



DG Undeb Sy'n Newid UK's Changing Union

Public finance in a changing union

The financial relations between governments

Background paper for the UK's Changing Union Forum

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The purpose of the fora organised by the Changing Union project is to harmonise the discussions over devolution occurring in the UK. So far official discussions have been conducted bilaterally between the centre and each devolved territory (DT) and the associated public debates have been similarly various and unconnected. That has been as true in the area of public finance as in the area of devolution of legislative and executive powers. The result has been a series of diverging financial settlements that in some respects appear to be inconsistent. This paper attempts to provide a framework for the discussion of that motley scene. It concentrates on the situation that should pertain if the Union persists in some federal form. That is not to deny that Scotland may secede and has the right to do so but in that situation there would not be a United Kingdom with a constitutional and financial settlement to discuss.

This paper has six sections. **The first section** summarises current arrangements in devolved finance and outlines a few of the widely-canvassed ways that the devolution of fiscal powers might proceed in the different DTs. This is familiar territory to a specialist audience so no attempt is made to be comprehensive. **The second section** asks whether there are limits to fiscal devolution within a union or federal system. Can a desire for fiscal autonomy be gratified without limit or are there certain economic or political constraints and can they be identified? Does the wish to retain common goods, labour and capital markets within the state, for example, preclude the devolution of some taxes? **The third section** proceeds from the second and examines the notion of a social union. How far does common citizenship of a state, even a federal state, imply a common set of protections and entitlements? To the extent that it does, can the provision of those entitlements be devolved without excessive cost or risk? **Section four** addresses the issue of symmetry in fiscal devolution. With a number of devolved territories can each be treated *ad hoc* or are there advantages to commonality or symmetry of arrangements? What principles should be applied in a scheme of devolution and what commonalities would those principles impose and how much variety would they permit? **Section five** deals with equalisation payments.

All federal and unitary systems have some procedure for ensuring rough equality of access to key public services by augmenting the revenues of poorer areas. Moreover, some devolved territories in the UK will continue to require a block grant irrespective of the extent of fiscal devolution. How should that grant be determined? Can the Barnett approach be further stretched to cope? How should entitlement to grants and the converse liability to make transfers be specified? **Section six** attempts a summary of the conclusions of the other sections.

1. The current and prospective settlements

(i) The block grant

All DTs are currently financed through a block grant. Wales and Northern Ireland will continue to be so for some time. Scotland has limited powers to raise additional tax revenue on its own account. These powers were extended by the Scotland Act of May 2012 but have not so far been exercised. The DTs all control the allocation of revenue support grants to local authorities in their areas and those local authorities have power to levy council tax. Northern Ireland and Scotland may also set non-domestic rates (business rates) in their areas, though Wales does not have the same powers. The block grants are not hypothecated but may be deployed as the DTs decide. In principle, they could therefore alter payments to local authorities and compel them to raise or enable them to lower local tax rates. This indirect access to revenue raising powers has not been extensively employed, however, no doubt because HM Treasury's Statement of Funding Policy provides that the block grant may be reduced if levels of 'self-financed spending' grow significantly more rapidly than in England over a period. In other words while no formal cap exists, the Treasury reserves the right to impose one, if provoked.

That uncertainty reflects a central fact about the current devolution settlement: its details have very little statutory basis. Legislation permits government ministers, in effect the Treasury, wide latitude to alter arrangements at will. That applies to the determination of the block grant itself, which depends on the so-called Barnett formula, sanctified by long usage but without any statutory basis or restriction.

The formula applies to annual increments to the block grant. It takes a detailed list of government expenditures in England and assigns to each a 'consequential' denoting the extent to which such expenditures are for a devolved responsibility. (Consequentials therefore range between zero and one). The consequentials for each government department are aggregated, weighting each one by the expenditures to which it applies. This weighted-average consequential is then applied to the total annual change in the department's per capita expenditure. The resulting sums are aggregated across departments to arrive at the total per capita increment (which may be positive or negative) to the previous year's block grant. Multiplied by the population of the DT, the per capita increment becomes the sum by which the grant rises or falls.

This contrasts with the situation in England where departmental expenditures are allocated to the regions of England according to complicated formulae that attempt to assess the relative need of each area for public spending. Before devolution the same procedure would have been applied to DTs but with growing executive devolution to the Secretaries of State

for Scotland, Northern Ireland and Wales the block grant became increasingly important. The same block grant process has been extended into the era of democratic and legislative devolution. Since the Barnett formula takes no account of measures of relative need beyond relative population sizes and has now been in operation for over 30 years, there is no reason to suppose the grants now do reflect relative need at all well. HMG gave the first tentative recognition of that in 2010 but declined to act.

The Treasury conducted a detailed bottom-up examination of relative need in 1979 when the Barnett formula was new but that work was not used in practice. The Independent Commission on Finance and Funding for Wales (ICFFW) used top-down regression analysis to derive relative needs from the detailed formula used for regional distributions within England, Scotland and Wales. The ICFFW found seven variables could explain 95 per cent of the variation driven by the complicated formulae.

The convergence mechanism built into the Barnett arithmetic means that as long as population growth is similar in different parts of the UK, the allocation to the DTs will tend to move down to the English average when public expenditure grows in nominal terms – even though allocations to English regions are diverse and there is no mechanism driving them to a national average. This will make Welsh underfunding worse over time and bring Northern Ireland into similar difficulties. Paradoxically perhaps, the divergence between allocations and relative need has made reform less likely since Scotland, the country with the strongest separatist party is over-funded on the basis of relative need.

Assessments of relative need, 1979 and 2009, and actual spending

	1979 Needs Assessment	Actual spending, 1979	Relative needs, 2009	Actual spending, 2008-09
England	100	100	100	97
Scotland	116	122	105	115
Wales	109	106	115	111
Northern Ireland	131	135	121	123

Data sources: Columns 1 and 2 derive from table 5 in House of Lords Select Committee on the Barnett Formula *The Barnett Formula*, p. 21; column 3 from Holtham Commission report, p. 28; column 4 from *Public Expenditure Statistical Estimates 2011*, Cm 8104, table 9.2. Note that column 4 relates to overall public spending, not just devolved services subject to the block grant system. Table assembled by Alan Trench in *More or less federal models for funding devolution: what the UK can learn from federal systems* (mimeo)

(ii) Current and prospective tax devolution

- Scotland

Scotland since 1998 has had the power to vary the basic rate of income tax by 3 pence in either direction. Following the recommendations of the Calman report 2009, the Scotland Act 2012 has conferred wider powers.

The UK is to reduce all income tax rates in Scotland by 10p 'leaving room' for the Scottish Parliament to introduce its own income tax that would apply the same flat rate to all taxpayers. If it were levied at 10p, everyone would pay the same total income tax as they do now but there is no limit on what rate the Scottish Parliament can levy. The Act obliges the Parliament to renew the tax annually so even a decision to make no change must be expressly made and stated.

A number of smaller taxes are also devolved, selected mainly because their bases were immobile so they could be evaded only with difficulty and there would be no or few spill-over effects across the border. These taxes were landfill tax, aggregates tax and stamp duty on property transactions. The Calman recommendation that Air Passenger Duty (APD) also be devolved was not accepted and incorporated in the Act.

The Calman report justified greater fiscal powers for Scotland on the grounds that it was necessary to improve the accountability of the Scottish Parliament. In that, it was responding to the orthodox view in the public finance literature that spending bodies should so far as possible themselves raise as much of their own revenue as possible. It recognised a series of trade-offs, however, between accountability, autonomy, stability and predictability of revenues, equity among the regions of the UK, administrative and compliance costs and economic efficiency and the absence of distortions. Its recommendations left the Scottish Parliament raising just 35 per cent of its expenditures. The Commission did not go further because it considered to do so would either subject Scottish revenues to too much volatility or would result in adverse spill-over effects that would be bad for the economy of the Union as a whole

There is now a broad consensus that Scotland should have more powers ranging from full fiscal autonomy 'devo-max' through various schemes for 'devo-plus'

Evidently various forms of devo-plus are possible. They generally, however, propose that enough taxes be devolved or assigned to Scotland for the Parliament to finance well over half its expenditures. A leading example and the most thorough to date is the report of the Devo Plus Group of May 2012 which sought to finance over 2/3 of devolved expenditure from Scottish tax receipts. It classified taxes into three: 1 wholly the responsibility of the Scottish Parliament; 2 shared in one of a number of ways; 3 wholly the responsibility of the UK government. The report also classified taxes into three tiers: 1 apt for immediate devolution; 2 requiring administrative changes that will take longer; 3 requiring agreement among UK nations and regions and therefore a long term ambition for devolution.

The principle applied was that only taxes linked directly to fund UK services and benefits and those where EU rules prohibit variation within a single state should be reserved. All other taxes could be considered for devolution at some point. The report concluded VAT and national insurance contributions were category 3 along with fuel duty and betting and gaming duty.

Devolution of income tax on earned income was proposed with assignment of revenues from income tax on savings (a distinction also proposed by Calman). However, full control of rates in different tax bands was proposed. The report also favoured the devolution of rates of corporation tax and small business profits tax but acknowledged the need for development of definitions of the relevant tax bases and of associated data bases. It is evidently attractive for Scots to claim the oil revenues but oil and gas taxes were left at the UK level, largely because their extreme volatility (second only to capital gains taxes) would make the Scottish budget much more difficult to manage

Other suggestions for devo-plus have appeared in the Scottish press and elsewhere. While EU legislation proscribes differential VAT rates within a single state there have been proposals for the assignment of Scottish VAT revenues. While all devo-plus schemes favour the extensive or complete devolution of income tax, there is considerably less unanimity on corporation tax or the tax on North Sea oil. Corporation tax is to be devolved under most devo-plus schemes with different degrees of acknowledgement of the awkward issues concerning spill-overs, horizontal equity within the UK and the consequences for the UK tax base of devolution.

Devo max would see the devolution of all those taxes. While it would confer full legal autonomy it would not abolish economic constraints and it seems probable that the Scottish government would need to discuss with its UK neighbours plans for things like corporation tax if conflict were to be avoided. Something similar would be true even under independence with the further consideration that EU states would have views on tax competition and 'social dumping' which they would doubtless air during discussions on Scottish admission to the EU as a new state.

b. Wales

In Wales, the Silk Commission has produced a report, which endorsed the bulk of the recommendations of the ICFFW. In seeking a political consensus, however, it set out a fairly gradual progress to tax devolution of income tax that would be introduced only around 2020 after a referendum and with the agreement of a super majority in the national assembly. These stipulations make it possible that the measures will never be applied. The recommendations themselves broadly resemble the provisions of the Scotland Act, the main difference being in the treatment of income tax. The Silk Commission recommends that 10p of each tax band be allocated to the Welsh government whereas the ICFFW recommended the Welsh Government taking half the revenue from each band and being able to change each rate but with changes being restricted to 3p in each direction. It seems probable that developments in Scotland will result either in the complete devolution of income tax on earned income or at the very least an arrangement where tax rates in different bands can be altered differentially. Silk resembles Calman and differs from the ICFFW in rejecting any systematic devolution of corporation tax, though with the caveat that Wales should have the option if there were devolution to other countries.

The same range of small taxes with immobile bases - landfill, aggregates and stamp duty on property transactions - was proposed as in the Scotland Act but with APD on long-haul flights devolved too. The ICFFW also proposed devolution of capital gains on land or property transactions but this was rejected by Silk. The ICFFW also tried to assess the revenue value of these taxes and what they would be 'worth' in terms of a cut in the block grant. Frequently tax devolution is discussed in the abstract without considering its relation to any equalisation flows or grants. Since the block grant and Barnett formula has no statutory base, the impact of tax devolution on the grant was not specified in the Scotland Act. Some of the smaller taxes could easily cost more than they are worth if the grant reduction is inappropriately handled.

The political situation in Wales is rather occluded in that the Labour Party has made reform of the block grant a precondition for taking on any powers over income tax. Indeed, some elements in the Labour party remain opposed to income tax devolution explaining Silk's caution on the matter.

- Northern Ireland

In Northern Ireland discussion of tax devolution has focused exclusively on two taxes: corporation tax and APD. There is no appetite for fiscal devolution on the part of the Unionist parties as a matter of principle. The interest in two particular taxes stems from their perceived utility as instruments of economic development policy. The Calman and ICFFW concerns about the full accountability of the devolved legislature has no echo in Northern Ireland.

The demand for corporation tax stems from observation of the perceived success of the Irish Republic in attracting foreign direct investment through a lower tax rate and the demand is justified by asserting the impossibility of competing with the Republic unless their lower rate of corporation tax can be emulated. Whether the measure would be effective now compared with the period of rapid growth in the Republic is moot but one view often heard in Northern Ireland is “we’ve tried everything else, corporation tax is what’s left”.

HMG has agreed in principle the devolution of corporation tax to the Province but the Treasury is trying to exact such terms for the measure as to make it unaffordable in practice. This involves not only subtracting an estimate of current revenues from the NI block grant (as required by the EU Azores judgement) but further subtracting an estimated revenue cost to the UK Treasury from companies registering in Northern Ireland following a cut in corporation tax there. This would entail an immediate revenue sacrifice of some £760 million from a block grant of around £9 ½ billion, a cut of some 8 per cent. The Treasury has shown no readiness to discuss a rational scheme for assigning corporation tax liability and avoiding ‘brass plating’ which would be a necessary condition for any sensible devolution of corporation tax. Instead it has simply assumed a degree of brass plating and sought to charge NI for it in advance. This suggests that its intention is to block the devolution rather than make it practical.

Meanwhile, however some partial devolution of APD has been agreed. Again this was the result of competition with the Republic. United Airlines threatened to withdraw its transatlantic flight from Belfast while continuing to fly from Dublin. The abolition of APD on long haul flights was the incentive not to keep the Belfast flight. A concession denied to Scotland was conceded as an expedient for a particular problem.

Some justification can be produced for devolving those taxes where Northern Ireland is in competition with the Republic. It is bizarre, however, when devolution settlements within the same state become not only different but diametrically opposed. At that point, in the words of Gwyn Thomas, “satire rolls its eyes and hits the floor”.

2. Limits to devolution

(i) Principles

A survey of fiscal arrangements in federal states shows a remarkable diversity. It is hard to infer from international experience that any tax is absolutely excluded from being devolved in a federal structure or that it must be devolved. Exceptions can be found to most rules.

Devolution of many taxes, if it leads to different rates being applied, can create effective incentives to alter the location of economic activity purely for tax reasons and that may result in a loss of efficiency if the original location was better in some economic sense. Shifting economic activity has distributional effects but there is said to be an efficiency loss if the gainer cannot compensate the loser and still remain better off. Even where a loss of efficiency occurs, a value judgement is required to trade off the freedom of action conferred by devolution against any economic distortion that arises. Differing value judgements on that score as well as historical accident help to explain the diversities observed.

When considering a tax for devolution, considerations are:

- Avoiding economic distortion, excessive 'tax competition' and inequities within the state.
- Practicality and cost of assessment and collection.
- Appropriate allocation of risk.

We can also distinguish three categories of tax devolution. Note these are prescriptive definitions since there is not complete uniformity of definitions in the literature or in political discourse.

- Assignment of revenues (with no power to alter taxes).
- Devolution of powers, limited by a framework agreement.
- Unlimited control of a tax.

Assignment raises no problems of distortion. There may be issues of practicality and cost; it clearly requires identification of the geographical source of tax revenues which otherwise may not be identified and recorded. It may well require devising and policing rules for the geographical incidence of tax liabilities where people live and work in different locations and when companies have activities in different tax areas.

Assignment of revenues also alters the distribution of risk since it forfeits the pooling effect which arises when tax receipts are centralised and revenue distributed according to other criteria. Unless fluctuations in revenue are perfectly correlated across regions, the pooling introduces some stabilisation into the revenues of regions. Assignment can introduce volatility into budgets. That may not matter if a tax is small but could become a problem if the tax is a large part of total revenue. That consideration dissuaded both the Calman Commission and the Devo Plus Group from proposing the assignment of oil-tax revenues to Scotland, for example.

A framework agreement may limit which characteristics of a tax are under devolved control. For example Calman, Silk and ICFFW accepted HMRC arguments that income tax rates could be devolved without excessive administrative costs so long as control of tax bases and thresholds was retained centrally. In an initial phase of fiscal devolution both Commissions judged that devolving rates without devolving other variables gave the best balance of freedom and cost. It must be acknowledged that this judgement is by no means unchallengeable but further data and research would be required to determine the cost differences involved.

A framework agreement could also limit the amount by which any tax variable may be changed by a DT. For example the ICFFW recommended that corporation tax could be devolved but only within a framework limiting rate changes according to criteria derived from relative GVAs.

The motive for such limitations can be either to restrict increases in administrative cost (as in the income tax example) or to limit negative spill-over effects and economic distortion (as in the corporation tax example).

The possibility of devolution within a framework agreement tends to be under-examined in the literature and in political discussion, where the devolution choice is often regarded as binary. Yet insisting on unlimited control of a tax is likely to narrow the range of taxes that are suitable for devolution since it means there can be no limit on tax distortions or tax competition so taxes have to be selected where spill-overs are small or unimportant.

The diversity of arrangements in existing federal arrangements suggests that a very wide range of possibilities exist. You can devolve almost anything but can you devolve everything and remain a federation? If all taxes are fully devolved there have to be contributions from each region to support common or joint functions and in many federations there is some equalisation scheme whereby the richer regions provide support for the poorer. This is often underpinned by a constitutional commitment to ensure that all citizens have access to some basic level of state services like policing

and social welfare. Nonetheless, complete tax devolution is highly unusual; there are almost always federal taxes.

	Supranational			Central government			State or Regional government			Local government			Social Security Funds		
	1975	1995	2010	1975	1995	2010	1975	1995	2010	1975	1995	2010	1975	1995	2010
Federal countries															
Australia	..	..	..	80.1	77.5	80.3	15.7	19.0	16.2	4.2	3.4	3.5	0.0	0.0	0.0
Austria	..	0.0	0.3	51.7	64.8	66.2	10.6	1.8	1.6	12.4	4.1	3.3	25.3	29.3	28.6
Belgium	1.4	1.0	0.8	65.3	60.0	56.5	..	1.8	5.1	4.4	4.8	5.1	28.8	32.3	32.4
Canada	..	..	..	47.6	39.1	41.3	32.5	37.1	39.4	9.9	9.8	10.2	10.0	14.0	9.1
Germany	1.2	0.6	0.5	33.5	31.4	31.4	22.3	21.6	21.2	9.0	7.4	7.9	34.0	39.0	39.0
Mexico	..	..	..	..	80.1	81.1	..	2.1	2.4	..	1.1	1.2	..	16.6	15.4
Switzerland	..	..	..	30.7	31.4	36.2	27.0	23.8	24.4	20.3	17.6	15.6	22.0	27.3	23.8
United States	..	..	..	45.4	42.0	37.8	19.5	19.9	20.5	14.7	13.2	16.1	20.5	24.9	25.7
<i>Unweighted average</i>	1.3	0.5	0.5	50.6	53.3	53.8	21.3	15.9	16.3	10.7	7.7	7.9	20.1	22.9	21.8
Regional country															
Spain ¹	..	0.5	0.4	48.2	50.4	34.7	..	4.8	18.2	4.3	8.5	9.5	47.5	35.8	37.1
Unitary countries															
Chile	..	..	..	..	89.9	88.6	..	..	..	..	6.5	6.2	..	3.6	5.2
Czech Republic	..	..	0.5	..	57.7	53.5	..	..	..	..	0.9	1.3	..	41.4	44.6
Denmark	1.0	0.5	0.4	68.1	65.4	70.8	..	..	..	30.4	31.9	26.7	0.5	2.2	2.1
Estonia	..	..	0.5	..	72.1	68.3	..	..	..	..	13.1	13.4	..	14.8	17.9
Finland	..	0.4	0.2	56.0	46.6	45.7	..	..	..	23.5	22.3	24.4	20.4	30.8	29.8
France	0.7	0.4	0.2	51.2	42.2	34.8	..	..	..	7.6	11.0	10.8	40.6	46.4	54.2
Greece	..	0.6	0.4	67.1	66.8	64.4	..	..	..	3.4	0.9	1.1	29.5	31.7	34.1
Hungary	..	..	0.2	..	63.8	62.8	..	..	..	..	2.5	6.4	..	33.6	30.5
Iceland	..	..	..	81.3	79.2	74.5	..	..	..	18.7	20.8	25.5	0.0	0.0	0.0
Ireland	2.3	1.6	0.5	77.4	83.2	81.0	..	..	..	7.3	2.4	3.2	13.1	12.8	15.4
Israel	..	..	..	..	80.0	75.3	..	..	..	..	5.9	7.5	..	14.1	17.2
Italy	..	0.4	0.3	53.2	62.7	53.0	..	..	..	0.9	5.4	15.4	45.9	31.5	31.3
Japan	..	..	..	45.4	41.2	33.0	..	..	..	25.6	25.3	25.9	29.0	33.5	41.1
Korea	..	..	..	89.0	69.2	60.4	..	..	..	10.1	18.7	16.7	0.9	12.1	22.8
Luxembourg	0.8	0.4	0.1	63.6	67.1	67.1	..	..	..	6.7	6.4	4.4	29.0	26.1	28.4
Netherlands	1.5	1.2	0.9	58.9	54.2	59.0	..	..	..	1.2	2.7	3.8	38.4	41.9	36.3
New Zealand	..	..	..	92.3	94.7	92.8	..	..	..	7.7	5.3	7.2	0.0	0.0	0.0
Norway	..	..	..	50.6	58.4	86.4	..	..	..	22.4	19.6	13.6	27.0	22.0	0.0
Poland	..	..	0.3	..	62.1	52.0	..	..	..	..	7.5	12.7	..	30.4	34.9
Portugal	..	0.8	0.3	65.4	73.5	67.7	..	..	..	0.0	4.2	5.7	34.6	21.5	26.3
Slovak Republic	..	..	0.8	..	62.5	53.7	..	..	..	..	1.3	2.9	..	36.2	42.6
Slovenia	..	..	0.4	..	51.8	48.8	..	..	..	..	6.4	10.9	..	41.9	39.9
Sweden	..	0.4	0.4	51.3	46.9	52.1	..	..	..	29.2	30.9	35.4	19.5	21.8	12.1
Turkey	..	..	..	..	75.1	66.8	..	..	..	..	12.8	9.5	..	12.1	23.7
United Kingdom	1.0	1.0	0.6	70.5	77.5	75.3	..	..	..	11.1	3.7	5.1	17.5	17.8	19.0
<i>Unweighted average</i>	1.2	0.7	0.4	65.1	65.8	63.5	..	..	..	12.9	10.7	11.8	21.6	23.2	24.4
1. Spain is constitutionally a non-federal country with a highly decentralised political structure.															
Source: OECD Tax statistics															

Indeed, the difficulty of finding taxes whose devolution is administratively inexpensive, which do not lead to distortions of unified markets and which do not result in unacceptable risk or volatility mean that in most federations a considerable vertical imbalance remains in which regions have more responsibilities for spending than their revenues can finance (see Table 2). The gap is bridged by transfers from the federal level financed by federal taxes. Against that background 'devo max' implies such a strong value weighting on freedom of action as opposed to all other desiderata that one may legitimately wonder why the region concerned does not take such values to their natural conclusion and declare independence.

(ii) The case of the United Kingdom

The UK is not a federal state and devolution departs from a situation of extreme centralisation. Local or regional taxes in the UK represent an unusually small proportion of the total, even for a unitary state. In 2007 only 5 OECD countries had a higher proportion of central taxes in total revenue than the UK, 25 had a lower proportion.

Property based taxes - community charge and non-domestic rates - are the only substantial taxes below central level in the UK. Property taxes are almost universally treated as local taxes since they are relatively easy to collect, evasion is difficult with such fixed assets.

The three DTs in the UK are in very different positions when it comes to the cost and feasibility of tax devolution. Differential rates of indirect taxation such as excise duties will tend to alter purchase locations. This is evidently less of a consideration in Northern Ireland where a sea trip or flight would be required to arbitrage tax differences with the rest of the UK. It may be of limited concern in Scotland where only 3.7 per cent of the population lives within 25 miles of the border and only 22 per cent live within 50 miles. In Wales the equivalent proportions are 48 per cent and 90 per cent respectively. The economic distortionary effects of tax variations will be much higher in Wales than in Scotland and probably higher in Scotland than in the North of Ireland.

The facts of economic propinquity affect the calculus for indirect taxes and are only slightly less relevant for direct taxes on income. Scotland and Ireland could no doubt sustain bigger income tax differentials with England than would be possible in Wales without perceptible effects on location decisions and house prices. In fact, the ICFFW concluded that variations in higher-band income tax rates in Wales would be likely to have unexpected 'perverse' effects; lowering rates would increase revenues over time by attracting people over the border and vice versa. The Calman scheme of a single Scottish income tax that affected all marginal rates equally was therefore unmanageable in Wales where any devolution must entail differential control of basic and higher rates. That has been accepted by Silk and the pressure in Scotland for greater freedom of action will no doubt move Scotland in the same direction.

Welsh Labour politicians currently, however, have little appetite for income tax devolution for reasons of perceived party disadvantage and that aversion is even stronger among Unionist politicians in Northern Ireland.

There is a growing consensus among specialists, however that income tax should be the cornerstone of a devolved tax system. It applies to most people and therefore is the tax most suited to increasing public engagement with a devolved government and to increasing the accountability of such a government. Revenues are also sufficiently large to make a meaningful contribution to devolved budgets.

As the debate over devolution has proceeded, greater boldness has been evident over income tax devolution. Calman recommended a sharing of the income tax base with Scotland taking about 41 per cent of income tax revenue, amounting to some 10 per cent of the budget. ICFFW recommended Wales take half of its income tax points (and revenue at standard rates) amounting to less than 17 per cent of the devolved budget. In Scotland most suggestions for devo-plus encompass complete devolution of income tax. While the Silk proposals would result in Wales keeping just under half its income tax receipts, a few bold spirits ask why all of current income tax points should not be devolved. That would still finance only 40 per cent of currently devolved Scottish spending and 33 per cent of devolved Welsh spending.

Note that this recommendation, which seems perfectly sensible, is ambiguous. It could mean that the UK has surrendered the tax base to DTs or it could mean the tax base continues to be shared but the

UK has conceded all existing tax points to DTs. The later would mean that if the UK increased income tax, it would expect to get additional revenue from the DTs as well as English residents. By the same token, if England reduced income tax it would increase the block grant to DTs since the deduction from the block grant would now be lower at standardised tax rates. In a unitary or federal state, continuing to regard the income tax base as shared has clear advantages. If the UK faced a national emergency which required higher taxes, for example, all citizens could thereby be required to contribute. Sharing a tax base has been demonstrated to work in Canada and is perfectly sensible although it appears to have become unfashionable in Scotland.

The area where the devolution debates seem most comically divorced concerns corporation tax. It is abundantly obvious that an unconstrained devolution of corporation tax makes no sense at all. The northern regions of England already enjoy lower levels of public spending than Scotland although they are poorer. Imagine the effect on them if Scotland were able to levy much lower rates of corporation tax than applied to them. They would either have to suffer or the UK would 'race to the bottom' and surrender much of its corporation tax base. Under the conventional interpretation of the Azores judgement, the UK government can allow DTs to reduce corporation tax so long as they absorb the effects on their own budgets without compensation. Yet it would not be allowed to reduce taxes for regions of England since these are not autonomous and do not have the budgets to take the strain.

The argument is not so very different for Northern Ireland even though the UK government has agreed 'in principle' to devolve corporation tax there. As noted, the Treasury is fighting a so-far successful rear guard action by insisting on a 'price' for the tax in terms of a cut in the block grant as to make it unaffordable.

Since the UK no longer has a regional policy beyond what it has outsourced to the EU, whose structural convergence funds are available in the poorer regions of the UK, some tax expenditures to promote development in poorer regions could be justified. But evidently those expenditures must be reasonable which means a devolution of corporation tax must be within a framework agreement, limiting what is possible as a function of two things: relative poverty and the impact on the UK tax base. Cuts in corporation tax in Scotland would be strictly limited because Scotland is not poor and there is no reason why it should enjoy tax advantages over poorer neighbours and in Wales would be limited by the extent of integration which would mean that substantial reductions in Wales could have massive distortionary effects around the border. Northern Ireland would have somewhat more latitude though that should not be exaggerated.

It would also be necessary to fix a better basis for assigning corporation tax liability than place of head office registration since that leads to brass-plating and avoidance. Many federal countries have formulae for assessing liability, notably the United States which does so on the basis of location of employment, capital assets and sales. The ICFFW proposed using proportion of the payroll, which would ensure that any relocation to enjoy lower taxes would be real. If relative GVA were the determinant of how far DTs could reduce a devolved corporation tax under a framework agreement, permitted Scottish reductions would be small. Wales and Northern Ireland would be permitted to cut further unless a way were devised to limit reductions in view of their effect on the tax base, in which case Wales would be restricted more tightly.

Devolution of corporation tax is possible. Eight member states of the OECD do level sub-federal corporation taxes. Yet it would surely only be workable within a framework agreement as proposed by the ICFFW and there has been a general reluctance to contemplate working that out.

Nevertheless if the UK just devolved all current income tax points to the DTs they would be able to finance a third or more of devolved budgets or perhaps 15 per cent of total public spending that can be attributed to them. That would make them not untypical of state and provincial governments in federal systems, as Table 2 reveals. Other smaller taxes would then increase that proportion.

An important power, which the Scotland Act concedes, albeit with restrictions, is the power to invent and levy new taxes. It is unlikely that this power will result in a major new source of revenue, though it could be useful at the margin and provide a laboratory for tax innovation. About the only large untapped revenue base in developed countries is the market in recreational drugs which are usually illegal. Producer surplus in that market is captured by criminal suppliers, not the state.

3. The social union

The Calman report characterised the United Kingdom as being several sorts of union; a political union of course and an economic union in that the legal framework facilitated a single market in goods' labour and capital. It laid particular emphasis on the social union, the most salient aspect of which was a shared and common social security system. Throughout the UK people and employers make the same national insurance contributions and draw the same unemployment and sickness benefits and the same old age pensions.

This 'welfare state' is the common heritage of all UK citizens and was in the view of the report an important social cement and component of a shared community.

The UK social security system is not funded and while there is a social security fund in name it is largely a fiction; certainly the future liabilities of the system are not funded or backed by a portfolio of assets. The system works on a pay as you go basis whereby current benefits are paid out of current taxes. National insurance contributions are therefore little different from another form of income tax levied only on those in employment. Indeed many tidy-minded economists have argued for integrating NICs and income tax and ceasing the fiction that national insurance contributions are particularly linked with social benefits.

Yet it does seem clear that the public still to some extent thinks of NICs as contributions that 'earn' the right to welfare benefits. The association persists in the public mind and is reinforced by the fact that the size of old-age pensions, for example does depend on the history of national insurance contributions.

Calman pointed out that a social security system, like any insurance pool, works better with a larger system. The more people participate, the greater the diversity of circumstances is likely to be and the more robust the system is likely to be in the face of misfortunes befalling some section of the community. Any devolution of social security that entailed splitting up the body of contributors and potential beneficiaries would increase risk. That is true whether the contributions are hypothecated payments or simply a share of general taxation. Calman argued, in effect, that it was simply more efficient to organise the welfare state on a United Kingdom basis than to break it up. And because of the association in the public mind between benefits and NICs the commission therefore argued that national insurance contributions should remain undevolved. That would avoid public confusion and make it clear, indeed symbolise the fact, that social security was a UK matter.

Silk and the ICFFW followed and accepted this line of reasoning and so to a large extent has the Devo Plus Group.

Yet while the argument about scale seems to be compelling this is one conclusion of Calman that is now widely repudiated in Scotland. At the risk of failing to do justice to the criticisms they seem to derive from the view that social attitudes are systematically different in Scotland and England, that the first is more communitarian and social democratic and the latter more neo-liberal. It follows from that view that the Scots would be prepared to pay more for a more extensive and generous social security system than the English and therefore the two systems should split and social security should be devolved. The argument may be more subtle or refined than that but if so I have missed the refinements.

It has been pointed out that polling evidence lends only slight support to the idea that Scots are more communitarian on average than their English neighbours. Differences in attitudes in fact appear to be quite minor. Even if we accept the proposition, however, the argument for separation does not follow. If it can be designed it seems preferable for the more communitarian country to share a social security system with a more liberal neighbour to enjoy the benefits of risk-spreading and, indeed to make its own contribution to the generation of those benefits. It can always introduce supplementary benefits where it wishes to augment the basic system. That does of course raise administrative issues. If rules for qualification for benefit, for example are very different in the basic and supplementary system it might be necessary to establish a separate benefits administration. Where qualifications are similar and it is simply rates of benefit or compensation that are different it may be possible to administer the supplementary system through the local offices of the UK agency. The agency would have to receive additional payments from the Scottish government to pay for the augmentation but those additional payments would be necessary in any event.

If having one's own social security system is regarded as an essential element of identity, as newly independent countries used to think it indispensable to have their own airline, there is nothing more to be said. The economic arguments in favour of continued integration seem conclusive in their own terms however, so separate social security is rather an expensive symbol. Perhaps the airline would be cheaper.

It is particularly odd that proponents of Devo Max favour a situation where Scotland remains in a defence union with England, which entails taking a share of heavy expenditures of doubtful utility to Scotland while repudiating a social union. Not only does the social union have the advantages of risk-diversification referred to but since Scotland has less favourable demographic and public health characteristics than England, the shared system surely affords a net transfer to Scotland. In Wales and Northern Ireland there has been no comparable demand for devolution of social security. As those countries have smaller, poorer populations than Scotland but also have higher dependency ratios than England it is perhaps more obvious to them that dissolving or devolving the social union would be financially disadvantageous.

4. Symmetry

Most designed federations, such as the United States or the Federal Republic of Germany have considerable symmetry in their fiscal arrangements.

States or federations that have evolved under the pressure of demands for regional or constituent-nationality autonomy can display considerable asymmetries. The UK and Spain are two striking examples of the latter, while Canada is a less extreme case where an essentially symmetrical set-up has been distorted under the pressure of Quebec separatism. It seems that that no-one designs an asymmetrical system but they evolve as being better than the alternative, a break-up of the state.

Asymmetry does not necessarily entail instability as long as those areas with less devolution are content with the situation and do not resent the situation of the more devolved.

What would seem to be desirable is the application of a consistent set of principles, which result in different arrangements when confronted with the different circumstances in different DTs.

Such principles should surely include the following. Local discretion is to be preferred and can be conceded for imobile tax bases where the effects of tax changes would be felt wholly or mainly in the devolved territory. Where tax bases are mobile and economic spillovers occur local discretion should be qualified to ensure that negative spillovers are restricted. In general DTs should not be able to make tax changes that inflict greater losses on the rest of the state than the gains they achieve for themselves. Where the DT is poorer than the rest of the state, some negative spillovers may be

accepted as, in effect, 'tax expenditures' by the richer parts of the state to support economic activity in the DT. Those tax expenditures should, however be of the scale that a reasonable regional policy would contemplate.

The circumstances of the UK DTs differ widely in a number of respects:

1. Different degrees of economic proximity and integration means the distortionary effects of tax variation are different in different territories, as noted above.
2. Levels of income per head differ and there is an associated difference in the extent of budget deficits and subsidy from the centre. If Scotland receives its geographical share of North Sea oil its budgetary position is not very different from that of the UK as a whole. Both Wales and Northern Ireland are running budget deficits of well over a third of their GVA.
3. The popular demand for freedom of action or autonomy is different. It is much more general in Scotland than in Wales where nationalist feelings are complicated by language difference and in Northern Ireland an important segment of the community is inclined to reject any fiscal devolution as weakening a Union they perceive to be under threat.

It is habitual for economists to approach all questions as applications of the theory of choice; nature presents a series of trade-offs among a number of objectives which are competing or conflicting. The best possible choice has to be made given the preferences of the chooser. If the rational actor, beloved of economists, were to frame the optimal degree of fiscal devolution in each case he would note that value differences alone would imply a selection of different positions on the trade-offs available. He would further note that the available trade-offs are themselves different given 1 and 2 above. Symmetry therefore is bound to entail a seriously sub-optimal position for someone and perhaps everyone. I am enough of an economist to conclude we should not worry about it.

Fairness is a different issue.

Arrangements in an evolving asymmetrical federation are not determined by anybody's optimisation but by negotiation. Two factors tend to dominate: relative wealth (he who pays the piper...) and strength of feeling about what one wants. The latter is associated with strength of feelings about identity and often means that those who feel most different are most insistent about it. In practice, wealth and will are correlated; identity unlike food and sleep is a luxury good; people value it when they can afford to. It is not invariable but it is usually the wealthier regions in long-established federations that are keenest on breaking away. The combination of will and money tends to mean regions like the Basque country in Spain and Scotland in the UK are able to negotiate better arrangements than other areas.

This natural development can go a long way before there is a mutual exasperation leading to conflict or break-up. The rupture of Czechoslovakia however shows the effect mutual exasperation. It is an old saying that anyone who thinks 'honesty is the best policy' may be a good calculator but is not really honest. Is Britain a nation? Whether it be yes or no, anyone who wishes to remain because it pays them and for no other reason is not a member of it. In that sense we must face the fact that perhaps 30 per cent of Scots and some smaller proportion of Welshmen are not members of a British nation, any more than Irish nationalists are. But multinational states can survive a long time and the current reality is that the fault lines run within the DTs, not between the DTs and the rest of the UK.

Nevertheless we can no more expect fairness than symmetry in the current situation, though the well-meaning will try and nudge the situation in that direction. As long as Scotland can nurse a sense of frustration, irrespective of how it is treated, it will continue to enjoy favourable treatment. Let that not prevent us from looking at what a fair system might look like.

5. Equalisation flows and the block grant

Most federations have a system of transfers to equalise or partly equalise revenue per head (revenue equalisation).

Given balanced budgets, equalisation of revenue implies equalisation of expenditure per head. Such a system therefore pays no regard to the possibility that different populations may have different needs that require different expenditures to bring them to similar levels of well-being.

Within the countries of the UK local distribution of expenditures is based on formulae that attempt to capture the elements implying different needs. Demands for the reform of Barnett usually take the form of suggesting it too should take account of need, somehow defined. Among Federations, only Australia attempts an exhaustive pattern of equalisation flows based on calculations of need by a state body independent of the government of the day. This requires a large body which, after an involved process, delivers obiter dicta which in practice are seldom if ever challenged. Not everyone is a fan.

Need is of course a contestable and contested notion and the difficulties that it gives rise to are the probable explanation for why most states do not attempt to assess it systematically. The UK tradition of expenditure equalisation based on an assessment of relative need is one reason that the Barnett formula is based on expenditures though the proximate reason was that it was devised to avoid argument during an expenditure round. In choosing not to update Barnett for changing needs successive British governments have made it anomalous within the British system - allocations within countries are needs-based, allocations among countries are not.

A number of observers have been uneasy that the block grant is derived from English expenditure patterns, arguing that this limits the ability of DTs to adopt different policies from those of England. However, this is a dubious position. Hard as it is to assess need in the context of a given class of expenditures, it is impossible to do so in a completely general sense. One can ask does one population need more education spending than another in light of the proportion of young children or the proportion with learning difficulties. The same population, being younger, may have less need for spending on health, which tends to increase for those later in life. Without an objective or target level of attainment in a specific field like health or education, need is not an operational term. It is not evident, therefore how one could adapt revenue equalisation for need - more particularly if the federation has an integrated social security system that ensures everyone has a minimum income at the individual or family level.

A needs-based equalisation must therefore depart from expenditures. And it seems perfectly reasonable to exclude those expenditures that are supposed to be for the benefit of the federation as a whole and are carried out by the federal government. That means one is driven to consider those expenditures for which responsibility is devolved, which is the Barnett approach. While Barnett departs from expenditures, however, it does not actually make an allocation based on relative need. While the block grant is derived from and is dependent on English spending patterns it is unhypothecated and can be spent on anything the DT chooses. With tax devolution, the DT should have the option if it considers English expenditure to be inadequate (or excessive) to raise (or lower) taxes and spend more (or less) in its jurisdiction.

Now it is true if the UK government decided to abolish the National Health Service in England at least two of the DTs would find their block grants reduced and would be unable to sustain an NHS themselves. But that is not a quirk of the Barnett formula. The situation derives from the fact that those DTs receive large subsidies from the centre and cannot maintain current expenditures from their own resources. It is not obvious why the English population should continue to enable them to do so if English residents themselves no longer enjoy such a level of expenditure. Moreover if England were to abolish the NHS and severely reduce public spending on health it would presumably reduce taxes, in which case a revenue equalisation based on standardized tax rates would be reduced too.

Basing the block grant on English expenditures does not in itself give rise to any particular problems and is a necessary condition for needs adjustment.

It does, however, have a political penalty in that it rules out a neat solution to the West Lothian question. Many 'English' Bills could have the consequence of altering the balance of expenditures on public services in England in a way that alters the aggregate 'consequential' for the block grant of the DTs. Their interests are therefore thoroughly engaged and it is reasonable that they should vote. If a UK government wanted to abolish the NHS in England, the consequence for the DTs would be great even though health policy is devolved. Since their own ability to maintain an NHS would be critically affected they surely have a right to vote on an 'English' matter. This may seem an overblown example but the same principle will often apply when less dramatic changes in English policy are being considered.

Where the net subsidy is small and social preferences deviate sharply, the solution is to replace as much of the block grant as possible with tax assignment since that source of revenue will be more stable even if the centre cuts expenditures and hence any expenditure-based grant. Tax assignment confers greater autonomy over expenditure at the cost of greater volatility but it is reasonable to go for more autonomy the more different are social preferences. As noted, however, this approach has limited purchase for DTs running large deficits and receiving large transfers.

England is such an overwhelmingly large part of the UK and for most of history has been the richest part that the issue of grants and transfers has been about how England should equalise the situation of the DTs with its own situation. But what would happen if the oil price, for example, went to \$300 a barrel and Scotland became much richer? If it were still in the Union, surely the question would then become what net contribution Scotland should make to equalisation flows.

To answer that, consider what an equitable system would look like. Suppose England takes its own expenditures in the devolved policy areas as the benchmark and asserts that all UK citizens should be able to enjoy the same level of social services as those expenditures imply (noting that MPs of other countries would retain a vote – precisely because England is a benchmark). The next step would be to adjust those expenditures for relative need factors to get expenditure targets for each DT. This need not be complicated, as demonstrated in the ICFFW report. Then subtracted from those targets would be the tax revenues of the DT at a standard rate of tax (that levied in England) in the case of devolved taxes or simply the revenues in the case of any assigned taxes. There would then be a charge to each DT for its share of combined services purchased at the union or federal level - defence and the like - presumably on a population basis. Note if the social security system remained integrated, social security payments and receipts would not enter the calculation since they are transfers between the federal state and individual citizens not regional governments. (This corresponds too to current practice whereby the Barnett formula is concerned only with Departmental Expenditure Limits not so-called Annually Managed Expenditures like social security).

Formulaically the grant/flow to a given DT would be:

(English expenditure per head x population ratio x need adjustment factor) - tax resources of DT - payment for population share of federal expenditures.

There is no reason why that quantity should be positive. If English spending is low and the DT revenues are high, a reverse flow could be implied. This is not a matter that has come in for much consideration. Note that, abstracting from current deficit difficulties, if English expenditure is low, its tax rates will tend to be so as well so this arrangement does not prevent a DT raising tax rates and using additional revenue to finance its own expenditures.

At the present time, of course, the grant is not needs adjusted and no explicit account has had to be made for any revenue capacity in the DT apart from council tax and non-domestic rates. Similarly no explicit account is taken of common federal expenditures. There seems no reason, however, while all these elements could not be grafted on to present expenditure-based procedures. Indeed very substantial reform could be achieved with remarkably small changes in procedures.

Needs-based expenditure equalization can be in direct conflict with the notion of accountability of the DT government. Why should a DT government care how its economy and tax base evolve if any revenue shortfall is made good by the equalisation procedure? Of course, it will care but perhaps not as much as it might. This consideration forces a fundamental consideration of the value placed on autonomy or local discretion and the requirement that all citizens of the state should have potentially equal access to certain key social services as a right of citizenship.

If local accountability is to mean anything, it is necessary that the consequences of the actions of the different tiers of government fall as far as possible on themselves and their electors not elsewhere. Ensuring that is so introduces some complexities into the way the block grant must be treated. The assessment of standardized revenues of devolved taxes that are to be subtracted from expenditure targets when calculating the block grant must be done with the appropriate allocation of risks and consequences in mind. If this is done incautiously, adverse incentives indeed may be created for tax policy. This issue was dealt with at length in the ICFFW report. In practice, the effects of local policies can be made to fall largely on the local population, which, however, need not be uniquely penalised by any action of central government. Correctly allocating risk and responsibility, however, could well result in a cumulative divergence across the state in prosperity and in the capacity to provide key social services to a similar level. If the union or federation is to be preserved, it seems reasonable not to eliminate but at least to limit such divergences. The ICFFW proposed to resolve this central dilemma with the following compromise: after a needs-based grant allocation has been made, taking devolved tax revenues into account, matters are allowed to take their course for three Parliamentary terms (some 15 years). There is then a recalibration of the block grant to ensure equal social services are available given current tax bases, assuming standardised rates of tax. In effect this allows divergence for 15 years (beyond the political horizon of many politicians and therefore leaving them with appropriate incentives) but resets the clock at the end of the period.

This proposal has not been echoed in any other report and most of the reforms enacted or proposed would entail the possibility of a cumulative and unlimited divergence. Implicitly this is being accepted as a cost and consequence of democratic accountability.

Outside HM Treasury, there is a widespread view that all the relevant calculations should be done by an independent body. However, they are of a simplicity such as not to require a large bureaucracy on the Australian model but could be done by a unit within the Office of National Statistics, OBM or some other state body independent of the government of the day. Moreover, increased reliance on own revenue introduces volatility and requires some borrowing powers for budget management purposes. At present public sector cash management is highly centralised in the UK with DTs drawing their grant from the Treasury on a just in time basis and effectively losing any allocation not spent. As devolution proceeds, it would seem appropriate for the cash grant to be disbursed regularly through the year with the DTs responsible for their own cash management and able to save any unspent funds.

6. Conclusion

It is hardly a caricature to say there are few conclusions and many open questions. Perhaps we can hazard the following:

- Asymmetry will persist and indeed increase because the economic circumstances of the DTs as well as their preferences differ.
- It will be difficult in practice, perhaps impossible, to ensure fairness but the good need not be the enemy of the best and simple needs adjustments are possible when calculating equalisation flows based on expenditures.
- Individual DTs should be able to opt for more or less assignment of tax revenues where full tax devolution is not appropriate, depending on how they trade off increased volatility of revenues against possible increased independence from English policy decisions.
- A bold devolution of income tax is the easiest way to give DTs substantial responsibility for their own budgets; this could involve devolving all existing tax points but continuing to share the tax base.
- If framework agreements are accepted as appropriate more taxes can be devolved without unacceptable efficiency losses, including corporation tax.
- The economic arguments for a shared social security system are strong.

- Accountability and local autonomy are the enemies of even a potentially equal access to public services. To limit indefinite divergences in access to social services some period recalibration and truncation of full responsibility would be necessary.