

Scotland: the Basque Country of the United Kingdom

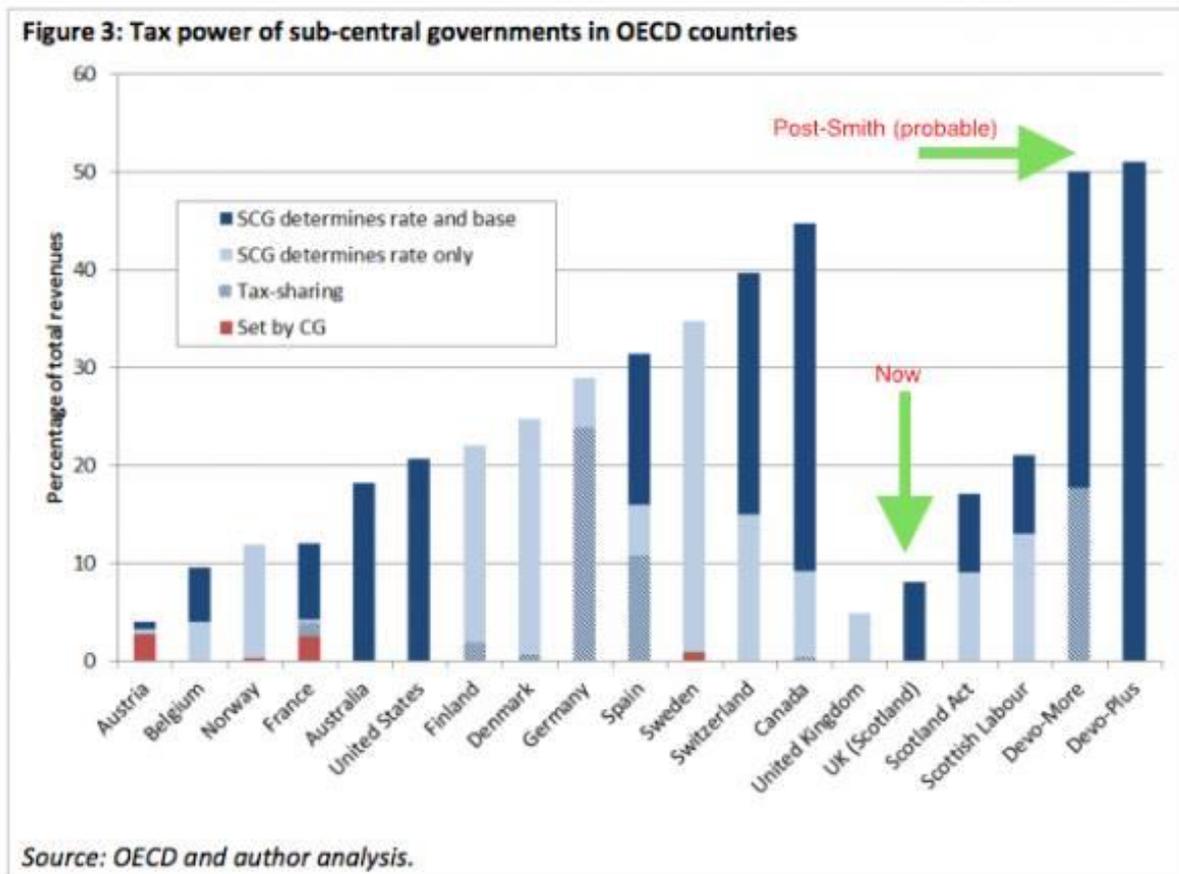
JOHN MCDERMOTT, Financial Times, 26 November 2014

Since Scots voted against independence on September 18 the Scottish National party has surged in [opinion polls](#) and appointed a [new, popular leader](#); pro-independence journalists have launched [a newspaper](#), The National; and the Scottish government is preparing to wield more power than any other devolved parliament in Europe.

“No” voters could be forgiven for considering theirs a pyrrhic victory. After all, 55 per cent of Scottish voters opted against independence. Nevertheless, this was not a vote for the status quo. A [majority of Scots want more devolution](#). The leaders of the three biggest (for now) UK political parties belatedly then rashly promised as much on the eve of the independence referendum. On Thursday, [the Smith Commission](#), charged with working out the details of further devolution, will issue its recommendations.

Although the comparison is imperfect, the recommendations will mark the point when Scotland becomes, in fiscal terms, the Basque Country of the United Kingdom.

To see the size of the shift, take a look at the chart below. An annotated version of one made by [David Bell and David Eiser](#), professors at the University of Stirling, the graph compares the share of total revenues that “subcentral governments” (abbreviated to SGD) in OECD countries can raise. It also shows whether those devolved governments only have control over tax rates or whether they can adjust the tax “base”, ie, who pays what tax in the first place. The green arrows point to Scotland’s current state – and roughly where it will be after Smith reports, based on the assumption that the commission will recommend devolving all income taxes.



In a matter of weeks, before Scotland has ever experienced life under the Scotland Act (which already had extra powers over income tax rates, due to be implemented in April), and without the parties putting their views to the electorate, the country that voted No to independence is to become one of the most devolved in the world. Is this a good idea?

Economic theory gives qualified [support](#) to “fiscal federalism”. So long as the taxes to be devolved are hard to evade, and the local politicians cannot easily renege on their commitments and they carry the responsibility for failure, the devolution of taxes to levels below central government can be both efficient and equitable. In other words, it can work well when the local politicians have the right incentives to expand their economy, increase the tax base and where they are held to account when they fail. The Smith proposals will probably be better than the status quo but less than ideal.

Politically, there is a rationale for radicalism on devolution of tax powers. Pro-union politicians have often found themselves catching up to public opinion on autonomy; this would be a chance to show leadership. This is why Jim Murphy, the frontrunner to be the next leader of the Labour party in Scotland, has said: “We will not meet our promise on more powers for Scotland, we will exceed it.” He is trying to stake out political ground outside of the “neverendum” – the endless independence campaign.

Further devolution should also help break the cosy consensus of Holyrood politics. Scotland needs a debate about how to spread the costs of policy as well as its benefits. I suspect that such a debate will show that Scots are human: they like high public spending and low taxes. They are not that much more left wing than other Britons. (Labour under Mr Murphy will call for a return to the 50 per cent tax rate for the 16,000 highest rate taxpayers but I can't see anyone proposing broad tax rises ahead of the election.) The SNP has managed to be both a party of government and an anti-government party; it hasn't had to make any hard choices in Holyrood. It is about time it was also judged on whether it did anything about Scotland's woeful public health and its worst-in-the-nation educational inequalities.

What the Smith Commission recommendations won't do is end discussions about whether Scotland should have more powers in the future – including independence. There are several reasons for this:

1. If most social security spending is devolved, as reported, then this undermines one of the arguments against independence: that there is such a thing as a “social union” among all Britons. Throw in full devolution of income tax, and as Alistair Darling argued on Monday, Scots won't be directly paying taxes towards any of the UK-wide functions such as defence and security. What, then, is left of the union?
2. If Scots control all of the decisions about income tax then the inconsistency of having Scottish MPs voting on the rest of the UK's income taxes becomes an obvious grievance for English MPs. They may want Scottish MPs to be prevented from voting on non-Scottish income taxes. And yet what the rest of the UK decides will have a huge influence on the Scottish economy. This could foster resentment in Edinburgh.
3. The way the “[block grant adjustment](#)” (the annual lump sum Scotland receives from the UK government in addition to its tax revenue) is expected to function, at least according to the Scotland Act, will work against Scotland in the long-run. This is a technical point with a potentially big political implication. The BGA is adjusted according to an index of comparable UK taxes. Growth in the overall UK tax base would mean a reduction in the BGA. This is fair for the rest of the country. It also gives Scotland an incentive to expand its own tax base. But Scotland's relatively poor (ageing) demographic projections mean that the UK tax base will grow faster than the Scottish one, and there could be grumbles over the shrinking BGA.
4. In a crisis, if Scotland's tax receipts fall and yet it has to balance its budget, it will be forced into “pro-cyclical” policies, ie, ones that risk worsening any downturn. Mr Darling thinks this is a big concern – and hints Scotland would require borrowing powers to get around this issue. In theory, so long as any downturn is UK wide, the block grant should adjust too. But if there were materially different downturns in the UK and Scotland, the problem Mr Darling identifies could arise. This would lead to calls from Edinburgh for borrowing power to smooth

fluctuations in revenues. If so, this would undermine the idea that the UK state controls the overall macroeconomy.

5. Although overall parity between revenues and spending does matter, what really matters is the extent to which Scotland can make policy *at the margin*. That is, even after having all this power devolved, does it feel it has the scope to raise taxes?

6. As Professor David Heald has argued, the UK Treasury may well adopt an approach to the Scottish tax base that combines “malicious actions” and “malign neglect”: competing with the tax base by levying additional indirect taxes and ignoring the interactions between Scotland’s income taxes and various other instruments, including capital gains tax and tax credits. This could also lead to resentment.

7. People may move or the self-employed may incorporate in response to Scottish taxes. (Self-employed oil consultants might look to do this if there an increase in the top rate.) Although the risk of this is perhaps overstated, it may lead to calls for the Scottish government to have more power over defining residency for tax purposes.

8. Scotland will have economic up and downs. It is inevitable that the SNP will call for revenues from North Sea oil and gas to be diverted to meet either acute or chronic needs. This issue won’t go anywhere, so long as there are still hydrocarbons.

As I wrote during the referendum campaign, the fundamental argument of the Yes side was that Scotland is different – and diverging. The Smith commission, while addressing the lack of accountability in Holyrood, looks set to affirm this. Inevitably, it will create new tensions, such as the ones described above. Scotland, the Basque Country of the UK, will continue to argue with government in London. Some “No” voters will doubtless ask what sort of victory they achieved in September.