Algebra and the Constitution: The Fiscal Framework of the Scotland Bill

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Executive Summary
The Scotland Bill currently before Parliament is will complete a transformation: the transformation of the government of Scotland from a territorial department within a single UK administration to a separate, self-standing government, taxing as well as spending, taking on powers and risks that were previously the sole preserve of central government. The UK too is transformed, from a state which could once think of itself as unitary, to one which is undeniably federal in many of its characteristics. One part of the Bill’s package, however, remains incomplete, the so-called "fiscal framework" for the operation of its new tax and spending powers. This framework is of constitutional significance, because it sets out in fiscal terms what kind of union the United Kingdom now becomes.

This issue has been locked in behind-the-scenes negotiations between the two governments involved, and is construed largely in terms of how good a fiscal deal the SNP can secure from the UK government. But the outcome of any deal is uncertain, dependent on economic change, political decisions, population growth and other factors. It would be foolish for any government to be guided by an unpredictable numbers game; a more principled approach than that is needed.

The most important principles are already given. During the referendum campaign, Scottish voters were promised not just more tax powers and a more powerful Parliament, but also the retention of the Barnett formula. Over nearly 40 years, Barnett has grown from an administrative convenience into a constitutional principle. The simple algebra means different things to different readers – an effective, depoliticised, formula for sharing out resources; the promise of a very good public spending deal for Scotland; or the threat that Scottish spending will converge to a lower level. Barnett certainly works in practice and, as the paper demonstrates, there is little sign of the threatened convergence. So retention of Barnett for determining the UK contribution to Scottish devolved spending is undeniably a good deal for the Scottish government and for Scots. Given the commitments made, Barnett is the UK alternative to a formal assessment of needs to share out the UK’s resources.

But Barnett has to change, as the Scottish Parliament will have substantial alternative revenue streams – from income tax, half of VAT and other taxes. Its resources have it be considered alongside its needs; and it is to gain welfare responsibilities, which have not hitherto been subject to Barnett. Arithmetically, that means a reduction to grant for the tax income, and an addition for the cost of new devolved benefits. It is inevitable that this will produce a different outcome from Barnett alone. The devolved budget will be taking on risks that are currently wholly absorbed by the UK.

The different options for these adjustments are analysed in detail in the paper. It is widely agreed that the Scottish government will have to take on economic risks along with the power to change taxes. It will have a very direct stake in the performance of the Scottish economy, and will retain all the income from the taxes it is responsible for, as well as the VAT which is assigned to it. Under discussion between the governments is whether it should also have some share in the growth of the same taxes levied elsewhere in the UK,
notably income tax. On the face of it, the obvious answer to that question is no. After all, income tax is devolved. Indeed that is how the two taxes which have been devolved since 1989 are dealt with. The growth of council tax and nondomestic rates than the rest of the UK affect the Scottish budget not at all. A good case can be made for treating all devolved taxes in the same way, which has been described as the “levels” method, though it is really no more than the strict application of tax devolution.

An argument can be made, however, for a degree of tax equalisation. First of all, recognising that the Scottish tax base starts out at a lower level, proportionately, to the rest of the UK, the change to the new system should not thereby require a proportionately greater tax effort in Scotland to yield the same amount of additional public spending. This would be avoided by the method described in this paper as simple indexation, which might be appropriate for VAT assignment too. The challenge would be to explain to taxpayers elsewhere in the UK why an increase in the taxes they paid would leak across to spending in Scotland. One answer might be that the formula would be symmetric: that if Scotland were successful and produced proportionally more taxes than England, equalisation would work in the opposite direction.

The Scottish government, it seems, may be arguing for more equalisation still. One of the characteristics of Barnett is that it is relatively insensitive to population change. If the Scottish population magically doubled, Barnett would bring very little extra resource. In fact it has been in gradual relatively decline, and the 5% drop has helped keep Scottish spending nearly a 25% per head more than the English comparator. Tax is different, and the population risk on devolved tax will be borne by the Scottish government. It has been suggested that, as decline is forecast to continue, that risk should instead be borne by taxpayers elsewhere in the UK. This would be achieved by the method described as per capita indexation.

The arguments for both different forms of equalisation have been justified by reference to the ill-defined principle enunciated by the Smith commission of "no detriment": that is to say that the shift to the new funding system should of itself not change the allocation of resources. This must clearly be so in the first year of its application, and it can be argued that a system which is almost guaranteed in the immediately following years to require a higher percentage tax rise to produce the same absolute revenue rise needed to support spending operates unfairly to Scotland's detriment. But is harder to argue that the risks which are explicit in taking on tax responsibilities - that tax revenues will grow at different rates, whether from population change or economic growth, can be offset on the basis of no detriment compared to what the Barnett formula might have produced in total. Barnett will continue to do what it has always done – allocate UK resources to the devolved administrations on an incremental population share. Supplementing that so as to insulate the Scottish budget from relative population decline would mean means allocating some rest-of-the-UK income tax payers to Scotland for revenue purposes, but not for spending purposes.
With tax devolution, the Scottish government will bear some economic risk – about of its resources half will depend on how the rest of the UK fares (as virtually all does under Barnett) but the other half will depend on how Scotland’s economy does. Tax equalisation under simple indexation will mean, in essence, that the UK accepts that present tax and per capita spending relativities are broadly right. As for population change, the Scottish government already bears the effect on spending need of Scottish population change and tax devolution will better match that, though continued use of Barnett will insulate Scotland from roughly half the effect. That is fair to the rest of the UK as well as Scotland.

On the new spending responsibilities, the Barnett formula could be applied, entirely consistently with other spending, but out of line with how reserved benefits will be changed, and this paper argues for a simple indexation method for spending as well. It is suggested that the new spending responsibilities and the tax responsibilities should be treated consistently in this respect.

Capital expenditure is the last vestige of the old, pre-devolution funding system. It is determined by the Barnett formula, and wholly funded by the Treasury. (The Scottish government is yet to use the borrowing powers it has already been given.) This should be changed, so that it is funded in the same way as current spending – part supported by shared UK taxation, and part by Scottish taxation. This would mean that the Scottish government should pay the Treasury interest on its borrowings (compensated under the "no detriment" principle to start with), but also borrow from the markets, and a prudential basis, supported by its own tax revenues. That’s what governments do.

The fiscal framework is not a routine haggle between governments about money. It is a constitutional set up. Making changes like these, on an agreed, principled basis would complete the journey from the administrative devolution of the Scottish Office, inside a single UK government, to a separate Scottish government inside a quasi-federal UK. That is what at the Scotland Bill does in legislative terms, and it should be matched in the fiscal framework.
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Introduction
The Scotland Bill, which gives the Scottish Parliament new tax and welfare responsibilities, is nearing the end of its Parliamentary progress. But it will not proceed to enactment without Holyrood’s consent, and one issue remains to be discussed and agreed between the two governments before this happens – the so-called "fiscal framework" for the Bill. How should the arrangements for funding the Scottish Parliament change, now that it has these new tax and welfare responsibilities, as well as wide borrowing powers? And how is this to be compatible with the promises made during the referendum campaign, notably to continue with the Barnett formula – something designed in an era before tax devolution was contemplated?

The two governments have been locked in private negotiation, although some of the issues under discussion have leaked out, or can be guessed at. What reduction should be made to the grant calculated under Barnett to take account of the stream of new tax revenues? Which risks, as a result, are to be borne by the Scottish government, and which retained at a UK level? How are the new welfare powers to be funded, as at the moment they are outside the departmental expenditure limits on which Barnett is based? And what is the significance of the borrowing powers now available to the Scottish Parliament, and to what extent are Holyrood’s debts guaranteed by the UK taxpayer?

There has been some academic work on this subject, in evidence to parliamentary committees or independently published [see e.g. Bell et al. 2015]. This paper reviews the issues, and the existing work, and suggests the principles on which change should be based and how the options stack up against them.

The Constitutional Algebra of Barnett
Section 1 of this paper reviews the Barnett formula, which has been the basis of territorial finance in the United Kingdom since the late 1970s. It discusses what Barnett was intended to do, and what not, and the extent to which the predictions that Barnett would squeeze Scottish public spending closer to average UK levels have been fulfilled. Barnett has been remarkably durable, and has achieved a constitutional and political status which has embedded it in the devolution settlement, and the Scottish political psyche, so that in the independence referendum campaign all of the main UK parties promised that it would be preserved. But Barnett has to change.
Tax devolution

Barnett is based on spending, but the Scottish Parliament is now, following the reports of the Calman and Smith commissions, to be a powerful tax-raising body. Council tax and nondomestic rates have always been a purely Scottish responsibility. Some small taxes were devolved in 2015, following the Calman report, in the Scotland Act 2012, which also devolved 10 percentage points of income tax from April 2016. Adjustments have been made to funding accordingly. Much more is coming under the Scotland Bill implementing the Smith recommendations, which will devolve virtually all income tax and two more small taxes, and assign half of VAT.

Section 2 of this paper therefore reviews the various detailed proposals for reducing the Barnett grant to take account of this new income. These have been extensively discussed in terms of the potential effect on the Scottish budget, and are the subject of intense intergovernmental negotiations, behind closed doors. It is important however to consider not merely the various potential arithmetical outcomes, but the implications of each of the potential solutions for the allocation of risks between the different levels of government, and the extent to which different tax revenues are shared across the UK, and why.

Spending: Welfare devolution

Section 3 of the paper looks at the welfare devolution proposals in the Scotland Bill. The Scottish Parliament will have the power to top up UK benefits, but will have to do so from its own resources. This aspect of the new powers therefore has no direct implications for the fiscal framework. But a bundle of welfare benefits are being devolved in their entirety, and funding arrangements will have to be made to deal with these. Welfare falls outside the Barnett arrangements, as the budgets are "annually managed" at a UK level. The options for changing the Scottish element of these budgets are discussed.

Spending: Capital Borrowing powers

Most of the Scottish government’s capital spending is still funded by grant from the UK government and it has not, at the time of writing, undertaken borrowing for capital investment, despite powers to do so. In section 3 the paper also reviews how capital expenditure is funded under the new regime, and suggests that, over time, capital grant from Westminster should be replaced by borrowing, and that there might be advantage in the Scottish government doing its borrowing directly from the markets which will give an external assessment of the prudence of its approach.
Squaring the circle of the constitutional algebra

The final section of the paper looks at the issues together, and tries to draw out some general principles. The Scotland Bill and the fiscal framework around it should complete the journey of the Scottish devolved institutions from a Department of government, wholly within the UK government’s public spending system and controls, to a self-standing institution, supported by a share of UK taxes, but raising its own taxes to cover a substantial proportion of its spending. The fiscal framework in which this sub-state government sits is something of constitutional rather than merely technical significance, and is not solely a question of how much budgetary change is implied in each of the options on various projections about future economic and social change. It needs to be markedly more principled than that. What risks are borne, by which government, and why? What are the mechanisms of resource sharing across the territory of the UK, and to what extent are different needs for spending recognised, and different taxable resources equalised?

How a sub-state government should be supported, and which risks it should be expected to bear will depend on economic and social circumstances. In Scotland’s case it is conditioned by the inherited system and by commitments made during the referendum campaign. The Barnett formula will still be used to calculate Scotland's share of UK resources, and the shift to the new system should not, of itself, give Scotland more or less money to spend, under the "no detriment" principle. But the precise boundaries of that principle are not clear. Certainly economic and policy changes after that shift will very likely mean that the devolved Scottish Budget is bigger or smaller under the new system than it would have been under the old. Those are the risks which come with wider powers. Scotland's tax base is relatively strong, more so than the tax base in the other devolved parts of the United Kingdom. It can bear the burden of any spending choices made by the Scottish government, and is strong enough, without additional support beyond what Barnett provides, to enable the Scottish government to make tax and spending choices different from those in the rest of the UK. But there remain decisions about the extent of equalisation, which have to bear in mind the interests of UK taxpayers and the fiscal position of Scotland as a whole. All of these choices have to be located inside a clear understanding of the nature of the union which the UK becomes once this legislation is implemented.

The preparation of this paper was greatly helped by a seminar at Nuffield College in December 2015, but none of those who attended, other than the author, is to blame for its contents.

1. Constitutional Algebra: Devolution and the Barnett Formula

More than 15 years after the creation of the Scottish Parliament in 1999, devolved government in Scotland is still funded in more or less the same way as the Scottish Office, the government department which preceded it. This is a remarkable piece of historical
continuity, and an illustration of path dependence in political change hard to match even in
the sclerotic constitution of the United Kingdom. The Barnett formula is simple – change in
devolved budgets is a population share of change in comparable budgets elsewhere in the
UK. So the Scottish devolved budget, $B_S$, in year $n+1$ depends on the change in the
comparable English (sometimes GB) budget $B_E^C$.

$$B_{S,n+1} = B_{S,n} + \frac{P_S}{P_E} \times [B_{E,n+1}^C - B_{E,n}^C]$$

This elementary algebra has become a constitutional artifact in its own right, and a political
symbol also. The symbol means different things to different people: for some it represents a
commitment to over-funding Scottish public services; for others it is an engine to drive
Scottish public spending down to UK levels. But at heart it is a piece of simple, reasonably
efficient, administrative machinery.

**Barnett as administrative machinery**

Barnett fits neatly into how the United Kingdom manages its public spending. The UK does
not have “zero-based” budgeting, setting budgets for each spending programme afresh
each year. Instead it has for many decades, going back as far as the public expenditure
survey system introduced after the Plowden report of 1961, operated an incremental,
multiyear system of budgeting, inside government and run by the Treasury. It is incremental
in that each programme has a "baseline" for future years and in periodic reviews (once
annually but now typically every two or three years) changes up or down are made to these
baselines to create a new budget and baseline for future years. Each year, Parliamentary
authority is sought for the cash for the coming year’s budget, in what have long been called
“Estimates”. The system assumes that revenue is centrally collected by the Treasury (aside
from the arrangements for local government revenue, which are a small part of the total)
and that the allocation to different programmes (health, education, defence etc.) is made
inside government by processes which are partly rational and partly political, by changing
some baselines up and others down. Barnett slots neatly into this, as changes to the
territorial spending baseline are then made as a population share of changes to the
baselines of comparable departments in England or, for services which were not separately
run in Wales, Great Britain.

The Barnett formula was negotiated between the Treasury and the then Scottish Office, and
named after the then Chief Secretary to the Treasury Joel Barnett (he seems to have had
little direct involvement in developing the formula and many years later repudiated it).
Previous to that each individual Scottish Office programme was negotiated with the
Treasury, usually in the margins of the negotiation for similar UK programmes. This was
administratively cumbersome, (Wales and Northern Ireland had to be dealt with too) and
the Scottish Office had proved adept at getting good deals on each of them, driving Scottish
public spending up. In fact there had been a long history of using proportional formula in public spending allocations, going back to the Victorian Chancellor Goschen, and the Goschen proportion of 11/80 (Victorian ratios) was sometimes used in those negotiations. The view of the Treasury was that a single up-to-date population formula would reduce the scope for special pleading on individual programmes by Scottish Office Ministers, and so constrain spending growth, but the quid pro quo for the Secretary of State for Scotland was the capacity to move money between budgets according to his own political priorities within what became the “Scottish Block”.

These were the limits of the aspirations of those who negotiated the Barnett formula. It is sometimes suggested that it was the intention of the Treasury that Barnett would not merely constrain the growth in Scottish public expenditure but over time, by the operation of the formula, drive Scottish public spending down to English levels (through convergence, discussed below) but this is unlikely to be so. At the same time as the Barnett formula was being negotiated, the Treasury and the territorial departments of government were undertaking a needs assessment, in preparation for devolution to come into operation once the Scotland Act 1978 had been approved in a referendum. The plan was that Assembly should be funded on the basis of assessed needs, not the Barnett formula. So Barnett was a stopgap. It has in the event proved rather more durable than that.

It is also sometimes suggested that the purpose was to produce generous spending allocations for Scotland to compensate it for the fact that North Sea oil revenues went not directly into Scottish spending but into the UK Treasury, and in the 1980s these were very large indeed. Now it is undoubtably the case that during the period of Barnett, Scotland has continued to have high public spending compared to the rest of the UK, and indeed it has been calculated that this additional public spending is comparable in size to the revenue yielded by North Sea oil (Ashcroft, 2013) While this may indeed be true, it was no part of the intentions of those negotiating Barnett. Not only was it seen as a stopgap, there was nothing in the formula to suggest that Barnett would have this effect, and the dominant principle in the allocation of public spending in the UK then (as now) was that spending should meet need, not depend on where revenue was generated – hence the needs assessment for the 1978 Scottish Assembly.

Barnett itself is in no meaningful sense a needs formula. To the extent that needs are measured by population, there is a very crude connection between spending generated by Barnett and need, and it is certainly the case that the outcome of the calculation generates higher spending in Northern Ireland, Scotland and Wales, in that order. It is not at all clear that Wales has lower spending needs in Scotland. In Scottish political discourse, however, Barnett became shorthand for a fiscal system which sustains Scotland's level of spending. This inevitably became important during the referendum campaign and the subsequent deal making over new powers for the Scottish Parliament.

Barnett is certainly administratively simple. The devolved budgets are set by the operation of a spreadsheet. There are some approximations involved, in that the formula is applied to
different government departments, rather than to budget provisions at the detailed level, and some departments are a mix of England, England and Wales, GB, or UK spending. So a so-called comparability percentage is applied to these, on the basis of the proportion of the budget which is comparable at the beginning of the spending review process. This can produce some rough justice, if additions or cuts impact disproportionately on the comparable elements of the budget (one such is discussed later in the paper). During the time of its operation, there have however been remarkably few disputes about whether the calculation is correctly done. The only significant one was an argument about whether the expenditure on the London Olympics was a local English or a UK programme.

The implications of the algebra: squeeze and convergence

The simple algebra of the Barnett formula has some very direct consequences for public spending. It is helpful to distinguish between Barnett "squeeze" and Barnett convergence, as there is some evidence that one has happened but the other has not. Barnett will produce the same per capita increase in spending in a devolved budget as in the comparable budget in England. So if English health spending rose by £10 billion, very roughly a rise of 10% and £2000 per head, enough resources were made available for Scottish health spending to rise by £2000 per head also. But if Scottish health spending is higher, by say 10%, that £2000 is only a 9% increase. If overall Scottish spending is around 20% higher, a 5% increase in comparable spending might produce a little over a 4% increase in the devolved budget. This has been described as the Barnett "squeeze". Algebraically it is expressed as

\[
\frac{B_S}{P_S} > \frac{B_E^C}{P_E^C} \Rightarrow \frac{\Delta B_S}{B_S} < \frac{\Delta B_E^C}{B_E^C}
\]

It also follows from this arithmetic that over time the Barnett formula ought, other things being equal, to tend towards the per capita level of comparable spending, as the starting budget will be an increasingly small proportion, and per capita shares a larger proportion, of the total. This is Barnett convergence. But it has been notable by its absence.

The absence of convergence

It is well known that Scottish public expenditure remains, per head, markedly higher than UK levels. The amounts are analysed in more detail below. No comprehensive audit of the factors affecting public spending has been produced which documents in detail why the Barnett algebra is not produced the result which might be expected in Scotland. It is undoubtedly the case that in the application of the formula the Barnett "squeeze" has been seen in the changes it produces to individual budgets, such as health. But a number of other factors have had significant effects, certainly between 1978 and 1997.
First of all, it is often forgotten that Barnett was introduced initially into a public spending planning system which used so-called "volume" planning. That is to say that budgets were calculated on a constant price basis, and the changes negotiated in the public spending rounds were intended to represent real allocations of resources, not of cash. Inevitably these were much smaller than the cash increases, especially at times of high inflation. And the cash increases were generated, even after cash limits were introduced, by applying a percentage inflation factor. Thus for several years until the introduction of cash planning by the Treasury in 1982, Barnett did not apply to the inflation element of the growth in budgets. But even after that, the way in which UK public expenditure planning dealt with inflation effectively sidestepped Barnett for some years. It was the practice to create in each annual spending review a new baseline figure for the last year of the planning period. Across government this was typically done by applying an inflation percentage to the previous year's figure. Hence, once again, inflationary growth in public spending was not subject to the Barnett squeeze.

Secondly, for much of the 1980s and 1990s, important elements of the Scottish Office budget were not included within the Barnett envelope, as they were not seen as directly comparable to English or GB spending. Not only did these include agriculture (which was more significant proportionately in the Scottish economy) and the funding of nationalised industries (the Scottish electricity industry in particular) but the politically highly important economic development budgets which continued to be negotiated directly between the Secretary of State for Scotland and the Treasury. This included funding for the Scottish Development Agency, later Scottish Enterprise, intended to modernise the Scottish economy as traditional heavy industry declined. Today, EU funded agriculture spending remains outside the Barnett envelope; of the nationalised industries, the vestige is Caledonian Macbrayne ferries and some Highland airports; and the outcome of the economic development deals spending can still be seen in the high economic development budgets of the Scottish government. One other minor factor was that the Scottish Office resisted updating of the population proportions in the formula for as long as possible, but that had only a small effect. Nowadays, they are uprated in each spending round.

Of course pre-devolution Treasury Ministers were very well aware that public expenditure in Scotland was too high for their liking. Some spending discussions began with a demand for a substantial reduction in the Scottish Block, but none ever produced this result, essentially for political reasons. It was the job of the Secretary of State for Scotland to look after the interests of Scotland, and reducing public expenditure by more than comparable English programmes would have been very hard for him to defend, indeed a resignation issue. So by the end of the Conservative administration in 1997 the idea that Scotland would get its Barnett share of changes in comparable budgets, no more and no less, had achieved the status of a principle, rather than simply an administrative convenience.

A substantial element of UK public spending is out with the spending review process on which Barnett is built: so-called annually managed expenditure. This is expenditure which cannot conveniently be managed on a three-year basis with fixed budgets as it is demand
determined. The largest single element is benefit payments, which have hitherto been largely irrelevant to devolution finance. Aside from local spending funded by local taxation, the only significant element of the Scottish budget which is annually managed is pensions in payment to NHS workers and teachers, and this is offset by pension contributions from current employees, which form part of the Scottish government’s budget, in the so-called departmental expenditure limit. Annually managed spending may however become more relevant in future.

By the late 1990’s, the Barnett envelope had been broadened to include virtually all significant Scottish Office spending, and the Scottish Block was a single budget within which the Secretary of State exercised wide discretion under administrative devolution. The idea that Scotland had a right to “Barnett consequentials” was well established. The system was one which worked smoothly in practice, and delivered high levels of public spending in Scotland.

So it was no surprise that Barnett became the basis of devolution funding when the Labour government created the Scottish Parliament. The formula extended to virtually all devolved spending (agriculture payments by this point being substantially funded by EU transfers) and it was applied mechanically in each spending review year. No substantive financial negotiations were needed between the Scottish and UK administrations, as the allocation of resources was purely mechanical. Like much of the apparently radical change of devolution, this was an incremental step.

The Formula since devolution: Barnett 2.0

By 1999 Barnett had become Barnett 2.0. The formula was applied to virtually the whole devolved budget and the elements of the funding system which had previously sidestepped it were not longer relevant. So it might be expected that Barnett convergence would now be seen. Does the published data show this? The following analysis is based on HMT (and DWP) data published on Scottish and UK public spending from 1999 until 2012/13 and 2013/14.

Graph 1 shows the first key finding. Identifiable public expenditure in Scotland, which comprises all spending except items like defence, foreign affairs and debt interest which are not geographically allocated, has shown very little sign of per capita decline, averaging around 17% per head higher than the UK average (about 20% higher than spending in England).
Identifiable spend however includes reserved spending in Scotland, (of which by far the largest single element is pensions and benefits). This is not affected by Barnett, and might be covering up convergence. Unfortunately no published data distinguishes devolved expenditure in Scotland and comparable UK spending. It is however possible to estimate a proxy for devolved and comparable spending just by removing welfare spending from the calculation

This calculation is instructive in two respects. First it shows that Scotland’s expenditure lead is concentrated in devolved services. Of the £1500 or so more public expenditure per head in Scotland in 2012-13, around £1400 was in services other than welfare, which are all devolved. That represents a relative advantage of not 17%, but approximately 24%. This lead has been marked since devolution.

This second graph compares the total growth of this proxy for devolved spending in Scotland compared with the rest of the UK, and its lead over the UK equivalent.

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1 It does not form part of the normal PESA data produced by HM Treasury (HM Treasury, 2015) but DWP published separate Scottish and UK data in the run up to the Scottish referendum and update it (Department for Work and Pensions, 2015).
It is clear that there are two different effects going on here. Scotland's share of UK benefit expenditure is trending down, but its per capita spending remains close to flat because its non-benefit spending is reducing only very slightly. We can get some explanation of why the non-benefit spending per head is hardly changing by comparing the relative growth of total non-benefit spending and non-benefit spending per head, in the third graph.
The blue line shows the ratio of the proxy for total devolved spending for Scotland over rUK's. Throughout the period it show some evidence of a Barnett “squeeze”, though at a lower level than might be expected – this proxy for devolved spending grew at 0.3% per annum less in Scotland than in the UK (5.6% vs 5.9% over the period) where one might have expected around 1% per annum less from Barnett convergence. It shows however no sign of convergence to the same per capita level, because of relative population decline. The red line in the graph show the ratio of per capita spending on these services in Scotland and the UK to be flat. The UK's population has been growing, at a substantial rate, and is now about 10% higher than it was at the time of devolution, but Scotland's has grown only by about 5%. So there has been relative population shrinkage, of around 0.3% per annum over the post devolution period (there was similar shrinkage of the period 1979 to 1999) and it has offset the Barnett squeeze.

This is an example of a weakness in Barnett. It deals badly with population change, which affects only the increment, not the baseline. Spending need and revenues are both directly affected by population, but Barnett changes only at the margin. So if Scotland’s population were magically to double, tax raised might double, but devolved spending would hardly change. In practice this has served very heavily to damp the effects of relative population decline but it might have been the other way round. Whether such damping can continue with tax devolution is discussed later.

It remains not wholly clear why, since devolution, there is so little evidence of convergence in Scottish devolved spending. Over a period of 15 years, more visible convergence might have been expected. Relative population decline is a partial explanation, but other factors may be at work: certainly Scottish ministers and civil servants, like their predecessors, continue to use every opportunity to extract advantage from the detail of each spending settlement. And it may be that some elements of annually managed spending are rising more swiftly than in the UK as a whole. However, when designing a fiscal framework for Scotland it would be unwise to assume that any convergence will happen, as the effects implied in the fiscal algebra do not get delivered in practice.

Continuity and change in devolution finance

It is quite remarkable that the Barnett formula has endured as long as it has, before and after devolution. One reason is simply that there has been no consensus for change, and no direction in which all of the devolved parts of the United Kingdom would wish to move. Barnett delivers generous and remarkably stable funding for Scotland, and all Scottish politicians have had a strong incentive to retain it. Welsh politicians are less comfortable as they fear that Barnett convergence could become a reality for them, as it seems to be for Northern Ireland (although from very high relative spending levels). While Wales might argue it would do well out of a needs-based formula, in practice it has successfully argued for a floor to be placed on any Barnett convergence. The administrative simplicity and surprisingly depoliticised nature of Barnett make it a very attractive option for central
government, compared to the complex and contested machinery used for local government finance distribution, or to the distribution mechanisms used in federal states.

Barnett however was constructed in a different world - the challenge was sharing out spending resource from uniform taxes inside a single government, within an integrated public spending system. Now that we have multi-level government, each to a greater or lesser degree with its own financial resources, it is important to understand the function which Barnett now discharges. It serves as a mechanism for allocating a share of the revenue from those taxes which are the responsibility of the UK government to devolved services. But before doing that the UK also has to make a decision about how much to spend on reserved services. Because devolved services in England are part of the UK government’s budgets, it is not immediately obvious that this task is being performed. But government at Westminster is both a federal, UK wide, institution and the English government too. Indirectly, using the Barnett formula is a convenient way to help UK ministers set the balance between reserved and devolved spending. In practice, when deciding on devolved spending for England, they have simply had to add around 15% for Barnett consequentials for the devolved nations.

This gets markedly more complex with devolved taxes – but even then, it will still be necessary for UK ministers to set a balance between the resources they allocate to reserved UK services and their English responsibilities, so having regard to the amount allocated to those English responsibilities in setting devolved budgets will be inevitable. Central government typically has every incentive to pass difficult spending decisions down to lower levels of government, and successive UK and Scottish governments have done this to local government. The UK government is quite separate from local government: but it is both a central government and itself a devolved government, and so Barnett protect devolved government from that risk as the UK deals consistently with the same responsibilities in its own and with the devolved governments’ budgets.

Of course the commitments made to Barnett during the Scottish referendum campaign were highly political, rather based on its technical utility. Barnett was a symbol not merely of the promise to keep sharing resources across the United Kingdom, as the UK political parties promised if Scotland remained in the UK, but doing so in a way which did well by Scotland. In that sense it met Scottish "needs" even though it is not a needs formula.

But Barnett will have to change. The Scottish Parliament and government will have access to a stream of tax revenue, and this must substitute for some of the Barnett grant received from central government. The changes were determined a highly political negotiation in the Smith commission. Scotland’s tax revenue will consist of income tax, over which the Scottish Parliament will have complete control, save for the definition of income and the relatively small amount of tax on savings and dividends. Tax rates and bands will be decided in Holyrood, and changes in Scottish tax revenue will be retained in the devolved budget. Scotland will also be assigned the revenue from half of the percentage points of VAT, giving it another very direct interest in the success of the Scottish economy. A number of small
taxes will also be completely devolved – air passenger duty and aggregates levy, on top of the landfill tax and stamp duty on real property, now replaced by a new Scottish tax. Together these will mean that around half of the devolved Scottish budget will be raised in Scotland. Holyrood will also take on a series of welfare responsibilities, not currently part of the Barnett system, because they are part of annually managed expenditure. These benefits will add between £2 and £3 billion of spending to the Scottish budget, and provide support primarily for people with particular individual needs. The Scottish government has increasing powers to borrow, for reasons of cash flow, managing the uncertainties in the stream of tax income across the year and beyond, and for the purposes of capital spending. Capital borrowing powers have not as yet been employed, though it is possible they will be in the current financial year. The borrowing will be from the UK government, to whom interest will be paid, but the power for the Scottish government to borrow directly from the markets also exists.

At a very minimum, therefore significant technical changes are needed to the funding system. But financial systems serve constitutional ends, and the choice between these technical changes should be made with a clear understanding of the objectives being pursued. The following sections of this paper examine the technical choices, but the conclusion seeks to place the options in a constitutional context.

2. Changing the Algebra: Tax Devolution and the Barnett Formula

This section of the paper discusses the options for adjusting Scotland’s block grant, calculated under Barnett, to take account of the substantial tax devolution in the Scotland Bill, and analyses the implications of each of the options.

A number of ways have been suggested to take account of the stream of income from devolved taxes. The most obvious has been the least discussed. Tax devolution has a longer history than often realised. Local taxation has always been a Scottish matter. Scottish councils set property rates, the poll tax which replaced them, and its successor the council tax. Nondomestic rates have been set the same across Scotland from the end of the poll tax, but still collected locally and applied to support local spending. When the Scottish Parliament was created in 1999, "local taxes in support of local expenditure" were devolved to Holyrood. Scottish Ministers set the nondomestic rate level (and have continued UK practice by raising it in line with inflation) and councils have the legal responsibility for deciding on council tax.

The Barnett calculation has dealt with this before and since devolution. It is instructive to see how. Council tax was never regarded as funding central government expenditure (instead it supported "local authority self financed expenditure") and therefore was wholly disregarded in Barnett, which applied to central government budgets. So changes in council
tax elsewhere in the UK did not feed through into Barnett consequentialials, and Scottish council tax income remained in Scotland. Scotland and England, therefore, each bore the risks of changes in council tax income and did not share it. This continues to be so.

The same approach, in principle, has been taken in relation to nondomestic rates, though the implementation mechanism was different, and the results differed also. Nondomestic rates were regarded as part of the central government support for local councils along with government grant, and the Barnett formula was applied to the total English budget for such support. Recognising, however, that nondomestic rates should not be included in the calculation, the "comparability percentage" applying to that English budget was less than 100%. This should have achieved broadly the same result, but in practice as government grant to English councils decreased markedly year on year for some time, while rates income rose steadily, the share of this programme constituted by nondomestic rates increased continuously, while the comparability percentage caught up only in arrears, as it was changed only in each periodic Spending Review. As a result, unintentionally, Scotland benefited from a share of this devolved English tax. This issue was drawn to public attention by the Institute for Fiscal Studies (Phillips, 2014) and the formula is now being changed to correct the error, though not to claw back resources which it allocated in previous years. These were substantial and may well have had an impact on the degree of convergence that might otherwise have occurred.

There is therefore an established method which provides a precedent for dealing with tax devolution in the allocation of grant under the Barnett formula. It could be applied to the new devolved taxes. Under this method, there would in fact be a single, one-off, adjustment to the block grant in the first year of tax devolution, and the Barnett formula would operate on a different base of comparable expenditure in each subsequent year. The base of comparable expenditure would be calculated by subtracting forecast changes in income tax and other devolved taxes in the rest of the UK from comparable expenditure. More simply but less accurately it could be done by applying a comparability percentage to the entirety of comparable spend. It is algebraically equivalent to what has been described as the "levels" method of indexing the adjustment to the block grant annually although that is a less instructive way of looking at it. (See Bell, Eiser and Phillips 2015, on whose thorough analysis this paper builds). so, in analysing its detailed consequences, it is assumed that there is one off reduction to the block grant ("BGA") which is adjusted each year.

The "Levels" method

This is calculated as follows. The reduction in the block grant ("BGA") is changed each year by a population share of the change in the devolved tax yield in the rest of the UK. It will readily be seen that this is equivalent to changing the total of comparable spend by that change in tax yield. This is expressed algebraically as
The Barnett formula, even though it starts from the same place. That is because Scottish devolved tax revenue will grow by a different amount and possibly at a different rate from UK taxes as a whole, and from the equivalent devolved taxes in the rest of the UK.

Going forward, the levels approach would mean that Scottish tax revenues would have to increase by the same cash amount per head of population so as to deliver the same cash increase in spending per head. That however is a proportionately larger increase in tax, as devolved Scottish tax revenues start out lower per head than the rUK’s (though if Scottish tax income rises in future the opposite could be the case). For income tax this is because Scotland has fewer higher and top rate payers than the UK as a whole. So it might be expected that a levels approach could create pressure to drive tax rates up, but the same effect has always been present for council tax and nondomestic rates – in total about 1/3 of income tax in size, and which yield less than their rUK equivalents by as much as income tax – and no such result has been seen there, either in taxes or spending. To be sure of avoiding such an effect it would be necessary to allow Scotland access to some of the revenues from devolved taxes in rUK, which might seem to contradict tax devolution and is arguably unfair to rUK taxpayers.

\[
BGA_t = \frac{P_t}{P_{rUK}^t} \left( T_{rUK}^t - T_{rUK}^{t-1} \right) + BGA_{t-1}
\]

(Where \( P \) is population, of the rest of the UK ("rUK") or Scotland as in to the superscript, \( T \) is total yield of the devolved taxes in rUK, and the subscript refers to each year.) The BGA in the first year is equal to Scottish tax yield, so that the change to the new system has a neutral effect on spending power, following the "no detriment principle" enunciated by Smith. Thereafter changes to it do not depend on Scottish population, Scottish tax revenues, or Scottish spending. Under this option Scotland retains all devolved tax revenue, and devolved tax revenue elsewhere in the UK is retained there too. If income tax in England were cut, and the reduction applied to English services only, there would be no effect on Scotland. If income tax in England were cut, and shortfall in resources for English services made up from UK taxation, Scotland would get a Barnett share of that additional taxation, and could make an analogous cut income tax or an increase in spending. If income tax in England grows, for whatever reason, the block grant adjustment will increase unless that money is spent on services for England only. Either way the Scottish government will have a strong incentive to match the growth in English taxes, and so it will have a stake in the performance of the Scottish economy. Barnett acts only on spending that is supported by taxes set, collected and shared out at a UK level.

The "levels" approach will almost certainly produce a different result from applying the Barnett formula, even though they start from the same place. That is because Scottish devolved tax revenue will grow by a different amount and possibly at a different rate from UK taxes as a whole, and from the equivalent devolved taxes in the rest of the UK.
The “Indexed Deduction” method

Nevertheless an alternative method, which does share tax revenues within the UK even for devolved taxes, was agreed as the way to adjust the block grant to take account of the stream of tax income coming to Holyrood under the Scotland Act 2012 after 2016/17 (and so is also to some degree precedent). It is the “indexed deduction” or “simple indexation” method. Under the Scotland Act 2012 the deduction is indexed to growth in the comparable rUK tax base (essentially income). Under full tax devolution it might be indexed to tax yield. Again there will be an initial adjustment to the Block Grant (“BGA”) equal to the expected value of Scottish tax revenues. It would then would grow in line with the growth in the same tax revenues in the rest of the UK. This is algebraically expressed as:

\[
BGA_t = \frac{T_{rUK}^t}{T_{rUK}^{t-1}} BGA_{t-1}
\]

This has similar but not identical effects to the first method. Again, the adjustment to the block grant each year is not influenced by anything happening in Scotland, to spending, tax or population, but to changes elsewhere in the UK in devolved taxes. Suppose that in the first year (t-1), Scotland’s income tax revenues are 1000 and therefore under “no detriment” the BGA is set to 1000. Suppose that over the course of the following year (t), tax revenues in rUK grow by 5% i.e. \( T_{rUK}^t / T_{rUK}^{t-1} = 1.05 \). It follows that the BGA will increase to 1050. Thus in order to keep its budget constant, Scotland has to increase its tax revenues by 5% - to 1050. The Scottish government has a strong incentive to pursue policies to match economic growth in rUK but it has to match only the proportionate, not the cash, increase in rUK tax income.

Once again it will be seen that if English tax rates rise, and the rise is spent on the rest of the UK only services, the increase in the block grant adjustment will tend to offset the increase in the Barnett formula consequentials from the increased spending. Similarly if English tax revenues rise because of economic growth, and this is spent on England only services, Scotland will get a Barnett consequential offset by the changing block grant adjustment. If rest of the UK tax revenues rise with no increase in the rest of the UK devolved spending, (and therefore an increase in reserved spending) Scotland will get the benefit of the reserved spending, but will lose income for devolved services. The Scottish government therefore has a strong incentive to match the rate of growth in rUK tax revenues unless it wants to spend less on services.

In this case however the matching between the rest of the UK tax and spending changes is not so close. This is simply because of how the calculation is done, as the algebra of the two formulae shows. In effect Scotland gets its own tax revenue supplemented by a share of any rise in the English tax. It is a kind of equalisation of taxable capacity: indeed, if Scottish tax
revenues were higher per head than England, the opposite would be the case: some of Scottish tax rises would go to support English spending. This applies whether the increase in English taxation is down to growth in the tax base or change in the tax rate. So if income tax rates were increased in England, some of the extra money raised would leak across to Scotland. Conversely, if income tax were decreased in England, Scotland’s income would decrease a bit too. These effects are potentially quite substantial. This additional revenue from the indexed deduction approach means that it is more generous than the levels approach.

To compare the effects of the two formulae, it is simplest to look at the change in the BGA from year 0 to year 1. Under indexation this is given by:

$$\Delta BGA = (T_1 - T_0) \frac{BGA_0}{T_0}$$

The same change BGA under levels (where p = Scottish population and P = rUK’s) is given by

$$\Delta BGA' = (T_1 - T_0)p/P$$

The difference between these is:

$$(T_1 - T_0)\frac{BGA_0}{T_0} - (T_1 - T_0)p/P$$

and since $BGA_0 = t$ (Scottish tax revenue in year 0), this equals

$$(T_1 - T_0) \times \frac{p/P - t/T_0}.$$
The “Per Capita Indexed Deduction” method

One other possibility has been suggested, and may be advanced by the Scottish government in the negotiations (See Muscatelli, 2015, Cuthbert, 2015). It is based on spotting that Scotland’s wealth per head has held up well compared to the United Kingdom’s, but its population has declined relatively. England’s has grown more than Scotland’s. (As we have seen this is one of the reasons why Scottish public expenditure per head remains so far ahead of England’s.) So instead of indexing to the growth in the rest of the UK devolved tax revenues, it has been suggested that the block grant adjustment should be indexed to the relative per capita growth in tax revenues. This is expressed algebraically as:

\[ BGA_{t+1} = BGA_T \left[ \frac{T^E_{t+1}}{P^E_{t+1}} \cdot \frac{p^E_{t+1}}{p^F_{t+1}} \cdot \frac{p^S_{t+1}}{p^T_{t+1}} \right] \]

This is perhaps more accurately called relative per capita indexation. It would in principle be possible to have an absolute per capita indexation, which referred only to rUK tax per head, so that the increase in the BGA was linked to the increase in per capita tax revenues in rUK only. Again, assume that Scotland’s tax revenues in year t-1 are 1000 and the BGA is therefore also set at 1000, that the population in rUK rises; overall tax revenue in rUK increases but there is no increase in tax revenue per head so that

\[ \frac{T^{rUK}_{t}}{P^{rUK}_{t}} = \frac{T^{rUK}_{t-1}}{P^{rUK}_{t-1}} \]

Tax revenues and population may both increase in rUK but this has no effect on the BGA so long as they are increasing at the same rate. The change in the budget then depends on how Scotland’s tax income rises. If it rises faster than in the rest of the UK’s rises per head, Scotland’s devolved budget will grow more than the rest of the UK’s. Under relative per capita indexation, the budget will grow more then the UK’s if tax per head grows more than the UK’s; under absolute per capita indexation the budget grows more even if the growth in Scottish tax revenues is caused by a growing Scottish population – on other words Scotland gets to keep all the devolved revenue benefits of population growth.

Scotland retains the incentive to grow the economy, and Holyrood keeps all the growth in Scottish devolved taxes, whether they result from rising tax revenues per head or an increase in the population of taxpayers. Under absolute per capita indexation however, the effect is asymmetrical: if the rest of the UK increases its devolved tax revenues by increasing population more than Scotland’s it does not retain all of that growth. So not only does Scotland share the growth in reserved taxes via the Barnett formula, it shares the growth in rUK devolved taxes also, and by more than it does under simple indexation. In essence Scotland would receive its own devolved taxes, plus a share of any increase in rUK devolved
tax per head as under the simple indexation method, plus an additional share of the tax paid by the rUK’s growing population.

The difference between BGA under indexation and *per capita* indexation can be shown as follows. The algebra is more complicated than simple indexation. Assume for simplicity that Scotland’s population remains the same, but not the rUK population, so the formulae for relative and absolute indexation are the same. Let $T_1$ = rUK tax revenue in years 0 and 1, $P_1$ = rUK population, BGA and BGA’ be the Adjustment under each formula. (It equals Scottish tax in year zero.)

Under indexation: \[ BGA = \frac{T_1}{T_0} BGA_0 \]

Under *per capita* indexation: \[ BGA' = \frac{T_1 P_0}{T_0 P_1} BGA_0 \]

Hence the difference between the two is

\[ BGA' - BGA = \left[ \frac{T_1 P_0}{T_0 P_1} - \frac{T_1}{T_0} \right] * BGA_0 \]

\[ BGA' - BGA = \left[ \frac{T_1 P_0 - T_1 P_1}{T_0 P_1} \right] * BGA_0 \]

To see what this implies, let:

\[ \Delta T = T_1 - T_0, \quad \Delta P = P_1 - P_0 \]

Then

\[ BGA' - BGA = \left[ \frac{(T_0 + \Delta T) P_0 - (T_0 + \Delta T)(P_0 + \Delta P)}{T_0 (P_0 + \Delta P)} \right] * BGA_0 \]

\[ BGA' - BGA = \left[ \frac{T_0 P_0 + \Delta TP_0 - T_0 P_0 - \Delta TP_0 - \Delta PT_0 - \Delta P \Delta T}{T_0 (P_0 + \Delta P)} \right] * BGA_0 \]

\[ BGA' - BGA = \left[ -\frac{\Delta PT_0 - \Delta P \Delta T}{T_0 (P_0 + \Delta P)} \right] * BGA_0 \]

\[ \Delta P \Delta T \ll \Delta PT_0 \], and so this term can be neglected. Hence:
\[ BGA' - BGA = \left[ \frac{-\Delta PT_0}{T_0(P_0 + \Delta P)} \right] * BGA_0 \]
So under *per capita* indexation Scotland would get its devolved tax yield increased each year by roughly the growth in rUK population. It is as if some of the new taxpayers were assigned to Scotland for revenue purposes, though not for spending. This would be on top of Barnett. Indeed it is doing for the devolved taxes what Barnett does for reserved taxes and if tax income per head changes by the same in each country relative *per capita* indexation delivers the same as Barnett.

While this might be to Scotland’s advantage, it hardly seems fair to the rest of the UK, which will carry the spending burden created by the new taxpayers. The argument for this is that the Scottish government has no tools to manage relative population growth. This is at best arguable, but it certainly has no responsibility to provide services for population growth that does not happen in Scotland.

One way of looking at this question is to ask – once a tax is devolved just how much should it nevertheless still be shared across the UK? Today, the Barnett formula shares all UK taxes (and will still do that for reserves taxes in future). The levels method says that once a tax is devolved, future sharing stops: some sharing is built into the baseline, but going forward each part of the UK takes the risk from devolved tax growth, up or down. Simple indexation retains some of Barnett’s sharing, equalise resources so that devolved taxes don’t have to rise more just because they started out lower in one part of the country. Relative *per capita* indexation is much more like Barnett: it shares devolved taxpayers as well as tax3.

**Application to different devolved taxes**

Nothing in this analysis depends on the nature of the tax in question. Nor does the algebra of the analysis depend on whether the Scottish Parliament has the power to vary the tax rates, so that any of these methods could in principle be applied to local taxes, income tax, the smaller devolved taxes, or to the assignment of value added tax.

In practice each of the methods will involve some degree of estimation of future revenue growth so that a budget can be set. To implement the "levels" method or indexation precisely over the three years of a spending review would require the government to use its assumptions about forecast tax revenues, which would inevitably require correction as outturn data became clearer. Alternatively, for levels an estimate could be made be made by applying a comparability percentage to Barnett consequentials (estimated from a

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3 *Absolute per capita* indexation does the same, but only where that benefits Scotland.
3: Spending powers - welfare and capital

The main purpose of the Scotland Bill is to give the Scottish Parliament additional powers of tax but changes are also being made to its spending powers.

Welfare devolution

Substantial new spending powers relate to welfare. The Scottish Parliament will be given the power to supplement or top up reserved UK benefits, but in addition some individual benefits have been wholly devolved, together with the budget to cover them. These include disability living allowance and its successor personal independence payment, attendance allowance and a number of other benefits. In general these relate to individual circumstances, and are not benefits for which the demand is driven by economic change, such as jobseekers allowance, or by population structure, such as old-age pensions. For these newly devolved benefits, the Scottish Parliament will have complete legislative and executive responsibility, and will be able to change their structure and as well as the amounts paid.
While any top-up to the UK benefits system will be met from existing Scottish government resources, and so requires no changes to the fiscal framework, devolving benefits expenditure currently running at £2.7 billion per annum will require change. As noted above, however, benefits are not part of the UK system of setting departmental expenditure limits in periodic Spending Reviews, on which Barnett is based. Instead they are part of ‘Annually Managed’ expenditure, set each year depending on economic and social circumstances. It will be relatively simple to increase the Scottish government’s budget in the first year during which it is responsible for the benefits, but as with taxation the question arises as to how the budget should be changed in each subsequent year.

The most obvious way to do this would be to deal with benefits via the Barnett formula, albeit operated on an annual basis. Thus if benefits expenditure in the rest of the UK on the same or cognate benefits rise or fell a population share of that change could be applied to the existing Scottish budget. Since, overall, benefits expenditure is slightly higher per head in Scotland compared to the rest of the UK, this would be to Scotland’s disadvantage on a rising budget, but to Scotland’s advantage on a falling budget. This application of Barnett would be consistent with how spending is dealt with today, and, broadly speaking, with the levels deduction for taxation, which treats population in the same way. On the other hand it suffers from the same disadvantages as Barnett, that is to say it is insensitive to relative population change. If Scotland’s population were to grow, and demand for these benefits grow with it, then additional resources would not follow. Similarly if Scotland’s population were to shrink in relative terms Scotland would retain resources that were not needed for this purpose. If the only objective is to maximise Scotland’s likely budget on the twin assumptions that expenditure on these benefits is planned to decrease and Scotland’s population share is likely to decline, then applying the Barnett formula on an annual basis might be a Scottish government objective. It is not so easy however justify that in terms of principle.

An alternative approach would simply be to look at percentage changes in the comparable budget elsewhere in the UK. Even if Scottish legislation changes the nature of the benefits it will still be possible to calculate how much is spent elsewhere in the UK on their equivalent. This is similar to indexation in the taxation changes, and the main argument for it is that it would enable the recipients of benefit to face the same change in rate in Scotland as elsewhere in the UK without any differential allocation of resources from other parts of the Scottish budget. This is a strong argument, as it will enable the same benefit policies to be followed in Scotland and have the same results on Scottish spending, so that the only impact on Scottish spending would be if the Scottish government driven took a different policy stance. It is in this way closely analogous to simple indexation on taxation. It does import into the Scottish budget the risks from relative population decline or growth, but in an entirely symmetrical way: demand and supply would be equally matched, unless the Scottish government chose to operate different benefit policies. Here per capita indexation would be harder to justify: it would be saying that with no change in benefit policy, benefits level could be higher or lower than elsewhere in the UK simply as a result of population change.
change (or alternatively that other devolved programmes should have a windfall gain or loss in order to sustain the benefits at UK levels.)

Capital expenditure

The Scottish government's capital expenditure is determined in almost exactly the same way as it was when the Scottish Office was the Department of the United Kingdom government. As with the rest of the Barnett formula, there is a capital baseline which is changed each year by population share of the equivalent comparable capital baselines. This has two consequences. First of all, the balance between current and capital expenditure is largely set by UK government decisions. Secondly it produces the result that if this is all of the Scottish government's capital expenditure, then capital spending will be wholly financed by shared UK taxation, unlike the current spending.

The Scotland Act 2012, however, changed this. The Scottish government was given additional borrowing powers, subject to certain statutory limits. That additional borrowing could be from the Treasury, or by the issuing of bonds in the markets, in the same way as a local authority can. So the Scottish government can borrow directly from the markets but it might well pay higher interest rates than borrowing from the Treasury. No Scottish government has yet exercised these additional borrowing powers, though it is possible that the present administration may do so before the end of the current financial year, by borrowing from the Treasury. There is no requirement that this borrowing should be financed by additional Scottish taxation, as the interest payments can be met by reductions in current spending below what it otherwise would have been.

The overall result, however, is that capital expenditure looks quite different from current expenditure. The proportion financed by UK taxation as opposed to devolved taxation is an accident of history, and bears no relation to the taxable capacity of the Scottish government. It is likely to be more than 90%. For expenditure which is financed by UK taxation the Scottish government pays (at least in cash terms) no interest charge: but for any additional borrowing it pays interest to the Treasury or to the markets. Arguably this distorts the Scottish government's incentives, and it certainly means that Scottish ministers get no signal from the markets about whether any borrowing they undertake is prudent or not.

An alternative approach to capital spending might be considered. First, it has to be recognised that capital spending is merely spending brought forward, at an interest cost, from future taxation. In the case of the Scottish government that can be either its own future taxation, or a share of the UK's future taxation that will be allocated through the Barnett formula. It would make sense, therefore, for capital expenditure to be financed in the same proportions as current expenditure. This could be achieved, first of all, by the Treasury charging cash interest (rather than a notional resource accounting charge, which is regularly ignored in any budgeting process in any event) on additional borrowing, and
making a transfer of resources which will cover that at present levels of interest budget. Future borrowing costs would then be supported by the whole revenue of the Scottish government, and the interest costs of borrowing would be an explicit impact on Scottish spending, giving the Scottish government incentive to make more rational spending decisions.

The UK government today takes an interest, however, in the total of public expenditure, including capital spending, however it is financed. This is because the markets take a view on its capacity to repay. Hence it sets limits on the amount it is prepared to lend to the Scottish government and allow it to borrow. A limit is provided for in statute on the Scottish government's total indebtedness, and on its annual borrowing.

A more radical approach would be, having made the Scottish government pay interest to the Treasury for the borrowing the Treasury is willing to make it (the Treasury might set that amount by reference to the proportions of devolved and UK taxation), then however to set no limits for borrowing above that from the markets, but with a clear statutory provision that such borrowing could never be repaid by the UK government, but would be a first charge on any devolved tax revenues. This will give the Scottish government spending freedom, but spending freedom which could only be exercised if the markets agreed that the level of borrowing involved was prudent. In order to reassure the markets and others, it might be that a prudential borrowing framework, similar to that in place for local authorities, might be agreed between the Scottish and UK governments before such a change was put into effect.

4. Squaring the Circle
It is too easy to see the development of the fiscal framework for the Scotland Bill as a tactical question, part of the day-to-day financial horse-trading between governments around the edges of the Barnett formula, and as a calculation of the potential arithmetical consequences of the different options. These matter, of course, but financial systems serve constitutional ends. So it matters more to see the constitutional context: the completion of the journey of Scotland's political institutions from a territorial department of government to a freestanding sub-state government responsible not just for spending money but for raising it, taking fiscal responsibility and hence bearing some of the risks which were previously carried only at the centre. For the UK this is a transformation from a wholly centralised state to a quasi-federal one with fiscal arrangements which support its constitutional objectives, setting an understood balance between autonomy and resource sharing, and which risks are carried by the sub-state government, and which pooled at a UK level. In fact we are setting out the fiscal elements of the UK's territorial constitution, fiscal federalism in a quasi-federal state.
Fiscal federalism: needs and resources with multiple levels of government

Any system of fiscal federalism has to deal with two realities: the need for public spending varies in different parts of the territory, dependent on the make-up of the population, the economy and other factors; and the distribution of taxable resources varies also. Typically, these are negatively correlated: richer areas tend to have less need for public services, while poorer areas demand more. So fiscal systems redistribute across territories, and usually this is done via central government – it taxes across the whole country, raising resources more from areas with high taxable capacity, and distributing spending according to some view of need. But there is a choice to be made: just how much equalisation should there be? Should areas with high taxable capacity be able to retain some of it, so as to enjoy more generous public provision, or lower tax rates? After all, it might be argued, some of that taxable capacity is down to the industry of the inhabitants, not merely accidents like the discovery of natural resources. So, for example, the Mayor of London argues that more of the tax by individuals and businesses in London should be retained in the capital, and not redistributed to the rest of the UK, or Scottish Nationalists used to say "it's Scotland's oil", in the days when oil revenues were significant. Further, it is argued, that allowing sub-state governments to retain additional tax revenues which their territory generates gives them an additional incentive to promote economic growth: they have a very direct stake in the growth of the economy. On the other hand, public spending, particularly in a welfare state like the United Kingdom, is all about meeting needs, and the demand for uniform access to public services – notably expensive but highly valued services such as health and education – is very strong. The phrase "post code lottery" encapsulates the objection to allowing access to services to vary according to local resources.

In the UK, for many decades, need has been the dominant explanation for the allocation of public resources. In a system of centralised government this is hardly surprising: central government is by its nature geographically redistributive, and comes under pressure to meet needs wherever they arise. This centralised approach has carried through into how the UK allocates resources to local government, but the same questions of needs and

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4 It is sometimes suggested that instead devolved government should have spending needs and taxable resources that match one another, so that it is not dependent on fiscal transfers from the centre. Not only is this contrary to the agreement made in the Smith commission, it is neither practicable nor desirable. Federal systems worldwide operate the basis of local resources plus transfers from the central government. This is desirable because it allows for territorial redistribution, and the alternative is also impractical as taxation is much easier to raise (and with in the EU some taxes such as VAT can only be set) at a national level. If Scotland is to remain part of the UK, therefore, fiscal transfers from the UK government, redistributing a share of UK-levied taxation, will always be part of the funding system.

5 Whether any of the allocations actually made do meet need is of course a different question: need is a contestable concept, measurement is at best difficult, and resource allocation influenced by history and politics. But the UK has had no practice of allocating government spending on the basis of where tax revenue was raised.
resources have to be dealt with there. Some lessons can be drawn from how it has operated, particularly in the past.

Today in local government, the distribution of resources has been dominated by governments’ desire to prevent local tax rises. In Scotland, for example, the council tax has been frozen for eight years, and the principles which underlay the distribution of grant have been obscured by an incremental system designed to fix tax levels while reducing local spending. When the council tax was introduced, however, to replace the discredited poll tax, the distributional principle for government grant was an apparently simple one: if each council spent the amount of money which the government thought it needed to spend, then each council was able to set its tax at the same, government-approved, level. This system therefore equalised for both needs and resources, but it came at a price: government determined not only relative need, but the total of spending. And it equalised only at that level of spending. If councils wanted to spend more, then the full cost fell on local taxable resource, and councils with a weak tax base found it harder to spend more than the government-approved level, and typically those were the councils with the greatest need.

This illustrates a general problem of equalising for both resources and needs in any system of fiscal federalism: there is a trade-off between them. Equalising for resources can mean that the same tax effort should allow a defined level of need to be met (as in the former council tax system) or it could mean that the same tax effort should produce the same, or at least some guaranteed minimum, revenue per head of population. In the system which preceded the poll tax, this latter was the approach: grant was distributed so that each council was able to generate a guaranteed minimum of revenue per head of population ("the standard penny rate product") for each additional penny increase in the rates. This form of resource equalisation meant no need for central government to set expenditure levels, but also implied that an area which taxed its own taxpayers more highly could draw in extra resources from elsewhere in the country, and those resources were not available to equalise for need. In practice a pragmatic compromise had to be reached between the two.

When putting these choices into practice for devolved or sub-state government in the UK might take the following lessons from local government. First of all, complete equalisation for both needs and resources requires the central government to make a decision about the right level of sub-state spending. Second, the only available principle for the distribution of central government resources, drawn from national taxation, is the basis of need, however assessed, measured or proxied. Third, a pragmatic choice needs to be made about how much, if any, resource equalisation is to be provided above that: in other words how much should devolved tax be supplemented and draw in additional resources from elsewhere in the UK? The answer to this question may depend on how strong the devolved tax base is: if it is so weak that additional tax effort produces disproportionately small spending power, so

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6 Nowadays, a system a bit like this is used for the nondomestic rates in Scotland, which are simply pooled at the national level and redistributed on a per capita basis, effectively as an element of grant.
that the incentive to make tax choices is very small, there may be a stronger case for resource equalisation, obviously on the basis agreed in advance, so that the results of a taxation decision are readily predictable. It may also, as on the council tax example, vary: resource equalisation might be available up to a certain level of tax rate, but not beyond.

**Fiscal principles for a territorial constitution**

The Smith commission was a political negotiation, and an unusually swift one. It agreed some very substantial policy items, reaffirmed the commitment to the use of the Barnett formula for the distribution of UK resources, and asserted a principle of "no detriment" (widely and rightly criticised as too vague, but containing some important safeguards). Smith did however not set out a comprehensive set of principles to guide the fiscal framework which it recognised was needed. In fact such a set of principles would be the fiscal element of a territorial constitution for the United Kingdom, put into practice through the legislation and the administrative documents which constitute the fiscal framework. These can be used to test the various options for grant reduction, resource transfer for welfare, and support for borrowing discussed earlier in this paper. The principles should be wide enough to apply to all of the devolved administrations, but would need to take account of different circumstances and different aspirations in each. In the first instance, however, they need to be put into practice in Scotland and the discussion that follows relates primarily to there.

The UK and Scotland form a union for the purposes of external relations and economic management. Macroeconomic management responsibilities fall to the UK government, but most economic development powers are exercised in Scotland. The majority of economic risk therefore falls to the UK government, but some is also carried by the Scottish government. The UK government carries the risks from the majority of taxation, and the cyclical risks for automatic stabilisers such as unemployment payments. The Scottish government bears the economic risk on devolved taxation, and little of the cyclical risk on spending need. The UK is also a union for social purposes. The main age-related and in-work benefits are supported by UK taxation, and distributed on the basis of individual circumstances. The distributive elements of social welfare – health and education in particular – are the responsibility of the Scottish government, but are supported by a share of UK resources sufficient to allow it to provide at least comparable provision. Accordingly,

- Devolved government in Scotland is funded by a mixture of shared UK taxation and "own resources", devolved or assigned taxation. The set of revenues to be devolved or assigned is as agreed by the Smith commission.
- UK taxation is distributed to support devolved services in Scotland via the Barnett formula. While this may be recognised to be at best a proxy for need, it was a commitment given to Scotland during the referendum campaign, and has advantages of continuity and simplicity. It is also used in Wales and Northern Ireland,
but need not be the same in detail in each of those, because of differing tax powers or for other reasons.

- The whole UK shares the risk that UK tax revenue will go up or down and affect both reserved and devolved services (the latter via Barnett). The devolved administrations, and the UK government for the rest of the UK, bear the risk that the yield of devolved taxes will rise or fall as time goes on. The Scottish government bears the risk from the yield of devolved and assigned taxes, and so has a direct fiscal stake in the performance of the Scottish economy.

- The principal equalisation mechanism for distributing resources across the UK is the Barnett formula. It is based largely on historic resource allocations, and a population share of the growth in shared UK taxes applied to devolved purposes across the UK but serves the purpose of needs equalisation that would otherwise require some form of needs assessment.

- A choice needs to be made about the degree of any further equalisation. Given that Scotland's tax base is relatively strong, and Scottish relative expenditure very high, it is hard to argue for resource equalisation on the old local government model: that Scottish tax decisions should draw in extra UK resources to ensure that an extra penny on the income tax, say, produces the same per capita revenue. (Where devolved taxation is weak by UK standards, there may be a case for resource equalisation on devolved taxes so that there is an incentive for the devolved administration to make tax choices that will have a perceptible effect on its spending, with the equalisation on a prearranged basis so that the effect of the tax decision is predictable. This could be argued for Wales, but not for Scotland.) But the principle of ‘no detriment’ may justify some equalisation, discussed below.

- Similar principles should apply in relation to capital expenditure. It is simply expenditure funded by future taxation, and so devolved capital expenditure should be funded by mixture of shared UK resources and devolved taxation. The devolved administration should have the choice as to whether to fund capital spending through shared UK borrowing (getting the advantages of scale and likely lower interest charges) or by borrowing directly from the markets on the strength of devolved tax base. To make this choice transparent, the devolved budgets be charged interest by the UK Treasury for any borrowing from them (with a transfer of resource for existing and likely future liabilities) and additionally repayment of devolved debts should be made a first charge on devolved revenues, and it should be made plain that devolved borrowing is not guaranteed by the UK taxpayer.

- The principle of no detriment enunciated by Smith is important, but needs to be properly understood. It means first of all that the shift to the new system of itself will produce on “day one” no change in the allocation of resources. This might be seen by some as "baking in" the advantages which Scotland has enjoyed by the Barnett formula, but that commitment was made during the referendum campaign. It does not however guarantee that future changes in devolved taxation will not produce more or less resources than Scotland would have received under Barnett had it
continued. That will depend on how the Scottish and UK economies diverge over time.

- No detriment also implies that where a tax base is shared (income tax and value-added tax), any changes made to the tax base by the UK government which affect devolved revenue will be the subject of compensatory changes. No detriment cannot reasonably be held to mean that any decision by either government which is argued to affect the tax revenues of the other should be the subject of a compensatory payment.

- It can also be argued that no detriment means that Scotland should not have under the new system to run harder just to stand still: that is to say it should not have to make a proportionately greater tax effort on devolved taxes so that, other things being equal, the same proportionate rise in devolved tax will have the same effect on spending. This would be the effect of the simple indexation as in section 2. Whether any more is justified is discussed below

- The system should be as simple to operate as possible, which may imply the use of some approximations.

- Experience with Barnett shows that fiscal formulae do not always have the results expected. Additionally, some of the projections of the outcome of the different formulae for adjusting the block grant might over very long periods produce unexpected or unreasonable outcomes. It should therefore be agreed at the outset that the system should be subject to review no earlier than 10 years after its initiation.

The implications of these principles

These principles merit some further explanation. The first may seem like a statement of the obvious, but represents in fact quite a profound change. Hitherto the Scottish government has been closely integrated into UK government financial planning. The only tax decision taken in Scotland since devolution not taken in Scotland before it has been the Scottish government's replacement of stamp duty land tax in 2015. That will change in 2016, but much more radically once the Scotland Bill is enacted. St Andrews House will finally cease to be a government department and become a government, and the Treasury's job will be to decide what share of common UK taxation goes to support devolved spending, rather than effectively the total of that spending. The fact that it uses the Barnett formula to do so is in a sense a historical accident: it is a simple way of sharing out UK taxes via decisions on comparable expenditure.

Consequences however follow, and these are evident in the next two principles. Barnett is the way of sharing out UK taxes, not devolved taxes. So just as all Scottish income tax goes to support services in Scotland, so rest of the UK income tax should be used to support comparable services elsewhere in the rest of the UK. If Scottish income tax revenues go up, because tax rates rise or because of economic growth, then that additional revenue will be
reached in Scotland. Similarly, increased income tax in the rest of the UK should be retained there. As explained earlier, this has been the position with local taxes since 1999. Strictly speaking, therefore, the proper approach to a block grant adjustment is the "levels" one. It is better understood as applying the Barnett formula to expenditure elsewhere in the UK funded by common UK taxes.

A great deal of nonsense has been written about the "no detriment" principle. It is right that changing to the new funding system should not on day one alter the resources available to Scotland: that is a reassurance to Scottish voters that the inherited position, based on Barnett, will not be removed simply because some of the funding is replaced by "own resources" when the new system is launched. Whether of course over time the new system provides more or less resources depends on how the Scottish economy fares, compared to the rest of the UK. Much has been made of pessimistic projections of the relative performance of the Scottish economy, and potentially also the size of the Scottish population. These are however only projections.

The principle of no detriment was initially introduced in the context of the Scotland Act 2012 by the coalition government, and it was intended to safeguard Scottish devolved revenues under the Scotland Act 2012 against changes by the UK government in the income tax base. If, for example, the threshold for the payment of income tax were increased, Scottish revenue would have fallen. It is right, of course, that if the UK government takes such a decision it should bear the fiscal consequences. The same obviously applies in relation to income tax and value-added tax under the Scotland Bill. What the principle of no detriment cannot realistically seek to achieve is to compensate either level of government for the indirect effects of their policy choices on each other’s revenue. If the Scottish government's policies cause a slump in the Scottish economy, it would be absurd for the UK to demand compensation for the VAT revenues. If the UK government's economic management increases unemployment, it would similarly be unreasonable for the Scottish government to demand compensation for the fall in income tax. Ownership of the tax base implies taking on the risks as well as the opportunities it offers.

Selecting amongst for the options for grant reduction

It will be clear from the foregoing argument that these principles are consistent with leaving wholly or virtually devolved taxes like income tax (and in principle Stamp Duty Land Tax or its replacement, Landfill Tax, Aggregates Levy and Air Passenger Duty) out of account in the Barnett calculation. Scotland then bears the risk of and takes the opportunities from growth in the tax base and changes in the tax rates on all these taxes and so does the rest of the UK. This is equivalent to the "levels" method.

There is no disagreement that the Scottish budget should be affected by the success or otherwise of the Scottish economy as time goes on, but there may be a case for more equalisation than levels provides. It can be argued that the principle of "no detriment" from
the change to the new system relates not only to the first year, and that it would be wrong to require the same absolute, and therefore higher proportionate, rises in devolved tax in Scotland to produce similar spending rises as elsewhere in the UK. (As explained above, because Scotland starts at a lower rate of tax, each extra pound of tax to be raised is a slightly higher increase in the tax rate.) Hence, more equalisation is appropriate than will be provided by Barnett plus levels alone. In other words, the UK has only a limited appetite for spending variation away from present relative levels, as a result solely of different inherited tax capacity. This would be achieved by the indexed deduction method. It is as if UK acknowledges that present spending relativities are broadly right at present tax rates. The same point arises perhaps more strongly in relation to assigned VAT, as the Scottish government has no power to raise the rate, and so a spending effect is likely7.

But the price of this is that taxpayers elsewhere in the UK have to accept that increases in their taxes will flow to Scotland, even though those taxes are devolved, and even if the extra revenues result from tax rate rises8. It would also have to be understood that in the event that Scottish taxes grew so much that they were proportionately higher than English levels, the opposite would apply. It is much harder to make an argument that equalisation should insulate Scotland from the effect of future relative population change in Scotland and the rest of the UK, as under the per capita method. It would be hard to explain to English taxpayers that if their population grows they must provide services for them, but also send some of the tax these voters pay to support additional services in Scotland when population has not grown there.

It can be argued that per capita indexation just does what Barnett does – if rUK spending rises because of population growth, Scotland gets a share of that growth, so it should not be denied a share of that growth even for taxes that have been devolved. But that is a false analogy for two reasons. First, as we have seen Barnett shares out UK taxes, and already excludes devolved ones. Secondly, under Barnett Scotland gets little benefit from its own population growth, but will when it retains devolved tax. As we saw above, Barnett deals poorly with relative population growth. It will continue to do so for UK taxes, but it is harder to argue that it should do so for devolved taxes.

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7 Assigned taxation was agreed by the Smith commission, and so is a given for the purposes of this paper. But it is not a very good idea. Both the Calman Commission and the Holtham Commission for Wales recommended against it. It imports revenue risk, up or down, but gives no power to deal with the consequences. A wise Scottish government would not have agreed to it. If in the present negotiations the Scottish government are concerned that they are taking on too much revenue risk, this is one they might ask to do without. That could be achieved simply by requiring the BGA for VAT to be the amount of VAT in Scotland, rendering assignment a dead letter.

8 Reductions would have the reverse effect.
The following table describes how risks are allocated under the different methods.

<table>
<thead>
<tr>
<th>RISK</th>
<th>UNDER BARNETT</th>
<th>SCOTLAND BILL UNDER LEVELS</th>
<th>SCOTLAND BILL UNDER INDEXATION</th>
<th>SCOTLAND BILL UNDER PC INDEXATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Changing Tax yield per head in Sc</td>
<td>UKG 96% Scot G 4%</td>
<td>UKG c. 75% Scot G c 25%</td>
<td>UKG 75% Scot G 25%</td>
<td>UKG 75% Scot G 25%</td>
</tr>
<tr>
<td>Relative population change on devolved spend</td>
<td>UK G c 5% Scot G 95%</td>
<td>UKG c. 2.5% Scot G c 97%</td>
<td>UKG c. 2.5% Scot G c. 97%</td>
<td>UKG c. 2.5% Scot G c. 97%</td>
</tr>
<tr>
<td>Relative population change on devolved tax revenues</td>
<td>Only local taxes devolved</td>
<td>UKG 0% Scot G 100%</td>
<td>UKG 0% Scot G 100%</td>
<td>UKG 100% Scot G 0%</td>
</tr>
<tr>
<td>Relative population change on total devolved revenues</td>
<td>UKG 96% Scot G 4%</td>
<td>UKG c. 50% Scot G c 50%</td>
<td>UKG c. 50% Scot G c 50%</td>
<td>UKG c. 100% Scot G 0%</td>
</tr>
</tbody>
</table>

It will be seen that Barnett arguably misallocates relative population change. If the Scottish population rises, the Scottish government gets all the demand for spending, but none of the tax income. *Per capita* indexation has the same effect. Either of levels or simple indexation matches the population growth risk more closely – spending need and income both move in the same direction – up or down. The argument for *per capita* indexation is essentially that Scotland will otherwise lose out as its population will decline relatively: but as the loss in spending need will be larger than the loss in tax income, that is an argument for increasing relative *per capita* spending in Scotland irrespective of either need or tax raised.

**A consistent approach to taxation and spending**

A good argument can be made for consistency between how the new tax powers and spending powers are dealt with in the fiscal framework, particular how economic and population risks are borne by the devolved government. A ‘levels’ approach to grant reduction would match neatly with a Barnett approach to the additional spending powers. A simple indexed deduction approach to grant matches well with an index approach to spending. The case for a *per capita* indexation is, on the argument in this paper, strong for neither taxation nor spending.
**Capital spending**

Capital spending remains an outlier, in that it has changed even less from the pre-devolution system than current spending. If the Scottish government is to have the true freedoms and responsibilities of a government, it needs to be given greater flexibility and responsibility for capital spending. That would involve the Treasury funding a proportion of the Scottish government's capital, at real cash cost (transferred to the Scottish government initially on a "no detriment" basis) with the remainder borrowed from the markets, without Treasury control, though with a prudential approach, and the statutory underpinning that these debts would not fall on taxpayers elsewhere in the UK, but only on taxpayers in Scotland.

What sort of union will this package leave the United Kingdom? Certainly one with an unusually high degree of decentralisation by international standards: as has frequently been pointed out, the Scotland Bill will produce a level of tax and spending decentralisation comparable to that in countries such as Switzerland and Canada. Nevertheless very roughly 3/4 of Scotland's public spending – including its main Social Security benefits and pensions – will be secured on the whole UK’s resources, so common levels of social provision can be sustained. The devolved funding system will give the Scottish Parliament very wide taxation choices, and real but constrained risks. Guaranteeing the continuation of Barnett and using a simple index deduction in the grant calculation will mean the funding system effectively starts from the assumption that present levels of relative *per capita* spending and taxation are broadly right and change will not be substantially driven by inherited weakness in the Scottish economy. The same effect will be achieved by simple indexation for those getting devolved benefits. About half of the devolved budget will be influenced by Scotland's relative economic performance, including the effects of relative population change, but the latter element affects both income and demand for expenditure. Change in the balance of devolved spending and taxation will therefore mainly be as a result of policy choice or future relative economic performance. This is a radically different approach even to the devolution of 1999. The Scottish Parliament will have scope to run a quite different social model in Scotland, and will have a direct stake in the success of the Scottish economy, but Scotland will retain the security of a share in the UK economy’s resources for both reserved and devolved services.
References


