Memorandum by Professor David Heald[1] to the Finance and Constitution Committee

THE IMPACT OF BREXIT ON THE SCOTTISH BUDGET

Introduction

1. The opportunity is welcomed to submit written evidence to the Finance and Constitution Committee Inquiry into the impact of Brexit on the Scottish Budget.

2. Before addressing the five specific questions posed in the Finance and Constitution Committee's (2017) call for evidence, I summarise key points of context:
   a) I have a long track record of emphasising the importance of devolved taxation, as in Heald (1976) where I proposed what later became known as the 'tartan tax' power of the *Scotland Act 1998* and later forewarned that the power might atrophy through non-use (Heald and Geaughan, 1997). The Smith Commission (2014) marked the point at which my relatively static position on tax powers was transformed from advocacy of careful extension of devolved taxation powers to nervousness about what had become conventional wisdom and legislated practice.
   b) The Kilbrandon Commission (1973) distinguished between an expenditure-based system of devolution finance and a revenue-based system. The *Scotland Act 2016* marks a shift towards a revenue-based system that was not foreseen at the time of the *Scotland Act 1998*, when the Barnett formula system transferred from a within-UK government mechanism into an intergovernmental relationship (Heald and McLeod, 2002). Regrettably, the necessary fiscal architecture for devolution finance has never been put in place, too much continuing to depend on Treasury goodwill and on constraining political circumstances.[2]
   c) Before Brexit became a serious possibility, the UK was experiencing the longest – but not the deepest – period of fiscal squeeze in the last century (Himaz and Hood, 2016). At least part of the criticism faced by the Scottish Government on the performance of education and health in Scotland ultimately derives from the

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[2] My view is that, with a few exceptions such as the Olympics and the Carter Review of prisons in England, the Treasury has largely played it straight by its own published rules, as articulated in successive Funding Policy documents. A Scottish MP being a Treasury-based Cabinet Minister from 1997 to 2015 was probably a factor in restraining Treasury action, notwithstanding a widespread view in Westminster and Whitehall that the Barnett formula over-privileges Scotland.

expenditure standstill enforced by the 2010-15 Coalition Government and by its Conservative successors, after a long period of strong public expenditure growth. There is growing evidence across the UK that the long period of fiscal squeeze is hurting public services, particularly when combined with demographic ageing, population growth and higher expectations.

d) Fourteen months after the EU Referendum and five months after the activation of the UK withdrawal procedure, there is uncertainty about (i) the UK's future relationship with the EU27; and (ii) the effects on the UK and regional economies of possible relationships with the EU27. Conflicting forecasts of prosperity or doom often seem to align with the individual or organisation's view of the desirability of Brexit, or the best form of Brexit.

e) The contrast between economic and political realities is striking: I have argued that the EU Divorce Bill is of limited fiscal importance but that it is politically toxic due to rhetoric about the 'huge amounts of money sent to Brussels' (Heald, 2017). A UK-EU dispute about something of minimal importance relative to future trading relationships has the potential to stall the Brexit negotiations.

f) Two dimensions of economic performance have to be monitored. If the Rest of the UK (rUK) performs well (badly), then higher (lower) levels of public expenditure in England would be affordable, with benefit (damage) to the Scottish Budget.[3] If Scotland performs better (worse) than rUK in terms of per capita revenues from devolved taxes, then the Block Grant Adjustment (ie deduction) will be lower (higher).[4]

3. The combined effect of the above is great uncertainty, for the UK as a whole and for the budgetary positions of the devolved administrations. The EU Referendum and the 2017 UK General Election demonstrated complex social divisions which exhibit territorial dimensions.

[3] The higher economic performance making possible higher levels of public expenditure requires that this translates into more taxation revenue: tax-poor recoveries have affected many countries since 2008.

[4] See Bell, Eiser and Phillips (2016) on the detailed mechanics of the Block Grant Adjustment under the Fiscal Framework.

Responses to the Committee's Specific Questions

4. My answers vary in length in accordance with the extent of my experience and/or expertise in relation to the five specific questions set out in the Finance and Constitution Committee's (2017) call for written evidence.

Q1: Are there any indications of a differential impact of Brexit in Scotland separately from rUK?

I defer on this question to research organisations which run economic models, such as the Fraser of Allander Institute and the National Institute for Economic and Social Research. Scotland has a diversified economy which is aligned with that of the UK as a whole. Paradoxically, divergent and unbalanced regions that were Leave voting, such as in the North and Midlands of England, may be more vulnerable to differentially adverse impacts. As on other Brexit issues there is uncertainty: Brexit has not yet happened and its form is uncertain; exchange rate depreciation has occurred; and anticipatory behaviour by firms and households is proceeding, to a large extent below the radar. One particular uncertainty is whether damage to London arising from the loss of EU financial passporting rights will have a positive or negative knock-on effect to the Scottish financial sector. My expectation is that it will be difficult to disentangle Brexit effects from other effects, particularly in real time.

Q2: What additional spending pressures are there on the public finances as a consequence of Brexit?

I will interpret this question broadly, to include potential revenue shortfalls as well as additional spending pressures.

The interaction of different factors means that attribution of spending pressures to Brexit will be technically difficult and politically controversial. Leaving aside those issues covered under Question 5 below, the following pressures can be expected:

a) Public sector costs will increase due to the effects of sterling depreciation working through the economy.
b) A remarkable feature of UK fiscal squeeze post-2010 has been the real reductions in public sector wages and salaries, which have in turn protected service levels. Mounting

evidence of recruitment and retention problems and of employee discontent might indicate that this policy of wage repression will be difficult to sustain.

c) Pressures from expectations of improved services and adverse demographic trends will not abate.

Whatever the contribution of Brexit to these pressures, their consequences will be interpreted through the lens of Brexit.

A paramount consideration for the Finance and Constitution Committee should be the monitoring of the implementation of the Scottish Parliament's extended fiscal powers. The precedents are discouraging, such as the failure to revalue the council tax base, which remains linked to property tax values in 1991.

The most important taxation power controlled by the Scottish Government is setting the bands and rates for personal income tax. While it is imperative that these powers do not atrophy as did the 1998 tartan tax power, such is the novelty of within-UK income tax variation that these powers require to be used cautiously on the basis of reliable statistical information. For the first time, taxpayers' declarations of residence are income tax-relevant and the revenues attributed to Scotland directly affect spending capacity. The following numbers (HMRC, 2017) are striking:

- Of 2,601,000 Scottish income taxpayers in 2014-15 paying £1.68 billion, the 4.38% with incomes greater than £50,000 accounted for 38.39% of that total
- The 0.77% of Scottish income taxpayers with incomes over £100,000 paid 18.82% of total income tax revenue
- The 10,000 Scottish income tax payers with incomes over £200,000[5] paid an average of £168,000, representing 14.07% of total revenues
- 68.74% of Scottish income taxpayers (incomes not higher than £20,000) pay 23.62% of the total, while 90.54% (incomes not higher than £30,000) pay 48.67%

These figures evidence not only the extent of income inequality within Scotland but also the vulnerability of the Scottish income tax base to decisions taken by a relatively small number of taxpayers.

[5] With numbers of taxpayers in this income range being so small, the practice of rounding to the nearest thousand introduces error into this calculation of the mean.

To maintain public consent, a tax system must be seen to be administered efficiently and even-handedly. Much damage to that consent in the UK has been done by the perception that corporations and an ill-defined category of ‘rich’ individuals do not pay the amounts that Parliament intended. Devolved income tax in a hitherto highly centralised fiscal state may create new avoidance and evasion possibilities. On the other hand, it may stimulate better enforcement[6] and heightened Parliamentary interest[7] in the taxation side of the public budget. The administration of Scottish income tax and the attribution of VAT to Scotland are far more important to the Scottish Parliament and Scottish Government than they are to HM Revenue & Customs (HMRC), for which these constitute a small part of its overall responsibilities.

Audit Scotland’s monitoring of Scottish tax revenues, whether these are administered by HMRC or by Revenue Scotland, will be of profound importance. Sample size in surveys, so that there are robust data for policy-making in Scotland, and the timeliness of data reporting by tax administrations have enhanced importance in the context of tax devolution.

Many of those who favoured greater tax powers for the Scottish Parliament envisaged these being used to support more generous public services than funded by Westminster grants. However, there is a counter possibility: for each tax within the Scottish Parliament’s portfolio of taxes, there will be those who advance plausible or specious arguments about the economic benefits of tax reduction.[8] This is almost never done on a revenue-neutral basis. If Brexit leads to economic difficulties at the UK level, or has differentially adverse effects on Scotland, such advocacy would intensify.

Q3: What should the Scottish Government’s priorities be in formulating Draft Budget 2018-19 in response to the likely economic impact of Brexit?

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[6] Unease about the extent of tax avoidance is reinforced by media reports about the non-declaration of income from private rented property: ‘Newham council in east London, the first to introduce a compulsory borough-wide licensing scheme for landlords in 2013, shared their names and property addresses with HM Revenue & Customs. Newham, which has 27,000 registered landlords, said it understands that 13,000 had not registered for self-assessment, which is generally required if a property owner receives £2,500 a year or more in rent. HMRC would not confirm the figure. The council estimated that unpaid tax by landlords is costing the public purse nearly £200m in London – and far more nationally’ (Guardian Online, 2017).

[7] In the 2010-15 UK Parliament, the Public Accounts Committee took an unprecedented interest in taxation.

[8] For example, in relation to business rates, council tax, land and buildings transaction tax, and air passenger duty. The motivation in Northern Ireland for securing a measure of corporation tax devolution was to lower the tax rate to the level prevailing in the Republic of Ireland.

This question cannot be answered directly because there is so much uncertainty about the economic impact of Brexit, particularly in relation to a fiscal year that precedes exit from the EU.

The composition of Budget expenditure is essentially a political question, outside the scope of this memorandum. I make the following observations on the narrower question of process:

(a) 2018-19 financial year is pre-Brexit, so relevant effects will come from expectations about Brexit, including decisions by firms on relocating productive activities and household decisions on migration.

(b) The spending envelope will be determined by UK Government decisions (for example, in the November 2017 Budget) and how those translate through the Barnett formula into changes in the Scottish block.

(c) 2018-19 will be a difficult financial year on the spending side, given the lengthy period of fiscal restraint and accumulating pressures for more spending on costly services such as health and education.

(d) The major risks will be on the revenue side, as the *Scotland Act 2016* reforms come into implementation, with ramification for later years should actual tax revenues fall below expectation.

Q4: Given that increased inflation is likely to disproportionately impact on the poorest, what measures should the Scottish Government take in its Budget to address this?

On grounds of fiscal principle and practicalities, I continue to adhere to the public finance tradition of emphasising that redistribution is primarily the responsibility of the highest tier of government which has a wider range of policy instruments and is less vulnerable to avoidance behaviour. Moreover, as a non-expert on social security expenditure, I have voiced concerns about (a) a widely-held assumption that Scotland can be 'more generous' than the UK Government, without specifying the source of financing,[9] and (b) the reputational risks to the Scottish Government arising from the implementation of devolved benefits.[10]

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[9] The risks and complexity are evident from the Financial Memorandum to the *Social Security (Scotland) Bill* currently before the Scottish Parliament (2017).

[10] These risks will be amplified by the likely lack of public understanding about the division of responsibility between the UK and Scottish Governments.

If there is a view in the Scottish Parliament that the poorest are being disproportionately affected by Brexit-induced higher inflation, then the case for remedial measures should be pressed upon the UK Government by the Scottish Parliament and Government and by Scottish Members of the House of Commons.

Q5: What issues require to be considered from the loss of EU funding mechanisms arising from Brexit?

There has been discussion about bringing expenditure hitherto funded by the EU within the Barnett formula, but a crucial distinction must be made:

(a) The normal practice when the expenditure responsibilities of the Scottish Parliament have been extended has been to transfer existing expenditure in Scotland into the block, not a pro-rata share of UK expenditure.

(b) If brought within the Barnett formula, that expenditure will have to be financed out of the block whose future path will be shaped by the non-statutory Fiscal Framework.

The additional fiscal risks to the Scottish Budget arise from unpredictability about the future institutional and policy setting in relation to, for example, agricultural support and from the greater volatility of such spending relative to those functions currently within the Barnett-controlled block.

Scotland, Wales and Northern Ireland have been more dependent on the EU subsidy regime than has England, making them more vulnerable to its termination. Assuming Brexit does not affect the subsidy regime in the EU27, then the critical issues are (a) how agriculture is covered in the trading arrangements that the UK negotiates with non-EU countries; (b) the common UK framework that the UK Government seems likely to insist upon; and (c) the UK Government's willingness to maintain existing levels of subsidy in England, as reductions would generate negative formula consequences for the devolved administrations.[11]

The important political point is that agricultural subsidy would in the Scottish Budget be in direct competition with other public services: the relative priorities of spending on sheep or nurses would attract media and political attention.

[11] If savings on agricultural support in England were to be transferred to health expenditure in England, then the net effect on Scotland would be zero.

Concluding Comments

5. Given the high level of uncertainty about the UK's future relationships with the EU and about the economic and fiscal impact of whatever those are, the continuing engagement of the Committees of the Scottish Parliament with these developments is welcome. The polarisation of opinion and widespread misinformation about Brexit will interact with what would in any case have been a difficult transition period in the financing of the Scottish Parliament. The Barnett-formula system for financing devolution has evolved since 1998, its durability surprising those commentators who have regularly predicted its demise. If the Brexit process were to go badly, it would be unsurprising if the widespread hostility to Barnett at Westminster (on grounds that it is too favourable to Scotland) were to become more vigorous.

6. After Scotland's Fiscal Framework was finalised in February 2016 (HM Government and Scottish Government, 2016), I cautioned that difficult issues of fiscal architecture and regulation had been kicked into the long grass, then thought be in 2021 (Heald, 2016). The climate in which such UK-Scotland negotiations take place will be influenced by Brexit, in a way that was not envisaged in February 2016 when the UK Government wished to secure a resolution before the Brexit referendum which it confidently expected to result in Remain.

Glasgow, 22 August 2017

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