The Smith Commission's Proposals – how big a change do they represent? And what questions remain to be addressed?

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Executive summary

The Smith Commission proposals

- Full devolution of income tax on non-savings and non-dividend income removes anomalies under the system of partial devolution due to take in effect in April 2016 which skew the Scottish Government's incentives towards tax rises and away from tax cuts. However, the system is not perfect. In particular, because the Scottish income tax would not apply to dividends (or savings) income, if Scottish tax rates were higher than UK tax rates, some could respond by shifting their income into dividends, on which the UK rate will apply. This tax avoidance would reduce the amount Scotland could raise from higher tax rates. This problem could be fixed by also devolving the taxation of dividend and savings income to Scotland, but practical issues make doing so difficult.
- The most notable tax which was *not* recommended for devolution was corporation tax, especially given that the UK government has agreed, in principle, to devolve corporation tax to Northern Ireland. Northern Ireland has previously argued that it has special circumstances – an economy with a

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particularly weak private sector, and a land border with the Republic of Ireland, where the corporation tax rate is just 12.5%, with whom it must for compete for investment. Whether these arguments are valid or not, it seems likely the Scottish Government (and, in all probability the Welsh Government) will argue that similar powers be devolved to Scotland (and Wales) too. This could mean a re-opening of the issue of *what* to devolve, that the Smith Commission was meant to answer.

- The full devolution of many disability benefits to Scotland would give the Scottish Government powers to change policies and control over the funding for these benefits. This would, remove anomalies where the Scottish government currently finds itself investing in health and social policy measures that might reduce disability benefit expenditure, but not benefitting from any reduced costs. On the other hand, while the Scottish Government would have the power to vary the housing elements of universal credit, funding these at their standard level of generosity would remain the responsibility of the UK government: the Scottish government would pay or gain only from changes in expenditure associated with deviations from these standard levels. Under this form of partial devolution it would therefore remain the case that if the Scottish Government chose to spend more on social housing it would bear the cost, but any resulting savings in housing benefits (as a result of lower rents) would accrue to the UK government.
- Taken together, the changes proposed would significantly increase the proportion of Scotland's budget that is funded by tax revenues under its control or assigned to it by the UK government: from around 13% currently, to more than 50%. This is more comparable to the situation in other countries. The Scottish Government would also have significant powers to alter the degree of redistribution through changes in income tax rates, and changes to the benefit system (including the power to "top up" undevolved benefits). However, significant tax and spending powers will remain with Westminster – including the responsibility for funding around 85% of benefit spending, including the state pension. The proposals are therefore some way away from "devo max".

Remaining questions and issues

- Given that we have proposals that have been agreed by the five main Scottish parties, it might seem that the most difficult decisions have been made. However, in many ways, the most difficult work lies ahead – getting the details of how the taxes and benefits are devolved will be crucial. In particular, how the block grant given to Scotland is adjusted not just in year one of devolution, but in the years ahead, will be crucial in determining whether the resulting system is seen as "fair", and what responsibilities, risks and incentives the Scottish Government faces.

- The Smith Commission recognises that any block grant reductions or additions made to account for further devolution should be "indexed appropriately", but does not elaborate further. Unfortunately the answer is unlikely to be the same for every area of tax or spending. But one option that has many attractive features is to index the block grant reduction (or addition) to what happens to revenues from the equivalent tax (or spending on the equivalent benefit) in the rest of the UK. This insulates the Scottish Government from revenue or spending shocks that hit the whole of the UK, but still gives the Scottish Government the incentive to grow revenues and limit expenditure, and the responsibility to bear the effects of its policies on Scottish revenues and expenditures.
- Scottish Government policies can have knock-on effects for UK government revenues or expenditure, and vice versa. The Smith Commission recommends that transfers be made between the governments to compensate for these knock-on effects. In principle this seems sensible. But in practice, implementing such a principle would be fraught with practical and political difficulties. The calculations required are inherently difficult, with much room for disagreement over methods and assumptions. This means it would be important to recognise that such compensating transfers would be practical in only a few cases – otherwise the system could quickly become unworkable.
- The Commission also recommends that "changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK". It seems clear that if, for instance, income tax were increased in the rest of the UK to fund additional spending on services in the rest of the UK, there should be no knock-on effect to Scotland. But what if the UK government increased income tax to reduce the budget deficit, or to raise more for defence or pensions that benefit the whole of the UK? In that case fairness would seem to require that changes were made to the size of the block grant given to the Scottish Government: if taxpayers in the rest of the UK were paying more in income tax to reduce the budget deficit it would seem only fair that Scottish taxpayers also contribute to deficit reduction – either through lower government spending or higher taxes levied by the Scottish Government.

1. Introduction

On November 27th 2014, the Smith Commission published proposals for further devolution of powers to Scotland agreed by the five parties represented in the Scottish Parliament (the Scottish Conservatives, Scottish Green Party, Scottish Labour Party, Scottish Liberal Democrats, and the Scottish National Party).[2] The process was certainly quick, taking less than 7 weeks from when the parties submitted their individual proposals to the Commission – proposals which differed widely from each other on how much further devolution there should be. But just how big are the changes that have been agreed upon? And what important questions remain to be answered?

2. Proposals for further tax devolution

Income Tax

The proposal that is attracting the most attention is the devolution of income tax rates and bands on non-savings and non-dividend income, and all associated revenues. This would give Scotland the power to vary each rate of tax individually – for instance, putting up only the top rate of tax, or cutting only the basic rate –, and to change the thresholds at which the higher (40%) and top (45%) rate become payable. In principle, it could also create entirely new bands and rates. This represents a significant increase in powers over the current situation – where the Scottish parliament has the (hitherto unused) power to vary the basic rate only by up to 3 percentage points – and the existing plans for further income tax devolution under the 2012 Scotland Act that are due to take effect in April 2016, which devolve 10 percentage points of each tax band to Scotland, but only allow the Scottish parliament to move them up and down together, not independently. Based on 2012–13 tax receipts, Scotland would keep around £10 billion of income tax revenues (compared to around £4.3 billion under 2012 Scotland Act, and nothing currently).[3]

The Commission proposes that a number of elements of income tax remain at Westminster, however. This includes the definition of income, the granting of

[2] The Smith Commission Report, available to download at: http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf.

[3] This compares to total income tax revenues in that year of £10.9 billion according to Government Expenditure and Revenues Scotland 2012–13 (http://www.scotland.gov.uk/Publications/2014/03/7888). Revenues under Smith Commission proposals are assumed to be 93% of the total, based on figures cited by the Calman Commission (http://www.commissiononscottishdevolution.org.uk/). Figures for revenues under the Scotland Act are taken from the Office for Budget Responsibility's forecasts for Scottish revenues (http://budgetresponsibility.org.uk/pubs/49381-Scottish_tax_forecasts_March14.pdf).

exemptions and reliefs, taxation of savings and dividend income, and the personal ('tax free') allowance. Although, with full powers over rates and bands, the Scottish Government could presumably introduce a zero-rate band, giving it the power to, in effect, increase but not decrease, the personal allowance in Scotland. With this in mind, it is hard to see any economic rationale for not devolving the personal allowance.

What might the effects of the income tax proposals be?

In one important respect, devolving all income tax revenues (from non-savings non-dividend) will provide the Scottish Government with better aligned incentives to change tax rates compared to the partial devolution envisioned under the existing legislation. Consider an increase in the rate of tax – which has a direct 'mechanical' effect of increasing revenue, but a second round 'behavioural' effect, which may reduce revenues as people cut back how much they work (or at least how much they declare to the tax authorities!). Under existing legislation due to take effect in April 2016, Scotland would have gained the full revenues arising from the 'mechanical' effect, but borne the 'behavioural' effect only on its 10-pecentage point share of income tax: the remaining behavioural effect (on 10 percentage points of tax for the basic rate, 30 for the higher rate, and 35 for the top rate) would be borne by the UK government. This would skew Scotland's incentives towards tax rises and against tax cuts.[4] If Scotland keeps all tax income tax revenues this situation does not arise: it bears both the full 'mechanical' and 'behavioural' effects of a change in tax rates on income tax revenues in Scotland. This should better align its incentives to set tax policy accounting for the feedback effect of changes in tax rates on peoples' behaviour.

If Scotland has different tax rates – particularly for high incomes –, people might have an incentive to move from Scotland to the rest of the UK (if the Scottish rate is higher) or vice versa (if the Scottish rate is lower) to reduce their tax bills.

[4] These problems would have become particularly acute if the lock-step meaning all rates have to be moved up or down together had been removed without devolving more of the revenues to Scotland. This is because people subject to the top rate (45%) of income tax are particularly responsive to tax changes – meaning a big behavioural effect –, and Scotland would bear a particularly small fraction (10/45ths) of the revenue consequences of these behavioural changes. Scotland could therefore find itself better off from increasing the top rate of income tax, even if it resulted in an overall reduction in the amount of income tax raised in Scotland. This situation has been avoided for Scotland as additional revenues have also been devolved to Scotland. But it is exactly the case in Wales, to which 10 percentage points of each tax band will be devolved, alongside the power to vary each rate individually (for instance, to increase only the top rate). Wales will therefore have skewed incentives to increase the top rate of income tax.

There has already been much talk of the so-called WILLIEs (Working in London, Living in Edinburgh)[5], many of whom work in the financial sector, leaving Scotland if it sets a higher top rate of tax than the rest of the UK. But because tax rates on savings and dividend income are not devolved, people might not have to move to avoid a higher top rate of Scottish income tax: some could incorporate and pay themselves in dividends, or existing owner-managers could shift their remuneration from wages to dividends. Thus, a higher top rate of tax in Scotland may be even less likely to raise much money than in the UK as a whole (see this observation):[6] it might be easier to move from Scotland to England, or convert income into dividends, than it is to avoid a tax that applies to the whole of the UK, and to dividends too.

Of course, if the Scottish rate of tax applied to dividends too, one of these avenues for avoidance would be closed. However, there are practical difficulties in having different tax rates for dividends in different parts of the UK, and other avenues of avoidance might open up if that were the case, which mean there may be no easy solution to this problem.

Other taxes

The other major source of revenue that is to be devolved to Scotland is revenue arising from 10 percentage points of the standard rate of VAT. Assigning these revenues gives the Scottish government the incentive to find ways to grow these revenues – through boosting economic growth, for instance. But it will not have the power to vary the VAT rate, because within-country variation in VAT rates is not allowed under EU law, except under special conditions.

Smaller taxes to be devolved include the aggregates levy, and air passenger duty – where there have been concerns about the potential impact of lower rates of duty in Scotland on English airports (notably Newcastle).

The most notable tax which was *not* recommended for devolution was corporation tax, especially given that the UK government has agreed, in principle to devolve corporation tax to Northern Ireland. Northern Ireland has previously argued that it has special circumstances – an economy with a particularly weak private sector, and a land border with the Republic of Ireland, where corporation tax is just 12.5%, with whom it must for compete for investment. Whether these arguments are valid or not, it seems likely the Scottish Government (and, in all

[5] See, for instance: http://www.newstatesman.com/politics/2014/05/charting-rise-new-willies.

[6] Information on what is known about the revenue effects of the 50% top rate of income tax in the UK is available in an IFS observation: http://www.ifs.org.uk/publications/7066/ .

probability the Welsh Government) will argue that similar powers be devolved to Scotland (and Wales) too. This could mean a re-opening of the issue of *what* to devolve, that the Smith Commission has supposedly already addressed.

The Scottish Government has previously stated its desire to reduce corporation tax to below the rate in the rest of the UK in an effort to attract additional investment.[7] However, firms could also respond by simply shifting paper profits (for instance, by changing the 'transfer prices' charged for intra-company transactions), which would boost revenues in Scotland at the expense of the rest of the UK. Fears that this could lead to tax competition and corporate tax avoidance might explain why the decision not to devolve corporation tax was made.

Other countries – such as the US and Canada – do operate systems where corporate taxes differ across states or provinces. Tax competition remains an issue, but is perhaps less of a concern because of the way in which taxable profits are allocated between different tax jurisdictions within these countries. Rather than basing it on 'transfer prices' associated with intra-company transactions – which can be manipulated to shift paper profits about –, a formula based on sales, payroll and property located in each jurisdiction is used. If this were applied within the UK, it could act to limit tax avoidance and therefore ameliorate worries about tax competition via profit shifting (although of course, companies could respond to the incentives created by the formulas by changing where they locate staff, or property, say). If corporation tax is recommended for devolution at a later stage, consideration should be given to such a "formula apportionment" method of allocating profits between Scotland and the rest of the UK (as it should be considered as an option for Northern Ireland, to which the UK government has announced that it is willing, in principle, to devolve corporation tax to).

Another notable exception is National Insurance (NI). The devolution of income tax but not NI will make it harder for both the UK and Scottish governments to integrate these two taxes – a key recommendation of the IFS's Mirrlees Review of the UK tax system.[8] And given the only very weak link between NI contributions and benefit entitlements, it is not clear from an economic perspective why one would want to devolve income tax on earned income but not NI, which in effect is just an additional tax on earned income. Politically, the notion that NI contributions are linked to benefit entitlements (even if that link is only very

[7] See, for instance, the Independence White Paper, available at: http://www.scotland.gov.uk/Resource/0043/00439021.pdf.
[8] Mirrlees, J, et al. (2011), "The Mirrlees Review: Tax by Design", available at: http://www.ifs.org.uk/publications/5353.

weak) may provide some rationale for treating the two taxes differently, thereby providing both the UK government and Scottish Government with revenue sources based on Scottish earnings.

3. Proposals for devolution of benefits policy

The Smith Commission proposes devolving several areas of benefits policy.

Universal credit

One of the biggest, and perhaps most difficult to implement, is the devolution of the housing element of universal credit (into which the existing housing benefit is set to be merged in the next few years). This would allow Scotland to vary the under-occupancy charge (i.e. abolish the "bedroom tax"), vary the maximum housing costs that can be claimed by private sector tenants, and change the deductions that are made for lodgers and other non-dependents (such as adult children living with their parents).

If the Scottish Government chose to make these elements of Universal Credit more or less generous, its block grant would be adjusted accordingly to ensure it paid for or gained from any change in expenditure. However, funding the housing element of universal credit at the same level of generosity as in the rest of the UK would remain the responsibility of the UK government.[9] In other words, no adjustment to the block grant given to Scotland would be made as a result of the granting of these powers to Scotland – adjustments would only be made if and when the powers *were used* and this use resulted in a change in expenditure.

This means that the UK government would still bear the funding risks associated with the housing element of universal credit. It is the UK government that would gain if slower growth in rents reduced costs, or lose if high unemployment meant more people could claim the housing elements. The Scottish Government would only bear the cost of the changes it made to the housing elements. Thus, the form of devolution proposed gives the Scottish Government fewer responsibilities and fewer incentives to find ways to reduce the costs of providing financial support for housing, than full devolution (including the funding of the housing elements) would.

In particular, it does little to address one of the main concerns that have been raised with regards to the existing centralised system. That is, that the system does not reflect the link between investment and spending on social housing on

[9] The Smith Commission report did not make clear whether funding for the housing element would be devolved alongside powers. Subsequent discussion with HM Treasury officials made clear that the proposal is to devolve powers *only*.

the one hand and spending on housing benefit (the benefit that the housing element of UC is set to replace) on the other. The Scottish government is already responsible for investing in and subsidising social housing. If it chooses to spend more on this (and spending data shows that it does[10]) it bears the cost, but any resulting savings in housing benefits (as a result of lower rents) accrue to the UK government, which is responsible for housing benefit. Fully devolving the funding of the housing element of universal credit to Scotland could address this problem, provided the interactions with the block grant calculation were got right (we discuss the importance of 'block grant adjustments' in more detail later). But the system of partial devolution proposed does not solve this problem – because funding the system remains primarily the responsibility of the UK government, and it is the UK government that gains from any savings as a result of lower rents in Scotland.

Devolving the funding for part but not all of universal credit would be complex. But many of the complexities would still need to be dealt with under the proposed system of partial devolution, given that the housing elements of universal credit can interact with other elements of universal credit. This means when deciding how much to change the block grant when Scotland changes the housing elements, it will be important to carefully calculate the change in *overall* universal credit spending – not just the change in spending on the housing elements themselves.

The Scottish Government will also have the power to change the frequency of universal credit payments (for instance, from the default monthly payment to weekly), to split payments between partners making a joint claim (rather than make a single payment to one of them), and to pay landlords directly for housing costs (rather than rely on benefit claimants to pass on this money to cover rent). These are areas where existing plans under universal credit have been particularly controversial.[11] Other areas of universal credit – including, importantly, the taper rate at which benefits are withdrawn as income increases, the earnings disregards, and the conditions attached to entitlement and sanctions that can be applied if those conditions are broken – , will remain under the control of Westminster.

[10] Spending data available in *Government Expenditure and Revenue Scotland 2012–13*, available at: http://www.scotland.gov.uk/Publications/2014/03/7888.
[11] See the following presentation by Fran Bennett, for instance: http://www.ifs.org.uk/docs/Fran%20Bennett_UC%20slides.pdf.

Other benefits

All parties had proposed devolving attendance allowance to Scotland – this benefit for disabled people aged over the state pension age has close links to personal care, an issue which is already devolved. Perhaps more surprisingly, a whole raft of other disability benefits aimed mainly at working-age people have also been devolved: disability living allowance, personal independence payments, carers allowance, industrial injuries disablement allowance, and severe disablement allowance. Again there are clear links between disability benefits and health and social care policy. Unlike with the housing element of universal credit, these benefits are being fully devolved – the Scottish government will become responsibility for funding them, and the block grant will be adjusted accordingly. This means devolution would, in this case, remove anomalies where the Scottish government currently finds itself investing in health and social policy measures that may reduce disability benefit expenditure, but not benefitting from those reduced costs.

But while most disability benefits will be devolved, not all will be. Universal credit will include disability elements because it will absorb the means-tested component of the existing employment and support allowance. And the Smith Commission makes no mention of who will be responsible for contributory employment and support allowance (which can be claimed for up to a year by people if they have paid enough National Insurance contributions) – which will not be rolled up into universal credit. Given that some disability benefits will be devolved and others won't be, the provision of information to disabled Scots on how to claim different benefits, and who is responsible for different benefits, will be vital.

A few other relatively small benefits will also be devolved – most notably, the winter fuel payment. But the biggest benefit of all, the state pension, will remain the responsibility of Westminster. As will the pension credit, child benefit, and a number of child- and bereavement- related benefits. However, the Scottish Government will have the power to top up these benefits (or any others, including universal credit) if it chooses to. This gives it the power to make non-devolved benefits more generous but not less generous in Scotland. The Scottish Government would, of course, have to pay for these "top ups" from its block grant. But calculating the cost of "top ups" could be difficult – especially if they are big enough to affect claimant behaviour. For instance, if a top up to payments of unemployed people encouraged them to remain unemployed for longer, this would also push up the amount spent on the standard level of unemployment benefit, funded by the UK government. As we discuss later, the Smith

Commission proposes that the Scottish Government would also have to pay for these knock-on effects by compensating the UK government. But, calculations of how much would likely prove contentious.

4. How big are these changes?

Taken together, the changes proposed will significantly increase the proportion of Scotland's budget that is funded by tax revenues under its control or assigned to it by the UK government. At present around 13% of Scottish Government and Scottish local government expenditure is funded by devolved taxes – business rates and council tax. This is set to increase to around a quarter under the plans for partial devolution of income tax, and the full devolution of stamp duty land tax and landfill tax under the 2012 Scotland Act. Table 1 shows that under the Smith Commission's proposals somewhat over *half* of Scottish Government spending (including the newly devolved benefits spending) will be funded by devolved tax revenues. This brings Scotland and the UK closer to the position in most other OECD countries, where sub-national governments (such as the Scottish Government, in this context), are responsible for raising a substantial proportion of what they spend.[12]

The proposals also represent a significant increase in powers across a range of areas of tax and welfare policy, especially given the traditional highly centralised nature of the UK tax and welfare system. It is further than some wanted to go (notably substantially further on income tax than Labour had initially favoured), but remains a long way from the powers the Scottish National Party were asking for (effectively "Devo Max"). Already it seems to be having an impact on the policy making process in Scotland. The Scottish First Minister, Nicola Sturgeon, for instance, has recently announced a Commission to examine a replacement for council tax, with a local income tax suggested as a possible alternative (this has been an SNP ambition for a long time).[13] And, Jim Murphy, the new leader of the Scottish Labour Party, has said that he would re-introduce a 50% top rate of income tax in Scotland even if the rate remained at 45% in the UK to give Scotland a "more progressive system than the rest of the UK".[14]

However, significant responsibilities will remain in Westminster. Major taxes like National Insurance, fuel, tobacco, and alcohol duties, corporation tax, North Sea

[12] Data is available from the OECD here: http://www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm#A_1.

[13] For instance, the SNP asked the IFS to analyse plans for a local income tax in 2007. Our analysis is available at: http://www.ifs.org.uk/publications/3897.

[14] See, for instance, here: http://www.scotsman.com/news/politics/top-stories/jim-murphy-pledges-50p-tax-rate-for-wealthiest-1-3615212.

taxation, and policy over VAT rates and more than half of VAT revenue, will remain under Westminster's jurisdiction. Therefore more than half the taxes paid in Scotland will still flow to Westminster: much of this will, in effect, flow back to Scotland in its remaining block grant from the Treasury, with the rest helping to pay for areas of spending that remain the responsibility of the UK government.

Table 1 Taxes to be devolved under Smith Commission proposals, and their 2012–13 revenues

Tax	Revenues (£s billions)	Devolution proposed
Income tax	10.9	Over 90% of revenues devolved
National Insurance	8.5	No
VAT	8.3	Approx. half revenues assigned
North Sea taxes	5.6	No
Onshore corporation tax	2.9	No
Council tax[a]	2.4	Already devolved
Fuel duties	2.3	No
Non-domestic rates[a]	2.2	Already devolved
Alcohol and tobacco duties	1.6	No
Stamp duty land tax	0.3	Devolved under Scotland Act 2012
Air passenger duty	0.2	Yes
Stamp duty on shares	0.2	No
Landfill tax	0.1	Devolved under Scotland Act 2012
Aggregates levy	<0.1	Yes, subject to state aid rules
Other taxes	1.7	No
Memo		
Scottish Govt spending (inc proposed devolved benefits)[b]	36.8	n/a
Approximate tax revenues to be devolved[b,c]	19.4	n/a

Note: (a) These figures are adjusted to account for reliefs and subsidies – such as council tax benefit, which are netted off reported figures. (b) Excludes spending on public service pensions by the Scottish Pensions Agency, which is part of annually managed spending, and not funded via the Scottish block grant. Includes council tax revenues which are collected and set by local authorities, but ultimately under the control of the Scottish Government. (c) It is assumed that 93% of Income tax is devolved to Scotland, and £4.0 billion of VAT is devolved.
Source: Government Expenditure and Revenue Scotland 2012-13, HMRC disaggregated tax receipts (for VAT), and Scottish Draft Budget 2015–16.

This includes things like defence, foreign affairs, and debt interest payments on the national debt. But the largest area will be those parts of the benefit system that are not to be fully devolved, such as the state pension, pension credit, child benefit, and universal credit. In all, around 85% of benefit spending in Scotland (around £15 billion's worth, in total) will remain the responsibility of the UK government (although as discussed above, the Scottish government will have the power to vary the housing elements of universal credit and top up all non-devolved benefits if it wants to). The Smith Commission proposals therefore remain some way away from "devo max".

5. What questions remain unanswered?

Given that we have proposals for further devolution that have been agreed by the five main Scottish parties, it might seem that the most difficult decisions have been made. We know *what* is to be devolved – the UK and Scottish Government now have the more prosaic task of implementing these agreed changes. We certainly shouldn't under-estimate the achievement of having a set of proposals that all parties have agreed to – they started a long way apart. However, in many ways, the most difficult work lies ahead – getting the details of *how* the taxes and welfare are devolved will be crucial to whether the resulting system is seen as "fair", and provides the right responsibilities and incentives to the Scottish Government. In particular, how the block grant Scotland receives is adjusted to account for the fact the Scottish government will now be raising much more of its own revenues and be responsible for some areas of welfare spending is a key issue: past experience shows that there can be big effects if mistakes are made here.

Adjusting the block grant to account for further devolution

One of the principles underlying the Smith Commission's work was that "the package of powers agreed...should cause neither the UK Government nor the Scottish Government to gain or lose financially simply as a consequence of devolving a specific power". Therefore, the proposals recognise that when a tax is devolved to Scotland, and the Scottish Government gets to keep the revenues raised, a reduction must be made to the block grant Scotland currently receives. Similarly, if additional spending responsibilities are devolved, then Scotland should receive additional money to account for that.

Implementing this in year 1 is relatively easy. When a tax is devolved, the block grant should be reduced by the amount of revenue that is being transferred to Scotland. When further spending powers are devolved, the block grant should be increased by how much the UK would have spent on that area in Scotland.

More difficult is determining what should happen to these "block grant reductions" or "block grant additions" in subsequent years. You cannot just keep them the same because inflation and economic growth mean that the amount raised from a tax or spent on a particular area will typically tend to grow over time. The Smith Commission recognises this, by stating that these block grant reductions or additions should be "indexed appropriately". But what does this rather cryptic phrase mean? And how important is it to get this choice right?

In a recent Briefing Note we looked at the experience with a tax that has already been fully devolved to Scotland and Northern Ireland – business rates.[15] We found that the way the block grant reduction was indexed in that case (by making an adjustment to how the Barnett formula treats grants to local government in England) was flawed, and will result in Scotland receiving about £1 billion more in 2015–16 than it would had a 'correct' way of indexing the block grant been used since devolution instead. This shows that there can be significant financial implications from choosing *inappropriate* ways to index the block grant reductions or additions. So it is clearly important to get things right – but what would a more appropriate way of indexing be?

Unfortunately, the answer won't be the same for every area of tax or spending. That is one reason why there is a lot of work for policy-makers and analysts still to do.

But there is one option that looks to have many attractive features – a variant of which is already going to be used to index the block grant reduction that will be made when income tax is partially devolved in April 2016 under the 2012 Scotland Act. That is to index the block grant reduction to what happens to revenues from the equivalent tax in the rest of the UK. Doing this means that if revenues from the devolved tax grow faster than comparable revenues in the rest of the UK, then they also grow more than the block grant reduction: Scotland would therefore see its budget increase. Alternatively, if revenues grow less quickly than those in the rest of the UK, they grow less quickly than the block grant falls: hence, Scotland would see a cut to its budget.

Indexing block grant reductions in this way would see the Scottish government benefiting if its tax revenues come in more strongly than those in the rest of the UK, and suffering if they come in more weakly. But the UK government would bear the revenue risk associated with economic shocks that affect the whole of the UK – in line with the principles agreed by the Smith Commission. If, during a recession, revenues fell in the rest of the UK as well as in Scotland, the amount taken off the block grant to account for tax devolution would also fall: thus, a larger block grant would offset the fall in Scottish tax revenues. This way of indexing the block grant reduction therefore acts to smooth the Scottish Government's budget, which would mean less need to rely on borrowing to

[15] D. Phillips (2014), *'Business as usual? The Barnett formula, business rates and further tax devolution'*, IFS Briefing Note 155, available at: http://www.ifs.org.uk/publications/7442.

smooth the ups and downs of tax revenues. This might be attractive to both the Scottish Government – which might find it relatively difficult and expensive to borrow –, and the UK government – which might be wary of the risks of giving Scotland much wide-ranging borrowing powers.

This approach also provides incentives for the Scottish Government to improve economic performance – it benefits from the marginal additional revenue generated by faster economic growth. And it means the Scottish Government largely bears the revenue effects of its policies – if its policies cause a change in its tax revenues relative to comparable revenues in the rest of the UK, it gains or loses the marginal revenues involved. On the other hand, in conjunction with the Barnett formula, it means that the UK government would largely bear the costs of its policy decisions. This is an issue to which we return later.

Of course, revenues from devolved taxes, and spending on devolved areas of welfare, may evolve differently from comparable items in the rest of the UK for reasons completely unrelated to devolved government policy. For instance, in the years ahead, Scotland's population is forecast to grow less quickly and age more rapidly than that in the rest of the UK. This may lead to slower growth in tax revenues, higher growth in spending on some benefits (such as benefits for the elderly like Attendance Allowance) and lower growth in spending on other benefits (such as housing benefit). And the Scottish Government may not be able to do much about these demographic changes.

Whether it is deemed appropriate for the Scottish Government to bear these risks depends on judgements about the importance of redistribution and risk-sharing across the United Kingdom. But trying to insulate Scotland from such risks while still providing it with the right incentives is complicated: it involves isolating the effect of Scottish policy measures (which we would want the Scottish Government to bear) from other factors affecting devolved tax revenues and welfare spending. Any modelling exercise like this is controversial – particularly when tens or even hundreds of millions of pounds could be at stake. Things could be simplified by trying to identify only the first round revenue or spending effects: that is, ignoring the effects that changes in tax or welfare policy have on peoples' or companies' behaviour. But this would mean the Scottish government would no longer have the incentive to take account of these behavioural effects when making policy – because the UK government rather than the Scottish Government would pick up the tab for these 'second round' effects. This would clearly be undesirable and could lead to poor policy decisions.

Is it possible to compensate for knock-on effects of policy decisions?

Such a simplified approach would also be in conflict with one of the Smith Commission's key principles: that the Scottish Government should bear the *full* revenue or spending consequences of its policy decisions, and the UK Government of its decisions. In particular it says:

"Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments."

In principle this is sensible. In order to properly align incentives for policy making, each government should bear the full costs (or receive the full benefits) of its policy decisions. It also seems only fair to compensate (or penalise) the other government for 'knock on effects' of policy decisions. But implementing such a principle would be fraught with practical and political difficulties, which mean that such transfers will often not be feasible.

To see this consider an example. Suppose that the Scottish Government were to increase the top rate of income tax from 45% to 50%, and that as a result those affected reduced how much they worked. In this case, the amount of National Insurance they would pay would be reduced. Because National Insurance is not set to be devolved, the UK government would see a fall in its revenues. Applying the above principle, the Scottish Government would have to compensate the UK government for this loss of revenue. But how much? That would require an estimate of how much people reduced their earnings as a result of the policy – something which is very difficult to do, and inevitably controversial. But what if people responded to the 50% rate of tax not by reducing their earnings, but by moving to England. In that case the UK government would see an increase in income tax revenues from England. Would it therefore reimburse the Scottish Government? And if so, how would the additional English income tax revenues be calculated?

Similarly UK government decisions may affect Scottish revenues. Suppose the UK increased the standard rate of VAT, leading people to shift their spending from goods subject to the standard rate of VAT (say, hot take-away food) to goods not subject to VAT (say, cold take-away food). Scotland's 10 percentage points of assigned VAT revenues would therefore be lower. But calculating how much lower – and therefore how much compensation should be paid by the UK government – would again be difficult.

Nearly all policy decisions could have knock on effects on the revenues or spending of the other government. But calculating what these are is inherently difficult, with much room for disagreement over the methods and assumptions used. This means it is important to recognise that such compensating transfers will be practical only in a few simple cases – otherwise the system could quickly become unworkable.

Should the Scottish Government's budget always be unaffected by changes to taxes in the rest of the UK which have been devolved to Scotland?

The next proposal from the Smith Commission could also be problematic in some cases. It says:

"Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland."

It seems clear that, for instance if income tax were increased in the rest of the UK to fund additional spending on services in the rest of the UK, then there should be no knock-on effect to the Scottish budget: Scots are paying the same taxes as before so should see neither a rise nor fall in the amount spent on them. And vice versa, for when taxes are changed in Scotland. Indexing the block grant reductions or additions as suggested above, achieves this outcome: an increase in the block grant reduction (because of growth in income tax receipts in the rest of the UK, say), would be offset by additional money via the Barnett formula as a result of the increases in government spending in the rest of the UK.

But what if the UK government wanted to spend more money on defence or pensions, or needed to raise more revenues to reduce the amount it had to borrow. These are things that benefit the whole of the UK, including Scotland. One interpretation of the proposal is that the UK government will no longer be able to use an increase in income tax – one of the main taxes it levies – to fund such policies (because it could only be used to fund spending 'in the rest of the UK'). This seems a fairly important restriction on how the UK government can respond to economic shocks or trends that affect the whole of the UK – such as the recent financial crisis, or the long-term ageing of the population.

We have sought clarification on this point from the Treasury on this point, and have been assured that this was not the intention of the Smith Commission. Instead, the idea underlying the proposal was that when a UK government tax that is levied only outside Scotland (like income tax) is changed, that should not affect the total amount spent *for the benefit of people in Scotland* (including spending on things that benefit people across the UK as a whole, such as pensions or defence). But this means if the UK government did use income tax as part of its response to such UK-wide issues, the amount of money given to the Scottish Government via the block grant presumably ought to change. For instance, if taxpayers in the rest of the UK were paying more in income tax to spend more on defence, the amount transferred to the Scottish Government via its block grant would have to be reduced – otherwise the total amount spent *for the benefit of people in Scotland* would increase (because of the higher defence spending). It is important to realise that requiring that the amount spent "in Scotland" (or more correctly, "for the benefit of Scotland") be unaffected by changes in UK government taxes like income tax means that in some circumstances, the amount allocated to the Scottish Government *has to change.* Note that, again, indexing the block grant reductions (or additions) to comparable revenues (or spending) in the rest of the UK again achieves this.

Furthermore, in some circumstances, fairness would seem to require that the amount spent for the benefit of Scotland would have to change when the UK government changed income tax. Suppose that the UK government increased income tax to reduce the budget deficit. In that case it would seem only fair that Scottish taxpayers also contribute to deficit reduction – either through higher taxes or lower government spending. In the first instance, this would be achieved by reducing the block grant given the Scottish Government, which would then be able to decide whether to increase its own taxes to make up for the reduced block grant. Devolution of income tax powers to Scotland should give Scots more freedom of taxation and spending in future – but not the ability to avoid cuts or tax rises needed to pay for things, like deficit reduction, that benefit the whole of the UK.

6. Summary

The Smith Commission has given us a set of proposals for further tax and welfare devolution, agreed by the five main parties. This is a significant achievement (although the announcement of the devolution of corporation tax to Northern Ireland could yet undermine it). But, as we have shown, many difficult issues remain to be addressed – not least, how the block grant will be adjusted to account for the additional revenues and spending areas that will come under Holyrood's control. No system will be perfect in every dimension. There is an inherent trade-off between providing incentives to the Scottish Government, and the degree of risk-sharing between Scotland and the rest of the UK. And, it will be almost impossible to devise a system where the UK and Scottish governments compensate each other for the knock on effects of their policy decisions as the Smith Commission recommends. We must also ask how willing we are to constrain the UK government's freedom of action to make decisions that affect the whole UK as more powers are devolved to Scotland. It is vital the kind of mistakes that were made when business rates were devolved are not repeated now that much more taxation is set to be devolved to Scotland.