

## Memorandum by Professor David Heald<sup>1</sup> to the Smith Commission

### THE FUTURE FINANCING OF THE SCOTTISH PARLIAMENT

#### INTRODUCTION

1. This memorandum is submitted in response to the Smith Commission's call for evidence. I provided oral evidence to the Finance Committee of the Scottish Parliament on 25 June 2014 (Heald, 2014b) and will do so again on 5 November 2014. As the Commission's call for evidence does not specify a set of questions to be addressed, I will follow the question structure suggested by the Finance Committee for the latter meeting. Other than editorial changes, this evidence is the same as that provided to the Committee. This 'Introduction' places those questions, mostly about devolved taxes, in the broader political, constitutional and economic context.
2. The Scottish Independence Referendum provides the context for this submission. Clearly momentum has built up that 'something dramatic' must be seen to be done; otherwise disenchantment is a likely response. A political auction has developed as to whose taxation proposals are the most far-reaching. Two cautions are vital: first, that some of the taxation issues are highly technical and poorly understood; and, second, that there are conflicting political objectives – making 'a New Union' (Jones, 2014) that will be durable; and demonstrating that nothing short of Independence will work.
3. Several issues are analytically distinct but in practice become interconnected:
  - a) **Whether all parts of the United Kingdom have access to the UK resource pool and can make claims based on territorial needs.** As well as the case for decentralisation within a state based on democratic accountability, decentralisation can also be argued as a way of reducing the size of the state, by way of tax competition. The standard public finance argument is that redistribution is more effective when undertaken at the highest available level of government, but this runs into difficulty if political preferences about redistribution diverge across the state.
  - b) **Which level of government decides the size of the state.**<sup>2</sup> Both sides of the Referendum debate seemed to want to spend more. On the 'Yes' side, this was to be financed by the growth and productivity gains it was claimed Independence would bring. On the 'No' side,

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<sup>2</sup> The controversy during the Referendum campaign about the future of the National Health Service (NHS) was confused. Since 2010, there have been strongly positive Barnett formula consequentials from increases in health spending in England, alongside large negative consequentials from other programmes. The Scottish Government has used its expenditure-switching discretion, for example, to mitigate the effects on local government services. Although the Scottish Government exercises legislative and political control over the NHS in Scotland, the overall level of funding for public services in Scotland is primarily determined by UK decisions.

there was inadequate recognition of the United Kingdom's existing fiscal deficit and of the present UK Government's plans to reduce 'public service spending' to its lowest level since 1948 (Johnson, 2014b). I have been an advocate of (partial) income tax devolution since 1976 (Heald, 1976), but recognise there are limits on the extent to which Scotland could levy personal taxes higher than elsewhere in the United Kingdom. Decisions made at Westminster remain profoundly important for Scotland, whether there is sharing of the income tax base or if Scotland's income tax is standalone. The UK Government will not allow Scotland (or Wales or Northern Ireland) to erode its own tax base and the Treasury will have retaliatory instruments.

- c) **Whether the devolved finance system remains expenditure-based or whether there is a significant move to make it more revenue-based.** If a system is expenditure-based, judgements – implicit or explicit – are taken as to the level of spending in each jurisdiction that the collectivity will support. If a system is revenue-based, the level of public spending will depend on the taxable capacity of jurisdictions, with implications for the standards of public services and for internal migration. This is best seen as a spectrum rather a dichotomy. A UK-specific difficulty is that England represents 84% of the UK population and 87% of the GB population. At the first modern census in 1801, England accounted for 74% of the GB population. This dominance of England, likely to increase through time, makes it difficult to design conventional federalism-type financial relationships within the United Kingdom.
- d) **Where the fiscal risks sit.** The United Kingdom is of sufficient size that it pools risks more effectively than Scotland could do alone, for example in relation to economic activity in, and tax payments from, the oil and financial sectors. On a strict revenue basis for devolution financing, Scotland would be exposed to fiscal risks, while lacking the policy instruments to manage such risks. This is a caution against assuming that devolution is necessarily enhanced by taking on all taxation powers that would have come with Independence.
4. In relation to what a good tax system would look like, there are marked differences between 'expert' and 'popular' views (Lim *et al*, 2013). These create difficulties for policymakers because popular views place little weight on neutrality (a key concern of reports such as Mirrlees (2011)) and tend to focus on single taxes rather than the effects of the tax system as a whole.

Six important questions (sections A-F below) are now addressed.

**(A) WHAT GENERAL PRINCIPLES SHOULD APPLY TO THE DEVOLUTION OF FURTHER FINANCIAL POWERS TO THE SCOTTISH PARLIAMENT?**

5. There is extensive discussion of relevant criteria in the report of the Expert Group to the Calman Commission (Muscatelli, 2008) and in the Calman (2011) report.
6. **On the issue of devolved taxation**, the particular points I wish to stress are:
- a) That the use of devolved tax powers, whether relating to tax rate or tax base, must be credible. Otherwise substantial administrative and compliance costs will be incurred, only for devolved Scottish taxes to remain identical to UK ones. There were specific reasons<sup>3</sup> why the tartan tax was never used: the power became effectively unusable when the Scottish Government took the unannounced decision in 2007 to let the 10-month HMRC readiness period to lapse (Scotland Office, 2010).
  - b) That what matters is ‘fiscal accountability at the margin’ (ie the ability to vary taxes) (Blow *et al*, 1996) and not the proportion of expenditure financed by taxes levied in Scotland if those decisions are not taken by the Scottish Parliament (ie revenues generated in Scotland on the basis of UK decisions). Raising 54% of revenues (*Guardian*, 2014) does not improve accountability or enhance discretion if powers to vary do not exist or are not usable.
  - c) That tax devolution (or the assignment of tax revenues) means that extensive borrowing powers are required in order to manage year-on-year fluctuations in revenues (see D below).
  - d) That consideration should be given to how powers made available to Scotland might later be extended to Wales and Northern Ireland, perhaps in modified form. This may not seem important in Scotland in the aftermath of the Referendum, but the durability of arrangements is more likely when all three countries have stakes in the arrangements.<sup>4</sup>
  - e) That while the United Kingdom remains a member of the European Union (EU), there are legal constraints on within-Member-State variation that affect both VAT and Corporation Tax.<sup>5</sup>
  - f) That there should be no detriment to other parts of the United Kingdom. This is easier to state as a general principle than to operationalise. Examples are tax incentives to induce re-location of high income individuals over internal borders or to divert air passenger traffic. As international examples of tax arbitrage demonstrate, the dangers of a ‘race to the bottom’

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<sup>3</sup> So much money came down the Barnett pipeline during the 2000s as consequential from increased health and education expenditure in England that all three Devolved Administrations built up End-Year-Flexibility; and Scottish Ministers were advised that use of the downwards variation of tartan tax would lead to the Treasury challenging the level of the block grant.

<sup>4</sup> Scotland tends to be sufficiently close to the UK average that tax base equalisation is likely to be unnecessary. That is not the case for Wales and Northern Ireland.

<sup>5</sup> Readings of these constraints differ, but the likelihood that such powers would end up in the European Court of Justice is one of several reasons for caution.

should not be underestimated. This should rule out devolution of those taxes where the only motivation for securing them is to reduce or abolish them.

- g) That urgent attention is required to local government taxation: there has been no council tax revaluation since 1991 and this is the seventh year of council tax freeze. Revaluation may be feared as politically toxic and council tax freezes may be politically popular, but this combination undermines claims that the Scottish Parliament itself needs more fiscal powers to be accountable.

**7. On the issue of assignment of tax revenues:**

- h) That the assignment of tax revenues (eg the Scottish Parliament receives some percentage of VAT revenues attributed to Scotland) is different from having devolved taxes where the Scottish Parliament has control over the tax rate and (perhaps) tax base. There might be some advantages in terms of political narrative (ie countering the view that the block grant is a subsidy from Westminster) but whether there is a genuine stake in VAT revenue growth in Scotland would depend on how the equalisation mechanisms work.

**8. On the issue of borrowing:**

- i) That greater reliance on devolved taxation and/or assigned revenues inevitably means that the income of the Scottish Parliament will be less predictable: for example, consider how it would have been affected by the 2008 recession and the present tax-poor economic recovery.
- j) That there will have to be ‘internal fiscal rules’ that constrain borrowing to offset cyclical fluctuations and for capital purposes so that the UK Government can meet its international obligations, in particular to the EU.

- 9. For arrangements to work, in the sense that new powers are usable and that they command consent in Scotland and in other parts of the United Kingdom, there must be full transparency of the funding arrangements (Heald, 2014b).

**(B) WHAT FURTHER FINANCIAL POWERS SHOULD BE DEVOLVED TO THE SCOTTISH PARLIAMENT AND WHY?**

- 10. My strong preference would have been for the Calman income tax powers contained in the *Scotland Act 2012* to be used. This would have been a gradualist step, during which implementation issues could have been resolved. This power is sometimes represented as being ‘much bigger’ than the tartan tax, but that is primarily because the first 10p of yield substitutes for the reduction in UK income tax for Scottish taxpayers. The genuine difference is that the Calman tax applies to the higher and additional rate bands, whereas the tartan tax only applied to the basic rate band.

11. At this juncture, it is useful to introduce some numbers. Scotland's mid-year 2014 population was 5,327,700, of which 4,416,021 (83%) were 16 or over. The electoral register for the 2014 Referendum contained 4,285,323 voters, estimated to be 97% of those eligible. The latest year for which data are available for Scottish income taxpayers is 2011-12 (HMRC, 2014a), so there is a lag but not one likely to be significant in the present context. There were 2.64 million Scottish income taxpayers paying £11.3 billion total tax. Taxpayers (217,000) with total incomes of £50,000 and above paid £5.018 billion total tax: thus, 8.22% of taxpayers paid 44.41% of total tax. Taxpayers with total incomes of £100,000 and above (42,000) paid £2.548 billion: thus 1.59% of taxpayers paid 22.55% of total tax. This concentration of yield indicates (a) that declarations on residence in Scotland acquire a significance they have never had before (the maximum additional tax payable/savable under the maximum tartan tax variation was modest)<sup>6</sup>; and (b) hints at the constraints on Scottish tax policy. One other source of constraint is that, like the tartan tax, the Calman tax would only apply to non-savings income, excluding savings and dividends because of the administrative complexity involved.
12. The rhetoric that surrounded the Referendum has been taken by many commentators to mean that it constituted a critical juncture in relation to taxation powers. There has been a clamour for full income tax devolution, without fundamental issues being addressed. These are illustrated below, on the assumption that UK income tax would not be levied on Scottish residents:
- a) This is likely to cause a flash point at Westminster regarding the role of Scottish MPs in voting for a UK budget containing income tax measures applicable to the residents of England, Wales and Northern Ireland. The implications for government formation have been publicly debated since the Referendum.
  - b) If income tax were to be fully devolved, that raises the question of whether Capital Gains Tax should also be devolved. These are closely related personal taxes and there are inevitably opportunities to convert income into more lightly taxed capital gains: such conversion would erode the Scottish tax base and benefit the UK tax base.
  - c) For the reasons discussed under section (C) below, Corporation Tax is not suitable for devolution. Given that Corporation Tax rates are falling internationally, relative to the taxation of earnings (particularly when National Insurance is added), there are taxation incentives for the self-employed to incorporate, for example, by using personal service

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<sup>6</sup> At the maximum +3p variation in 2014-15, the maximum annual charge from the (now lapsed) tartan tax would have been £956. Doubling that for a household consisting of two higher rate taxpayers does not reach a total at which actual or declared change of residence from Scotland to other parts of the United Kingdom would have seemed likely.

companies. These are widespread in the oil services sector, constituting another leakage from the Scottish tax base.

13. Four matters concern me greatly:

- a) If the UK Treasury does not have a financial stake in the Scottish income tax base, I would expect both malicious actions (eroding that base through other tax measures) and malign neglect (inadequate attention being paid to interactions with other tax measures and inadequate enforcement from HMRC in the entirely new situation where determination of Scottish residence matters).
- b) The potential loss of access to the expertise and economies of scale of HMRC. Over recent years HMRC has received much criticism about its performance, but at least part of its perceived failures relate to the internationalisation of business and the way in which tax avoidance exploits complexity yet acts as a driver for more complexity.
- c) Whereas the Calman Commission took 14 months from appointment to the publication of its final report, the Smith Commission is expected to deliver on a much more complex agenda within 10 weeks in the build-up to a UK General Election campaign.<sup>7</sup>
- d) So much effort having gone into devising new financial powers, political parties go into the 2016 Scottish Parliament election promising not to use them.

**(C) WHAT FURTHER FINANCIAL POWERS SHOULD NOT BE DEVOLVED TO THE SCOTTISH PARLIAMENT AND WHY?**

14. In relation to the large revenue generators:

- a) Corporation Tax should not be devolved because, *inter alia*: (i) EU legal cases are likely which will consume time and resources, whatever the outcome; (ii) recent high-profile instances of avoidance show how vulnerable this form of taxation has become despite the OECD's efforts in its Base Erosion and Profit Shifting project (OECD, 2014); (iii) this would create economic distortions within the United Kingdom; and (iv) the UK Government would use other financial levers against a Scottish Government that reduced its Corporation Tax below the UK level.
- b) VAT should not be devolved because, *inter alia*: (i) EU treaties forbid VAT variation within a member state; and (ii) this would create new avoidance and evasion possibilities when the VAT 'tax gap' is estimated to be 10.9% in 2012-13 (HMRC, 2014b). It would be possible to fully or partially assign VAT revenues as a substitute for part of the block grant, but that

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<sup>7</sup> The Holtham Commission took 24 months and the Mirrlees Review 31 months.

would increase revenue volatility and increase the importance of damping and smoothing mechanisms (see section (E) below).

- c) National Insurance should not be devolved because, *inter alia*: (i) though economists correctly regard this as a second income tax, psychologically the public links it to pensions and other welfare benefits provided at the UK level; (ii) this would lose the pooling benefits over the UK population as a whole; and (iii) this would further complicate policy attempts at the UK level to address the future role of National Insurance.
- d) Oil tax revenues should not be devolved because, *inter alia*: (i) of their future volatility in relation to oil prices, production costs and output; and (ii) of these natural resource rents being part of the pool of UK resources.

**(D) TO WHAT EXTENT COULD THE SCOTTISH GOVERNMENT BE CONSTRAINED IN HOW IT USES NEW TAX POWERS GIVEN THE INTERACTION WITH FISCAL DECISIONS AT A UK LEVEL?**

15. Paradoxically, to make devolution finance work better, it is not the Devolved Parliaments/Assemblies/Governments that must change most, but the UK Parliament and Government. UK Budgets are treated as political theatre, where the obligation on the Chancellor of the Exchequer is to pull some rabbits out of the hat in order to catch Opposition parties off guard. The Budgets that attract the most instantaneous praise are often the ones that do the most damage. The predictable result is that UK tax policy has become incoherent (Johnson, 2014a). Reforms that would benefit the UK Parliament itself would be to bring the Budget forward to November and to establish a Tax and Spending Committee which would take on the budget review function that the wide-ranging responsibilities of the Treasury Committee lead it to neglect (Heald, 2014a). Otherwise income tax powers are likely to lead to parity, as any change by a Devolved Administration is vulnerable to countering – whether on thresholds, bands, or rates – by the UK Government. Without appropriate constitutional machinery on intergovernmental financial relations, it would be possible for a UK Government to subvert the financial arrangements, for example, by significantly reducing income tax rates in England while increasing National Insurance and VAT.

16. It is necessary to distinguish between what are (a) constitutional or legal constraints and (b) those that come from the same political parties operating at UK, national and local government levels. Parties have played a highly centralising role, with UK-based parties concerned that actions at sub-national level will be used against them in UK elections. For the ‘New Union’ to work, UK politicians will have to learn to think in constitutional terms (possibly a German-style

debt brake: Lodge and Wegrich (2014)), and to develop a harder skin about differential priorities at different tiers of government and jurisdictions.

17. The long-term direction of travel of UK policy has been greater integration of taxes and benefits, yet devolving income tax while holding most social security at the UK level will involve a partial change of direction in the Devolved Administrations. There are some welfare payments where there is a strong case for devolution because of the connections to devolved service functions: housing benefit is an obvious example. There is a public attachment to UK-wide benefit levels (eg the state pension, even though it is widely known that its purchasing power varies markedly). The interactions of tax thresholds, tax bands and tax rates, on the one hand, with tax credits and the welfare system (including Universal Credit), on the other, raise issues outside my expertise. What appeared to be the case in the Scottish Referendum is that both sides favoured a more generous social safety net than the UK Government. If that view survives beyond the Referendum campaign, there will be difficult issues of policy design and funding.

**(E) WHAT ARE THE IMPLICATIONS OF FURTHER FISCAL DEVOLUTION FOR THE BLOCK GRANT?**

18. Having a Referendum was bound to put pressure on the Barnett formula in the event of a ‘No’ vote. ‘The Vow’ (Cameron *et al*, 2014) on the front page of the *Daily Record* on Tuesday 16 September included the three leaders’ commitment to ‘the continuation of the Barnett allocation of resources’. Although this sounds definitive, the actual meaning is ambiguous. Does it mean one or more of the following:

- a) That the Barnett name will be kept;
- b) That the population-based adjustment mechanism will continue, whether or not in combination with needs assessment; and/or
- c) That Scotland’s per capita public expenditure, which has consistently been above UK=100, will maintain this relative position?<sup>8</sup>

19. The Barnett formula receives a bad press, some justified but much showing little understanding of how the United Kingdom operates. Indeed, it can be argued that the population-adjustment mechanism of Barnett, and of its Goschen predecessor (Mitchell, 2003), has played a significant role in sustaining the United Kingdom as a multinational state. As well as the advantage to the Treasury (ie not having to become involved in detailed negotiations with the three territories

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<sup>8</sup> The Treasury has consistently refused to publish spending data on services in England that would be devolved according to each of the three schemes of devolution. The comparative figures which are regularly cited are those for identifiable expenditure, published annually in *Public Expenditure: Statistical Analyses* (Treasury, 2014) which include much non-devolved expenditure, particularly in relation to social security. The Barnett formula should produce long-term convergence on England = 100 provided that nominal expenditure is increasing. However, this has not happened for a variety of reasons, the most important being the falling relative population of Scotland (see Heald and McLeod, 2002).



and (now) Devolved Administrations), the formula avoids the Treasury intervening in expenditure priorities. Given the population predominance of England, UK policy is often perceived as English policy and non-English needs would be perceived through those eyes (eg by extending English needs assessment formulae). The existence of the territorial blocks has allowed expenditure-switching, originally by Secretaries of State in the UK Cabinet and later by the elected governments of Scotland, Wales and Northern Ireland. Those arguing for a needs assessment tend to (a) underestimate the complexity and sensitivity of such an exercise,<sup>9</sup> and (b) fail to recognise how a built-up calculation might constrain devolved policy-making. The most telling criticisms of the Barnett formula are that (i) there has been a failure by UK Governments to explain the rationale and explore alternatives, and (ii) the 2000s' period of unprecedented public expenditure growth was not used to recalibrate the formula (Heald and McLeod, 2002). Barnett is now blamed for perceived injustices that have nothing directly to do with Barnett, such as the treatment of the North East of England by within-England distribution formulae.

20. If the devolution finance system was strictly revenue-based, the Scottish Parliament would have its budget determined by the revenue yield of its own taxes and the revenue yield in Scotland of UK taxes. There would be no grants from the UK Government: there would have to be extensive borrowing powers to cope with volatility, otherwise fiscal decisions would become strongly pro-cyclical. The transfer of tax bases from the UK Parliament to the Scottish Parliament will be accompanied by compensating reductions in the block grant. As with the Calman 10-points income tax transfer, there will be complicated issues of how that is indexed in the future. The view that this makes the block grant less important is mistaken:
- a) How this adjustment is done is profoundly important and introduces complexities to a previously simple calculation.
  - b) Even when there is no explicit needs assessment, the size of the block grant indicates the level of Scottish spending that the UK Government is willing to underwrite.
  - c) Securing transparency of the calculations acquires more salience because Scottish Ministers have to move tax resolutions to restore the revenue loss, or to exceed or go below that. Under the Calman tax, MSPs would demand assurance that the Treasury has not made changes to the block grant as a consequence of the Scottish income tax being higher or lower than 10p. The same issue will apply in the case of beyond-Calman income tax devolution.

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<sup>9</sup> One of the by-products of the Holtham Commission on devolution finance in Wales was the proposal by two of its three members that the Scotland budget should be cut by £4 billion (Holtham and Miles, 2010). Outside Scotland, it is widely assumed that the Scottish Parliament is over-funded.

## (F) WHAT ARE THE IMPLICATIONS OF FURTHER FINANCIAL POWERS FOR THE ROLE OF REVENUE SCOTLAND?

21. I would expect the role of Revenue Scotland to grow through time, but the maintenance of an effective relationship with HMRC in relation to income tax is the foremost organisational issue. Devolved taxes will require a bedding-in period, during which there will be those looking for administrative failures or cases of egregious tax avoidance.

### CONCLUSION

22. I understand the attraction of capitalising on the present momentum to secure an extension of the powers of the Scottish Parliament that would not otherwise be possible or only be possible over a long timescale. Nevertheless, I urge caution. Those who wish to maximise devolved taxes should clarify whether they believe:

- a) that public expenditure in Scotland is too high, too low, or just about right.
- b) that their tax devolution proposals are expected to lead to the overall level of taxation in Scotland being higher, lower, or about the same as in other parts of the United Kingdom.

*Aberdeen, 31 October 2014*

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