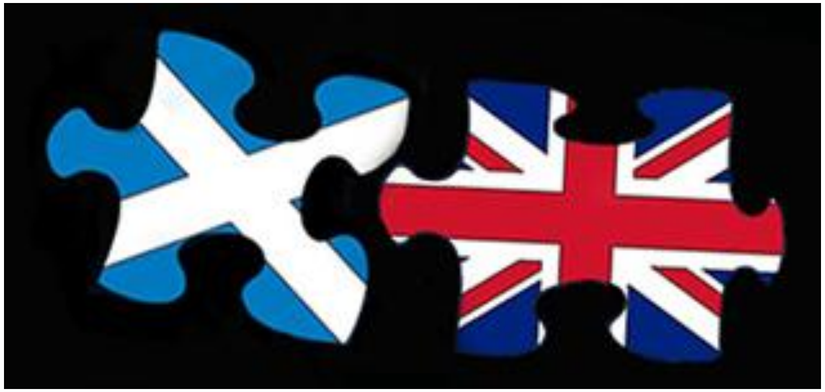
Institute for Fiscal Studies



Fiscal changes and challenges for the devolved governments

David Phillips

IPFIN conference, Cardiff, September 14th 2016

Introduction

- Biggest ‘structural’ change is tax devolution and associated changes to fiscal frameworks, block grants, etc
  - Last year I presented on the challenges of implementing the Smith Commission recommendations in Scotland
- Agreement on Scotland’s fiscal framework reached Feb 2016
  - What does it deliver?
- Fiscal frameworks now need to be agreed for Wales and NI
- Changes taking place against backdrop of continued budget cuts
  - New IFS/WPS2025 report on budgetary trade-offs in Wales
- And questions about what Brexit means for funding currently provided by the EU

Fiscal Change

Recap: devolution to Scotland

- 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 over discretionary payments and 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

Recap: the Smith Agreement's principles

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

Recap: Impossible to satisfy spirit of both

- Year 1 block grant adjustment (BGA) relatively easy to calculate
  - Subtract amount equal to tax being devolved
  - Add amount equal to welfare spending being devolved
- Need to index these BGAs in subsequent years
  - Many different ways to do this
- None satisfy the spirit of both ‘no detriment’ principles

Scottish Government's opening position

- Scottish Government wanted 'Indexed Per Capita' (IPC) method
- Each year BGA is updated according to:
  - % change in revenue/spending per capita for equivalent item in rUK
  - % change in population
- Scotland neither gains nor loses if its revenues/spending per capita grow at same % rate as in rest of UK
  - Protects Scotland from its lower revenues per capita
  - Protects Scotland from traditionally slower population growth
  - Still incentive to grow revenues / constrain spending per capita
- Seems to accord with principle of 'no detriment from the decision to devolve'

UK Govt argued this method would be unfair

- UK government said unfair as IPC method implies continued transfers of rUK revenue growth to Scotland
  - Needed to stop Scotland losing from lower revenues per capita and lower population growth
  - Potentially violates the other 'no detriment' principle
- UK government proposed the 'Levels Deduction' (LD) method that would prevent such revenue transfers
  - Scottish Government says No!
- UK government suggests compromise 'Comparable Model' (CM)
  - Accounted for lower revenues per capita but not lower pop. growth
  - Scottish Government says No!

The Agreement on BGA indexation

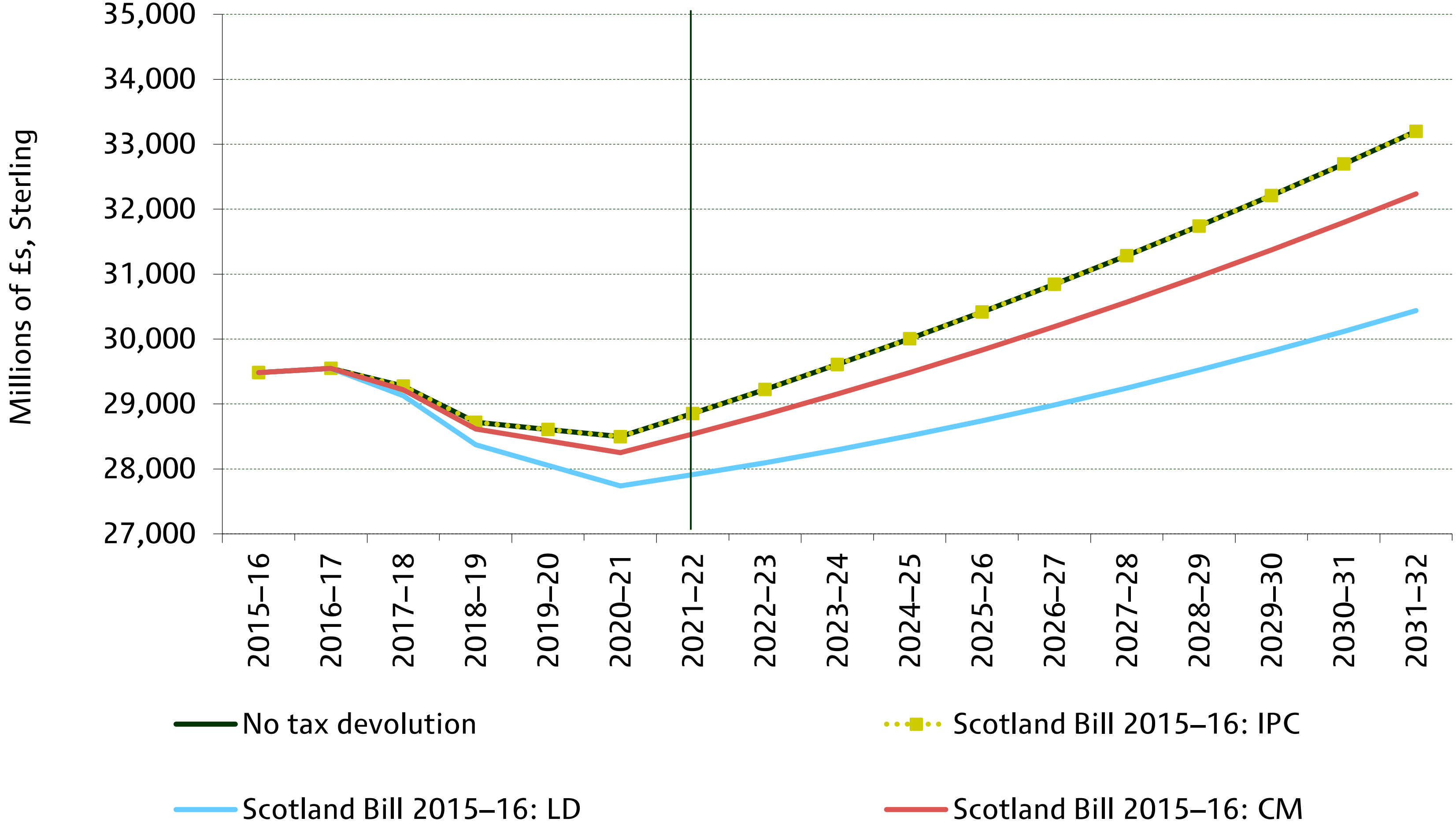
- Agreement says that for a transition period lasting 5 years that the indexation should be…

  "effected by…the Comparable Model…, whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method"

- At first glance this looks like a compromise:
  - Both the Scottish Govt's preferred and UK Govt's latest proposals are mentioned

- But using Comparable Model and then modifying the result to match the IPC method is ultimately the same as using the IPC method all along
  - Scottish Govt has got it's way – for the first 5 years

Impact of tax devolution if same per capita revenue growth…



Institute for Fiscal Studies

Implications of this approach to indexing BGA

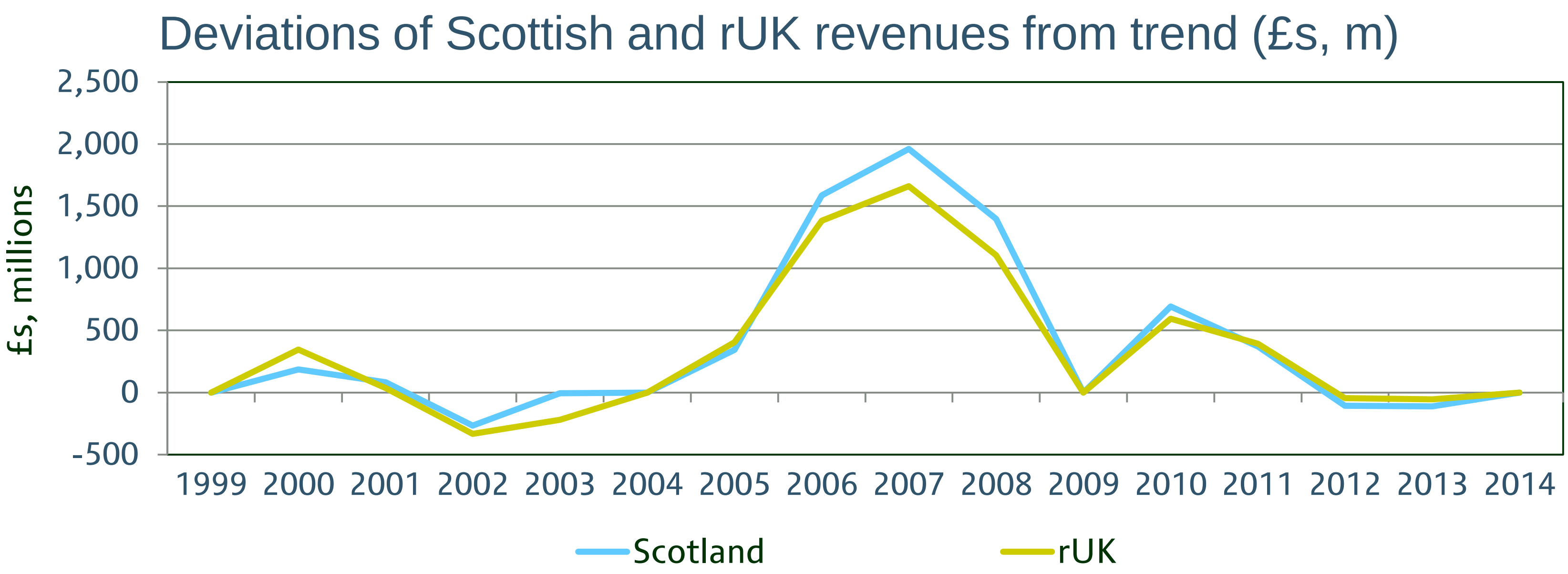
- Scotland is insulated from revenue/welfare spending shocks that affect it in same way as rest of UK
  - e.g. a global recession
- But Scotland bears 100% of risk at margin for faster/lower *relative* growth in revenues/spending per capita
  - Incentives to grow
  - But Scotland bears all risk of short or long-term divergence in revenue/welfare spending trends
- Combines 100% equalisation at point of devolution (to avoid detriment) and 0% equalisation if diverge/converge in future
  - Very unusual in international context

Other aspects of Scotland’s fiscal framework

- Only direct ‘first round’ knock on effects on other government’s budget to generate compensatory transfers
  - To be based on ‘shared understanding’ of effects
  - Behavioural ‘second round’ effects can be accounted for if ‘material and demonstrable’
- Borrowing limits to be increased a little
  - Total capital borrowing limit up from £2.2 to £3 billion (£450m a year)
  - Resource borrowing limit of £1.75 billion (£600m a year)

Resource borrowing limit look enough..

- Strong correlation between Scottish and rUK revenues mean BGA does most of work of insuring Scottish revenues



- But constraining rules (GDP growth <1% & >1% slower than UK)
- And need to index/update limits so continue to be enough

Institute for Fiscal Studies

Other aspects of Scotland’s fiscal framework

- Only direct ‘first round’ knock on effects on other government’s budget to generate compensatory transfers
  - To be based on ‘shared understanding’ of effects
  - Behavioural ‘second round’ effects can be accounted for if ‘material and demonstrable’
- Borrowing limits to be increased a little
  - Total capital borrowing limit up from £2.2 to £3 billion (£450m a year)
  - Resource borrowing limit of £1.75 billion (£600m a year)
- Independent Scottish Fiscal Commission to make economic and tax revenue forecasts
  - Scottish Government had wanted to make them and have them vetted by the Fiscal Commission

What about Wales? (I)

- Wales needs to agree BGAs for stamp duty land tax and landfill tax
  - And maybe 10 percentage points of income tax if devolved too
- Welsh revenues per capita and population growth (recently) even lower than in Scotland
  - Even more costly if UK government got its LD or CM models
- Welsh Governance centre showed Wales may struggle to generate same % growth in revenues per capita
  - Increasing income tax allowance relatively more costly
  - Lack of high value properties (concentrated in South East England)
- If true, Wales would lose from devolution under IPC method
  - Calculate and index BGAs for each tax band separately?
  - Exclude South East of England from BGA calculations?

Institute for Fiscal Studies

What about Wales? (II)

- More fundamentally, does Wales want to bear 100% of risk of convergence/divergence in devolved revenues?
  - Scottish Govt sees devolution as stepping stone to independence
  - Not the case for Welsh Govt
  - Look for a method with more risk-sharing?
- How much extra borrowing powers will Wales get?
  - £500m capital borrowing limit about pro-rata if income tax devolved
- Is it worth setting up independent Welsh Fiscal Commission?
  - At very least budget documents need to be much better at setting out revenues as well as spending

What about NI?

- Corporation tax to be devolved to NI
  - Plan to cut rates to 12.5%
  - Tax with a particularly mobile base so knock-on effects to rUK revenues seem particularly likely
- As a result UK government says BGA will include an estimate of how much corporate profits are shifted from rUK to NI
- Hugely complex and controversial set of calculations
  - Wide range of estimates of responsiveness of profits and investments to corporate tax rate differences
  - Different assumptions mean millions more or less for NI Executive
- NI DoF commissioned Ulster University and Fraser of Allander Institute (Strathclyde) to look at different options/assumptions

Fiscal devolution summary

- Scottish Fiscal Framework
  - Delivers Scottish Governments preferred BGA approach
  - But less borrowing and greater independence for Fiscal Commission than they wanted
- Not clear that same approach is right for Wales
  - Does Wales have political clout to negotiate a better deal?
- Devolution of corporation tax to NI particularly tricky to deal with
  - How ensure proper scrutiny of such complex issue as ‘elasticity of corporate profits and investment’?

Fiscal challenge

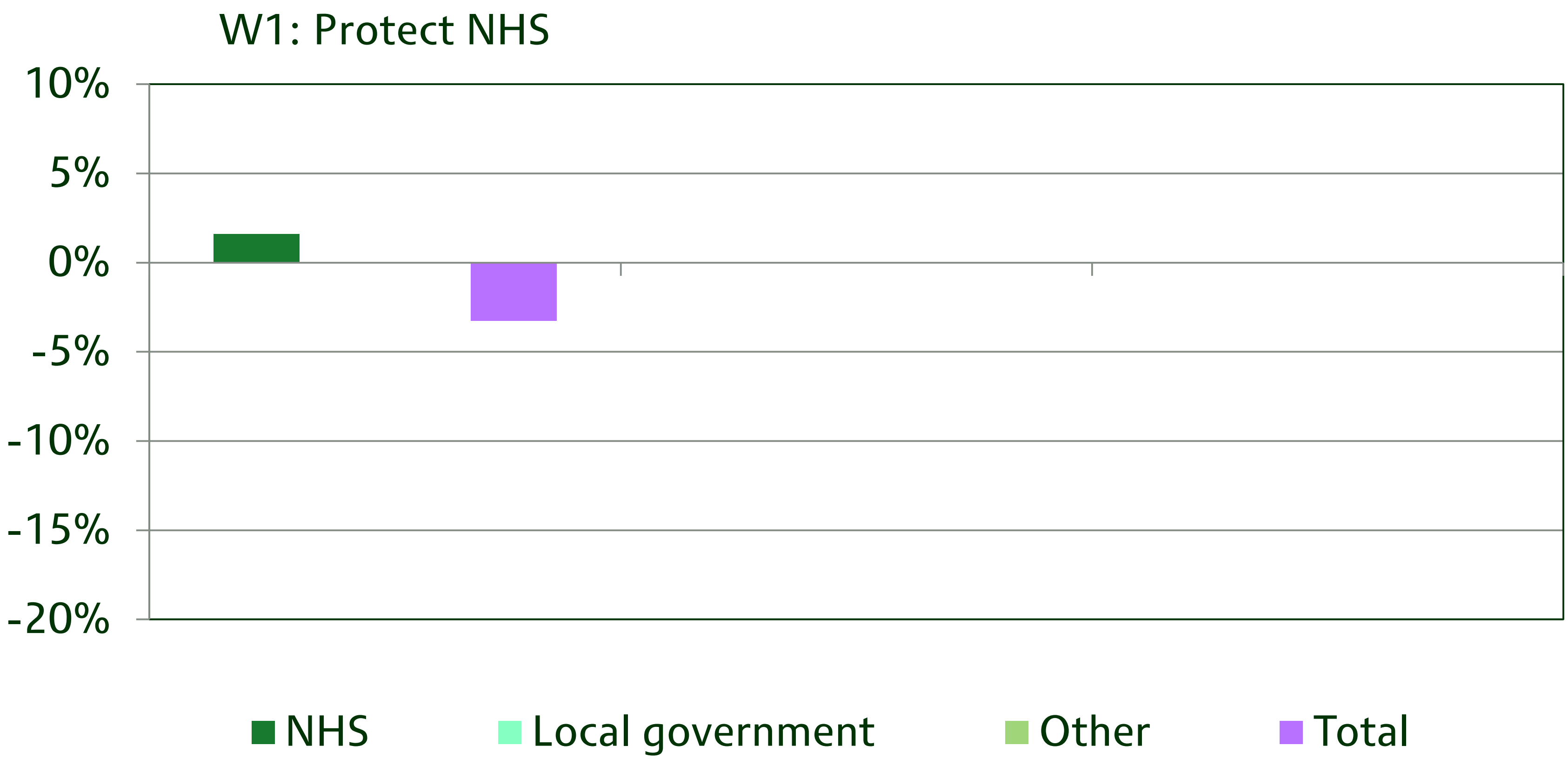
Our baseline projection for Welsh Govt’s budget

- Based on UK government’s March 2016 budget plans and forecast
  - And assumes £3.5 billion of planned but unallocated cuts go ahead
- Welsh budget would fall 3.2% in real terms by 2019-20
  - 0.3% in 2017-18, 1.4% in 2018-19 and 1.6% in 2019-20

Trade-offs when allocating across services

- Protecting core and central NHS budgets in same way as England would deliver 1.6% real-terms increase by 2019-20

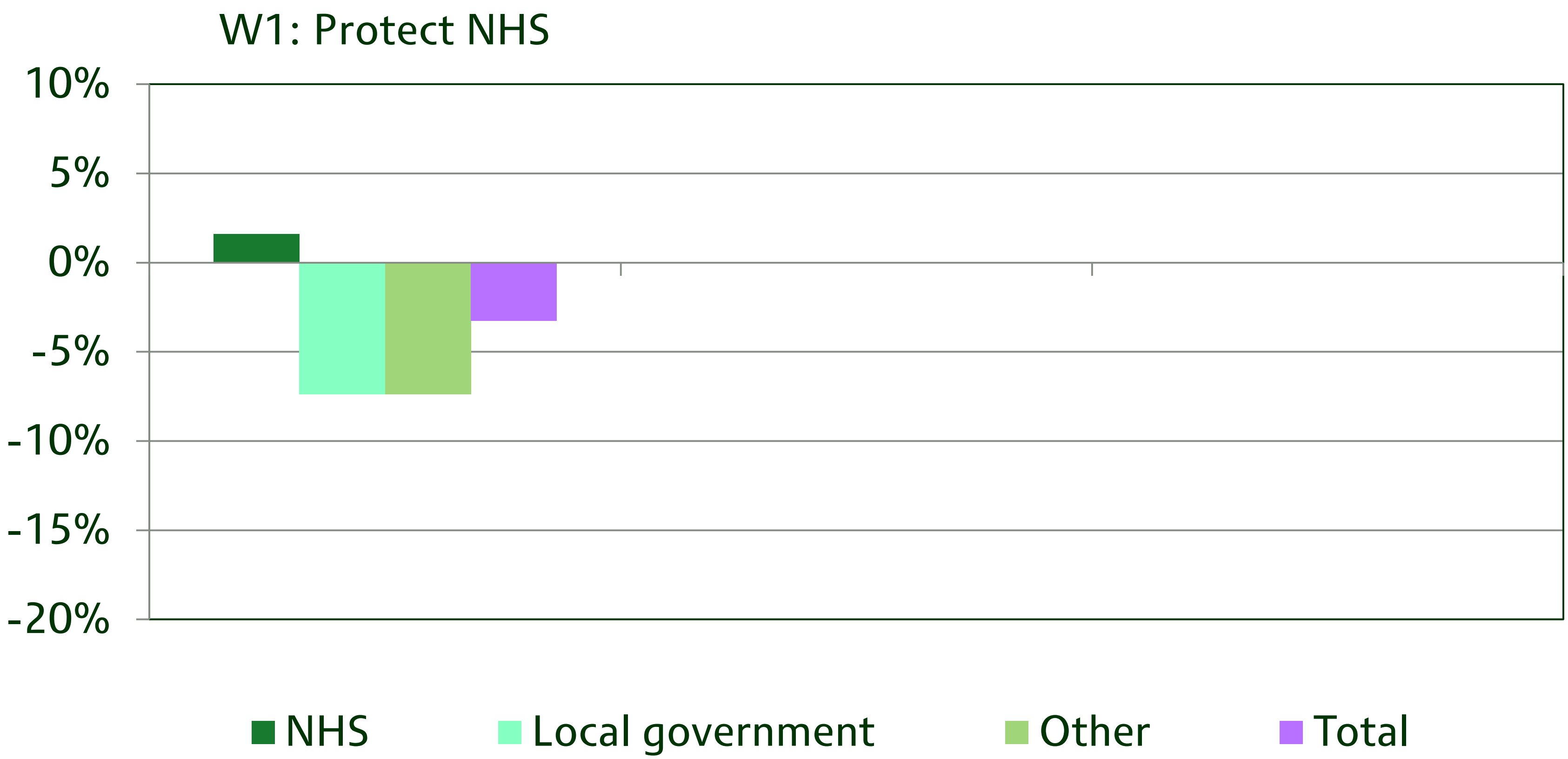
Real-terms change in budget, 2016-17 to 2019-20



Gwasanaethau Cyhoeddus Cymru Wales Public Services 2025

Institute for Fiscal Studies

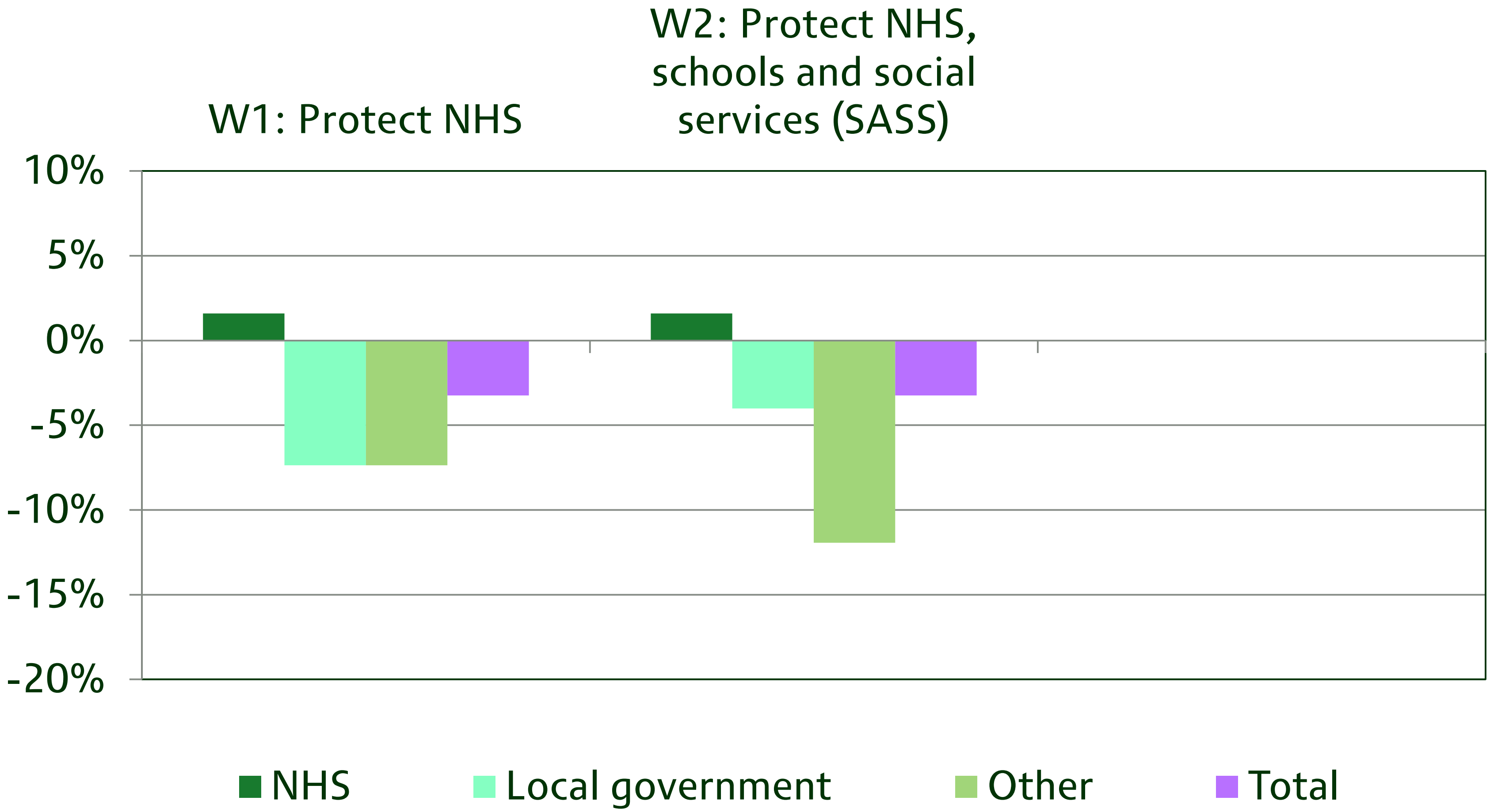
Real-terms change in budget, 2016-17 to 2019-20



Gwasanaethau Cyhoeddus Cymru
Wales Public Services 2025

Institute for Fiscal Studies

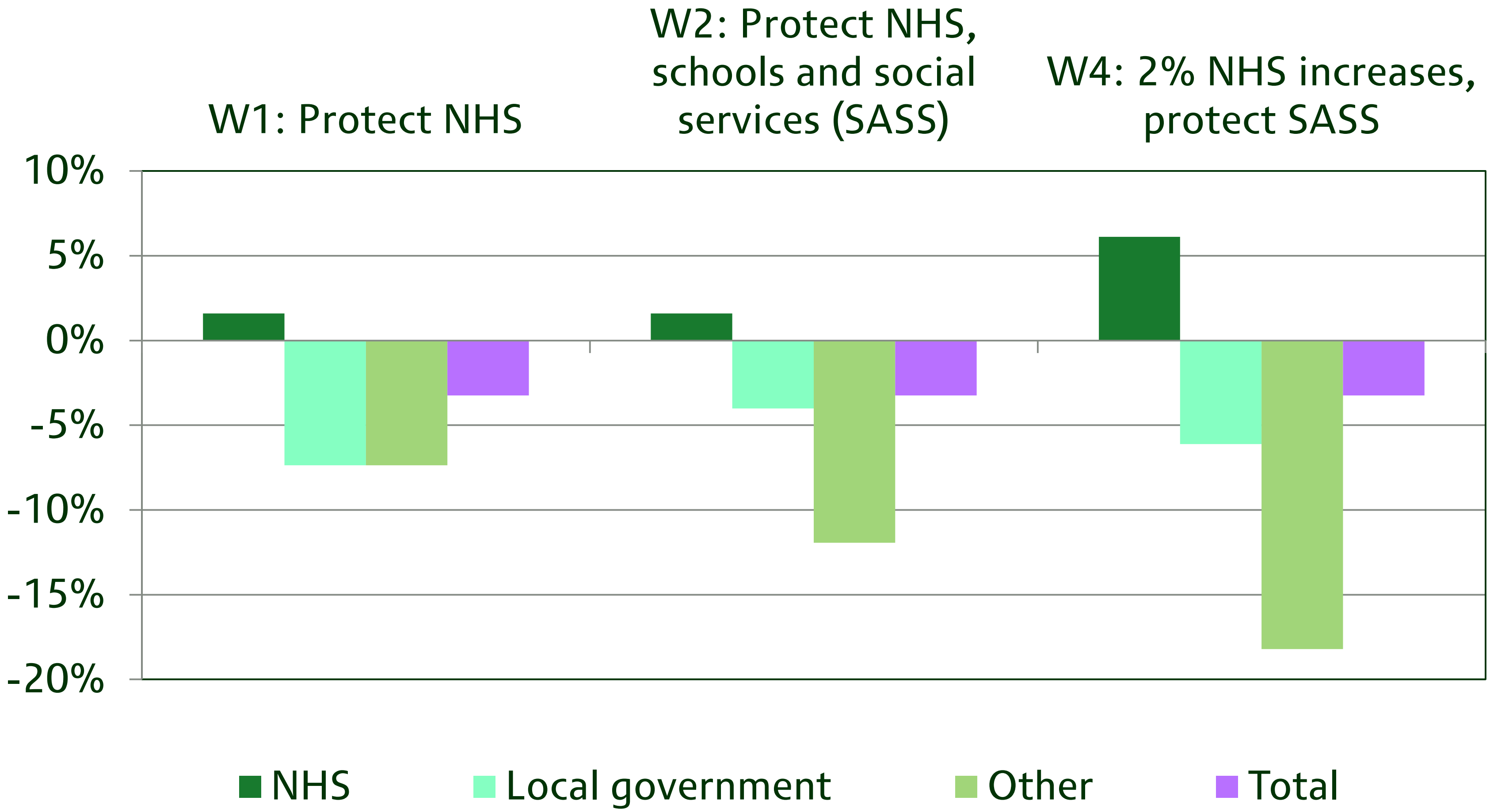
Real-terms change in budget, 2016-17 to 2019-20



Gwasanaethau Cyhoeddus Cymru 2025
Wales Public Services

Institute for Fiscal Studies

Real-terms change in budget, 2016-17 to 2019-20



Gwasanaethau Cyhoeddus Cymru 2025
Wales Public Services

Institute for Fiscal Studies

What about Brexit and the Welsh budget?

- Figures above based on inflation forecasts as of March 2016
  - *If* post-referendum fall in pound pushes up inflation, Wales would face bigger real-terms cuts unless Chancellor boosted spending
- If Chancellor pares back budget cuts in the short term, more money would be available over next 3 years
  - But even if Chancellor cancels all cuts, boosting NHS spending by 2% a year and protecting schools and social services would mean cuts of 8% to other areas over 3 years
  - And remember, Chancellor needs to cut eventually
- Wales receives over £500 million in EU funding a year
  - Farm payments guaranteed to 2020 but other projects not
  - If, after 2020, Wales had to find money for all EU schemes from own budget, overall cuts more than double to 6.9% (from 3.2%)

What about Welsh Taxes?

- The new Land Transactions Tax and Landfill Disposals Tax will be too small to be used to generate sizeable additional revenues
  - e.g. Revenues from landfill tax would need to increase 5-fold to generate amount equal to 1% of Welsh Govt spending
- If income tax were partially devolved, across-the-board 1p in the pound increase in rates could halve budget cuts faced
  - Although still tricky trade-offs
- Across-the-board 1p in the pound cuts in rates would increase cuts from 3.2% to 4.7% by 2019-20, making trade-offs trickier
  - Protecting NHS would require 10% cuts elsewhere (rather than 7.4%)
- Need to carefully consider knock-on effects to spending if vary income tax policy

Overall summary

- Fiscal devolution will bring additional budgetary risk
  - Flipside of the incentives and potential rewards it also delivers
- At the same time devolved governments will continue to face difficult budgetary trade-offs
- Brexit will have many different impacts on budgets
- Role of parliamentary financial scrutiny units never more important
  - Nor, the role of independent analysts