Y Pwyllgor Cyllid / Finance Committee
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Cynulliad Cenedlaethol Cymru / National Assembly for Wales
Y Pwyllgor Cyllid / The Finance Committee
Future Funding For Wales Inquiry / Ymchwiliad i Ariannu Cymru yn y Dyfodol

FIN(4) FF06
Ymateb gan Y Sefydliad Astudiaethau Cyllid
Response from The Institute for Fiscal Studies

Response to Consultation on Future Funding

David Phillips

1. Introduction

This is a response by David Phillips, a senior research economist at the Institute for Fiscal Studies (IFS). David has led the IFS's work on devolved finance issues. He is also a member of the Welsh Finance Minister's Tax Advisory Group. However, the views and opinions expressed here are those of the author only. The IFS has no corporate views.

This earlier work may also be useful to the committee's work. Please see the following publications:

http://www.ifs.org.uk/publications/7711

http://www.ifs.org.uk/publications/7484

http://www.ifs.org.uk/publications/7442

Please note this response focuses on the following areas:

- The trade-offs between different types of funding arrangements
- The practical issues involved in moving from

As a result, responses are not provided to all questions. And it does not make recommendations about which funding system should be used. Ultimately, that is a political question, involving bargaining between the nations and governments of the UK, and political views on the appropriate degree of redistribution across the UK and how to trade-off risk-sharing/insurance versus fiscal incentives.

2. What are the main weaknesses in the current financial settlement for Wales?

The Welsh Government currently receives the bulk of its money from the UK Government in the form of a block grant. This block grant is calculated each year as the prior year's grant plus (or minus) an increment calculated using the Barnett formula and based on changes in "comparable" budgets in England. In addition, the Welsh Government receives income from non-domestic rates (NDR), and Welsh local authorities receive money from council tax. Non-devolved spending (such as welfare) is the responsibility of the UK government.

From 2018-19, powers over and revenue from Stamp Duty Land Tax (SDLT) and Landfill Tax (LT) will be devolved to Wales, and the block grant will be reduced accordingly. There is also the potential for income tax to be partially devolved, subject to a referendum, which would necessitate similar adjustments to the block grant. As shall be discussed later, adjusting the block grant is a complicated issue which has profound implications for the level of funding the Welsh Government will see in future, and the financial risks and incentives it will face. At the same time, the Welsh Government will acquire some borrowing powers (for both capital and current purposes) subject to strict rules.

A number of elements of this framework attract criticism:

1) That the Barnett formula is arbitrary and takes no account of relative needs (or revenue contributions for that matter).
2) That the result of the use of the Barnett formula is an underfunding of Wales, and in the long term, a "Barnett squeeze".
3) That the specific way in which the Barnett formula treats devolved NDR revenues is flawed (http://www.ifs.org.uk/publications/7442) and has what appear to be unintended consequences. Whilst these flaws benefit Wales (from this year), Scotland and Northern Ireland during periods in which the Local Government budget in England is doing poorly relative to overall "comparable" departmental spending, the flaws would cost Wales (and Scotland and NI) if the Local Government budget were to do relatively well from budget settlements.
4) That information on the application of the Barnett formula is not readily available, and that application of the formula is controlled solely by the Treasury (which makes decisions about what spending is deemed 'comparable', for instance).
5) That a system largely based on block grant funding gives little financial incentive for the Welsh Government to boost economic performance, and hence boost revenues (or reduce welfare costs). Proposals for tax devolution will address this concern to some extent.
6) That the proposed borrowing powers are too limited and highly constrained, both on the capital side (see CIPFA's submission) and on the current side (where borrowing will be available only for forecast errors).

There is disagreement about some of these issues.

For instance, the UK Government says that it thinks that Wales' level of funding is within the appropriate range suggested by the Holtham Agreement, and has said it will consider a 'funding floor' to prevent any further convergence if agreement is reached on devolving income tax. It is also pointed out that the Barnett squeeze does not operate (at least to the same extent) when spending is being cut, and when there is lower population growth in Wales (as is currently the case).

But each is an issue worth considering by the Committee.

How can these be resolved?

Some issues can, in principle, be resolved relatively easily. For instance, further information about the application of the Barnett formula (or any replacement formula) could be published alongside each fiscal event (such as Budget or Autumn Statement). In addition, the Barnett formula (or any replacement formula) and associated Statement of Funding Policy could be managed by an independent body, rather than the Treasury.

Similarly, the flaws in the way the Barnett formula treats devolved NDRs can be corrected for by a simple change to the technical workings of the formula.[1]

However, some of the issues reflect trade-offs between different objectives. For instance, a needs-based approach to funding would cushion Wales from any adverse budgetary effects from increases in its relative needs – such as weaker economic performance or a more rapidly ageing population –, but would also mean Wales would not gain from any reduction in its relative needs. The latter would blunt the incentives the Welsh Government has to take action to reduce relative needs and to boost economic performance. Depending on whether the needs based formula also took into account revenue-raising capacity, it could also blunt incentives to boost revenue growth from devolved taxes.

Addressing one issue (making the funding more responsive to changes in relative needs) may therefore make other problems worse (lessening the incentive of the Welsh government to take action to reduce spending needs). These trade-offs between risks and incentives are at the core of any funding arrangement for sub-national governments.

How will upcoming changes in relation to: a reserved-powers model for Wales, and the St David's Day devolution proposals and Smith Commission recommendations, impact on future funding arrangements of the Welsh Government?

The response to this question focuses on adjusting the block grant as a result of further devolution, and draws on work being undertaken as part of assessing the Smith Commission proposals.

Clearly when additional revenues or spending are devolved, adjustments have to be made to the block grant.

In principle at least, the *first year* adjustments to the block grant are relatively straightforward to implement, although the calculations involved may be complex. When devolving a tax, the block grant is reduced by the amount of revenue being transferred. When devolving responsibility for an additional area of spending, the block grant is increased by the amount the UK would have spent in Wales on that area.

Given the complex calculations that may be required in order to estimate these quantities, it would be preferable if the UK Government and Welsh Government agree on a methodology, and publish detailed information on the calculations. This will allow proper external scrutiny. If agreement on a single method cannot be reached, then both parties should publish detailed information on their methods, and resulting calculations. The OBR and an equivalent Welsh fiscal commission should assess and, if appropriate, sign off these calculations. Information should also be published on the mechanism by which ultimate agreement is reached (and what that agreement entailed). Consideration should be given for an independent institution to act as an arbiter.

Calculating the adjustment to the block grant in *subsequent years* is more conceptually complex. One cannot simply continue to deduct or add an amount equal to the revenues or spending devolved. Doing this would remove any incentive for the Welsh Government to boost tax revenues or limit expenditure growth (including through discretionary tax rises, or spending cuts): any change

[1] Again see http://www.ifs.org.uk/publications/7442.

in revenue or spending would simply be cancelled out by an offsetting change to the block grant adjustment.

There are a number of methods for adjusting the block grant, and each has different properties. The attached presentation sets out three possible mechanisms, and their advantages and disadvantages (including worked examples of how they perform under different scenarios).[2]

The following summarises the findings (with advantages in green, and disadvantages in red):

- Fixed % adjustment to block grant (i.e. block grant reduced by the same % in each year as in 1st year)
  - Easy to understand and can be implemented using Barnett formula
  - But Wales bears risk of UK-wide shocks it is ill-equipped to bear
- Index to % change in rUK revenues
  - Insulates Wales from UK-wide shocks but still growth incentive
  - In spirit of "no detriment simply from devolution" as Wales is left no better off or worse off in the long term if revenues grow at the same % rate as in rUK
  - Wales affected (a bit) by rUK decisions on taxes that in Wales are the responsibility of the Welsh Government
- Index to £s p.p change in rUK revenues
  - Also insulates Wales from UK-wide shocks while still proving growth incentive
  - Wales in principle unaffected by rUK decisions on taxes that in Wales are the responsibility of the Welsh Government
  - But Wales loses out unless its revenues grow more quickly in % terms than rUK

From a Welsh Government perspective, the last option would worsen the Barnett Squeeze. Indexing block grant adjustments to the percentage change in rUK revenues has attractions in general.

However, if yield from a particular tax were expected to grow less quickly (or more quickly) in Wales than in the rest of the UK due to underlying economic factors, indexing the block grant adjustments to revenue growth in the rest of the UK may not be appropriate. This may be the case for Stamp Duty, where the lower property prices in Wales mean that revenues might be expected to grow less quickly in Wales (as fewer properties will be subject to the highest tax rates even if property price growth kept up with growth in England). This issue has prevented agreement on the method to adjust the block grant after the 1st year of devolution of Stamp Duty (and Landfill Tax) in the case of Scotland. This suggests two options:

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[2] The presentation is also available at: http://www.ifs.org.uk/publications/7711.

1) Assess each tax on a case-by-case basis to decide what method should be used to adjust the block grant. However, this risks a zero-sum bargaining approach by the devolved and UK governments where each side pushes for a system that is likely to benefit them for the particular tax in question.
2) Combine revenue from all taxes and make a single adjustment. Because the bigger taxes (like Income Tax) are not so prone to such problems of differential revenue growth, doing this may make it easier to use a single principles-based adjustment mechanism.

It is also worth discussing the 'no detriment' principles suggested by the Smith Commission for Scotland to see if they are relevant for Wales.

The ideas behind the two 'no detriment' principles seem sensible at first glance:

- Neither government should gain nor lose simply as a result of the decision to devolve revenues or spending responsibilities (1st no detriment principle);
- Each government should bear the risks and reap the benefits of their own policies, and not win or lose from knock on effects from the other government's policies. Related to this, it seems reasonable that changes in taxes in rUK for which the Welsh Government has responsibility in Wales, should *not* impact the amount spent for the benefit of Wales (together, the 2nd no detriment principle).

The difficulty arises in practice, when considering how to implement the principles.

It does not seem possible to design a block grant adjustment mechanism that satisfies the need for transparency and 'automaticity', and at the same time, satisfies both of these no detriment principles. For instance, indexing the block grant to the % change in equivalent revenues/spending in rUK seems to satisfy the spirit of the 1st no detriment principle, but does not fully satisfy the 2nd no detriment principle. Conversely, indexing the block grant the £s p.p change in equivalent revenues/spending in rUK satisfies the 2nd no detriment principle, but does not seem in the spirit of the 1st (as it has an effect similar to the "Barnett squeeze").

There is a further issue with the 2nd no detriment principle: taken at face value, it implies that where there are knock-on effects from one government's decisions on the revenues or spending of the other, compensating transfers should take place. The calculation of such transfers would be difficult, however, involving complex calculations and modelling; seemingly minor and technical differences in assumptions may lead to very different answers. This aspect of the no detriment principles therefore leaves much scope for disagreement – which could cause difficulties for inter-governmental relations. Difficult negotiations would likely be required in such circumstances, which would mean the system was not "mechanical", and may lead to a lack of transparency.

This would suggest restricting the circumstances in which such transfers take place to the most significant and obvious examples of "knock on" effects; and requiring full information to be published by both the UK government and Welsh government on assumptions and modelling undertaken during negotiations about what compensating transfers should take place. Again, assessment and sign off of costings by the OBR and an equivalent Welsh fiscal commission seems worthwhile; as does investigation of whether an independent body can act as an arbiter.

It is also worth noting that while the "no detriment" principles may seem intuitively appealing, they are not a central feature of the fiscal frameworks of other countries, perhaps because of the difficulties of implementing such principles in practice.

What financial and economic information is needed by the UK and Welsh Governments to provide support for future funding arrangements?

The data requirements to implement future funding arrangements will depend upon precisely what those are.

Tax devolution will require forecasts and outturns data for revenues from devolved taxes in Wales and equivalent taxes in the rest of the UK (or England). The forecasts of those revenues will require improved data and forecasts on the Welsh economy – housing volumes and prices, landfill volumes, employment, earnings, profits and other incomes etc. It would also be useful to have more detailed statistics on the devolved taxes (e.g. income tax collected by income range or tax band; housing market transactions by stamp duty band, and revenue per band).

Any move to a needs-based formula for allocating the block grant will require data on the indicators that enter that formula. The Holtham Commission showed that it is possible to base a formula on a relatively small set of indicators which would reduce data requirements.

As discussed above, information on how the Barnett formula (or any replacement formula) has been applied at each fiscal event (and the resulting budgetary consequentials) should be published to allow proper oversight and scrutiny.

Are there any issues the Committee should be aware of in relation to developments on the issues of convergence, underfunding and Barnett reform?

I would suggest the Committee examine two contributions to these issues.

First, a recent paper by myself, which looks at the Barnett Formula's treatment of devolved NDRs:

(http://www.ifs.org.uk/publications/7442)

Secondly, a paper by Jim Cuthbert (actually from 2001) which provides some analytical results on the extent to which the Barnett formula leads to convergence at given levels of nominal spending growth, and different levels of relative population growth:

http://strathprints.strath.ac.uk/52628/

The proposal to put operate a funding floor for Wales by adjusting the Barnett formula so that Wales gets 115% of any increase in per-person comparable spending in England (if needs were assessed to be 115% of those in England) should be seen in the light of the paper by Mr Cuthbert. In effect, if population growth were slower in Wales, such a mechanism would lead to funding in Wales moving quite away above that floor.

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The Smith Commission proposals: the unresolved issue of the “fiscal framework”

David Phillips

CIPFA Scotland Conference 2015, March 26th 2015

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Coming up

- The Smith Commission and the fiscal framework
  - The big unresolved issue
  - The Commission’s principles for the framework
- Assessing the options for adjusting the block grant
  - Do any of them satisfy all the Commission’s principles?
- Borrowing powers
  - What about a prudential borrowing regime?
- Beyond the Smith Commission proposals
  - The financial implications of ‘full fiscal autonomy’
- Concluding thoughts

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The Smith Commission proposals

- Significant devolution of tax powers and revenues
  - ~ £10 – 11bn of income tax, ~£4 bn of VAT, and others
  - Devolved or assigned revenues will make up >50% of Scottish Government spending
- Partial devolution of welfare
  - ~ £2.5bn of mainly disability benefits
  - Powers to top up benefits and vary housing elements of UC
- Need to adjust the block grant given to Scottish government to account for additional revenues and spending responsibilities
- And changes to the wider 'fiscal framework' are needed given additional budgetary risk

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Adjusting the Block grant in year 1

- Adjusting the block grant in year 1 is conceptually simple:

Initial Block Grant

+ Additional spending

- Additional revenues

New Block Grant

- But what about in subsequent years?

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Adjusting block grant in subsequent years

- Cannot just keep making the same cash-terms adjustment
  - Need to account for inflation and economic growth
- But cannot adjust based on how much is raised from devolved taxes and spent on devolved welfare each year
  - Remove incentive for Scottish govt. to grow tax revenues and limit expenditure growth
  - Changes in block grant would neutralise such efforts

Revenues up £500m	**Block grant cut £500m**	**= no net change**

- Smith Commission recognises importance of issue
  - Adjustment should be “indexed appropriately”
  - But what would be an appropriate method?

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The Smith Commission's fiscal principles (I)

- Smith Commission also sets out a number of principles the new fiscal framework (including block grant adjustments) should meet:

95.1 "Barnett Formula"

The block grant from the UK Government to Scotland will continue to be determined by the Barnett formula

95.2 "Economic Responsibility"

The Scottish budget should benefit in full from Scottish Government policy decisions increasing revenues or reducing expenditures, and bear the full cost of policy decisions that reduce revenues or increase expenditures.

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The Smith Commission’s fiscal principles (II)

95.3 “No detriment as a result of the decision to devolve further powers”

The Scottish and UK Governments’ budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

95.4 “No detriment as a result of UK or Scottish Government policy decisions post-devolution”

Where policies of either government affect spending or revenues of others, compensating transfers should take place.

Changes in rUK to taxes devolved to Scotland should not affect government spending in Scotland

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The Smith Commission’s fiscal principles (II)

95.5 “Borrowing powers”

Need to be consistent with the mechanism by which block grant is adjusted to account for tax and spending devolution

95.8 “UK economic shocks”

The UK Government should continue to manage risks and economic shocks that affect the whole of the UK.

95.6 “Implementable and stable”

Once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation.

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Assessing block grant adjustment options

- There are a number of ways block grant adjustment can be calculated in subsequent years
- Adjust the block grant by a constant %
- Index the adjustment to what happens to revenues from equivalent taxes (or spending on equivalent welfare) in rUK
  - In % terms
  - In £s per person (p.p) terms
- We need to assess the various methods
  - How do they perform under different scenarios?
  - Do they satisfy Smith Commission's principles?

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Adjusting by a constant percentage (I)

- Suppose year 1 block grant is£30bn and income tax revenues of £10bn is being devolved*
  - Block grant is therefore reduced by £10bn to £20bn
  - Reduction is equivalent to 33% of initial block grant
- In future years reduce block grant by 33% compared to what it otherwise would be
  - e.g. if grant otherwise £33bn: £33bn – 33% = £22bn
- The good…
  - Can adjust for rUK policy changes using Barnett formula
  - Simple & a similar system already operates for business rates

* We abstract from devolution of other taxes and welfare only to keep examples simple.

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Adjusting by a constant percentage (II)

- The bad…
  - Scottish budget would end up bearing risk of shocks that affect the whole of the UK, contrary to Smith Commission

Following devolution, Scotland's budget is £20bn (grant) + £10bn (revenues)

e.g. Income tax revenues fall by 20% in Scotland and rUK (UK-wide shock)

UK govt leaves spending unchanged so underlying block grant still £30bn and adjusted still £20bn

Scotland's budget is now £20bn (grant) +£8bn (revenues): a shortfall of £2bn due to 20% revenue fall

- And the ugly…
  - Scotland isn't well placed to bear such risks
  - Fewer mechanisms to compensate
  - Borrowing is likely to be more expensive for Scotland

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Indexing to % change in rUK revenues (I)

- Keeping with example of 20% revenue fall in Scotland and rUK
  - Block grant adjustment is reduced by 20% from £10 to £8bn
  - Scottish Govt budget is now £22bn (grant) + £8bn (revenue) = £30bn
  - Scottish Govt budget is insulated from UK-wide shocks
  - Need less additional borrowing powers to smooth shocks
- If Scottish and UK revenues change at same % rate, Scotland's overall budget is same as without devolution
  - In the spirit of the first "no detriment" principle (95.3)
- But does gain/lose if its revenues do better/worse than rUK
  - Ensures incentives to grow economy and manage fiscal risks

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Indexing to % change in rUK revenues (II)

- rUK revenues also affected by UK government policy changes
- Suppose UK government cuts income tax in rUK by £10bn.
  - This is equivalent to about 8%, so block grant adjustment reduced by 8% (£0.8bn) to £9.2bn
- Further, imagine this is funded by cutting spending in rUK
  - Barnett formula means £10bn cut in spending in rUK reduces underlying block grant to Scotland by about £0.92bn
- Net effect is to reduce Scottish Govt. budget by £0.12bn
  - £0.8bn - £0.92bn
- So Scottish Govt sees its budget cut to fund a tax cut in rUK
  - Violates second "no detriment" principle (95.4)

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Indexing to £s p.p change in rUK revenues (I)

- Problem arises because revenues per person differ between Scotland and rUK
  - Barnett formula works on £s p.p changes not % changes
- Indexing block grant adjustment to £s p.p change in rUK revenues solves this problem
- But introduces another problem
  - Scottish revenues would have to grow quicker in % terms to keep up £s per person growth in rUK revenues

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Indexing to £s p.p change in rUK revenues (II)

- Scottish income tax revenues in 2013-14 were £11.4 billion
  - £2,140 per person, compared to £2,460 in rUK
- Suppose devolved at that time, and thereafter revenues grow 5% in Scotland and rUK
- 10 years after devolution, the amount taken off block grant would increase to £19.7 billion, but Scottish revenues would only grow to £18.9 billion.
  - Shortfall of £1.1 billion
  - Shortfall would continue growing over time
- Scottish revenues would have to grow quicker than those in rUK to avoid such a fate
  - Does not feel in the spirit of 1st "No Detriment" principle (95.3)

Summarising the options

- Fixed % adjustment to block grant
  - Easy to understand and implement using Barnett formula
  - But Scotland bears risk of UK-wide shocks it is ill-equipped to bear
- Index to % change in rUK revenues
  - Insulates Scotland from UK-wide shocks but still growth incentive
  - In spirit of “no detriment simply from devolution”
  - Scotland affected (a bit) by rUK decisions on devolved taxes
- Index to £s p.p change in rUK revenues
  - Scotland unaffected by rUK decisions on devolved taxes
  - But Scotland loses out unless its revenues grow more quickly in % terms than rUK – not in spirit of 1st “no detriment” principle

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Can any mechanism satisfy all Smith principles?

- Clear trade-offs between different Smith Commission principles
- Our ongoing analysis suggests that there is **no method that will satisfy all the principles**
  - Fiddly fixes would increase risk of political deadlock
- Need to prioritise principles and choose method accordingly
- **Indexing to % change in rUK revenues looks best to me**
  - Insulates Scotland from UK-wide shocks
  - Taxes in rUK go up and down and the (relatively small) increases and reductions in Scotland's budget this method causes would balance out
- Problems under other methods larger & likely to grow over time
  - e.g. after 20 years, loss to Scotland at 5% revenue growth under £s p.p indexation would increase to £2.8bn.

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Should the "no detriment" principles be ditched?

- More generally, not clear "no detriment" principles are sensible
  - Devolution necessarily increases budget risk (& possible "detriment")
- Consider "compensation" for knock-on effects
- Suppose Scotland increases top rate of tax to 50%
  - Scots work less, so pay less NICs –Scottish govt compensate UK govt?
  - Scots shift income from earnings to dividends; or Scots move from Scotland to rUK – UK govt compensate Scottish govt?
  - How do you measure these effects?
- Such an approach necessarily require lots of negotiation
  - £millions at stake , so lots to argue about – political chaos?
- Better to accept there may be some detriment to either govt?
  - Other countries (e.g. US, Canada, Australia) do

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Borrowing powers

- Scotland would need borrowing powers commensurate with the fiscal risks it faces under devolution
- By insulating Scotland from UK-wide shocks, indexing block grant adjustment to % change in rUK revenues reduces necessary scale of extra borrowing powers
  - Reduces Scotland's debt interest bill
  - Less risk of UK govt. having to bail out Scotland?
- CIPFA has argued for a system of prudential borrowing
  - Argue it has worked well for local authorities
  - Central government can intervene if local authorities over-borrow
  - But politics with Scotland is difficult – intervention by UK govt could cause a political and constitutional crisis
  - Could be in some groups' interests to cause such a crisis

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Beyond Smith: full autonomy (I)

- Smith proposals not necessarily the end of the devolution journey
  - SNP has argued for “full fiscal autonomy”
- Full fiscal autonomy normally interpreted as Scotland raising all its own revenues and controlling all its spending
  - Includes contribution to UK govt for defence, foreign affairs, and servicing Scotland’s share of UK’s existing debt
  - No more Barnett formula
- Latest GERS figures for 2013-14 show:
  - Scottish deficit of 8.1% of GDP, compared to 5.6% for UK as a whole
- Oil price falls mean Scotland’s relative position likely worsened
  - In 2015-16 deficit of 8.6% of GDP (4.0% UK)

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Beyond Smith: full autonomy (II)

- At the moment full fiscal autonomy would therefore entail
  - Very high borrowing (not feasible?) or
  - Substantial tax rises or spending cuts
- Oil revenues need to be about £8bn a year to make up for loss of funding under Barnett formula
  - Currently forecast at £0.6 billion a year
  - May rebound, but volatile, and longer term decline
- Faster growth in onshore economy would help close the gap
  - Easier said than done
  - Main policies suggested involve taxing less or spending more – make the gap bigger, not smaller
- Full fiscal autonomy would entail significant fiscal challenges

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Conclusions

- Updating the fiscal framework to account for further devolution is important – for responsibility, fairness, and incentives
- But it looks like cannot satisfy all Smith Commission principles
  - And "no detriment" principles not so sensible in practise as on paper
- Devolution necessarily involves budget risks
  - Policymakers should focus on ensuring the system is workable and risks shared sensibly between UK and Scottish govt
  - Politics is key: Will two governments design and operate a system in good faith? Or will it be used a battleground for point scoring?
- Borrowing is another key issue – not sure prudential borrowing is the right approach
- Smith Commission may only be start of the journey
  - Full fiscal autonomy presents a big fiscal challenge

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Response from The Institute for Fiscal Studies - Annex A

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The Smith Commission proposals: the unresolved issue of the "fiscal framework"

David Phillips

CIPFA Scotland Conference 2015, March 26th 2015

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- The Smith Commission and the fiscal framework
  - The big unresolved issue
  - The Commission's principles for the framework
- Assessing the options for adjusting the block grant
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  - Devolved or assigned revenues will make up >50% of Scottish Government spending
- Partial devolution of welfare
  - ~ £2.5bn of mainly disability benefits
  - Powers to top up benefits and vary housing elements of UC
- Need to adjust the block grant given to Scottish government to account for additional revenues and spending responsibilities
- And changes to the wider 'fiscal framework' are needed given additional budgetary risk

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  - Need to account for inflation and economic growth
- But cannot adjust based on how much is raised from devolved taxes and spent on devolved welfare each year
  - Remove incentive for Scottish govt. to grow tax revenues and limit expenditure growth
  - Changes in block grant would neutralise such efforts

Revenues up £500m | **Block grant cut £500m** | **= no net change**

- Smith Commission recognises importance of issue
  - Adjustment should be "indexed appropriately"
  - But what would be an appropriate method?

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The Smith Commission's fiscal principles (I)

- Smith Commission also sets out a number of principles the new fiscal framework (including block grant adjustments) should meet:

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The block grant from the UK Government to Scotland will continue to be determined by the Barnett formula

95.2 "Economic Responsibility"
The Scottish budget should benefit in full from Scottish Government policy decisions increasing revenues or reducing expenditures, and bear the full cost of policy decisions that reduce revenues or increase expenditures.

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Need to be consistent with the mechanism by which block grant is adjusted to account for tax and spending devolution

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The UK Government should continue to manage risks and economic shocks that affect the whole of the UK.

95.6 "Implementable and stable"
Once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation.

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Assessing block grant adjustment options

- There are a number of ways block grant adjustment can be calculated in subsequent years
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- We need to assess the various methods
  - How do they perform under different scenarios?
  - Do they satisfy Smith Commission's principles?

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Adjusting by a constant percentage (I)

- Suppose year 1 block grant is£30bn and income tax revenues of £10bn is being devolved*
  - Block grant is therefore reduced by £10bn to £20bn
  - Reduction is equivalent to 33% of initial block grant
- In future years reduce block grant by 33% compared to what it otherwise would be
  - e.g. if grant otherwise £33bn: £33bn – 33% = £22bn
- The good...
  - Can adjust for rUK policy changes using Barnett formula
  - Simple & a similar system already operates for business rates

* We abstract from devolution of other taxes and welfare only to keep examples simple.

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Adjusting by a constant percentage (II)

- The bad...
  - Scottish budget would end up bearing risk of shocks that affect the whole of the UK, contrary to Smith Commission

Following devolution, Scotland's budget is £20bn (grant) + £10bn (revenues)

e.g. Income tax revenues fall by 20% in Scotland and rUK (UK-wide shock)

UK govt leaves spending unchanged so underlying block grant still £30bn and adjusted still £20bn

Scotland's budget is now £20bn (grant) +£8bn (revenues): a shortfall of £2bn due to 20% revenue fall

- And the ugly...
  - Scotland isn't well placed to bear such risks
  - Fewer mechanisms to compensate
  - Borrowing is likely to be more expensive for Scotland

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Indexing to % change in rUK revenues (I)

- Keeping with example of 20% revenue fall in Scotland and rUK
  - Block grant adjustment is reduced by 20% from £10 to £8bn
  - Scottish Govt budget is now £22bn (grant) + £8bn (revenue) = £30bn
  - Scottish Govt budget is insulated from UK-wide shocks
  - Need less additional borrowing powers to smooth shocks
- If Scottish and UK revenues change at same % rate, Scotland's overall budget is same as without devolution
  - In the spirit of the first "no detriment" principle (95.3)
- But does gain/lose if its revenues do better/worse than rUK
  - Ensures incentives to grow economy and manage fiscal risks

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Indexing to % change in rUK revenues (II)

- rUK revenues also affected by UK government policy changes
- Suppose UK government cuts income tax in rUK by £10bn.
  - This is equivalent to about 8%, so block grant adjustment reduced by 8% (£0.8bn) to £9.2bn
- Further, imagine this is funded by cutting spending in rUK
  - Barnett formula means £10bn cut in spending in rUK reduces underlying block grant to Scotland by about £0.92bn
- Net effect is to reduce Scottish Govt. budget by £0.12bn
  - £0.8bn - £0.92bn
- So Scottish Govt sees its budget cut to fund a tax cut in rUK
  - Violates second "no detriment" principle (95.4)

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Indexing to £s p.p change in rUK revenues (I)

- Problem arises because revenues per person differ between Scotland and rUK
  - Barnett formula works on £s p.p changes not % changes
- Indexing block grant adjustment to £s p.p change in rUK revenues solves this problem
- But introduces another problem
  - Scottish revenues would have to grow quicker in % terms to keep up £s per person growth in rUK revenues

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Indexing to £s p.p change in rUK revenues (II)

- Scottish income tax revenues in 2013-14 were £11.4 billion
  - £2,140 per person, compared to £2,460 in rUK
- Suppose devolved at that time, and thereafter revenues grow 5% in Scotland and rUK
- 10 years after devolution, the amount taken off block grant would increase to £19.7 billion, but Scottish revenues would only grow to £18.9 billion.
  - Shortfall of £1.1 billion
  - Shortfall would continue growing over time
- Scottish revenues would have to grow quicker than those in rUK to avoid such a fate
  - Does not feel in the spirit of 1st "No Detriment" principle (95.3)

Summarising the options

- Fixed % adjustment to block grant
  - Easy to understand and implement using Barnett formula
  - But Scotland bears risk of UK-wide shocks it is ill-equipped to bear
- Index to % change in rUK revenues
  - Insulates Scotland from UK-wide shocks but still growth incentive
  - In spirit of "no detriment simply from devolution"
  - Scotland affected (a bit) by rUK decisions on devolved taxes
- Index to £s p.p change in rUK revenues
  - Scotland unaffected by rUK decisions on devolved taxes
  - But Scotland loses out unless its revenues grow more quickly in % terms than rUK – not in spirit of 1st "no detriment" principle

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Can any mechanism satisfy all Smith principles?

- Clear trade-offs between different Smith Commission principles
- Our ongoing analysis suggests that there is **no method that will satisfy all the principles**
  - Fiddly fixes would increase risk of political deadlock
- Need to prioritise principles and choose method accordingly
- **Indexing to % change in rUK revenues looks best to me**
  - Insulates Scotland from UK-wide shocks
  - Taxes in rUK go up and down and the (relatively small) increases and reductions in Scotland's budget this method causes would balance out
- Problems under other methods larger & likely to grow over time
  - e.g. after 20 years, loss to Scotland at 5% revenue growth under £s p.p indexation would increase to £2.8bn.

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Should the "no detriment" principles be ditched?

- More generally, not clear "no detriment" principles are sensible
  - Devolution necessarily increases budget risk (& possible "detriment")
- Consider "compensation" for knock-on effects
- Suppose Scotland increases top rate of tax to 50%
  - Scots work less, so pay less NICs –Scottish govt compensate UK govt?
  - Scots shift income from earnings to dividends; or Scots move from Scotland to rUK – UK govt compensate Scottish govt?
  - How do you measure these effects?
- Such an approach necessarily require lots of negotiation
  - £millions at stake , so lots to argue about – political chaos?
- Better to accept there may be some detriment to either govt?
  - Other countries (e.g. US, Canada, Australia) do

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Borrowing powers

- Scotland would need borrowing powers commensurate with the fiscal risks it faces under devolution
- By insulating Scotland from UK-wide shocks, indexing block grant adjustment to % change in rUK revenues reduces necessary scale of extra borrowing powers
  - Reduces Scotland's debt interest bill
  - Less risk of UK govt. having to bail out Scotland?
- CIPFA has argued for a system of prudential borrowing
  - Argue it has worked well for local authorities
  - Central government can intervene if local authorities over-borrow
  - But politics with Scotland is difficult – intervention by UK govt could cause a political and constitutional crisis
  - Could be in some groups' interests to cause such a crisis

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Beyond Smith: full autonomy (I)

- Smith proposals not necessarily the end of the devolution journey
  - SNP has argued for "full fiscal autonomy"
- Full fiscal autonomy normally interpreted as Scotland raising all its own revenues and controlling all its spending
  - Includes contribution to UK govt for defence, foreign affairs, and servicing Scotland's share of UK's existing debt
  - No more Barnett formula
- Latest GERS figures for 2013-14 show:
  - Scottish deficit of 8.1% of GDP, compared to 5.6% for UK as a whole
- Oil price falls mean Scotland's relative position likely worsened
  - In 2015-16 deficit of 8.6% of GDP (4.0% UK)

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Beyond Smith: full autonomy (II)

- At the moment full fiscal autonomy would therefore entail
  - Very high borrowing (not feasible?) or
  - Substantial tax rises or spending cuts
- Oil revenues need to be about £8bn a year to make up for loss of funding under Barnett formula
  - Currently forecast at £0.6 billion a year
  - May rebound, but volatile, and longer term decline
- Faster growth in onshore economy would help close the gap
  - Easier said than done
  - Main policies suggested involve taxing less or spending more – make the gap bigger, not smaller
- Full fiscal autonomy would entail significant fiscal challenges

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Conclusions

- Updating the fiscal framework to account for further devolution is important – for responsibility, fairness, and incentives
- But it looks like cannot satisfy all Smith Commission principles
  - And "no detriment" principles not so sensible in practise as on paper
- Devolution necessarily involves budget risks
  - Policymakers should focus on ensuring the system is workable and risks shared sensibly between UK and Scottish govt
  - Politics is key: Will two governments design and operate a system in good faith? Or will it be used a battleground for point scoring?
- Borrowing is another key issue – not sure prudential borrowing is the right approach
- Smith Commission may only be start of the journey
  - Full fiscal autonomy presents a big fiscal challenge

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