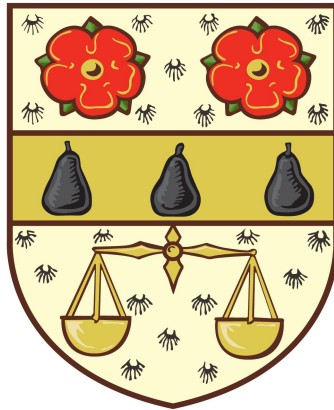


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**Fiscal Federalism and Fiscal Responsibility:
the Case of Scotland**

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Fiscal Federalism and Fiscal Responsibility: the case of Scotland

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Abstract

Since 1998, the Scottish Parliament has had substantial powers to spend but very little power to tax. This has encouraged fiscal irresponsibility, because politicians enjoy spending tax that has been raised by other people. Scottish politicians have not faced the essential discipline of matching their marginal wish to spend with their marginal wish not to tax.

The UK is not formally a fiscal federation but current moves are taking it closer to becoming one, and therefore less of a fiscal outlier. If the Scottish referendum of 2014 had led to independence, then of course the principle of matching marginal taxing to marginal spending would have been implemented in full. That will also be the outcome should current strains between Scotland and the UK lead to a second independence referendum that produces a vote in favour of independence.

Parallels and differences with the recent politics of fiscal federalism in Spain and Canada are briefly drawn.

Keywords

Scotland; taxation; public expenditure; marginal principle.

Fiscal Federalism and Fiscal Responsibility: the case of Scotland

The referendum – how and why the Losers won and the winners lost

On 18 September 2014, the people of Scotland voted on the question “Should Scotland be an independent country?” The turnout was 84.6%, the highest ever recorded in a UK referendum and higher than the turnout in any UK general election since 1945. The result was a win for ‘No’ by a margin of 55.3% to 44.7%: i.e., a lead of just over 10%.

Three things are puzzling about this result. The first is that polling going back continuously to the early 1990s shows that the level of support for Scottish independence has always lain steadily between 25 and 35%. Therefore:

Question 1: Why did the Scottish National Party (SNP) Scottish government insist on a referendum which 20 years of opinion polling suggested it was always likely to lose?

Question 2: Why none the less did support for independence then spike at the referendum? And

Question 3: how and why has the party which lost the referendum – the SNP – become utterly hegemonic in Scottish politics?

In the UK General Election of 2015 the SNP won half of the vote, which translated into a clean sweep of 56 out of the 59 Scottish seats in the House of Commons. The Scottish Parliament is elected by the Additional Member (AMS) system of proportional representation (also used in Germany and New Zealand). Under AMS, a party only wins a majority of seats if it is at or close to a majority of the votes cast. The SNP secured about 44% of the votes cast in 2011, enough to form a majority government because votes for small parties which got no seats were ‘wasted’. Current polling suggests it is likely to win over 50% of the vote in 2016. Its leader, Nicola Sturgeon, is the only UK politician to have a strong net popularity rating: +55% (Scottish respondents) or 33% (all respondents) on the standard poll question “Do you approve/disapprove of how [name] is doing his/her job?”¹. UK political leaders of all parties score negatively. On the latest available (December 2015) figures from IPSOS-MORI, which tracks these numbers every month, Prime Minister David Cameron scored -14%, Labour leader Jeremy Corbyn -17%; Liberal Democrat Tim Farron -7% (with almost half of respondents having no idea), and UK Independence Party leader Nigel Farage -15%².

¹ Herald 2015, http://www.heraldscotland.com/news/13211668.Poll_shows_Sturgeon_is_now_the_most_popular_politician_across_Britain/, accessed 19.01.2016

² IPSOS-MORI 2016, <https://www.ipsos-mori.com/researchpublications/researcharchive/88/Political-Monitor-Satisfaction-Ratings-1997Present.aspx?view=wide>, calculated from results for December 2015, accessed 19.01.2016

These three questions matter not only for Scotland but also for other democracies with successful secessionist movements, including Spain and Canada. To explain them, we need to probe the history of the SNP.

'It's Scotland's oil' and the history of the Scottish National Party

The SNP dates back to a merger of two prior nationalist parties in 1934. Until the 1960s it lay on the fringe of Scottish politics. It won a parliamentary by-election in 1945, during a wartime truce among the major parties, but lost the seat again within a few weeks. It started doing respectably in by-elections and municipal elections beginning in 1961. In 1967 it again won a parliamentary by-election, this time on an enormous swing from the incumbent Labour Party, and in 1968 it topped the poll in the Scottish municipal elections.

In the ensuing General Election in 1970 it lost its by-election gain. But it picked up the UK's smallest and most remote seat, the Western Isles (now known by its Gaelic name of Na h-Eileanan an Iar). It might have remained a curiosity but for the discovery of North Sea oil, which began being shipped in commercial quantities in 1973. In that year, the SNP hit on a slogan which has served it well ever since: *It's Scotland's Oil*. In the original poster campaign, the headline was followed by various markers of social deprivation (e.g., 'so why do 5,000 people in Scotland die every year of hypothermia?') McLean and McMillan 2005: 162.) This contributed to a surge in SNP support in the two General Elections of February and October 1974. In February it won seven seats. In October of the same year, it won eleven seats and over 30% of the vote, tipping the Conservatives into third place in votes but not in seats. Politicians knew what 2015 was to prove: that with the UK's single-member district ('first-past-the-post') electoral system, a party with very broad support is penalised up to somewhere between 30 and 35% of the vote, at which point the system tips abruptly from penalising it to rewarding it. The SNP has very even support across Scotland. It would have won almost every seat in 2015 on considerably less than its actual vote share of 50%.

These events revealed enduring characteristics. On the SNP side: that independence is a blank slate on which every Scot may write her favourite policies; and, on the unionist side, that the demand for separatism must be met by offers of devolved powers.

On the SNP side, the 1973 claim was that if all the oil tax revenue from the Scottish sector of the North Sea were available for Scotland to spend, then Scotland could spend considerably more on alleviating social deprivation. This argument has never stacked up fiscally, except for a brief period in the 1980s when both the oil price and the rate of extraction from the North Sea were high. In fact, public spending per head in Scotland has always been substantially higher than in England (McLean 2005), throughout the period when the SNP has been a credible party. It was higher before oil; it was higher during peak oil; it remains higher now that oil revenue is approximately zero. In most years, the allocation of oil revenue to Scotland would not have made much difference to that fact. Until 1998, there was no elected government in Scotland. Since 1998, there has been one, with extensive

powers to spend but very limited powers to tax. One effect of this disjunction is that credible parties can make incredible spending promises.

The unionist reaction to the SNP advance of 1974 was controlled panic. The governing Labour Party had been in favour of devolution in the distant past when Scotland seemed a little like Ireland. Irish Home Rule was the radical cause *par excellence* from 1885 to 1914. Both of Labour's first leaders, Keir Hardie and Ramsay MacDonald, began their careers as Scottish Home Rulers. The Depression, World War II, and the welfare state changed all that. Like other parties of the left, Labour was in principle redistributive. It favoured what has come to be called a social union (McLean, Gallagher, and Lodge 2014 chapter 5). As social protection grows as a proportion of public spending (it is now the largest component), uniform benefit rates throughout the country come to be seen as important. A citizen's chances of being protected against hard times should not depend on where she lives. This biases parties of the left against devolution of power.

Labour executed a handbrake turn in the summer of 1974 (McLean and McMillan 2005: 162, 189). Its national leaders forced on its reluctant Scottish leaders a policy switch towards favouring devolution. This involved picking up the findings of the previously neglected Kilbrandon Commission (Kilbrandon 1973a). Kilbrandon had recommended elected assemblies for Scotland and Wales, but not for the regions of England. It proposed that a number of functions should be transferred to these assemblies: essentially, the functions of government which were already being carried out by the Scottish and Welsh Offices of the UK central government.

That project ended badly. The dissenting members of the Kilbrandon Commission pointed out that, on the Commission's own evidence, the demand for devolution in Scotland was imperceptibly greater than that in the poor regions in the north of England (Kilbrandon 1973b, Research Paper 7). Public expenditure per head data for the regions of the UK were beginning to become available. These showed that Scotland was richer than, in particular, the North Region of England. According to the social union view, therefore, public expenditure per head should have been higher in the poorer region. Instead, it was higher in the richer region. As it seemed to Labour politicians in the North of England, the Labour government was rewarding the Scots for their disloyalty – viz., threatening to support the SNP – while penalising northern England for its loyalty. The safe Labour cities of the north of England had nowhere else to go: safe for Labour, hopeless for the Conservatives. Labour politicians in the north of England killed off their government's plans for assemblies in Scotland and Wales by engineering a defeat on a 'guillotine' – timetable – vote in the House of Commons in 1977. The Scotland and Wales bill limped on, and were enacted with a provision that they would only come into force after a referendum in which more than 40% of the electorate voted for devolution.

The referendums took place in 1978. In Wales, the assembly was turned down by a large margin. In Scotland, it was supported but on a low turnout, so that the 40% criterion was

not met. The Labour government lost a vote of confidence, and was defeated by the Conservatives at the ensuing General Election (McLean 2016).

The Conservatives, who were weak in Scotland, governed for the ensuing 18 years. Devolution seemed to disappear from the UK political agenda. In a back-handed compliment to the Kilbrandon researchers who had shown that demand for devolution in Scotland was no higher than in other parts of the country, there was no mass uprising in Scotland in protest against the denial of the assembly for which it had (just) voted. Meanwhile, the finance ministry, HM Treasury, invented a device to curb they saw as the excess of public spending in Scotland. A recently uncovered memorandum explains:

[T]he Scots and Welsh – and for that matter the Northern Irish – were indeed able to ‘have it both ways’ in the sense of automatically receiving extra according to the traditional formula whenever English Departments got more and further additions for special problems peculiar to their own countries. The Scots, over a long period of time (and the Northern Irish in the early 1970s), played this game skilfully and effectively; the Welsh much less so. The result was to build up public expenditure per head on Scottish Office (and NIO) programmes to something of the order of 25% more than England; and in Wales to something like 5% more. . . . [W]e should at least stop the rot by preventing further increases in the differential. (P. Cousins, HM Treasury memo, 25.09.1978, in Levitt 2014: 237).

The result was the Barnett Formula, which was designed to cap ‘over’-spending in the three non-English parts of the UK. For many reasons, it has barely done so, and the latest available regional public expenditure figures are in Table 1.

Table 1 draws on two UK official data series, both classed as ‘National Statistics’ (a certificate that they are reliable and not subject to political interference). The first series comes from *Public Expenditure: Statistical Analyses* (PESA) published annually by HM Treasury (HM Treasury 2015). This publication reports public expenditure per head in each of the four nations of the UK, and, within England, in each of its nine top-level statistical (‘NUTS 1’) regions. The second series comes from the Office for National Statistics, and comprises the latest available data for regional gross value added (GVA). In national income accounting, there are different ways of calculating GVA, which in a world of perfect information would all give the same answer. The tables used are for the income approach, and they exclude extra-territorial income. Both sets of figures are indexed to a UK average of 100. In earlier years, the GVA series would have shown a higher relative score for Scotland if all the income derived from oil extraction in the Scottish sector were assigned to Scotland. But, as explained above, that income is now trivial and its absence does not distort the picture shown in Table 1. The Scottish Government statistical series *GERS* (Scottish Government 2015) has data for oil revenue going back to 1998 (thus not capturing the period of very high revenue). This is shown in Table 2.

Table 1. Public expenditure per head compared to Gross Value Added per head; nations and regions of the United Kingdom, 2014

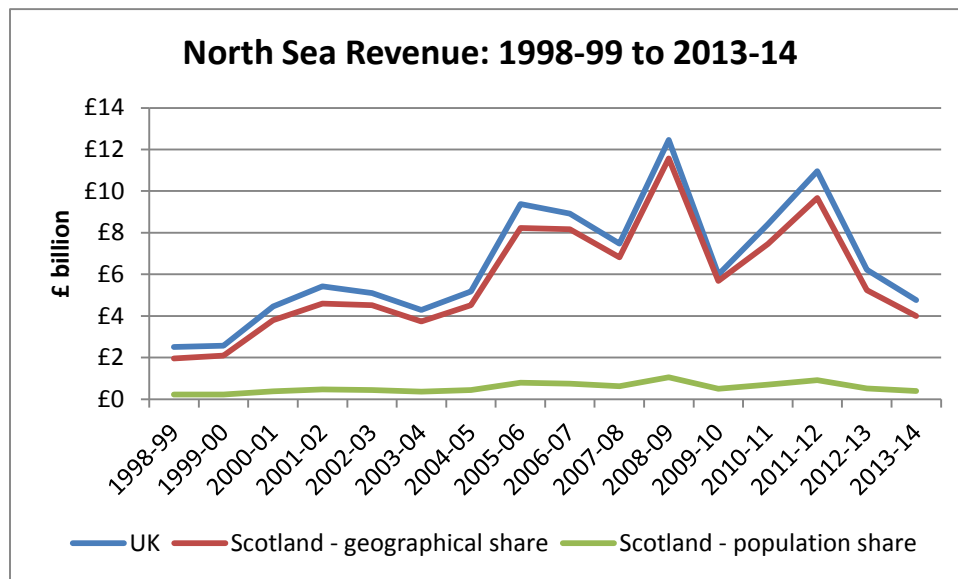
	Pub expenditure per head 2013-14	GVA per head 2014	Expenditure/head compared to social union standard
North East	107	74	79
North West	104	85	89
Yorkshire and the Humber	97	81	78
East Midlands	92	83	77
West Midlands	97	82	79
East	89	94	83
London	110	173	191
South East	87	110	95
South West	93	91	84
England	97	103	100
Scotland	115	94	108
Wales	111	71	79
Northern Ireland	123	76	93
UK	100	100	100

Sources.

- Column 2. HM Treasury, Public Expenditure Statistical Analyses Table 9.2 Total identifiable expenditure on services by country and region, per head 2009-10 to 2013-14
- Column 3. Office for National Statistics. Regional Gross Value Added (Income Approach) Reference Tables December 2015 Table 3. Gross Value Added (Income approach) per head indices
- Column 4. Author's calculations. 'Social union standard': level of expenditure required to alleviate relative poverty

Table 2 shows that, if all the oil in the Scottish sector of the North Sea were apportioned to Scotland (as the Scottish Government would prefer), annual revenue to Scotland would have been apparently about £11 billion (roughly £2000 per head) higher in a good year such as 2008-9, and apparently about £2 billion (roughly £400 per head) higher in a poor year such as 1998-9. The next edition of *GERS*, to be published just after this chapter is submitted, will probably show oil revenue at close to zero, since the recent collapse of oil prices has brought the profitability of the North Sea, on which tax is levied, to zero or negative.

Table 2. North Sea Revenue



Source: Scottish Government 2015. Chart 4.1

It is important to realise, however, that Table 2 represents only an accounting transfer. The revenue of the UK would have been identical whether or not oil revenue had been assigned to its component parts. If oil revenue from the Scottish sector of the North Sea had been assigned to Scotland, as the Scottish Government has requested since 2007, the UK government would have certainly demanded a pro rata reduction in block grant transfers to Scotland under the Barnett formula. Oil revenue is not an 'extra' in national income accounting, but only in political perceptions. Therefore, it is reasonable to assume that the PESA numbers in Table 1 would have been the same, if oil revenue had been assigned to Scotland.

The PESA tables confirm what they have shown for the entire lifetime of the series. Public expenditure per head in Scotland is higher than in England, currently by about 18%. That is maybe to be expected because Scotland is poorer than England. But it is also higher than in Wales, which again has been true for the entire life of the PESA series. But this is puzzling, because Wales has always been poorer than Scotland. They show that the Barnett Formula has not worked in the way envisaged by Mr Cousins of HM Treasury in 1978.

To understand how puzzling the numbers are, they must be compared with the next column of Table 1, showing regional GVA per head. Here again, the relative positions of the four nations of the UK have changed very little over the lifetime of the series. Scotland is slightly poorer than England, by about 9% per head on the most recent data. Wales and Northern Ireland are significantly poorer. Average income in Wales is below 70% of the English level, and in Northern Ireland below 75%.

The rightmost column of Table 1, which I have calculated and which does not qualify as National Statistics, shows the results of the following thought experiment. Suppose that the whole of public expenditure went on social protection, instead of the actual figure of about 40%. Then, in a social union, it would all go on redistribution from rich people to poor people, from healthy people to sick people, from working-age people to pensioners, and so on. If some regions are poorer than others, then almost by definition they contain a higher proportion of poor, sick, unemployed, and disabled people.

In such an oversimplified world, we would expect public expenditure per head to vary exactly inversely with income per head (i.e., there should be a correlation of -1 between them). The final column of Table 1 shows how much relative spending in the UK regions varies from this imaginary situation. Like the other two columns, it is indexed to 100. A region that scores higher than 100 is getting more expenditure than it “should”, and one that scores lower than 100 is getting less expenditure per head than it “should”. On this measure, the winners of the regional lottery are London (massively) and Scotland. The losers are every other standard region of the UK, including Wales and Northern Ireland.

Of course, not all spending is on social protection. But it is hard to think of any other category of public expenditure in which relatively-rich Scotland should get more than relatively-poor Wales. True, Scotland has the most extremely remote areas in the UK; but Wales has some too, and their total population is trivial. For instance, the population of all Scottish islands is 99,000 out of 5 million³. So my thought experiment has face validity. Two factors are at work here: distribution between the nations, which is governed by the Barnett formula; and distribution around England, which is not. The numbers show that the Barnett formula is not the only source of imbalance; but it is the one that is relevant to this chapter.

Second time lucky: the creation and development of the Scottish Parliament

We have broken the historical narrative in order to explain the relative public spending advantage for Scotland. This has persisted through thick and thin; when there was not a Scottish Parliament, and since there has been; when the oil revenue was non-existent, high, low, and (now) non-existent again. Having established that, it is time to come back to chronological narrative.

The failure of devolution in 1979 caused no great stir in Scotland. However, the Conservatives won the next three General Elections (1983, 1987, and 1992), although their support in Scotland was steadily declining. Their most unpopular policy, which led to the downfall of the charismatic Prime Minister Margaret Thatcher in 1990, was the so-called ‘community charge’, or poll tax. This was piloted in Scotland in 1986, and was as unpopular there as it soon became everywhere else (Butler, Adonis and Travers 1994).

³ source: <http://www.scottish-islands-federation.co.uk/population.htm>, accessed 29.02.2016

Increasing unease at Scotland being governed by a party for which it had not voted led to the creation of a cross-party Constitutional Convention. This began with a sonorous 'Claim of Right' for Scotland, and produced a full blueprint for a Scottish Parliament (Scottish Constitutional Convention 1995). It was adopted by the opposition Labour Party, which had been represented on the Convention. When Labour came to power in 1997, it therefore promised to introduce a Scottish Parliament and Welsh Assembly, if the people of the two territories voted for one. They did; by a substantial margin in Scotland, although only a bare margin in Wales. Accordingly, the present Scottish Parliament came into existence in 1999. There have been elections to it (using the German additional member system of proportional representation) in 1999, 2003, 2007, and 2011; the next will be in May 2016 just after the submission of this chapter.

The first two Scottish Parliaments were controlled by the Labour Party. Since 2007, the governing party has been the SNP, in a minority until 2011, and since then with an overall majority. Most observers agree that there have been many good things about the Scottish Parliament. It has pioneered legislation that would probably not have happened without it (for instance on land reform). It has led the UK in banning smoking indoors and in public places. And it has taken (very) tentative steps in tax reform.

The last, however, is the most disappointing, because the Parliament has had a structural failure from the beginning: *It spends, but it does not tax*. This is not quite true, because it does control some relatively small taxes, but it is close to the truth. We return to this in the discussion of fiscal fantasy below.

In the 2007-11 parliament, the SNP minority government proposed a referendum on independence. This was what economists call a 'cheap talk' gesture. It would enthuse the 25 to 30% of Scots who wanted independence. It would not be passed, because the government correctly anticipated that it would be voted down by the unionist parties, who between them held a majority of seats. It appeared therefore to be a costless gesture.

It was not. When the SNP won an overall majority that neither they nor any other party had expected in the 2011 election, they could not say "Oh, we weren't really serious about an independence referendum". They were committed to it, despite the well-known data showing that only a minority of Scots desire independence. The Scottish Parliament did not have the legal power to call a referendum on the constitution. It could, like the Catalan parliament, have tried to go ahead regardless. It actually took a different route. It negotiated with the Conservative-led UK government to secure a referendum that both sides would recognise as constitutional and binding. This agreement was signed in Edinburgh in 2012 between First Minister Alex Salmond and UK Prime Minister Cameron.

At the UK government's insistence, the referendum was to have a single question. The independent Electoral Commission determined its wording: "Should Scotland be an independent country?" Numerous commentators (e.g., McLean, Gallagher and Lodge 2013) pointed out that most of Scotland's population wanted more devolution, and preferred that to either the *status quo* or independence. This would have argued for a three-option

referendum. On the other hand, people cannot be reasonably asked to vote on something that has not been defined, and no party had produced a consensus definition of 'devo-more' or 'devo-max', the two terms that were being bandied around.

As Robert Burns wisely said,

The best-laid schemes o' mice an' men
Gang aft agley (Burns 1786, 'To a Mouse')

The scheme of the 2007 Scottish government for a cheap-talk promise of a referendum that would not have to be honoured went agley when the SNP gained an overall majority in the 2011 parliament. That answers our Question 1 above.

The scheme of the 2010 UK government was accordingly to force a referendum on a question which it thought the SNP government was bound to lose. That almost went agley. Having stood at no more than 30% in the polls for 20 years, support for Scottish independence, crystallised as the intention to vote "Yes" to the referendum question, suddenly spiked upwards in the months and weeks before the vote. Most polls showed the No camp to be only 5 or so percentage points ahead of Yes. A single poll gave a Yes lead. This panicked the unionist parties into making a last-minute 'Vow' to the effect that if Scotland voted No it would be given a package of substantial further devolution (Clegg 2014).

Good reasons for voting for independence

As noted above, the actual result was a victory for No by about 10 percentage points. However, the losers soon bounced back and the winners split and dissolved. The Yes side had been dominated by a single party – the SNP. The No side was an amalgam of three parties that agreed on nothing else, viz., the Labour Party, the Conservative Party and the Liberal Democrats. At the UK General Election of 2015 the Labour Party in Scotland suffered grievously for this collaboration with the Conservatives, as did the Liberal Democrats throughout the UK. In Scotland, the election produced 56 seats for the SNP, and one each for the Liberal Democrats, the Labour Party, and the Conservatives. The electoral system would have delivered this result on much less than the 50% of the vote that the SNP received. And it is worth noting that the SNP won fewer votes in the General Election than, on a higher turnout, Yes had won in the referendum (1,454,436 for the SNP in the General Election; 1,617,989 for Yes in the referendum). Without any doubt, however, the SNP is hegemonic in Scotland, and all polls suggest it will retain this position in the 2016 Scottish Parliament election.

Part of the answer to our initial Question 3 is thus that the Yes side was united and the No side divided. As most of the rest of this chapter is devoted to the bad reason for the successes of Yes and the SNP, it is right to acknowledge that there are many good reasons for a vote in favour of independence. The most fundamental of these is just a wish to control one's own government. Up to the 1950s, the two main UK parties were quite evenly

matched in Scotland. Since then, the Conservative Party has been in secular decline there. Therefore, particularly during the years of Conservative-led governments in Westminster (1955-64, 1970-4, 1979-97 and 2010 to date), Scotland was governed by a party that was in a minority (latterly a small minority) there. This might have been alleviated by the creation of the Scottish Parliament, but it has not been.

Another good reason for voting Yes relates to the UK's independent nuclear deterrent. This is housed in the Trident submarine fleet, which operates out of Her Majesty's Naval Base (HMNB) Clyde. The two principal sites are Faslane on the Gare Loch and Coulport on Loch Long. These are two fjords in the west of Scotland, which has the only locations in the UK where deep water adjoins narrow inlets. The movement for nuclear disarmament in Scotland has opposed the siting of nuclear warheads there for decades. A supporter of nuclear disarmament therefore had every good reason to vote Yes. More broadly, so had any voters whose cultural affiliations with Scotland were stronger than their affiliations with the United Kingdom.

The bad reason: fiscal fantasy

We have not yet answered Question 2, and some more background is needed first. The platform of the SNP since 1973 has been the economy, and most of the arguments around the referendum were about the economy. Most of them, on both sides, were bad. Ever since 1973, the SNP have used "It's Scotland's oil" as an argument for more public spending in Scotland. Their unionist opponents, terrified of being outflanked, have been willing for the higher spending per head in Scotland, already notable in the mid-1970s (McLean 2016), to continue. For various reasons, the convergence towards equal spending per head that Barnett was planned to bring about has not occurred.

When the Constitutional Convention drew up its blueprint for a Scottish Parliament, this might have been addressed. Sadly, it was not. The Parliament as constituted simply took over the services that were already being administered by the Scottish Office, a department of the UK government. Instead of the Barnett block grant being paid to the Scottish Office to fund education, health, and transport in Scotland, it was simply transferred to the Scottish Parliament to run those things. By world standards, the Scottish Parliament has remarkably wide responsibilities for a subnational parliament. It has remarkably few tax resources with which to pay for them. According to (OECD 2015), locally raised taxes in the UK comprised 4.90% of total tax receipts in the latest available year (2014). This share, which includes the local tax take in England as well as in the rest of the UK, is one of the lowest among OECD member states (only Czech Republic, Slovakia, Greece, Ireland, and Luxembourg had a lower share). However, local expenditure was 25.09% of general government expenditure, which is much closer to the OECD norm.

From its establishment, the only two taxes controlled by the Scottish Parliament were the two local property taxes, on houses and on businesses. Council tax (on houses) is levied by local councils, but the Scottish Parliament and Government are always tempted to freeze

them. The SNP boasts that its governments have frozen council tax rates for their entire time in office (SNP 2016). But the effect of this is actually to reduce the proportion of its spending that is raised in Scotland, and therefore to increase its dependence on Barnett block grant.

Thus the Scottish Parliament has always been fiscally irresponsible. It has spent money but has only trivially raised money. This has damaged the Parliament, and all parties in it. Scottish Parliamentary elections have always been a 'me-too' contest in which each of the parties promises to spend more money than the others.

Reducing fiscal fantasy: the marginal principle

To rescue the situation, taxing and spending must be brought into some sort of balance. Independence would of course produce this, as the Scottish Parliament would become responsible for all the tax it raised and all the money it spent. This might have been listed above as one of the good reasons for voting Yes, if any of the campaigners had mentioned it. Instead, the Scottish Government's Yes manifesto, published as a White Paper (Scottish Government 2013) was a wish-list of uncosted promises, with something for every sector of Scottish society. Under the 'me-too' principle, the other parties reacted by promising increased spending on (especially) health in Scotland if the electorate voted No (Clegg 2014). Nevertheless, the Yes and SNP promise to spend fantasy money was more credible than the other parties'. The White Paper offered an illustrated manifesto for every spending wish that any sizeable proportion of Scots wanted. That is the fundamental answer to my initial Question 2.

Scottish politics cannot remain in fantasy land for ever. At some point, the Scottish Parliament must balance its total taxing with its total spending; or at least must balance its marginal taxing with its marginal spending. What is the difference between these two principles? In practice, not very much. If Scotland becomes independent after a second referendum (perhaps in the event that the UK as a whole votes to leave the EU in the June 2016 referendum, while Scotland has voted to remain), then it will have to balance total taxing with total spending. If it fails to do, its debt will be downgraded by international bond markets.

However, the schemes that are in force or in process when this chapter is submitted are schemes to balance *marginal* rather than total spending and taxing. They have come in two phases. The first was embodied in the Scotland Act 2012; the second in the Scotland Bill 2016, which is about to resume its parliamentary progress after a three-month failure by the Scottish and UK governments to agree a compensation formula. The newly-agreed formula (HM Treasury 2016) is analysed below. The key to both the 2012 scheme and the 2016 proposal is to ensure that, at the margin, the Scottish Parliament considers whether it wants to spend more (and therefore to raise tax) or to cut tax (and therefore to spend less).

The 2012 Act was passed by the UK Coalition government with assent of the Scottish Parliament. But it originated with the prior UK Labour Government under the Prime Ministership of the Scotsman Gordon Brown. Brown knew that the fiscal framework under which the Scottish Parliament operated was unsustainable, as was Scotland's relative spending advantage. But, as a serving Scottish MP (whose seat like almost all the others went to the SNP in 2015), he could not publicly say so. Therefore, he appointed a committee. The Calman Commission (Calman 2009) had a wide-ranging brief, but its core function was to propose new arrangements for taxing and spending in Scotland, which would reduce the fiscal irresponsibility of the Scottish Parliament and perhaps make some progress towards implementing the marginal principle discussed in this chapter. The author was a member of the Independent Expert Group of academics working on fiscal issues that was appointed by Calman. It was chaired by the economist Anton Muscatelli, then Principal of Heriot-Watt University (now of Glasgow University).

The Independent Expert Group (IEG) produced four reports (IEG 2008, 2009a, b, c). Its work is fully analysed in McLean (2010). In brief, it considered how Scotland might move from fiscal irresponsibility to fiscal federalism, while remaining inside the UK (independence was ruled out by the terms of reference for Calman and the IEG). Fiscal federalism must combine the marginal principle with an equity rule. The marginal principle, as stated above, requires that at the margin, the lower tier of government (here, Scotland) must decide how to balance the benefits of the last pound of spending against the costs of the last pound of taxing. The equity rule relates to the social union, also discussed above. In any federation, some provinces (states, territories) are poorer than others. The poor ones have less capacity to raise taxes and more need for public services. Therefore, some equalisation rule is needed so that they are not left too far behind.

How far is 'too far'? That depends on the political culture and history of the federation. Switzerland and the USA are examples of federations where there is very little equalisations. Their poor cantons/states are just poorer than their rich ones. Although there are federal transfers to West Virginia and Alabama, they are not nearly sufficient to prevent those from being the poorest states in the Union, nor do they hurt California or Massachusetts enough to prevent them being among the richest states.

The most egalitarian federation in the democratic world is probably Australia, whose Commonwealth Grants Commission (CGC: McLean 2004) attempts to equalise for both the relative resources and the relative needs of Australia's six state and two territories. Equalising for needs means assessing what is needed for an averagely efficient government to provide the same standard of service to a comparably situated citizen in each state and territory. Equalising for resources means taking account of the states' different capacities to raise revenue from their own taxes. The central problem faced by the CGC, and by any egalitarian distributor of block grant, is reconciling equity with efficiency. If the Commission did nothing except transfer resources to meet relative needs, the states could sit back and do nothing, except demonstrate to the CGC how poor they were. They would have little incentive to deliver services efficiently and no incentive to make more tax effort. Since its

creation in 1933, the CGC has developed elaborate procedures to try to avoid this problem. Most importantly, the proceeds of an extra tax effort are not immediately equalised away from the state which makes it.

The Calman IEG studied both the Australian and Canadian arrangements. It heard from the chair of the CGC, and from the two leading Canadian experts. Canada does not attempt to equalise for needs, but does equalise for resources (i.e., for the provinces' varying tax bases). Unsurprisingly, the IEG, the Calman Commission, and ultimately the Scotland Act 2012 plumped for a scheme that is more Canadian than Australian. An Australian scheme would have entailed assessing the relative needs of the four countries of the UK. Therefore, it is popular in Wales, which would gain from it (ICFFW 2009), and was tacitly buried in Scotland, which would have lost from it.

The Scotland Act 2012 provides for the UK government to do what the Canadians call 'vacate tax points'. From April 2016 the UK government will reduce the rate of income tax charged to Scottish taxpayers by 10 pence in the pound in each tax band (Audit Scotland 2015). The Scottish Parliament will then have to set a tax rate. It will no longer be a passive recipient of Barnett transfers. To begin with, it is almost certain to keep the tax rates as they are: but that, in accordance with the marginal principle, will partly determine how much it can spend. It has the option to raise or lower the rate. Some smaller taxes were also transferred to Scotland under this Act – essentially, as the theory of fiscal federalism recommends, taxes on things that don't move, such as holes in the ground. The Scottish Government will control both aggregates levy, a tax on digging holes, and landfill tax, a tax on filling them up again. Notably, however, the 2012 Act does *not* provide for the devolution of taxes on North Sea oil. As they have since 2012 dwindled essentially to zero, the Scottish Government must regard that as a blessing in disguise, although it has claimed for over forty years that *It's Scotland's Oil*.

The 'Vow' of 2014 is expected to lead to considerable further devolution of tax, and some further devolution of spending responsibilities. The immediate aftermath of the Vow and the *No* victory was the creation of the Smith Commission, on which all the main political parties were represented. In a very short time, Smith managed to produce a consensus report (Smith 2014). This called for the complete devolution of income tax to Scotland; assignment of half the proceeds of Value Added Tax (VAT); and the proceeds of a number of other taxes to be devolved to the Scottish Parliament. The difference between devolution and assignment of a tax is as follows. A tax is devolved if the lower-tier parliament has the power to alter its rate and base. A tax is *assigned* if the lower-tier parliament does not have that power, but receives the proceeds of that tax, or some of them. Under EU rules, VAT may not be devolved within a member state, because variation of rates would be considered to be inadmissible state aid. As in 2012, it was not proposed to devolve the proceeds of offshore oil taxes; as in 2012, the Scottish Government did not object to this failure to devolve.

The Smith report led to a very long standoff between the Scottish and UK governments, on the question of how the Barnett block grant would be reduced to take account of the transfer of tax powers. Conceptually, this is very simple on the day of the transfer. The block grant is reduced by the yield of the relevant tax(es) in Scotland in the year prior to the transfer. The much more difficult question is: what happens in subsequent years? Once a tax has been transferred, the fiscal history of the two countries will diverge. That is the point. The risks, from a Scottish perspective, are that tax receipts per head grow more slowly, and that population grows more slowly, in Scotland than in the rest of the UK. (Correspondingly, the upside benefits for Scotland are that they rise faster). The Scottish Government sought a formula that gave it the maximum protection from the downside risks. After three months' deadlock, the UK government in effect conceded this in late February 2016, although insisting on a five-year review of the arrangements (HM Treasury 2016). It is now expected that the stalled Scotland Bill 2016 will be enacted, transferring these powers, and some correlative duties, to the Scottish Parliament (Scottish Parliament 2016).

How much does this add to the Calman / 2012 Act arrangements? Rather little, in my view. The marginal principle, for income tax, is already in the 2012 Act. Transferring the whole of income tax may focus the minds of Scottish parliamentarians, but it does not make any difference to the marginal principle that the 2012 Act brings in. Under the 2016 prospective Act, the Scottish Government has chosen the most risk-averse option available: one that shields it from the risks that tax take per head, or population growth, or both, rise more slowly than in England. Of all the available solutions, it has chosen the one furthest removed from the independence for which it campaigned in 2014.

Lessons for and from Spain and Canada

This chapter is written at a time of rapid flux in the fiscal relations between Scotland and the rest of the UK. They will inevitably have changed even before it is published. What provisional lessons and comparisons may be made with the two other democracies where the relation between the centre and the provinces or regions is most in contention, namely Spain and Canada?

Spain is discussed extensively in other chapters of this book. But a few remarks about the obvious comparison between Scotland and Catalonia may be helpful. Catalonia, with 16% of Spain's population, has had between 19.6 and 20% of Spain's GVA/GDP since 2006⁴. It is thus at about 125% of national average GDP per head, compared to Scotland's ratio of between 90 and 95%. The Basque Country has even higher GDP per head relative to Spain as a whole, an EU source putting it at over 135%⁵. The range of GDP per head between the

⁴ source: Statista at <http://www.statista.com/statistics/327257/catalonia-s-share-of-spanish-gross-value-added-gva/>, accessed 01.03.2016

⁵ source: EU at <https://ec.europa.eu/growth/tools-databases/regional-innovation-monitor/base-profile/basque-country>, accessed 01.03.2016

richest (Basque Country and Madrid) and poorest (Extremadura) regions of Spain is about 2:1⁶.

For this reason alone, the politics of secession in Catalonia and Scotland are different. Secession would have deadweight costs. Catalonia and Scotland would need to set up foreign embassies and tax-collecting agencies. They would need to negotiate treaties with the countries from which they were seceding. Those countries, Spain and the rest of the UK (rUK), would also incur one-off costs. But once secession had occurred, the consequences would be worse for Spain, with a rich region seceding, than for rUK, with a below-average income region seceding. North Sea oil may once have changed this calculation, but no longer does.

Another difference is at the constitutional level. On 2 December 2015, Spain's constitutional court held that the resolution of the Catalan parliament to begin independence negotiations was unconstitutional. The UK has no codified constitution and no constitutional court. However, there were legal constraints limiting the freedom of the Scottish government to call an independence referendum. The Scotland Act 1998, which created the current Scottish Parliament, set down a number of 'reserved' areas in which the parliament had no legislative competence. One of these was the constitution of the UK.

The Scottish Parliament could have proceeded regardless, rather as the Catalan Parliament did. It could have told its supporters that the very act of the UK blocking its referendum was a reason for voting for independence. However, such an unofficial referendum would have been challenged in the courts – not necessarily by the UK government. Any litigant, private or corporate, could have complained that the referendum was 'ultra vires' and that the court must stop the Scottish Government from acting ultra vires. The court would have agreed. In the light of this threat - always present but rarely mentioned - the Scottish and UK governments instead made the 'Edinburgh Agreement' on the terms on which the referendum could legally take place. Any future independence referendum, say in the event of the UK voting to leave the European Union when a majority of Scots have voted 'Remain', would be subject to the same forces. It would again require the consent of both governments to be legal.

The UK's wish for Scotland to remain in the Union is expressive more than it is instrumental. After the initial disruption, the economic costs of secession would fall more per head on the Scots than on the rest of the UK. The dominant instrumental reason for opposing secession is probably military, namely the presence of the UK's nuclear-deterrent submarines in Scotland. If it were not for that factor, a future UK government might think that there was no reason to stop the Scots from leaving. The wish to keep the union together is an expressive wish: that is, a belief that the union is good in itself, requiring no further justification. But in its intensity it is vastly less than the expressive wish of UK Unionists,

⁶ source: Eurostat at <http://ec.europa.eu/eurostat/statistical-atlas/gis/viewer/?year=2015&chapter=06>, accessed 02.03.2016

between 1885, to keep an unwilling Ireland in the union. That expressivism almost ended in civil war.

One factor that is common between the UK and Spanish situations is the resentment of poor parts of the country against what are perceived as threats from richer, secessionist, parts. Although Catalonia has above-average GDP per head for Spain and Scotland has below-average GDP per head for the UK, in both cases poorer regions resent transfers to those territories, which are perceived as being made for political reasons rather than to preserve a social union. This limits the ability of both the UK and the Spanish government to kill off secession by throwing money at it.

Turning to Canada, there were referendums on the secession of Quebec in 1980 and 1995. In 1980, to an enormously long question (108 words in the English version), the vote was 59.6 to 40.4%, on a turnout of 85.6%, against 'giv[ing] the Government of Quebec the mandate to negotiate the proposed agreement between Quebec and Canada'. In 1995, the question was slightly shorter. The English version ran:

Do you agree that Quebec should become sovereign after having made a formal offer to Canada for a new economic and political partnership within the scope of the bill respecting the future of Quebec and of the agreement signed on June 12, 1995?⁷

The vote was again No but by a margin of only 50.6 to 49.4%, and on a turnout of 93.5%. In stark contrast to Scotland 2014, the winners then made further advances, and the very narrow losers retreated further.

The constitutional status of the referendum was challenged before it occurred. In *Bertrand v. AG Quebec* 127 D.L.R. (4th) 408, the Quebec Supreme Court held that a unilateral declaration of independence after a Yes vote would be unconstitutional under the Canadian Charter of Rights and Freedoms, but declined to stop the referendum. After the vote, the federal government took two related actions. One was its *Reference to the Supreme Court of Canada re Quebec Secession* [1998] 2 S.C.R. 217 as to the acceptable constitutional procedure for Quebec secession. The court held that 'Democracy, however, means more than simple majority rule': if a 'clear majority of Quebecers votes on a clear question in favour of secession', Canada must negotiate in good faith for secession, but Quebec could not secede unilaterally. The Court did not define either 'a clear majority of Quebecers' or 'a clear question'. The federal Clarity Act (S.C. 2000 c.26) provides for the House of Commons to certify whether a referendum question is sufficiently clear to meet the court's conditions, and states that a proposition to open negotiations, or a multi-option referendum, would both fail that test. To be valid under the Clarity Act, a referendum question must have the same form as the Scotland 2014 question.

⁷ source: Elections Quebec, at <http://www.electionsquebec.qc.ca/francais/tableaux/referendums-quebec-8484.php>, accessed 03.03.2016

Under the Act, the House of Commons must also certify whether a clear majority for secession has been achieved, taking account of

- (a) the size of the majority of valid votes cast in favour of the secessionist option;
- (b) the percentage of eligible voters voting in the referendum; and
- (c) any other matters or circumstances it considers to be relevant. S.C. 2000 c26, section 2(2).

On issues of taxing and spending, Canada is in a fairly similar position to both the UK and Spain. The range of GDP per head in the ten provinces is from C\$91,000 in Alberta to below C\$45,000 in three of the four Maritime provinces (New Brunswick, Prince Edward Island and Nova Scotia (2014 data, source Statistics Canada). GDP per head in Quebec in 2014 was just over C\$45,000, about 81% of the all-Canada average. Undoubtedly the politics of envy have played out in Canada as in Spain and the UK, with other poor provinces complaining that Quebec gets public expenditure out of proportion to need because of its threat potential. But this is a smaller issue than in Spain or the UK, because, as described above, Canada's regime for transfer between the federal budget and the provinces is less redistributive than in European states. The key economic issue surrounding Quebec secession is surely that it would cut Canada in two, with the four Maritimes, all of them poor except for Newfoundland which has a high resource-based GDP, being physically separate from the rest of Canada.

What would Spanish and Canadian constitutionalists say about the Scottish referendum?

The political economy of envy is similar across all three jurisdictions. National governments are always tempted to offer tax breaks or higher public expenditure per head to their rebellious provinces. This may placate their citizens, but angers those in the rest of the federation. In the EU, limits are set on this by the state aid rules, as the Azores and La Rioja judgments (Case C-88/03; consolidated Cases C-428/06 to C-434/06) of the European Court of Justice have clarified. The analyst can say nothing more in general except that that is what territorial politics is about.

The constitutional issues are more profound. In a recent paper, Stéphane Dion, who was the Canadian federal minister responsible for the reference to the Supreme Court and the Clarity Act, reflects on that experience and compares it with Spain and the UK:

The principle underlying the indivisibility of the State in a democracy is the right to citizenship. All citizens are entitled to full membership in the State and have the right to transmit that citizenship to their offspring. No group of citizens, even when claiming to form a people or a nation, may take it upon itself to take the country away from other citizens. Thus Article 2 of the Spanish Constitution

makes it clear that Spain is an indivisible country, making it legally impossible for any Catalan to take Spain away from another Catalan.

In Canada, the United Kingdom and a few other democracies, the thinking is different: it is considered that national unity should be based on mutual consent. Canada is one of a very few democracies that recognize their divisibility in law (Dion 2015)

Dion goes on to draw a further distinction between Canada and the UK. In Canada, the Clarity Act has specified that 50% plus one is not enough for a secession referendum to succeed; and that the federal parliament should not respond unless the question has been clear. The UK is more permissive. In the (abortive) UK referendum legislation of 1978, a rebel amendment was inserted to insist that a 'Yes' in Scotland and Wales should not be binding unless 'Yes' comprised at least 40% of the electorate. This was widely derided as a pure wrecking move, which it probably was. Yet, Dion argues that there is a point in requiring a supermajority of some sort.

As the UK faces at least one and possibly two constitutional referendums – one on EU membership and possibly another one on Scottish independence – Dion's arguments should lead constitutionalists to think hard. Although, both in Scotland and the EU, the UK government has followed one provision of the Clarity Act by requiring a simple unambiguous question, it has not followed the other. No threshold, of majority, or turnout, has been specified for the EU referendum. Prime Minister Cameron should perhaps have paid more careful attention to the Canadian experience than he seems to have done.

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