fiscal powers
2nd edition

reform scotland

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About Reform Scotland

Reform Scotland is an independent, non-party think tank that aims to set out a better way to deliver increased economic prosperity and more effective public services based on the traditional Scottish principles of limited government, diversity and personal responsibility

About the authors

In 2008, Reform Scotland engaged the expertise of Graeme Blackett, an economist, and James Aitken, a lawyer, in helping to shape a workable scheme which would make the Scottish Parliament more financially accountable within the context of the United Kingdom. Graeme and James have reviewed and updated that work.

Graeme Blackett is Managing Director of BiGGAR Economics Limited, a leading independent economic consultancy that advises government and companies across the UK and Ireland. He is an economist with 17 years' experience in applied economics.

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Objective

Reform Scotland's paper on Fiscal Powers was published in November 2008 (available at www.reformscotland.com). As well as being widely debated publicly, the report was submitted to the Commission on Scottish Devolution or Calman Commission (to which Reform Scotland also gave oral evidence on the subject of fiscal powers for the Scottish Parliament) and to the SNP Government's National Conversation.

Since November 2008, there have been significant changes to the political, economic and legal context in which the debate on fiscal powers for the Scottish Parliament is taking place. These include:

- **political** – the endorsement of the Calman Commission recommendations by Labour, Conservatives and the Liberal Democrats which means that all of the major parties in Scotland now support an increase in fiscal powers for the Scottish Parliament;
- **economic** – the challenges associated with the economic recession, including the policies required for economic recovery and how to deal with the public sector debt that has been incurred;
- **legal** – a new judgement from the European Court of Justice which confirms that different tax arrangements within a member state do not breach state aid rules provided key tests are met.

This update to the Fiscal Powers paper reviews the implications of these changes for the recommendations previously made by Reform Scotland and considers what the next steps should be to prepare Scotland for new fiscal powers.

Findings

- The Scottish Parliament is responsible for 60 per cent of government spending in Scotland (£32 billion) with 40 per cent spent by the UK Government (£21 billion). However, the Scottish Parliament currently has control over taxes which raise less than £4 billion of the total tax raised from Scotland, equivalent to only 7 per cent of all taxes and 11 per cent of the Scottish Parliament's budget. The Scottish Parliament is, therefore, not sufficiently financially accountable to the Scottish electorate.

- The size of the Scottish Budget is still largely determined by the Barnett formula, which means that it is based on spending decisions made for England. The current financial relationship is unpopular on both sides of the border. The pressure on UK public finances over the next few years is likely to put further pressure on the block grant approach to setting the Scottish Budget, particularly as the Barnett formula will see spending cuts in Scotland at a slightly lower level than in England. It is not difficult to foresee a political environment in which this will be seen as untenable.
- The need to ensure that the Scottish Parliament is financially accountable by increasing its fiscal powers now has wide political support. The debate in Scotland is no longer whether the Scottish Parliament should have fiscal powers but which fiscal powers should be devolved and how.
- The Calman Commission recommended that the Scottish Parliament should have a range of fiscal powers (including a new Scottish rate of Income Tax, Stamp Duty Land Tax, Aggregates Levy, Landfill Tax and Air Passenger Duty) which would give the Scottish Parliament responsibility for raising 31 per cent of the total devolved Scottish budget (up from 11 per cent currently devolved). Under the Calman recommendations, the Scottish Parliament will still be dependent on a block grant from Westminster for more than two-thirds of its budget.
- The Calman Commission also set out a number of characteristics that one might want any financing system for a "sub-national" government to have (equity, autonomy, accountability, stability/predictability, simplicity/transparency and efficiency). While the Commission's own recommendations are a good fit with the characteristics of stability/predictability, simplicity/transparency and efficiency, the biggest weakness of the Calman recommendations is that they do not deliver financial accountability. Real financial accountability requires that a government is responsible for raising all, or at least the vast majority, of the revenue that it requires to meet its spending commitments.

- The Reform Scotland Fiscal Powers recommendations can also be assessed against these characteristics. Overall, the recommendations made by Reform Scotland in the Fiscal Powers paper are a better fit with the desirable characteristics of a financing system listed in the Calman Commission report than the Commission's own recommendations on finance. In particular, the characteristic of accountability.
- Whatever Scotland's constitutional future may be, there will be a need to introduce policies that address the UK's serious fiscal deficit. In the short term, this will require public sector spending cuts or tax rises or a mix of both.
- The economic and public sector funding situation faced by the UK and Scotland over the next few years highlights the weaknesses in the current devolution model and the advantages of increasing the Scottish Parliament's fiscal powers. As long as most of the Scottish Parliament's budget is determined by the Barnett formula (or a successor "needs based" formula as recommended by the Calman Commission) there will be no strong incentive for the Scottish Government to identify areas where public spending might be reduced in Scotland. Indeed, it could be argued that, since any cuts in budgets in areas of devolved spending will be proportionately lower than in England (due to the Barnett formula which allocates the budget based on population share rather than the baseline budget level), there is a disincentive for the Scottish Government to identify areas for saving.
- If the Scottish Government was responsible for raising the money that it spent, there would be a much greater incentive to improve the efficiency of public services since any savings could be passed on to Scottish taxpayers creating the conditions for higher growth.
- Any doubt as to whether the European State Aid rules prevent taxation powers being devolved to the Scottish Parliament has been removed by the European Court of Justice annulling the veto imposed by the European Commission against the reform of corporate tax in Gibraltar thus allowing Gibraltar to introduce a tax regime which is different from the rest of the UK.[1]

1 European Court of First Instance judgement in the Joined Cases T-211/04 and T-215/04 relating to Gibraltar of December 2008 and the European Court of Justice judgement in the case C88/03 of September 2006 in relation to the Azores judgement in Joined Cases C-428/06 to C-403/06 of September 2008 relating to the Basque Autonomous Community in Spain.

- The last year has also seen a great deal of comment questioning how the UK Treasury and HM Revenue & Customs interact with the Scottish Government. Almost all of the comment concerned the Scottish Government's proposal for a Local Income Tax. There was though an example of a UK Government agency cooperating closely with a Scottish Government agency. Earlier this year after many years of campaigning, the Edinburgh Stamp Office, a part of HM Revenue & Customs, agreed to co-locate with Registers of Scotland, a Scottish Government agency.

Policy recommendations

- **Greater financial accountability:** We recommend that, as a principle, all levels of government in Scotland – UK, Scottish and local – should have the power to raise the bulk of the money which they are responsible for spending.
- **UK-wide solution:** We recommend a new financial settlement, set out in legislation, for the whole of the United Kingdom. This would set out which taxes were UK taxes and what they were funding, separately from taxes and spending for each of the nations of the UK. This would also entail the establishment of a body to represent English interests.
- **Scottish financial settlement:** We recommend that the Scottish Parliament and the UK Parliament become responsible for raising the money they spend. Both levels of government should have the flexibility to set a range of taxes in order to cover their spending, with an agreed starting point which enables them to cover their existing share of spending in Scotland. There are a number of ways of achieving this based on the most recent figures. However, our preferred option would give the UK Government control over all National Insurance contributions; 40 per cent of Income Tax revenues from Scotland; 40 per cent of Scotland's geographical share of North Sea oil revenues; together with additional income from TV licences, passport fees and the National Lottery tax. The Scottish Government would set the rates for all other taxes, except for VAT which would be set at a UK level with 40 per cent of the revenue from Scotland going to Westminster and the remainder assigned to the Scottish Parliament. Crucially, this new financial relationship must be flexible enough to meet any future contingencies or take account of any further devolution of power. For this reason, both the Scottish and UK Governments would be able to change existing taxes

or levy new ones they needed to meet their spending commitments. However, they would have to justify such changes to the electorate. This rebalancing of the financial arrangements underpinning devolution would ensure greater financial accountability at all levels of government, is based on the experience of what other countries have found to be practical and is fair to all the constituent parts of the UK.

- Scottish Exchequer: We recommend that the remit of the Scottish Government's Finance Department is increased to include most of the powers and responsibilities presently held by HM Treasury and HM Revenue & Customs. The greater fiscal powers of the Scottish Parliament would make this necessary. This new body would be responsible for collecting the revenue from all taxes levied in Scotland on behalf of the UK and Scottish Governments unless specifically reserved to Westminster.
- Lower, simpler taxes: We recommend that the overall burden of taxation in Scotland is lowered and that the whole system is simplified. Our first paper, 'Powers for Growth', set out the correlation between a lower overall tax burden and faster economic growth. Greater financial accountability would provide the scope to create a fiscal framework in Scotland that is conducive to economic growth. It would also provide the opportunity to look at how taxes could be simplified and made more efficient, once the power had been devolved.

Conclusion

In the last year, the debate in Scotland has moved on from one about whether the Scottish Parliament should have additional fiscal powers to one about the extent of those powers and how they should be implemented.

If those additional fiscal powers are to have a real impact on the governance of Scotland and on the performance of the Scottish economy, they must be of a scale that is great enough to address the fundamental defect of the current devolution settlement – its lack of financial accountability. This can be achieved within the context of the UK if both the UK and Scottish Governments were to be responsible for raising the taxes required to fund their spending proposals, as recommended in Reform Scotland's paper Fiscal Powers.

Reform Scotland calls for the work to commence on preparing the way for greater fiscal powers for the Scottish Parliament. This will enable implementation to quickly follow the political decisions that will be taken over the next year or two on the extent of fiscal devolution to Scotland. This must include, for example, preparing the draft legislation that will be required, business planning for the new institutions such as the Scottish Exchequer and further research into Government expenditure and revenue in Scotland to establish, with greater certainty, the size of the Scottish tax base and the tax revenues collected from Scotland.

There is also a need for parallel work to engage both politicians and important institutions in Westminster (such as HM Treasury) so that there is an increased understanding at the UK level, as well as in Scotland, of the benefits to Scotland and to the rest of the UK of devolution of fiscal powers to Scotland.

Finally, the time has now come for the political debate in Scotland to include what the political parties would do with additional fiscal powers. In the run up to the UK and Scottish Parliament elections, both of which will take place within the next two years, Scottish voters are entitled to know what each of the political parties in Scotland would do if given the power to tax as well as the power to spend.

1. Context for fiscal powers

Since Reform Scotland's Fiscal Powers paper was published in November 2008, there have been significant changes to the political, economic and legal context in which the debate on fiscal powers for the Scottish Parliament is taking place, in particular:

- political context – following the endorsement of the Calman Commission recommendations by Labour, Conservatives and the Liberal Democrats, all of the major parties in Scotland now support an increase in fiscal powers for the Scottish Parliament;
- economic context – Scotland has not been immune to the economic recession and the pressure on public finances (caused by high debt levels resulting from the UK Government's bank bailout, fiscal stimulus, failing tax revenues and increasing spending in areas like unemployment benefits) will have a significant impact on Scotland;
- legal context – the European Court of Justice's decision in the Gibraltar case makes it clear that the European Union's State Aid rules do not prevent the devolving of tax powers provided that a number of conditions are met.

The debate has moved on from one about whether the Scottish Parliament should have additional fiscal powers to one about the extent of those powers and how they should be implemented.

The case for fiscal powers that was made in the previous Reform Scotland paper is now even stronger than it was when that paper was published. This revised paper explains why, with reference to the changed political, economic and legal context.

2. Political context

Since Reform Scotland's Fiscal Powers paper was published in November 2008, the Scottish Government has published a number of papers on Scotland's fiscal position including a paper on Fiscal Autonomy for Scotland.[2]

However, probably the most significant political development has been the publication of the Final Report of the Commission on Scottish Devolution (the Calman Commission) in June 2009.[3]

Calman recognised the shortcomings of the current system of financing the Scottish Parliament, "In particular because so much of the budget comes by grant from the UK Parliament, the Scottish Government and Parliament are not accountable to the Scottish electorate for how revenue is raised in the same way that they are for how it is spent" and made a number of recommendations for significant changes:

- a new Scottish rate of income tax should replace the current powers to vary the rate of income tax, to be applied to basic and higher rates of income tax. To make this possible, the UK Government should reduce income tax levied in Scotland by 10 pence in the pound and reduce the block grant accordingly. Income tax on savings and distributions should not be devolved to the Scottish Parliament but the yield should be assigned on a formula basis and the block grant reduced accordingly. The structure of the income tax system, including the bands, allowances and thresholds should remain entirely the responsibility of the UK Parliament;
- Stamp Duty Land Tax, Aggregates Levy, Landfill Tax and Air Passenger Duty should be devolved to the Scottish Parliament, with a corresponding reduction in the block grant;
- the Scottish Parliament should be given a power to legislate, with the agreement of the UK Parliament, to introduce specified new taxes;

2 "Fiscal Autonomy in Scotland: The case for change and options for reform", Scottish Government, February 2009.

3 "Serving Scotland Better: Scotland and the United Kingdom in the 21st Century", Commission on Scottish Devolution, June 2009.

- the block grant, as the means of financing most associated with equity, should continue to make up the remainder of the Scottish Parliament's Budget but it should be justified by need;
- the system will require a strengthening of the intergovernmental arrangements to deal with finance;
- these changes should be introduced in a phased way, step by step, to manage the risks of instability in public finances and of windfall gains or adverse shocks to the Scottish Budget;
- Scottish Ministers should be given additional borrowing powers to allow for managing cash flow when devolved taxes are used and for borrowing from the National Loans Fund or Public Works Loans Board to increase capital investment in any one year (subject to an overall limit to such borrowing, similar to the Prudential regime for local authorities).

The calculation of what the changes would mean for the Scottish Budget would depend on the detail of how the proposed changes, particularly the income tax proposals, are implemented. However, half of Scottish income tax revenues, Stamp Duty Land Tax (based on 50 per cent of all Stamp Duties), Aggregates Levy, Landfill Tax and Air Passenger Duty together with the already devolved Council Tax and Non Domestic (Business) Rates would have generated just over £10 billion in 2007/08 (Figure 1). This is 19 per cent of all tax revenue from Scotland (up from 7 per cent currently devolved) and 31 per cent of the total devolved Scottish budget (up from 11 per cent currently devolved). So under these proposals, the Scottish Parliament will still be dependent on a block grant from Westminster for more than two-thirds of its budget.

Figure 1: Taxation revenue from Scotland if Calman recommendations implemented (based on latest available data, 2007/08)

	£m
Income Tax (based on 50 per cent of Income Tax from Scotland)	5,622
Council Tax	1,936
Non Domestic Rates	1,724
Stamp Duty Land Tax (estimated 50 per cent of Stamp Duties)	454
Air Passenger Duty	164
Landfill Tax	83
Aggregates Levy	52
Total Tax Revenues Devolved (Calman implemented)	10,035
Total Tax Revenues from Scotland	52,511
Calman Devolved Taxes as percentage of all Tax Revenues from Scotland	19%
Total Devolved Spending (2007/08)	32,321
Calman Devolved Taxes as percentage of Total Devolved Spending	31%

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

The endorsement of the Calman Commission report by Labour, Conservatives and the Liberal Democrats means that all of the major parties in Scotland now support an increase in fiscal powers for the Scottish Parliament. The debate has moved on from one about whether the Scottish Parliament should have additional fiscal powers to one about the extent of those powers and how they should be implemented.

Given that this is now the debate, it is worth considering whether the Calman Commission recommendations represent the best division of fiscal powers between the UK and Scottish Parliaments. The expert group on finance that advised the Calman Commission suggested a number of characteristics that one might want any financing system for a "sub-national" government to have:

- equity: it is fair to all regions of the country;
- autonomy: allows the sub-national government choice on what and how much to spend, and potentially, would allow the use of fiscal powers as policy instruments;

- accountability: it is clear to taxpayers the effect that decisions made at the regional level have on their tax bill;
- stability/predictability: so that public spending can be managed properly;
- simplicity/transparency: so that it is readily implemented and the justification is evident;
- efficiency: to avoid creating economic distortions by incentivising movements of people and the factors of production.

These are reasonable characteristics against which a system for devolved fiscal powers should be assessed. Our assessment of the Calman recommendations against these characteristics is summarised below.

We conclude that the Calman recommendations are a good fit with the characteristics of stability/predictability, simplicity/transparency and efficiency. However, there is nothing in the proposals that changes the current position with regard to equity and there would be limits on the autonomy of the Scottish Government. The biggest weakness of the Calman recommendations though is that they do not deliver financial accountability. The Scottish Government will continue to remain dependent on the UK Government for the majority of its revenue. Real financial accountability requires that a government is responsible for raising all, or at least the vast majority, of the revenue that it requires to meet its spending commitments.

Figure 2: Calman Commission recommendations and desirable characteristics of system for sub-national financing

	Calman Commission recommendations	
Equity	✗	The current block grant funding system is unpopular on both sides of the border and there is a perception south of the border that Scotland unfairly benefits from higher spending than elsewhere in the UK. Given that the recommendations retain a block grant system for more than two-thirds of the Scottish Budget, it is likely that this perception of lack of fairness will continue (whether or not it is based on reality). On the other hand, if a future UK Government were to cut the block grant, it is reasonable to assume that this would lead to a feeling that the arrangements are unfair north of the Border.
Autonomy	?	With responsibility for raising less than a third of its budget, the autonomy of the Scottish Government would be limited. For example, if the Scottish Government decided to increase a tax under its control to fund a spending commitment, there would be nothing to stop the UK Government (which might have a different political philosophy from the Scottish Government) from cutting the block grant, if it did not agree that the spending commitment was a high priority. While co-operation between the two Governments would be both necessary and desirable, it is not difficult to see how this situation might occur, if for example, the proposed spending was on a benefit that was not available south of the border.
Accountability	✗	The Scottish Government would still depend on the UK Government for more than two-thirds of its budget. The UK Government rather than the Scottish Government will still make most of the decisions about the level of taxation in Scotland. It is difficult to argue that a government is financially accountable unless it is responsible for raising all, or at least the majority, of the revenue that it requires to meet its spending commitments.
Stability/ predictability	✓	The proposals should be consistent with the need for stability and predictability in the management of public finances.
Simplicity/ transparency	✓	While the income tax proposals might take some time to become familiar, similar splits in income tax operate and are understood in other countries.
Efficiency	✓	The limits to autonomy of the proposals mean that there will be little scope to introduce policies that will create incentives for movements of people and the factors of production, regardless of whether such policies would have a positive or negative impact on the Scottish economy.

The Reform Scotland Fiscal Powers recommendations can also be assessed against these characteristics. The key difference between the Calman recommendations and those of Reform Scotland are that the Reform Scotland proposals are for a larger number of taxes to be devolved, which would result in both the UK and Scottish Parliaments being responsible for raising the tax revenues required to meet their respective spending commitments in Scotland. That is, the proposals are for devolution of tax powers to the Scottish Parliament equal to the £32.3 billion (2007/08) value of the Scottish Budget.

Figure 3: Reform Scotland Fiscal Powers recommendations and desirable characteristics of system for sub-national financing

	Reform Scotland Fiscal Powers recommendations	
Equity	✓	The proposals are fair for both Scotland and other regions in the UK since, if the Scottish Government wanted to have a different level of public spending (whether higher or lower) than the rest of the UK, it would have the power to do this. The proposals will require "UK spending" to be separately identified from Scottish or English spending so that any transfers to or from Scotland from the rest of the UK would be transparent.
Autonomy	✓	Yes, subject to being able to raise the tax revenues required to meet spending plans and run a balanced budget, the Scottish Government would have the power to make significant changes to the level of spending in Scotland for which it is responsible as well as to the distribution of that spending. So higher spending in Scotland would require higher tax revenues and lower spending would allow the Scottish Government to cut its tax take.
Accountability	✓	The proposals would require an education campaign to ensure that taxpayers understood which taxes were paying for Scottish Parliament responsibilities and which taxes were paying for UK responsibilities. The Scottish Parliament would therefore be accountable to Scottish voters for both tax and spending decisions. The UK Parliament would also be more accountable due to the increased transparency as to whether spending is for the whole of the UK or only for England.
Stability/ predictability	✓	Both Parliaments would have a wide range of taxes, with a wide tax base giving both the stability and predictability required for the sound management of public finances.
Simplicity/ transparency	✓	Any change to the taxation system will take time to implement (this is discussed further later in this report) but the division of retained and devolved taxes recommended is a simple one and could be implemented quickly provided that the starting point was the transfer of all of the existing relevant legislation to Scotland. Improvements to the system, including its simplification, could be implemented in a second phase of reforms.
Efficiency	✗	The proposals would allow the Scottish Government to set competitive tax rates compared with the rest of the UK (subject to matching any tax cuts with spending cuts; due to the need to balance the budget and to ensure compliance with EU State Aid rules) that would create incentives for movements of people and the factors of production, and encourage greater growth in the Scottish economy, resulting in greater tax revenues for both UK and Scottish Governments. This should be seen as a positive development since such tax competition is likely to be beneficial to both Scotland and the UK in the longer term.

Overall, the recommendations made by Reform Scotland in the Fiscal Powers paper are a better fit with the desirable characteristics of a financing system listed in the Calman Commission report than the Commission's own recommendations on finance.

Reform Scotland has welcomed the Calman Commission's recommendations to increase the tax powers of the Scottish Parliament. However, we are concerned that the detailed recommendations on which taxes should be devolved do not meet Calman's own objective of improving the financial accountability of the Scottish Parliament. The Scottish Parliament is either financially accountable or it's not – it can't be a bit accountable. That objective of financial accountability is one that is deliverable by implementing the Reform Scotland recommendations.

3. Economic context

Reform Scotland's Fiscal Powers paper was published in November 2008, based on research undertaken over the summer of 2008. At that time, it was clear that the world, UK and Scottish economies were entering an economic downturn with the signs already clear in banking and in other sectors such as construction. It has since become clear that the UK, like most other Western economies, is in the middle of the worst recession for sometime, perhaps since the 1930s.

This does raise the question of whether the recession weakens or strengthens the case for increasing the fiscal powers of the Scottish Parliament. We believe that the case is now stronger as a result of the need to have fiscal policies in place that will meet the needs of the Scottish economy to secure economic recovery. In this respect, it would offer the Scottish Government the opportunity to make decisions on an appropriate fiscal policy for Scotland rather than simply implementing the budget decisions taken by the UK Government.

While there is no denying that the recession is serious, it is also worth placing the current state of the economy in some context. Scotland is one of the richest countries in the world and, even excluding North Sea oil, Scotland is one of the wealthiest parts of the UK, with higher economic output per person than Northern Ireland, Wales and six of England's nine regions. Scotland's economic output last year was £114 billion, or £142 billion if that part of the North Sea oil industry based in Scottish waters is included.

3.1 Government expenditure and revenue in Scotland – update

Reform Scotland's Fiscal Powers paper was based on the latest figures available on Government Expenditure and Revenue in Scotland (GERS) at that time, for 2006-07, which showed that current revenue gathered in Scotland for that year was £49.915 billion (including a geographic share of North Sea revenue) while total public expenditure for Scotland was £49.895 billion.

This section considers whether the conclusions and recommendations that were made based on that analysis remain valid, given the more up to date GERS data that has since been published (2007-08) and the best projections that can currently be made for Scottish and UK public finances over the next few years.

3.2 Scotland's fiscal position

The 2007-08 GERS figures[4] show that Scotland, with 8.4 per cent of the UK population, contributed 8.4 per cent of the UK's tax revenues, even when North Sea revenue is excluded. On this basis, Scotland is paying its way in the UK.

What is often debated is whether the additional public spending per capita in Scotland compared to the rest of the UK (although it should be noted that many other regions of the UK, including London, have a higher per capita public spend than Scotland) is funded from North Sea revenues, and whether spending such windfall tax revenues on current spending is a sensible approach to managing the public sector budget.

The 2007-08 GERS figures[5] show that current revenue gathered in Scotland for 2007/08 was £52.511 billion (including a geographic share of North Sea revenue) while total public expenditure for Scotland (including accounting adjustments and capital consumption) was £52.292 billion. Scotland had a small surplus of £219 million in its current budget in 2007-08.

3.3 Government expenditure in Scotland

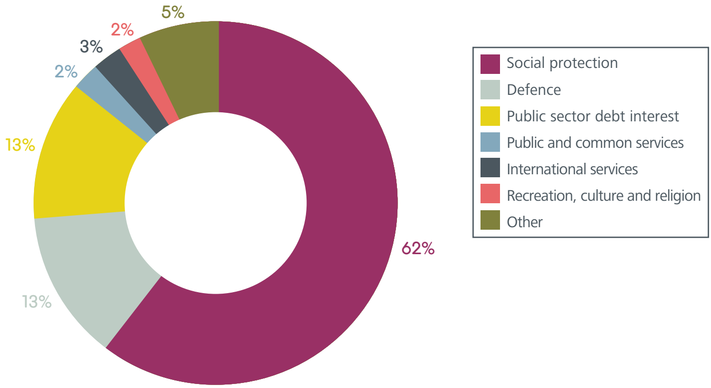
There was little change in the proportion of government expenditure in each of the main categories of spending between 2006-07 and 2007-08.

The UK Government spent approximately £21 billion in and on behalf of Scotland in 2007/08, 62 per cent of which was on social protection, 13 per cent on defence and 13 per cent on public sector debt interest (Figure 4).

4 Government Expenditure & Revenue Scotland 2007-08', Scottish Government, June 2009.

5 Note: care should be taken when comparing 2007-08 with 2006-07 since the above numbers are not directly comparable due to some changes in GERS methodology. Also, these are cash figures with no adjustment made for inflation.

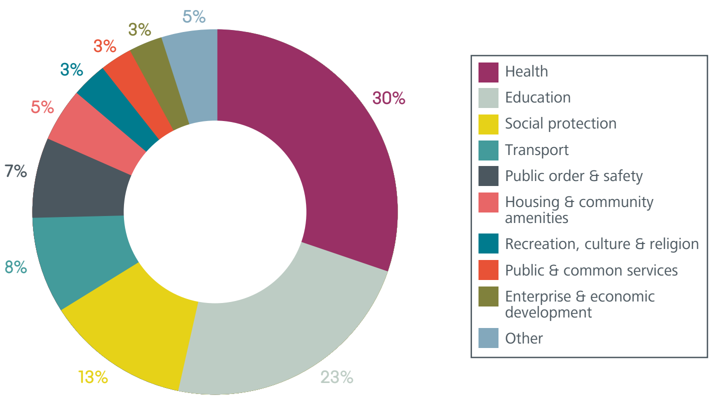
Figure 4: UK Government expenditure in and for Scotland (£m), 2007/08



Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

The Scottish Government spent approximately £32 billion in 2007/08, 30 per cent of which was on health, 23 per cent on education and 13 per cent on social protection (Figure 5).

Figure 5: Scottish Government expenditure (£m), 2007/08



Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

The split in expenditure between the UK and Scottish Governments for 2007/08 was broadly 40:60, as in 2006/07 (Figure 6).

Figure 6: Expenditure by UK and Scottish Government, 2007/08 (£m)

	Expenditure (£m)	%
UK Government	21,018	39.4%
Scottish Government (including local government)	32,321	60.6%
Total	53,339	100%

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

3.4 Government revenue from Scotland

The tax that generated the greatest revenue in 2007/08 was income tax at £11.2 billion, 21 per cent of taxation revenue generated (Figure 7). Other important sources of revenue were VAT (£8.0 billion, 15 per cent), national insurance (£7.8 billion, 15 per cent), oil revenues (£7.3 billion, 14 per cent) and corporation tax (£3.5 billion, 7 per cent).

When Reform Scotland gave evidence on fiscal powers to the Calman Commission, members of the Commission raised some concerns that the recommendations in Reform Scotland's Fiscal Powers paper on the devolution of tax powers could leave Scotland's budget vulnerable to the volatility of North Sea Oil & Gas revenues. It is worth noting that the Scottish geographic share of North Sea Oil & Gas revenues in 2007-08 was £7.320 billion, compared with £7.664 billion in 2006-07 and £7.861 billion in 2005-06. There has been greater volatility in other sources of tax revenue, including in income tax.

Oil prices have fallen in the recession but are still high when compared with historic prices, particularly prices in previous recessions. So the biggest issue with oil revenues and their impact on public finances is not so much an issue of short term management of the budget but longer term considerations of how to grow the Scottish economy so that oil revenues are no longer essential to meet public spending requirements. This is something that will need to be planned for whatever the future constitutional arrangements for Scotland.

Figure 7: Taxation revenue from Scotland, 2007/08

	£m	%
Income Tax	11,244	21%
VAT	7,972	15%
National Insurance	7,766	15%
Oil Revenues (Scottish Geographic share)	7,320	14%
Corporation Tax	3,465	7%
Fuel Duty & Vehicle Excise	2,074	4%
Council Tax	1,936	4%
Non Domestic Rates	1,724	3%
Alcohol & Tobacco Duties	1,641	3%
Stamp Duties	908	2%
Capital Gains	299	1%
Other	2,900	6%
Adjustments (Gross Operating Surplus & Transfers)	3,263	6%
Total	52,511	100%

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

Of these taxes, Council Tax and Non Domestic Rates are devolved to Scotland, a total of £3.7 billion in 2007/08 or 7 per cent of all taxation revenue generated from Scotland. The other 93 per cent, some £48.9 billion, is collected by the taxation powers retained at Westminster (Figure 8).

Figure 8: Taxation revenue from Scotland, retained & devolved, 2007/08 (£m)

	£m	%
Retained at Westminster	48,851	93%
Devolved to Scotland	3,660	7%
Total	52,511	100%

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

There are more than 30 sources of taxation revenue collected in Scotland – a full list of the main taxes is included in Figure 9.

Figure 9: Longer list of tax revenues from Scotland (2007/08)

	£ million
Income tax	11,244
VAT	7,972
National insurance contributions	7,766
North Sea revenue (Geographical share)	7,320
Corporation tax (excl North Sea)	3,465
Gross operating surplus	2,865
Fuel duties	2,074
Council tax	1,936
Non-domestic rates	1,724
Tobacco duties	923
Stamp duties	908
Interest and dividends	748
Alcohol duties	718
Other taxes and royalties	552
Vehicle excise duty	425
Rent and other current transfers	398
Capital gains tax	299
Inheritance tax	269
Other taxes on income and wealth	244
Insurance premium tax	195
Air passenger duty	164
Betting and gaming and duties	103
Landfill tax	83
Climate change levy	65
Aggregates levy	52
Total current revenue (including North Sea revenue)	52,511

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

3.5 Expenditure and revenue at different levels of government

The current devolution settlement is unbalanced in that the Scottish Government has control over 60 per cent of government expenditure in Scotland but very limited responsibility for raising the revenue required to meet those expenditure commitments, other than the local taxes collected by local government. As shown in Figure 10, revenue generated by taxation powers devolved to Scotland accounts for only 11 per cent of the expenditure that is devolved to Scotland.

Figure 10: Expenditure and taxation revenue by level of government, 2007/08 (£m)

	Expenditure (£m)	Revenue (£m)	Revenue as % of expenditure
UK Government	21,018	48,851	232%
Scottish Government (including local government)	32,321	3,660	11%

Source: Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

3.6 Fiscal powers model

Reform Scotland's Fiscal Powers paper recommended that: "our preferred option would give the UK Government control over all National Insurance contributions; 40 per cent of Income Tax revenues from Scotland; 40 per cent of Scotland's geographical share of North Sea oil revenues; together with additional income from TV licences, passport fees and the National Lottery tax. The Scottish Government would set the rates for all other taxes, except for VAT which would be set at a UK level with 40 per cent of the revenue from Scotland going to Westminster and the remainder assigned to the Scottish Parliament."

This was based on 2006/07 figures and would have ensured that the starting point for fiscal powers would be that the UK and Scottish Governments were responsible for raising the revenue required to meet their expenditure. This preferred option remains valid when the 2007/08 figures are used (Figure 11).

Figure 11: Share of expenditure and taxation revenue by level of government, 2007/08 (£m), if Reform Scotland Fiscal Powers recommendations implemented

	UK/Scottish Govt. expenditure split	UK/Scottish Govt. revenue split
UK Government	39.4%	39.7%
Scottish Government (including local government)	60.6%	60.3%

Source: Reform Scotland Analysis based on Government Expenditure & Revenue Scotland 2007-08, Scottish Government, June 2009

3.7 Public finances and the case for fiscal powers

However, while these are the latest figures available, the state of the UK and Scottish economy and of the UK's public finances has changed since the end of 2007/08. There are no reliable figures yet available on Government Expenditure and Revenue in Scotland for last year (2008/09) or this year (2009/10). On current statistical publication schedules such an analysis will not be available until June 2010 (for 2008/09) and June 2011 (2009/10).

However, work has been undertaken for the Scottish Parliament's Finance Committee by Professor David Bell[6] which considers the UK's fiscal position and the implications for the Scottish Budget. Professor Bell notes that:

- although the fall in UK economic output (of around 6 per cent) between 2008 and 2009 is close to the European and OECD averages, the UK has suffered the worst deterioration in its public sector finances of all of the OECD countries since the recession has focused on parts of the economy which generate a high proportion of UK tax revenue, while Government spending has broadly followed the path set in the pre-recession spending review of 2007;
- as a result the UK faces the most serious fiscal deficit in the OECD, at around 14 per cent of GDP, limiting the policy options of the UK Government (for example, making any further discretionary spending to stimulate the economy unlikely) and leading to significant increases in debt interest payments (from 1.7 per cent of GDP in 2004 to 2.7 per cent in 2010, based on an assumption of relatively low interest rates);

6 "The 2010-11 Draft Budget", Report By Professor David Bell, University Of Stirling to the Finance Committee, Scottish Parliament, September 2009.

- based on current projections, UK national debt is expected to double from its 2007-08 levels, as a share of GDP, by 2013-14. In order to sell UK debt at reasonable interest rates, very significant cuts in UK public expenditure over an extended period of time and/or increases in taxation are likely to be required;
- one of the likely consequences of the recession is that an increased proportion of government spending will be allocated to areas such as higher social security payments and increased debt interest payments, both of which are reserved to the UK Government. Therefore, the Scottish Government will control a significantly lower proportion of overall government spending in Scotland;
- while this implies significant cuts to the Scottish Budget, the Barnett formula will mean that the cuts will be slightly less than comparable areas in England (since it will result in cuts based on Scotland's population share of 8.4 per cent rather than Scotland's share of spending in these areas).

Whatever Scotland's constitutional future may be, there will be a need to introduce policies that address the UK's serious fiscal deficit. In the short term, this will require public sector spending cuts or tax rises or a mix of both. However, in the medium to longer term, the most effective strategy will be one that increases the growth rate of the Scottish economy above the trend level that has been achieved over the last 30 years since this will generate higher tax revenues as well as increasing prosperity.

The economic and public sector funding situation faced by the UK and Scotland over the next few years highlights the weaknesses in the current devolution model and the advantages of increasing the Scottish Parliament's fiscal powers.

As long as the Scottish Parliament's budget is largely determined by the Barnett formula (or a successor "needs based" formula as recommended by the Calman Commission) there will be no strong incentive for the Scottish Government to identify areas where public spending might be reduced in Scotland. Indeed, it could be argued that, since any cuts in budgets in areas of devolved spending will be proportionately lower than in England (due to the Barnett formula which allocates the budget based on population share rather than the baseline budget level), there is a disincentive for the Scottish Government to identify areas for saving.

As things stand, the size of the future Scottish Budget will continue to be determined by decisions on the levels of spending on areas such as education and health in England rather than any assessment of either Scotland's overall economic needs or of the costs of delivering such services in Scotland.

So the approach to reducing public sector spending will be very much top down, driven by Treasury decisions in London and will take no account of the opportunities that might exist for reform of public services to deliver better services at lower cost, increasing the public sector's productivity. The top-down approach to budget cuts could have serious knock-on effects for the Scottish economy given the greater contribution of the public sector to economic output than elsewhere in the UK.

If the Scottish Government was responsible for raising the money that it spent, there would be a much greater incentive to improve the efficiency of public services since any savings could be passed on to Scottish taxpayers, creating the conditions for higher growth.

4. Legal context

4.1 EU law and Gibraltar decision

Any doubt as to whether the European State Aid rules prevent taxation powers being devolved to the Scottish Parliament have been removed by the European Court of Justice annulling the veto imposed by the European Commission against the reform of corporate tax in Gibraltar thus allowing Gibraltar to introduce a tax regime which is different from the rest of the UK. The European Court of Justice also reaffirmed the rules it set in a 2006 case involving the Azores and which outline when a different tax rate can be set by a devolved administration. The rules are:

- The devolved administration has its own constitutional, political and administrative status separate from that of the national government; and
- The national government does not have any power to intervene directly in the procedure of setting the tax rate; and
- The economic consequences of any reduction is borne by the devolved administration itself.

The European Court of Justice also considered whether the degree of autonomy is an issue. That might have meant that the Scottish Parliament failed the first of these criteria as the European Commission had tried to argue that the devolved administration had to have a degree of autonomy similar to that of the national government - in other words de facto independence. The European Court of Justice rejected that argument.

That means that the Scottish Parliament meets the first of the Azores criteria. There is also no problem with meeting the second and third of these criteria. Indeed, the recommendations outlined in this paper go further than is deemed necessary by the European Court of Justice as we recommend that the underlying law associated with each of the taxes we have chosen to devolve is devolved as well.[7]

7 European Court of First Instance judgement in the Joined Cases T-211/04 and T-215/04 relating to Gibraltar of December 2008 and the European Court of Justice judgement in the case C88/03 of September 2006 in relation to the Azores judgement in Joined Cases C-428/06 to C-403/06 of September 2008 relating to the Basque Autonomous Community in Spain.

4.2 Institutional structures required

The last year has also seen a great deal of comment questioning how the UK Treasury and HM Revenue & Customs interact with the Scottish Government. Almost all of the comment concerned the Scottish Government's proposal for a Local Income Tax. There was though an example of a UK Government agency cooperating closely with a Scottish government agency. Earlier this year after many years of campaigning, the Edinburgh Stamp Office, a part of HM Revenue & Customs, agreed to co-locate with the Registers of Scotland, a Scottish Government agency.

Cooperation is crucial. The Scottish Government and in particular HM Treasury and HM Revenue & Customs need to cooperate at all levels. This is absolutely crucial to what we are proposing. Once a political decision to devolve fiscal powers has been made the "powers that be" need to make it absolutely clear that their wishes are to be carried out.

We recommend that the remit of the Scottish Government's Finance Department is increased to include most of the powers and responsibilities presently held by HM Treasury and HM Revenue & Customs.

We must though go further. Does Scotland need a separate Registers of Scotland, a Companies House and a Stamp Office? We argue that it does not. That is the type of question that must be asked and answered.

4.3 Devolution of tax powers

Any change to the taxation system will take time to implement but the division of retained and devolved taxes recommended is a simple one and could be implemented quickly provided that the starting point was the transfer of all of the existing relevant legislation to Scotland. Improvements to the system, including its simplification could be implemented in a second phase of reforms. This will ensure a degree and period of certainty to the process.

Having the ability to amend the underlying tax legislation is just as important as having the power to amend a rate of tax. For example, the debate surrounding allowing the Scottish Parliament to set its own rate of corporation tax does not take into consideration that the legislation that decides how the tax is implemented or a specific relief is granted is likely to be just as important as the headline rate of tax.

Another anomaly of the present system is that even where the Scottish Parliament has the power to legislate, for example on health issues, it has no power over alcohol or tobacco duty. Under our proposals, this anomaly would be removed.

Similarly, responsibility for transport policy is currently shared between the Scottish and UK Governments. The responsibility for provision of infrastructure and domestic transport policy is devolved while the fiscal powers related to transport are retained at Westminster. This is an example of a policy area where fiscal powers are important policy levers. With fiscal powers, the Scottish Parliament would have a wide range of policy options available. For example, it would be possible to replace road tax and fuel duties with a road pricing approach, as recommended in Reform Scotland's Power to Connect report. This would deliver greater fairness as the costs of driving would be highest where there are alternative choices, where transport infrastructure investment costs are high and where the environmental impact might be greatest. The costs of driving in more rural areas where alternatives to the car are more limited would be lower.

4.4 Approach to taxation

As part of this debate we need to start to look at what form of taxation system we wish to see. This is both a great opportunity and a great challenge and should be viewed as such. This debate is in its infancy. A starting point might be fewer and less complex taxes combined with stringent enforcement. That is our starting point. That though is only part of the debate. We need to decide how we deal with tax avoidance and tax evasion. Also how our taxes are to be collected and administered as well as how we "balance" our tax regime. For example, do we apply a lower rate of tax to capital transactions? What rate of tax do we apply to a deceased's estate whose assets have already incurred taxation?

The UK Government are already raising taxes. There are proposed changes to the higher rate of income tax, National Insurance increases and restrictions on tax relief on pensions and personal allowances. The Conservatives are likely to delay the introduction of their Inheritance Tax proposals and the Liberal Democrats are looking to implement a so-called "mansion tax" on houses worth more than £1 million.

If Scotland is to have the economic levers to achieve sustainable economic growth it must have the power to tax, both from the object of raising finance or encouraging enterprise and, where appropriate, to change behaviour.

5. Next steps

In the last year, the debate in Scotland has moved on from one about whether the Scottish Parliament should have additional fiscal powers to one about the extent of those powers and how they should be implemented.

If those additional fiscal powers are to have a real impact on the governance of Scotland and on the performance of the Scottish economy, they must be of a scale that is great enough to address the fundamental defect of the current devolution settlement – its lack of financial accountability. This can be achieved within the context of the UK if both the UK and Scottish Governments were to be responsible for raising the taxes required to fund their spending proposals, as recommended in Reform Scotland's paper Fiscal Powers.

Reform Scotland calls for the work to commence on preparing the way for greater fiscal powers for the Scottish Parliament. This will enable implementation to quickly follow the political decisions that will need to be taken over the next year or two on the extent of fiscal devolution to Scotland.

This will include, for example:

- Preparing the draft legislation that will be required.
- Business planning for the new institutions such as the Scottish Exchequer.
- Further research into Government expenditure and revenue in Scotland to establish, with greater certainty, the size of the Scottish tax base and the tax revenues collected from Scotland.
- Secondment of HM Revenue and Customs and HM Treasury officials to the Scottish Government.
- Preparing draft agreements as to how a Scottish Exchequer will liaise with UK Government institutions in the future.
- Institutional re-organisation to deliver efficient services (for example, merging the Edinburgh Stamp Office with Companies House Edinburgh and Registers of Scotland).

It would be reasonable to expect this work to be undertaken by the Scottish authorities, with the support and assistance of HM Treasury. The Treasury already has significant experience in this area, having assisted many countries around the world in establishing and reforming taxation systems.

At a political level, there is a need for debate at two levels.

The devolution of fiscal powers within the UK will require legislation at Westminster. However, despite the consensus in Scotland amongst the three main UK-wide parties, there has been little debate on the merits of fiscal devolution at Westminster. There is a need for Scottish politicians to engage with politicians at Westminster so that there is an increased understanding at the UK level, as well is in Scotland, of the benefits to Scotland and to the rest of the UK of greater devolution of fiscal powers to Scotland.

These benefits include the ending of the unpopular Barnett formula, greater transparency in the UK taxation and spending system and greater financial accountability for the UK and devolved parliaments.

Finally, the time has now come for the political debate in Scotland to include what the political parties would do with additional fiscal powers. In the run up to the UK and Scottish Parliament elections, both of which will take place within the next two years, Scottish voters are entitled to know what each of the political parties in Scotland would do if given the power to tax as well as the power to spend. Key questions for the political parties include:

- Should they support the current UK approach to taxation and spending or a system of simpler, lower taxes, as recommended by Reform Scotland?
- How would they change the taxation system?
- How should they use fiscal powers to promote sustainable economic growth?
- What would they do, if the Scottish Parliament had fiscal powers now, to deal with the impacts of the recession and to stimulate recovery?

6. Conclusion

In the last year, the debate in Scotland has moved on from one about whether the Scottish Parliament should have additional fiscal powers to one about the extent of those powers and how they should be implemented.

If those additional fiscal powers are to have a real impact on the governance of Scotland and on the performance of the Scottish economy, they must be of a scale that is great enough to address the fundamental defect of the current devolution settlement – its lack of financial accountability. This can be achieved within the context of the UK if both the UK and Scottish Governments were to be responsible for raising the taxes required to fund their spending proposals, as recommended in Reform Scotland's paper Fiscal Powers.

Reform Scotland calls for the work to commence on preparing the way for greater fiscal powers for the Scottish Parliament. This will enable implementation to quickly follow the political decisions that will be taken over the next year or two on the extent of fiscal devolution to Scotland. This must include, for example, preparing the draft legislation that will be required, business planning for the new institutions such as the Scottish Exchequer and further research into Government expenditure and revenue in Scotland to establish, with greater certainty, the size of the Scottish tax base and the tax revenues collected from Scotland.

There is also a need for parallel work to engage both politicians and important institutions in Westminster (such as HM Treasury) so that there is an increased understanding at the UK level, as well as in Scotland, of the benefits to Scotland and to the rest of the UK of devolution of fiscal powers to Scotland.

Finally, the time has now come for the political debate in Scotland to include what the political parties would do with additional fiscal powers. In the run up to the UK and Scottish Parliament elections, both of which will take place within the next two years, Scottish voters are entitled to know what each of the political parties in Scotland would do if given the power to tax as well as the power to spend.

7. References

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