from a policy approach which properly integrates all policy levers.

Erosion of mechanisms necessary for the successful operation of a monetary union

3.18 It is widely recognised that, for a monetary union to be successful, there have to be mechanisms in place for fiscal transfers between different parts of the union, as and when the need arises. Requirements for such transfers would either be temporary, (as one part of the union suffered a temporary economic shock), or more or less permanent, (if there are fundamental and long-standing imbalances between the resources or economic performance of different parts of the union.)

3.19 The effect of implementing the Smith proposals will be to reduce the impact of the mechanisms for fiscal transfers which currently exist within the UK monetary union, as the Scottish government moves to having more than half of its expenditure funded from own resources. This is not to say, of course, that the existing mechanisms for fiscal transfers were by any means perfect. For one thing, since 1980, the subsidy transferred from Scotland to rUK has been worth approximately £150 billion, despite the relatively high levels of public expenditure in Scotland funded by the Barnett formula: (Cuthbert and Cuthbert, 2014.). Furthermore, the relatively high levels of public expenditure funded by Barnett were largely accidental, (arising from relatively slower population growth in Scotland), and were not delivered by any conscious policy.

3.20 Nevertheless, imperfect as the current mechanisms are, replacing them by the Smith proposals is likely to be very unsatisfactory. Scotland will have to depend on its own income tax and VAT resources, without having sufficient tools to ensure it can grow the economy and tax base. And Scotland will not be able to benefit from tax receipts on oil or renewables which, (despite recent fluctuations in oil prices), are in the medium term likely to be significant. In effect, Scotland is being forced to compete on ground which would not be of its own choosing, and without adequate weapons in the shape of economic powers. In these circumstances, (and further handicapped by the adverse effects of Holtham indexation), the weakening of mechanisms for compensating fiscal transfers is likely to adversely penalise Scotland.

4. Conclusions and Recommendations

4.1 There has been a widespread hope that Scotland might be able to use its new taxation powers to achieve radical change in disparate areas like raising extra revenue to fund new social policies and/or to mitigate the worst effects of UK public expenditure cuts: redesigning the tax system to achieve greater equity: and implementing policies which will grow the economy, and hence the tax base. In effect, the Scottish government, like any government, faces a complex multi-dimensional optimisation problem: and the hope that has been raised by Smith is that the Scottish government, with its new powers, might be able to achieve a much better solution to this problem than has been possible to date.

4.2 Reality, however, is likely to be very different, given the problems and issues discussed in the previous section. First of all, any Scottish government will actually be severely constrained in its freedom of action – and will also have to spend a lot of its policy effort acting in a reactive, rather than pro-active, mode. The constraints arise because, in practice, it will not be able to change rates of income tax in Scotland too much from those in the rest of the UK: because it is being handed a single tool to manage multiple problems: and because it has limited economic powers to attempt to grow the economy and the tax base. It will be forced into a reactive mode of working because the gearing problem has not been satisfactorily solved – which will mean that the Scottish government will have to either increase its income tax rate, or cut devolved services, whenever the rest of the UK uses income tax to increase spend on reserved services. And it will also be forced to react to the inherent volatility implicit in the unsuitable choice of income tax as the primary vehicle for giving Scotland fiscal responsibility.

4.3 But it is not just that the Scottish government lacks powers: the way that the fiscal framework is being constructed means that there is a real danger of Scotland being locked into a self-perpetuating cycle of relative economic decline. Holtham indexation, together with the marked differences in the income tax base between Scotland and rUK, mean that at some time the income tax base in Scotland will be growing less fast than the tax base in the UK as a whole. At that point, lacking the adequate powers to grow the economy and the tax base, a Scottish government is likely to respond by raising Scottish income tax rates: this is likely to further damage the economy, leading to further relative decline. In the absence of oversight mechanisms for adjusting fiscal transfers within the UK monetary union, there will then be no way of addressing such a situation. The perversity of the way the Smith reforms are being implemented means that Scotland could well find itself in a position rather like Greece – locked into a cycle of relative decline within a malfunctioning monetary union. Indeed, in certain important respects, Scotland's position would be worse than that of Greece. Scotland is a resource rich country, but barred from controlling or accessing much of its own resources, and Scotland does not have anything like the range of economic and taxation powers possessed by Greece.

4.4 It is perhaps not surprising that the Smith Commission ended up with such a problematic result. First of all, achieving successful constitutional change is an inherently complex task: and setting a timetable of seven weeks was virtually asking for the impossible. Secondly, the Commission tackled its brief from what one might call an accounting mindset: with too little appreciation of the fundamental importance of the economy, and of Scotland having adequate economic powers. And thirdly, there is a strong suspicion that certain parties to the Commission were coming from a particular free market and neo-liberal economic viewpoint. On this viewpoint, the primary requirement is to balance the budget, and shrink the state – and then the economy, (and social justice), will look after itself. It is little short of a tragedy that at a time when the hollowness and cruelty of such a neo-liberal viewpoint is becoming increasingly apparent worldwide, nevertheless Scotland is being lumbered with a fiscal framework which would only make any sort of sense if one ascribed to such views.

4.5 So what should be done to make the Smith proposals workable? Assuming the continuation of the Union, we suggest that reform is vital in three main areas.

First of all, there would have to be a recognition that fundamental constitutional change is required, not just in Scotland, but at Westminster. Without major changes at Westminster, there will be no solution to the gearing problem. Further, as long as the UK remains a monetary union, proper mechanisms will be required for determining what fiscal transfers may be necessary, and for overseeing such transfers. Westminster as presently constituted is inherently not suited to carrying out this role – as is graphically illustrated by the parochial and divisive stance the UK Prime Minister took in the Referendum and General Election.

Secondly, there needs to be a recognition that Scotland requires much greater powers if it is to have a chance of making a success of increased fiscal responsibility. Scotland needs more tax powers: as we have argued, one major tax lever is not enough. Scotland needs more economic powers: growing the economy, and the tax base, are essential. And Scotland cannot be barred from exploiting and benefiting from its major natural resources, as it is now.

Thirdly, the various technical problems which surround the implementation of the Smith proposals need to be tackled. This in itself is no simple task. At the root of the problems surrounding the indexation of the various abatements and adjustments in the current Smith proposals lies the very complexity of the system. It is unlikely that a satisfactory solution can be found without a radical simplification of the whole approach.

4.6 So can the above requirements be achieved? In fact, they probably can, in the shape of a properly federal approach. As we have already noted, federalism would solve both the gearing problem, and provide the necessary oversight mechanism for any fiscal transfers that would be required. With federalism, there would naturally come much greater fiscal and economic powers. However, we would fall short of describing this as full fiscal autonomy - because in any federal system, (and in any monetary union), some balance must necessarily be struck between federal and individual state powers. Another advantage of federalism is that the tortuous system of financial abatements and adjustments required under Smith would disappear. The individual states would set the taxes designated for use as own resources, and this would be topped up by the federal government who would oversee the system of transfer payments for the constituent parts of the UK. And naturally, a country operating on a federal basis would evolve mechanisms for directly measuring the taxes raised in the constituent states – rather than relying on the crude and unsatisfactory apportionment methods which we have today in the UK.

4.7 So federalism could provide a solution to the difficulties we have identified with Smith. The big question, of course, is whether England would be prepared for the inevitable compromises on English sovereignty which such an approach would require. But that is a question for England: and if England wishes to preserve the Union, it may be that such compromises are the price which it would have to pay.

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Annex: Scotland's Fiscal Framework: Finance Committee Call for Evidence on Smith Commission Implementation.

Submission by Dr J. R. Cuthbert on behalf of the Jimmy Reid Foundation, March 2015

Introduction

This paper is submitted on behalf of the Jimmy Reid Foundation, though the contents are the responsibility of the author. The bulk of this paper will consist of detailed comments on some of the specific questions in the Finance Committee's call for evidence. However, it is worthwhile beginning by clarifying the nature of the points being made here, which fall into two categories.

First of all, at a fundamental level, it is extremely difficult to see how the Smith Commission proposals can be implemented in a fair and equitable way, and without adverse unintended consequences, unless deep-rooted reforms in the constitutional and funding arrangements for Westminster are also implemented. This is because of the implications of what will be referred to as the gearing problem, which arises if changes in income tax rates in the rest of the UK (rUK) are allowed to affect not just "devolved" services in rUK, but also reserved services for the whole of the UK. As will be shown, the proposed way in which the "no detriment" principles in Smith are to be implemented does not provide a satisfactory answer to the gearing problem: instead, it leads to a situation where, if Westminster decides to change rUK income tax to fund a reserved service like defence, then this will force the Scottish government to increase the Scottish rate of income tax, or to cut Scottish devolved services like health or education.

At another level, however, this note will also discuss a number of technical issues which will arise in the implementation of the current proposals: for example, problems with the operation of the proposed method for indexing the abatement to the Scottish Block Grant: and a separate range of problems which will be posed by the need to index the adjustments to the Block Grant which will be required in the light of decisions to change rUK income tax.

At first sight, it might appear that there is an inherent contradiction between these two approaches. If it is impossible to implement a satisfactory Scottish fiscal framework in the absence of fundamental UK changes, why should this note concern itself with technical points of implementation? But in fact, as will be seen, both approaches ultimately point in the same direction. The technical complexities of satisfactorily implementing the arrangements which are currently proposed are so great that it is likely to prove impossible to operate the resulting system in a fair, transparent, and acceptable manner. Solving the technical problems inexorably points to the same conclusion: that is, to the need for a fundamental reform of the UK framework, along some kind of properly federal lines.

To achieve this, there would need to be an rUK chamber responsible for taking the rUK Block Grant, setting the rUK income tax rate, and determining spending priorities on health, education, etc., from the resulting budget. And there would need to an over-arching body setting the whole UK budget, and determining the allocation of UK resources, (excluding income tax and other devolved taxes), between reserved functions and the territorial Block Grants.

Specific Finance Committee questions.
(Note that the numbering in what follows refers to the ordering of the original Finance Committee list of questions: not all questions are considered here.)

Question 1: What needs to be included within a revised funding framework for Scotland and how do we ensure that it is fair, transparent, effective and mechanical rather than requiring regular negotiations?
1.1 Giving Scotland the ability to set its own income tax rates for the whole of non-saving non-dividend income raises problems which are a good deal more complex than those posed by the Calman tax proposals. One of the new issues which arises relates to the gearing problem. This problem occurs if changes in income tax in rUK are allowed to affect not just "devolved" services in rUK, but also reserved services for the whole of the UK. Suppose, for example, that Westminster decides to implement a significant cut in rUK income tax rates, and to fund this it cuts public expenditure. Suppose, further, that the cut in public expenditure is spread evenly over not just domestic "devolved" services in rUK but also over "reserved" services like defence, social security etc.

1.2 Now consider Scotland's position. If the Scottish government does not match the cut in income tax rates by the rest of the UK, then the Scottish economy is likely to be at a chronic disadvantage: ultimately, any Scottish Government operating under the Smith arrangements would have to follow suit if the rest of the UK were pursuing an aggressive policy of cutting income tax rates. But if the Scottish Government does adopt the same cut in tax rates as the rest of the UK, then, the cut it would have to make in public expenditure will be concentrated on devolved services in Scotland, rather than being spread over devolved and reserved services as in the rest of the UK. As a result, the cut in devolved services in Scotland would be significantly deeper than in the rest of the UK.

1.3 This kind of arrangement would put Scotland in an intolerable situation. The gearing effect would mean that an income tax cutting policy in the rest of the UK would force upon Scotland either disproportionately higher tax rates or disproportionately greater cuts in public expenditure: there would be no escape.

1.4 The Smith Commission report does not specifically spell out this gearing problem: but, on the other hand, one of the "no detriment" principles in Smith would, if satisfactorily implemented, have the effect of solving the problem. This is the principle set out in paragraph 95.4(b), relating to the effect of decisions taken by the rUK or Scottish Governments post-devolution, which states:

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.

1.5 The proposals for implementing Smith published on 21st January 2015 in Cm8990 accepted the principle of this clause, but proposed to implement it in the following way. If, for example, the Westminster government chose to use an increase in rUK income tax to fund reserved functions, then paragraph 2.4.14(ii) of Cm8990 explains what would happen: *"… 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*."

1.6 To see what this means, consider the following. Suppose a UK government decided it was going to fund extra expenditure on say, Trident, by raising rUK income tax rates. Since defence is a reserved function, public expenditure on Trident is regarded as "benefiting" the whole of the UK. So public expenditure in Scotland will rise by Scotland's population share of the extra spend on Trident. Since aggregate public expenditure in Scotland has now risen by this amount, the principle of Clause 95(4)(b) is in danger of being breached, so to avoid this happening, Westminster will reduce Scotland's Block Grant correspondingly.

1.7 The implications of this are stark: if Westminster decides to use an increase of rUK income tax to fund a reserve service like Trident, (as it is perfectly entitled to do under the current proposals), then Scotland has the choice of either

a) Accepting a cut in Scotland's devolved services equal to our population share of the increase in reserved expenditure: or
b) Raising our own income tax rates so as to recover an amount equal to our population share of the extra income tax revenue being raised in the rest of the UK.

1.8 This is profoundly unsatisfactory. Letting Westminster spend rUK income tax on reserved services means that Westminster can force on Scotland cuts in devolved services or changes in Scottish tax rates. This is absolutely counter to the popular conception of the scope of the extra powers promised under Smith. We thought we were getting control of income tax: well, it now turns out that this is only true to the extent that Westminster does not decide to use rUK income tax to fund reserved services.

1.9 But in fact, the actual situation is even worse than this. Previously, if Westminster chose to use a change in income tax to fund a reserved matter like Trident, what each part of the UK would contribute would be the sum yielded by the relevant change in income tax applied to that part of the UK. Now, when Westminster decides to increase rUK income tax to fund a reserved service, what Scotland will have to contribute (by cutting services or raising income tax) is Scotland's pro rata population share of the change in rUK tax yield. And since the income tax base in Scotland is very different from the income tax base in rUK, (with Scotland having many fewer of the very high taxable incomes associated with

London's financial sector), then the implications are serious. Since income tax yields per head are significantly lower in Scotland, (with Scotland having 7.4% of total UK income tax receipts, compared with 8.3% of UK population), then raising an equivalent sum per head in Scotland would mean a bigger increase in Scottish income tax rates than the original increase in rest of UK rates.

1.10 The way in which it is proposed to implement Smith's paragraph 95.4(b) principle is therefore unacceptable. The problem arises because, under the current implementation proposals, it will still be possible for the Westminster government to use changes to rUK income tax to fund changes in reserved services. Solving the problem would require hypothecation of rUK income tax receipts so that they could only fund rUK "devolved" services.

1.11 However, hypothecating rUK income tax receipts like this has very fundamental implications. What would be required is that there would have to be 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. (In fact, this description simplifies in two respects, since it ignores funding from other own resource taxes like non-domestic rates and council tax, and also because it sweeps up the separate England, Wales and Northern Ireland into the composite rUK). 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.

1.12 The conclusion is that, if the difficulties posed by the gearing problem are to be satisfactorily addressed, there would need to be an rUK chamber responsible for taking the rUK Block Grant, setting the rUK income tax rate, and determining spending priorities on health, education, etc., from the resulting budget. And there would need to an over-arching body setting the whole UK budget, and determining the allocation of UK resources, (excluding income tax and other devolved taxes), between reserved functions and the territorial Block Grants. That is, a proper federal system for the UK would be required. Westminster as currently constituted, or even after implementing proposals for English Votes for English Laws, (EVEL), could not fulfil this latter function, since most of the time it would be the same group of MPs who would control both Westminster, and whatever chamber is constituted to exercise EVEL.

1.13 On a separate point, question 1 implies that it is a desirable property that the fiscal arrangements should be largely mechanical. It is by no means clear that being largely mechanical is actually desirable. After all, Barnett is often referred to as a well-functioning mechanical arrangement. However, it was the mechanical nature of the arrangements surrounding Barnett, whereby Scottish tax revenues were automatically transferred to Westminster, which allowed subsidies worth approximately £150 billion, (over and above the relatively higher spending levels funded by Barnett), to be transferred from Scotland to the rest of the UK, largely without any comment. Furthermore, as the implementation of Smith weakens the (admittedly imperfect) arrangements for fiscal transfers within the UK monetary union, the case for regular high-level oversight of the effects of the arrangements will become even stronger. In this context, arrangements that are largely mechanical are not necessarily desirable, since they represent an attempt to depoliticise and managerialise what should inherently be a political and democratic issue.

Question 3: What mechanisms are required to ensure the transparency and effective scrutiny of how the block grant is calculated including the operation of the Barnett formula.

3.1 The overall funding which a Scottish government will receive from Westminster will consist of the Scottish government's block grant as determined by the Barnett formula, with two different types of abatement or adjustment:

a) abatements relating to tax revenues foregone by the UK government:

b) adjustments compensating for the effects of rUK decisions to change rUK controlled tax rates.

(Para 2.4.2 of Cm 8990, which sets out how the Barnett based block grant will be adjusted, does not specifically mention this second type of adjustment. However, as already noted, the existence of these adjustments is clearly spelled out in para 2.4.14, which explains how Smith's second no detriment principle will be applied.)

The difficulties posed by these two different types of abatement/adjustment will be discussed under Questions 4 and 5 respectively. However, the complexity of this overall arrangement has an important implication for the setting of the original block grant by means of the Barnett formula. Namely, it will be essential that the Barnett formula itself should operate in a very clear and transparent fashion.

3.2 Unfortunately, to date the Treasury has signally failed to operate the Barnett formula transparently. In particular, there has been a major failing on the part of the Treasury to align two key information sources. One is the Treasury Funding Statement (TFS) which indicates at a fairly detailed level which items of expenditure are reserved or devolved, (for Scotland, Wales, and Northern Ireland): the TFS is the source which drives the operation of Barnett. The other key data source is the Public Expenditure Statistical Analyses (PESA) which records the outturn of public expenditure, including a territorial analyses of identifiable expenditure. Because the TFS and PESA databases are not aligned, it is not possible to calculate, other than by fairly crude estimates, what the outturn expenditure for England has been on those services which are devolved respectively to Scotland, Wales, or Northern Ireland. These, however, are key pieces of information, because they are required in order to monitor whether or to what extent, the operation of the Barnett formula is bringing about convergence of per capita spending levels.

3.3 It will be of even greater importance in future that the Treasury align the TFS and PESA databases, and that it produces, and publishes, clear statements on public expenditure per head in England on the aggregate of services devolved to Scotland.

Question 4: What mechanisms are required to ensure the transparency and effective scrutiny of adjustments to the block grant to reflect the tax revenues foregone by the UK Government?

4.1 It is understood that the final details of this type of adjustment to the block grant are yet to be determined: but the current proposal is that the adjustment to the block grant for income tax receipts foregone should be indexed from year to year in line with the so-called Holtham method – that is, in line with the overall growth in the UK income tax base. (This approach was originally suggested in relation to the Calman tax proposals by the Holtham Commission in Wales.) This raises a number of important issues.

4.2 First, there is the question of equity. It is interesting that Question 4 as posed mentions transparency and effective scrutiny, but does not mention equity. Equity is, however, clearly of great importance. As Professor Holtham himself said, in giving evidence to the Finance Committee at an earlier stage, the Holtham method "*might not be in Scotland's interest if [the Scottish] tax base grows more slowly than that of the UK*". The Holtham indexation approach has been justified on a number of grounds, including the desirability of giving the Scottish government an appropriate incentive to grow its income tax base. This neglects, however,

a) the fact that the Scottish income tax base is very different from that of the UK as a whole, with Scotland having materially fewer, in proportionate terms, of the very high incomes associated with the City of London. The implication is that there are naturally going to be extended periods when the income tax base in Scotland grows more slowly than that of the UK as whole.

b) the fact that the Scottish government lacks many of the economic powers it would need in order to take effective action to grow the income tax base.

Given the above, there must be serious doubts about the equity of Holtham indexation. In effect, the Scottish government is being forced to fight on ground which would probably not be of its own choosing, (i.e., the income tax base), without adequate weapons, (in the form of economic powers).

4.3 Leaving aside these general doubts about the equity of what is proposed, there are specific concerns about the effects of Holtham indexation, relating to the effects of relative population growth. It is a long standing feature that population growth in England has been relatively faster than that in Scotland: moreover, population in Wales and Northern Ireland has also tended to grow relative to that in Scotland. In fact, over the last ten years, the rate of population growth in the UK as a whole has been higher than the rate of population growth in Scotland by an average of 0.22% annually. Suppose that Holtham indexation is applied at the level of growth in the overall UK income tax base, as currently appears to be proposed: (see, for example, SPICE Financial Scrutiny Unit Briefing: "Scotland act 2012: Financial Provisions", p18.) Then Scotland will be penalised unless the per capita income tax base in Scotland grows as fast as the per capita tax base in the UK as a whole, multiplied by the relative rate of population growth of the UK compared to Scotland. (The algebra demonstrating this is given in Annex 1). Since UK population has been growing relative to Scotland's, the effect is that Scotland has to grow its per capita tax base faster than the UK, if it is not to be penalised by Holtham indexation. This anomaly would be corrected if Holtham indexation were based, not on the overall growth in the UK tax base, but on growth in the per capita UK tax base. There appear to be strong grounds for making, at least, this change.

4.4 In addition to the abatement to the Scottish block grant for UK income tax receipts, there will also need to be abatements for the other taxes which the Scottish government will control (like LBTT), or which are hypothecated to Scotland, (like approximately half of Scottish VAT receipts). These abatements will need to be appropriately indexed as well. Again, similar issues of principle and technicality are likely to arise as with Holtham indexation.

Question 5: What mechanisms are required to ensure the effective working of the "no detriment" principle.

5.1 As noted above in the answer to question 1, the specific version of the operation of the no detriment principle envisaged in paragraph 2.4.14 of Cm8990 is very problematic, if decisions to change rUK income tax are allowed to impact on expenditure on reserved functions. Leaving this difficulty aside, and assuming that appropriate arrangements for hypothecating rUK income tax receipts to "devolved" services have been put in place, operation of the no detriment principle will still lead to significant difficulties.

5.2 The implication of paragraph 2.4.14 is that, every time there was a decision to change an rUK controlled tax, (like income tax), there would need to be an adjustment to the Scottish block grant, to cancel out the Barnett implications of the change in rUK public expenditure. One difficulty with this approach is that there would be plenty of scope for argument about whether a given change in rUK income tax was a decision related change or not. Consider, for example, a change in tax thresholds. If the change is merely to uprate thresholds in line with inflation, so as to avoid fiscal drag, then this could be regarded as a housekeeping measure, rather than a tax change. But what if thresholds were not uprated in a given year: is this a specific decision, or would it just be overlooked? If some threshold changes are treated as tax changes for the purposes of 2.4.14, and others are not, how would the danger be avoided of consistent ratchet effects being built in on the adjustments being made to the Scottish block grant?

5.3 Furthermore, the adjustments to the Scottish block grant for rUK tax changes will need to be indexed in some way. But it is not at all clear how this should be done. There is a real danger that the Treasury might argue that the adjustments should be aggregated with the tax foregone abatements discussed under Question 4, and indexed by the Holtham method. However,

a) an rUK tax change which took the form of, say, introducing or abolishing a basic 10p tax rate on a given band would have revenue consequences which would primarily grow in line with the number of taxpayers, not in line with the growth in taxable earnings. So Holtham indexation would be inappropriate for this, or similar, changes.

b) ideally, whatever form of indexation is used should be self-cancelling, in the sense that, if a given rUK tax change is made at one point in time, and then reversed a few years later, the resulting net adjustment to the Scottish block grant should be zero. Holtham indexation of the initial adjustment would only achieve this by accident.

5.4 For these reasons, the question of how to index the adjustments to the Scottish block grant arising from rUK tax changes looks fraught with difficulty. Another possible approach would be to take the year zero UK tax structure as a fixed reference point, and to ask HMRC to conduct an annual exercise to assess, at rUK level, the revenue consequences of the difference between the current rUK structure, and the reference structure. This would solve the indexation and self-cancelling problems: but would have the significant down-side of enshrining an increasingly irrelevant year zero tax structure as a fixed reference point.

Question 8: How should inter-governmental machinery including the Joint Exchequer Committee be strengthened and made more transparent.

8.1 In line with the comment made at 1.13, it is not desirable for the operation of the funding mechanism to be too mechanistic. There is a need for a high level body to take a view on how the arrangements are working, and to make adjustments, (to powers, and to fiscal transfers), as appropriate. This is a role which would most naturally be played by the federal government in a proper federal system. It goes well beyond what the currently constituted Joint Exchequer Committee (JEC) is appropriate for.

8.2 In addition, there is a need for a different kind of forum in which day-to-day issues on the running of the fiscal framework can be raised and ironed out. The existing JEC seems appropriate for this role, provided it does not simply impose Westminster decisions in those cases where agreement cannot be reached.

<u>Conclusion</u>

1. A satisfactory solution to the gearing problem – that is, the problem that arises if changes in rUK tax rates are allowed to affect both "devolved" and reserved services – is of fundamental importance. It has been argued here that the implementation of the Smith Commission's no detriment principle as currently proposed does not provide an acceptable solution. A full solution of the gearing problem would involve meaningful hypothecation of rUK income tax receipts to rUK "devolved" expenditure. It is difficult to see how this could be achieved without introducing an rUK block grant, and along with this some form of properly functioning federal organisation for the UK.

2. Separately, the note has looked at a number of technical issues which will arise relative to the current proposals, particularly relating to the proposed method of Holtham indexation of the abatement to the Scottish block grant for tax revenues foregone by the UK: and in relation to the adjustments required to the Scottish block grant for rUK tax changes. A specific proposal has been made here to improve the equity of Holtham indexation – namely, that the abatement for income tax receipts foregone should be indexed in relation to the movement in the per capita UK tax base rather than the overall tax base. Apart from this, however, it is clear that:

a) there are technical problems on how the different abatement and adjustment elements should be indexed.
b) there is scope for a good deal of argument about what elements of future rUK tax changes are decision related, (so requiring block grant adjustment), and which are just housekeeping changes.
c) the resulting system will be so complex that it will be difficult to open up the whole process for scrutiny.

3. On technical grounds, therefore, (and quite separately from the difficulties posed by the gearing problem), it is doubtful if the proposals to implement Smith set out in Cm 8990 can be put into operation in a way which is open, fair, and not subject to argument. The technical difficulties with the current Smith implementation proposals would, however, be avoided under a proper federal system, under which there were separate block grants for rUK and Scotland, (or, more accurately, for England, Scotland, Wales and Northern Ireland), and where each country's budget for devolved services was then determined as its block grant plus designated own resources. Implementing such a system would, of course, require fundamental change to UK constitutional arrangements.

<u>Annex 1. Holtham indexation and relative population growth.</u>

Let ${p^{UK}}_k$ and ${p^S}_k$ denote respectively populations in UK and Scotland in year k, and let ${T^{UK}}_k$ and ${T^S}_k$ denote the tax bases in UK and Scotland in year k.
Holtham indexation is neutral for Scotland between year k and year (k+1) if the tax base in Scotland grows at the same rate as that of the UK:
That is, if

$$\frac{{T^S}_{k+1}}{{T^S}_k} = \frac{{T^{UK}}_{k+1}}{{T^{UK}}_k} \qquad (1)$$

Let ${\overline{T}^{UK}}_k$ denote the per capita UK tax base in year k: so that ${\overline{T}^{UK}}_k = \frac{{T^{UK}}_k}{{p^{UK}}_k}$, and so on.
Then equation (1) is equivalent to

$$\frac{{p^S}_{k+1}{\overline{T}^S}_{k+1}}{{p^S}_k{\overline{T}^S}_k} = \frac{{p^{UK}}_{k+1}{\overline{T}^{UK}}_{k+1}}{{p^{UK}}_k{\overline{T}^{UK}}_k},$$

i.e.

$$\frac{{\overline{T}^S}_{k+1}}{{\overline{T}^S}_k} = \left[\frac{{p^{UK}}_{k+1}}{{p^{UK}}_k} \bigg/ \frac{{p^S}_{k+1}}{{p^S}_k} \right] \frac{{\overline{T}^{UK}}_{k+1}}{{\overline{T}^{UK}}_k}.$$

In other words, for conventional Holtham indexation to be neutral, the per capita tax base in Scotland must grow at the same rate as the per capita tax base for the UK as a whole, multiplied by the relative rate of population growth for the UK as compared with Scotland.