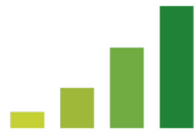

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The Smith Commission proposals: the unresolved issue of the "fiscal framework"

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CIPFA Scotland Conference 2015, March 26th 2015

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Coming up

- The Smith Commission and the fiscal framework
  - The big unresolved issue
  - The Commission’s principles for the framework
- Assessing the options for adjusting the block grant
  - Do any of them satisfy all the Commission’s principles?
- Borrowing powers
  - What about a prudential borrowing regime?
- Beyond the Smith Commission proposals
  - The financial implications of ‘full fiscal autonomy’
- Concluding thoughts

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The Smith Commission proposals

- Significant devolution of tax powers and revenues
  - ~ £10 – 11bn of income tax, ~£4 bn of VAT, and others
  - Devolved or assigned revenues will make up >50% of Scottish Government spending
- Partial devolution of welfare
  - ~ £2.5bn of mainly disability benefits
  - Powers to top up benefits and vary housing elements of UC
- Need to adjust the block grant given to Scottish government to account for additional revenues and spending responsibilities
- And changes to the wider 'fiscal framework' are needed given additional budgetary risk

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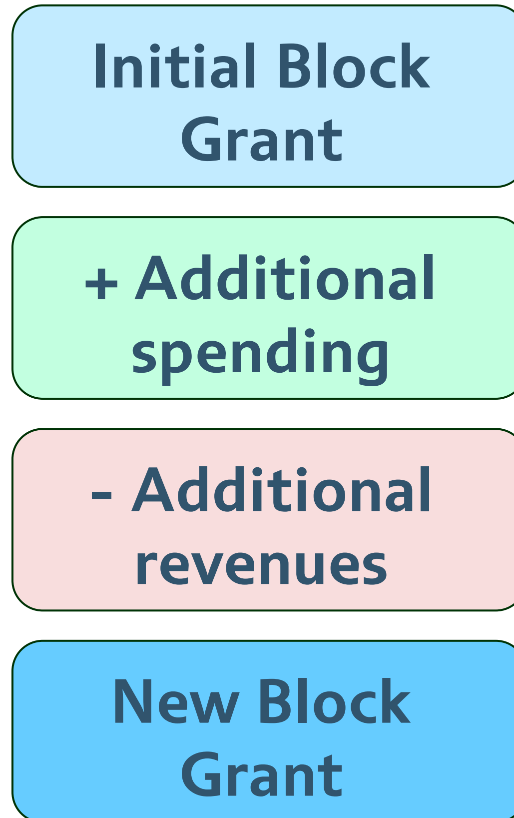
Adjusting the Block grant in year 1

- Adjusting the block grant in year 1 is conceptually simple:



- But what about in subsequent years?

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Adjusting block grant in subsequent years

- Cannot just keep making the same cash-terms adjustment
  - Need to account for inflation and economic growth
- But cannot adjust based on how much is raised from devolved taxes and spent on devolved welfare each year
  - Remove incentive for Scottish govt. to grow tax revenues and limit expenditure growth
  - Changes in block grant would neutralise such efforts

Revenues up £500m | **Block grant cut £500m** | **= no net change**

- Smith Commission recognises importance of issue
  - Adjustment should be "indexed appropriately"
  - But what would be an appropriate method?

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The Smith Commission's fiscal principles (I)

- Smith Commission also sets out a number of principles the new fiscal framework (including block grant adjustments) should meet:

95.1 "Barnett Formula"

The block grant from the UK Government to Scotland will continue to be determined by the Barnett formula

95.2 "Economic Responsibility"

The Scottish budget should benefit in full from Scottish Government policy decisions increasing revenues or reducing expenditures, and bear the full cost of policy decisions that reduce revenues or increase expenditures.

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The Smith Commission's fiscal principles (II)

95.3 "No detriment as a result of the decision to devolve further powers"

The Scottish and UK Governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

95.4 "No detriment as a result of UK or Scottish Government policy decisions post-devolution"

Where policies of either government affect spending or revenues of others, compensating transfers should take place.

Changes in rUK to taxes devolved to Scotland should not affect government spending in Scotland

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The Smith Commission’s fiscal principles (II)

95.5 “Borrowing powers”

Need to be consistent with the mechanism by which block grant is adjusted to account for tax and spending devolution

95.8 “UK economic shocks”

The UK Government should continue to manage risks and economic shocks that affect the whole of the UK.

95.6 “Implementable and stable”

Once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation.

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Assessing block grant adjustment options

- There are a number of ways block grant adjustment can be calculated in subsequent years
- Adjust the block grant by a constant %
- Index the adjustment to what happens to revenues from equivalent taxes (or spending on equivalent welfare) in rUK
  - In % terms
  - In £s per person (p.p) terms
- We need to assess the various methods
  - How do they perform under different scenarios?
  - Do they satisfy Smith Commission's principles?

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Adjusting by a constant percentage (I)

- Suppose year 1 block grant is£30bn and income tax revenues of £10bn is being devolved*
  - Block grant is therefore reduced by £10bn to £20bn
  - Reduction is equivalent to 33% of initial block grant
- In future years reduce block grant by 33% compared to what it otherwise would be
  - e.g. if grant otherwise £33bn: £33bn – 33% = £22bn
- The good…
  - Can adjust for rUK policy changes using Barnett formula
  - Simple & a similar system already operates for business rates

* We abstract from devolution of other taxes and welfare only to keep examples simple.

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Adjusting by a constant percentage (II)

- The bad…
  - Scottish budget would end up bearing risk of shocks that affect the whole of the UK, contrary to Smith Commission

Following devolution, Scotland's budget is £20bn (grant) + £10bn (revenues)	**e.g. Income tax revenues fall by 20% in Scotland and rUK (UK-wide shock)**	**UK govt leaves spending unchanged so underlying block grant still £30bn and adjusted still £20bn**	**Scotland's budget is now £20bn (grant) +£8bn (revenues): a shortfall of £2bn due to 20% revenue fall**

- And the ugly…
  - Scotland isn't well placed to bear such risks
  - Fewer mechanisms to compensate
  - Borrowing is likely to be more expensive for Scotland

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Indexing to % change in rUK revenues (I)

- Keeping with example of 20% revenue fall in Scotland and rUK
  - Block grant adjustment is reduced by 20% from £10 to £8bn
  - Scottish Govt budget is now £22bn (grant) + £8bn (revenue) = £30bn
  - Scottish Govt budget is insulated from UK-wide shocks
  - Need less additional borrowing powers to smooth shocks
- If Scottish and UK revenues change at same % rate, Scotland's overall budget is same as without devolution
  - In the spirit of the first "no detriment" principle (95.3)
- But does gain/lose if its revenues do better/worse than rUK
  - Ensures incentives to grow economy and manage fiscal risks

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Indexing to % change in rUK revenues (II)

- rUK revenues also affected by UK government policy changes
- Suppose UK government cuts income tax in rUK by £10bn.
  - This is equivalent to about 8%, so block grant adjustment reduced by 8% (£0.8bn) to £9.2bn
- Further, imagine this is funded by cutting spending in rUK
  - Barnett formula means £10bn cut in spending in rUK reduces underlying block grant to Scotland by about £0.92bn
- Net effect is to reduce Scottish Govt. budget by £0.12bn
  - £0.8bn - £0.92bn
- So Scottish Govt sees its budget cut to fund a tax cut in rUK
  - Violates second "no detriment" principle (95.4)

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Indexing to £s p.p change in rUK revenues (I)

- Problem arises because revenues per person differ between Scotland and rUK
  - Barnett formula works on £s p.p changes not % changes
- Indexing block grant adjustment to £s p.p change in rUK revenues solves this problem
- But introduces another problem
  - Scottish revenues would have to grow quicker in % terms to keep up £s per person growth in rUK revenues

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Indexing to £s p.p change in rUK revenues (II)

- Scottish income tax revenues in 2013-14 were £11.4 billion
  - £2,140 per person, compared to £2,460 in rUK
- Suppose devolved at that time, and thereafter revenues grow 5% in Scotland and rUK
- 10 years after devolution, the amount taken off block grant would increase to £19.7 billion, but Scottish revenues would only grow to £18.9 billion.
  - Shortfall of £1.1 billion
  - Shortfall would continue growing over time
- Scottish revenues would have to grow quicker than those in rUK to avoid such a fate
  - Does not feel in the spirit of 1st "No Detriment" principle (95.3)

Summarising the options

- Fixed % adjustment to block grant
  - Easy to understand and implement using Barnett formula
  - But Scotland bears risk of UK-wide shocks it is ill-equipped to bear
- Index to % change in rUK revenues
  - Insulates Scotland from UK-wide shocks but still growth incentive
  - In spirit of "no detriment simply from devolution"
  - Scotland affected (a bit) by rUK decisions on devolved taxes
- Index to £s p.p change in rUK revenues
  - Scotland unaffected by rUK decisions on devolved taxes
  - But Scotland loses out unless its revenues grow more quickly in % terms than rUK – not in spirit of 1st "no detriment" principle

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Can any mechanism satisfy all Smith principles?

- Clear trade-offs between different Smith Commission principles
- Our ongoing analysis suggests that there is **no method that will satisfy all the principles**
  - Fiddly fixes would increase risk of political deadlock
- Need to prioritise principles and choose method accordingly
- **Indexing to % change in rUK revenues looks best to me**
  - Insulates Scotland from UK-wide shocks
  - Taxes in rUK go up and down and the (relatively small) increases and reductions in Scotland's budget this method causes would balance out
- Problems under other methods larger & likely to grow over time
  - e.g. after 20 years, loss to Scotland at 5% revenue growth under £s p.p indexation would increase to £2.8bn.

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Should the "no detriment" principles be ditched?

- More generally, not clear "no detriment" principles are sensible
  - Devolution necessarily increases budget risk (& possible "detriment")
- Consider "compensation" for knock-on effects
- Suppose Scotland increases top rate of tax to 50%
  - Scots work less, so pay less NICs –Scottish govt compensate UK govt?
  - Scots shift income from earnings to dividends; or Scots move from Scotland to rUK – UK govt compensate Scottish govt?
  - How do you measure these effects?
- Such an approach necessarily require lots of negotiation
  - £millions at stake , so lots to argue about – political chaos?
- Better to accept there may be some detriment to either govt?
  - Other countries (e.g. US, Canada, Australia) do

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Borrowing powers

- Scotland would need borrowing powers commensurate with the fiscal risks it faces under devolution
- By insulating Scotland from UK-wide shocks, indexing block grant adjustment to % change in rUK revenues reduces necessary scale of extra borrowing powers
  - Reduces Scotland's debt interest bill
  - Less risk of UK govt. having to bail out Scotland?
- CIPFA has argued for a system of prudential borrowing
  - Argue it has worked well for local authorities
  - Central government can intervene if local authorities over-borrow
  - But politics with Scotland is difficult – intervention by UK govt could cause a political and constitutional crisis
  - Could be in some groups' interests to cause such a crisis

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Beyond Smith: full autonomy (I)

- Smith proposals not necessarily the end of the devolution journey
  - SNP has argued for “full fiscal autonomy”
- Full fiscal autonomy normally interpreted as Scotland raising all its own revenues and controlling all its spending
  - Includes contribution to UK govt for defence, foreign affairs, and servicing Scotland’s share of UK’s existing debt
  - No more Barnett formula
- Latest GERS figures for 2013-14 show:
  - Scottish deficit of 8.1% of GDP, compared to 5.6% for UK as a whole
- Oil price falls mean Scotland’s relative position likely worsened
  - In 2015-16 deficit of 8.6% of GDP (4.0% UK)

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Beyond Smith: full autonomy (II)

- At the moment full fiscal autonomy would therefore entail
  - Very high borrowing (not feasible?) or
  - Substantial tax rises or spending cuts
- Oil revenues need to be about £8bn a year to make up for loss of funding under Barnett formula
  - Currently forecast at £0.6 billion a year
  - May rebound, but volatile, and longer term decline
- Faster growth in onshore economy would help close the gap
  - Easier said than done
  - Main policies suggested involve taxing less or spending more – make the gap bigger, not smaller
- Full fiscal autonomy would entail significant fiscal challenges

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Conclusions

- Updating the fiscal framework to account for further devolution is important – for responsibility, fairness, and incentives
- But it looks like cannot satisfy all Smith Commission principles
  - And “no detriment” principles not so sensible in practise as on paper
- Devolution necessarily involves budget risks
  - Policymakers should focus on ensuring the system is workable and risks shared sensibly between UK and Scottish govt
  - Politics is key: Will two governments design and operate a system in good faith? Or will it be used a battleground for point scoring?
- Borrowing is another key issue – not sure prudential borrowing is the right approach
- Smith Commission may only be start of the journey
  - Full fiscal autonomy presents a big fiscal challenge

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