

SUBMISSION FROM PROFESSOR DAVID HEALD

In this evidence, I respond directly to the questions posed by the Commission's Consultation Paper in the section on financial accountability. Before that, I briefly make a number of general comments. Some of these comments contextualise my detailed answers to the Commission's questions whereas others draw the attention of the Commission to fundamental issues which deserve priority attention.

Part A: General Comments

My approach to these issues derives from the following propositions developed in my writings which I will state but not justify here:

- The label of 'fiscal autonomy' should not be attached to an arrangement whereby the funding of the Scottish Parliament depends on receiving the estimated or actual proceeds in Scotland that derive from UK Government decisions on tax bases and tax yields. Such an arrangement would be much inferior to the present financing arrangements
- When discussing devolved or assigned taxes, a prior question is whether there are equalisation arrangements and, if so, how they operate. Crucially, it has to be established whether the apparent discretion on taxation is subsequently nullified by the way in which equalisation operates. The 'stage' in the determination of available resources at which equalisation occurs is fundamentally important. Commitment to equalisation is implicit within the present funding arrangements. In a system more dependent on own revenues or assigned revenues, the equalisation mechanisms would have to be carefully specified.
- More attention should be given by the Commission to identifying the exact nature of the constraints on sub-national variation of taxes resulting from the United Kingdom's membership of the European Union. Recent court decisions have given this longstanding issue even greater salience.
- The local authority taxation system has been mismanaged in both Scotland and England, most particularly by the failure to have regular council tax revaluations. Local authority taxation is an important source of potential discretion within the United Kingdom's highly centralised fiscal system. It should be noted that, at a time of enhanced concern about the limited fiscal discretion of the Devolved Administrations, the Scottish Government's proposal for a Scottish Local Income Tax would deprive local authorities of their tax-varying power. Local and devolved taxes need to be examined together, not least because property and income are the bases most suitable for devolved/local discretion within the fiscal context of the United Kingdom.
- The implementation of tax credits as a major tool of UK tax/benefit policy came after the 1990s' debates about the financing of the Scottish Parliament; the Commission is urged to study the implications of the UK tax credit system for the design and operation of devolved taxes on income, whether this be the existing Scottish Variable Rate (the tartan tax) or some modified power.

Part B: Response to Questions 24-34

Funding principles

Based on the findings of the Independent Expert Group's review of how sub-national or regional governments were funded across the world, the Commission has identified three key principles to consider when analyzing potential funding systems. (Paragraphs 6.28 and 6.29)

Q24. Do the broad principles of equity, accountability and efficiency provide the correct framework to analyse potential mechanisms or systems that could be used to fund the Scottish Parliament? Should one be weighted above the others and, if so, why?

In examining the generic issue of the vertical fiscal structure of a state, the principles of equity, accountability and efficiency provide a useful framework and a language in which to analyse trade-offs. However, care has to be taken not to set criteria that are either so demanding that no real-world fiscal structure could satisfy them or which divert attention from the political context that generated the multi-level fiscal structure.

The UK context is highly particularistic because, *inter alia*:

- The United Kingdom has an extraordinarily centralised political and fiscal culture
- The fiscal structure of the United Kingdom is constrained by international obligations, especially by the developing jurisprudence of the Court of First Instance and the European Court of Justice
- England constitutes 85% of the UK population, a proportion that seems likely to grow
- There are important differences in political and economic context between Scotland, Wales and Northern Ireland, thereby differentiating aspirations about their future governance and the criteria on which the 'success' of devolution will be judged.

Within this context, the devolution financing system has to operate in face of cross-cutting pressures. Improvements could certainly be made to the present system of funding through the Barnett formula.¹ An important issue to address is the legitimacy of the formula in England, though it is sometimes unclear how much some criticism of the Barnett formula is a proxy for other views relating to Scotland.

Those who criticise the existing system in unqualified terms should remember that the Barnett formula's ancestor was the Goschen formula which ran from 1888 until at least 1959. As a multinational state, whose components are of dramatically unequal size, the United Kingdom is complex and untidy to govern. The only tidy 'solutions' are full integration of Scotland, Wales and Northern Ireland or division into four independent states. The advantage of the Barnett mechanism is that, by controlling totals but conferring expenditure-switching discretion, it facilitates the shaping of expenditure programmes by the Devolved Administrations to priorities that may diverge from those of England. Moreover, it does not challenge UK control of fiscal policy because the discretion on total spending by the Devolved Administrations is very small in relation to UK fiscal aggregates.

The test for alternative fiscal mechanisms is whether they would continue to meet aspirations for an important measure of self-government within the United Kingdom.

¹ These are discussed in my evidence to the House of Lords' Select Committee on the Barnett formula.

Funding mechanisms

The Independent Expert Group identified three main mechanisms used in funding systems: tax assignment; grant-based systems; and fiscal autonomy (or tax devolution). (Paragraph 6.30)

Q25. The Commission recognises that there are three generic mechanisms that may be used to fund the Scottish Parliament: the assignment of tax revenues, the devolution of taxes and block grant from the UK Government – are there any others which might apply?

These cover the generic mechanisms, which can be used in varying proportions. It is fundamentally important, in a particular case, to understand how a devolution financing system actually works, as opposed to its formal description. A telling example was the financing system for the Stormont Parliament under the *Government of Ireland Act 1920*.

Excise duties

The fact that the UK is an integrated single market has implications for indirect taxes, and hence for the scope to devolve sales taxes like VAT or excise duties. (Paragraphs 6.45 and 6.46)

Q26. What are the potential benefits and costs of allowing a Scottish variation of existing excise duties such as those on alcohol and tobacco?

Excise duties are unsuitable for tax variation within the United Kingdom. The main reason is that, within the geographically compact United Kingdom, the scope for cross-border shopping and criminal activity such as smuggling would be extremely large. The United Kingdom itself experiences severe difficulties in protecting excise revenues, as is evidenced by the data published by Her Majesty's Revenue & Customs on the tax gap.

Within-EU member state variation of VAT is not permitted. Even without this external restriction, the difficulties of protecting the VAT yield against avoidance and evasion would strongly argue against different VAT rates within the United Kingdom.

Corporation Tax

Devolving the power to vary Corporation Tax would increase the autonomy of the Scottish Parliament. A number of representations from business bodies argued for maintaining the present system. The Commission is concerned that any changes might cause significant distortions inside the UK economy by introducing opportunities for wasteful tax competition. (Paragraphs 6.40 to 6.44)

Q27. Would allowing the Scottish Parliament to determine a Scottish rate of Corporation Tax produce wasteful tax competition?

This question is wrongly formulated. According to perspective, there is scope for debate as to whether inter-jurisdictional differences in Corporation tax rates are beneficial (they discipline spendthrift governments to restrain tax rates on business) or harmful (they lead to sub-optimal public spending).

The UK question is distinct from this generic issue. The European Union (EU) accepts differences in Corporation tax rates between member states but – as a general principle – not variations in rates within a member state. Accordingly, an independent Scotland could have lower/higher rates than the rest of the United Kingdom, but a devolved Scotland cannot. Although there are unresolved issues arising from the Azores, Basque and Gibraltar cases, it is difficult to envisage Corporation tax variations within the United Kingdom that would fully satisfy the tests established by the European Court of Justice.

Even without EU constraints, it is difficult to envisage a UK Government agreeing to such a measure, not least in light of recent difficulties in protecting the UK yield from Corporation tax. The scope for shifting tax liability within the United Kingdom would create new avoidance possibilities. Moreover, recent events in the banking and financial sectors would have drastically affected the revenues of the Scottish Parliament had its funding directly depended on devolved or assigned Corporation tax revenues.

Other taxes

The Commission has received little evidence on any other taxes which could be candidates for devolution. These include air passenger duty, vehicle excise duty, stamp duty on property, insurance premium tax, landfill tax and aggregates levy. (Paragraph 6.77)

Q28. What might be the potential benefits and costs of allowing the Scottish Parliament to determine a Scottish rate of other existing taxes?

The issue here is whether the administrative, compliance and enforcement costs of differentiation, together with the potential for avoidance and economic distortions, are worthwhile in relation to the modest yields. I have seen no evidence to suggest that this is so. If such taxes were levied at Scottish rates, the question would arise as to whether there would be equalisation of tax bases.

National Insurance contributions

National Insurance contributions raise substantial revenue, but seem intrinsically linked to benefit entitlements, which are reserved, and the UK welfare state. (Paragraph 6.75)

Q29. Should National Insurance contributions be rejected as a potential tax to be devolved to the Scottish Parliament?

In economic terms, National Insurance contributions are taxes, as there is limited required benefit for the individual. Employee contributions are an additional tax on employment and self-employment income, whilst employer contributions are likely to be shifted back to employees. The connection between what is spent on benefits and what is collected in National Insurance contributions was broken long ago. The linguistic distinction between income tax and National Insurance contributions is politically useful to governments, which can promise to freeze/cut income tax whilst increasing National Insurance contributions.

Psychologically, however, there is a link in public perceptions between National Insurance contributions and the benefit dimension of the UK welfare state (a reserved function). Given this symbolism, National Insurance contributions are not suitable for devolution whilst there remains commitment to a UK-wide benefit system. It is worth noting that, in Belgium, the continuation or break-up of the social security system is deeply contested.

New taxes

The Steel Commission proposed that the Scottish Parliament should have the power to levy additional new taxes. (Paragraph 6.77)

Q30. Should the powers of the Scottish Parliament be extended to allow it to create new taxes whilst maintaining the reservation on existing taxes?

An independent Scotland could establish any taxes it wished, subject to the constraints imposed by membership of the European Union. Within the context of devolution, there are additional constraints on within-state variation of certain taxes. It is unclear what new taxes could be devised which would simultaneously raise worthwhile amounts of revenue and not run up against EU constraints or create difficulties with the UK Government/rest of the United Kingdom.

Although this proposal sounds as if it offers considerably enhanced powers to the Scottish Parliament, it is not clear what the practical benefits would be. If such taxes were levied, the question would arise as to how revenues were treated for equalisation purposes.

Scottish Variable Rate (SVR)

The Scottish Parliament has the power to vary the basic rate of Income Tax applying in Scotland by up to plus or minus 3p in the pound. Some evidence claimed this has not been used because administrative costs associated with its introduction would be large in relation to potential revenues. Some suggested that the limited scope of the SVR makes it insufficient either to meet economic needs or to provide an adequate degree of accountability or autonomy. (Paragraphs 6.72 to 6.73)

Q31. Could the scope of the SVR be widened and thus be made more flexible, and, if so, what would the impact of this be?

I have an interest to declare because (a) I proposed this mechanism in 1976² and (b) later co-operated with John Reid in the development of Labour Party policy in 1983. I continue to believe that this is a mechanism well-suited to the context of UK devolution. Alongside local property taxes, it contributes to 'fiscal accountability at the margin'.

Before answering the question, I will comment on the reasons suggested for the non-use of the SVR over the period 1999-2009. The administrative and compliance costs of such a variation power are inevitably going to be much higher than those for typical UK tax revenue. Those, like myself, who supported this devolved taxation power believe that the accountability benefits are worth those costs. Moreover, its existence was in part designed to rebound complaints about inadequate funding from Westminster into questions about why the Scottish Parliament was not using the taxation powers it possessed under the Scotland Act 1998.

² D.A. Heald, *Making Devolution Work*, Young Fabian Pamphlet 43, London, Fabian Society, 1976.

My interpretation is that:

- As early as the 1999 Holyrood elections, the Labour Party in Scotland was told by its UK leadership not to levy the SVR.
- Upward variation became irrelevant given the remarkable and unforeseen flow of additional money down the Barnett pipeline, as evidenced by the accumulation of End-Year Flexibility.
- There was widespread apprehension in Scotland, shared by leading politicians and civil servants, that downward variation would lead to a Treasury challenge to the funding arrangements; this might affect not only levels of Scottish spending but also the highly-valued power to vary expenditure composition.
- The SVR power atrophied from non-use,³ leading to doubts about whether the administrative machinery could be activated on a credible timescale and without significant error.
- Notwithstanding the non-use of the SVR, its existence did help to quell complaints about inadequate funding which had been a feature of pre-devolution controversies.

In answer to the Commission's Question 31:

- The width of discretion could be recalibrated so that it is greater than -3p to +3p. This width was chosen at a time when the principle of tax variation had to be won. Noticeably many of those who claimed, pre-devolution, that any tax variation power would be a disaster for the Scottish economy are now prominent in criticising the Scottish Parliament's lack of fiscal accountability. It is a matter of political judgement how wide that discretion should be. I would support a move to a wider range, say, -5p to +5p (see my answers to Questions 32 and 33 below). On the basis of the estimated yield provided by the Treasury in the 2008 Budget Report, that would give a maximum expenditure variation of plus/minus £2,000 million in 2009-10.⁴ (In Canada, this would be described as the transfer of tax points from the Federal Government to the provinces.) There is an understandable political difficulty in extending a power that has never been used.
- In the decade since the SVR was established, there has been a fundamental change to the UK tax/benefit system, with the establishment of tax credits. This would affect yield from the existing SVR and from an extended SVR. I strongly recommend that the Calman Commission investigate this issue and provide a published analysis of the implications of tax credits for SVR-type powers.
- The political visibility of income tax will constrain the use of SVR powers and this would be the case irrespective of the width of the SVR power. A Scottish Government using the power upwards would have to present a powerful case to its electorate for why the power was being used. None of this would change whether the power is +/- 3p or +/- 5p. Similarly, a Scottish Government using the power downwards would require confidence that it could fully justify its grant funding from the UK Exchequer.
- The wider the band, the more important would become the fact that savings and investment income is excluded from the SVR tax base. This exclusion originated in the practicalities of a proposal developed in Opposition, in the face of hostile attacks from the then Conservative UK Government and without access to the resources of the then Inland Revenue. Given the well-established status of Self-Assessment for a proportion of

³ This danger was identified in advance: see D. Heald and N. Geaughan, 'The tartan tax: devolved variation in income tax rates', *British Tax Review*, 1997, No, 5, pp. 337-48.

⁴ Treasury, *Budget 2008 – Stability and Opportunity: Building a Strong, Sustainable Future*, HC 388 of Session 2007-08, London, Stationery Office, 2008, para A9 on p. 113.

the population, it should be investigated whether this exclusion remains necessary on operational grounds. The Calman Commission could usefully hold discussions with Her Majesty's Revenue & Customs on design and operational issues, and then clarify these matters in its Report.

Extending the SVR to include the higher rate of Income Tax would increase the maximum yield for the present 3p variation by about 30%, to £1.4 billion. (Paragraph 6.74)

Q32. Are there any potential costs and benefits of extending the Scottish Variable Rate to the higher rate of Income Tax?

This is a difficult question, on which there is scope for opposing views. Although the origin of the restriction to the basic rate band lies in historical political context (see Q31 above), good reasons can be advanced for retaining this restriction:

1. There are large numbers of basic rate taxpayers in Scotland, constituting an important sub-set of the Scottish electorate. Upward use of the SVR would communicate to them the opportunity cost of additional spending by the Scottish Parliament, and they would benefit from expenditure restraint.
2. There are many fewer higher rate taxpayers in Scotland. Restricting the SVR to the basic rate caps an individual's maximum additional liability at £660 in 1998 and at £1,044 in 2008-09. This capped liability can be supported on the following grounds:
 - The public finance literature indicates that redistribution is most effectively exercised by central/federal governments.
 - The UK devolution settlement predominantly leaves the redistributive function of the welfare state with the UK Government. The corollary is that decisions on the degree of progression of the income tax system should be taken at the UK level.
 - Without a cap, some individuals would have extremely large additional tax liabilities and this would incentivise avoidance (eg changes of tax residence and/or transformation of income into forms that are outside the scope of the SVR).

The opposing arguments are as follows:

1. Extension to the higher rate is estimated to increase the yield by 30%, though that estimate is subject to possible taxpayer reactions.
2. Restriction of the SVR to the basic rate leaves the power more vulnerable than otherwise to UK decisions on tax thresholds and bands (eg the introduction and abolition of the 10p rate affected both the yield of the SVR and its incidence across income deciles).
3. It is an inevitable result of basing the tax-variation power on income tax that those who do not pay income tax neither pay more nor less tax as a result of the operation of the SVR. Those who lose or gain are basic rate taxpayers and higher rate taxpayers. The capped amount will be a lower percentage of income for higher rate taxpayers than for some taxpayers whose highest marginal rate is the basic rate. It might be argued that equal proportional contributions would be a better approximation to equity in taxation.

My judgement is to support the continuing restriction to the basic rate on the grounds that the additional 30% revenue is not worth the likely administrative, economic and political costs of extension.

This discussion is formulated entirely in relation to Scotland, where per capita income is sufficiently close to the UK average to make equalisation of the tax base unnecessary. However, if a similar power were extended to Wales and Northern Ireland, a decision would be required on whether this should be done.

Tax decision

Because the SVR is a power to alter a tax rate already set by the UK Government, a decision to do nothing has no effect on the budget of the Scottish Parliament; that is, revenue is secured without the necessity to take a taxation decision. An obligation to make a tax decision might improve the accountability of the Parliament. (Paragraph 6.73)

Q33. Are there any ways in which the Scottish Parliament could be required to make a tax decision, so that its revenue would be affected if it did not?

I would support a legislative change whereby the Scottish Government is required annually to move an order to set the SVR. In order to sustain the fundamental principle of Executive control over total public spending, opposition parties would be able to vote down, but not amend, that motion. This is a change that could be made by the Scottish Parliament itself, without the UK Parliament amending the *Scotland Act 1998*.

There is a further change that would involve UK legislation, which would be worthwhile if that were required to expand the width of the power. Instead of the SVR in its present form, there would be a statutory deduction in the basic rate of UK income tax paid by Scottish residents. For the purpose of illustration, this might be 5%, making the applicable UK rate in Scotland 15% rather than 20%. The Scottish Government would each year move an order to set the rate of Scottish income tax at a rate between 0% and 10%. The default position would be a rate of 0%, at which the level the Assigned Budget of the Scottish Parliament would be reduced by £2,000 billion.⁵

This mechanism would require the establishment in advance of a register of taxpayers resident in Scotland. Each taxpayer would receive an annual statement from Her Majesty's Revenue & Customs stating the amount of UK and Scottish income tax paid. Only by incurring the administrative and compliance costs up-front, regardless of whether the variation power is effectively used (ie a rate different from 5% is set), will the capability of using that power be preserved.

Borrowing

Borrowing powers are linked to the scope for revenue raising, as the greater the dependence on uncertain flows of revenue the greater the need to be able to borrow so as to smooth over revenue fluctuations and allow consistent profiles of spending and long-term capital investment.

Significant borrowing powers however require effective means of fiscal coordination for macro-economic management. (Paragraphs 6.78 to 6.81)

Q34. Is the Commission's analysis of the issues in relation to borrowing correct?

⁵ This estimate relates to 2009-10. This assumes the existing basis of the SVR, applying only to the basic rate and excluding income from savings and investment.

In an expenditure-based devolution financing system, borrowing powers are required for handling the different in-year profiles of income and expenditure. This is a reasonable characterisation of the existing system, notwithstanding the role of council tax and Non-Domestic Rates (revenues are predictable) and local authority borrowing for capital purposes (this scores against the Assigned Budget).

If the system were to move significantly in a revenue-based direction, extensive borrowing powers would be required to handle revenue uncertainty (e.g. from an income tax or from assigned taxes). There is a practical judgement about what would constitute a significant move; that depends in part on the tax in question and in part on the year-to-year variation in yield, especially the unexpected component.

There are two obstacles to extensive borrowing powers for the Scottish Parliament:

- The UK Government would resist conceding unconstrained borrowing powers to Devolved Administrations, not least because it would fear irresponsibility, particularly by those without long-term commitment to the United Kingdom.
- The United Kingdom has an extraordinarily centralised fiscal system and it is unlikely that the UK Government in general, and the Treasury in particular, would ever agree to share responsibility for macro-fiscal policy with sub-national governments.

In current public debates in Scotland, arguments for borrowing powers are often expressed in ways that suggest a route to higher expenditure. Borrowing powers *per se* do not allow higher expenditure, only the re-profiling of expenditure through time. Moreover, borrowing which scores against the Assigned Budget has the same in-year effect as grant.

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