DG Undeb Sy'n Newid
UK's Changing Union

Forum 2

Public finance in a changing union

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A report on the proceedings

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Those who gathered for the second Changing Union Forum to examine the financing of devolution rapidly agreed that all the technical issues were solvable. What mattered was tackling the politics. Technical solutions had to be delivered within a constitutional context. As one participant said, "Until you have a description of your desired union, it's hard to devise the technical measures that will get you there." Another added:

> "Generally speaking, there's a trade-off between autonomy for the regions and the relative efficiency of centralised tax collection and spend. It's harder if there's an issue about whether a country wants to remain within a state – as there is at the moment with Scotland in the UK. In that situation trade-offs don't apply. It's somewhat ignoble, after all, to say you're staying inside a state only so long as you can get something out of it. A nation exists where there is a generalised will that it should continue. However, in the UK we're in a state where some say they're British and others do not."

The essential question that preceded consideration of fiscal devolution - the block grant and tax and spend - was the nature of the union of the UK. Were we talking about a single union or rather a series of unions? This question was elaborated in the following terms:

> "Are we looking at narratives for one, two or even three unions? It seems to me that we're writing at least two narratives. Ireland is different. To begin with it's an island, and there are economic issues in terms of tax competition within it. Historically, the UK's relationship with Ireland is contingent – we say to its people "You're welcome to stay in the union, but we're totally relaxed if you wish to leave". On the other hand the UK government will be campaigning to keep Scotland in the union in the autumn 2014 referendum. So there's at least that difference between the union narratives between the two main islands of the British Isles.
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> "What's the difference between Scotland and Wales? Are they part of the same story but at different stages of development? Currently one technical device that is common to both is the Barnett formula. However, we are now pulling that apart over giving significant tax powers to Scotland. Once that happens we will

return to that question of whether the Scottish and Welsh narratives are essentially the same or different."

It was agreed that the nature of future fiscal arrangements across the UK would depend on the way the politics of the devolution process developed over the next few years, and especially the outcome of the Scottish independence referendum that would be held in autumn 2014. At present the financial arrangements with the various devolution settlements were broadly symmetric. Soon, however, it is likely we will have four different financial systems within the UK, which will then become completely asymmetric in the way it is financed. In those circumstances two vital questions follow:

1. How sustainable would be the Barnett formula that is used to calculate the distribution of the block grant to Scotland, Wales and Northern Ireland and what set of circumstances might precipitate any change?
2. Who will hold the ring in determining outcomes? Would it continue to be the Treasury? Or would we search for a less partisan locus such as the Office for Budget Responsibility?

Before these questions were addressed in detail the Forum considered the current state of play and likely future trends in each of the devolved territories. At the outset it was noted that Scotland is different from both Wales and Northern Ireland in the potential it has for balancing its books. Because of oil Scotland could raise a high proportion of its own revenue, which would diminish its dependence on the block grant. This is simply not the case with Wales and Northern Ireland, both of which remain highly dependent on fiscal transfers.

Scotland was moving from theoretical debates about finance and taxation to practical delivery, depending on the outcome of the referendum in autumn 2014. If there is a No vote the tax and borrowing powers contained in the 2012 Scotland Act would be implemented as planned, and possibly legislation on further tax devolution. The latter had been signalled by the 'Devo Plus' proposals, around which the unionist parties were beginning to coalesce, although to what extent is currently unclear. Under Devo Plus the UK would set the tax thresholds and remain responsible for pension allowances, after which most fiscal matters would be devolved to the Scottish Parliament. When it came into force the Scotland Act 2012, which implemented the proposals of the Calman Commission, would make the Scottish Parliament responsible for about 33 per cent of its revenue. Devo Plus would take this to about 60 per cent. In this eventuality it would also be necessary to change the way the block grant is calculated and distributed. As the Forum was told:

> "Calman is about as far as you can go and still keep the Barnett formula. This is possible when you devolve up to about a third of revenue raising. However, if you move to a scheme where a devolved administration is raising most of its revenue then a Barnett redistribution becomes less plausible."

The Devo Plus or 'New Union' initiative, being promoted by the Reform Scotland think tank, addresses the problem that has long been associated with the Tory peer Lord Alec Douglas Home at the time of the 1979 referendum. He promised improved devolution if the Scottish people voted No, but then failed to deliver. Precedents for overcoming this have been set by the unionist party leaders in Scotland signing up to

change and then placing it in their manifestos – first, ahead of the 1997 referendum, and then, following the 2007 election, with the Calman process.
Will they do the same around some formulation of Devo Plus? This is a question currently preoccupying politics in Scotland, along with three related, but more technical issues:

1. Can the parties agree on: (1) which taxes are to be regarded as for the UK only, for example National Insurance; (ii) which can be shared between the UK and the devolved administrations, for example income tax; and (iii) which can be completely devolved, for example airport tax?
2. In future the balance between need and equalisation in the way funding is distributed will have to be much more clearly defined, implying Barnett reform.
3. How far can welfare reform be devolved in a situation where welfare credit payments are universal across the UK?

Even if these issues are resolved and the unionist parties present a united front in the referendum in Scotland it was made clear at the Forum that all might not be plain sailing. As one participant explained:

> "Any change to the Barnett formula will entail taking money from Scotland and that will be difficult. I don't think we've analysed sufficiently the dangers to Scotland that would accompany a No vote in the referendum. Until now the Scottish budget has been protected by a combination of Scottish Ministers in the UK Cabinet combined with the threat from the SNP. What will happen when these are eroded?"

And another participant warned:

> "It is asked whether the unionist parties will get together to agree a vision for taking devolution forward. However, they could still be outflanked. For the party that loses the referendum may go on to win the Scottish elections in 2016. It could then put together a new Home Rule package and put that to another referendum. There's a lot of ugly sneer-ridden politics that are going to occur between now and 2016."

Wales is some way behind Scotland in contemplating tax devolution. However, a few days before the Forum met the Silk cross-party Commission that is examining further devolution to Wales published its first report *Empowerment and responsibility: Financial Powers to Strengthen Wales*. This recommended extensive tax devolution, majoring on income tax. Implementation would be subject to a mutually agreed way forward on fair funding for the block grant, following the announcement by the two Government in October 2012, and a referendum. Wales would take 10p off each of the three tax bands – Basic Rate 20p, Higher Rate 40p, and Additional Rate 45p – and could vary each band separately. This entitlement to differential control of each tax band (which is more than Calman recommended, and more than is contained in the Scotland Act 2012), would have the effect of greater flexibility for each tax change.

In addition, Silk recommended that the Welsh Government should have control of aggregates tax, landfill tax, stamp duty, and passenger airport duty on long haul flights. It should also have borrowing powers at least commensurate with Scotland, amounting to about £130 million a year for capital investment and similar powers to Scotland on borrowing for current expenditure. In addition there should be full devolution of business rates, as is already the case in Scotland and Northern Ireland. However, Silk said corporation tax should remain with London unless it is devolved to Scotland and Northern Ireland. The Welsh Government should have an option to 'buy' capital allowances in Enterprise Zones beyond the Barnett share. It also recommended that there should be better information on data of tax and spend, and a stronger Treasury function within the Welsh Government, and various other recommendations.

A major effect of these recommendations is that, in contrast to the Calman Commission proposals, they would give the Welsh Government the ability to alter income tax rates differentially. One consequence, for example, would be to give a Welsh Government an incentive to cut the top rate of tax. This could be calculated to increase revenues, by drawing more well off people across the Welsh border into Wales. Conversely, and in contrast with Scotland, if the top rate of tax were increased, the likelihood is that revenue would be lost, because of movement the other way. The Holtham Commission estimated that a 1p income tax increase on the higher rate of income tax could reduce income tax yields by £39 million. As the Forum was told:

> "About 10 per cent of the population move each year. Even small changes on the top rate of tax could have significant cumulative effects. One option for a Welsh Government would be to accompany a cut in the higher rate of income tax with increasing the number of council tax bands, allowing a greater tax take on the highest valued properties. That way you would increase your income in both directions."

However, some doubt was cast on the likelihood of a future Welsh Government taking advantage of the Silk recommendations, even if they were implemented:

> "How realistic is it to expect that this income tax power would be used in practice? A 1p increase in the basic rate would raise somewhere between £140m and £150m. You would take a big political hit to increase your income by just 1 per cent of your overall budget. In Scotland the equivalent tax take was greater, between £400m and £500 million – about 1.5 per cent of the overall budget. But even then the option was not taken under the so-called Tartan Tax that was available from 1999 onwards."

It was suggested, too, that the same might apply to the Calman proposals for Scotland that are enshrined in the 2012 Act:

> "In 1997 we knew that the 3p tax variation rate approved in the referendum would never be used. It was there to enhance the credibility of the Scottish Parliament. Calman was conceived out of the political necessity for the unionist parties to have something positive to say against the SNP. I don't think its recommendations will be implemented in practice, even though they are now part of the Scotland Act 2012."

However, it was emphasised that a key aspect of both the Calman and Silk proposals was that the Scottish Parliament and Welsh Assembly would have to make an income tax decision each year. Even if the tax rates were not changed with the rest of the UK, their spending would still be to some extent dependent on Scottish and Welsh tax receipts, thereby increasing accountability.

The Forum was told that in Northern Ireland it was beginning to dawn on politicians how little power they had over macro-economic policy - over tax, tax bands, and the block grant. This had been highlighted by tax competition with the Republic, and by growing pressure for tax initiatives in Northern Ireland to harmonise with the tax regime south of the border.

So, for example, there were calls for the Northern Ireland Assembly to gain powers over corporation tax so the rate could match the 12.5 per cent level in the Republic. The aim was not the potential tax take but to achieve higher value added in terms of foreign direct investment. However, the Treasury was demanding a reduction in the block not only equivalent to direct loss of tax revenues, but an estimate also on losses incurred though firms moving their headquarters base to Northern Ireland from the rest of UK. As a result no agreement had so far been reached on corporation tax, though discussions between the UK Government and the Northern Ireland Executive were ongoing.

There had been greater movement on airport passenger duty for direct long haul flights which has been devolved and will be reduced to zero from 1 January 2013. This was done in a way that ensured we complied with the EU Azores requirements - that is to say, Northern Ireland will receive a reduction in its block grant equivalent to the amount raised by airport taxes, about £5 million. To have included tax on domestic flights as well would have entailed a corresponding reduction in the block grant of between £60 and £90 million.

Yet, apart from the issue of tax harmonisation with the South, the Forum was told there was no real debate in Northern Ireland over fiscal devolution:

> "Constitutional issues are at the top of every agenda – except fiscal accountability as a driver for additional tax revenues. When the Silk Commission visited Northern Ireland it met separately with the coalition partners in the government, Sinn Fein and the DUP, a reflection of where we are. There are no real concerns about the operation of the Barnett formula. We've been able to negotiate deals outside the Barnett arrangements, for instance on devolving the Department of Justice and EU matters."

In contrast with Northern Ireland, debates on how fiscal powers can encourage more balanced economic development across the United Kingdom are more advanced in Scotland and Wales. At the Forum two recent reports were quoted. The first, published in the journal *Accounting Forum* in 2012, provided a snapshot of how the present recession is affecting different parts of the UK disproportionately. For example, between 2007 and 2010, some 712,500 jobs were lost across the UK but more than 85 per cent of them - some 621,200 - were lost in the ex-industrial regions of the West and North. By way of contrast, the East, East Midlands and South East regions each suffered job losses of no more than 50,000; and the number of jobs in London actually increased by just over 5,000. Meanwhile the GVA in Wales is less than 50 per cent of that in London and destined, according to forecasts to drop to a third over the next 20 years.[1] Commenting on these statistics the contributor who drew attention to the study stated:

> "The phrase beggar my neighbour comes to mind. What will be the impact in 20 years time if this economic disparity continues?"

Another pointed out that the disparities were not just between England and the devolved nations but were just as great within England itself. In the week the Forum was held IPPR North launched a report which highlighted the north-south divide within England.[2] It gives the figures for planned capital spend per head across the English regions, as announced alongside the Chancellor of the Exchequer's 2011 autumn statement. The figure for London was £2,731 and for the Southeast £792. After that only the East Midlands came close with £311 per head. However, the figure for the North East was a diminutive £5. It was emphasised that, against these imbalances, taxation powers could be used to promote economic development:

> "Control of corporation tax, for example, can be utilised to encourage research and development by companies. When fiscal transfers are discussed the argument is couched as though they only go in one direction, from the centre outwards. But there are many transfers in the opposite direction. For instance, Wales contributes to defence and foreign affairs spending, and to the general running of central government in Whitehall. What does it get back for these expenditures when so much non-identifiable spending is, in fact, spent in and to the benefit of, the southeast? Taxation needs to be thought of in a more nuanced way and we need a more balanced transfer of resources within the UK."

However, another participant cautioned:

> "You can use tax policy to correct economic imbalances and to stimulate regions, but there are constraints. There is a trade-off between incentives and diversion – will you simply move economic activity from one place to another rather than create anything new? However, a place like Wales has particular problems. A nationality is at stake. The decline of its economy can threaten its existence. You can think of ways of using the tax system to stimulate economic activity, but you need the levers to do so. We need a story about how we can stimulate activity through greater tax and economic powers."

Despite these arguments it was generally agreed that fiscal transfers remained at the heart of the way devolution is financed. In turn this led to an underlying dilemma that was sure to surface sooner or later. It was pointed out that fundamental changes in spending patterns underway in England – described as the elephant in the room - threaten to undermine the stability of the system:

> "There's a radical revolution happening in England in terms of spending patterns in education and health, major areas where there used to be more of a consensus about priorities across the UK. But what happens to a needs-based assessment of spending when there's disagreement about what should be

[1] Ismail Erturk et. al., 'Accounting for national success and failure: Rethinking the UK case', in *Accounting Forum*, No 36, 2012.

[2] Katie Schmuecker, Guy Lodge and Lewis Goodall, *Borderland – Assessing the implications for a more autonomous Scotland for the North of England,* IPPR North, November 2012.

funded out of taxation? Scotland and Wales remain broadly social democratic in this respect but England is diverging rapidly away from that perspective. We can see this in the way university students in England are being self-funded, English local authorities are seeing 20 per cent cuts to their budgets, and the English health service is on a road leading towards privatisation. How are we going to get a consensus on relative need when there's no agreement on what services should be in the public sector? This is a more important question than the technical difficulties around devising a needs-based formula."

Another participant added:

> "What this points to is the reality that there's no such thing as the West Lothian Question. Scotland, Wales and Northern Ireland are entirely dependent on English spending decisions to determine the size of their block grant. So, for example, if England decides not to have the NHS in its present form then that will have a major knock-on effect. You can't expect England to pay for something in Wales or Scotland that they're not paying for themselves. What this comes down to is the reality that at the end of the day your autonomy depends on how much money you've got. Add to that the fact that England is much bigger than Scotland or Wales, that it has a winner-take-all majoritarian culture, and has no appetite amongst its regions for a federal approach, and you end up with a real difficulty. Any assessment of needs across the UK as a whole can only apply to those things that England decides it wants to fund for itself."

Responding to this a Scottish participant said the argument explained why Scotland might vote Yes in the referendum in 2014:

> "All the political parties in Scotland tend to position themselves in roughly the same ideological position – including the Conservatives. The PR system in Scotland has only accentuated this tendency – which is why Labour and the SNP hate each other so much, because they occupy the same position. Set against this an English polity (with 85 per cent of the UK population) which is increasingly dominated by the South East where neo-liberalism reigns, and you summarise the fundamental politics of the issue.

If the Forum came to any conclusion it was that the devolved administrations in Scotland and Wales should become responsible for raising a significant proportion of their spending through taxation which they controlled. In turn, this would increase pressure for a more robust and fair way of calculating and distributing the block grant, which was needed if the integrity of the UK was to have a chance of being secured. We should move from the present population-based determined system of calculating the block grant to one that is more needs based and has some external, perhaps legal under-pinning, to prevent the perception that the Treasury acts as judge and jury in its own cause. As one participant put it:

> "After all, can it be justified that the Treasury handles the national budgets of the Scottish and Welsh Governments as though they are merely departments in Whitehall?"

Despite this it was acknowledged that the political difficulties in achieving consensus across the UK on the changes that were needed would be considerable.