Nuffield College

A Gwilym Gibbon Centre for Public Policy Working Paper

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July 2015 Scottish Parliament

Devolution (Further Powers) Committee

Memorandum for oral evidence session on 10 September 2015.

1. This note comments on the proposed taxing and spending powers of the Scottish Parliament under the Smith Commission agreement and in the Scotland Bill.
2. I have reviewed:
    a. The report of the Smith Commission;
    b. The Scotland Bill as it currently stands and its Explanatory Notes (UK Parliament website);
    c. The Scottish Parliament's joint briefing note on the Scotland Bill dated June 2015
3. Pillar 2 of the Smith Commission's Heads of Agreement provides that the State Pension will remain fully reserved; Universal Credit will be partly reserved (Scottish Parliament to have powers over frequency of payment, and over the so-called 'bedroom tax'); and a number of benefits outwith UC will be devolved. The Scottish Parliament will have powers to top-up reserved benefits and create new benefits.
4. Pillar 3 of the Smith Commission's Heads of Agreement provides that Income Tax on non-savings and non-dividend income for Scottish taxpayers will be fully devolved. The first 10p in VAT receipts at the standard rate will be assigned to the Scottish Parliament. Air Passenger Duty and Aggregates Duty are to be devolved, as recommended by the Calman Commission's Independent Expert Group. National Insurance Contributions (employers' and employees' NICs), Corporation Tax, and offshore revenues are to remain reserved.
5. Pillar 3 also contains Smith's two 'no-detriment' statements:
    a. 'No detriment as a result of the decision to devolve further power';
    b. 'No detriment as a result of UK Government or Scottish Government policy decisions post-devolution'.
6. As your briefing note observes, many of these matters, including Scotland's future fiscal framework and the future borrowing powers of the Scottish Parliament, are not in the Scotland Bill.
7. The Bill contains detailed provisions for the transfer of Crown Estate functions in Scotland to Scottish Ministers. The Explanatory Notes to the Bill observe at 202, 'the Scottish Ministers may be able to take a different approach to managing the Scottish assets (for example, to adopt a less commercial approach to some aspects of management, including widening the role of social enterprise).' However, the Bill does not specify the consequences of Scottish Ministers taking such a decision. It would reduce the money going into the Scottish Consolidated Fund and to that extent constrain public expenditure. It could give rise to a UK Government claim under the second Smith no-detriment principle to top-up the Sovereign Grant.
8. These important matters are believed to be currently the subjects of inter-governmental negotiations. Although they are not in the Bill, the Scottish Parliament must take them into account as it decides whether to approve a Legislative Consent Motion in respect of the Bill.

Vertical Fiscal Imbalance and the Scotland Bill.

9. As I and others have frequently stated, the tax-and-spend arrangements for the Scottish Parliament since 1998 have always given it substantial power to spend but by international

standards remarkably little power to tax. This has created a severe vertical fiscal imbalance (VFI), which gives perverse incentives to both the Scottish and UK governments.

10. VFI arises when one government has most of the taxing power and the other government has most of the spending power. The spending government has an incentive to overspend. The taxing government has an incentive to put tight restrictions on the use of the money it raises.
11. In a social union such as the UK, however, some VFI is inevitable and even desirable. Without some VFI, horizontal fiscal equalisation (HFE) is difficult or impossible. HFE means the transfer of resources from relatively rich people to relatively poor ones, and hence from relatively rich parts of a country to relatively poor ones
12. None the less, so long as it does not unduly restrict the ability to equalise horizontally, any policy which reduces VFI is, presumptively, good; any policy which increases it is presumptively bad.
13. The recommendations of the Calman Commission aimed to reduce the imbalance. Most of them are enacted in the Scotland Act 2012; the current bill sweeps up a couple more (re Air Passenger Duty and aggregates levies). This is to be welcomed.
14. The Smith Commission, and hence this Bill, go much further than Calman. With the tax devolution and assignment in this bill, the Scottish Parliament becomes responsible for raising about 40% of public expenditure in Scotland, and for spending about 60% of it. This reduces VFI still further.
15. However, the Smith proposals immediately muddy the waters again, by proposing the transfers of certain social protection functions from the UK to the Scottish Government. This increases VFI again unless more taxes are devolved.
16. What is the scope for further tax devolution to Scotland? Estimates of the yield of each tax in Scotland are produced annually in the Scottish Government's *Government Expenditure and Revenue Scotland* (GERS) publication. Table 1 gives the Scottish Government's estimate of total public sector revenue by source for 2013-14.
17. Table 1 shows that only a few taxes are candidates for further devolution. Income tax is almost fully devolved, and VAT cannot be devolved because of EU rules prohibiting differential VAT rates within a member state.
18. Therefore the candidates for further devolution or assignment appear to be:
    a. The rest of VAT (assignment, not devolution);
    b. NICs: either employees' or employers' contributions, or both;
    c. North Sea corporation tax;
    d. Non-North Sea corporation tax;
    e. Fuel tax and/or excise duties.
19. Devolution or assignment of other taxes would make little difference to VFI, as the taxes are small.
20. Devolution of fuel tax and/or excise duties might be beneficial. These are classically taxes on things that government would like citizens to do less (pollute the atmosphere; harm their health; behave antisocially). The Scottish Parliament might wish to discourage these behaviours by raising some of these taxes (a more efficient device than, for instance, imposing minimum unit prices on alcohol sales). There is, however, a classic trade-off. If raising that tax rate successfully discourages the anti-social activity, the tax take does not rise pro rata to the tax rate, and may decline.
21. Assignment of the whole of VAT levied in Scotland would nominally reduce VFI, but would give the Scottish Government no further policy levers, as it cannot vary the rate or the base of VAT in Scotland.

22. North Sea corporation tax is the most suitable candidate for further devolution, and non-North Sea corporation tax is the least suitable. For most corporate activities, tax rate changes risk incurring massive deadweight loss, as taxable activities can be booked to the jurisdiction with the lowest corporation tax rate. However, hydrocarbons in the North Sea are where they are. There is no scope for corporate tax avoidance in that case. The general theory of optimal taxation states that land, property, and other immovables (such as unextracted minerals) are the most suitable subjects for taxation by a subnational government. On the same principle, therefore, taxation of any revenues from onshore mineral extraction, such as fracking, would be very suitable for devolution.
23. Devolution of either employers' or employees' National Insurance, or both, is feasible. Each amounts to roughly half the total of NICs receipts (employer's slightly more, employee's slightly less). Although the formal incidence of employer's NI is on the employer, the real incidence is largely on the employee.
24. Devolution of NICs would reduce or eliminate the VFI discussed above. However, it would delink social protection in Scotland from that in the rest of the UK. Scottish contributions and benefits could go up, or down, relative to those in the rest of the UK. It would make horizontal fiscal equalisation between Scotland and the rest of the UK hard or impossible.
25. The Bill, and most surrounding political discourse, assumes that tax in Scotland would be no higher than in the rest of the UK, and benefits in Scotland would be no lower than in the rest of the UK after the bill is enacted. This does not seems realistic in the light of the best estimates of Scotland's fiscal balance up to 2020 (Table 2).
26. The numbers in Table 2 suggests that Scotland may face a fiscal crunch between now and 2020, irrespective of the amount of tax that is devolved. But the more the proportion of tax devolved, the less is covered by any Barnett 'cushion', and hence the more painful any crunch will be.
27. Neither of the two Smith no-detriment principles help the Scottish taxpayer here. The first principle merely establishes that on day 1 of any tax transfer the total available to the Scottish Government to spend is the same as on day 0. The second establishes that governments must compensate each other for the consequences of policy changes; but the numbers in Table 2 assume no policy changes.
28. The asymmetry of some of the Smith provisions therefore comes into focus. The Scottish Government has power to top up benefits but not to reduce them. It is unclear how it can continue to balance its budget up to 2019-20.

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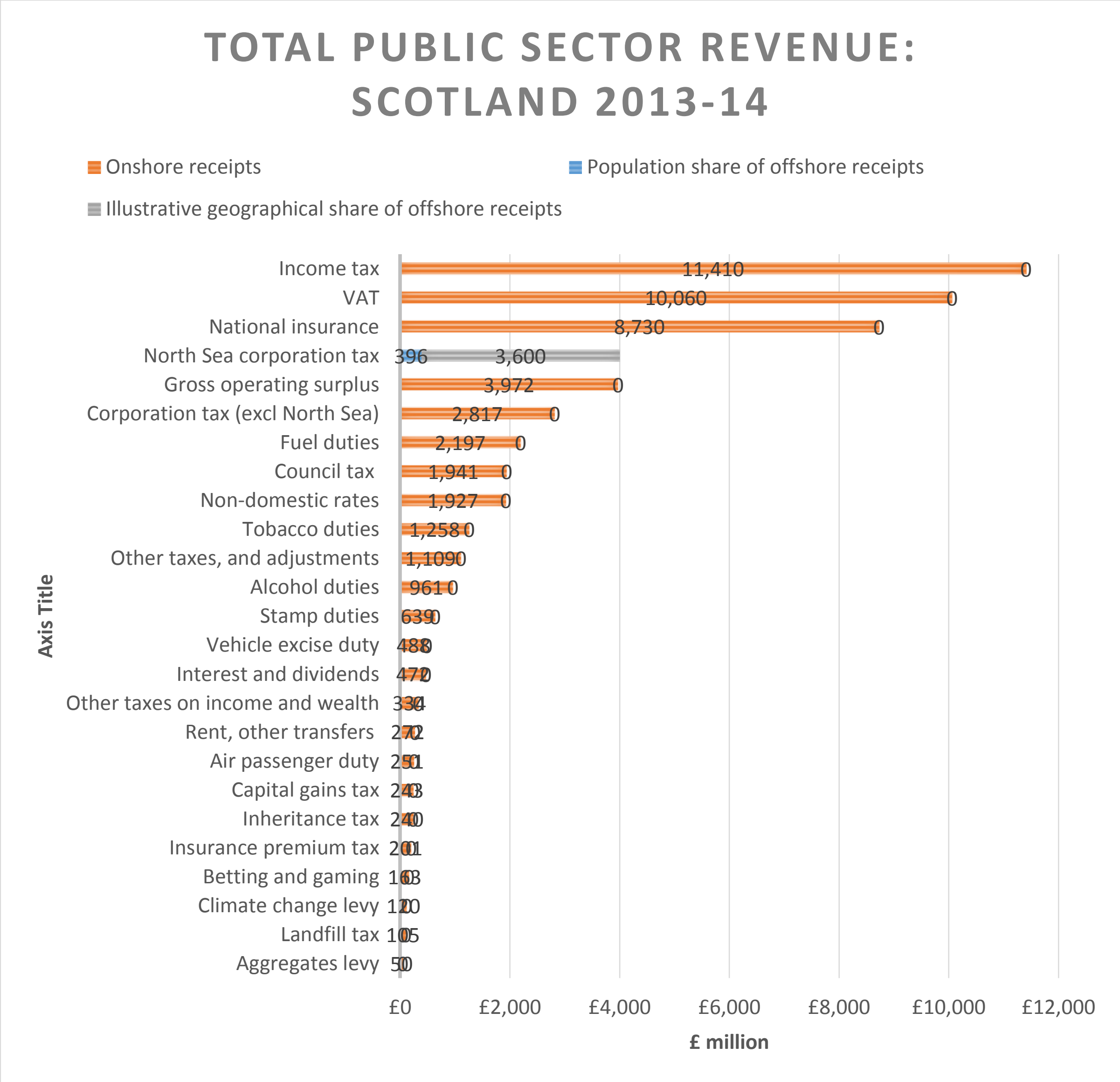
Table 1.



Source: Scottish Government, *GERS 2013-14*

Table 2

Overall fiscal balance, Scotland and the UK, 2014-15 to 2018-19, £million (cash)

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
SCOTLAND						
Onshore Revenues(i)	52,298	54,117	56,844	59,295	61,990	65,229
Expenditure(i)	68,403	68,914	68,700	69,034	70,454	73,990
Onshore Fiscal Balance	-16,105	-14,797	-11,856	-9,739	-8,464	-8,761
Total UK North Sea revenues	2,600	700	600	700	800	700
Scottish North Sea revenues(i)	2,287	616	528	616	704	616
Overall Fiscal Balance	-13,817	-14,181	-11,328	-9,123	-7,760	-8,145
UK Overall Fiscal Balance	-90,200	-75,300	-39,400	-12,800	5,200	7,000
Overall Fiscal Balance as % GDP Scotland	-8.8	-8.7	-6.7	-5.2	-4.3	-4.3
UK	-5.0	-4.0	-2.0	-0.6	0.2	0.3
Difference	-3.8	-4.7	-4.7	-4.6	-4.5	-4.6
Overall Fiscal Balance £ per head Scotland	-2,585	-2,643	-2,103	-1,687	-1,429	-1,494
UK	-1,398	-1,158	-603	-193	80	105
Difference	-1,186	-1,485	-1,501	-1,494	-1,509	-1,599
Cumulative Difference (£, million)	-6,343	-7,968	-8,083	-8,080	-8,235	-8,753

Source: Fiscal Affairs Scotland, *Monthly Bulletin Supplement*: *Government Expenditure and Revenue Scotland (GERS) 2015.* March 2015