



The Scottish Parliament
Pàrlamaid na h-Alba

DEVOLUTION (FURTHER POWERS) COMMITTEE

AGENDA

10th Meeting, 2016 (Session 4)

Thursday 3 March 2016

The Committee will meet at 9.00 am in the Mary Fairfax Somerville Room (CR2).

1. **Scotland Bill and Fiscal Framework:** The Committee will take evidence from—

John Swinney, Deputy First Minister & Cabinet Secretary for Finance, Constitution and Economy, Sean Neill, Acting Deputy Director of Finance, and Gerald Byrne, Constitution and UK Relations Division, Scottish Government;

and then from—

Rt. Hon David Mundell, Secretary of State for Scotland, Scotland Office, Rt. Hon Greg Hands, Chief Secretary to the Treasury, HM Treasury, and Francesca Osowska, Director of Scotland Office, UK Government.

2. **Scotland Bill and Fiscal Framework (in private):** The Committee will consider the evidence heard earlier in the meeting.

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Cultivating illusions, while kicking fundamentals into the long grass

1. The published February 2016 Agreement between the UK and Scottish Governments results in the Scottish Parliament having to take a decision on whether to pass a Legislative Consent Motion for the *Scotland Bill 2016* on the basis of inadequate information. The document (HM Government and Scottish Government, 2016) will have a still-to-be published annex (para. 114).
2. I have provided extensive evidence on these matters to Committees of the Westminster and Holyrood Parliaments, so I will not be comprehensive here. The reason why the negotiations took so long and the outcome is unsatisfactory is that there is a clash between:
 - a) A long-held view at the Treasury and at Westminster that Scotland is over-funded through the Barnett formula;⁵ and
 - b) The view in Scotland that it would be disastrous for the credibility of tax devolution if the act of so doing automatically reduced the size of the Scottish budget.

The February 2016 Agreement does nothing to address this clash of perceptions, but pushes executive action beyond two Scottish Parliament elections and definitely one Referendum, and possibly three.

3. The United Kingdom has not learned how to 'do' constitutional politics, which are inevitably problematic for it because of the asymmetries of country size, institutions and powers. The policy process has been inadequate, *inter alia* for the following reasons:
 - Commitments have been entered into, notably through the Vow and the Smith Commission, without analysis of the implications or evidence that proposals fit coherently together
 - The Barnett formula has been transformed in Scottish debate from being inherently damaging to Scotland – remember the 'Barnett squeeze' – to being a cornerstone of the Union. During the 2000s' period of public expenditure plenty, opportunities to review, refurbish and re-legitimise the formula were ignored (Heald and McLeod, 2002)
 - Rather than relevant documents being published early in the Fiscal Framework process, negotiations have been quasi-diplomatic, supplemented by a media war between proxies
 - The Scottish Parliament has been presented with a *fait accompli*, with a strong possibility that the UK Parliament would never pass comparable legislation should the Scottish Parliament or its successor not pass the Legislative Consent Motion
 - Northern Ireland and Wales have been excluded from negotiations which are likely to have fundamental implications for them, damaging Scotland's

⁵ Calls for a needs assessment across the United Kingdom often seem to be premised on this assumption.

interest in the three Devolved Administrations developing common positions in relation to the Treasury. This has amplified the strains created by the Smith Commission being focused solely on Scotland; England can also claim to have been excluded.

4. Just as alarmingly, false characterisations of the post-*Scotland Act 2016* Fiscal Framework are becoming conventional wisdom through the force of repetition:

- *Scotland will have one of the most powerful devolved Parliaments in the OECD (or in the world):* this illusion rests upon the proportion of expenditure notionally financed by own taxes and assigned revenues, yet this calculation is irrelevant if the political and fiscal architecture means that devolved tax powers are rendered unusable and those powers atrophy⁶
- *The Scottish Parliament will have powers to significantly affect relative economic performance and relative demographic growth:* this illusion neglects that most economic levers remain with the UK Government, that demographic trends date back as far as the Act of Union, and that there are Scotland-specific risks connected with the oil and finance-related sectors. Moreover, any use of powers to deviate from UK policy seem likely to be greeted with a chorus of disapproval from the UK Government and its proxies, in order to magnify the political and economic costs of usage, and to bolster future claims that economic and demographic trends are the fault of the Scottish Government
- *The Scottish Government will be responsible for virtually all income tax:* this illusion misses the points that:
 - The definition of the tax base is not devolved. This would be undesirable in the UK context, but a common tax base means that there should be intergovernmental consultations, not unilateral action by the UK Government
 - The personal allowance is not devolved, in part because of interactions with the UK social security system. There could be a Scottish zero-rate band, which would be equivalent to increasing the personal allowance, but that could not be reduced below the UK level. This issue is profoundly important because there are differences in the distribution of taxable income across the four countries, which leads to differential reductions in their tax base whenever the personal allowance is increased (as has dramatically been the case since 2010)⁷

⁶ I suggested to the Scottish Parliament's Finance Committee in November 2014 that devolved tax powers could be constrained or neutralised by malicious actions or malign neglect on the part of the UK Government (Heald, 2014, para. 13). The danger is that the new taxation powers will atrophy, as did the tartan tax powers, though the latter was in the context of the block grant growing rapidly because of rapid increases in expenditure on education and health in England. A design fault in the *Scotland Act 1998* was that the Scottish Parliament did not have to take a decision to set the tartan tax rate variation at zero. It is likely that a design fault in the *Scotland Act 2016* will be the issue of the uniform personal allowance, in the absence of co-determination procedures.

⁷ The Wales Governance Centre (2016) has drawn attention to the way in which increases in the UK personal allowance means that a higher proportion of Welsh income taxpayers drop out of the tax base. The Welsh First Minister has stated that no future Labour administration in Wales would increase income tax rates, but has not ruled out cuts (Murray Brown, 2016). This illustrates how devolved tax powers can be eroded, even before their actual creation.

- Savings and dividend income remains taxed at the UK level
- There are likely to be issues concerning the conversion of taxable income in Scotland into dividends, capital gains or corporate income taxed at the UK level
- *There appears to be a widespread assumption in Scotland that devolution of some welfare powers will mean more spending without increases in taxation: the talk is of top-up, not of cut-down.*

Such illusions carry severe risks of disillusionment when the realities bite. Future UK spending cuts will affect Scottish public services through the Barnett formula and there seem likely to be further cuts to existing benefit levels.

5. The issue that delayed the publication of the Fiscal Framework was the indexation mechanism to revalue the initial reduction of the block grant at the time of the transfer of tax responsibilities. The issues are explained by Eiser (2015) and Muscatelli (2015), particularly in relation to differential rates of population growth.
6. My understanding of what has been agreed is that the UK Government's preferred method of Block Grant Adjustment (Levels Model) has been modified to take account of differences between Scotland's population share and its revenue shares of relevant taxes (HM Government and Scottish Government, 2016, para. 18). This is now called the Comparable Model. This will be the base calculation, but for six years the result will be further modified in a way that generates the result which would have been obtained from use of the Scottish Government's preferred method (Per Capita Indexation). Two issues arise:
 - This does nothing for intelligibility and transparency and, while there might be some presentational benefits for the two Governments, this exposes the Agreement to ridicule
 - Such a time-limited over-ride requires a default position: what will happen in 2022-23 when what the Agreement (para. 17) labels the 'transitional period' has ended?⁸ There is a long tradition in intergovernmental grants of using safety nets to stretch out in time the impact of adverse changes, but the assumption is always that the safety net is temporary. Future significance may be attached to the fact that the Comparable Model is first used, then its effects eliminated during the transitional period, rather than there being a direct application of Per Capita Indexation during that period. This may lead to the argument that the Comparable Model is the implicit default, which a future UK Government may impose.

⁸ The independent review is to be presented to the two Governments by the end of 2021 and the Joint Exchequer Committee 'will jointly agree conclusions, recommendations and revisions of the review' (HM Government and Scottish Government, 2016, para. 112). Therefore 2022-23 is the first year in which there could be new provisions in place.

7. In my academic writings on UK devolution finance and in my submissions to Parliamentary and Governmental inquiries, I have consistently called for greater transparency about the operation of the Barnett formula. Success has been limited, particularly with regard to the timing of updates to the Statement of Funding Policy, the publication of data on comparable expenditure in England, and the publication of the arithmetical application of the Barnett formula at Spending Reviews and other budget events. Full transparency of the block grant calculations is imperative in the context of the Scottish Government setting income tax bands and rates. The Agreement does not make clear what will be regularly published.
8. In terms of the application of the Smith Commission's No Detriment principles:
 - I remain of the view that an indexation mechanism that leads to an automatic reduction of Scotland's budget is likely to discredit tax devolution, leading to claims that the Fiscal Framework has been a trap. Therefore, the first No Detriment principle is important to uphold, so tax devolution is not associated with block grant reductions (see para. 2 above)
 - While I understand the motivation for the second No Detriment principle, my view is that implementation is not feasible. The circumstances in which the Agreement indicates that it will apply will lead to controversy about calculations and whether compensation should be paid. A further level of complexity will be added to the Barnett formula system, one of the original attractions of which was its simplicity.
9. The critical issues that must be addressed before the Legislative Consent Motion is passed are:
 - Future arrangements for data transparency which past experience demonstrates cannot be taken on trust
 - Clarity about the default position from 2022-23

Otherwise the finances of the Scottish Parliament and its Welsh and Northern Ireland counterparts will be even more vulnerable to the UK Government's deficit reduction and state shrinkage objectives.

Professor David Heald
29 February 2016

References

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http://www.scottish.parliament.uk/2015.12.02_David_Eiser.pdf

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