

Institute for
Fiscal Studies



The Smith Commission proposals: the unresolved issue of the “fiscal framework”

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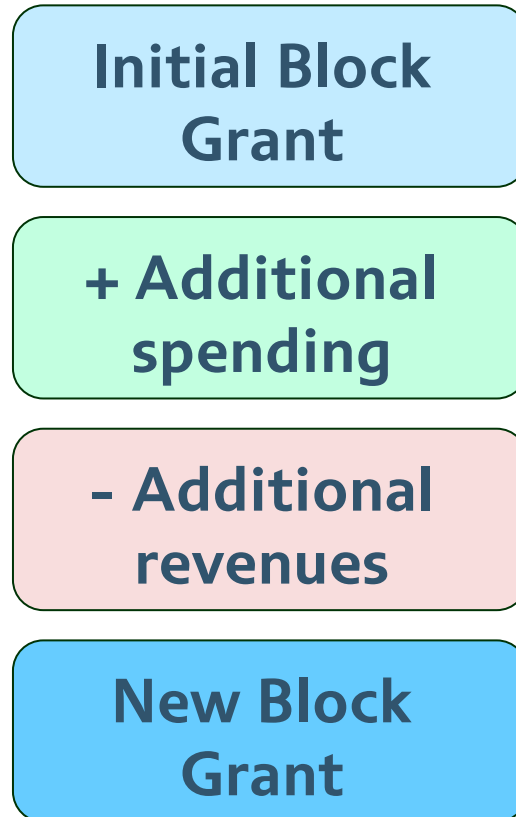
Scottish parliament finance committee away day

The Smith Commission proposals

- Significant devolution of tax revenues and welfare spending
 - Devolved or assigned revenues will make up >50% of Scottish Government spending
 - ~ £2.5bn of mainly disability benefits
- 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

Adjusting the Block grant in year 1

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



- But what about in subsequent years?

Adjusting block grant in subsequent years

- 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?

The Smith Commission's fiscal principles (I)

- Smith Commission also sets out a number of principles the new fiscal framework should meet. Including:

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”

Compensation for policy knock on effects

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

The Smith Commission's fiscal principles (II)

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.

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 %
 - e.g. If initially need to reduce block grant by 1/3, reduce it by 1/3 in subsequent years
- 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?

Adjusting by a constant percentage

- May seem attractive and simple solution
- Problem is Scottish budget would end up bearing risk of shocks that affect the whole UK
- Suppose initially £30bn grant, and £10bn of taxes to be devolved

After devolution Scotland's budget is made up of £20bn (adjusted grant) + £10bn (tax 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

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

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

Indexing to % change in rUK revenues (II)

- But problem can arise when UK govt changes tax policy in rUK
 - Tax increase/decrease has knock on effects for spending in rUK
 - Barnett formula works on a £s p.p basis, not % basis
 - Given % change in revenue is smaller in £s p.p in Scotland than rUK
- So, Scottish Govt would see its budget cut (a bit) when rUK income tax cut, or increased when rUK income tax put up
 - Violates second “no detriment” principle (95.4)
- 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 than those of rUK to keep up with growing block grant adjustment

Indexing to £s p.p change in rUK revenues

- Suppose income tax devolved to Scotland in 2013-14, and therefore Scottish and rUK income tax revenues grow 5% a year
- Revenues and block grant adjustment both start at £11.4bn
- After 10 years, the amount taken off block grant to account for devolution would increase to £19.7bn, but Scottish revenues would only grow to £18bn
 - Shortfall of £1.1bn
 - 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)

Can any mechanism satisfy all Smith principles?

- Clear trade-offs between different Smith Commission principles
- Looks like **no method that will satisfy all the principles**
 - Fiddly fixes would mean lots of negotiation and 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

The difficulties of “no detriment” (I)

- More generally, not clear “no detriment” principles are workable
- 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 side?
 - Other countries with devolution (e.g. US, Canada, Australia) do

The difficulties of “no detriment” (II)

- Important to recognise there will be times when changes in rUK taxes do affect Scottish Govt budget
- Suppose increase in income tax in rUK to fund higher pensions
 - Pensions are UK-wide so Scots benefit too
- Fairness means if Scots benefit, should also contribute to cost
 - In first instance this is by cutting block grant given to Scotland
 - Scotland can then decide whether to increase its own income tax, or reduce spending
- Indexing block grant adjustment to rUK revenues achieves this

“English Votes for English Laws”

- But this example shows why income tax in rUK isn't an “English (and Welsh and NI) only” matter
- It can have knock on effects for Scottish Govt's budget, and through that influence Scottish taxes
- What if Scots thought NICs or VAT should go up instead?
 - Not devolved so cannot make that decision themselves
 - If want to make up lost grant, only real option is income tax
- So a case that Scottish MPs should still have a vote on “devolved taxes” in rUK
 - Although maybe only on amount of ‘revenue’ not rate structure – difficult to separate in practise!

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?