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1st Report of Session 2015–16

A Fracturing Union? The Implications of Financial Devolution to Scotland

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EXECUTIVE SUMMARY: A FRACTURING UNION?

> "Only three people have ever really understood the Schleswig-Holstein business—the Prince Consort, who is dead—a German professor, who has gone mad—and I, who have forgotten all about it."[1]

During the Committee's investigation into the devolution of public finances, Lord Palmerston's assessment of the Schleswig-Holstein question has often sprung to mind. Funding of devolved administrations, particularly with regards to Scotland, is a complex mix of social, economic and political questions; "You would not start from here", has been the lament of many of our witnesses.[2]

This inquiry was prompted by the Smith Commission agreement. The Scottish cross-party Smith Commission was established by the Prime Minister, following the September 2014 referendum on Scottish independence, to agree further powers which should be devolved to Scotland. The Committee was particularly interested in the proposals that seek to increase the financial accountability of the Scottish Parliament.

The Smith Commission agreement will be delivered through the Scotland Bill 2015 and the renegotiation of the 'fiscal framework' by the UK and Scottish Governments. The fiscal framework sets out how Scotland, Wales and Northern Ireland receive funding from the UK Government and the institutional arrangements that govern the process. The renegotiation of the fiscal framework may also have implications for future funding arrangements for Wales and Northern Ireland. Negotiations on the fiscal framework have yet to be concluded.

The process by which powers are devolved should be clear and transparent, to experts and the public alike. Any solution should be logical, intended for the long-term and based on principle. The Scotland Bill and accompanying negotiations on the fiscal framework reflect none of these ideals. This is not unique to current events: it is characteristic of the way devolution has always progressed in the United Kingdom. This is regrettable.

This report draws attention to certain problems we have identified that the UK Government and devolved administrations need to address.

Problem 1: The Absence of the Fiscal Framework

The implications of the Scotland Bill 2015 cannot be understood without reference to the fiscal framework and vice versa. Despite this the Scotland Bill has gone through the House of Commons without MPs having any details of a revised fiscal framework. The Second Reading of the Bill in the House of Lords is scheduled for Tuesday 24 November. The Bill should not progress to Committee Stage until the fiscal framework is published.

Problem 2: Funding of Devolved Administrations in the UK

The regime for funding devolved services is perceived by many as unfair: in 2014/15 identifiable expenditure per head was £8,638 in England, £10,374 per head in Scotland, £9,904 per head in Wales, and £11,106 per head in Northern

1 L. Strachey, *Queen Victoria,* (New York Harcourt: Brace And Company, 1921). Strachey attributed the quote to Lord Palmerston and described the Schleswig-Holstein question as "the most complex in the whole diplomatic history of Europe."

2 Q 15 (Prof Adam Tomkins), Q 36 (Alistair Darling), Q 101 (Prof John Kay)

Ireland.[3] In the absence of any mechanism to promote fairness based on need, a sense of grievance will persist. The UK Government claims to be seeking an enduring settlement. This will not succeed if the new arrangements take as their starting point the existing inequity and contain no provision to adjust the system over time to make it fairer and to keep it fairer.

The Smith Commission had to work in the shadow of the 'Vow' made by the leaders of the major UK political parties, which included a commitment to maintain the existing mechanism, the Barnett Formula, for funding devolved administrations. This was the wrong decision. The Formula is not a sustainable, long term solution and should be replaced. We recommend the Government considers the case for introducing a needs based approach to funding devolved administrations.

Problem 3: Adjustment of the block grant for Scotland to reflect devolved income tax receipts

The fiscal framework will set out how the Scottish block grant should be adjusted to account for Scotland retaining nearly all of its income tax receipts. Three methods were described to us in evidence. Whichever method is chosen could have a large impact on the size of the Scottish block grant: a witness told us that the existing method for doing this under the Scotland Act 2012 would lead to an "intolerable" reduction.[4] To find a sustainable solution, it needs to be clear what risks the Scottish government should bear. Without such clarity, it is impossible to decide which method is preferable.

Problem 4: the second 'no detriment' principle

The Smith Commission suggested that there should be "no detriment as a result of UK Government or Scottish Government policy decisions post-devolution".[5] Such a principle is unworkable in practice and a recipe for continuing conflict.

Problem 5: choice of devolved taxes

The Scotland Bill 2015 will give the Scottish Parliament nearly full control over income tax revenues in Scotland. We heard that it was very rare for part of a country to pay almost no income tax to central Government. The Rt. Hon. Alistair Darling told us that this would cause confusion for Scottish taxpayers: "I am a Scottish taxpayer…How am I funding overseas aid or pensions?"[6] There is a risk this will weaken the connection between the Scottish electorate and the UK Parliament and UK Government.

Problem 6: borrowing powers

The fiscal framework will grant Scotland additional borrowing powers. These should be subject to clear limits.

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3 HM Treasury, *Country and Regional Analysis*, November 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476354/Country_and_regional_analysis_November_2015.pdf#page=13 [accessed November 2015]. Alternatively, using an index method and taking UK identifiable expenditure as 100, spending per head is 97 in England (3 per cent below the UK average) and 116 in Scotland (16 per cent above the UK average), 111 in Wales (11 per cent above the average), and 125 in Northern Ireland (25 per cent above the average). See Table 6 in Annex 3 for a full breakdown of spending per head by country and region in the UK.

4 See Figure 4.

5 Q 39 (Dr James Cuthbert)

6 Q 28 (Alistair Darling)

Problem 7: transparency and scrutiny

The Smith Commission process and subsequent negotiations have been opaque. Professor Gerald Holtham, former Chair of the Independent Commission on Funding and Finance for Wales,[7] told us that "we are having negotiations in [a] vacuum as far as what we are trying to achieve is concerned."[8]

In future, HM Treasury needs to be much more transparent about how funding is allocated to Scotland, Wales and Northern Ireland and an independent body such as the Office for Budget Responsibility should scrutinise this and the operation of the fiscal framework. There is also too little Parliamentary scrutiny of the funding arrangements. The UK and devolved legislatures should co-operate to remedy this.

The increase in devolved powers will require greater co-ordination between the UK Government and devolved administrations and intergovernmental relations must be improved.

Huge risks to the Union?

A number of witnesses expressed concern that overlooking the problems identified above is storing up trouble for the future, even threatening the existence of the Union. Professor David Heald, Professor of Accountancy, University of Aberdeen Business School, described the political climate around these issues as "toxic … the future of the United Kingdom remains at risk."[9] Professor John Kay, Visiting Professor of Economics at the London School of Economics, thought the Scotland would drift towards independence, "because it is the only way to resolve these problems."[10]

We agree that the proposed arrangements could lead to friction and to regular disputes. Without a complete fiscal framework underpinned by clear principles securing an enduring settlement will remain an aspiration.

The rest of this report examines our concerns in detail. If they are not addressed, the future of the United Kingdom could well be at risk.

7 Known as the Holtham Commission, which reported in 2010.
8 Q 81 (Prof Gerald Holtham)
9 Q 1
10 Q 106

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

The Fiscal Framework

1. The fiscal framework will be central to future devolution arrangements and the Scotland Bill cannot be properly understood or considered in its absence. (Paragraph 15)

2. The lack of an agreed fiscal framework leaves a significant gap in the information before Parliament. It is to be regretted that the Bill passed through the House of Commons without MPs having the opportunity to scrutinise the fiscal framework. (Paragraph 16)

3. We recommend that the Government:

   (a) provides up-to-date information to Parliament on the progress of the fiscal framework negotiations; and

   (b) gives a date by which the fiscal framework will be agreed. (Paragraph 17)

4. We recommend that the Scotland Bill does not proceed to Committee stage in the House of Lords until the fiscal framework is published. (Paragraph 18)

The Barnett Formula

5. Given the declaration of continued support for the Barnett Formula by the major political parties, the Smith Commission had to accept that the existing mechanism for funding devolved administrations would be retained. But if the aim is to produce a sustainable, long-term solution, retention of the Barnett Formula is the wrong decision. (Paragraph 28)

6. It is generally assumed that on the basis of relative need, funding per head should be greater in Scotland, Wales and Northern Ireland than it is in England. The present system however can produce arbitrary and unfair results. The funding mechanism needs to be replaced, particularly in light of the forthcoming changes to the fiscal framework. The report of the House of Lords Select Committee on the Barnett Formula recommended allocating funding on the basis of relative need. We believe this approach could provide a long-term, sustainable solution. We endorse that Committee's conclusions and recommendations and recommend that the Government considers the case for introducing such an approach. (Paragraph 30)

No Detriment and Adjustment of the Block Grant

7. Of the three methods proposed to the Committee for how to adjust the Scottish block grant to account for devolution of income tax receipts, there is no obvious choice. There are also many other methods that could be chosen. The decision will influence the size of Scotland's block grant. The choice is difficult as the UK and Scottish Governments have not enunciated any principles from which to derive a solution: it has not been made clear what risks—for example, a UK-wide recession or slower population growth—Scotland should bear when it has greater income tax raising powers. It is therefore difficult to assess the political choice as to which of the three methods, if any, is preferable. This is a critically important component of the new regime in Scotland and the UK and Scottish Governments must be clear about what is proposed. (Paragraph 48)

8. We agree with many of our witnesses that the second no detriment principle is unworkable. It is a recipe for future disagreement. The Government must set out in the fiscal framework how it intends to implement the second no detriment principle. (Paragraph 57)

Income Tax Devolution

9. The UK Government is relinquishing full receipt, and almost full control, of £11 billion of income tax revenues in Scotland. No comparable central government has ever done this. While we agree that income tax is a suitable candidate for devolution, we are concerned that a decision to devolve nearly all revenue, uniquely amongst countries in a similar position to the United Kingdom, has been adopted with undue haste and little assessment of the economic and political consequences. It may not be clear to people in Scotland how they fund reserved services and which Government is accountable for them. There is a risk that this will weaken the connection between the Scottish electorate and the UK Government. (Paragraph 62)

Borrowing Powers

10. The borrowing powers granted to Scotland will be an important part of the fiscal framework. We recommend that the UK and Scottish Governments agree simple and clear rules for borrowing including a ceiling on Scottish Government debt. We consider that any 'no bail-out' rule would not be believed by the markets. The assumption that the rest of the UK would bail-out Scotland would prevail.(Paragraph 72)

Scrutiny

11. We recommend that the Office for Budget Responsibility scrutinise the ongoing operation of the fiscal framework and the funding of the devolved governments. In Scotland this work should be done in co-operation with the Scottish Fiscal Commission. (Paragraph 85)

12. To enable the OBR to conduct effective scrutiny, data on the workings of devolution, including the operation of and adjustments to the Barnett Formula, must be published. This was a recommendation of the Select Committee on the Barnet Formula that has not been implemented. It is a recommendation we endorse. (Paragraph 86)

13. We agree with the conclusions of the Constitution Committee: it is vital that inter-governmental relations become more transparent. In practice this means that meetings are regular; that dates and agendas are announced in advance; and that information published after the meeting is sufficient to allow scrutiny and debate. (Paragraph 89)

14. Parliamentary scrutiny of financial devolution will be an important component of overall accountability. It is a matter for each legislature how it arranges this scrutiny. The number of interested devolved legislatures gives rise to a potential for duplication of this work. Closer co-operation should mitigate this risk. We propose that the chairs of the finance committees of the national and devolved legislatures meet regularly to ensure effective and co-ordinated scrutiny. (Paragraph 93)

A Fracturing Union? The Implications of Financial Devolution to Scotland

THE ISSUES

Introduction

1. In public and political discussion about devolution, especially in the immediate aftermath of the Scottish referendum, various models of devolution were suggested, from expanding the current devolution offered ('devo more') to full fiscal autonomy ('devo max').[11] The aim of this report is not to assess whether the current and proposed devolution arrangements are theoretically consistent with particular models but rather to examine the practical issues arising from the proposals now being put forward.

2. The evidence we heard raised a number of issues, questions and concerns. In this part of the report we highlight and summarise each problem. Full analysis of the evidence we heard is contained in the Annexes.

Background

The Financial devolution settlements

3. Initially the Scottish, Welsh and Northern Irish administrations were granted the power to spend money but little or no power to raise it.[12]

4. The Scotland Act 2012 granted the Scottish Parliament the ability to vary the rates of income tax, albeit within limits, and expanded of Scotland's borrowing powers. The Wales Act 2014 provided for the partial devolution of income tax to Wales, subject to this being endorsed by the people of Wales in a referendum.

5. The Scotland Act 2012 also allowed the Scottish Government to set landfill tax and stamp duty land tax. The Wales Act 2014 will devolve the same powers to the National Assembly for Wales.

6. When the Corporation Tax (Northern Ireland) Act 2015 comes into force, the Northern Ireland Assembly will have some powers to set the rate of corporation tax.

7. The Smith Commission was established in the wake of the referendum on Scottish independence. The five parties in the Scottish Parliament were represented on the Commission. They agreed further powers to be devolved to Scotland in addition to those in the Scotland Act 2012. The main additional tax powers were:

   (a) The full devolution of income tax on earnings (tax on savings and dividend income was not devolved);

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11 The Constitution Unit, *Devolution and the Future of the Union* (April 2015) p 4: https://www.ucl.ac.uk/constitution-unit/publications/tabs/unit-publications/163.pdf/ [accessed October 2015]

12 See Annex 1.

(b) The assignment of the first 10 per cent of VAT raised in Scotland; and

(c) The devolution of air passenger duty and aggregates duty.

8. The situation, once the all the powers provided come into force, is illustrated in the table below:

Table 1: Devolved taxes

	Scotland	Wales	Northern Ireland
Income tax	Full devolution of income tax on earnings. Tax on savings and dividend income not devolved.	Partial devolution subject to referendum.	Not devolved.
VAT	Assignment of first 10 per cent of VAT revenues.	Not devolved.	Not devolved.
Corporation Tax	Not devolved.	Not devolved.	Partially devolved.
Air Passenger Duty	Fully devolved.	Not devolved.	Partially devolved (for direct long-haul routes).
Stamp Duty Land Tax	Fully devolved.	Fully devolved.	Not devolved.
Landfill Tax	Fully devolved.	Fully devolved.	Not devolved.
Aggregates Tax	Fully devolved.	Not devolved.	Not devolved.

Problem 1: 'Nobody knows what is going on': The absence of the fiscal framework

9. The Smith Commission recommended that a new fiscal framework should be agreed between the Scottish and UK governments to underpin the new tax and spending powers. The Smith Commission agreed that the fiscal framework would include:

> "the funding of the Scottish budget, planning, management and scrutiny of public revenues and spending, the manner in which the block grant is adjusted to accommodate further devolution, the operation of borrowing powers and cash reserve, fiscal rules, and independent fiscal institutions."[13]

10. The fiscal framework will therefore underpin the new settlement with Scotland.[14] The Rt. Hon. Sir Danny Alexander, former Chief Secretary to

13 Smith Commission, *The Report of the Smith Commission for further devolution on powers to the Scottish Parliament* (27 November 2014) p25: https://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf [accessed October 2015]

14 The Cabinet Office, *Scotland in the United Kingdom:An Enduring Settlement*, Cm 8990, January 2015, p21: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf [accessed October 2015]

the Treasury,[15] considered it as important as the Scotland Bill itself.[16] It will be crucial to the understanding and operation of the finances Scotland and the rest of the UK following devolution.

11. The fiscal framework is not yet agreed, however. There is no known date for its publication. Negotiations are being conducted through the Joint Exchequer Committee which will next meet "soon".[17]

12. The Rt. Hon. Alistair Darling, former Chancellor of the Exchequer and leader of the 'Better Together' Campaign, was particularly critical of this process:

> "Nobody has a clue what is going on at the moment. I think that is a massive problem because people in Scotland, who ultimately are going to have to live with this and pay for it, do not know what the discussions are and do not know what consideration is being given to the various choices before them."[18]

13. HM Treasury and the Scottish Government declined to give oral evidence to the Committee while negotiations are ongoing, although both submitted written evidence and HM Treasury officials briefed the Committee privately.[19] Whilst we recognise that a running commentary on the talks would be unhelpful, the stance of the Treasury and the Scottish Government does little to shed light on an opaque situation. It would, witnesses considered, be possible for some information on the progress of the discussions—for example remaining points of disagreement and a clear timetable for conclusion—to be made public without prejudicing the negotiation process.[20]

14. The absence of any information about the fiscal framework was disquieting for a number of witnesses.[21] Members of the Scottish Parliament have also raised concerns.[22] Mr Darling told us "I have seen rotten processes before but this one is pretty difficult to understand and to justify".[23] Sir Danny Alexander agreed that Parliament must see the fiscal framework before the Scotland Bill is passed.[24]

15. **The fiscal framework will be central to future devolution arrangements and the Scotland Bill cannot be properly understood or considered in its absence.**

16. **The lack of an agreed fiscal framework leaves a significant gap in the information before Parliament. It is to be regretted that the Bill passed through the House of Commons without MPs having the opportunity to scrutinise the fiscal framework.**

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15 Sir Danny Alexander was the UK Government's representative to the Smith Commission.
16 Q 89
17 HM Treasury, *Joint Exchequer Committee October 2015* (9 October 2015): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/467075/Joint_Exchequer_Committee_9__October_communique.pdf [accessed October 2015]
18 Q 28 (Alistair Darling)
19 Written evidence from HM Treasury (DPF0015), written evidence from the Scottish Government (DPF0016)
20 Q 77 (Charlotte Barbour, Prof Gerald Holtham)
21 Q 77 (Charlotte Barbour, Prof Gerald Holtham)
22 The Scottish Parliament, *Official Report Meeting of the Parliament* (7 October 2015): http://www.scottish.parliament.uk/parliamentarybusiness/report.aspx?r=10135 [accessed October 2015]
23 Q 28
24 Q 89

17. **We recommend that the Government:**

    (a) **provides up-to-date information to Parliament on the progress of the fiscal framework negotiations; and**

    (b) **gives a date by which the fiscal framework will be agreed.**

18. **We recommend that the Scotland Bill does not proceed to Committee stage in the House of Lords until the fiscal framework is published.**

Problem 2: Funding of devolved administrations in the UK

19. At present, the majority of spending by the Scottish, Welsh and Northern Irish administrations is funded by the UK Government.[25] As with UK Government departments, most funding for the devolved administrations comes in the form of the 'Departmental Expenditure Limit' for current and capital spending, set by HM Treasury at Spending Reviews to cover a number of years. Devolved administrations also receive 'Annually Managed Expenditure' which is set annually.[26] Together, these amounts are referred to as the 'block grant'. The devolved administration, with the approval of the devolved legislature, is free to spend its Departmental Expenditure Limit in any of the areas for which it has responsibility. HM Treasury's Statement of Funding Policy, last published in October 2010, sets out how the grant is determined.[27] Further background information, including the history of funding for devolved administrations, is available in Annex 3.

20. The grant from central government is required as devolved administrations have much greater responsibility for spending than they do for revenue raising. Using Scotland as an example, Figures 1 and 2 show the difference between devolved revenue and expenditure powers in 2013/14.

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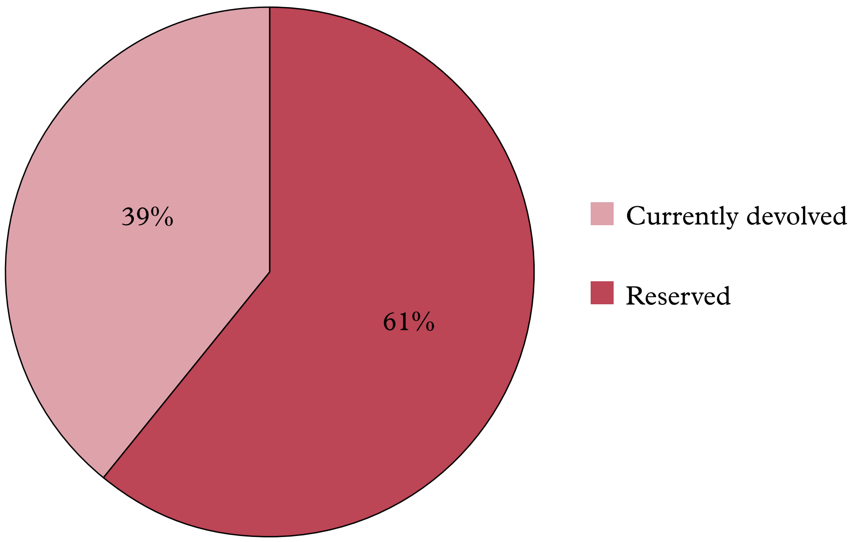
25 Each devolved administration's budget is not funded exclusively by the block grant. Other sources include non-domestic rates, the European Commission and borrowing to fund capital spending. See Annex 3 for further information.

26 Annually Managed Expenditure is less predictable than Departmental Expenditure Limit spending so is set annually rather than under multi-year limits. In the Scottish Government's draft budget for 2015/16, Departmental Expenditure Limit made up £30.3 billion of the total budget of £37.4 billion, Annually Managed Expenditure making up the remaining £7.1 billion. Most of the Annually Managed Expenditure for Scotland is used to pay public sector pensions. Scottish Government, *Scottish Budget Draft Budget 2015/16*, October 2014: http://www.gov.scot/Resource/0046/00462296.pdf#page=181 [accessed November 2015].

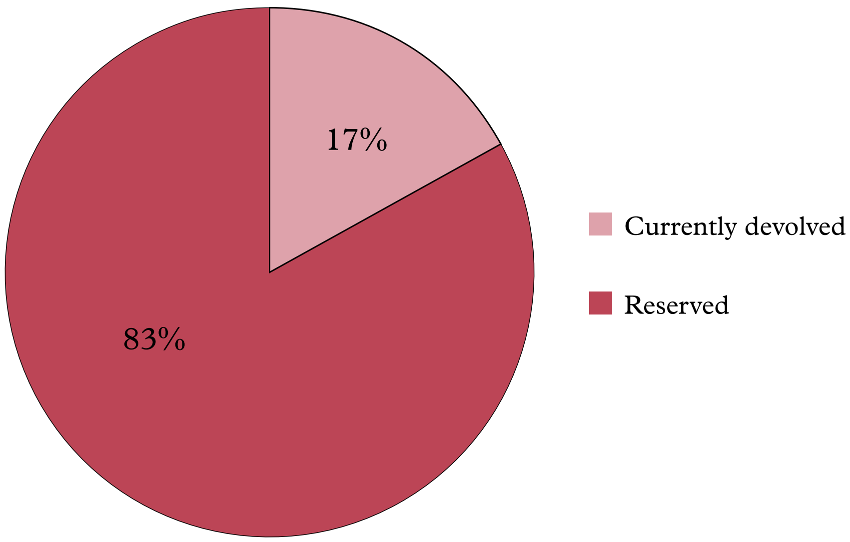
27 HM Treasury, *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy* (October 2010): http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/sr2010_fundingpolicy.pdf [accessed November 2015]

Figure 1: Devolved and reserved expenditure in Scotland, 2013/14



Source: Scottish Government, Government Expenditure & Revenue Scotland 2013/14, March 2015, http://www.gov.scot/Resource/0047/00472877.pdf#page=29 *[accessed November 2015]*

Figure 2: Devolved and reserved revenue in Scotland, 2013/14



Source: Scottish Government, Government Expenditure & Revenue Scotland 2013/14, March 2015, http://www.gov.scot/Resource/0047/00472877.pdf#page=29 *[accessed November 2015]*

21. Table 2 shows the block grant for the devolved administrations in 2015/16:

Table 2: Allocated block grant funding for devolved administrations, 2015/16, £ billion

	Scotland	Wales	Northern Ireland
Departmental Expenditure Limit[28]	30.4	15.8	11.3
Annually Managed Expenditure[29]	7.1	0.6	9.2

Source: Scottish Government, Scottish Budget Draft Budget 2015/16, October 2014: http://www.gov.scot/Resource/0046/00462296.pdf#page=26 *[accessed November 2015]; Welsh Government, Annual Budget Motion 2015/16, December 2014:* http://gov.wales/docs/caecd/publications/141202-motion-en.pdf#page=104 *[accessed November 2015]; Northern Ireland Executive, Budget 2015/16, January 2015:* http://www.northernireland.gov.uk/budget-2015-16.pdf#page=152 *[accessed November 2015]*

The Barnett Formula

22. Adjustments to the Departmental Expenditure Limits are linked to changes in planned spending by departments of the UK Government. The extent to which a planned spending change by a UK Government department requires an adjustment to a block grant depends upon the extent to which the UK departmental programme is comparable with the services carried out by each devolved administration. If an adjustment is required, the devolved administration receives a population-based proportion of the changes in planned spending. This mechanism is known as the Barnett Formula, first used in 1978.[30]

23. When the UK Government sets the Departmental Expenditure Limits for its departments, the Barnett Formula is used automatically to work out the changes that should be made to each block grant. It is important to note that the Barnett Formula is only used to calculate the size of the increase (or decrease) to the block grant for a particular year; the size of the block grant from the previous year is taken as given and used as the baseline.[31] The Formula contains no mechanism to correct any unintended consequences being built permanently into the baseline.

24. Some witnesses expressed concern that the application of "English Votes for English Laws" could prove problematic: legislative changes that affect England-only could have consequences for Government spending in England, Government spending in England could have a knock-on effect in Scotland, Wales, and Northern Ireland because of the Barnett Formula.[32] We regret that the introduction of English Votes for English Laws by amendment of the House of Commons Standing Orders, and without the consultation sought

28 Resource and capital spending. Departmental Expenditure Limit capital spending also includes use of a borrowing facility. The figure for Scotland assumes full use of the Scotland Act 2012 borrowing facility of up to £302 million.
29 Mainly used to fund public sector pensions. See footnote 26.
30 More information on the history of the Formula can be found in Annex 3.
31 A worked example of how the Barnett Formula operates can be found in Annex 3.
32 Q 32 (Alistair Darling), Q 48 (Peter Jones). The Rt. Hon. Chris Grayling MP, Leader of the House of Commons, however, told the House of Commons Procedure Committee in September 2015 that this was not an issue as Scottish MPs retain the ability to vote on Bills which change overall departmental budgets through votes of Estimate each year. Oral evidence taken before the House of Commons Procedure Committee, 9 September 2015 (Session 2015–16), Q 132 (Rt. Hon. Chris Grayling MP).

by the House of Lords, pre-empted full consideration of its consequences for financial devolution. In our view, future disputes are inevitable.

25. Many witnesses questioned the appropriateness of the Barnett Formula. Some, such as Professor Gerald Holtham, former Chair of the Independent Commission on Funding and Finance for Wales, and David Phillips, Senior Research Economist at the Institute for Fiscal Studies, favoured replacing it with a mechanism that took relative need into account.[33] Carlo Cottarelli, former Director of the Fiscal Department at the International Monetary Fund, said there were "better ways to transfer resources than just looking at population."[34]

26. In 2009, the House of Lords Select Committee on the Barnett Formula found the arguments for introducing a needs-based system to be "compelling".[35] Their conclusions and recommendations are summarised in Box 1.

Box 1: House of Lords Select Committee on the Barnett Formula—Summary of conclusions and recommendations

"The advantages of the Barnett Formula—simplicity, stability and the absence of ring-fencing—are important and should be maintained whatever the future method of allocating funds to the devolved administrations.

"The changing populations of the devolved administrations and the failure of the Formula to take account of population changes over time within the baseline create a significant problem for the Barnett Formula today. In our view, the resulting per capita allocations are arbitrary and unfair. In essence the baseline of the grant provides funds for a level of population that has changed.

"We find the argument that devolution funding should be based on relative need to be a compelling one. Public spending per head of population should be allocated across the United Kingdom on the basis of relative need, so that those parts of the United Kingdom which have a greater need receive more public funds to help them pay for the additional levels of public services they require as a result. Those levels of need—and which parts of the United Kingdom need them—may well change over time. Historically, they have certainly done so.

"The new system should be based on the following principles:

- It should consider both the baseline and any increment in funds;
- It should be fair and seen to be fair;
- It should be comprehensible;
- It should respect territorial autonomy;
- It should be stable and predictable.

"Any needs assessment should take these aspects into account:

- The age structure of the population;
- Low income;
- Ill-health and disability;

33 Q 81 (Prof Gerald Holtham), Q 60 (David Phillips)
34 Q 111. The arguments we heard on this subject are summarised in Annex 3.
35 Select Committee on the Barnett Formula, *The Barnett Formula* (1st Report, Session 2008–09, HL Paper 139)

- Economic weakness.

"While we are not in a position to reach a conclusion about precise relative needs in the four countries and regions, on the basis of our initial analysis, we believe that Scotland now has markedly lower overall need than Wales and Northern Ireland in comparison to England. The current allocation of spending does not properly reflect this basic pattern across the devolved administrations."

27. Professor Adam Tomkins, Professor of Public Law at the University of Glasgow, explained to the Committee that the Smith Commission, of which he was a member, took it as given that the Formula would survive the process, "because it was in the Vow, and the Smith Commission was meeting and working in the shadow of the Vow".[36]

28. **Given the declaration of continued support for the Barnett Formula by the major political parties, the Smith Commission had to accept that the existing mechanism for funding devolved administrations would be retained. But if the aim is to produce a sustainable, long-term solution, retention of the Barnett Formula is the wrong decision.**

29. The current system takes no account of need beyond the change of population since the previous year, which is only reflected in the size of the annual increase to the block grant. For example, the Departmental Expenditure Limit part of the block grant for Scotland was £30.4 billion for 2015/16 and £29.6 billion for 2014/15, but only the £800 million increase will take account of relative population; the £29.6 billion, the product of the original 1978 baseline and subsequent additions, is simply taken as given.[37]

30. **It is generally assumed that on the basis of relative need, funding per head should be greater in Scotland, Wales and Northern Ireland than it is in England. The present system however can produce arbitrary and unfair results. The funding mechanism needs to be replaced, particularly in light of the forthcoming changes to the fiscal framework. The report of the House of Lords Select Committee on the Barnett Formula recommended allocating funding on the basis of relative need. We believe this approach could provide a long-term, sustainable solution. We endorse that Committee's conclusions and recommendations and recommend that the Government considers the case for introducing such an approach.**

Problem 3: Adjustment of the block grant to reflect devolved income tax receipts

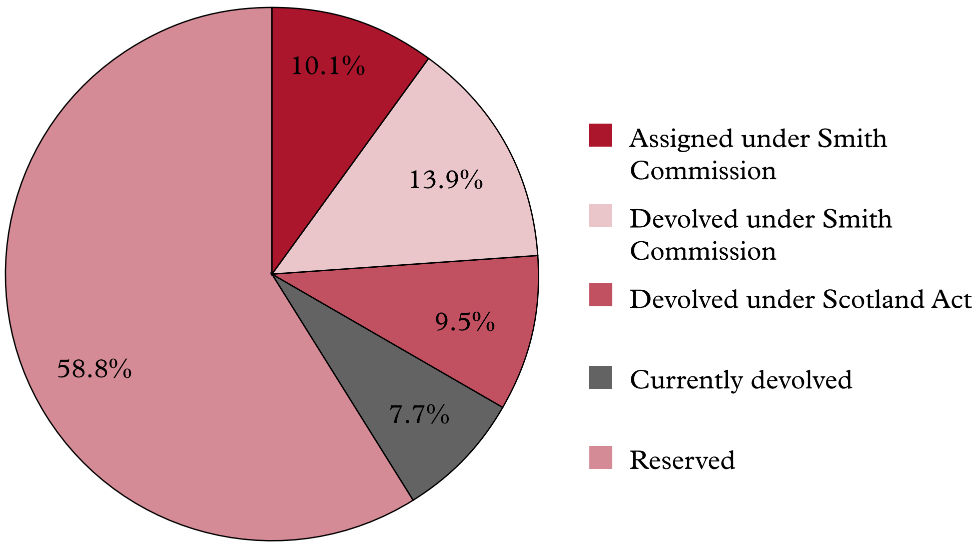
31. When tax receipts are devolved to Scotland, Wales or Northern Ireland, a corresponding reduction in that administration's block grant from the UK Government is required.[38] This reflects the fact that the UK Government has forgone tax revenue in that nation.[39] For each tax that is devolved, a different method of adjusting the block grant may be appropriate. Annex 4 explores this in more detail.

36 Q 17
37 The Scottish Government, *The Draft Scottish Budget 2014/2015* (September 2013): http://www.gov.scot/Resource/0043/00433802.pdf [accessed November 2015].
38 The block grant would also be adjusted if further expenditure powers are devolved. This would be accounted for in the comparability percentages used in the Barnett Formula (see Annex 3).
39 See Annex 2.

32. This section focuses on how Scotland's block grant should be adjusted to reflect the reassignment of income tax receipts under the Scotland Bill. This is an important question as Scottish income tax receipts were £11 billion for 2013/14, a sizeable proportion of the existing £37.5 billion total block grant for Scotland.[40] Whichever method is agreed for Scotland may also be relevant for Wales: the UK Government has suggested that the same method may be used to adjust the Welsh block grant in the event that the Welsh Assembly is granted powers to vary income tax.[41]

33. Figure 3 illustrates the size of the change which the Scotland Bill would make to the proportion of tax receipts assigned to Scotland.

Figure 3: Effect of Smith Commission proposals on devolved and reserved revenue in Scotland (estimated for 2013/14 figures)[42]



Source: Scottish Government, Government Expenditure & Revenue Scotland 2013/14, March 2015, http://www.gov.scot/Resource/0047/00472877.pdf#page=29 *[accessed November 2015]*

34. The Smith Commission's report stated neither the Scottish Government nor the UK Government should gain or lose financially simply as a result of the decision to devolve expenditure or revenue (referred to as the first 'no detriment' principle').[43] For the first year in which powers of taxation are devolved, this is straightforward: the Smith Commission recommended that the initial devolution and assignment of tax receipts be accompanied by a reduction in the block grant equivalent to the revenue foregone by the UK Government.

35. More complicated is what happens after the first year. One purpose of devolving revenue raising powers is to give the administration more responsibility for raising its own funding; if the deduction in the block grant continues to be linked to the revenue raised by that tax in the devolved

40 The £37.5 billion figure includes Departmental Expenditure Limit and Annually Managed Expenditure. See Table 2.

41 The power of the Welsh Government to vary income tax, provided for by the Wales Act 2014, is subject to a referendum in Wales.

42 'Assigned under Smith Commission' refers to VAT revenues that will be assigned to the Scottish Parliament under the Scotland Bill (see paragraph 140 in Annex 2). 'Devolved under Scotland Act' refers to Scotland Act 2012. Reserved refers to revenue raising powers, such as National Insurance, that remain under the full control of the UK Government.

43 Smith Commission, *The Report of the Smith Commission*

administration, there is little transfer of responsibility or incentive to grow that tax base.[44] A method of ongoing adjustment for the block grant needs to be agreed. Different taxes may require different methods.

36. The Smith Commission recommended that "the future growth in the block grant should be indexed appropriately".[45] No view was offered as to what might be considered appropriate.

37. Three methods of indexation were suggested to the Committee in evidence and are described below. This is not an exhaustive list, and there are many other methods that could be chosen. Further detail can be found in Annex 4.

Method 1: fixed percentage change to the block grant adjustment

38. Dr James Cuthbert suggested that the block grant adjustment should be reduced by a fixed percentage, giving the example of 1 or 2 per cent a year: "grow your tax base faster than that, you are quids in, you get to keep the difference. Grow slower than that, you suffer."[46] Mr Phillips thought this was the worst of the three options: "it does not satisfy the principle that the UK Government should bear shocks that affect the whole of the UK. That would mean that the Scottish Government would be exposed to recessions that affect the whole of the UK and would have to borrow a lot to smooth the cycle."[47] Box 5 in Annex 4 illustrates how this method would work and Figure 4 (see below) compares this method against the other two methods.

Method 2: index deduction to changes in rest of UK revenues

39. Under this method, the size of the deduction from the block grant is linked to the revenue from non-savings, non-dividend income tax in the rest of the UK. A worked example is given in Box 6 in Annex 4.

40. Mr Phillips argued that this was his preferred method as it insulates Scotland from UK-wide shocks and is broadly consistent with the second no-detriment principle (see paragraph 50 below).[48] Professor John McLaren, Honorary Professor of Public Policy at the University of Glasgow, however said that Scotland would lose out if the UK's population continues to rise faster than that of Scotland, as tax revenues in the rest of the UK are also likely to rise faster due to that extra population growth (as opposed to increased productivity). He also said that as Scotland has a lower proportion of people in the higher tax bands (additional and higher rate) than England, Scottish income tax revenues are likely to grow more slowly than the rest of the UK's.[49] Dr Cuthbert said this created "artificial penalisation", especially as Scotland has "limited powers" to grow its economy.[50]

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44 For example, if the devolved tax raises £1 billion in Year 1 and £950 million in Year 2, it would not make sense to decrease the block grant by £1 billion in Year 1 and then increase it by £50 million in Year 2 to cover the shortfall; any decision of the Scottish Parliament regarding the rates of taxation would have no net impact on Scotland's overall finances.

45 Smith Commission, *The Report of the Smith Commission*

46 Q 39

47 Q 57

48 Q 57

49 Written evidence from Prof John McLaren (DPF0019)

50 Q 39

41. Under the Scotland Act 2012, a Scottish rate of income tax is to be introduced from April 2016.[51] The UK and Scottish Governments agreed that in the first year following a transition period, however much is generated by the Scottish rate will be deducted from the block grant. In subsequent years, the adjustment made in the previous year will be indexed against movements in the UK non-savings, non-dividend income tax base.[52] This differs from the method described above as the indexation is to UK-wide revenues, not rest of UK revenues. Dr Angus Armstrong, Director of Macroeconomics at the National Institute of Economic and Social Research, proposed the same method of UK-wide revenue indexation, to "make it as simple as possible".[53]

Method 3: index deduction to changes in rest of UK revenues per head

42. Under this method, the size of the deduction in the block grant is linked to the revenue from non-savings, non-dividend income tax in the rest of the UK *per head*. A worked example is given in Box 7 in Annex 4. This protects Scotland in the event its population grows at a lower rate than the rest of the UK; whereas under Method 2, Scotland would lose out if population growth were faster in the rest of the UK as income tax revenues would also rise faster (more people paying income tax).

43. Professor McLaren, advocated this method on the grounds that Scotland does not have control over immigration policy: "if [Scotland] cannot change those policies and more people are coming into England than Scotland, I do not think that is a level playing field and therefore I would adjust in per capita terms."[54] Mr Phillips however thought this method would be inconsistent with the Barnett Formula:

> "The way the Barnett formula works is that it does not take account of differential population growth, because it does not update the base-level spending to account for the change in population. You might say that, given that the Barnett formula on the spending side does not account for differential population growth, on the revenue side you also should not account for differential population growth, because otherwise you are ignoring differential population growth where that would penalise Scotland and accounting for it where it benefits Scotland."[55]

51 For Scottish taxpayers, the main UK rates of income tax will be reduced by 10 pence in the pound. The Scottish Parliament will set, in its annual budget, the new Scottish rate of income tax to be added to the reduced UK rates.

52 The Scotland Office, *Second Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012*, (May 2014): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/308446/40078_Un-Act_Implementation_accessible.pdf#page=24 [accessed November 2015]

53 Q 4

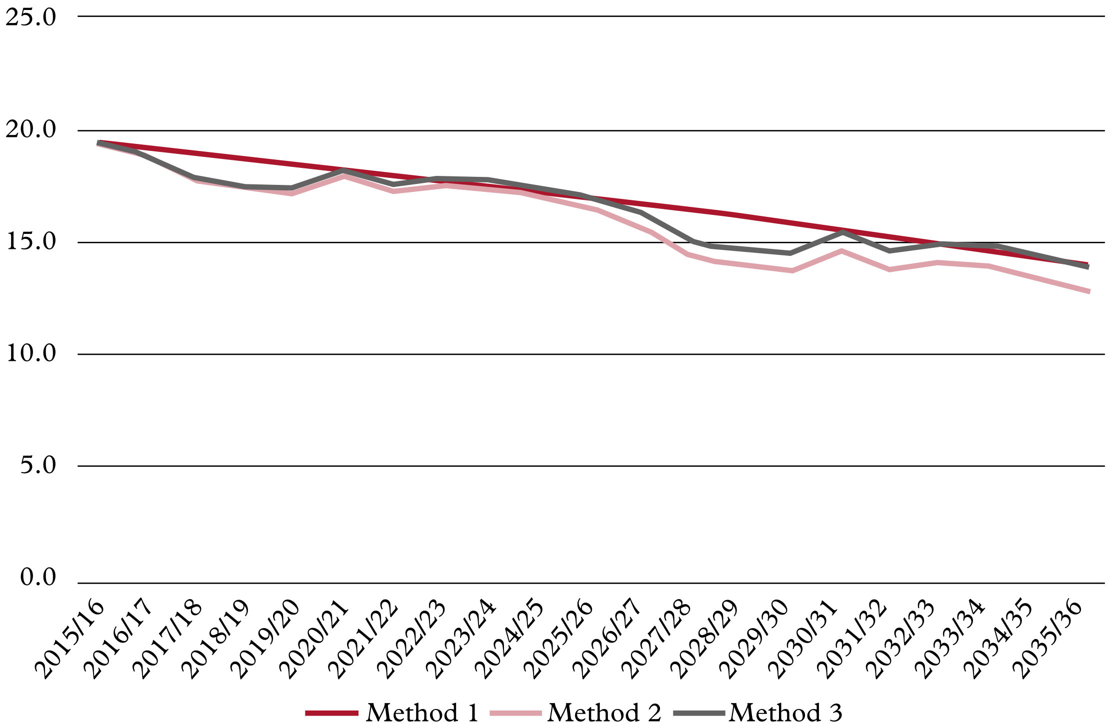
54 Q 20

55 Q 57

Which method is preferable?

44. Figure 4 shows how each method would affect the size of the block grant over a 20 year simulation:[56]

Figure 4: Estimated size of the Scottish block grant under different indexation methods (£ billion)



45. For Method 1, the simulation assumes a fixed percentage decrease of 2 per cent a year in the adjustment made to the block grant. For Methods 2 and 3, this simulation assumes the following growth in English income tax revenue from 2015/16 to 2035/36:

Table 3: Assumed growth rates in rest of UK income tax revenue for the purposes of the simulation (per cent)[57]

2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24
5.7	8.6	2.7	1.2	-5.6	5.3	-1.5	0.8

2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
3.2	4.0	5.7	8.6	2.7	1.2	-5.6	5.3

2032/33	2033/34	2034/35	2035/36
-1.5	0.8	3.2	4.0

56 For the purposes of the simulation, the block grant is assumed to remain constant each year, the operation of the Barnett Formula is not modelled. A full list of assumptions used in the simulation are described in Annex 3 from paragraph 167.

57 For the purposes of the simulation, the growth rates for English income tax revenue between 2005 and 2015 were used for the periods 2016/17 to 2025/26, and 2026/27 to 2035/36. This allows a comparison between how the different methods affect the block grant during periods of large positive and negative growth.

For Method 3, the rest of UK population is assumed to grow by 2 per cent a year; the Scottish population grows in line with forecasts from the National Records of Scotland.

46. The three methods make different implicit assumptions about who should bear what risk. Two examples are described below:

- Economic downturn: Scotland bears the risk of a UK-wide economic downturn under Method 1 but is insulated under Methods 2 and 3. This is illustrated in the graph between 2020 and 2023, and 2030 and 2033: under Methods 2 and 3, the block grant increases during these downturn periods but continues to decrease under Method 1.

- Population growth: Scotland bears the risk of population growth under Method 1 and 2 but is insulated under Method 3, which takes account of differential population growth between the rest of the UK and Scotland. Scottish population growth is slower than for the rest of the UK for the period of the simulation; the graph illustrates how Method 3 compensates for this.

47. The choice of adjustment mechanism chosen depends on which risks it is decided Scotland should bear.

48. **Of the three methods proposed to the Committee for how to adjust the Scottish block grant to account for devolution of income tax receipts, there is no obvious choice. There are also many other methods that could be chosen. The decision will influence the size of Scotland's block grant. The choice is difficult as the UK and Scottish Governments have not enunciated any principles from which to derive a solution: it has not been made clear what risks—for example, a UK-wide recession or slower population growth—Scotland should bear when it has greater income tax raising powers. It is therefore difficult to assess the political choice as to which of the three methods, if any, is preferable. This is a critically important component of the new regime in Scotland and the UK and Scottish Governments must be clear about what is proposed.**

Problem 4: The second 'no detriment' principle

49. The Smith Commission proposed that there should be "no detriment as a result of UK Government or Scottish Government policy decisions post-devolution"[58]. This is referred to as the second no detriment principle. HM Treasury told us in written evidence that "any policy decisions that affect the tax or spending of the other government are the responsibility of the decision-making government."[59] These statements appear contradictory and could be interpreted as both Governments having their cake and eating it.

Application in selecting a method for adjusting the block grant to reflect devolved powers of taxation

50. In January 2015, the UK Government published a Command Paper, 'Scotland in the United Kingdom: An enduring settlement', setting out proposals for implementing the Smith Commission recommendations. The paper discussed how the second no detriment principle may apply to

58 Smith Commission, *The Report of the Smith Commission*, p 26
59 Written evidence from HM Treasury, (DPF0015)

considerations of "taxpayer fairness".[60] It stated that changes to a UK tax, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK, while, conversely, changes to devolved taxes in Scotland should only affect public spending in Scotland.

51. The following example was given in the paper: if the UK Government reduces spending on devolved areas (for example, health or education) to allow a decrease in 'rest of UK' income tax, the Barnett Formula will lead to a decrease in the Scottish Government's block grant (despite the tax not applying in Scotland). A method of adjustment to the block grant to account for devolved income tax powers,[61] which was linked to income tax receipts in the rest of the UK would compensate Scotland automatically in this scenario: if income tax receipts decrease in the rest of UK compared to the previous year, the block grant to Scotland would be increased as the adjustment made for devolved taxation would be indexed to rest of UK income tax revenues, thus offsetting the decrease to the block grant caused by the Barnett Formula.

52. Methods 2 and 3 for adjusting the block grant, discussed in the previous section, would thus satisfy partially the second no detriment principle; while Method 1 would not.[62]

But otherwise unworkable?

53. Beyond the choice of method of how to adjust the block grant to reflect devolved income tax powers, it is difficult to see how and where the principle can apply.

54. Professor John Kay, visiting Professor of Economics at the London School of Economics, gave an example in evidence:

> "Suppose you reduce health expenditure in England and make people pay for it, with the result that ill people are more inclined to go to Scotland and healthy people are more inclined to go to England. Does anyone really imagine that you are going to pay compensation between the two jurisdictions to reflect that?"[63]

55. Most witnesses agreed that it was not possible to apply this principle literally.[64] The Scottish Government said it was "not well defined" and they were working with the UK Government to clarify its meaning and application[65]. The evidence we received on this subject is discussed in Annex 4.

56. Some witnesses were concerned that the principle could be interpreted as applying to tax competition: one example given was that if the Scottish Government lowered Air Passenger Duty, it would have to compensate Newcastle Airport for any loss of revenue caused by passengers moving their custom to Scottish airports. Professor Iain McLean, Professor of Politics at the University of Oxford, described this as "patently absurd" and the Chancellor of the Exchequer indicated to the Treasury Committee in January

60 HM Government, *Scotland in the United Kingdom: An enduring settlement* (January 2015): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf [accessed November 2015]
61 See previous Problem (from paragraph 39).
62 See Problem 3.
63 Q 104
64 Q 82 (Prof Gerald Holtham and Charlotte Barbour), Q 4 (Dr Angus Armstrong), Q 54 (Peter Jones)
65 Written evidence from the Scottish Government (DPF0016)

2015 that it would not apply to such situations.[66] Many witnesses suggested it could only work as a high-level principle; Mr Cottarelli said it should be "interpreted more as a general guideline."[67]

57. **We agree with many of our witnesses that the second no detriment principle is unworkable. It is a recipe for future disagreement. The Government must set out in the fiscal framework how it intends to implement the second no detriment principle.**

Problem 5: Choice of devolved taxes

58. The history of tax devolution and current proposals for Scotland, Wales and Northern Ireland are set out in Annex 2. The choice of taxes to devolve to Wales appears broadly consistent with the recommendations of the Silk Commission and the principles set out by the Holtham Commission.[68] We did not hear major concerns about the devolution of corporation tax to Northern Ireland.[69]

59. For Scotland, the choice of taxes to devolve is similar to Wales.[70] Under the Scotland Bill, nearly all income tax revenue raised in Scotland will go to the Scottish Parliament. The Bill will also give the Scottish Parliament the power to introduce new rates and bands of income tax above the UK personal allowance. This was a recommendation of the Smith Commission. The Scottish rate of income tax would apply to income from employment, profits from self-employment, pensions, taxable social security benefits and income from property. The UK rate of income tax would continue to apply to income from savings and dividends. Total income tax raised in Scotland for 2014/15 was £11.9 billion;[71] non-savings, non-dividend revenue (i.e. the part which will be assigned to the Scottish Parliament) is estimated to be £11 billion.[72] The draft Scottish budget for 2015/16 was £37 billion.

60. Witnesses were largely in agreement that income tax was a sensible tax to devolve.[73] Several, however, emphasised the unique nature of a central government raising almost no income tax from a region of its territory[74] and Carlo Cottarelli described such a situation as "very rare".[75] Sir Danny Alexander said he was not worried by this because, "in the UK we have two forms of income tax. One is called income tax and the other is called national insurance, but they are both income taxes".[76] Mr Darling however shared the concerns of the other witnesses:

66 Q 74; Oral evidence taken before the Treasury Committee, 20 January 2015 (Session 2014–15) Q 231 (Rt. Hon. George Osborne MP, Chancellor of the Exchequer)
67 Q 114
68 See Annex 2.
69 See Annex 2.
70 See Annex 2.
71 HM Revenue and Customs , *A disaggregation of HMRC tax receipts between England, Wales, Scotland & Northern Ireland* (October 2015): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/464199/HMRC_disaggregated_receipts_-_Methodology_Note.pdf [accessed November 2015]
72 For the UK as a whole, 91.4 per cent of income tax was non-savings, non-dividend revenue in 2014/15. Applying the same percentage to the total Scottish figure gives £11 billion for non-savings, non-dividend revenue.
73 Q 83 (Prof Gerald Holtham), Q 7 (Prof James Gallagher)
74 Q 7 (Dr Angus Armstrong), Q 53 (Peter Jones), Q 64 (David Phillips)
75 Q 110
76 Q 95. National Insurance Contributions will remain the responsibility of the UK Government and will not be devolved.

> "I am a Scottish taxpayer. Who am I paying taxes to and what am I paying them for? My income tax is all going to the Scottish Government. How am I funding overseas aid or pensions? This is not clear."[77]

61. Peter Jones was concerned that the UK Government would have "much less fiscal flexibility in macro-economic management" as a result of relinquishing control of a major tax lever in a large region of the country.[78] Mr Phillips thought it would have been more sensible to have given Scotland a "bigger chunk of income tax" rather than completely devolving it.[79]

62. **The UK Government is relinquishing full receipt, and almost full control, of £11 billion of income tax revenues in Scotland. No comparable central government has ever done this. While we agree that income tax is a suitable candidate for devolution, we are concerned that a decision to devolve nearly all revenue, uniquely amongst countries in a similar position to the United Kingdom, has been adopted with undue haste and little assessment of the economic and political consequences. It may not be clear to people in Scotland how they fund reserved services and which Government is accountable for them. There is a risk that this will weaken the connection between the Scottish electorate and the UK Government.**

Problem 6: Borrowing Powers

63. Each devolved administration has the power to borrow money to meet cyclical fluctuations in income and to fund capital expenditure. The borrowing powers of Scotland, Wales and Northern Ireland have grown as devolution has progressed. As with other aspects of devolved finance the extent and type of borrowing available varies between the devolved governments as outlined in Table 4. [80]

Table 4: Current Devolution of borrowing powers

	Current Account borrowing	Capital Borrowing
Scotland	£200m each year within a cap of £500m to be paid within 5 years[81]	Up to 10 per cent of the Capital Departmental Expenditure Limit per year (currently this is £300m) within a cap of £2.2bn[82].
Wales	£200m each year within a cap of £500m[83]	From April 2018, £125m per year within a cap of £500m[84]

77 Q 28
78 Written evidence from Peter Jones (DPF0020)
79 Q 64
80 See Annex 5 for details of the borrowing powers of each devolved nation.
81 Scotland Act 2012, section 32
82 Written evidence from HM Treasury (DPF0015)
83 Government of Wales Act 2006, section 121 (as amended by Wales Act 2014, section 20)
84 Government of Wales Act 2006, section 122 (as amended by Wales Act 2014, section 20). The limit of £125m each was agreed between the Welsh Government and HM Treasury, HC Deb, 6 May 2014, col 83.

	Current Account borrowing	Capital Borrowing
Northern Ireland	Secretary of State may advance sum to a maximum of £250m[85]	£200m each year up to a maximum of £3bn.[86]

64. The capital borrowing available to the Welsh Government was expanded by the Wales Act 2014. Northern Ireland's significant borrowing powers will remain unaltered.

Questions about borrowing powers for Scotland

65. Our witnesses paid most attention to the question of Scotland's borrowing powers, both those contained in the Scotland Act 2012—but not used—and the expanded powers needed to take account of the tax devolution discussed above.

66. Scotland's existing powers, including the ability to issue bonds,[87] will need to be revised and, crucially, extended as increased dependence on taxation will expose the Scottish Government to greater volatility of income.[88] HM Treasury said in written evidence that "sufficient additional borrowing power … will be discussed as part of the fiscal framework negotiations."[89] Dr Armstrong, told us that the issue of Scotland's borrowing powers was, "the most important question in the whole debate".[90]

67. The significance of these extended powers, both in the Scotland Act 2012 and fiscal framework, is twofold. First, we were told, it would increase the accountability of the Scottish Government to the markets. The Scottish Government will be able to exercise greater control over economic levers and receive feedback from the market on its economic performance. This could lead to greater fiscal discipline.[91]

68. Second, as Scotland will have the ability to borrow both greater amounts, and to borrow from the market, it raised the question of what the rest of the UK would do if Scotland could not honour its debts. Would Scotland receive a bail-out? Mr Cottarelli said that because Scotland shares a currency with the rest of the UK, "in principle this may create expectations of bail-out from the centre in case of problems".[92]

69. Several witnesses asked what would happen in the event Scotland required a bail-out.[93] There is we were told a "moral hazard" presented by a guarantee

85 Northern Ireland Act 1998, section 61
86 Northern Ireland Loans Act 1975, section 1 (as amended by the Northern Ireland (Miscellaneous Provisions) Act 2006, section 22)
87 Known as 'kilts'.
88 Q 49, Q 12, Q 96
89 Written evidence from HM Treasury (DPF0015)
90 Q 12
91 Written evidence from Prof James Gallagher (DPF0001), written evidence from the Weir Group (DPF0012), written evidence from PWC (DPF0023)
92 Q 113
93 In written evidence the Scottish Government emphasised its record of fiscal responsibility (DPF0016). In the report of this Committee on *the Economic Impact of Scottish Independence* we noted that during the financial crisis of 2008 the RBS was too big for the Scottish Government alone to save. *The Economic Implications for the United Kingdom of Scottish Independence* (2nd Report, Session 2012–13, HL Paper 152), p 31.

or presumption that a bankrupt Scotland would be rescued by the UK.[94] "The Scottish Government", Sir Danny Alexander told us, "should not operate on the basis that if they make mistakes with their borrowing they will be bailed out."[95]

70. Other evidence suggested that any 'no bail-out rule' written into the fiscal framework or legislation would not be truly credible.[96] Dr Armstrong conceded that it the UK couldn't guarantee it would never bail Scotland out, "particularly when you can afford to bail it out, and Scotland can be bailed out because it is only 8.5 per cent of the UK and you can afford to do it. The very fact that people know that you can afford to do it starts to play into that."

71. Mr Darling pointed out that the eurozone has a no bail-out rule, "which we can see works very well." He thought a no bail-out rule would be "unnecessary and downright provocative and actually sound very patronising … I am part of the UK as well; do not tell me I cannot be bailed out by a country that I happen to be a citizen of."

72. **The borrowing powers granted to Scotland will be an important part of the fiscal framework. We recommend that the UK and Scottish Governments agree simple and clear rules for borrowing including a ceiling on Scottish Government debt. We consider that any 'no bail-out' rule would not be believed by the markets. The assumption that the rest of the UK would bail-out Scotland would prevail.**

Problem 7: Transparency and Scrutiny

Scrutiny prior to devolution

73. The financial devolution to Scotland agreed at the Smith Commission and contained in the Scotland Bill will alter fundamentally the fiscal structure of the United Kingdom. Such measures should be the result of a coherent, transparent process and subject to scrutiny. The evidence we heard is that aspects of the current proposals lack transparency and opportunities for scrutiny are accordingly limited.[97]

Consultation processes: How did we get here?

74. The packages of financial devolution to Scotland, Wales and Northern Ireland developed by markedly different routes.[98] In Wales, three years elapsed between the establishment of a commission to consider further financial devolution[99] and the legislation implementing that commission's proposals.[100] The devolution of corporation tax to Northern Ireland was

94 Q 96
95 Q 96
96 Q 87, Q 10, Q 96
97 Q 77 (Charlotte Barbour, Prof Gerald Holtham), Q 67 (Prof Iain McLean), Q 13 (Prof David Heald), written evidence from Dr James Cuthbert (DPF0004), written evidence from the Scottish Government (DPF0016)
98 See Annex 1.
99 The Commission on Further Devolution in Wales, Chaired by Sir Paul Silk was launched on 11 November 2011. The Silk Commission, *First Report: Empowerment and Responsibility Financial Powers to Strengthen Wales* (November 2012): http://webarchive.nationalarchives.gov.uk/20140605075122/http://commissionondevolutioninwales.independent.gov.uk/files/2013/01/English-WEB-main-report1.pdf [accessed October 2015].
100 Wales Act 2014

first discussed four years before a Bill was introduced to Parliament.[101] By contrast, in Scotland the Smith Commission completed its work in eight weeks[102] and a draft bill was published two months later.[103]

75. Several witnesses thought that questions now being raised about the proposed devolution to Scotland could be traced back to a "rushed" process of consultation and negotiation.[104]

76. A long consultative process is not a guaranteed path to a robust solution. Nevertheless, we consider that a number of the problems we highlight in this report may have been avoided if a greater level of detail and clarity had been achieved during the negotiation process and prior to the Scotland Bill being introduced to Parliament.

Future scrutiny

77. The devolution arrangements for the UK are becoming increasingly complex and more powers are, or will be, shared between the UK and devolved governments.

78. Once devolved, the financial powers given to Scotland, Wales and Northern Ireland will not simply pass 'out of sight; out of mind' to the respective countries. The Scottish and Welsh and Northern Ireland Governments will not operate their new authority in a vacuum. The sharing of some of the machinery of government will require co-operation to ensure all parts work together.

79. The House of Lords Constitution Committee and the Scottish Parliament's Devolution (Further Powers) Committee have recently investigated how effective inter-governmental co-operation can be achieved following further devolution.[105] The Constitution Committee concluded that:

> "Good inter-governmental relations are vital to the effective governance of the United Kingdom. The structures and practices of inter-governmental relations should serve to strengthen, and provide constitutional stability to, the Union."[106]

The Devolution (Further Powers) Committee concluded that a transparent and accountable structure of intergovernmental relations should be the guiding principle.[107]

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101 HC Deb, 24 March 2011 col 59WS; Corporation Tax (Northern Ireland) Act 2015

102 Smith Commission, *The Report of the Smith Commission*. The Smith Commission received terms of reference on 23 September 2014 and published a final report on 27 November 2015.

103 The Cabinet Office, *Scotland in the United Kingdom, An Enduring Settlement*, Cm 8990, January 2015: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/397079/Scotland_EnduringSettlement_acc.pdf [accessed November 2015]

104 Q 47, Q 77 (Prof Gerald Holtham who told us, "My suspicion is that … that the can has been kicked down the road in too many respects. One gets the impression that the thing is being busked, as it were, and that difficult decisions are being deferred or they are failing to reach agreement on them").

105 Constitution Committee, *Inter-governmental relations in the United Kingdom* (11th Report, Session 2014–14, HL Paper 146); Scottish Parliament, Devolution (Further Powers) Committee, *Changing Relationships: Parliamentary Scrutiny of Intergovernmental relations* (October 2015): http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/Reports/DFPS042015R08.pdf [accessed October 2015]

106 Constitution Committee, *Inter-governmental relations in the United Kingdom* (11th Report, Session 2014–15, HL Paper 146)

107 Scottish Parliament, Devolution (Further Powers) Committee, *Changing Relationships*, p 25

80. The evidence we heard echoed these principles and three themes emerged as important for scrutiny of the arrangements for financial devolution:

(a) The publication of data in particular on how funding arrangements will operate.

(b) A revised and robust structure of inter-governmental relations.

(c) Scrutiny, ideally co-ordinated scrutiny, of the arrangements the UK parliament and the devolved legislatures.

Publication of Data

81. The operation of the funding arrangements for Scotland, Wales and Northern Ireland will become more complex as further spending powers are delegated and as the devolved governments have enhanced ability to raise funds through taxation. The current funding arrangements—the block grant adjusted by the Barnett Formula—are discussed above and in Annex 3. To ensure these arrangements are accountable they first must be transparent.

82. Sir Danny Alexander and HM Treasury described the current operation of the Barnett Formula as "simple" and "transparent".[108] Outside the Treasury there was widespread dissatisfaction regarding the operation of the formula, the lack of transparency and the absence of publicly available data. We too find it obscure.[109]

83. Several witnesses thought there were insufficient data available about tax revenues in different parts of the country. Professor McLaren said in written evidence that the reliability of data on the actual tax revenues and expenditures incurred at the sub-UK level "remains a challenge for the UK and Scottish governments".[110] Professor Alan Trench, Professor of Politics at the University of Ulster, said "we need much better information … about what tax revenue is raised by what sources across the UK, what is spent across the UK and how the block grant system works to change the amounts allocated through that."[111]

84. In addition to data, Mr Cottarelli told us that a fiscal council, similar in operation and remit to the Office for Budget Responsibility (OBR), was an important component of successful decentralised systems.[112] Other witnesses agreed that the OBR—or a similar body—could perform a useful function scrutinising information and assessing compliance with fiscal rules.[113]

85. **We recommend that the Office for Budget Responsibility scrutinise the ongoing operation of the fiscal framework and the funding of the devolved governments. In Scotland this work should be done in co-operation with the Scottish Fiscal Commission.**

108 Written evidence from HM Treasury (DPF0015), Q 91

109 Witnesses were concerned that the Treasury is both judge and jury: written evidence from Prof Alan Trench (DPF0002), written evidence from the Welsh Government (DPF0011). Further that the operation of the Formula is opaque; and, that no data is published: Q 9 (Prof Alan Trench and Prof James Gallagher), Q 61.

110 Written evidence from Prof John McLaren (DPF0019)

111 Q 9

112 Q 108

113 Q 9, Q 27

86. **To enable the OBR to conduct effective scrutiny, data on the workings of devolution, including the operation of and adjustments to the Barnett Formula, must be published. This was a recommendation of the Select Committee on the Barnet Formula that has not been implemented.**[114] **It is a recommendation we endorse.**

Intergovernmental co-operation and financial devolution

87. The Smith Commission concluded that a more complex devolution settlement required "productive, robust, visible and transparent" intergovernmental relationships.[115]

88. The intergovernmental relationship on financial issues is mediated through the Joint Ministerial Committee, and the Finance Ministers' Quadrilateral. In addition, bilateral Joint Exchequer Committees were established to implement financial devolution. Whilst the Treasury indicated that these structures were "valued", other witnesses, and the Scottish Parliament Finance Committee, considered them ad hoc, unsatisfactory and opaque.[116]

89. **We agree with the conclusions of the Constitution Committee: it is vital that inter-governmental relations become more transparent. In practice this means that meetings are regular; that dates and agendas are announced in advance; and that information published after the meeting is sufficient to allow scrutiny and debate.**[117]

Parliamentary scrutiny

90. The ongoing operation of the devolved finances of Scotland, Wales and Northern Ireland must be accountable to the national and devolved legislatures and subject to proper scrutiny.

91. Parliamentary scrutiny of financial devolution involves, first, scrutiny of the fiscal powers operated by the devolved Government. The Smith Commission recommended that the Scottish Government's financial accountability to the Scottish Parliament be increased.[118]

92. The second aspect of parliamentary scrutiny is the operation of the relationship between the UK Government and the devolved administrations on financial matters. The Devolution (Further Powers) Committee of the Scottish Parliament commissioned research comparing parliamentary scrutiny in systems with a federal or quasi-federal structure. This work concluded that "in almost every country examined … the role of parliaments in scrutinising

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114 Select Committee on the Barnett Formula, *The Barnett Formula* (1st Report, Session 2008–09, HL Paper 139) stated that HM Treasury should "publish their statistics on the workings of the formula, or its successor, in a single coherent and consistent publication. This annual publication should contain all material data on devolved finance, showing the allocations of grant to the devolved administration, changes from previous years and explanations for any changes made."

115 Smith Commission, *The Report of the Smith Commission*, p 5

116 Written evidence from HM Treasury (DPF0015), Q 9, Scottish Finance Committee, *Scotland's Fiscal Framework* (June 2015) p 32: http://www.scottish.parliament.uk/S4_FinanceCommittee/Reports/fir15-12w.pdf [accessed November 2015]

117 Constitution Committee, *Inter-governmental relations in the United Kingdom* (11th Report, Session 2014–15, HL Paper 146)

118 Smith Commission, *The Report of the Smith Commission*, p 6

[inter-governmental relations] is greater than the role the UK's parliaments currently enjoy in the scrutiny of UK [inter-governmental relations]".[119]

93. **Parliamentary scrutiny of financial devolution will be an important component of overall accountability. It is a matter for each legislature how it arranges this scrutiny. The number of interested devolved legislatures gives rise to a potential for duplication of this work. Closer co-operation should mitigate this risk. We propose that the chairs of the finance committees of the national and devolved legislatures meet regularly to ensure effective and co-ordinated scrutiny.**[120]

119 Nicole McEwan, Bettina Petersohn, Coree Brown Swan, *Intergovernmental relations and parliamentary scrutiny a comparative overview* (September 2015): http://www.scottish.parliament.uk/2015.09.30_IGR_External_Research_Report_FINAL.pdf [accessed October 2015]

120 At present this is the Treasury Select Committee, the Economic Affairs Committee, the Scottish Parliament Finance Committee, Welsh Government Finance Committee and the Northern Ireland Assembly Committee for Finance and Personnel.

ANNEX 1: DEVOLUTION IN THE UK

94. On 18 September 2014, 55.3 per cent of the people of Scotland voted 'no' in a referendum on whether Scotland should become an independent nation. In the last days of campaigning before the vote Scotland was the centre of considerable political activity. The parties in favour of retaining the union promised that, in the event of a 'no' vote, Scotland's position within the UK would be transformed. This promise included the transfer of further tax and borrowing powers.

95. The drama and pace of developments in Scotland have overshadowed the changing landscape of devolution to Wales and Northern Ireland, but devolution to one country cannot be considered in isolation from the remainder of the UK.

96. In April 2013 this Committee published a report on *The Economic Implications for the United Kingdom of Scottish Independence.*[121] We observed:

> "The decision the Scots will have to make is not a simple one. It will have far-reaching constitutional, political and social, as well as economic, consequences. Nor will their verdict be confined in its effects to North of the Border."[122]

97. The decisions the Governments of the UK, Scotland and Wales now have to make are complex ones.[123] They will also have far-reaching consequences for the entire country. Professor Holtham commented: "As Poul Anderson said, there is no problem, however complicated, that when looked at in the right way does not become still more complicated".[124]

How did we get here? The Evolution of Devolution in the UK

98. The Bingham Centre for the Rule of Law points out that the UK in its present form is not an old state "but it is a state comprising ancient nations".[125]

Scotland

99. The full political and economic integration of England, Wales and Scotland was achieved by the 1707 Act of Union in England and the Scottish Parliament adjourned on 25 March 1707.

100. The clear support for devolution shown by the 1997 referendum led to the re-establishment of a Scottish legislature and creation of a Scottish Executive.[126] The referendum also granted the Executive tax raising powers. Devolution of taxation was limited to the power to vary the basic rate of income tax

121 Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence* (2nd Report, Session 2012–13, HL Paper 152)

122 *The Economic Implications for the United Kingdom of Scottish Independence*, para 4

123 The devolution proposed to Northern Ireland is more limited and thus many of these issues we raised in this report do not arise.

124 Q 84. Poul Anderson was an American science fiction author: http://www.britannica.com/biography/Poul-Anderson [accessed November 2015]

125 Bingham Centre for the Rule of Law, *A Constitutional Crossroads: ways forward for the United Kingdom* (May 2015) p 1: http://www.biicl.org/documents/595_a_constitutional_crossroads.pdf [accessed October 2015].

126 Scotland Act 1998, section 1 and section 44. The Scottish Executive was formally renamed the 'Scottish Government' in the Scotland Act 2012, section 12(1).

by three pence in the pound. This power was never used and the Scottish Government allowed it to lapse.[127]

101. The Scotland Act 2012 expanded the Scottish Government's fiscal powers by transferring full or partial control of:

- Income tax: the basic and higher rates of income tax could be varied by 10 percentage points. This power was restricted by a 'lock step' limiting the variation in rates the Scottish Government could achieve.[128]
- Stamp Duty Land Tax, which became the Scottish Land and Transaction Tax.
- Landfill Tax which became the Scottish Landfill Tax.
- The creation of Revenue Scotland to administer the latter two taxes.
- Borrowing powers.

102. During the referendum campaign attention focussed on what further powers Scotland would receive in the event of a vote against independence (see Box 2 below).

Box 2: The Vow

On 16 September 2014, the front page of the *Daily Record* featured what the newspaper termed 'The Vow' made by the three main party leaders to the people of Scotland.

"We are agreed that:

"The Scottish Parliament is permanent and extensive new powers for the Parliament will be delivered by the process and to the timetable agreed and announced by our three parties, starting on 19th September.

"And it is our hope that the people of Scotland will be engaged directly as each party works to improve the way we are governed in the UK in the years ahead.

"We agree that the UK exists to ensure opportunity and security for all by sharing our resources equitably across all four nations to secure the defence, prosperity and welfare of every citizen.

"And because of the continuation of the Barnett allocation for resources, and the powers of the Scottish parliament to raise revenue, we can state categorically that the final say on how much is spent on the NHS will be a matter for the Scottish Parliament.

"We believe that the arguments that so powerfully make the case for staying together in the UK should underpin our future as a country. We will honour those principles and values not only before the referendum but after.

"People want to see change. A No vote will deliver faster, safer and better change than separation."[129]

127 John Swinney, 24 November 2010, *Official Report of the Scottish Parliament*, http://www.scottish.parliament.uk/parliamentarybusiness/report.aspx?r=8109 [accessed October 2015]

128 Under the lockstep the basic, higher and additional income tax rates can only be changed by the same number of pence in the pound. So if the Scottish Government wanted to reduce the basic rate by 1p then the other two rates would also have to be reduced by 1 pence.

129 'The Vow' *The Daily Record* (16 September 2014): http://www.dailyrecord.co.uk/news/politics/david-cameron-ed-miliband-nick-4265992 [accessed October 2015]

103. The Government asked Lord Smith of Kelvin to lead a Commission working with the five main parties represented in the Scottish Parliament to agree a package of new powers for the Scottish Parliament. The Smith Commission invited submissions. It received over 400 from institutions and groups and over 18,000 from members of the public.[130]

104. The agreement negotiated by the Smith Commission included a package to strengthen "the financial responsibility of the Scottish Parliament".[131] The package is set out in Table 5 below.

Table 5: Tax devolution agreed by the Smith Commission

Tax	Devolved Powers	Reserved Powers
Income Tax	Unrestricted power to set the rates and thresholds of non-savings and non-dividend income tax.	The personal allowance, the ability to introduce and amend tax reliefs, the taxation of savings and dividends, and the definition of income.
National Insurance		Reserved.
Capital taxes		Inheritance tax and capital gains tax reserved.
Corporate Taxes		Corporation tax and the taxation of oil and gas receipts reserved.
Value Added Tax	The receipts of the first 10 per cent of the standard rate of VAT assigned to the Scottish Parliament.	All other aspects of VAT.
Air Passenger Duty	Devolved.	
Aggregates Levy	Devolved.	
Fuel and excise duties		Reserved.

Source: Smith Commission, The Report of the Smith Commission for further devolution on powers to the Scottish Parliament, 27 November 2014, p 23–24

105. The devolution of further responsibility for tax and spending would, it was agreed, be accompanied by an updated fiscal framework encompassing:

> "A number of elements including the funding of the Scottish budget, planning, management and scrutiny of public revenues and spending, the manner in which the block grant is adjusted to accommodate further devolution, the operation of borrowing powers and cash reserve, fiscal rules, and independent fiscal institutions."[132]

130 Smith Commission, *The Report of the Smith Commission*, p 10
131 Smith Commission, *The Report of the Smith Commission*, p 23
132 Smith Commission, *The Report of the Smith Commission*, p 25

Wales

106. Welsh devolution has followed a different path to that in Scotland. Endorsed by a narrow margin in the 1997 referendum, the National Assembly for Wales was created in 1998.[133] In 2011 a second referendum sanctioned the exercise by the Assembly of primary law making powers in defined areas.[134] The Assembly was not granted competence over tax policy save for council tax.

107. The perception that the Barnett Formula operates to the detriment of Wales has fuelled debate about the funding of Wales.[135] The Independent Commission on Funding and Finance for Wales (known as the Holtham Commission) established by the Welsh Government to consider funding and financial devolution concluded in 2010 that the Barnett Formula should be replaced by a needs based assessment and the Assembly granted further tax and borrowing powers.[136]

108. The Commission on Devolution in Wales (known as the Silk Commission) was established by the UK Government to assess further financial devolution and the devolution framework. The Commission produced two reports. The first, which drew on the work of the Holtham Commission, made recommendations for further financial devolution which were largely incorporated in the Wales Act 2014 and include:

- The devolution of stamp duty land tax and landfill tax.
- Partial devolution of income tax if approved by a referendum of Welsh voters.[137]
- Capital borrowing powers.[138]

109. The final piece of the current jigsaw of Welsh financial devolution is contained in the 'St David's Day Agreement'. The UK Government agreed to introduce a floor in the level of relative funding it provides to the Welsh Government. The precise level of the floor, and the mechanism to deliver it, will be agreed alongside the next Spending Review.[139]

Northern Ireland

110. The legacy of conflict defines much of the nature of devolution in Northern Ireland. Despite having extensive borrowing powers,[140] the Northern Ireland

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133 Government of Wales Act 1998

134 Government of Wales Act 2006. Between 2006 and 2011 an incremental model of devolution conferred powers on the Assembly on a case-by-case basis approved by the UK Parliament.

135 Prof Lloyd told us that people in Wales were 'excited' by the Barnett Formula and that the Silk Commission, despite having no remit to consider the Barnett Formula, received a large number of written submissions on the topic (Q 101).

136 The Holtham Commission, *Funding Devolved Government in Wales, Barnett and beyond* (July 2009): http://gov.wales/docs/icffw/report/090708barnettfullen.pdf [accessed October 2015], The Holtham Commission, *Fairness and Accountability: a new settlement for Wales* (July 2010): http://gov.wales/docs/icffw/report/100705fundingsettlementfullen.pdf [accessed October 2015]

137 Devolution of income tax in the Wales Act 2014 was initially subject to a 'lock-step' identical to that in the Scotland Act 2012. Subsequently this restriction was removed.

138 The Silk Commission, First Report, *Empowerment and Responsibility: Financial Powers to Strengthen Wales* , November 2012, Wales Act 2014

139 Wales Office, *Powers for a purpose: towards a lasting devolution settlement for Wales* (February 2015): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/408587/47683_CM9020_ENGLISH.pdf [accessed October 2015]

140 See Annex 5 and Table 4.

Assembly has not been granted the same power over taxation as Scotland and Wales.

111. The one tax Northern Ireland may in future take partial responsibility for is corporation tax. The Corporation Tax (Northern Ireland) Act 2015 granted the Assembly the power to set the main rate of corporation tax over certain trading profits. This partial devolution is due to take effect from April 2017.

ANNEX 2: TAX DEVOLUTION: PRINCIPLES AND PRACTICE

112. In the previous Annex we outlined the development of financial devolution to the constituent parts of the UK. In this Annex we consider the proposed devolution of tax to Scotland, Wales and Northern Ireland. We examine the evidence we heard regarding the principles for devolution of taxes; the current package of proposals; and the details of each individual tax to be devolved.

113. Scotland, Wales and Northern Ireland have tax powers of considerably different size and strength. Northern Ireland will have partial control of corporation tax alone. The Scottish Parliament will be able to raise over 50 per cent of the money it spends.[141]

Principles: which taxes are best to devolve?

114. The Holtham Commission set out six principles for the devolution of taxation (see box 3 below). Professor Noel Lloyd, former member of the Silk Commission, told us that the Commission built on this work and established a set of priorities—accountability, empowerment, incentivisation and stability—against which each tax could be measured.[142] Other witnesses cited Professor Holtham's principles as relevant when considering what further taxes to devolve.[143]

115. Professor Holtham said that the best taxes to devolve are those where "the tax base is as immobile as possible" as there is no, or very limited, possibility of tax payers moving assets (such as a building or house) to avoid or evade the tax. He also thought that "the argument for maximum accountability of devolved government implies that devolved taxes should be evident, paid by a high proportion of the population and make up a material part of the revenue of the devolved government."[144]

116. Professor James Gallagher, Visiting Professor of Government, University of Glasgow, and Professor Kay agreed that the mobility of the tax base was the first question to be asked when deciding which taxes were suitable for devolution.[145] For this reason, "property taxes devolve best, income taxes adequately, corporation taxes less so, taxes on online transactions not at all."[146]

Box 3: Holtham Commission Principles for devolving taxation

- Promotes accountability because the tax is:
  - Paid by a high percentage of residents;
  - Raises a substantial revenue;
  - Visible to most citizens;
  - Well understood by the general population.

141 The Cabinet Office, *Scotland in the United Kingdom: An Enduring Settlement*, p 7
142 Q 98
143 Written evidence from the Bevan Foundation (DPF0007)
144 Written evidence of Prof Gerald Holtham (DPF0003), Q 83
145 Written evidence from Prof James Gallagher (DPF0001), Q 98 (Prof Kay)
146 Written evidence from Prof James Gallagher (DPF0001)

- Does not harm economic efficiency because:
  - Avoids distorting the region's economic relationship with the rest of the UK
  - Avoids altering economic behaviour (to avoid paying the tax) in ways which damage efficiency.
- Does not harm administrative efficiency because:
  - Avoids a substantial compliance burden on citizens and businesses;
  - Avoids relatively high costs of administering collection (especially, as percentage of revenues raised).
- Is relevant to policy in terms of providing a useful policy lever and helping to achieve policy goals of the devolved Assembly (could be economic but also social, health or environmental policy objectives).
- Is compatible with legal constraints (notably, EU law).
- Has minimal impact on the tax base of the rest of the UK.

Source: The Holtham Commission, Fairness and Accountability a new settlement for Wales (July 2010): http://gov.wales/docs/icffw/report/100705fundingsettlementfullen.pdf *[accessed October 2015]*

Practice: rationale for current tax devolution

117. There was broad agreement in the evidence we heard on the theoretically ideal structure of tax devolution. When we asked witnesses to measure the current proposals for Scotland and Wales against that ideal, the answers were more divergent.

Scotland

Support for proposals

118. HM Treasury told us that the cross-party agreement behind the Smith Commission's conclusions gives them a "strong pedigree".[147]

119. Professor Kay considered "in terms of underlying principles, the choice of devolved tax has been quite sensible."[148] Professor Trench also supported the package of taxes proposed by the Smith Commission. He said the package was "designed to bring about a closer relationship between devolved spending and tax revenues, and to put in the hands of devolved governments those taxes best suited for exercise at a more local level."[149]

Criticism of Proposals

120. The first criticism of the package of taxes proposed for devolution to Scotland was that, rather than being an attempt to apply the above—or any other—set of principles, they were a messy political compromise. Professor McLean thought, taken as a whole, the devolved tax and spending powers were "a bit of a rag-bag".[150] Professor Holtham was critical in his written evidence, telling us that the proposals appear "to be the result of political horse-trading and it is difficult to detect any particular rationale."[151]

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147 Written evidence from HM Treasury (DPF0015)
148 Q 98
149 Written evidence from Prof Alan Trench (DPF0002)
150 Q 70
151 Written evidence from Prof Gerald Holtham (DPF0003), Q 83 (Tom Crotty)

121. The second criticism levelled at the proposals is that they do not provide the Scottish government with sufficient policy controls. Dr Cuthbert said the rationale was "poor" as Scotland is only given control of one major tax lever: "it removes the possibility of designing an overall tax package".[152] Professor Ronald MacDonald, Research Professor of Macroeconomics and International Finance at the University of Glasgow, said he would have preferred a better balance between the taxes that were devolved, "because then you could think about them having actual trade-offs: 'Well we cut corporation tax; what do we do, cut spending or increase income tax to pay for that?' "[153]

122. Professor David Heald, Professor of Accountancy, University of Aberdeen Business School, worried that the limited control would lead to a repeat of the situation between 1998 and 2006, when Scotland had a power to vary the basic rate of income tax but did not use that authority.[154]

123. A third specific concern was raised about the full devolution of income tax. We consider the evidence relating to income tax in the section 'The Issues'.

Wales

124. The proposed tax devolution for Wales arises from a lengthy consultative process and cross-party consensus. These proposals attracted praise from our witnesses

125. Professor Holtham said that the Wales Act 2014 "is a reasonable attempt to apply" the principles he identified as underlying devolution of taxation.[155] The Bevan Foundation said that the choice of taxes in the Wales Act 2014 was mostly based on the Silk Commission, which drew heavily on the work of the Holtham Commission.[156] Plaid Cymru said the rationale behind the choices in the Act was "quite sound and is directly linked to the work of the Silk Commission".[157]

126. Some witnesses from Wales were concerned about the imbalance between taxes devolved to different parts of the UK. Plaid Cymru supported the devolution of corporation tax to Wales.[158] The Welsh Government noted that the one recommendation of the Silk Commission omitted from the Wales Act 2014 was the devolution of Air Passenger Duty. This tax would, they argued, "help to rebalance the UK economy away from airports which are close to capacity and it would strengthen the financial accountability of the Welsh Government."[159]

Northern Ireland

127. The only tax which it is proposed to devolve to Northern Ireland is corporation tax. We did not receive evidence suggesting further powers of taxation should be devolved to Northern Ireland. Corporation tax is considered further under paragraph 134 below.

152 Written evidence from Dr James Cuthbert (DPF0004), Q 45
153 Q 23 (Prof Ronald MacDonald)
154 Q 10 (Prof David Heald)
155 Written evidence from Prof Gerald Holtham (DPF0003)
156 Written evidence from the Bevan Foundation (DPF0007)
157 Written evidence from Plaid Cymru (DPF0008)
158 Written evidence from Plaid Cymru (DPF0008)
159 Written evidence from the Welsh Government (DPF0011)

Individual taxes

Income Tax

128. The evidence we heard in favour and against the devolution of income tax are considered in the section 'The Issues'.

129. In addition to the matters of principle, some witnesses were concerned about how HMRC would administer the tax following devolution to Scotland.

130. PWC said the experience of implementing the Scotland Act 2012 reinforced their view that "most governments underestimate the time needed to draft and consult meaningfully on legislation and the time needed for a tax authority to prepare for change. Both are vital in producing a system that is robust and facilitates compliance. It is not a process that should be rushed."[160]

131. The Institute for Chartered Accountants Scotland (ICAS) told the Committee that defining income in Scotland for the purpose of income tax will be "difficult". They said this would also require the identification of English and Welsh taxpayers.[161] In oral evidence Charlotte Barbour, Director of Taxation, Institute of Chartered Accountants of Scotland (ICAS), said:

> "At the moment, employers and some of our members are slightly nervous about [the introduction of the Scottish rate of income tax], because we are still waiting for HMRC to roll out the general information programme. That is not to be done until the rate is set, understandably, but once it is in place I think employers will find that it is very little different from what they do today with [Pay As You Earn]."[162]

132. Sarah Walker, HMRC Deputy Director, Devolution, wrote to the Chairman explaining the measures taken to adapt the PAYE system for the introduction of the Scottish rate of income tax.[163] The "basic mechanics" for the system have been in place since 1998.[164]

133. Ms Walker also confirmed that the definition of a Scottish taxpayer will be based on an individual's main place of residence. This will provide a clear answer in the "vast majority" of cases.[165]

Corporation Tax

134. When the Corporation Tax (Northern Ireland) Act 2015 comes into force Northern Ireland will have the power to set the rate of corporation tax. The rationale for this is that Northern Ireland shares a land border with the Republic of Ireland which has a significantly lower corporate tax rate.

Support for devolution of Corporation Tax

135. There was some support for devolution of corporation tax generally and specifically to Northern Ireland. Professor James Gallagher said it was "easy" for companies to recognise profits in different jurisdictions and the

160 Written evidence from PWC (DPF0023)
161 Written evidence from ICAS (DPF0010)
162 Q 83
163 The changes made by the Scotland Act 2012 will come into force in April 2016. Those contained in the Scotland Bill are expected to take effect from April 2017.
164 In order to facilitate the introduction of a Scottish Variable Rate of income tax (a facility that was never used).
165 Written evidence from HMRC (DPF0024)

Government's proposals for Northern Ireland assist this: "I see no objection to devolving it in Wales, and even Scotland. It then becomes a tool of regional economic development."[166] The Welsh Government said it recognised Northern Ireland was in a "unique position" because of its land border with the Republic.[167]

Criticism of devolution of corporation tax

136. Corporation tax is in principle, some witnesses noted, an unusual tax to devolve. Professor Kay told us it "is probably the hardest of all taxes to attach a location to".[168] Mr Cottarelli was not aware of any subnational state that had complete control over corporation tax but noted that some countries operated a system of local corporate income taxes, together with a central corporate income tax.[169]

137. Other witnesses questioned the rationale for devolving corporation tax to Northern Ireland. Mr Phillips said he had never quite bought the idea that Northern Ireland is a special case because of its border with the Republic of Ireland, "given that business decisions are internationally mobile, not just mobile across land borders."[170] Mr Cottarelli pointed out "in the modern world, firms compete worldwide, so why pay particular attention to what the tax rate is in the Republic of Ireland?"[171]

138. The Welsh Government did not seek the devolution of corporation tax to Wales and was concerned about a "race to the bottom … which might harm the tax base while delivering few net benefits to any part of the UK".[172] The Holtham and Silk Commissions similarly ruled out this option. The Weir Group said it did not see the merits of devolving corporation tax to Scotland, "potentially importing additional complexity and consequent costs."[173]

Assignment of Value Added Tax

139. The Scotland Bill proposes to provide Scotland with the first 10 per cent of standard rate VAT revenue raised in Scotland (and the first 2.5 per cent of reduced rate VAT). This topic has received less attention than the devolution of income tax: a fact reflected in the evidence to the Committee. Witnesses did, however, raise questions about how such devolution will operate.

140. Professor Kay acknowledged the limited freedom the UK Government has to devolve VAT and described the current proposal as an unsatisfactory compromise.[174] PWC in written evidence were concerned that the Scottish Government would "bear the risk of any fluctuations or falls in [VAT] revenue, whilst having no direct influence on the setting or collection of the tax."[175]

141. Ms Barbour thought depending on how the assignment was calculated, "you may have unintended consequences of that becoming a driver of where you

166 Written evidence from Prof James Gallagher (DPF0001)
167 Written evidence from the Welsh Government (DPF0011)
168 Q 98
169 Q 109
170 Q 65
171 Q 109
172 Written evidence from the Welsh Government (DPF0011)
173 Written evidence from the Weir Group (DPF0012)
174 Q 98
175 Written evidence from PWC (DPF0023)

target your economic measures—on to VAT-able things, because you would want your VAT up."[176]

142. A member of Scottish Parliament Finance Committee told the Committee in a private session that the question as to whether VAT should be assessed at the point of production or consumption had not received enough attention.

143. ICAS said that "considerable analytical and statistical work will be required if there is to be an amount that can be identified which truly reflects the VAT attributable to Scotland and will in future reflect any changes in the Scottish economy." [177]

176 Q 83
177 Written evidence from ICAS (DPF0010)

ANNEX 3: THE BLOCK GRANT AND THE BARNETT FORMULA

Expenditure per head in the UK by country and region

144. As set out in paragraph 20, the majority of expenditure by the Scottish, Welsh and Northern Irish administrations is funded by the UK Government at present. A large proportion of this expenditure will be subject to changes each year as a result of the operation of the Barnett Formula. Table 6 below gives a breakdown of total identifiable expenditure on services by country and region, per head, from 2010/11 to 2014/15:

Table 6: Total identifiable expenditure on services by country and region, per head 2010/11 to 2014/15

Country/Region	2010/11	2011/12	2012/13	2013/14	2014/15
North East	9,300	9,185	9,270	9,316	9,347
North West	9,074	8,917	9,106	9,109	9,197
Yorkshire and the Humber	8,419	8,389	8,473	8,508	8,660
East Midlands	7,885	7,815	7,964	8,033	8,159
West Midlands	8,415	8,358	8,467	8,513	8,683
East	7,804	7,577	7,668	7,817	7,881
London	10,211	9,916	9,791	9,827	9,840
South East	7,579	7,398	7,554	7,745	7,756
South West	7,901	7,896	8,034	8,217	8,295
England	**8,523**	**8,381**	**8,474**	**8,563**	**8,638**
Scotland	**9,949**	**9,954**	**10,196**	**10,171**	**10,374**
Wales	**9,615**	**9,691**	**9,629**	**9,740**	**9,904**
Northern Ireland	**10,595**	**10,677**	**10,862**	**10,899**	**11,106**
UK identifiable expenditure	**8,755**	**8,642**	**8,742**	**8,820**	**8,913**

Source: HM Treasury, Country and Regional Analysis, November 2015: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476354/Country_and_regional_analysis_November_2015.pdf#page=13 *[accessed November 2015]*

History of funding for Scotland, Wales and Northern Ireland

145. The report of the House of Lords Select Committee on the Barnett Formula set out how the funding for services in Scotland, Wales and Northern Ireland evolved from the nineteenth century.[178] Box 4 below provides selected excerpts.

178 Select Committee on the Barnett Formula, *The Barnett Formula* (1st Report, Session 2008–09, HL Paper 139)

Box 4: Development of funding for Scotland, Wales and Northern Ireland since the 1880s

Pre-Barnett Formula

A formula was first used to calculate funding for services in Scotland and Ireland compared with England and Wales in 1888. The ‘Goschen Formula’, named after George Goschen, Chancellor of the Exchequer, allocated funds based on population in the proportion 80:11:9 to England and Wales, Scotland and Ireland respectively.

After World War II successive Scottish Secretaries of State negotiated additional allocations for their territorial departments by arguing special needs, such as sparsity of population in the remote areas and density and poor housing in the central belt.

Introduction of the Barnett Formula

The introduction of what became known as the Barnett Formula was part of a wider attempt to constrain public spending in what were difficult times. The creator of the Formula, Joel Barnett MP, intended to find a way of apportioning changes in public spending to the territorial departments by allocating proportional shares to the Scottish and Welsh Offices and Northern Ireland departments when there were changes in spending on ‘comparable functions’ for England. Those proportional shares were based on the relative populations of the regions and countries of the United Kingdom in the late 1970s.

The Barnett Formula began to operate in Scotland and Northern Ireland in 1979 and in Wales in 1980. The purpose of the new Formula was to respond to pressure from ministers in other departments to rein in the excessive, as they saw it, share of resources going to territorial departments, in particular to Scotland, at a time of cash limits and in dire economic circumstances nationally. It was intended to be temporary until a formula that paid more attention to relative need could be devised and agreed.

The Barnett Formula and devolution

When planning for devolution after the 1997 general election, the United Kingdom Government decided at an early stage to continue to use the Barnett Formula to allocate funding for the devolved administrations. The Formula was slightly adapted to cater for the fact that different administrations, accountable to separate elected bodies, were to be responsible for wide but differing ranges of public service provision.

From 1997 the use of the Formula was increasingly formalised. In 1999 the methodology used was set out in the Treasury’s document *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: A Statement of Funding Policy*. The basis on which it operated was explicitly stated and its application was therefore less flexible with little scope for negotiation within the published rules. Since 1997 the application of the Formula has been largely a technical, even arithmetical, exercise.

Source: Select Committee on the Barnett Formula, The Barnett Formula (1st Report, Session 2008–2009, HL Paper 139).

The Barnett Formula—an example

146. The net change to spending allocations for each devolved administration is determined as follows:

Change to the UK Government department's programme	×	*Comparability percentage*	×	*Appropriate population proportion*

The comparability percentage is calculated by HM Treasury by examining each part of a Department's planned spending programme. The population proportions are taken from the annual mid-year estimates published by the Office for National Statistics.

147. For example, The UK Government grants the Department for Transport an extra £100 million to fund the reopening of the Woodhead Line between Manchester and Sheffield. This is a purely English project and transport is a largely devolved matter. Extra allocations would be made to the devolved administrations as follows:

	Change to the UK Government department's programme		**Comparability percentage**[179]		**Appropriate population proportion**[180]		**Additional Allocation**[181]
Scotland	£100m	×	0.915	×	0.1008	=	£9.22m
Wales	£100m	×	0.683	×	0.0584	=	£3.99m
Northern Ireland	£100m	×	0.94	×	0.0343	=	£3.22m

148. The UK Government would therefore have to provide an extra £16.43 million to compensate the devolved administrations.

Should the Barnett formula be replaced?

149. HM Treasury said in written evidence that the Barnett Formula should be maintained for each of the devolved administrations as it delivers a "relatively simple and transparent funding arrangement."[182]

150. Many witnesses questioned the appropriateness of the Barnett Formula. Professor Holtham thought the formula had led to Scotland being "clearly overfunded."[183] The Welsh Government said that the Barnett formula "does not apportion spending fairly."[184] Dr Peter Kenway of the New Policy Institute, disliked the arbitrariness: "Barnett is unsatisfactory since it produces the figures it does as an accidental arithmetical bi-product."[185] Mr

179 As calculated by HM Treasury for transport. The figures are taken from an identical worked example on the Government's website: https://www.gov.uk/guidance/devolution-of-powers-to-scotland-wales-and-northern-ireland [accessed November 2015].

180 The population proportions are taken from the worked example on the Government's website. See footnote above.

181 By contrast the Department for Transport's budget was decreased by £100 million, the budgets of the devolved administrations would be reduced by these amounts.

182 Written evidence from HM Treasury (DPF0015)

183 Written evidence from Prof Gerald Holtham (DPF0003)

184 Written evidence from Welsh Government (DPF0011)

185 Written evidence from Dr Peter Kenway and Dan Corry (DPF0013)

Phillips said there is "no clear economic rationale" for the Barnett formula.[186] Professor Trench said it was "fundamentally inappropriate" and leads to "a sequence of fairly arbitrary decisions".[187]

151. Professor Trench was further concerned that the Barnett formula implicitly ties devolved governments to the same overall package of public services as applies in England:

> "if the UK Government makes a large enough spending decision affecting 'comparable functions' in England, devolved governments will have to adjust to that decision. Their options for doing so are to cut their spending … to raise more revenue … or to follow the UK Government decision … The problems that this creates are all the more serious if devolved governments are not involved in the making of those decisions."[188]

Needs-based system

152. Some witnesses were in favour of replacing the Barnett formula with a needs-based assessment. Professor Holtham, following the conclusions of the Holtham Commission, suggested a "simple extension" of the Barnett formula which would add four factors beyond population: demographics, specifically dependency ratios; incidence of poverty; incidence of chronic ill-health and sparsity of population. He said the necessary data to quantify these factors were available for each country on a comparable basis.[189]

153. The Welsh Government said that a need-based allocation formula is "ultimately the most sensible way to deliver fairness across the UK."[190] Nicolas Ramsay highlighted the conclusion of the House of Lords Select Committee on the Barnett Formula which found the case for funding based on relative need to be a "compelling one".[191] Mr Phillips thought it would be "difficult" to move to a needs-based system but that the difficulties were not insurmountable. He favoured a simple assessment, along the lines recommended by the Holtham Commission, using only five or six factors.[192]

154. Other witnesses doubted how feasible such a change would be. Professor McLean thought it might be "difficult to get a consensus" between the different administrations.[193] Professor MacDonald thought any such switch would reduce funding for Scotland, creating "a big political economy issue."[194]

155. Professor McLaren said the idea that such an assessment was objective "is wrong; they are very subjective … There are all sorts of questions about how you weight things."[195] Mr Darling thought that assessing need would take a long time, "and I am not sure you would ever come up with a satisfactory answer … experts too can be guilty of coming along with their own prejudices."[196]

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186 Q 60
187 Q 1
188 Written evidence from Prof Alan Trench (DPF0002)
189 Written evidence from Prof Gerald Holtham (DPF0003)
190 Written evidence from Welsh Government (DPF0011)
191 Written evidence from Nicholas Ramsay (DPF0005)
192 Q 60
193 Q 72
194 Q 16
195 Q 17
196 Q 31

156. Allocation of funding in Canada attempts to compensate for differential tax bases; in Australia an assessment of relative need is used. Professor McLean said that they are both huge countries: "the states within them are so enormous, that they are very different things." This compared unfavourably to the UK as a small country: "the north of Wales is right beside Liverpool, the south of Wales is right beside Bristol, and the middle is near various parts of the West Midlands, so what is the need of Wales that can be shared with the West Midlands and what is it on its own?"[197]

157. Professor Trench said he did not like what the Australian Commonwealth Grants Commission (CGC) does: "it uses something like 70 different indicators … and is therefore a very data-intensive process. It is equally prone to being gamed by finding bits of data that advantage you and pushing the case for the inclusion of these in the formula."[198] Professor Holtham said the Australian system was an "enormously complex procedure" that the UK should not try and replicate.[199]

158. The Select Committee on the Barnett formula found the arguments for a needs based system to be "compelling".[200]

Support for the Barnett formula

159. Professor Gallagher thought the formula had been "remarkably robust…It has advantages that people do not recognise." He said that public spending has long been an incremental system, of baselines and reviews: "that has big advantages of stability, and will remain."[201]

160. Professor McLean said that the only justification for keeping Barnett is that it was part of 'The Vow': "that, I think, ties the legislature in good faith to continuing to operate Barnett".[202] Professor Holtham said that Barnett was "extremely simple … that's all it has going for it."[203]

197 Q 17
198 Q 3
199 Q 79
200 Select Committee on the Barnett Formula, *The Barnett Formula*
201 Written evidence from Prof James Gallagher (DPF0001)
202 Q 70
203 Q 81

ANNEX 4: ADJUSTING THE BLOCK GRANT TO REFLECT DEVOLVED REVENUE RAISING POWERS

161. When tax receipts are devolved to Scotland, Wales or Northern Ireland, a corresponding reduction in that administration's block grant from the UK Government is required. This reflects the fact the UK Government has forgone some tax revenue in that nation.

162. In the first year a tax is devolved, the adjustment should be relatively easy as the revenues foregone can be deducted from the block grant. What happens in subsequent years is more complicated. One purpose of devolving revenue raising powers is to give that administration more responsibility for raising its own funding; if the deduction in the block grant continues to be linked to the revenue raised by that tax in the devolved administration, there is little transfer of responsibility or incentive to grow that tax base.[204] A method of ongoing adjustment for the block grant needs to be agreed. Different taxes may require different methods.

163. One method is indexation to the UK tax base for that particular tax; the adjustment each year tracks the growth in the UK tax revenue for that tax. This is the method that will be used when the Scottish rate of income tax is introduced from April 2016 under the Scotland Act 2012: in the first year following a transition period, however much is generated by the Scottish rate will be deducted from the block grant; in subsequent years, the adjustment made in the previous year will be indexed against movements in the UK non-savings, non-dividend income tax base.[205] The UK Government has proposed the same arrangement for Wales, should the Welsh people agree in a referendum that the Welsh Government should have the power to vary income tax.[206]

164. The main advantage of this method is that it insulates the devolved administration from volatility in income tax revenue. For example, if the UK went through a recession that hit income tax receipts, the adjustment to Scotland's block grant would be lower (or perhaps even increase the size of the block grant), ensuring Scotland is compensated for its (presumably) lower income tax revenues during the recessionary period.

165. For other taxes, indexation may not be appropriate. The UK Government, following the recommendation of the Silk Commission, recommended that the adjustment of the block grant to reflect devolution of stamp duty land tax and landfill tax in Wales should not be indexed against the corresponding UK tax base.[207] Instead, the Welsh Government will bear full responsibility for managing the volatility of those devolved tax revenues. The complexities of managing the ongoing indexation are likely to be undesirable for what is a relatively small tax base.

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204 For example, if the devolved tax raises £1 billion in Year 1 and £950 million in Year 2, it would not make sense to decrease the block grant by £1 billion in Year 1, and then increase it by £50 million in Year 2 to cover the shortfall.

205 The Scotland Office, *Second Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012* (May 2014): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/308446/40078_Un-Act_Implementation_accessible.pdf#page=24 [accessed November 2015]

206 See Annex 2.

207 Wales Office, *Wales Bill: Financial Empowerment and Accountability,* Cm 8838, March 2014: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/294470/Wales_Bill_Command_Paper_-_English.pdf [accessed November 2015]

The three methods for adjusting the block grant to reflect devolved powers of taxation to Scotland

166. Boxes 5 to 7 contain worked examples of the three methods that were proposed in evidence. The assumptions listed in these boxes are also used in the simulation that was described in paragraph 44.

Box 5: Fixed percentage adjustment to block grant deduction

This example uses the following assumptions:

- For 2015/16, the Scottish block grant is £30.4 billion (see Table 2).[208] For subsequent years, the Barnett Formula will continue to be used to calculate the change to the block grant. But for the purposes of this example, the grant is assumed to be the same size in each subsequent year.
- The value of the devolved and assigned tax receipts under the Scotland Bill proposals are assumed to be £11 billion in 2015/16.[209]
- The block grant reduction is increased by 2 per cent each year.

For 2015/16, the deduction to the block grant is the initial £11 billion of devolved tax receipts. The block grant is therefore £19.4 billion.

For 2016/17, the initial £11 billion deduction is increased by 2 per cent to £11.2 billion. The block grant is therefore £19.2 billion

For 2017/18 and each subsequent year, the previous year's deduction is increased by 2 per cent.

Consequences

The Scottish Government has an incentive to grow its devolved and assigned tax revenues by more than 2 per cent a year in order to compensate for the annual deduction.

208 The £30.4 billion is the Departmental Expenditure Limit which is subject to the Barnett Formula.

209 HMRC estimated that total income tax revenues for Scotland in 2014/15 were £11.97 billion: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/464199/HMRC_disaggregated_receipts_-_Methodology_Note.pdf#page=11. £11 billion is assumed here as the non-savings, non-dividend income tax revenue.

Box 6: Index deduction to changes in rest of UK revenues

This example uses the following assumptions:

- For 2015/16, the Scottish block grant is £30.4 billion (see Table 2).[210] For subsequent years, the Barnett Formula will continue to be used to calculate the change to the block grant. But for the purposes of this example, the grant is assumed to be the same size in each subsequent year.
- The value of the devolved and assigned tax receipts under the Scotland Bill proposals are assumed to be £11 billion in 2015/16.
- Non-savings, non-dividend income tax receipts in the rest of the UK increase by 5.7 per cent for 2016/17 and 8.6 per cent for 2017/18. This is for purely illustrative purposes.

For 2015/16, the deduction to the block grant is the initial £11 billion of devolved tax receipts. The block grant is therefore £19.4 billion.

For 2016/17, the £11 billion deduction is increased by 5.7 per cent (the rate rest of UK income tax receipts have increased by). The block grant is therefore £18.8 billion (£30.4 billion - £11 billion x 1.057).

For 2017-18, the previous year's deduction (£11 billion x 1.057 = £11.6 billion) is increased by 8.6 per cent. The block grant is therefore £17.8 billion (£30.4 billion - £11.6 billion x 1.086).

For subsequent years, the previous year's deduction is increased (or decreased) by the same rate of change in the non-savings, non-dividend rest of UK income tax base.

Consequences

Scotland has an incentive to grow its income tax revenues by more than the rest of the UK. Failure to do so will result in a contraction of its budget compared with the position prior to tax devolution.

Scotland's population is growing at a slower rate than the rest of the UK. The rest of UK income tax receipts are therefore likely to grow at a quicker rate if there are more people. The effects of this are likely to become apparent only in the medium to long term.

210 The £30.4 billion is the Departmental Expenditure Limit which is subject to the Barnett Formula.

Box 7: Index deduction to change in rest of revenues per head

This example uses the following assumptions:

- For 2015/16, the Scottish block grant is £30.4 billion (see Table 2).[211] For subsequent years, the Barnett Formula will continue to be used to calculate the change to the block grant. But for the purposes of this example, the grant is assumed to be the same size in each subsequent year.
- The value of the devolved and assigned tax receipts under the Scotland Bill proposals are assumed to be £11 billion in 2015/16.
- Rest of UK non-savings, non-dividend income is £145 billion in 2015/16.[212] This increases by 5.7 per cent for 2016/17 and 8.6 per cent for 2017/18. This is for purely illustrative purposes.
- The population of the rest of the UK is 60.19 million in 2015/16, 60.63 million in 2016/17, and 61.08 million in 2017/18.[213] The population of Scotland is 5.38 million in 2015/16, 5.40 million in 2016/17, and 5.41 million in 2017/18.[214]

For 2015/16, the deduction to the block grant is the initial £11 billion of devolved tax receipts. The block grant is therefore £19.4 billion.

For 2016/17, non-savings, non-dividend income tax receipts in the rest of the UK are £153 billion (£145 billion x 5.7 per cent). Revenue per head is therefore £2,524 (£153 billion / 60.63 million). For 2015/16, revenue per head was £2,409 (£145 billion / 60.19 million). Revenue per head has increased by 4.8 per cent. The population in Scotland has increased by 0.4 per cent over the same period. The block grant for 2016/17 is therefore £18.8 billion (£30.4 billion - £11 billion x 1.048 x 1.004).

For 2017/18, non-savings, non-dividend income tax receipts in the rest of the UK are £166 billion (£153 billion x 8.6 per cent). Revenue per head is therefore £2,717 (£166 billion / 61.08 million). Revenue per head has increased by 7.6 per cent. The population in Scotland has increased by 0.2 per cent over the same period. The block grant for 2017/18 is therefore £17.9 billion (£30.4 billion - £11.6 billion x 1.076 x 1.002).

Consequences

Scotland has an incentive to grow its income tax revenues per head by more than the rest of the UK. It will lose out if it fails to do this.

Link to the second no detriment principle

167. In January 2015, the UK Government published a Command Paper, *Scotland in the United Kingdom: An enduring settlement*, setting out proposals for implementing the Smith Commission recommendations. The paper discussed how the no detriment principle may apply to considerations of "taxpayer fairness".[215]

211 The £30.4 billion is the Departmental Expenditure Limit which is subject to the Barnett Formula.
212 HM Revenue & Customs, 'UK Income Tax Liabilities Statistics' (22 May 2015): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/428961/Income_Tax_Liabilities_Statistics_May_2015.pdf#page=38 [accessed November 2015]. The rest of UK non-savings, non-dividend income tax receipts are calculated by deducting £11 billion of the equivalent Scottish revenue from the UK 'Tax on Earnings' 2015-16 receipts.
213 Office for National Statistics, 'Summary Results, 2014-based National Population Projections' (29 October 2015): http://www.ons.gov.uk/ons/dcp171776_420466.pdf [accessed November 2015]
214 *Ibid.*
215 The Cabinet Office, *Scotland in the United Kingdom: An Enduring Settlement*

168. The paper stated that changes to a UK tax for which responsibility in Scotland has been devolved should only affect public spending in the rest of the UK, while, conversely, changes to devolved taxes in Scotland should only affect public spending in Scotland. The following example was given: if the UK Government reduces spending on devolved areas (for example, health or education) to allow a decrease in 'rest of UK' income tax, the Barnett Formula will lead to a decrease in the Scottish Government's block grant (despite the tax not applying in Scotland). A method of deduction from the block grant to account for taxation powers that was linked to income tax revenues in the rest of the UK would satisfy no detriment in this scenario.

ANNEX 5: BORROWING POWERS

Devolution of borrowing powers

169. The existing legislation grants the three devolved governments the power to borrow for two broad purposes. First, current account borrowing to manage income fluctuations. Secondly, borrowing to fund capital expenditure. No witness advocated that these powers should be removed or curtailed.

170. In 2014 the UK Government granted the Scottish Government the power to issue its own bonds, nicknamed kilts, as an additional source of borrowing (but within the same limits of the 2012 Act). Wales and Northern Ireland do not have this access to the capital markets.

171. Dr Armstrong considered the issue of borrowing powers to be "the most important question in the whole debate."[216] Professor Gallagher told us that he favoured devolving borrowing powers as the devolved governments "need them for cash flow reasons when they rely on tax income. But it would be better if they also borrowed for all of their capital expenditure … so they would feel its full economic cost, and get signals from the markets about the riskiness of their fiscal policies."[217]

Additional borrowing powers for Scotland and Wales[218]

172. In Scotland, further borrowing powers will be negotiated as part of the revised fiscal framework.[219] Submissions from the Welsh Government Plaid Cymru put forward the case for further borrowing powers for Wales.[220]

173. The evidence we received was supportive of further borrowing powers but a number of witnesses raised three substantive questions regarding their nature and operation:[221]

- How do you assess the extent of any further powers?
- What limits are placed on borrowing powers? Should there be a borrowing ceiling or a prudential regime?[222] How are "lumpy" items of capital expenditure accounted for?[223]
- Should a 'no bail-out rule' be included in the legislation or fiscal framework?

Support for further borrowing powers

Scotland

174. HM Treasury said in written evidence that to reflect the additional risks the Scottish Government will have to manage following the Smith Commission proposals, "the updated fiscal framework should provide sufficient additional

216 Q 12
217 Written evidence from Prof James Gallagher (DPF0001), written evidence the Weir Group (DPF0012), written evidence from PWC (DPF00023)
218 No witness suggested that Northern Ireland required further borrowing powers.
219 Written evidence from HM Treasury (DPF0015)
220 Written evidence from the Welsh Government (DPF0011), written evidence from Plaid Cymru (DPF0008)
221 Northern Ireland has substantial borrowing powers and there are no proposals to extend those.
222 Q 96
223 Q 86

borrowing powers to manage risks. These will be discussed as part of the fiscal framework discussions."[224]

175. Mr Jones said that if you are going to devolve a tax, then "you have to devolve borrowing powers, otherwise you leave the Scottish Parliament stuck with a balanced budget."[225] Dr Armstrong concurred:

> "If you are the equivalent of a powerful federal state without borrowing powers, you will be the only one in the world. You would have to have a balanced budget all the time. That is very unlikely to be acceptable."[226]

176. Sir Danny Alexander agreed that increases in the current account spending limit will be required.[227]

Wales

177. The capacity of the Welsh Government to borrow for capital amounts is a recently devolved power and yet to come into full effect. The Welsh Government said there was a very good case for Wales to have enhanced capital borrowing powers: "based on the current borrowing rules for Scotland, and our low PFI debts, the Welsh Government believe Wales could comfortably handle a borrowing ceiling of around £1.3 billion."[228]

178. Professor Holtham told us that the £200 million limit on capital borrowing was "completely arbitrary" and "it would be useful to have some principles" behind the limits imposed.[229] Professor Holtham considered the £200 million threshold to be low. He pointed out that one major infrastructure project, such as a proposed extension of the M4 motorway, could wipe out a third of Wales' capital budget.[230]

Extent of further borrowing

179. On the need for further borrowing, in particular for Scotland, there was broad consensus between witnesses. There was less agreement on the details.

Current Account Borrowing

180. For current account expenditure, Professor Holtham argued "it is not impossible to derive sensible limits. If you just look at the fluctuation of revenue, that should tell you what your requirements are likely to be, worst case, for short-term borrowing and so on."[231]

181. Mr Phillips said that when income tax is fully devolved Scotland would need to be able to borrow for both forecast and not forecast shortfalls: "They definitely need further borrowing powers on the current side to allow them to smooth forecast as well as unforecast shocks."[232]

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224 Written evidence from HM Treasury (DPF0015)
225 Q 49
226 Q 12
227 Q 96
228 Written evidence from the Welsh Government (DPF0011)
229 Q 86
230 Q 86
231 Q 86
232 Q 62

Borrowing ceiling or a prudential borrowing regime?

182. The devolution of significant borrowing powers raised for a number of witnesses the question: how should Scotland's borrowing powers be contained and managed?

183. Mr Jones told us that the powers would need to be "constrained, otherwise you end up with the mess that Spain got into."[233] Various methods of constraint were put before us. Professor Holtham favoured a debt ratio for long term borrowing.[234] The Weir Group suggested a limit comparable to the eurozone of 3 per cent of GDP.[235] Professor Lloyd stated that the quantum should be related to the amount of tax-raising powers that the Welsh Government have.[236]

184. The most frequently mentioned options were the continuation of a legislative borrowing ceiling or the imposition of a prudential borrowing regime.

185. The borrowing powers of each devolved government are currently restrained by legislation. HM Treasury in written evidence said that "it is expected that this will continue to be the case."[237] For Scotland there is a tension between this expectation and the agreement reached at the Smith Commission that the merits of a prudential borrowing regime would be considered.[238]

186. A prudential regime should, according to Sir Danny Alexander, be given "serious consideration":

> "It would give full control over capital spending amounts year by year to the Scottish Government—provided that there is a form of the prudential code that the Treasury can trust, so it will not result in excessive borrowing that cannot then be repaid … It might well enhance responsibility, enable better planning of infrastructure and capital projects and avoid the sorts of oddities that you have when you have quite a strict capital budget but very big and lumpy projects to pay for within it."[239]

187. The Scottish Government welcomed the consideration of a prudential borrowing regime and emphasised their record of prudent financial management.[240] The Welsh Government also expressed interest in a prudential regime.[241]

188. Mr Phillips suggested that this could be problematic because, unlike with local authorities, it would be politically difficult for Westminster to intervene if it thought the Scottish Government was borrowing too much: "the political ramifications of that would be pretty big."[242]

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233 Q 49
234 Q 86
235 Written evidence from the Weir Group (DPF0012)
236 Q 105
237 Written evidence from HM Treasury (DPF0015)
238 Smith Commission, *The Report of the Smith Commission*, p25; Written evidence from the Scottish Government (DPF0016)
239 Q 96
240 Written evidence from the Scottish Government (DPF0016)
241 Written evidence from the Welsh Government (DPF0011)
242 Q 62

No bail-out rule

189. We asked a number of witnesses, whether the legislation should include a rule that Scotland would not, in the event of financial calamity, be bailed out by the rest of the UK. As a matter of principle, Sir Danny Alexander told us, you "absolutely need to avoid the moral hazard". He considered, "the Scottish Government should not operate on the basis that if they make mistakes with their borrowing they will be bailed out". Sir Danny did not consider that such a rule needed to be incorporated into legislation.[243]

190. Mr Jones said it should be made "very explicit, both to Scottish taxpayers and the markets, that no-one should have any expectations that the costs of imprudent borrowing in order to, say, sustain revenue spending will be paid by other UK taxpayers."[244] Dr Armstrong said there should be a legislative safeguard that "the rest of the UK would in no circumstances bail [Scotland] out."[245]

191. Mr Darling was one of the few witnesses who questioned the need for a no bail-out rule. He thought a no bail-out rule would be "unnecessary and downright provocative and actually sound very patronising … I am part of the UK as well; do not tell me I cannot be bailed out by a country that I happen to be a citizen of."[246]

192. The difficulty, many witnesses conceded, is the credibility of any no bail-out rule. Professor Holtham told us "the market would not believe it".[247] Dr Armstrong accepted that the UK couldn't guarantee it would never bail Scotland out, "particularly when you can afford to bail it out, and Scotland can be bailed out because it is only 8.5 per cent of the UK and you can afford to do it. The very fact that people know that you can afford to do it starts to play into that."[248]

193. Professor McLean said that Scotland is not too big to fail and "the UK Government would not intervene. Why should they, especially as their stake in Scotland would be much less than now?" Any bail-out would be "on terms."[249]

194. A parallel was again drawn with the situation of local authorities. Sir Danny Alexander praised the working of the local government prudential code. He pointed out "there are very few examples of irresponsible borrowing taking place, because local authorities simply do not expect that that will then be bailed out in a way that is cost free to them."[250]

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243 Q 96
244 Written evidence from Peter Jones (DPF0020)
245 Q 12
246 Q 34
247 Q 87
248 Q 10, Q 96
249 Q 76
250 Q 96

APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

Members

Baroness Blackstone
Lord Forsyth of Drumlean
Lord Griffiths of Fforestfach
Lord Hollick (Chairman)
Lord Kerr of Kinlochard GCMG
Lord Lamont of Lerwick
Lord Layard
Lord May of Oxford
Lord Monks
Lord Sharkey
Lord Teverson
Lord Turnbull
Baroness Wheatcroft

No interests relevant to the subject-matter of the report were declared by Members of the Committee.

A full list of Members' interests can be found in the Register of Lords Interests: http://www.publications.parliament.uk/pa/ld/ldreg.htm

Specialist Adviser

Professor David Bell FRSE, Professor of Economics at the University of Stirling, acted as Specialist Adviser for this inquiry and declared the following interests:

Funded by Economic and Social Research Council and Nuffield Foundation to study topics related to the Inquiry.

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at http://www.parliament.uk/devolution-of-public-finances and available for inspection at the Parliamentary Archives (020 7219 3074).

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

**	Professor David Heald, Professor of Accountancy, University of Aberdeen Business School	QQ 1–13
*	Professor Alan Trench, Professor of Politics, University of Ulster	
*	Professor Jim Gallagher, Visiting Professor of Government, University of Glasgow	
**	Dr Angus Armstrong, Director of Macroeconomics, National Institute of Economic and Social Research (NIESR)	
*	Professor Ronald MacDonald, Research Professor of Macroeconomics and International Finance (Economics), University of Glasgow	QQ 14–27
**	Professor Adam Tomkins, Professor of the John Millar Chair of Public Law, University of Glasgow	
*	Professor John McLaren, Honorary Professor of Public Policy at the Business School, University of Glasgow	
**	The Rt. Hon. Alistair Darling	QQ 28–37
*	Dr James Cuthbert	QQ 38–46
*	Margaret Cuthbert	
**	Lesley Riddoch	QQ 47–55
*	Peter Jones	
**	David Phillips, Senior Research Economist, Institute for Fiscal Studies	QQ 56–76
**	Professor Iain McLean, Professor of Politics, University of Oxford	
*	Professor Gerald Holtham, Cardiff Business School, Chair of the Holtham Commission	QQ 77–88
**	Tom Crotty, Director, INEOS Group	
*	Charlotte Barbour, Director of Taxation, Institute of Chartered Accountants of Scotland (ICAS)	
**	The Rt. Hon. Sir Danny Alexander	QQ 89–107

*	Keith Cochrane, Chief Executive, The Weir Group	
**	Professor John Kay, Visiting Professor of Economics, London School of Economics	
**	Professor Noel Lloyd CBE, Former Vice Chancellor of Aberystwyth University, Silk Commission	
**	Carlo Cottarelli, former Director, Fiscal Affairs Department, International Monetary Fund (IMF)	QQ 108–116

Alphabetical list of all witnesses

**	The Rt. Hon. Sir Danny Alexander (QQ 89–107)	
**	Dr Angus Armstrong (QQ 1–13)	
	Bevan Foundation	DPF0007
	Constitution Reform Group	DPF0018
**	Carlo Cottarelli (QQ 108–116)	
*	Dr James Cuthbert (QQ 38–46)	DPF0004 DPF0014 DPF0021
*	Margaret Cuthbert (QQ 38–46)	DPF0004 DPF0014 DPF0021
**	The Rt. Hon. Alistair Darling (QQ 28–37)	
*	Professor James Gallagher (QQ 1–13)	DPF0001
**	Professor David Heald (QQ 1–13)	
	Her Majesty’s Revenue & Customs (HMRC)	DPF0024
	Her Majesty’s Treasury	DPF0015
*	Professor Gerald Holtham (QQ 77–88)	DPF0003
**	Tom Crotty, Director, INEOS Group (QQ 77–88)	
*	Institute of Chartered Accountants of Scotland (ICAS) (QQ 77–88)	DPF0010
	The Institute of Economic Affairs	DPF0006
*	Peter Jones (QQ 47–55)	DPF0020
**	Professor John Kay (QQ 89–107)	
	Dr Peter Kenway and Dan Corry	DPF0013
**	Professor Noel Lloyd CBE (QQ 89–107)	
*	Professor Ronald MacDonald BA MA (Econ) PhD OBE (QQ 14–27)	DPF0022
*	Professor John McLaren (QQ 14–27)	DPF0019
**	Professor Iain McLean (QQ 56–76)	
**	David Phillips (QQ 56–76)	
	Plaid Cymru—The Party of Wales	DPF0008

	PricewaterhouseCoopers LLP	DPF0023
	Nicholas Ramsay	DPF0005
**	Lesley Riddoch (QQ 47–55)	
	The Scottish Government	DPF0016
	Socialist Health Association Cymru Wales	DPF0017
**	Professor Adam Tomkins (QQ 14–27)	
*	Professor Alan Trench (QQ 1–13)	DPF0002
*	The Weir Group PLC (QQ 89–107)	DPF0012
	The Welsh Government	DPF0011
	Welsh Liberal Democrats	DPF0009

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords Economic Affairs Committee, chaired by Lord Hollick, is conducting an inquiry into the possible models for devolution of the public finances in the United Kingdom. This follows on from the Committee's report of April 2013 on the Economic Implications for the United Kingdom of Scottish Independence and is intended to inform debate in the House on the Scotland Bill later this year.

The Committee invites interested organisations and individuals to submit written evidence as part of the inquiry, and is keen to take evidence from a wide range of stakeholders. Written evidence is sought by 21 August 2015. The submissions we receive will guide the Committee's deliberations in oral evidence sessions later this year, and also inform the Committee's final conclusions and recommendations. The Committee will report to the House in the autumn, in time for the Report stage of the Scotland Bill. The Report will receive a response from the Government.

Issues

The Committee would welcome submissions of written evidence that consider any of the following questions (not listed in any particular order of importance).

Fiscal framework

- What principles should govern the way devolved nations are funded? For example, is a new needs assessment required and if so, what should it take into account?
- Is the correct institutional framework in place for the devolved governments and UK Government to discuss these matters? What processes will need to be in place to make new settlements sustainable and effective? Are there lessons the UK might take from other countries that have devolved spending and revenue raising powers?
- How should block grant funding reflect devolved tax and welfare powers? How should future changes to the block grant be decided? How should the Smith Commission proposal of "no detriment" apply over time?
- Should devolved governments receive further borrowing powers? What form of contract between the UK government and the devolved nations will prevent bail-outs of governments that do not stick to their borrowing limits?
- What would the implications be of full fiscal autonomy for Scotland? How would Scotland shrink any fiscal gap?
- What implications will the renegotiation of the fiscal framework for Scotland have on Wales and Northern Ireland?

Tax powers[251]

- What is the rationale behind the choice of taxes proposed to be devolved in the Scotland Bill?
- What is the rationale behind the choice of taxes devolved by the Wales Act 2014?

251 The Scotland Bill proposes to devolve the rates and thresholds of income tax on non-savings and non-dividend income, Air passenger duty and aggregates levy. From 2018, the Welsh Assembly will set business rates, stamp duty and landfill tax. Subject to a referendum, the Assembly will be able to vary income tax by 10p in the pound. The Corporation Tax (Northern Ireland) Act 2015 allows the devolution of power to set the rate of corporation tax in Northern Ireland.

- What are the implications of devolving corporation tax to Northern Ireland? Will it have on effect on business in the rest of the UK?
- With the above measures in place, will Scotland, Wales and Northern Ireland have the correct tax raising powers? Should other taxes be devolved (for example corporation tax to Scotland and Wales)?
- Will devolution of tax powers lead to competition between Northern Ireland, Scotland, Wales and England? Would competition be welcome?