

Economic perspectives

Flaws and myths in the case for Scottish fiscal autonomy

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1. Introduction

In May of this year Paul Hallwood and Ronnie MacDonald (H&M) published a paper under the auspices of the Policy Institute in which they argue the case for fiscal autonomy in Scotland with or without independence (Hallwood and MacDonald, 2006). They conclude that fiscal autonomy is to be preferred because it

“...offers a much sharper and clearer incentive mechanism – for both the private sector and the elected representatives in Edinburgh – than the current Barnett financial arrangement and also relative to other lesser forms of fiscal devolution, such as fiscal federalism” (page 31).

The authors claim empirical support for their view that the incentive generating effects of fiscal autonomy will result in more efficient resource allocation and faster economic growth in Scotland. Moreover, they contend that the size of this return will be more than sufficient to outweigh the risks inherent in fiscal autonomy. They argue that such risks include the loss of the block grant from Westminster of a certain and known amount, and no bail out from London in the event of a tax shortfall.

We welcome Hallwood and MacDonald's further contribution to the debate on financing devolved Scotland. The most recent paper adds to their earlier distinguished work published in the *Allander Series*, where they argued in favour of a fiscal federalist solution to the financing of Scotland's public sector (Hallwood and MacDonald, 2004; 2005). However, we contend that H&M fail to establish a case for fiscal autonomy in Scotland, and that the arguments deployed in their previous work in favour of a form of fiscal federalism in Scotland do not, as they suggest, have even greater force in the case for fiscal autonomy within the Union. Moreover, we go further and argue that in adopting fiscal autonomy Scotland would lose many of the benefits of economic and fiscal integration with the rest of the UK for little or no gain compared with a form of fiscal federalism or even the present Barnett based system of financing Scottish devolution.

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The remainder of this paper is in four parts. We first assess some of the arguments typically used to justify greater fiscal responsibility at the sub-central government (SCG) level and highlight the principal differences between fiscal federalism/decentralisation and full fiscal autonomy. Secondly, we compare fiscal autonomy with the present Barnett-based system of funding the Scottish parliament using a standard set of criteria. Our view is that H&M either misunderstand or misrepresent the present funding system, which has many of the efficiency characteristics that they seem to uniquely associate with fiscal autonomy. The next section identifies a set of largely political and administrative problems associated with fiscal autonomy that are little considered in H&M's latest work. Finally, the paper concludes by reiterating the reasons why fiscal autonomy is not to be preferred either to the present Barnett system or to a form of fiscal federalism. We also note that some of the claimed advantages of fiscal federalism may not be as robust as asserted by its proponents and that further research is advisable before serious consideration is given to the adoption of new funding arrangements for Scotland.

2. Fiscal autonomy and fiscal federalism

Under fiscal autonomy the Scottish parliament would be wholly responsible for raising, and spending its tax revenues. Part of these revenues, an amount agreed to cover Scotland's share of centrally provided public goods such as defence, and foreign affairs would go to Westminster. The rest would be retained in Scotland. There would be no subvention from the rest of the UK to ensure that levels of provision of public and merit goods met a UK standard. Therefore, apart from the central provision of UK public goods, it would be as if Scotland was a separate state within the UK union.

Fiscal federalism is a more subtle concept than fiscal autonomy. It is generally agreed that if public goods and services are provided and financed in the geographical jurisdictions that embrace the benefits and costs of their provision, then there will be potential gains. These gains are to static and dynamic economic efficiency (i.e. resource allocation and growth), and to political accountability and transparencyⁱ. But, crucially, some sub-national authorities may not have sufficient taxable resources to finance the provision of appropriate services (vertical imbalances) and taxable capacity is likely to vary across jurisdictions (horizontal imbalances). In these inevitable circumstances, proponents of fiscal decentralisation and fiscal federalism argue that the unity of the state requires equalisation payments from the centre and redistribution from jurisdictions with high levels of income to those with lower taxable capacity.

Fiscal federalism therefore differs from fiscal autonomy at the SCG level in that under fiscal federalism inter-jurisdictional transfers via central government are made for equity (and also economic stabilisation) reasons. Under fiscal autonomy they are not. Further, under fiscal

federalism the degree of decentralisation to SCGs in spending and tax powers can vary considerably. On the expenditure side, jurisdictions may have complete freedom to determine the allocation, or may be allowed to spend on a basket of goods and services subject to certain centrally directed standards of provision. These standards may effectively ring fence spending on certain areas. On revenues, SCG's autonomy may vary from the very little, with no own local taxation and funding provided by a grant from the centre, through higher degrees of local taxation and the sharing/assignment of tax revenues, to a high degree of own taxation and the devolution in part or in whole of rates and bases of national taxes.

According to Ebel and Yilmaz (2001) fiscal decentralisation has the potential to improve economic efficiency through the promotion of allocative and managerial efficiencies. Better allocation results from local governments having better information than central government on the preferences of local people for specific goods and services, including the allocation of resources between present and future consumption i.e. for economic growth. In addition, competition between jurisdictions will increase as individuals migrate to those areas that best meet their preferences. It is argued that such competition will ensure the better use of public resources, limit excessive taxation and a burgeoning state (Brennan and Buchanan, 1980).ⁱⁱ

One thing the literature on fiscal federalism fails to make clear is the relationship between the degree of decentralisation and the postulated economic benefits. H&M assert that "fiscal autonomy is like fiscal federalism but more so!" (page 2). By which they mean that economic incentives are even clearer under the former than the latter. However, they reach this conclusion by privileging efficiency considerations whilst marginalizing equity and stabilisation concerns. This drives them to an extreme conclusion. This is actually unusual for economists who are generally keen to stress the need to focus on trading off marginal benefits and costs.

However, this would be less problematic if the theoretical arguments for the incentive promoting powers of fiscal autonomy were as strong as the rhetoric. Unfortunately they are not. We show in the next section that the present Barnett based system already exhibits many of the key characteristics required to encourage the efficient use of resources and to allow a democratically disciplined Scottish Parliament to make optimal allocation choices.

Another related difficulty with some of the literature on fiscal decentralisation is a lack of clarity on the mechanisms that link decentralisation to improved economic performance. H&M's work seems particularly prone to this problem. In addition to the benefits that flow from a better reflection of local preferences and tax competition between jurisdictions, H&M take the reasonable view that people, including politicians, will make more rational - better, superior - decisions if they have to

face the costs as well as enjoy the benefits of public expenditure (Hallwood and MacDonald, 2006, page 10). This is implicit in the tax competition argument for fiscal decentralisation, where it is assumed that people will migrate towards those jurisdictions that offer a given basket of public goods and services at a lower tax cost, or offer greater quality and choice at given cost.

H&M take this point further and argue that greater fiscal responsibility implies a harder budget constraint, which will make political decision makers spend more wisely – more efficiently – to meet local preferences than in jurisdictions with less fiscal responsibility. However, H&M appear to assume (page 11) that a fiscal imbalance at the SCG level – funded by central government - is synonymous with the budget constraint facing the SCG authorities. We suggest that this is incorrect.

Whether a budget constraint is hard or not depends on the mechanisms that set the budget. The fact that a SCG is subject, in the jargon of the literature, to a vertical imbalance, where its expenditure needs are greater than its taxable capacity, says little about the conditions that determine the level of expenditure incurred to meet those needs. Jurisdictions that have responsibility for own taxation and have ample taxable capacity might still be subject to a soft budget constraint if they are in receipt of central government grants, or are able to borrow profligately at below opportunity cost. Conversely, jurisdictions that have little responsibility for own taxation may have their expenditure limits rigorously set, which we argue below is the case in the UK Barnett system, and so are subject to a hard budget constraint.

So, from the standpoint of economic efficiency, a fiscal system will be efficient if for changes in public spending the marginal social benefits and the marginal social costs are perceived *and equated* by the political authority. There remains some doubt that increasing levels of fiscal decentralisation, up to and including fiscal autonomy, are inherently more likely to satisfy this condition. This would appear especially so in a world of increasing economic interdependence and spillovers in and between jurisdictions through trade, factor and knowledge flows. In such a world, the need for central government to apply tax and subsidy policy differentially across jurisdictions to internalise such externalities would appear to be more pressing.

3. The Barnett system and fiscal autonomy

H&M are particularly disparaging about the present Barnett based system for financing the Scottish Parliament. We take a much more sanguine view. Table 1 compares some of the key characteristics of the present (Barnett) mechanism with those of full fiscal autonomy. The characteristics reflect, in the context of the UK, the desired properties of an efficient and effective fiscal system at the SCG level.

Table 1 Characteristics of Present (Barnett) System vs Full Fiscal Autonomy

Characteristics	Present System (Barnett)	Full Fiscal Autonomy
1. Hard budget constraint	+	+
2. Composition of public spending	+	+
3. Private/Public sector split	+	+
4. Scottish growth incentive	-	+
5. Choice of tax mix	-	+
6. Westminster incentive	+	-
7. Democratic accountability	+	+
8. Automatic stabilisation	+	-
9. UK spatial distribution (equalisation)	+	-

Characteristics 1 to 6 embrace economic efficiency and growth issues, characteristics 7, 8 and 9 refer to democratic accountability, stabilisation and equalisation, respectively. A plus sign indicates that the characteristic is present while a minus sign suggests the opposite. No attempt is made in the table to indicate the degree or extent to which each characteristic is present in each system. However, this is considered in the discussion below. We deal with each characteristic in turn.

Hard budget constraint

H&M attach extra-ordinary importance to public sector decision makers having a “hard” budget constraint. H&M (p. 11) put it this way: “If a region knows that the size of the bloc grant it receives is [positively] related to the size of its fiscal imbalances [the difference between the local public expenditure and the local tax take], the incentive to reduce its fiscal imbalance is compromised: the region in effect faces a soft budget constraint.” The essence seems to be that where devolved decision makers know that they have to live with their mistakes, they will make better decisions. A hard budget constraint implies no *ex post* bail out from central government.

H&M believe that fiscal autonomy gives the hardest budget constraint. However, the formal system for allocating funding to the Scottish Parliament, the Barnett formula, also provides a hard budget constraint. The system of funding to the Scottish Parliament produces incremental financial allocations that are driven by a formula based upon Scotland’s population share within the UK. This is unrelated to the size of the fiscal balance. Formula bypass may still occur, as was the case with Treasury funding of

the debt write-off in the Glasgow housing stock transfer, but it is transparent and relatively rare. In addition, the Scottish Parliament and its Executive have no borrowing powers. Conversely, under fiscal autonomy while spending is limited by own taxation H&M allow scope for borrowing. There would appear to be little between the two systems in the hardness of the budget constraint.

H&M's lack of understanding of the present funding system for Scotland is revealed (page 12) when in support of their view that the budget constraint presently is soft, they suggest that poor Scottish standards of health may be used as an argument for a larger grant from Westminster. The Barnett formula does not work in this way. There is no moral hazard: Scotland does not get more funding if it has poor health. It is incorrect to suggest that the Scottish Executive is a 'Leviathan' government intent on expanding its budget with no incentive to improve the health of the Scottish people. The recent legislation banning smoking in pubs, restaurants and other public places would appear to give the lie to that contention.

Composition of public spending

H&M suggest (page 14) that a key argument in favour of fiscal federalism is that it improves the use of resources both in a static - allocative efficiency – and dynamic – growth – framework. Scottish Parliament politicians would be encouraged to better reflect the Scottish people's preferences on education, innovation, private capital and infrastructure, which could have an important influence on growth. H&M make the argument in terms of fiscal federalism, so it cannot be construed as an argument for fiscal autonomy *per se*. It should be clear that the allocation of spending has little to do with how the funding is raised or collected. The arrangements for funding the Scottish Parliament as determined by the Scotland Act (1998) allow no constraint to be placed on the composition of public spending outside the areas of defence, foreign affairs, social protection and certain regulations that are reserved to Westminster. As the Steel Commission (2006) notes:

“...the Scottish Parliament has very significant autonomy and discretion because of the fact that the block grant system does not ring-fence spending areas. In comparison with most other federal or quasi-federal systems, the extent of real power over policy and decision-making is considerable” (page 85).

And the parliament is accountable for these spending decisions through the normal democratic process, which will ensure in the long-term at least that the preferences of the Scottish people are respected.

Private/public sector split

H&M argue (page 8) that the present funding arrangements give the Scottish Executive and parliament little incentive to choose the correct balance between the size of the public and private sectors. H&M err in implying that there is some optimal size for the public sector in an absolute sense: it is

a decision that should be taken at the margin and should depend on the extent of market failure, the efficiency and effectiveness of delivery mechanisms e.g. the adoption of contestability and choice mechanisms as opposed to target setting and monopoly supply (Crafts 2005), the efficiency of regulation etc. as well as public preferences, all of which affect the social benefit from public spending.

H&M would be correct in arguing that the incentives to reduce the size, and/or increase the efficiency, of the public sector may be less under the present system than under fiscal autonomy. Under fiscal autonomy a marginal tax rule effectively operates where an extra pound of public spending has to be funded by an extra pound of taxation – in the long run if a borrowing facility is allowed. So, the optimal size of public sector provision would be determined at the point where the marginal benefits of an extra pound of public spending equal the marginal tax cost.

Yet under the present system a constrained version of the marginal tax rule is possible through variations in the tartan tax. The Scottish Parliament can increase or decrease its budget through increasing or decreasing the standard rate of income tax. H&M (p. 26) do acknowledge this but simply state that “the amount of variation is not great”. However, the point is that variation at the margin is possible. H&M do not appear to have an answer to the question that if the size of the public sector is an important issue for the Scottish electorate – in whose intelligence they claim to place great faith (page 3) – then why have voters not forced the parliament to use the tartan tax one way or the other?

Scottish growth incentive

Fiscal federalism according to H&M (pages 14, 15) would provide a much stronger incentive for the Scottish executive to adopt policies to raise economic growth than the present funding arrangements where the extra tax take from improved growth flows to the UK Treasury. On the face of it this argument is correct. However, we offer some caveats. First, it is not clear that fiscal autonomy offers a much greater incentive than fiscal federal arrangements of assigned tax revenues or the ability to lower or vary tax rates and bases. Secondly, it is an assumption that the return of higher tax revenues will provide an incentive to Scottish politicians to promote growth. This is almost tantamount to assuming a 'Leviathan' government where the pursuit of higher revenues and expenditure is paramount. It is not clear that the Scottish Executive would behave in this way and the empirical evidence supporting the Leviathan hypothesis is not at all conclusive (Ebel and Yilmaz, 2001). One of the key arguments favouring fiscal decentralisation is that it enables a SCG to better reflect local preferences. The present Scottish devolution settlement also has this property and if the Scottish electorate desires higher growth it should be expected that the Scottish parliament would respond to it. Thirdly, this argument suggests that local politicians are forward looking and have low time discount rates: not a characteristic

normally associated with the practice of politics. Fourth, H&M now assert that the empirical evidence indicates that increased fiscal decentralisation is favourable to economic growth. They did not adopt such a straightforward view in their previous work. And as the Steel Commission (2006) points out “the evidence on the link between fiscal decentralisation and economic growth is ... (hard) ... to come by with relatively little research having been conducted” (page 38).

Choice of tax mix

The present funding arrangements severely constrain the Scottish people from choosing their preferred mix of taxes. Some scope is present through the ability to alter the tartan and council taxes, but it is clear that fiscal autonomy offers the most scope to meet such preferences. However, it is unclear how important such an issue is with the Scottish electorate and it is a moot point whether a different tax mix from the present UK would be more economically efficient.

Westminster incentive

The present system provides an incentive to Westminster to watch what is going on in Scotland and monitor the impact that Scottish policies may have on the UK as well as the impact of UK policies on Scotland. Spatial spillovers are important within an integrated economy (McGregor and Swales, 2005) suggesting a need for co-ordination, the incentive for which would be lacking under fiscally autonomy.

Democratic accountability

Under the present Scottish devolution arrangements the parliament is accountable for the allocation of public expenditure and, given the tartan tax, the absolute size of the budget to be spent at the margin. An argument cannot be sustained that Scottish politicians are less democratically accountable under the present system than would be the case under fiscal federalism or fiscal autonomy.

Automatic stabilisation

The adoption of fiscal autonomy would remove most of the stabilisation benefits that accrue to participation in the UK tax and benefits system: increased social protection payments, and reduced income tax and corporation tax outlays. It is true that a fiscally autonomous Scotland with borrowing rights would be able to increase its fiscal deficit in the face of an exogenous shock. However, the scope for this is likely to be severely limited since a binding borrowing constraint is likely to be imposed for UK macro-stabilisation reasons. Under fiscal autonomy the risk of greater cyclical instability would probably increase, with all the implications that would have for investment and forward planning.

UK spatial distribution

The adoption of fiscal autonomy would also remove from Scotland the equalisation payments that are found to be part of both unitary and most federal systems. In the

absence of greater tax revenues, current needs could only be met by higher tax rates or would fail to be met through public expenditure having to be lower. H&M recognise this (page 26) but imply that Scottish oil revenues may be sufficient to substitute – which ignores one of the rules of fiscal federalist theory that natural resource taxation should not be devolved due to price, and hence tax revenue, variability. However, if oil revenues were returned to Scotland it would be a foolhardy government that based long-term public expenditure plans on such variable revenues.

H&M contend that even if equity transfers were reduced under fiscal autonomy the faster economic growth resulting from fiscal autonomy would provide the tax revenue to fill the gap (pages 26 and 27). But as we have noted the evidence does not allow us to be so sanguine about the link between fiscal decentralisation, never mind fiscal autonomy, and economic growth.

4. Uncertain issues for full fiscal autonomy

In their paper, H&M stress that they are arguing for the economics of fiscal autonomy. They refer to the Steel Commission as being “largely driven by political considerations” (p.2) and assert that “[t]he politics of the Scotland Act (1998) has gotten in the way of sensible economics” (p.8). However, we believe that H&M’s argument cannot abstract economic theory from the political reality in which their proposals must operate and that the resolution of a number of issues is crucial to the functioning of any alternative fiscal system. We look in turn at issues surrounding Scotland’s resource transfer to the United Kingdom for those public or merit goods that remain UK-wide, how issues of national debt repayment and debt issue may prove awkward to resolve and whether the proposals offer any solution to the West Lothian Question.

H&M propose sufficient fiscal control to SCG that the United Kingdom government would find itself in a deficit position relative to its own revenue generation and expenditure responsibilities for Scotland (they do not comment on the economic inefficiency this would create at the United Kingdom level while they seek to solve the same concern in Scotland’s present fiscal position). They suggest that Scotland would make transfers to Westminster to pay for the services provided for the whole of the United Kingdom, presumably defence, foreign and diplomatic affairs and immigration. They do not provide any indication as to how this may be done.

There is a historical precedent within the United Kingdom of SCG being given authority to raise the majority of taxation and subsequently make transfer payments to Westminster: that of Northern Ireland between 1920 and 1972. The terms of the Government of Ireland Act 1920 envisioned the Stormont government running a budget surplus sufficient to make what was termed an “Imperial Contribution” for the services provided for its benefit by Westminster and for its share of the costs in managing the

Empire. Mitchell (2006) provides an acute analysis of the failure of the system and the quick transfer of the Imperial Contribution into an effective Imperial subsidy. While the time and circumstances may have been different many of the failures of the system remain pertinent.

Northern Ireland faced the problem of simply being unable to afford a United Kingdom standard of public expenditure given its own fiscal capacity. The Westminster government could not permit large out-migration flows and sought to subsidise Northern Ireland to prevent this. While the problem is not so acute for Scotland, the fact remains that even with all North Sea Oil receipts Scotland is reckoned to be in a persistent deficit position (Scottish Executive, various). Fiscal autonomy must concern itself not with what revenue it can raise but with what level of expenditure it can afford.ⁱⁱⁱ

An Imperial Exchequer Board was established to determine the level of contribution expected of Northern Ireland on the basis of its revenues and the services it received. A similar body would be required to regulate the financial relations between a fiscally autonomous Scotland and the United Kingdom. This would need to consist of representatives of both governments and have terms of reference in case of disputes, such as may occur over the increased, and probably unforeseen, defence requirements that the United Kingdom government may be required to undertake. An issue in such cases is likely to be whether the new body would have first call on financial resources. Mechanisms can be established to resolve these issues, but they are part of the fiscal package and cannot be dismissed as political considerations.

H&M envisage Scotland being granted borrowing powers. This raises the problem of how to treat existing as opposed to future national debt. Again Ireland provides an example. The constitution of the Irish Free State stipulated that it was required to service the debt of the United Kingdom. In fact this did not happen and when the Republic of Ireland was established it did not inherit any share of the existing United Kingdom debt. It is unlikely Scotland would be permitted such an outcome. Instead, a division would require to be made between that debt incurred for the benefit of the United Kingdom prior to fiscal autonomy and subsequently that debt incurred by the Scottish government for Scotland's benefit and that incurred for the United Kingdom on those services provided for the whole of the United Kingdom (including Scotland). This is no easy task.

At present the United Kingdom does not borrow for specific purposes – it has a general borrowing requirement that it meets through lending markets and a large part of borrowing is recycled as debt is repaid and re-issued. Another body would need to be established to address these issues and to determine what share of whole United Kingdom existing debt servicing Scotland should incur and

subsequently what share of post-fiscal autonomy whole United Kingdom debt servicing is due to Scotland.

A final issue is whether fiscal autonomy offers any potential solution to the West Lothian Question. Put simply, this is the anomaly that Scottish MPs may vote on all matters affecting England while English MPs at Westminster can vote only on those matters affecting Scotland that are not devolved to the Scottish Parliament. H&M propose the devolution of almost all taxation to Edinburgh. If additional responsibilities currently held at Westminster do not follow the change in fiscal responsibility to Edinburgh, then there will remain a large vertical fiscal imbalance: Scotland's taxation receipts in 2003-04 were estimated at £34bns while total government expenditure in Scotland is estimated at £45.3bns. Of that, spending by the Executive amounted to £23.5bns with the remaining £20bns being spent by the United Kingdom government between reserved matters in Scotland and Scotland's share of expenditure incurred for the benefit of the whole of the United Kingdom. An outcome without further devolution of powers from London to Edinburgh would put great pressure on inter-governmental transfers and the body required to oversee them.

If anything H&M's proposals are likely to increase the pressure on Scottish MPs at Westminster. Should greater devolution of powers than currently granted under the Scotland Act be considered as a part of the plans for fiscal autonomy laid out by H&M, then the scope for Scotland's MPs to vote on matters affecting Scotland would be reduced to the limited remnants of whole-UK functions. However, there is no method at present to restrict those issues on which Scottish MPs may vote and without a radical change in the procedures of the House of Commons Westminster could have less influence on the lives of those living in Scotland while the role of its representatives is unchanged. Sufficient changes in fiscal structure can demand institutional alteration and there can be little doubt that fiscal autonomy would require a radical recasting of the role of Scotland's representatives at Westminster, with the impacts we have discussed above as the 'Westminster incentive'.

5. Conclusions

In this paper we have argued that Hallwood and MacDonald (2006) while purporting to establish a case for fiscal autonomy in Scotland have signally failed to do so. The arguments deployed in their previous work in favour of a form of fiscal federalism in Scotland do not, as they suggest, have even greater force in the case for fiscal autonomy within the Union. They do not appear to appreciate fully the problems that would arise from the adoption of such a system, nor do they appear to be fully aware of the properties of the present form of funding devolution under the Barnett based system.

We contend that in adopting fiscal autonomy Scotland would lose many of the benefits of economic and fiscal

integration with the rest of the UK for little or no gain compared with a form of fiscal federalism or the present Barnett system. It is, therefore, not surprising that Hallwood and MacDonald (2004 and 2005) in their earlier work could not identify one example of an advanced federal or devolved country that had opted for fiscal autonomy at the sub-central government (SCG) level. But, in view of this, it is surprising that H&M now cease to reject full fiscal autonomy for Scotland and embrace it with enthusiasm. The Steel Commission (2006) concludes that

“... full fiscal autonomy is not in the interests of Scotland – in fact it would be extremely damaging to Scotland. It also ignores the considerable benefits, both to Scotland and the rest of Britain, of being part of the United Kingdom. It exists in no other industrialised country in the world and it is clear that such a system effectively negates any meaningful role for a wider UK state” (page 91).

Our analysis supports that conclusion.

Steel Commission (2006) “Moving to Federalism – A New Settlement for Scotland”, Edinburgh.

Endnotes:

ⁱIt is assumed that central government can only provide public goods and services uniformly across jurisdictions (Ebel and Yilmaz (2001)).

ⁱⁱ Although the degree of competition under the limited and asymmetrically devolved UK system is small.

ⁱⁱⁱ This raises the question of whether H&M see fiscal autonomy as a general financing mechanism for all the devolved administrations and what the response would be for fiscal autonomy for London, for example.

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