Will the benefits of fiscal devolution outweigh the costs?

Considering Scotland's new fiscal framework

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Abstract. An extensive programme of fiscal devolution to the Scottish Parliament is underway. Fiscal devolution is expected to bring a number of benefits, including the ability to align policy more closely to preferences, and enhancing the accountability of the devolved parliament. But it can entail costs in the form of diseconomies of scale, complexity for taxpayers, and various inequities and inefficiencies. This paper reviews Scotland's new devolved fiscal settlement and considers the extent to which it is realising the benefits that were intended, and how these compare to the costs and risks.

Key words: fiscal federalism; devolution; Scotland

JEL codes: H71, H72, H77, R50

Introduction

A long-standing literature seeks to understand the conditions under which fiscal decentralisation might yield an 'economic dividend'. This literature hypothesises that fiscal decentralisation (encompassing spending competencies and revenue raising powers) might yield a dividend through several channels – including a better alignment of public services provision to individual preferences, and more accountable and representative systems of governance that are more conducive to policy innovations (Oates, 1999).

But the literature recognises that fiscal decentralisation can also entail costs. These may include diseconomies of scale in administering separate tax and benefit systems, additional complexity and cost for taxpayers and employers, particularly where the devolved system is shared or partly integrated with the reserved system, and a range of inefficiencies through inter-jurisdictional competition and agency problems (Rodriguez-Pose and Gill, 2005). The balance between the costs and benefits of decentralisation depends on factors including the nature and scope of the fiscal competencies that are decentralised, and the design of supporting institutional arrangements (including mechanisms for grant allocation and budget management).

An extensive programme of fiscal devolution[i] to the Scottish Parliament is underway. Over the course of a few years, the proportion of the Scottish Government's budget raised from devolved and assigned revenues will increase from 11% to 49%. The Scottish Government will gain control over a major redistributive tax (income tax), and take over responsibility for designing and administering eleven social security benefits affecting over one-fifth of the population. A new fiscal framework is in place, which sets out how the Scottish block grant will be determined following tax devolution, forecasting responsibilities, and the extent of budget management tools such as borrowing.

This paper assesses the extent to which the current programme of fiscal devolution might yield an economic dividend, based on how aspects of Scotland's new devolved settlement compares to the theoretical literature, and what has been learnt during the initial years of the operation of Scotland's new fiscal framework. It is primarily an *ex ante* assessment of a programme that will be implemented over the period to 2024/25 and possibly beyond (devolution is famously a process rather than an event).

The framework for undertaking this assessment is the literature on fiscal federalism. As a strand of public economics, fiscal federalism seeks to understand the conditions under which particular spending competencies and revenue raising powers are most appropriately administered centrally, and which are most appropriately administered by a decentralised tier of government (Oates, 1999). This literature also considers how the design of supporting fiscal institutions (including the allocation of grant to, and the design of fiscal rules for, subnational governments) can help maximise the benefits from decentralisation.

Despite its name, the literature on fiscal federalism is not predicated on a particular form of government, a specific type of fiscal decentralisation, a given level of fiscal autonomy, or a particular degree of factor mobility between jurisdictions. Instead it provides a set of principles that can be applied to all countries (federal, confederal, unitary) attempting some form of fiscal decentralisation (King, 1984).

Of course, it could be argued that the fiscal federalism literature was not developed with the UK's specific form of fiscal devolution in mind. Fiscal devolution is normally characterised as a particular type of fiscal decentralisation, specifically one where there is a transfer of powers to an independent and often directly elected subnational government (Prud'homme, 1994), often in response to a demand for greater autonomy. Fiscal devolution in the UK is characterised by asymmetry (the responsibilities of the devolved legislatures in Scotland, Wales and Northern Ireland are somewhat different from one another, and there has been no comparable devolution for England or the English regions), and, until recently, a substantial mismatch between the spending and revenue raising responsibilities of the devolved institutions.

Nonetheless, the fiscal federalism literature provides a useful and insightful framework with which to consider the design of Scotland's new fiscal settlement and the ways in which it might evolve in future – as it has in previous studies (Pike et al. 2012; McGregor & Swales, 2005).

Although it considers the costs and benefits of fiscal devolution in the context of recent Scottish experience, the paper has implications for devolution in other contexts. Most directly, there are likely to be parallels with devolution to Wales (where income tax is being partially devolved under a similar framework to Scotland) and to Northern Ireland (where

there are plans to devolve Corporation Tax revenues (Birnie and Brownlow, 2017; Budd 2016).

Fiscal federalism and the costs and benefits of fiscal decentralisation

An early strand of literature (belonging to so-called 'first generation' theories of fiscal federalism) highlighted the scope for decentralisation to allow policies to be tailored to jurisdictions' heterogeneously distinct preferences and conditions (Oates, 1972; Tiebout, 1956). But it also emphasised that decentralisation might entail costs in the form of spillovers – underprovision of particular public services by one jurisdiction if those potentially benefitted residents of neighbouring jurisdictions.

First generation theories of fiscal federalism tended to conclude that there was often a case for decentralising provision of local public goods and property taxation, but that central government should play the key role in taxation, redistribution and macroeconomic stability, given the constraints faced by local governments in exercising these functions (namely the open nature of local economies and scope for factor mobility).

A subsequent strand of literature (known as the second generation fiscal federalism literature) examines the workings of different political and fiscal institutions in a setting of imperfect information and control, with a focus on the incentives that these institutions embody and the resulting behaviour they induce (Oates, 2005).

This literature produced a number of different insights about the allocation of fiscal functions to different tiers of government. First, it argued that the case for decentralisation rests not only on differences in preferences, but also on the potential for enhanced local control and 'accountability' under decentralised provision, where accountability is taken to mean the extent to which political agents can be associated with outcomes (Tommassi and Weinschelbaum 2007; Seabright 1996).

Second, whilst recognising that it is easier to identify spending than tax functions that are appropriate for decentralisation, second generation fiscal federalism theory places a heavy emphasis on the idea that decentralised budgets should be determined as much as possible by own source revenues, in order to enhance the responsibility of subnational politicians for the size of their budgets, and hence to enhance their accountability for spending decisions at the margin.

Second generation theories of fiscal federalism have also argued that the design of institutions matters (Oates, 1999). Intergovernmental grants play an important role in closing vertical fiscal imbalances and ensuring horizontal (between region) equity – but can interfere with subnational jurisdictions' incentives to pursue efficient policy and to protect themselves from economic shocks. Borrowing powers provide an important tool to smooth spending over time or in the face of revenue volatility, but might be used inefficiently if subnational governments perceive them as a soft budget constraint (i.e. if they think there is a possibility of bailout by the central government).

Taken together, the fiscal federalism literature argues that decentralisation can yield an economic dividend through several channels, namely through a more effective tailoring of policies to preferences and circumstances, enhanced accountability of local politicians, and more general by encouraging policy innovation (sometimes referred to as 'laboratory federalism').

But fiscal decentralisation can also entail costs. Rodriguez-Pose and Gill (2005) identify three broad categories of costs: inefficiencies in public good provision (stemming either from 'agency problems' if subnational governments do not face hard budget constraints, or 'spillover effects' such as counter-productive race to the bottom on tax rates); issues of spatial equality (where territories have differing economic or fiscal capacities, devolution may increase inter-jurisdictional inequalities in public good provision – and this may be exacerbated if the strongest jurisdictions are able to influence central policy-making); and institutional burdens (which can potentially include diseconomies of scale in service provision or a loss of coherence or cohesion in policy, particularly where powers are shared across different levels of government).

Much of the fiscal federalism literature was developed in the context of local government, but the framework is applicable to economically and geographically larger, and potentially quasi-autonomous, subnational governments. At a broader subnational level, the case for decentralisation (and which functions are decentralised) is similarly influenced by the extent of preference heterogeneity, economic mobility between regions, and economies of scale in public good provisions (Alesina and Spolaore, 1997).

Given the potential for devolution to impose costs, it has been widely recognised that the economic dividend of devolution is not a given (Hamlin, 1991). Instead, the extent to which devolution might generate an economic dividend, and the extent to which it is associated with costs, is a function of institutional choices, political processes, and historical and cultural factors.

However, the literature says relatively little specific about how institutions should be designed to maximise the benefits of devolution, instead framing institutional choices as a series of trade-offs.

For example, theory has emphasised the appropriateness of decentralisation of local good provision, whilst arguing that powers over redistributive taxation of mobile economic units should be a matter for central government. But it is easier to identify spending functions that are appropriate for local control than it is to identify taxation functions. The resulting imbalance between the spending and revenue responsibilities of subnational government conflicts with the view that decentralised budgets should be determined as much as possible by own source revenues to avoid agency problems and enhance the accountability of subnational politicians. A trade-off thus emerges between, on the one hand, a desire to assign spending and taxation levers to appropriate levels of government, and on the other hand, the objective that sub-national governments should fund themselves through own sources of revenue as far as possible.

Trade-offs emerge too in the design of intergovernmental grant mechanisms. Grants play an important role in relation to horizontal equity, redistributing between poorer and richer subnational governments, and in providing an insurance function to subnational governments against the risk of economic shocks. However, the provision of these redistributive and insurance functions may create moral hazard problems, disincentivising subnational authorities from providing outputs or programmes which improve the economy's capacity to grow or respond to exogenous shocks.

To conclude, fiscal devolution is recognised to have a number of potential merits, but only if the broader fiscal institutions have been appropriately designed. The challenge is thus to design fiscal institutions capable of realising the benefits of decentralisation while avoiding the potentially negative effects. Rather than necessarily providing specific answers however,

the literature serves largely to highlight the trade-offs that exist in determining options for fiscal decentralisation.

Fiscal devolution in Scotland

When the Scottish Parliament was established in 1999 it had substantial spending responsibilities but limited responsibility for revenue raising (i.e. taxation). On spending, the parliament has substantial responsibilities in relation to health, education, justice and policing, economic development, the environment, and culture and sport. On tax however, only two relatively small property taxes were determined in Scotland – the Council Tax (a tax on domestic property) and Non-Domestic Rates, a tax on business property.

Revenues from these two taxes amounted to around 10 per cent of the Scottish Parliament's spending budget, with the remainder of the budget provided by the block grant from the UK Government (Scottish Government, 2018).

The Calman Commission report, published in 2009, argued that this imbalance between spending responsibility and revenue raising responsibility was problematic. It noted '*Funding by block grant alone means that while the Scottish Parliament is completely accountable for the spending of its budget, it is not accountable for the total of that budget or how it is raised; it has no fiscal powers that can be used as policy instruments and it does not have a direct financial stake in the performance of the Scottish economy'* (Commission on Scottish Devolution, 2009, para 3.87).

The findings of the Calman Commission were thus broadly aligned with the conclusions from the literature on the economics of decentralisation, which argue that spending and tax responsibilities should be aligned as far as possible if the benefits of decentralisation are to be realised. The Calman Commission recommended that this imbalance should be addressed through the partial devolution of income tax to the Scottish Parliament, alongside devolution of stamp duty land tax (a tax on property transactions) and landfill tax (a tax on waste sent to landfill), (Bell and Eiser, 2014). These recommendations were passed into legislation through the Scotland Act 2012.

Meanwhile, the election to the Scottish Parliament of a majority Scottish National Party (SNP) administration in 2011 paved the way for a referendum on Scottish independence to take place in September 2014.

In the final days of the referendum campaign, the leaders of the three main UK unionist parties made a high profile 'vow' to devolve further powers to the Scottish Parliament following the referendum, if Scotland voted to remain in the UK. Following the remain-vote at the referendum, a cross-party commission (the Smith Commission) was established to agree which new fiscal powers should be devolved to the Scottish Parliament, in order to fulfil the 'vow'.

The Smith Commission recommended that:

- Non Savings, Non-Dividend (NSND) income tax revenues should be transferred to the Scottish Parliament. NSND income tax revenues account for around 92% of all income tax revenues raised in Scotland. The Commission recommended that the Scottish Parliament be able to vary income tax rates and bands in Scotland without constraint. But the UK Government will retain authority to determine the income tax base. This means that the setting of the tax-free Personal Allowance, and the way in which the pensions tax relief is defined for example, are determined by the UK Government.
- Air Passenger Duty (APD), a tax on passengers on flights from Scotland, should be devolved in full.
- A share of Value Added Tax (VAT) collected in Scotland should be assigned to the Scottish Parliament. Specifically, the first ten pence of Standard Rate VAT and the first 2.5 pence of reduced rate VAT to be assigned to the Scottish Parliament. Given that the Standard and Reduced rates of VAT are currently 20% and 5% respectively, this means that under current policy, half the VAT revenues raised in Scotland will be assigned to the Scottish budget.
- Aggregates Levy, a tax on the extraction of aggregates, should be devolved in full.

The Smith Commission argued that these new fiscal powers would '*strengthen the Scottish Parliament's ability to pursue its own vision, goals and objectives*' and make the Scottish

Parliament '*more accountable and responsible for the effects of its policy decisions and their resulting benefits or costs*', ultimately making the parliament '*more responsive, durable and stable*' (Smith Commission, 2014). The Smith Commission's recommendations were enacted through the Scotland Act 2016. The Smith Commission's recommendations again draw implicitly on the notion that devolution can yield a dividend by tightening the link between policy decisions and outcomes. However the UK Government's support of the Smith Commission and its findings is clearly also underpinned by an expectation that devolution may help assuage demands for independence.

The Scottish Parliament's new tax powers are being implemented on a staged basis (Table 1).

TABLE 1 HERE

In addition to tax devolution, the Smith Commission recommended devolution of a number of social security benefits. Eleven UK-administered benefits, mainly related to ill-health, disability and care for the elderly are being devolved to the Scottish Parliament. Spending on these benefits in Scotland by the UK Government in 2017/8 totalled around £2.9bn and covered over one million claimants (Scottish Government, 2018). The social security benefits are being devolved on a phased basis over the period to 2024/25. Additionally, the Scottish Government now has the ability to 'top-up' benefits that are controlled by the UK Government, and make some (minor changes) to the way in which Universal Credit, the UK's main working-age benefit, is paid.

Once the programme of fiscal devolution is complete, the value of devolved and assigned revenues will be around £23bn, of which £5bn is accounted for by the assigned VAT. To put this in some context, Scottish on-shore GDP in 2017/18 was £156bn, whilst the total spending of the Scottish Government and devolved institutions in Scotland was around £42bn and will rise to around £45bn once the social security powers are transferred. Devolved revenues (over which the Scottish Government can vary rates and bands) will account for around 37% of Scottish Government spending (Scottish Government, 2018). Devolved and assigned revenues (i.e. including assigned VAT) will account for 48% of Scottish Government spending.

How would the Smith Commission proposals be viewed within the context of the literature on the economics of decentralisation? This literature provides few categorical conclusions around which taxes should be devolved to a sub-national government. The decision to devolve income tax to the Scottish Parliament might be seen as surprising given its key redistributive role and the mobility of the income tax base across UK regions. But this decision must be seen in the context of the fact that few taxes meet all the criteria for devolution (Bahl and Cyan, 2011), and income tax does have the virtues of being visible to the electorate and a reasonably stable source of revenue. The social security levers being devolved are closely linked to existing devolved functions in health and social care, and do not include benefits that are either very cyclically sensitive or that are particularly effective for redistributive purposes. From this perspective the fiscal powers that have been devolved to Scotland reflect the types of tradeoffs that are highlighted by the literature. They also accord with the proposals for fiscal devolution that had been put forward by the various political parties in Scotland in the lead-up to the 2014 Referendum (Bell and Eiser, 2014).

A substantial infrastructure is being established to support the proposed fiscal devolution. A new Scottish tax agency, Revenue Scotland, has been established to collect revenues for the fully devolved Scottish taxes (LBTT, Scottish Landfill Tax, Aggregates Levy, and Air Departure Tax). (Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC, the UK tax collection agency.) A forecasting organisation, the Scottish Fiscal Commission, has been established to forecast the revenues and expenditure associated with the new powers. And a new Scottish Social Security Agency, Social Security Scotland, has been established to administer the devolved Scottish benefits.

The transfer of tax revenues to the Scottish budget has also entailed significant changes to the way in which the Scottish block grant from Westminster is calculated which were set out in the Fiscal Framework agreed by the UK and Scottish Governments (HM Treasury, 2016).

Since the parliament was established in 1999, the Scottish Government's budget from Westminster has been determined by the Barnett Formula[ii]. The Barnett Formula determines the change in the Scottish block grant by allocating to Scotland a population share of changes in comparable spending by the UK Government in England, and this change is added to the block grant of the previous year.

Perversities in how the formula treats relative population change, and the high starting baseline to which subsequent changes are applied, means that the Barnett Formula is recognised as providing Scotland with a generous per capita allocation, relative to its likely spending need (McLean and MacMillan, 2005; Christie and Swales, 2010; King and Eiser, 2017). This generosity means that the Barnett Formula takes on totemic importance in any debate about Scotland's constitutional future, and has the potential to constrain fiscal devolution even when the theoretical case for doing so may be strong. During the Independence Referendum, the UK Government vowed to retain the Barnett Formula if Scotland voted to remain in the UK.

The UK and Scottish Governments therefore had to agree on a way of adjusting the Barnett-determined block grant to take account of the transfer of revenues. The basic problem was to agree on how to make a deduction from the block grant each year which would reflect the revenues foregone by the UK Government as a result of transferring a given revenue stream to Scotland – whilst simultaneously enabling the Scottish Government to capture the revenue effects of any policy decisions it might make.

The process ultimately agreed for adjusting the block grant is set out in detail in the Fiscal Framework (HM Treasury, 2016), and its implications are discussed in detail in Bell et al. (2016) and Eiser (2017). A so-called block grant adjustment (BGA) is calculated for each tax separately, and consists of two elements: an initial deduction and an indexation mechanism.

The initial deduction is simply equal to the tax revenues collected in Scotland in the year immediately prior to the devolution of the tax power. For example, if income tax is devolved in 2017-18, the initial deduction is equal to income tax receipts in Scotland in 2016-17.

The indexation mechanism provides a measure of the rate at which 'comparable revenues' have grown in rUK between the date of the initial deduction and any subsequent year. The BGA thus provides an estimate of a counterfactual: what level of tax revenue would have been raised in Scotland in any given year, had tax policy been the same in Scotland as in rUK, and had the tax base grown at the same rate in Scotland as in rUK over the period since the tax was devolved?

After protracted negotiations (Bell et al. 2016), the Scottish and UK Governments agreed to index the BGA according to the growth rate of comparable revenues per capita in rUK. Specifically:

$$BGA_t = BGA_{t-1} \cdot \left(\frac{Pop_t^{Sco} / Pop_{t-1}^{Sco}}{Pop_t^{rUK} / Pop_{t-1}^{rUK}} \right) \cdot \quad (TR_t^{rUK} / TR_{t-1}^{rUK})$$

The BGA in time period t is equal to the BGA in the previous time period, multiplied by the growth in tax revenues (TR) in rUK and a factor that accounts for the growth of rUK population relative to the growth of Scottish population.

To illustrate what this means in practice, consider the following example. If income tax is to be devolved in 2017/18, the initial deduction is equal to the revenues raised in 2016/17, which say for example is £11bn. If income tax revenues in rUK grow by 5% between 2016/17 and 2017/18, and if population grows at the same rate in Scotland and rUK, then the income tax BGA in 2017/18 would be £11.55bn.

The key implication of the BGA arrangement is that, if the sum of the revenues raised from the devolved/ assigned taxes is greater than the sum of the BGAs, then the Scottish budget is better off than it would have been without tax devolution. This could happen under two circumstances: if the tax base grows relatively more quickly in Scotland than in rUK; or if tax rates in Scotland increase relative to those in rUK.

The arrangements for adjusting Scotland's block grant thus include elements of equalisation and elements of incentivisation. The existence of the 'initial deduction' ensures that the Scottish Government's relative spending power is not affected by the revenue transfer (Scotland raises relatively less per capita from all of the taxes being transferred than is the case in rUK). But once a revenue stream is transferred, the Scottish budget is exposed in full to any differential growth in Scottish revenues per capita relative to rUK revenues per capita.

This arrangement reflects principles established by the Smith Commission that the devolved Scottish budget should 'benefit in full' from policy decisions by the Scottish Government that increase revenues (and conversely bear the costs in full of policy decisions that reduce revenues or increase expenditures); and that the UK Government should manage economic shocks and budgetary risks that effect the whole UK.

As well as the arrangements for calculating Scotland's block grant, the Fiscal Framework also set out arrangements for the Scottish Government to manage forecast error associated with the devolved taxes and social security powers. These arrangements include limited resource borrowing powers (to cover forecast error), and the ability to establish a cash reserve. The Scottish Government was also accorded limited powers to borrow to fund capital spending (up to £450m annually within an overall cap of £3bn). The Fiscal Framework also sets out issues around intergovernmental information sharing and dispute resolution, including arrangements for so-called 'no detriment' principles which state that neither UK nor Scottish Government should face detriment as a result of policy decisions taken by the other.

Realising the benefits of devolution?

As discussed previously, the economic dividend of devolution is expected to be realised through one of several channels: a better alignment of policy to preferences; scope for policy learning; and more accountable, responsive government.

There was some scepticism that Scottish policy would diverge materially from rUK following the transfer of powers. This scepticism arose partly from a view that Scottish politicians have been relatively conservative on fiscal policy reform since the parliament was established, but also from a view that the policy preferences of Scots do not differ markedly from residents of rUK. Bell and Eiser (2015) find no evidence that Scots have significantly different socio-political attitudes, as measured by scales of 'left-rightism', 'welfarism' and 'libertarian-authoritariansm'; furthermore whilst a majority of Scots are in favour of tax devolution to the Scottish Parliament, there was limited appetite for tax policy divergence from UK policy norms. In itself this might suggest that the scope for tax devolution to yield an economic dividend by aligning policy more closely with preferences was limited.

In practice however, policy divergence has occurred remarkably quickly. The Scottish income tax schedule has progressively diverged from the rUK schedule in each of the first three years of income tax devolution. In 2017/18, the Scottish Government froze the threshold at which the higher rate of income tax becomes payable, despite the UK Government increasing the threshold above the rate of inflation. In 2018/19 the Scottish Government adopted a quite different income tax structure, introducing two new tax bands (a starter rate at 19p and an intermediate rate at 21p), adding one pence to both the Higher

and Additional rates of tax, and again setting a lower threshold for the Higher Rate than is the case in rUK. In 2019/20, the Scottish Government again froze the higher rate threshold in cash terms (at £43,430), despite the equivalent threshold being increased markedly above the rate of inflation (to £50,000) in rUK. These differences were retained in 2020/21.

These changes signal a willingness to diverge reasonably strongly from the rUK tax schedule to yield both distributional and revenue effects. Scottish taxpayers earning over £27,000 will face a higher average tax rate than rUK taxpayers with the same income, with this difference peaking at three percentage points for taxpayers with incomes of £50,000. In 2019/20, the Scottish Government forecast that its income tax policy would raise some £500m more in revenues than if the rUK policy had been followed, (although this is fairly small in the context of a discretionary resource budget of around £27bn in 2019/20).

Divergence is evident in relation to other fiscal powers too. The schedule of tax rates on property transactions is different in Scotland compared to England (for both residential and non-residential transactions), with a more progressive rate schedule and a slightly higher supplement for homes that are not the buyer's primary residence. Taken together with changes to the two taxes that have always been under the control of the Scottish Government, (council tax and non-domestic rates), the picture that emerges is one of the Scottish Government seeking to establish more progressive tax structures in relation to income, property value and council tax band than prevails in the rest of the UK (Eiser, 2019). The Scottish Government had also committed to lower the rate and eventually abolish Air Passenger Duty when it is devolved, although that commitment was scrapped in May 2019 – deemed incompatible with the government's climate change policy.

The Scottish Government has announced that a slightly higher rate of 'Carer's Allowance' will be applicable in Scotland from 2018, whilst the Sure Start Maternity Grant will be replaced with a more generous 'Best Start Grant' from 2019. The Scottish Government has also exercised its ability to give Scottish claimants of Universal Credit the option to be paid fortnightly rather than monthly (which is default in the rest of the UK), and the option for the housing element of Universal Credit to be paid direct to landlords. These are marginal changes, but have been taken up by almost 50% of claimants. More significantly, the Scottish Government is consulting on what should replace Disability Living Allowance and the Personal Independence Payment – the UK's major disability benefits – when they are

devolved, with an aspiration to deliver a system that differs from the existing UK system in relation to the frequency and nature of assessments that recipients are obliged to undertake. It has also announced a commitment to deliver a new Income Supplement to reduce rates of child poverty.

If policy divergence is the mechanism through which an economic dividend of devolution is realised, then this suggests that the scope for fiscal devolution to yield a dividend is relatively high. Of course, there remains a risk that some of the aforementioned reforms, particularly in relation to new social security policy, run into political, administrative or financial barriers and do not materialise. Administratively, the challenge of setting up a Scottish specific social security agency capable of delivering payments – without interruption – to one million claimants and potentially exchange information with the UK's DWP is substantial; the Scottish Government is currently aiming to roll-out the new Scottish specific benefits on a staggered basis between 2020 and 2025. An early test will come in the form of the rollout of the new Scottish Child Payment (which was due to begin in 2020 but has been postponed as a result of the coronavirus pandemic). This will be a payment made by Social Security Scotland to low-income families, effectively delivered as a top-up to Universal Credit, a low income benefit administered by the UK Government's Department of Work and Pensions.

Politically, it remains unclear to what extent it will be possible for a Scottish social security system to depart substantially from the UK's. A substantially 'more generous' Scottish system could in principle be stymied by the UK Government under the so-called 'no detriment' principles, if the Scottish policy was perceived to reduce UK Government revenues or increase UK Government expenditure. A hypothetical example of a direct policy spillover in the social security sphere could be if the Scottish Government broadened the eligibility criteria for one of the new Scottish disability benefits in such a way that this led to an increase in the number of people in Scotland who qualify automatically for the disabled child addition in Universal Credit – which is paid by the UK Government. However, the likelihood of such 'no detriment' claims arising remains unclear.

Beyond the straightforward policy divergence argument, tax devolution has led to policy innovations, supporting the 'laboratory federalism' arguments for devolution. In 2015, the first year that Stamp Duty Land Tax was transferred to Scotland, the Scottish Government

introduced in its place a new tax, the Land and Buildings Transactions Tax (LBTT). In designing LBTT, the Scottish Government heeded criticisms of the UK Stamp Duty's 'slab' structure (when a house moves into a higher tax threshold, the higher tax rate is charged on the full value of the property, leading to large jumps in tax liability at particular price points), and designed LBTT so that each additional tax rate is applied only to the portion of property value above that threshold. The introduction of the LBTT in Scotland catalysed the UK Government to replace the 'slab' structure of Stamp Duty in rUK with a more efficient 'slice' structure, providing a practical illustration of the 'policy innovation' arguments for devolution.

A third mechanism through which devolution is anticipated to yield an economic dividend is by enhancing the accountability of Scottish policy-makers. The concept of accountability is itself opaque and contested. Polverari (2015) defines accountability as a relationship between two groups, decision-makers and decision-takers (the electorate), where the first acts on the second's behalf, or where the first, because of its actions or inactions, determines an impact on the second. For the relationship between these groups to be one of accountability, 1) decision-takers must be able to inform decision-makers' choices, 2) decision-makers must be prepared to give account of their choices and of the outcomes of such choices, and 3) decision-takers must have the faculty to express dissatisfaction and request changes to the course of action adopted.

Quantifying the extent to which fiscal devolution will enhance the accountability of Scottish policy makers for decisions taken is challenging. Anecdotally it seems hard to deny that debate and discussion of the Scottish budget has had higher profile within the media and civic society than it was in the days when the Scottish budget was largely a spending budget. A more concrete observation is that turnout at the Scottish election in 2016 of 55.6% was noticeably higher than the turnouts of 49.4%, 51.7% and 50.4% observed in the elections of 2003, 2007 and 2011 (but not as high as the 58.2% turnout in the 1999 inaugural election).

Perhaps therefore the Scottish electorate feels more engaged in aspects of devolved government, and keener to exert influence on the way the new powers are exercised. The Scottish Parliament has debated intensely over the merits and risks of increasing tax rates on Scottish taxpayers, and on the need for additional spending. In this sense then, tax

devolution does seem to have enhanced accountability in the sense envisaged by the Calman and Smith commissions.

But there are aspects of the design of the fiscal framework that may risk eroding or weakening these lines of accountability, because the complexity of the fiscal framework makes the links between policy decisions and budgetary outcomes somewhat opaque. This opacity between policy decisions and budgetary effect often results from the fact that the Scottish budget is not simply a function of the block grant and revenues from the devolved taxes, but is also jointly determined by comparable rUK revenues (via the BGAs). This means that assessing the revenue or distributional effects of Scottish policy decisions can be quite challenging.

The Scottish Government has sometimes attributed a reduction in the tax liabilities of lower earners to its own tax policy, when in reality a large part of the effect has arisen from decisions of the UK Government in relation to the Personal Allowance – over which the Scottish Government has no power.

More fundamentally, the underlying logic of the interaction between the Barnett Formula determined block grant, the devolved revenues and the BGAs can be difficult to grasp and is easy to misconstrue. The interaction between the BGAs and the tax revenues has been likened to a race which the Scottish Government has to win if its budget is not to decline relative to what it would have been had tax devolution not ocurred, and this has led to calls that the system is unfair.

For example, when the UK Government introduced a Stamp Duty supplement on those purchasing a second home, this raised UK Government Stamp Duty revenues and hence increased the BGA (the amount deducted from the block grant). There were claims that the Scottish Government was constrained to follow this policy if its budget was not to be 'cut'. This argument however ignores the role of the Barnett formula in determining the block grant. A rise in UK Government revenues from an increase in Stamp Duty is likely to increase UK Government spending on 'comparable' public services, triggering a consequential increase in the Scottish block grant. The increase in the BGA offsets the increase in the block grant, ensuring that Scottish taxpayers do not benefit from a policy which does not apply in Scotland. If the Scottish Government does introduce its own version of the supplement

(which it did), then revenues from this would contribute directly to Scottish Government spending power.

More significantly, the idea of the fiscal framework creating a race has been seen particularly strongly in relation to income tax. Divergence between Scottish and rUK income tax rates should in principle have raised Scottish revenues by around £500m relative to the BGA in 2019/20. But this presupposes that the Scottish income tax base grows at the same rate as the rUK tax base. Whilst outturn data is not yet available, there is now strong evidence that the Scottish tax base has grown less strongly than the rUK tax base since tax devolution occurred, with the effect that Scottish income tax revenues are unlikely to exceed the BGA in 19/20. So whilst Scottish taxpayers are paying £500m more than they would have done under the rUK tax system, and whilst the Scottish budget is £500m higher than it would have been without this policy divergence, the Scottish budget is unlikely to be much better off than it would have been had tax devolution not occurred.

The extent to which these outcomes might be seen as a reasonable consequence of devolution might depend in part on what causes them. Perhaps the most likely explanation for slower growth in the Scottish income tax base since income tax devolution in 2017/18 relates to weaknesses in the North Sea oil and gas sector as a result of global conditions – a factor which the Scottish Government cannot directly be accountable for (opposition parties' arguments that the relative weakness of the Scottish tax base are solely attributable to taxpayer behavioural responses to the policy itself are not creditable).

The Scottish Government itself has also argued that differences in the relative growth of the income tax base might reflect various other factors that are effectively beyond its control. One of these relates to demographic change, and the slightly faster growth of the older age population (who pay proportionately less tax per capita compared to working age) in Scotland relative to rUK. In principle, if it was felt that the Scottish budget should not be exposed to the risk of differential demographic change, the calculation of the BGA could be adapted to control for this risk. This would represent a move towards resource equalisation, and it is not clear whether the UK Government would countenance this without a similar move towards needs equalisation on the spending side.

The Scottish Government has also made the case that recent UK Government policy decisions to increase the Personal Allowance faster than inflation may have detrimental effects on the Scottish budget. Whilst an increase in the Personal Allowance represents a tax cut for most income taxpayers, the Personal Allowance is tapered away from those earning above £100,000, and ceases to apply at incomes above £125,000 (in 2019/20). Scotland has proportionately fewer of these high income individuals than rUK. In turn, this means that an increase in the Personal Allowance represents a tax cut for proportionately more Scottish income taxpayers than rUK taxpayers, and this means that the Personal Allowance increase is likely to reduce Scottish revenues by more than it reduces the BGA. The Scottish Government has argued that the example of the Personal Allowance increase represents an infringement of the so-called 'no-detriment' principles, and that the Scottish Government should be financially compensated for resulting detriment to the Scottish budget. The issue remains unresolved at the time of writing.

The transparency between Scottish Government policy decisions and budgetary effects may be further eroded by the long lags between the publication of income tax forecasts that inform Scottish budgets, and the reconciliation of these forecasts to outturn data. When Scottish budgets are set, they are based on forecasts of Scottish income tax revenues (made by SFC) and forecasts of the income tax BGA (made by the OBR). HMRC collects Scottish income tax revenues on behalf of the Scottish Government, and the UK initially allocates to the Scottish Government the forecast difference between Scottish revenues and the BGA. Once income tax outturn data is available, the Scottish budget is 'reconciled' with the forecasts. But outturn data is not available until 15 months after the end of the financial year, with reconciliation happening in the subsequent budget. This means that the forecasts made for 2017/18 are not reconciled until 2020/21.

This lag might reduce accountability, in that in any 5-year parliamentary term, only two full cycles from budget forecast to reconciliation will take place. But its interpretation has also been subject of much confusion. Forecasts underpinning the 2017/18 budget implied a positive difference between revenues and BGA. Outturn data revealed a negative difference. As a result, a £200m negative reconciliation (deduction) was applied to the budget in 2020/21, reflecting the fact that the 2017/18 spending plans had been based on an assumption that the Scottish Government would have £200m more resources available

to it than subsequently turned out to be the case. The forecast error was due in part to the SFC over-estimating Scottish revenues in 2017/18, but also by the OBR underestimating rUK income tax revenues (which determine the BGA). The extent to which the subsequent reconciliation should be attributed to forecasters (and which one) or was symptomatic of ‘underperformance’ of the Scottish economy – and for what reason – was the source of much debate (and confusion).

Accountability may be weak in relation to assigned VAT. There will be no Scottish VAT outturn data. Instead, the Scottish share of UK VAT will be estimated each year through survey data. The methodology for estimating Scottish VAT revenues is being developed, but initial indications are that the 95% confidence interval around the estimate could be several hundred million pounds. This raises the possibility that annual fluctuations in the Scottish budget could result from sampling error. As a result of this uncertainty, plans to partially assign VAT were put on hold during 2019.

So whilst the new fiscal powers do seem to have stimulated greater interest and engagement in the Scottish Parliament, complexities in the fiscal framework suggest that the links between policy decision and budget outcome will often appear weak. It could also be argued however that systems of public finance are inevitably complex, particularly in the case of decentralised government, and that linkages between policy decisions and outcomes is always somewhat opaque given the multitude of factors that influence policy outcomes. The extent to which the complexities of the Scottish framework fuel distrust or disenchantment about the new powers remains to be seen.

The costs of fiscal devolution

The fact that income tax is now a shared tax, with the potential for different rates and thresholds in Scotland, imposes costs on HMRC. These costs largely relate to the identification within HMRC’s tax systems of ‘Scottish taxpayers’ and the ability to collect different rates of tax from these taxpayers. The identification of Scottish taxpayers is not simply a one-off exercise, but will require monitoring on a perpetual basis, with up to 80,000 taxpayers relocating across the border in either direction each year. The initial years of income tax devolution have already been beset by various issues around the misidentification of income taxpayers.

The Scottish Government will reimburse HMRC's costs associated with income tax devolution. These are currently estimated at around £25m in set-up costs (Table 2), as well as recurrent annual costs of around £1.5m (Scottish Government, 2018b). These are cash sums that reduce the Scottish Government's broader spending power.

In terms of the 'fully devolved' taxes (LBTT, Landfill Tax, and in due course, APD), the Scottish Government has established a Scottish tax collection agency, 'Revenue Scotland' which costs around £6m in annual running costs. Annual running costs of the newly established Scottish Fiscal Commission are relatively small.

These administrative costs associated with tax devolution are small in the context of the revenues generated, and whilst devolution does clearly entail some diseconomies of scale, these costs do appear small in the context of the economies of scope discussed previously.

More substantial costs are associated with the devolution of the social security powers which are currently implemented and delivered by the UK's DWP. The Scottish Government has established Social Security Scotland (SSS), which will take over the management and implementation of these benefits for the more than one million Scottish claimants. SSS will imply substantial set-up costs, estimated to be just over £300m (Scottish Parliament, 2017). Running costs of SSS are anticipated to be in the region of £150m per annum (in the context of payments to claimants likely to be in the region of around £3bn per annum).

Not all of the costs outlined above are net additional costs to the public sector; some costs to the Scottish Government will be offset by savings to the UK Government. The UK Government has agreed to contribute £200m to the set-up costs of the Scottish institutions, and to transfer up to £66m annually as a contribution to ongoing running costs, reflecting savings that it can make as a result of no longer collecting some revenue streams or delivering some benefits in Scotland.

Other costs associated with the new powers include the costs associated with estimating revenues from assigned VAT in Scotland, and the costs to the UK and Scottish Governments in overseeing the design and implementation of the devolution programme. Scotland's public audit organisation has found that the focus on setting up and staffing SSS has 'put pressure on other directorates' ability to deliver business-as-usual activities' (Audit Scotland, 2018).

TABLE 2 HERE

As well as the public finance costs, the sharing of income tax may impose costs on Scottish income taxpayers in the form of added complexity and reduced coherence.

An example of reduced coherence of the tax system as a whole relates to the interaction between income tax and National Insurance Contributions (NICs, which remain reserved to the UK Government). In the UK tax system, the Higher Rate Threshold for income tax (at which point the marginal tax rate increases from 20% to 40%) coincides with the Upper Earnings Limit for NICs (at which point the NICs contribution rate falls from 12% to 2%). Thus in the UK, the combined marginal tax rate on earnings increases from 32% to 42% at this threshold. In Scotland, the decision to set a Higher Rate Threshold almost £7000 below the UK threshold means that, in the band of income between the Scottish and UK Higher Rate Thresholds, Scottish taxpayers pay a marginal rate of 53%, before it falls to 43% above the UK Higher Rate Threshold.

Tax devolution can also create unexpected issues for legislators and policy-makers. The narrowing of the 'basic rate' band of income tax in Scotland in 2018/19 had implications for various tax allowances and reliefs that are provided at a UK level. For example, UK legislation allows for the Marriage Allowance to be paid to certain 'basic rate' taxpayers. A literal interpretation of the legislation following the introduction of an 'intermediate rate' in Scotland in 2018/19 might have resulted in some intermediate rate income taxpayers in Scotland losing entitlement to the allowance. But following discussions between the Scottish Government and HMRC, the UK law was changed to extend the allowance to Scottish basic and intermediate rate taxpayers.

Conclusions

An extensive literature argues that fiscal decentralisation can yield an economic dividend through several channels, but that it can also entail costs, with the balance between benefit and cost being influenced by the scope of powers decentralised, and supporting institutional and governance arrangements. The current programme of fiscal devolution to Scotland was motivated by some of the core conclusions of this literature, namely that fiscal devolution

can provide scope for policy variation, and improve accountability by aligning spending and revenues raising responsibilities.

Emerging evidence suggests that several of the anticipated benefits of fiscal devolution are being realised. Devolved tax policy has been clearly differentiated from rUK policy in a number of areas, with the aims to both raise additional revenues and establish more progressive tax structures. The Scottish Government is paying a higher rate of Carer's Allowance, is consulting on changes to the social security payments that are being devolved, and has announced a new benefit aimed at low income families with children. Policy differentiation is one of the key channels through which theory anticipates that an economic dividend of devolution might be realised, both by matching more closely the electorate's preferences, but also by catalysing policy innovation – which has also been an early outcome of recent tax devolution to Scotland.

Fiscal devolution has created some administrative costs through diseconomies of scale. However, whilst these administrative costs are not insignificant, they are small in the context of the value of revenues and spending being devolved. Policy divergence also creates costs for taxpayers and employers in navigating complexities and incoherencies between devolved and reserved tax systems, but the additional complexities associated with devolution are small in relation to those that already existed in the UK's extensive tax code.

Fiscal devolution to the Scottish Parliament was motivated by a desire to enhance accountability, although there is legitimate concern that the complexity of the fiscal framework may undermine the extent to which devolution genuinely strengthens the link between policy and outcomes. The manner in which the budget is jointly determined by Scottish and equivalent rUK revenues, uncertainty in the estimation of assigned VAT revenues, long lags between budget plans and outturn data, and the shared nature of some of the main fiscal powers may limit accountability. Failure to improve transparency around these issues may undermine trust in the new framework.

The fiscal federalism literature emphasises the important trade offs between equity and efficiency considerations. The new Scottish framework aims to link the Scottish budget more closely to the performance of the Scottish economy and Scottish tax base, relative to rUK.

As such the Scottish budget is exposed to the risk in full that devolved tax bases grow more weakly than the equivalent rUK tax bases (although initial differences in tax capacity are equalised in full). It is perhaps surprising that the fiscal framework contains no risk-sharing insurance against idiosyncratic asymmetric shocks. This can perhaps be explained by the fact that, in the past, the Scottish and rUK business cycles have been reasonably strongly correlated. Nonetheless, current divergence in apparent economic fortunes and demographic trends is raising fundamental questions around which budgetary risks the Scottish budget should be exposed to, and which it should be protected from. This question will be at the heart of the review of the fiscal framework, which the UK and Scottish Governments have committed to hold in 2021/22.

There is also a risk that hoped-for reforms under Scotland's devolved social security powers may be stymied by administrative or political constraints. Eligibility for the new Scottish Child Payment is based on receipt of Universal Credit, a UK-administered benefit, with recipients needing to apply and demonstrate their eligibility. It is not clear to what extent full uptake and smooth delivery of the benefit will be contingent on robust information sharing between the SSS and DWP, and whether processes are in place to allow the necessary information sharing to take place. There are also concerns that proposed changes to devolved social security payments in Scotland may be constrained by the 'no detriment' principles, although the extent of this risk remains unclear.

Looking to the future, there will be ongoing debate too about the scope of the powers, both in terms of the particular fiscal levers devolved, and the way in which exercise of those powers might be constrained. The scope for further tax devolution to further enhance accountability exists, but will need to be balanced against the costs and risks associated with devolution of other major taxes. The SNP-led Scottish Government had called for devolution of National Insurance Contributions as part of its 2019 General Election Manifesto, which would in principle provide scope to better align income tax and national insurance in Scotland, but would accentuate budgetary risks (given that both taxes operate on essentially the same tax base). There are also ongoing calls for the Scottish Government to be able to borrow to fund discretionary resource spending. Writing in mid-2020, it seems likely that the Covid-19 health crisis will put these debates temporarily on hold, although they will likely be reignited by the Scottish Parliamentary elections in 2021.

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[i] This paper refers both to fiscal decentralisation and fiscal devolution. Fiscal decentralisation is a generic term to refer to the shifting of some responsibility for expenditure or revenue raising decisions to lower levels of government. Fiscal devolution is generally characterised as a particular form of fiscal decentralisation, involving the transfer of fiscal powers to a subnational government which has a degree of political independence. The term fiscal devolution tends to be used in the Scottish context, reflecting the clear constitutional and political separation between the UK and Scottish parliaments. But where previous studies have considered the broader concept of fiscal decentralisation, this paper retains the use of that nomenclature.

[ii] In fact the Barnett Formula pre-dates the establishment of the Scottish Parliament, having been used to determine the Scottish budget since the 1979/80 financial year. The difference is that, since 1999 it has been used to allocate resources to the devolved Scottish

Government, rather than to allocate within departments of the UK Government (Heald and Mcleod, 2005).