Economic perspectives

Assessing the financial impact of the Scotland Bill: problems of Scottish Government accounting

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The Scotland Bill contains proposals based on the Calman Report [1]to remedy the major financial weakness of the 1997 devolution settlement – namely its limited tax-raising powers[2]. (The new funding model will combine Block Grant with new tax revenues from a Scottish Income Tax, a Scottish Land Transaction Tax and a Scottish Landfill Tax. However, it has been heavily criticised by the Scottish Government for having a "long-term deflationary bias"[3] .

This is a strong attack on a model intended to maintain stability and promote accountability in devolution finance. The current approach is embedded in the UK fiscal framework, in which the UK Government has responsibility for the planning and control of the public finances, and resource allocation to UK Departments and Devolved Administrations. The Scottish Budget therefore benefits from

> "an automatic macroeconomic stabilisation level and a public expenditure per capita substantially above the UK average"[4].

The UK Budget process provides a high degree of stability. It operates through incremental change, in which the major part of the new budget is the existing baseline, and decisions are made around the margins of this budget base. In the case of the Scottish Budget, incremental adjustments are made through the Barnett Formula which delivers the same per capita increase/decrease as comparable UK programmes, and has delivered "stability and predictability" since devolution"[5].

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Vol.35 No.1, pp.42-45.

Fiscal reform

The Bill states that the new model will create a system which will allow the Scottish Parliament to determine how revenues are raised to supplement its existing responsibility to determine how budgets are spent, and be accountable for those choices. It creates a degree of risk over revenue receipts, but will have borrowing powers to manage this flow of resources As the majority of funding will still be provided by a Block Grant, stability and predictability will be maintained. These plans will operate within the UK fiscal framework which will allow the Treasury to retain aggregate control "consistent with the continuing reservation of overall macroeconomic policy"[6].

So the Scottish Budget will now have two revenue streams, from its "own revenues" and from a smaller Block Grant, calculated as at present, but reduced by the amount of anticipated revenues.

Initially, the tax revenues will be forecast and assigned to the Scottish Budget in a transparent way to show how much grant is being replaced by taxation, based on the current levels generated by 10p tax rate across all bands.

The full system is planned to be implemented by 2016. Firstly, the minor taxes will be introduced in 2015, with the new revenue borrowing powers of £200 million per annum, up to a £500 million limit, to manage any deficits from revenue shortfall, whilst surpluses can be retained in a new Scottish cash reserve for offsetting any deficits in future years.

In 2016, the main UK rates will be reduced by 10p for Scottish taxpayers, and the Scottish Parliament will set a replacement tax necessary to balance its Budget. There will then be a permanent reduction of Block Grant.

If there is an outturn deficit of less than 0.5%, the Parliament will be expected to absorb this in the Budget. Any borrowing can fund shortfalls for up to four years. Any shortfalls or surpluses arising from forecasting errors will be dealt with by transfers between the Scottish Budget and the UK Consolidated Fund.

The Scottish Government's response

In the Scottish Government's view, the new model will "generate greater volatility in future budgets" and result in "UK cuts by the back door", as they expect tax receipts to grow more slowly than the Block Grant, thereby reducing the Scottish Budget. Therefore

> "we estimate that these proposals would have cost Scotland £8 billion since 1999"[7].

Secondly, they claim it leaves Scotland exposed to the impact of changes to UK tax policy even though a detriment provision will prevent any loss of resources, which has been a key principle of devolution since 1999.

Thirdly, it regards the revenue borrowing powers as insufficient to manage revenue volatility. Overall, it sees the proposals as a "backward step" which "could make the spending and economic challenges Scotland faces more difficult".

This is a contentious interpretation of the financial impact of the Bill. The cumulative shortfall of £8 billion exaggerates the financial impact of the new system on the Budget. This Government uses this practice regularly in presenting spending plans and efficiency savings, or in forecasting future allocations.

More importantly, it is inappropriate when seeking to assess the financial impact of the new tax powers on the Scottish Budget. What matters is the stability of annual budgets and the capacity of the borrowing powers to cope with any volatility in the revenue stream.

The Scottish Government's estimate of the additive shortfall since devolution is £1.2 billion, or £109 million per annum on average. However, specific years can exceed this average and could be a concern. Fortunately, the Scottish Government's revenue estimates are significantly lower than the official estimates from HMRC.

The Finance Minister advised the Scottish Parliament (Official Report, 14/1/2011, col.157) that his Government's position had been strongly influenced by an academic paper by Professors Hughes-Hallet and Scott. This paper reports broadly similar conclusions, and the academics have since gone on record in The Scotsman of 14th January 2011 as supporting the Scottish Government's position, and that their cumulative shortfall assessment figures which they see as economically damaging (and indeed also use the term "deflationary bias"), is based on Scottish Government data[8].

The Scottish Government's estimate of the yield from a 10p tax rate is that on average, it is 15% of the Departmental Expenditure Limit. This is based on data in Government Expenditure and Revenues in Scotland, but GERS only provides an estimate of total yield. Their note does not illustrate how the 15% figure was reached, and also excludes revenues from the other taxes.

The official estimates, provided by HMRC, are much higher, at 17.25% over the same period, with a range from 14.6% to 20.2%. Table 1 compares the annual estimates of the Scottish Government with the official statistics on which the reforms will be based, and shows the official estimates are consistently higher, and add to a total of around £1 billion more than the Scottish Government's estimates between 1999 and 2007. This would result in a modest total shortfall of around £200 million, not £1.2 billion.

This suggests that the volatility will be much less than the Scottish Government assumed, but the range of scores from 14.6% to 20.2% is wide enough to create concerns over the degree of volatility in revenues and the intention to use an average figure for the permanent adjustment to the Block Grant.

This could be overcome, however, by continuing the practice of forecasting and assigning the tax revenues to the Scottish Budget as intended during the transition. The UK Government objective is to increase the Parliament's financial powers and to link the Scottish Budget more closely to Scottish tax revenues. It is not its purpose to change Scotland's share of UK funding, but to increase choice at the margins. With two funding streams, however, there could be changes to the Budget, compared with the Barnett model, in any year. Now the changes will depend on the tax decisions of the Parliament and the performance of the economy.

The Bill acknowledges that the new tax powers give the Parliament "an interest in the economy" (i.e. to increase its tax yield). In the Scottish Parliament, the major division was over the lack of economic levers to influence growth. The Bill Committee's report[9] reflects the conflicting evidence over the causal link between fiscal devolution and economic growth. The report quotes several economic experts expressing scepticism over the Scottish Government's economic arguments. These included views that economic growth is driven mainly by factors other than taxes and spending, and that the fiscal powers should lead to better governance, which might lead to improved growth later.

This is a combination of empirical and theoretical arguments. The evidence on fiscal causality has been examined extensively, but "better governance" is a slippery concept. The Committee draws on this substantive body of evidence to reject the case made by Scottish Minister's for full fiscal autonomy, on the grounds that "the overwhelming balance of expert opinion" did not find any causal link between fiscal devolution and growth (paragraph 36).

The Committee then appears to adopt a contradictory position over the grant reduction mechanism in that "it should not insulate the Scottish Budget from the performance of the Scottish economy, so that the Scottish Parliament has a direct financial stake in Scotland's economic success!" (paragraph 74).

Politicians may be unwilling to publicly acknowledge their inability to influence economic growth under the devolution settlement. It is certainly the case that growth was heavily influenced by the growth of public spending between 1999 and 2005[10], but that simply reflects UK budgetary strategy.

The problem remains that the new model could result in a smaller Budget even if the Scottish Parliament simply maintained tax revenues as they are at present. This would blur the clear lines of accountability for tax decisions.

Implementation can be achieved without the need for a permanent adjustment to the Block Grant, thus maintaining stability. For the initial period, the intention is to deduct forecast revenues from the Block Grant total to provide a required level of grant, adjusted for any variation in tax levels, the tax revenues will then be assigned to the Scottish Budget.

This model could simply continue, removing the need for a permanent adjustment of the Block Grant based on average revenues as a proportion of the DEL. This would also remove the need for borrowing powers, the Block Grant will continue to be set by Barnett, minus the forecast revenues, and there would be no shortfall/surpluses on the Budget because of volatility in revenues.

Put more simply, the Scottish Budget would continue to have a full Barnett-based spending assessment, funded by assigned tax revenues and a reduced Block Grant. This would remove the volatility problem, and maintain our relative position in UK allocations, and only vary when tax decisions are taken to do so.

This approach would better meet the UK Government's objective "to ensure that the relative levels of public expenditure remain constant"[11]. The Scottish Budget's share of UK funding would remain stable, with any budget variations reflected in higher or lower taxes on Scottish taxpayers.

Conclusions

The Scotland Bill will increase the financial accountability of the Scottish Parliament by requiring tax levels to be set annually to balance the Scottish Budget, and to vary the Budget according to its political preferences by increasing or decreasing spending and taxation at the margins. The Scottish Budget will remain within the UK fiscal framework.

Whilst the new funding mechanism will create a degree of volatility in tax revenues, this will not result in the deflationary bias as suggested by the Scottish Government. Their estimating errors and practice of cumulative accounting greatly exaggerate the financial impact of the Bill on the Scottish Budget.

The degree of volatility is much less, and can be dealt with within the UK fiscal framework by maintaining the practice of forecasting and assigning revenues to the Scottish Budget, whilst reducing the Block Grant accordingly from the conventional Barnett spending assessment. This would remove the need for a permanent adjustment to the Block Grant, and for revenue borrowing powers. This would meet the Calman principles of autonomy, accountability and equity within the principles of the Union and Treasury management of the public finances.

This would operate in the same way as the grant system in local government. Barnett would continue to determine Scotland's appropriate share of the UK Budget. That figure would then be adjusted to reflect the tax yield set in Edinburgh. A reduction from 10p would reduce the allocation, whilst an increase above 10p would increase spending.

The Scottish tax decision would determine the total budget available, whilst Barnett would retain our relative position and provide funding stability. Accountability would therefore be increased and the constitutional objectives met.

Table 1: Comparative estimates of 10p tax yield in Scotland Bill

Year	Scottish Government £million	HMRC £million
1999-2000	2651	2600
2000-1	2898	2980
2001-2	3018	3130
2002-3	3098	3210
2003-4	3207	3310
2004-5	3427	3510
2005-6	3746	3930
2006-7	4073	4260
2007-8	4394	4570
Total	30572	31560

Footnotes

[1]Commission on Scottish Devolution (2009) Final Report – Serving Scotland Better, Edinburgh.

[2]Arthur Midwinter and Murray McVicar (1996) "Uncharted Waters? Problems of Financing Labour's Scottish Parliament", Public Money and Management, Vol.16, No.2, pp.47-53.

[3]Scottish Government (2010) Scotland Bill Financial Provisions, Edinburgh, November.

[4]Brian Ashcroft, Alex Christie and Kim Swales (2006) "Fiscal Autonomy for Scotland – A Rejoinder", FAI Quarterly Economic Commentary, October, Vol.31, No.2, pp.54-56.

[5]Commission on Scottish Devolution (2008) First Report. The Future of Scottish Devolution within the Union, Edinburgh, p.59, para. 6.15.

[6] Strengthening Scotland’s Future, CM7973, Chapter Two, page 22 (London: HMG).

[7] Scottish Government (2010) Scotland Bill, Financial Provisions, p.1.

[8] A. Hughes-Hallet and D. Scott (2010) Scotland: A New Fiscal Settlement, CDMA 10/09, working paper series.

[9] Scotland Bill Committee (2011) 1st Report 2011 (Session 3) Report on the Scotland Bill and relevant legislative consent memoranda.

[10] Experian (2006) “Economic Impact of the Scottish Budget”, report for Scottish Parliament Finance Committee, October.

[11] UK Government (2011) “Modelling the potential impact of the Scotland Bill Income Tax Measures on the Scottish Budget”. A technical note prepared for the Scotland Bill Committee.