Chapter 28
The Politics of Scotland's Public Finances

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Abstract

Politics and fiscal mechanics play interwoven roles in the public finances of devolved Scotland. Asymmetric devolution, in the context of divergent economic performance and relative population size and growth rates, has contributed to the longevity of the Barnett formula. Though criticized for either overfunding or underfunding Scotland, its resilience stems from its role as political convention in reducing overt conflict, and from maintaining the expenditure autonomy of the Scottish Parliament. The low level of self-financing from devolved taxes stimulated allegations that the Parliament lacked accountability and fiscal responsibility. Extended taxation powers advanced through the cautious Calman Commission to the rushed Smith Commission, and were driven by imperatives for a 'counter-offer' after the 2014 Independence Referendum. The early operation of the 2016 Scottish Fiscal Framework and the divergence of UK and Scottish income tax rates highlights the practical issues of devolved tax policy in the context of UK fiscal centralization. These developments have been driven by changes in Scottish political circumstances rather than by changes in fiscal fundamentals.

INTRODUCTION

The chapter highlights the roles that politics and fiscal mechanics play in Scotland's public finances. The wider context of UK devolution includes a mood change about intergovernmental fiscal transfers, aligned to post-1980 challenges to the welfare state. Extensive territorial transfers of fiscal resources are required when governments fund universal services such as health and education and there is a commitment to broadly equivalent quality of services, because the taxable capacities of sub-national jurisdictions vary markedly. Towards that objective, Musgrave (1961) designed generous and internationally influential transfer schemes to decentralized jurisdictions, some of which compensated for all differences in needs, resources and costs. Yet contemporary fiscal writing by economists is more likely to stress the efficiency costs (populations stay in uneconomic locations) and perverse incentives (rent-seeking by jurisdictions) of territorial equalization (Albouy 2012).

The political world has also changed. Post-2010 UK austerity saw the seizing of fiscal crisis as an opportunity for state-size reduction. Scottish politics is dominated by cleavages associated with claims for independence, while Brexit was outside the realms of political imagination when the UK devolution settlement was legislated in 1998. The core argument of the chapter is that the messy fiscal arrangements

that characterize UK devolution finance are explicable in terms of context and legacy, and attempts to reform that system without recognition of 'why we are where we are' will not succeed.

The chapter addresses:

- How constitutional asymmetry interacts with policy controversies about the size of the state and the extent of acceptable variation in the bundle of services enjoyed, and taxes faced, by citizens across the UK;
- How Scottish political parties positioned themselves on fiscal decentralization, particularly the extent to which the Scottish Parliament should depend on block grants from Westminster or have 'fiscal autonomy';
- The path of Scottish public expenditure and its financing during the first twenty years of devolution, characterized by one decade of plenty and one of famine;
- The reasons why the pre-devolution Barnett formula has defied predictions of its demise, surviving in a more complex form as part of the new Scottish Fiscal Framework;
- The extent to which the package of taxation powers now held by the Scottish Parliament brings autonomy, accountability, and legitimacy or has landed it in a 'fiscal trap', as claimed by Macwhirter (2017).

Although conflictual constitutional times are unpredictable, twenty years of devolution is a convenient point at which to appraise what has happened so far and to assess future prospects.

THE DILEMMAS OF FISCAL DECENTRALIZATION

Fiscal decentralization within a nation state results in individuals and households being treated differently according to the sub-national political jurisdiction to which they are attached. The effects are more pronounced when taxation as well as expenditure functions are devolved from the centre. These differences may generate discontent, not least because the resulting patterns are often neither transparent

nor supported by explicit justification. Symmetrical fiscal decentralization has been heavily theorized (Oates 1972; King 1984) and studied in diverse contexts. In contrast, asymmetrical fiscal decentralization, under which parts of a nation state are devolved and other parts are less devolved or not devolved at all, has received much less attention (McGregor and Swales 2005). Both symmetric and asymmetric cases differ markedly from the fully centralized case in which—at least in theory—there can be uniform treatment of individuals and households across the nation state. There is much greater sensitivity about variations in cash benefits than in the resource costs of public services, though the purchasing power of equal cash benefits varies significantly according to local costs.

Unlike in a federal country, UK devolution only applies to Scotland, Wales, and Northern Ireland, constituting 16 per cent of the UK population and 47 per cent of land mass. UK individuals are hence treated significantly differently according to their country of residence; interpersonal horizontal equity across the nation state is explicitly breached. Territorial equity requires ensuring that sub-national governments have the resources to deliver to their citizens public services of comparable quality to those in other jurisdictions. The actual pattern of public services will depend on 'local' choices, so interpersonal horizontal equity applies only within that jurisdiction in a way that reflects federal rather than unitary notions of citizenship. For example, though the National Health Service is often portrayed as core to 'Britishness', there are in fact four National Health Services, one for each component nation. This differentiation long preceded devolution in 1999 in the cases of Scotland and Northern Ireland, though the mechanisms were not transparent and the constitutional context was different (Kellas 1989).

Historical legacies result in there being two small high-needs/low-resources units (Wales and Northern Ireland), one small high-needs/average-resources unit (Scotland) and one numerically dominant average-needs/high-resources unit (England). Moreover, there are pronounced variations within each country. Such asymmetry creates technical problems of fiscal design, and guarantees that fiscal relationships will be controversial, probably dissatisfying all.

[Insert Figure 28.1 around here]

For simplicity of exposition, Figure 28.1 works on the basis that there is no sub-national tier in the non-devolved part of the nation state and similarly that there is no local government tier in the devolved parts. This results in the central government having two distinct roles: directly managing the non-devolved part and topping up the funding of the devolved parts.

For the non-devolved part, the national government could provide services to geographical areas either on the derivation principle (Case 1: public services are what can be afforded on the basis of local revenues) or on the territorial equalization principle (Case 2: uniform services provided irrespective of locally generated revenue).

For the devolved parts (right-hand side of Figure 28.1), there are three possible sets of fiscal mechanics. First, there is no equalization (Case 3), either vertical or horizontal, and each sub-national jurisdiction depends on its own taxable capacity ('stand on your own two feet'). Second, there is a Musgrave-type fiscal equalization scheme ('fairness achieved through solidarity') (Case 4), with the extent of territorial fiscal equalization depending on the details. Third, there is a politically determined mechanism based on 'rough justice' (Case 5) which over time acquires the status of non-statutory convention for distributing central funds ('territorial distribution of power'). One such mechanism, that will be discussed below, is the Barnett formula.[1]

POLITICAL REALIGNMENTS ON STATE SIZE AND FISCAL DECENTRALIZATION

[1] Devised in 1978, the Barnett formula became operational from financial year 1981-1982 (Heald 1994; Levitt 2014) and is a key component of the Scottish Fiscal Framework (HM Government and Scottish Government 2016). Announced in 1888, the earlier Goschen formula was in operation until at least 1958 (Mitchell 2003).

Making sense of Scottish fiscal developments requires recognition of two different political spectrums: the size of the fiscal state (proxied by the public expenditure/GDP ratio) and the degree of fiscal decentralization (proxied by the proportion of decentralized spending that is 'locally' financed). Alongside these two spectrums is the binary choice between Scotland either being an independent country or a constituent part of the UK.

Whether justified or not, the standard assumption in devolution finance debates in Scotland has been that Scotland favours more generous public provision and higher taxation than would England. Successive Social Attitudes Survey results cast doubt on this, particularly if Scotland had to pay the full costs instead of benefiting from UK net fiscal transfers and (now disappearing) oil tax revenues. Traditionally, Scottish devolution and independence were seen as the route to higher spending, an assumption that seemed to be shared by both sides of the devolution and independence debates. However, the Scottish National Party's (SNP) post-Independence Referendum Growth Commission report (Wilson 2018) led its opponents to claim that New Zealand's neo-liberalism has now replaced Nordic high-spending social democracy.

The dominant Labour tradition in Scotland and Wales had been to seek control of the commanding heights of the UK economy, via political control at Westminster, for the benefit of Scotland and Wales. This was combined with fierce protection of existing territorial privileges, never being shy of warning of the threat in Scotland from separatism. Nationalist pressures in the 1970s undermined this stance, leading to a revival of the Labour devolutionist strand on decentralist rather than neo-nationalist lines, as had earlier been articulated by John Mackintosh (1968). In the 1990s, cross-party Scottish political developments escaped the control of the Labour Party at Westminster, later provoking the attempt by the incoming 1997 Labour Government to scupper the proposal for a Scottish Variable Rate of Income Tax

(the so-called 'tartan tax')[2] by the insertion of a second 1997 Devolution Referendum question on tax-raising powers (Heald and Geaughan 1997). From 1997 to 2010, UK Labour was terrified that fiscally irresponsible Scots would lose them middle England: an illustration of perceived political constraints is that the UK basic rate of income tax has not increased since 1975–1976.

Whereas Labour and Liberal Democrats nervously implied that tax-varying powers might lead to higher taxation in Scotland than in England, the SNP relied heavily on oil revenues and on projected post-independence improvements in the Scottish economy, to be achieved in part by lower Corporation Tax on the Irish 'Celtic Tiger' model. The most significant shift has been the Conservative Party's conversion from hostility to all devolved taxation (1997 Referendum) to its lead role in the Smith Commission's devolution of (almost all) income tax revenue and partial VAT assignment. The revised aspiration among Scottish Conservatives was that tax devolution could bring lower taxation in Scotland than in England, and thereby lead the UK Conservative agenda. Rather than continue to oppose devolution after 1999, most of the Scottish Conservatives who owed their Holyrood seats to proportional representation accepted devolution as a fact. They sought to become the voice of unionism within Scotland, re-harnessing the centre-right votes that had been lost, and putting SNP Governments under pressure if they proposed tax increases to counter UK-imposed austerity.

During the 2000s, Scottish think tanks with strong media links played a role in this shift: the Policy Institute published Jamieson (2001) and Mackay and Bell (2006), arguing that Scotland's public spending was already too high, while Reform Scotland promoted fiscal autonomy on the basis that lower taxes would increase the growth rate of the Scottish economy. Hallwood and MacDonald (2009) criticized the Barnett-based funding system as lacking in fiscal discipline because of excessive grant dependence. In May 2014, before the Independence Referendum, the Strathclyde Commission (2014), appointed by the

[2] The Scottish Variable Rate of Income Tax allowed the Scottish Parliament to vary the basic rate of income tax paid by Scottish taxpayers, by plus/minus 3 pence.

Leader of the Scottish Conservatives, reported in favour of the devolution of income tax bands and rates and raised the possibility of partial VAT devolution.

This development follows the 'public choice' school in economics in stressing the imperative of controlling the size of the Leviathan state by promoting fiscal discipline through tax competition and fiscally induced migration (McKinnon 1997). A strand of literature, following in the tradition of James Buchanan, concludes that fiscally decentralized states have lower public expenditure/GDP ratios than do centralized ones (Feld et al. 2010), and exhibit some substitution of public service charges for taxation.

The wider context has also affected the issue of devolved finance. The 1997–2010 Labour Government significantly increased public expenditure, later to be reversed under the Conservative–Liberal Democrat Coalition (2010–2015) and Conservative (2015–) Governments. Moreover, the focus on political devolution can divert attention from the tightening by the centre over public finances, particularly in relation to the diminished role of English local authorities. Thus far, Scottish local authorities have been more sympathetically treated by SNP Governments, though tensions are evident as the SNP is centralist within Scotland.

PUBLIC FINANCES OF SCOTLAND VERSUS SCOTTISH-CONTROLLED PUBLIC FINANCES

The level of political interest in the public finances of Scotland has resulted in the availability of high-quality data for this component part of the UK.[3]

[3] Nevertheless, the letters columns of Scottish newspapers and the evidence that some give to Scottish Parliament Committees demonstrate, at best, a lack of understanding of economic statistics.

A vital distinction is between the public finances of Scotland as a geographical entity (including activities within Scotland controlled by the UK Government and its entities) and the public finances for which the Scottish Government is accountable to the Scottish Parliament (including local authorities). These data have different uses. The former show the extent to which all expenditure in, or attributed to, Scotland is funded by Scottish revenues, rather than by Scottish borrowing or by explicit or implicit transfers from the UK Government. The latter show the extent to which expenditure on devolved Scottish public services is funded by revenue raised by Scottish public authorities, rather than by Scottish borrowing or by grants from the UK Government. The principal reason why these data series differ is that defence and most social security are not devolved.

[Insert Figure 28.2 around here]

Figure 28.2 considers Scotland as a geographical entity combining the expenditure attributed to Scotland, whether undertaken by the UK or Scottish Governments. The original 1991 motivation for *Government Expenditure and Revenue in Scotland* (most recent issue: Scottish Government 2018) was to argue that devolution was unaffordable, later being used to argue that independence is unaffordable. Nevertheless, the systematic efforts of Scottish Government statisticians over the years (Goudie 2002), reinforced by pressures from academic users of these data, have contributed to a robust analysis and a time series that extends back to just before devolution.

The solid black line in Figure 28.2 plots total Scottish public expenditure in nominal terms (pounds actually spent in those years) while the grey line plots expenditure converted to real terms using the GDP deflator (2017–2018 prices). Definitionally, these lines intersect at the base year of 2017–2018. From 1998–1999 to 2010–2011, real-terms expenditure increased from £47.105 billion to £74.456 billion (a rise of 58.1 per cent), but by 2017–2018 it had fallen to £73.938 billion (down from 2010–2011 by 0.1 per cent).

The dashed black line in Figure 28.2 plots the Scottish Government's Total Departmental Expenditure Limit (TDEL), not its total budget, which includes Annual Managed Expenditure (AME). In

the absence of consistent time series, this is a suitable proxy for expenditure changes. The dotted grey line plots TDEL in 2017–2018 prices. From 1999–2000 to 2009–2010, real-terms TDEL increased from £20.207 billion to £32.844 billion (a rise of 62.5 per cent), but by 2017–2018 it had fallen to £30.258 billion (a reduction of 7.9 per cent).

[Insert Figure 28.3 around here]

The solid black line in Figure 28.3 plots total Scottish public expenditure as a percentage of GDP when the GDP measure excludes North Sea activity. Because UK GDP includes North Sea activity, the UK public expenditure/GDP ratio (dashed black line) is compared with Scotland's ratio (grey line) when its GDP includes a geographical share of North Sea oil activity. This shows that this Scotland ratio usually exceeds the comparator UK ratio and demonstrates the diminishing importance of the North Sea in GDP terms.

[Insert Table 28.1 around here]

Table **Error! Reference source not found.** shows the percentage compositions of total Scottish public expenditure (left-hand side) and of the Scottish Government's TDEL (right-hand side). The tabulated years are 1998–1999 (year before devolution), 2010–2011 (first year of the Coalition Government's austerity programme) and 2017–2018 (latest year for which finalized data are available). Unsurprisingly there is substantial stability in where the public spending goes. However, some changes are noteworthy.

Viewing the composition of total Scottish spending, space has been created for other programmes by the reduction in the percentages for Defence (post-Cold War) and debt interest (lower interest rates). Health has expanded its share from 14.4 per cent to 17.5 per cent, with large increases in Transport. Notwithstanding austerity, Social Protection has retained approximately one-third of the total. Viewing the composition of TDEL as a proxy for Scottish devolved spending, Health has expanded its share from 26.0 per cent to 29.6 per cent while Education and Training have contracted from 22.6 per cent to 19.5 per cent. There is now ample evidence of intense pressures for more spending across the board.

[Insert Figure 28.4 around here]

Figure 28.4 brings together expenditure and revenue, plotting Scotland's Net Fiscal Balance[4] from 1998–1999 to 2017–2018 and showing how it compared with the UK's. The grey line for the UK shows the dramatic effect of the 2008 global financial crisis. Scotland's black line (excluding North Sea oil revenues) closely follows the UK line, but around 6–8 per cent of GDP worse. The dotted line plots Scotland when it includes a geographical share of North Sea oil revenues. This had a big effect in narrowing the gap before 2012–2013 but the decline of oil revenues caused by price falls and decommissioning costs has removed much of the significance of this inclusion.

The Net Fiscal Balance in Figure 28.4 has relevance to establishing the starting point for analysis of Scotland as an independent state, with no budgetary connections to the 'Rest of the UK' (rUK). However, nothing definitive about independence can be drawn from it. Those favouring Scottish independence would project forward policies more attuned to Scotland's needs, thereby producing better economic performance and fiscal outcomes. Opponents would point to deficit-financing difficulties after independence and to potential trade disruption, especially in light of what has been learned about the practicalities of Brexit since the 2016 EU Referendum.

Two conclusions can be drawn from these data. First, there has been one devolution decade of plenty (2000s) and one of famine (2010s). The long period of austerity started after the 2008 global financial crisis and continued through the 2010s. The effects on public services of the fiscal squeeze of the latter period have been accentuated by rising population and by the unknown extent to which the GDP deflator (used to calculate real terms) underestimates the increases in public sector input costs. The austerity-

[4] Net Fiscal Balance (expressed as per cent of GDP) is calculated as the difference between a government's revenues (taxes and proceeds from asset sales) and its expenditure. A negative ratio (i.e. below the horizontal axis in Figure 28.1) indicates revenues being less than expenditure.

induced constraints on public expenditure in the 2010s have been more severe because of the Relative Price Effect.[5]

The years of plenty fed into costly policy variation (free personal care, no student fees, abolition of prescription charges, Scotland-wide travel concessions for over-60s), widely portrayed as successes of devolution. Famine led not to roll-back of policy variation, but to increased pressure on mainstream services, with the SNP Government now blamed by Labour and Conservatives for austerity transmitted to Scotland by UK Government policy.

Second, the public finances of Scotland as a geographical entity are less robust than those of the UK as a geographical entity. Attributing to Scotland its geographical share of North Sea oil revenues leaves Scotland with a higher adverse net fiscal balance in the 2010s than the UK. Large variations in net fiscal balance are to be expected across a nation state whenever such data are available. Of the twelve UK statistical regions, Scotland usually comes third or fourth on indicators of economic performance, but far behind London and the South-East. The economic geography of the UK is damaged by the excessive dominance of its capital and expanding hinterland (Dorling and Thomas 2016; Beatty and Fothergill 2017). The UK2070 Commission, which is an independent inquiry into city and regional inequalities, has emphasized the decoupling of London and the South East from the rest of the UK economy (Kerslake 2019). Other regions denounce the configuration of macro, financial, and industrial policy as having damaged their interests and, for example, led to de-industrialization and weak economic and fiscal performance.

THE WORKINGS AND IMPACT OF THE BARNETT FORMULA

[5] Although this may not happen in the short term, in the medium and long term, the prices of government inputs (e.g. nurses' salaries and pharmaceuticals) rise faster than the GDP deflator. The implicit price deflator for government consumption is too broad for direct applicability to Scottish devolved expenditure.

First acknowledged in the public domain in 1980 (Younger 1980), but later disowned by Joel Barnett (2009), who had been Labour Chief Secretary to the Treasury when the formula was established, the Barnett formula has for forty years been misunderstood and denounced, seemingly from all possible directions. Its core idea is a simple mechanism. Increases in public expenditure in England generate increases in the Scottish block grant (Barnett consequentials) by multiplying the English change by Scotland's population ratio and by the programme's comparability percentage (the extent to which such responsibilities are devolved to Scotland). The same process applies when there are reductions in comparable English expenditure.

McLean and McMillan (2005: 233) described the Barnett formula as 'irretrievably broke', 'a disaster' (234), and 'unsustainable' (235), while McLean (2005: 89) referred to claims that it is 'iniquitous'. These criticisms derive from the view that the formula has been too generous to Scotland. In contrast, the political debate in Scotland in the 1980s and 1990s revolved around the so-called 'Barnett squeeze', an expression inspired by the mathematical property of the formula that, *ceteris paribus*, devolved public expenditure in Scotland would increase more slowly than comparable expenditure in England (Heald 1994; Cuthbert 2001). The arithmetic of the convergence process is mechanical: the carried-forward expenditure base is more generous to Scotland than the Barnett-determined increments based on population.[6]

Some political protection for the formula came from the fact that such attacks rained in from all sides: if all interested parties denounce it, perhaps the Barnett formula has some merits. However, there are four substantive reasons why the formula has survived, despite probably being only intended as a

[6] Convergence of the expenditure relatives of the devolved administrations has been less pronounced than modelling would suggest, mainly because of offsets from Scotland's population decline relative to England and of bypassing of the formula (additional amounts, particularly to Northern Ireland and Wales, that became known as 'Barnett plus').

stop-gap measure when the Treasury had much bigger issues to worry about—the 1976 IMF loan being a recent memory.[7]

First, critics usually do not say what should be put in its place under conditions of asymmetric devolution. Often they talk about something different, like an independent Scotland which would have superior economic performance and fiscal health. Whatever the details of the system of asymmetric fiscal decentralization, the political configuration and economic geography of the UK mean that there is going to be Horizontal Fiscal Imbalance (per capita tax capacity varies enormously) and Vertical Fiscal Imbalance (UK legacies of fiscal centralization are deeply embedded in politics and the media).[8] Total centralization of spending is the only way to avoid grants to sub-national governments, and that runs against the direction of travel at the devolved level. Criticisms of the Barnett formula as idiosyncratic usually ignore the constraints that constitutional asymmetry imposes.

Second, Barnett is not 'broke'. Indeed, the complaints since 1999 have been fewer in number than one might have expected, the SNP being surprising converts, given that they previously characterized the Barnett squeeze as punishment inflicted by London on Scotland (Torrance 2017). The longevity of Barnett is not an accident: it economizes time and transaction costs for the UK Treasury; it sets parameters on how much the devolved nations can gain at the expense of the centre; and the block grant provides expenditure-switching discretion beyond that held by sub-national governments in Australia, Canada, Germany, and Spain. Of utmost importance, UK money goes through the Scottish Parliament,

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[7] Joel Barnett's own account of his experiences as Chief Secretary to the Treasury (1974–1979) never mentions the formula (Barnett 1982), confirming that its later importance had not been contemporaneously recognized.

[8] Horizontal Fiscal Imbalance refers to differences in taxable capacity in relation to need-to-spend for jurisdictions at the same tier of government. Vertical Fiscal Imbalance refers to the mismatch between expenditure responsibilities and taxable capacity between tiers of government, the usual case being that taxable capacity is concentrated at upper tiers.

not direct to Scottish entities within the latter's control. Some erosion of this feature of the 1998 devolution settlement will be examined below.

Third, what was conceived as an ad hoc Treasury fix, imitating the Goschen formula (McCrone 1999), survived because it served political interests by facilitating UK control of spending aggregates and defusing political tensions, while continuing Scottish decision-making on expenditure composition. Constitutional asymmetry makes alternatives such as needs assessments on the Treasury (1979) model difficult to construct, expensive to implement and politically risky. Chance factors such as there being a Scottish MP serving as a Treasury Cabinet Minister from 1997 to 2015 helped to ensure that the official Treasury largely played the Barnett formula straight, despite the lack of transparency about formula operation. Indeed, lack of transparency on formula operation and on the generation of consequentials was favoured by Scottish Executives/Governments as protection against earmarking claims by Scottish spending lobbies (arguments such as 'all health consequentials should go to health', whereas John Swinney as Cabinet Secretary for Finance diverted large sums to Scottish local government). Like Goschen before it, the longevity of the Barnett formula is a manifestation of the salience of territorial politics (Bulpitt 1983; Midwinter et al. 1991), particularly given the population disparities that work against the rhetoric of 'being partners in the Union'.

Fourth, the mathematical convergence of the spending relative on UK=100 never happened for Scotland, largely because of significantly lower population growth than in England. Defence of Barnett became a priority of successive devolved Scottish Executives/Governments. Instead of a threatening 'Barnett squeeze', the formula came to be viewed in Scotland as a protective mechanism, particularly after 2010, against UK Governments in which Scots were less prominent and which relied less on Scottish political support. In contrast, convergence has been a recurrent theme in the politics of Wales and Northern Ireland, in part offset by greater access to supplementary above-formula payments (colloquially known as 'Barnett plus') than Scotland.

The substantive political problem with Barnett has been the lack of ownership; Bell and Christie (2001) captured the position well when they invoked the image of 'nobody's child'. The 1997–2010 Labour Government wanted to hide it, for fear of alienating England. There was a half-hearted pretence that Barnett was directly about needs, but no attempt to explain the key functions that it performed as a governance mechanism within an asymmetric governmental system of three devolved units and one non-devolved unit. The automatic application of the formula removed threats of targeted grant cuts and protected devolved policy discretion. Moreover, it functioned as a transactions cost-reducing mechanism, since the Treasury could concentrate on English expenditure and just apply a multiplier to reach UK costs.[9]

The 1997–2010 Labour Government failed to take ownership of the formula and defend its role, or be transparent about its purposes and effects. The Barnett formula became associated with claims of unfairness: too much money (English MPs' views of Scotland) or too little money (seemingly everyone in Wales, and those in Scotland who argued that Scotland's oil had been seized by the UK). In the absence of a comprehensive needs assessment,[10] Heald and McLeod (2002) proposed a subjectively determined floor on how far convergence could go for Wales (implemented in March 2015) and Northern Ireland (never implemented but relevant to the context of 'Barnett plus'). It was not until 2017 that transparent data were made available on the composition of consequentials, but this did not include information on what constitutes expenditure in England comparable to the respective blocks.

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[9] Barnett could not work the other way round, as increases in devolved administration spending would generate much larger increases in English spending.

[10] McLean (2005) and King and Eiser (2016) make proposals as to how a needs assessment might work in the context of asymmetric devolution. This would correspond to Case 4 in Figure 28.1 whereas the Barnett formula corresponds to Case 5.

What was originally a simple mechanism embedded in the UK public expenditure system (Heald and McLeod 2005) has become more complex through time, for example, due to the splitting of DEL into Resource DEL and Capital DEL, and the later creation of Financial Transactions CDEL which sometimes funds low-priority spending that meets rules for a scheme devised mostly for Help-to-Buy in England. The task of block management by the devolved administrations has become more difficult, and the complexities impede public understanding. This is inspired by politically motivated programmes intended to highlight UK Government spending in the devolved countries. 'City Deals' are partnerships amongst the UK, devolved and local governments, together with other public bodies, which breach the principle that UK money to devolved entities always goes through the devolved administrations.[11] The new 'Stronger Towns Fund' initiative was interpreted as a UK Government plan to secure 'Leaver' Labour MP votes for the Brexit 'Withdrawal Agreement', bypassing both the Barnett formula and the Scottish Government (Kentish 2019; Ministry of Housing, Communities & Local Government 2019). The 'pork barrel' politics of the Conservative Minority Government's 'Confidence and Supply' arrangement[12] with the Democratic Unionist Party (Conservative and Unionist Party and Democratic Unionist Party 2017; Cabinet Office 2017) disincentivized politically difficult choices on devolved taxes. The Barnett formula

[11] City Deals from the UK Government to English cities have been a limited offset to the harsh funding cuts that have characterized UK Government policy towards English local authorities in the 2010s. The devolved administrations are party to City Deals in their jurisdictions.

[12] The Northern Ireland package provoked outrage from many Scottish politicians who demanded formula consequentials, claiming a breach of Barnett principles. In fact, Scottish, Welsh, and Northern Ireland consequentials have always been driven by changes in comparable expenditure in England, of which there were none in this case. In contrast, spending in England from the 'Stronger Towns Fund' should generate formula consequentials.

has survived modest elements of ‘bypass’ and ‘plus’ but remains fragile if the convention is not respected.

The problems of communicating the Barnett formula mechanism to political, media, and citizen audiences have been increased by the devolution of tax powers in the Scotland Act 2016. Misrepresentations and misunderstandings of the Barnett formula, and largely unanswered criticisms of the devolved finance system, damaged its credibility. Yet Barnett remains a central feature of Scotland’s new Fiscal Framework (Audit Scotland 2018), negotiated in February 2016 between the UK and Scottish Governments (HM Government and Scottish Government 2016).

The accountability issue is straightforward: if the UK Government forgoes tax revenues by transferring tax powers to the Scottish Government, then there should be an offsetting Block Grant Adjustment (BGA) to Scotland’s Barnett-driven block grant from the UK Treasury. Yet the technical issue of how that calculation should be done for the year of transfer and in future years is complex, and views will reflect the interests of the parties. The decision was rendered more complex by the two ‘non-detriment principles’ enunciated by the Smith Commission (2014), namely that a devolved administration would not lose money at the point of further tax devolution (reasonable) and that there would be no future detriment to either party (undeliverable because divergent policies will affect tax revenues to an extent that is contestable). After tetchy negotiations and much media spinning, the 2016 outcome on the BGA was more favourable to Scotland than it might have been. Crucially, UK Prime Minister David Cameron wanted this issue settled before the Brexit Referendum he expected to win on 23 June 2016, an approach which resulted in key issues being ‘kicked into the long grass’ (Heald 2016). What was agreed was an interim settlement that will have to be renegotiated for 2022–2023 onwards. The key point is that higher rUK population growth than in Scotland means that rUK’s tax revenues are likely to grow faster than

Scottish tax revenues; how this is treated in the BGA calculation has potentially huge effects on the public finances of the Scottish Government.[13]

DEVOLVED TAXATION

Claims for 'fiscal autonomy' became a front-line political issue in Scotland in the 2000s. However, there was much confusion about terminology and what the political objective was. An independent Scotland would have 'full fiscal autonomy' in the sense of sole political responsibility for its net fiscal balance, though there would be market constraints on debt and borrowing and EU constraints if Scotland were an EU Member State inside or outside the eurozone.

In the context of devolution within the UK, what is meant by fiscal autonomy is less clear. The SNP before 2007 and SNP Governments since 2007 have held a maximalist position on tax devolution, partly for strategic reasons (greater control of tax is thought to take Scotland closer to looking like an independent state) and partly for tactical reasons (this constitutes a benchmark against which all fiscal arrangements within the UK will fail). Greater tax devolution therefore has intrinsic value to those favouring independence; even if not of practical use, such powers might make Scotland seem better

[13] The size of Scotland's BGA for each devolved or assigned tax depends on the change in rUK revenues. The higher population growth rate of rUK would lead over time to BGAs greater than Scottish revenues. The current Fiscal Framework operates in terms of per capita revenues and applies a multiplier reflecting the lower revenue productivity of each tax in Scotland (HM Government and Scottish Government 2016; Bell et al. 2016). Furthermore, the Scottish Fiscal Commission (2019) warned that BGA reconciliations between budget forecasts and finalized outturns can be significantly negative and will be a charge against future budgets or the resource borrowing facility.

prepared to take the final leap. Once acquired, each increment in taxation powers can be denounced as inadequate, only useful when more has been delivered.

Fiscal autonomy might mean that a jurisdiction finances all its expenditure from its own revenues (hence no territorial equalization, as in Case 3 of Figure 28.1), or that its taxpayers must finance marginal increases in expenditure (and receive tax reductions if there are cuts in services or efficiency gains). The fiscal federalism literature stresses the importance of a hard budget constraint. It is clear why fiscal designers want at least some devolved taxation, in order to respond to Vertical Fiscal Imbalance (decentralized governments spend central government money whilst being ungrateful), to allow some autonomy in fiscal choices (efficiency benefits from expenditure levels and patterns better reflecting 'local' preferences), and to bring some accountability for spending and tax. But, whenever there are pronounced jurisdictional variations in resources and needs, this will never work like the theoretical model. In most federations other than the United States, there are constitutional (Germany) or political mandates (Australia) to address, which insist on extensive measures of territorial equalization. Nevertheless, marked differences between these countries in the proportion of sub-national expenditure financed by genuinely devolved taxes indicate that there are choices to be made about self-financing ratios and about the comprehensiveness of territorial equalization. International comparisons of country own-revenue percentages should be treated with caution because of institutional features. For example, IMF statistics and research papers based on them treat Germany as highly fiscally decentralized, notwithstanding the extremely limited tax discretion of Länder governments in a system characterized by assigned revenues subjected to vertical and horizontal equalization.

The key distinctions are:

a) *Fully devolved taxes*: the sub-national government controls (i) the tax rate (and thresholds), and (ii) the tax base (definition of what is taxable);

b) *Partially devolved taxes*: the sub-national government controls (i) the tax rate (and thresholds), but not (ii) the tax base;

c) *Assigned revenues*: the sub-national government has no control over the tax rate or tax base, but receives the resulting revenue, calculated as (i) actual receipts, (ii) estimated receipts, or (iii) formula apportionment.

It is imperative to understand the context set by the prevailing framework for territorial redistribution, not least because this can offset the projected effects of tax devolution:

(i) The principle of *derivation* indicates that a jurisdiction keeps taxation revenues generated there;

(ii) The principle of *equalization* indicates some form of pooling to offset differences in resources and/or needs and/or costs.

Derivation follows the injunction that 'one keeps what one kills' whereas equalization implies (some degree of) revenue sharing. In practice, those jurisdictions making explicit or implicit transfers into the central pool of resources usually think that their revenues are derived from merit or performance and are thus deserved. Even when luck is clearly involved, as in the geographical location of natural resources and their taxable economic rents, it becomes 'Scotland's Oil', not to be shared with the UK or EU.

The design of a decentralized fiscal system has profound implications for which territorial entities and their citizens carry two types of fiscal risk:

- Which level of government carries the macro-fiscal risk?
- Which level of government carries the tax policy risk?

Sources of macro-fiscal risk include recessions, financial crises, technological change, and events such as Brexit, where policy leverage is likely to be highest at the top tier of political authority. Sub-national governments will experience differential effects, mostly out of their control.

In contrast, the designers of fiscal devolution want lower-level governments to carry at least some of the tax policy risks attributable to their own actions. In the globalized economy, national governments face revenue losses from the location decisions of multinational firms and from individuals' migration decisions, particularly those of high-worth taxpayers. Such behavioural responses will present more

severe constraints on the tax policymaking of sub-national governments. Moreover, firms and individuals may respond to expectations of future tax changes and not just to actual changes: firms may choose Northern Ireland in the expectation of lower Corporation Tax and high-earning individuals might give up their Scottish tax residence in the expectation of higher and more progressive income taxation. The public finance literature concludes that redistribution is most effectively pursued by higher levels of government where this has less visibility, and redistributive measures are more difficult to circumvent. However, tensions arise if lower tiers of government want more redistribution than does the central government.

Having to raise tax revenue before spending it can be seen as an inescapable discipline on potential spendthrifts, more subtle than legislative control from higher-level governments. Spending lobbies will be countered by locally based taxpayer resistance. Re-expressed in aspirational rather than in control language, reliance on devolved taxes connects spending and taxation decisions, creates fiscal accountability and legitimates democratic decisions on the use of public resources. What remains in dispute is how far own-revenue-raising must be taken to gain these benefits. An absence of fiscal autonomy exposes the central fiscal authority to uncontrolled rent-seeking behaviour by lower-level governments. Full fiscal autonomy rules out territorial equalization.

Into this fraught arena stepped the Muscatelli Expert Group (Muscatelli 2008), giving technical support to the Calman Commission (Commission on Scottish Devolution 2009) established by the UK Government in co-operation with the opposition parties in the Scottish Parliament after the SNP had formed a minority government in 2007. The direction of travel was clear, in that Calman was expected to favour more tax devolution to Scotland, but at a cautious pace. In the background was the SNP Government's demand for 'fiscal autonomy' (within the UK state) (Scottish Government 2009) and its claim for full political independence (outside the UK state).

The Muscatelli Expert Group developed its own set of taxation principles for Scottish devolution, paying homage to Adam Smith's canons of taxation. The Muscatelli principles are as useful guides as one

will find; the unavoidable problem is that the principles come into conflict when addressing practical issues of tax design even at the unitary state level.

Briefly summarized, these are the six Muscatelli (2008: 7) principles:

(1) *Equity*—ensure fairness to all regions of the country;

(2) *Autonomy*—allow the regional government choice on what and how much to spend, and potentially allow the use of fiscal powers as policy instruments;

(3) *Accountability*—ensure that the effect of decisions made at the regional level on tax bills is clear to taxpayers;

(4) *Stability/predictability*—enable public spending to be managed properly;

(5) *Simplicity/transparency*—enable taxation and spending decisions to be readily implemented and the justification made evident;

(6) *Efficiency*—avoiding creating economic distortions by incentivizing movements of people and factors of production.

These Muscatelli principles would command widespread consent from fiscal experts. Examples of conflicts that arise are those between Equity and Efficiency and between Autonomy and Simplicity/Transparency.

Ideas from optimal taxation theory were synthesized for a policy audience by the Mirrlees Review (Mirrlees et al. 2011) of the UK tax system, commissioned by the Institute for Fiscal Studies. The budget problem is to extract the resources that a government needs for public services in a way that does the least economic damage to the private economy. Tax bases should be broad and marginal rates should not be too high. Mirrlees concluded that the UK tax system is dysfunctional and that policy reforms emphasizing ‘neutrality’ (taxes should not distort private economic decisions) could increase revenue and decrease efficiency costs. Neutrality has become more important in the context of the globalized economy and liberalized markets.

Puzzlingly, the Mirrlees Review omitted reference to local government finance and to devolution finance, indicating that the Inquiry thought in terms of the unitary state, not of the multilevel state. In the latter, there is tension between (a) neutrality (reflecting the Mirrlees Review's desire to minimize damage to economic efficiency) and (b) subsidiarity (facilitating autonomy and accountability at lower levels of government). There will be a trade-off between neutrality and subsidiarity if sub-national governments are to exercise taxation powers in order to enhance their fiscal accountability. Local government taxes were often ignored by those who argued that the 1999 Parliament had negligible tax powers, even though the structure of local government taxation was fully devolved.

Midwinter and McVicar (1996) observed how cautious Scottish devolutionists had been in their proposals for devolved taxation powers, citing Heald's (1990) proposals to the Scottish Constitutional Convention. Indeed, the common theme then was 'fiscal accountability at the margin' (Blow et al. 1996). The Scotland Act 1998 brought a self-funding ratio of 10 per cent: the Scottish Variable Rate of Income Tax only applied to the basic rate (three percentage points up or down). The 21 per cent after the Scotland Act 2012 reflects the cautious approach of the Calman Commission. This reduced the rate of UK income tax for Scottish taxpayers by 10 percentage points and set no limit on what the Scottish Parliament could substitute, but required the same percentage-point increase to be applied to all tax bands. The four smaller taxes were seen to add some ballast to the Calman package, but modest amounts of revenue (see Table 28.2).

The 2016 Scotland Act's jump to 52 per cent reflects the political circumstances, after the eve of Referendum 'Vow' by the three main UK party leaders, of strengthened devolution (Cameron et al. 2014), rather than changes in fiscal fundamentals. All revenue from Non-Savings Non-Dividend Income (that is income from employment, self-employment, pensions and property) is devolved. There are no constraints on rates or on bands other than UK setting of the Personal Allowance. Fifty per cent of VAT revenue is assigned to Scotland. Calman's caution was set aside. Value Added Tax assignment seemed to result from a political desire to raise the self-funding percentage to over 50 per cent. In popular discourse,

acquisition of more taxation powers was usually presented as conferring more power: in practice, the Scottish Parliament has taken on much more risk, particularly from differential economic performance to rUK and in contestable calculations such as the BGAs for each devolved or assigned tax.

Those opposing Scottish independence, particularly after the 'Vow' of strengthened devolution, thought that saving the Union required a dramatic gesture which would show that the devolved Scottish Parliament enjoyed real power. This was to protect the legitimacy of devolution as an alternative to independence. Astonishingly, the design of fiscal decentralization (a UK matter) was delegated to the Smith Commission consisting of five Scottish political parties, with an independent chair (Sir Robert Smith) appointed by the UK Government (Kenealy et al. 2017). This appears to have resulted from UK Prime Minister David Cameron's willingness to take risks and his expectation that what would be proposed would be acceptable.

This dramatic shift of support towards extensive tax devolution might have energized political opinion: the Smith Commission was solely a Scottish event, the results of which two UK Governments signed up to. Yet the policy dilemmas and practical UK constraints have not changed. Constitutional asymmetry and small geographical distances still make devolved taxes technically difficult to operate in the UK. Moreover, UK-based parties worry about electoral spillovers to England from high-spending/'fiscally irresponsible' devolved administrations under their control. These could include the perception of Scotland as the highest-taxed part of the UK; or portrayals of the Labour-controlled NHS Wales as a disaster warning to English voters. This constrained the 1998 settlement and contributed to the atrophying of the tartan tax which Labour First Minister Jack McConnell promised not to use. Higher income tax in Scotland than in England would be denounced as damaging the Scottish economy. Lower income taxes than in England might bring down the Barnett funding mechanism, a development feared by Scottish Executive/Government civil servants in the 2000s when it was impossible to spend all the Barnett consequentials generated by years of large increases in English education and health spending.

There has thus far been limited experience of the post-Scotland Act 2016 powers due to newness and phased implementation. Table 28.2 summarizes how powers have been accumulated and whether and how they have been used to date. The political context must be remembered: these are the years after the 2014 Independence Referendum, after the SNP Government's loss of its majority in the 2016 Scottish Parliament election, and after the 2016 Brexit Referendum.

[Insert Table 28.2 about here]

The Scottish Variable Rate of Income Tax (1998 Act) was never used, HMRC's administrative capacity to implement it being secretly allowed by the Scottish Government to disintegrate. The Scottish Rate of Income Tax (2012 Act) only applied to one tax year (2016–2017) and was set to ensure no difference between UK and Scottish income tax, as the Smith Commission tax powers were already being legislated (Barbour 2017).

[Insert Table 28.3 about here]

Table 28.3 sets out the position in tax year 2019–2020 after three years in which the Scottish Income Tax has applied. The loss of the SNP Holyrood majority in 2016 was a critical event, especially as its strict party discipline could make a very small majority work. All these changes were negotiated between the SNP Minority Government and the Scottish Green Party. Because of the issue of a second Independence Referendum, the 'Unionist' parties are unlikely to support an SNP budget, unless the Conservatives could be detached by tax-cutting policies, though these might alienate 'Yes' supporters.

Two aspects of the UK-set Personal Allowance are important: the UK Government has increased this to £12,500 (compared with £6,475 in 2009–2010);[14] and it is reduced by £1 for every £2 earned over £100,000. The cumulative result of three years of SNP–Greens budget deals was that Scotland split the

[14] Given differences in the profile of Scottish incomes and rUK incomes, policy-driven increases in the Personal Allowance reduce Scottish revenues more than rUK revenues, thereby increasing the BGA.

basic rate band into three; Scotland has a much lower higher-rate threshold (£43,430 rather than £50,000); and Scotland's top two bands are one percentage point higher than their rUK counterparts.

[Insert Figure 28.5 about here]

Figure 28.5 shows the effects of these changes on Scottish taxpayers' Marginal Rate of Tax (i.e. how much extra tax is paid on an extra £1 of income) (black line) and their Average Rate of Tax (what percentage of income is taken as tax) (grey line) at income levels between £0 and £160,000 (an arbitrary upper cut-off).

Other complications could be introduced, including the interaction of income tax and National Insurance, which is not devolved.[15] National Insurance is a second income tax on a narrower base that seems to be less disliked by voters, hence UK Chancellor of the Exchequer Gordon Brown's use of increased Contributions when UK Labour election promises had ruled out increases in income tax rates. The first complication this causes is that the lower threshold (£8,632) is much lower than the income tax threshold (£12,500), so many non-income taxpayers are paying Contributions. Second, adding the two together produces a cumulative Marginal Rate of Scottish Income Tax and National Insurance (dotted line) of over 30 per cent on incomes above £12,500. Third, whereas the rUK higher rate threshold is aligned with the National Insurance Upper Earnings Limit (at which the Contribution rate falls to 2 per cent), there is a wide range (£43,430–£50,000) over which both these higher rates apply to Scottish taxpayers. This explains the spiking in Figure 28.5 of the combined Marginal Rate at 53 per cent. In all three years (2017–2018, 2018–2019 and 2019–2020) of the Scottish Income Tax, the width of the spike has grown as the gap between the Scottish and rUK higher rate threshold has widened. Fourth, the UK-

[15] For example, in relation to the tapered withdrawal of child benefit and to the interaction of income tax with the benefits system.

determined withdrawal of the Personal Allowance results in a combined spike of 63.5 per cent on incomes between £100,000 and £125,000.

The grey line in Figure 28.5 plots the Average Rate of Scottish Income Tax and the dashed line the Average Rate of Scottish Income Tax and National Insurance Contributions. This shows a progressive structure (the AR lines are always increasing), but there is flattening when incomes exceed £125,000 (at the end of the withdrawal of Personal Allowance).

[Insert Figure 28.6 about here]

The SNP–Scottish Greens' budget deals purported to achieve greater fairness in the distribution of the tax burden, but they failed due to faults in both the UK system and in the way these Scottish deals were constructed. Over the same income range as before, but focusing solely on income tax, Figure 28.6 shows the percentage that a Scottish taxpayer will pay more or less than their English counterpart. The 'less' part (below the horizontal axis) results from the effects of the 19 per cent starter rate. The maximum saving is £20.50 per year. The switchover point is £26,993, above which a Scottish taxpayer pays more than their rUK counterpart; the maximum excess is 20.59 per cent on an income of £50,000. At an income of £50,000, a Scottish taxpayer pays £1,545 more. The shape of the 'less or more' line in Figure 28.6 is indefensible in relation to the Muscatelli or other principles of equitable or efficient taxation.

Because there are a lot of taxpayers at the bottom end of taxable income, the Scottish Government was able to proclaim that in 2018–2019 the majority of Scottish taxpayers paid less than their English counterparts. The design of the package was driven by public relations considerations, in the context of limited public understanding of how income tax works. Excessive attention is paid to tax rates in isolation from the overall effects of bands and rates. Scotland's splitting of the basic rate band into starter, basic, and intermediate from 2018–2019 (see Table 28.3) marked the first 'basic-rate' increase in the UK since 1975–1976.

After the atrophying of the tartan tax, willingness to use the 2016 Act powers was welcome. How these have been used is seriously defective. First, introducing five bands instead of three for presentational reasons runs directly counter to the Muscatelli principle of Simplicity/Transparency. Unintelligibility damages vitally important consent.

Second, the spikes in both the marginal rate schedules are indefensible: the lower spike around the higher rate threshold derives from Scottish decisions but the upper spike derives from UK decisions.[16] Treating £43,430 to £50,000 as 'rich' in contemporary Scotland imposes high marginal rates on, for example, principal teachers and senior nurses. Marginal rates drive incentives and also do reputational damage. This is a sensitive part of the income distribution, not least because of the UK policy of child benefit withdrawal. In the case of professional households with two earners, there are incentives for reductions in hours which are now much easier to negotiate with employers but will adversely affect labour supply.

Fewer Scottish taxpayers will be located at the upper spike, but the way in which the BGA works means that revenues from taxpayers near the top end of the income distribution are vitally important. There are well-known means for converting income into capital gains or corporate income, both taxed by the UK Government. High-income Scottish taxpayers have access to professional advice and may have multiple residences, some outside Scotland, thereby raising enforcement issues about residence. Once taxpayers become more involved in tax planning and avoidance, such practices might spread. Examples include the reported reaction of NHS consultants to UK pension taxation changes, which resulted in some refusing additional shifts and some taking early retirement (Taylor 2019). UK controversies about

[16] In the 2009 Budget, Labour Chancellor of the Exchequer Alistair Darling announced the phased withdrawal of Personal Allowance on incomes above £100,000 from 2010–2011 as a budgetary response to the global financial crisis. Large increases in the Personal Allowance since then have widened this upper spike.

backdated HMRC-imposed charges for remuneration disguised as loans warn about the extent of past and current avoidance activity.

Third, the Marginal Rate profiles in Figure 28.5 make it difficult to secure an upwards tilt in the Average profiles, which would be consistent with Green, Labour, and Liberal Democrat objectives of making the tax system more progressive. The interaction of income tax and national insurance is dysfunctional: the latter is effectively a second income tax on employment income, starting at a lower level than the Personal Allowance, creating high combined marginal rates on moderate earners, even without considering the interactions with the benefits system. Furthermore, Scotland alone cannot respond to the concentration of income in the top five per cent and one per cent, this being a challenge for UK tax policy and for international action against avoidance and evasion.

CONCLUSION

The fiscal dilemmas addressed in this chapter are partly inevitable consequences of Scotland being one component of a multilevel state, yet partly the product of the unusual structure of the UK, whose fiscal characteristics have been made heavily path-dependent by history.[17] The commonalities make Scotland's case interesting to a wider international audience, but the constraining specificities must be unravelled before valid policy conclusions can be drawn about the desirability or durability of present or other arrangements.

Devolution arrived just before a period of strong UK public expenditure growth fuelled by concerns about the quality of public services, particularly in England, which automatically brought additional

[17] For example, concentration of tax revenue at the central government tier; neglect of the local government taxation system; a narrower VAT base than later adopters; and a dysfunctional relationship between income tax and National Insurance Contributions.

funding to Scotland via the Barnett formula. Then came the austerity of the 2010s, to which devolved Scotland was similarly subjected since Scotland's public finances are deeply embedded within UK public finances. The increase in transparency about fiscal arrangements has been slow, but some gains from that have been offset by increased funding complexity as a consequence of tax devolution. Such inaccessibility encourages political and media debate to remain badly informed.

Strategic choices about the public expenditure/GDP ratio will continue to be taken by the UK Government. Nordic-quality public services cannot be funded by US-level taxation. The devolved administrations have some capacity to soften the effects of austerity, via territorial politics to gain additional off-system resources ('Barnett plus') or by use of their own taxation powers, but should taxation rise to significantly higher levels than in England, the claim that Scotland prefers higher public spending than England would be tested. Such countervailing action will always be met by claims that differentially lower taxation would increase relative economic growth. Moreover, the Office for Budget Responsibility (2018: para. 47) has warned that UK public finances are fiscally unsustainable because unchanged expenditure and taxation policies would lead to a net debt ratio of 282.8 per cent in 2067–2068, while still on a rising path.

There are sometimes orderings of political objectives which assert the absolute primacy of one in particular, such as: national identity (for example, German reunification in 1990 and Brexit); location on the state–market spectrum (such as the Thatcher and Reagan reforms in the 1980s); and commitment to policy and fiscal decentralization within the dominant political entity (such as Spanish decentralization after Franco). Alternatively, complex trade-offs might be made between all three. Scotland is caught up in the fact that the UK has not addressed these objectives in an integrated manner, and there is no consensus view on which matters most or what the trade-offs should look like.

Viewing the post-Scotland Act 2016 powers as a fiscal trap overstates the coherence of UK Government policy and ignores the historical record of within-Scotland pressures for 'fiscal autonomy', whether that be 'devolution max' or 'full fiscal autonomy'. Developments in Scottish income tax in

2017–2018, 2018–2019 and 2019–2020 were conditioned by several factors: the SNP Government's dependence on the Scottish Green Party to pass its budget (the possibility of a second Referendum alienating other Holyrood parties); the rushed deliberations of the Smith Commission; and the belief of the UK Conservative Party and UK Liberal Democrats in the redistributive value of higher Personal Allowances. Such increases take a higher proportion of the Scottish population out of paying income tax (now 44 per cent while the UK is 43 per cent), reduce the Scottish tax base more than the rUK tax base due to the different income distribution, and increase the BGA.

Austerity in the 2010s has opened up the question of whether Scottish Governments will levy higher taxes in Scotland than in rUK in order to protect public services, as opposed to having these funded by higher per capita grants. This context has produced a more coherent anti-taxation argument in Scotland than before, with the SNP Government opportunistically attacked by Conservative and Labour for real-terms expenditure reductions and for—relatively minor in revenue terms—higher rates of taxation. The political configuration at Holyrood has meant that the viable budget deals for the minority SNP Government have been with the Scottish Greens, the results of which have been to create the lower spike in the Marginal Rate of Income Tax schedule. If Scotland wishes to support a higher public expenditure/GDP ratio than is underpinned by UK public finances, then it would be possible to set rates and thresholds in order to achieve a more progressive Average Rate of Taxation schedule. The obvious obstacle is that politicians, media, and international comparisons focus on income tax rates, neglecting the effects of the definition of income, of Personal Allowance and thresholds, and of social security taxes such as National Insurance Contributions.

Making devolved tax policy is not easy. Scotland has mismanaged local government taxation just like England: levying council tax in 2019 on the basis of 1991 valuations invites ridicule. The distortions have become so great as to make reform more difficult than it would have been at the time of the Burt Committee (Burt 2006) when Barnett funding was plentiful but political courage was lacking. Moreover, revenues from Non-Domestic Rates (Barclay 2017) are threatened by rapid economic change, such as the

growth of online retailing. There are more encouraging signs in relation to the design of the Land and Buildings Transaction Tax, but the much-delayed Air Departure Tax was always intended to be a source of revenue loss.

Convincing arguments for tax devolution include seeking to make sub-national governments fiscally responsible when they no longer so heavily depend on transfers from higher-tier governments. Issues of relative power, as well as of principle, always lurk behind territorial fiscal politics. In the first twenty years of devolution, Scottish Governments and Parliaments have mismanaged the two significant tax sources that came to them in 1999. Political paralysis has afflicted policy on council tax and Non-Domestic Rates. There are similar risks of mismanagement of devolved income tax, which reinforce the point that there are difficult trade-offs. Moreover, a new source of fiscal risk comes from demand-led devolved social security benefits (Scottish Fiscal Commission 2019), even when 'generosity' is similar to that in rUK.

The issue is usually not that UK Governments are trying to frustrate devolution, but that the implications of UK policy on devolution are neither understood nor cared about. The destabilizing potential is dangerous, especially in the absence of a settled constitutional position for Scotland. Since the 2014 Independence Referendum, Scotland has effectively sacrificed fiscal certainty for (a) the notion that greater fiscal powers are always one more step on the journey to independence (the 'Yes' side); and (b) the notion that they provide greater political legitimacy for devolution (the 'No' side). Thus, politics continues to trump orderliness in Scotland's public finances.

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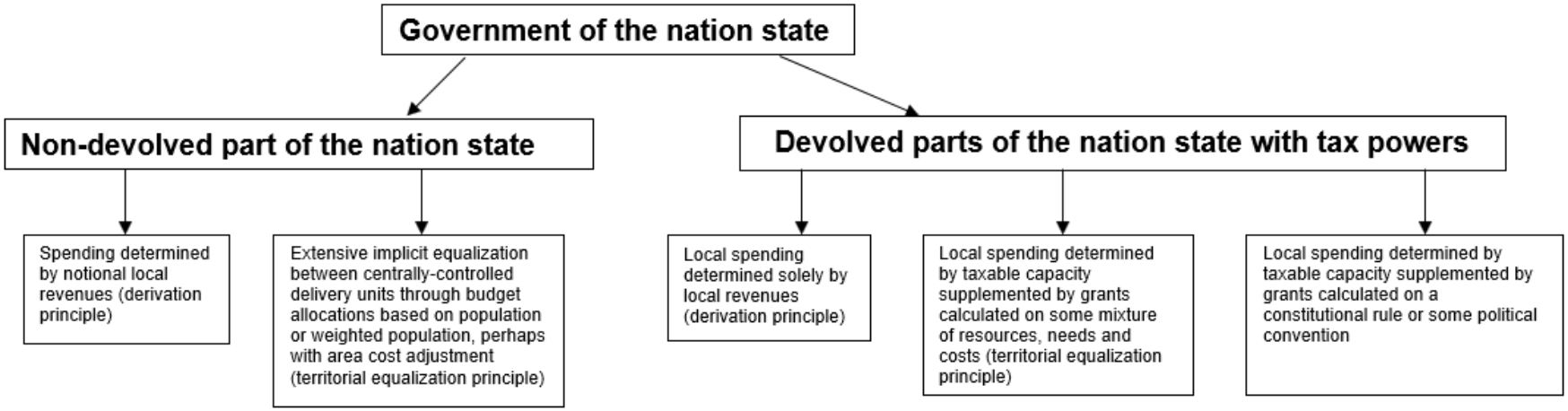
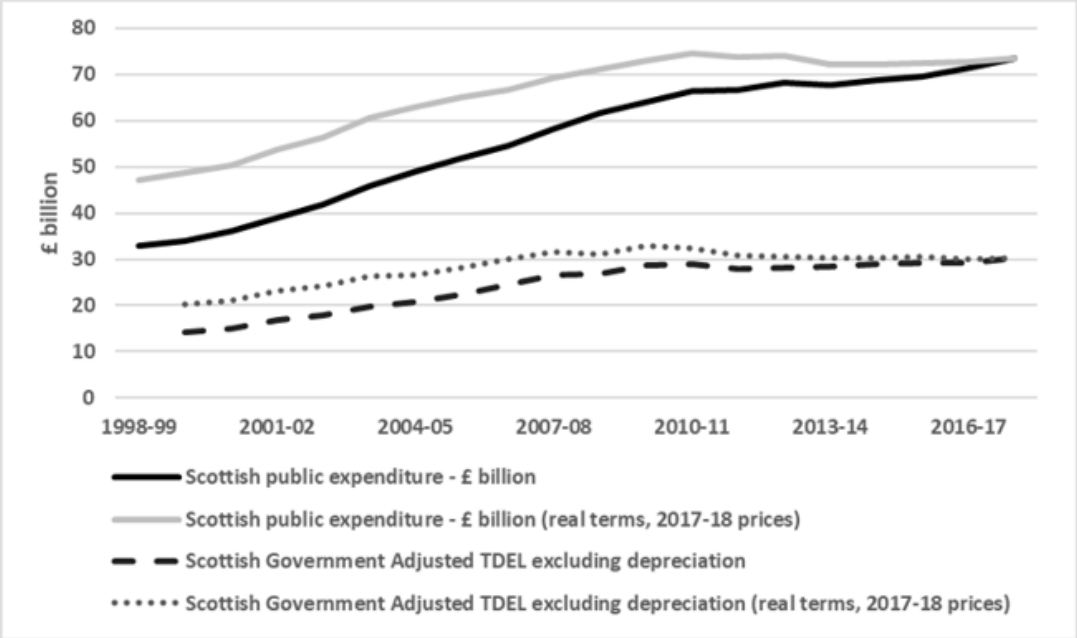
Figure 28.1: Asymmetrical Fiscal Decentralization



	Case 1	Case 2	Case 3	Case 4	Case 5
Taxpayer location influences taxes paid	No	No	Yes	Yes	Yes
Citizen location affects services received	Yes	No	Yes	Yes	Yes
	Huge inequalities in spending per head, with implications for migration, economic performance and political consent **No territorial equalization**	Politically controversial distribution of funds is vulnerable to political capture Likely that either data will not be collected or that these will not be publicly released **Full territorial equalization, at least in principle**	Huge inequalities in spending per head, with implications for migration, economic performance and political consent **No territorial equalization**	Politically controversial grant distribution vulnerable to political capture Explicit transfers are more transparent to the contributors than are implicit transfers, especially between politically separate governments. These could be seen as symbolic of federal or quasi-federal responsibilities. This requires central machinery for needs assessment Disincentive to improve tax base experienced by both recipients and contributors **Extent of territorial equalization depends on the details of the system**	Politically controversial grant distribution vulnerable to political capture, though embedding as rule or convention might assist durability Explicit transfers are more transparent to the contributors than are implicit transfers, especially between politically separate governments. These could be seen as symbolic of federal or quasi-federal responsibilities Some mechanisms might incentivize growth of the sub-national tax base **Territorial equalization does not follow theoretical principles but its extent might reflect the territorial distribution of power**

Source: Author drawing

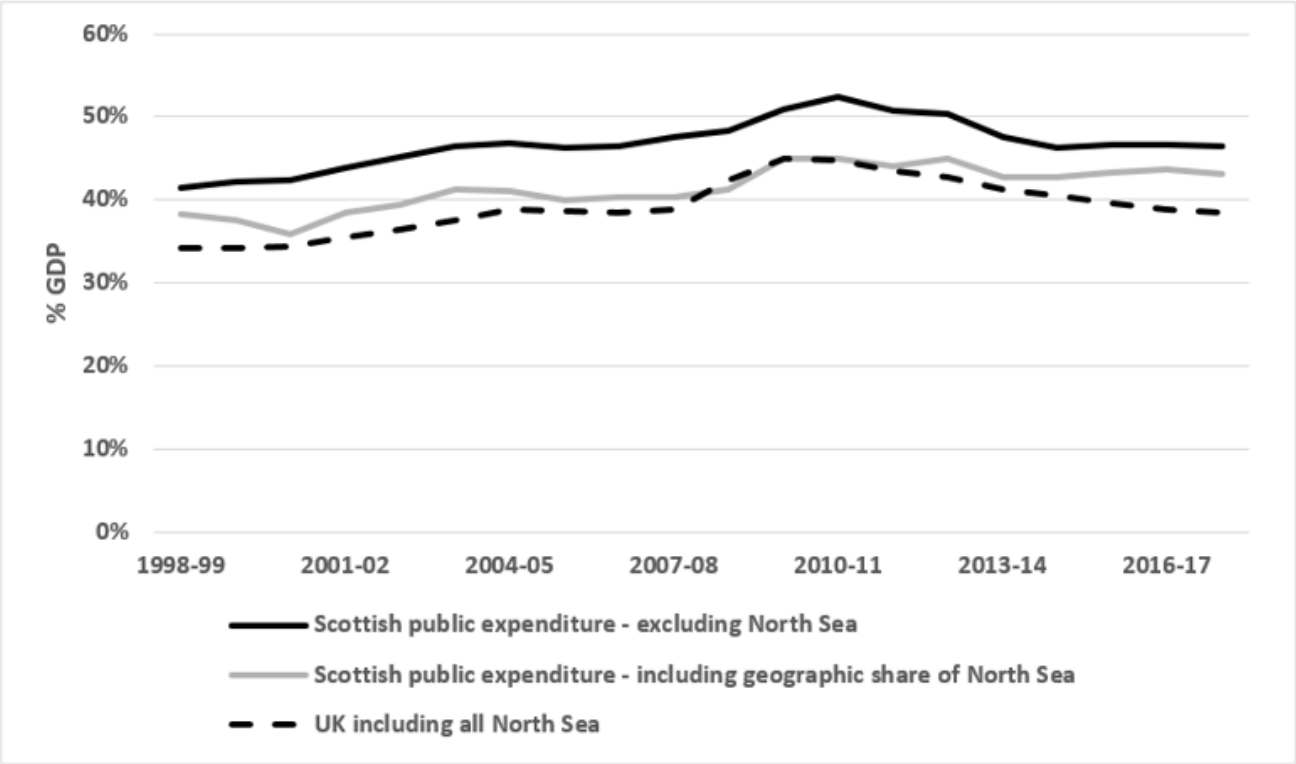
Figure 28.2: Total and Devolved Public Expenditure in Scotland, 1998-99 to 2017-18



Note: Adjusted Total Departmental Expenditure figures are necessarily approximations because there is not a consistent data series covering the post-devolution period.

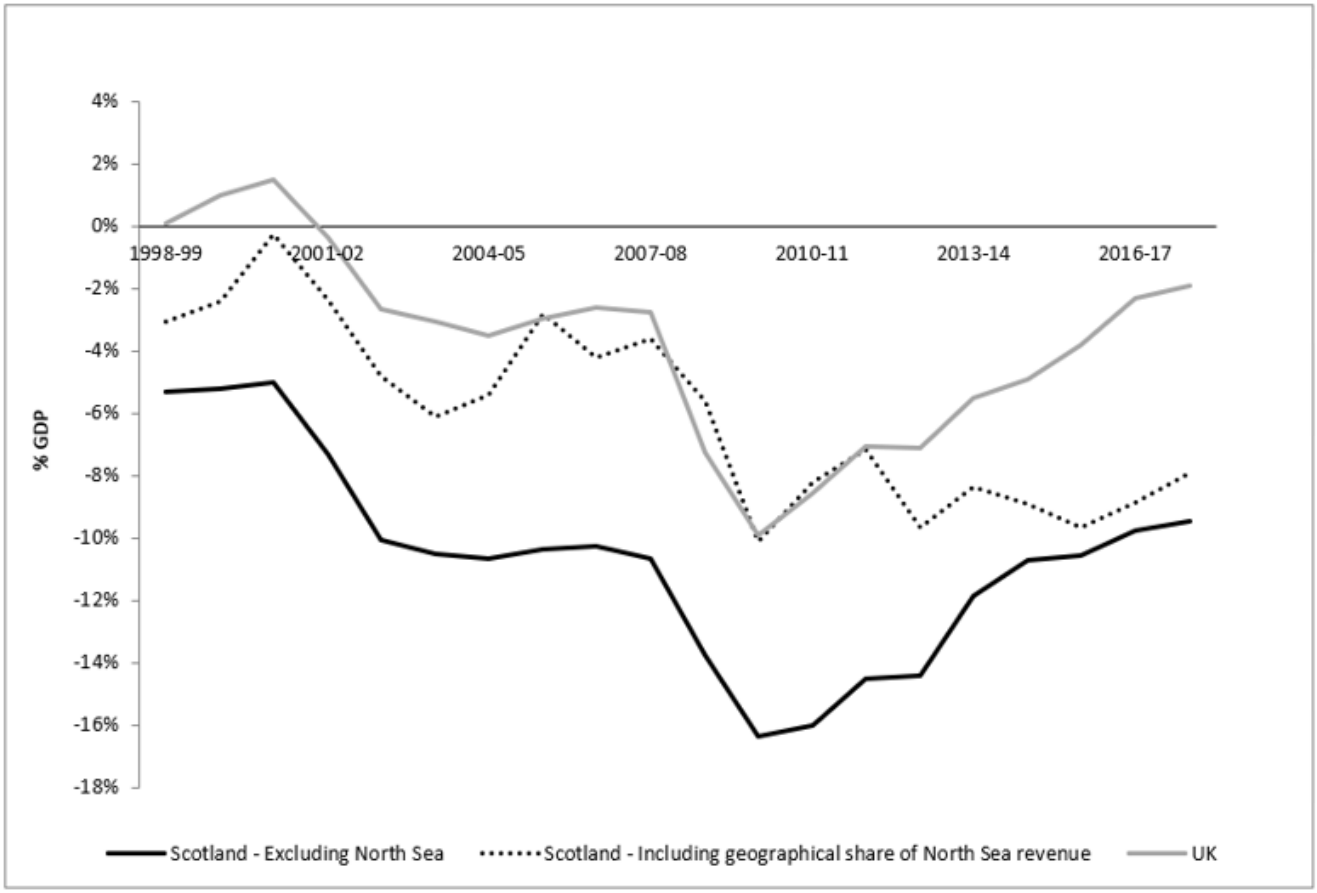
Source: Scottish Government (2018) and various issues of *Public Expenditure: Statistical Analyses* (Treasury 2018).

Figure 28.3: Public Expenditure as Per Cent of GDP



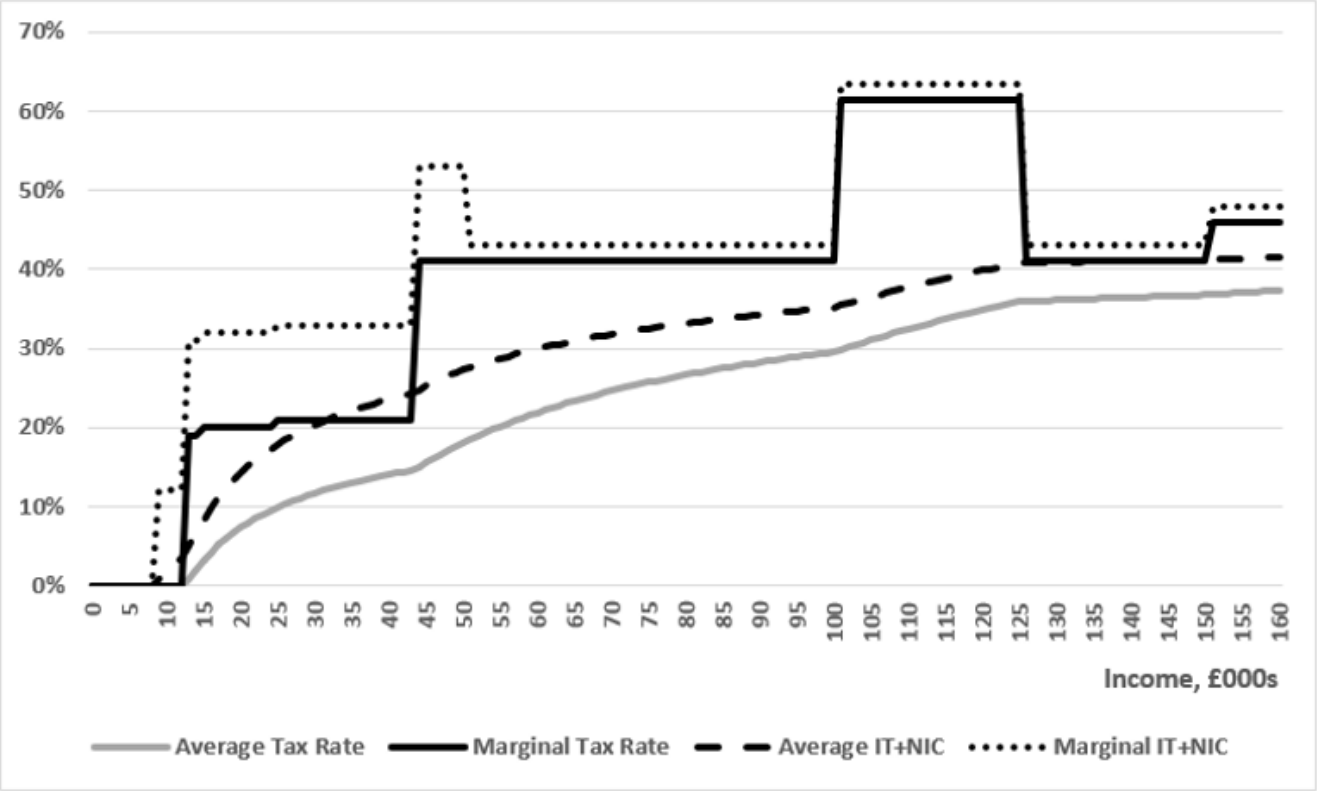
Source: Scottish Government (2018).

Figure 28.4: Net Fiscal Balance: Scotland & UK, 1998-99 to 2017-18



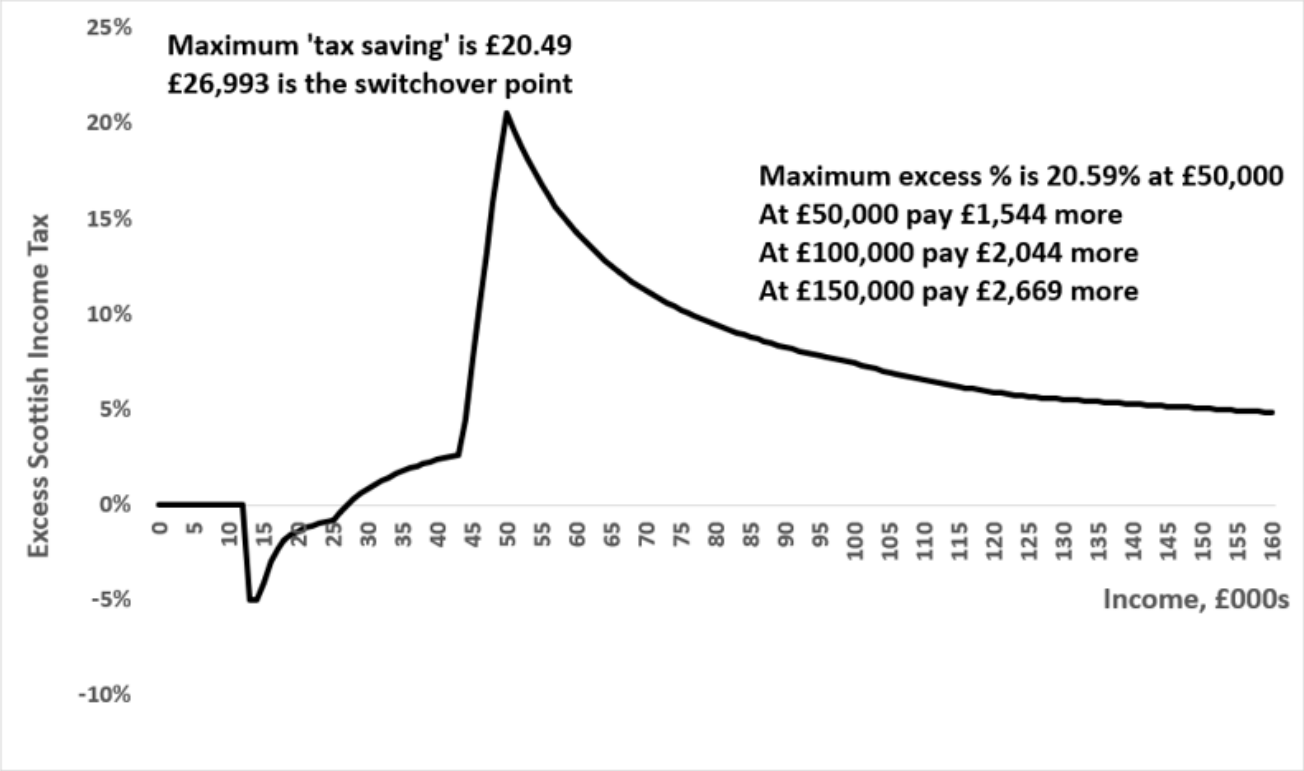
Source: Scottish Government (2018).

Figure 28.5: Scottish Income Tax and UK National Insurance Contributions, 2019-20



Source: Author drawing.

Figure 28.6: Lower or Higher Scottish Income Tax Paid, 2019-20



Source: Author drawing

Table 28.1: Composition of Scottish Public Expenditure: 1998-99, 2010-11 and 2017-18

	Total			Devolved		
	1998-99	**2010-11**	**2017-18**	**1998-99**	**2010-11**	**2017-18**
General public services						
Public and common services	2.4%	2.5%	2.1%	2.6%	2.9%	2.4%
International services	0.8%	1.0%	1.2%			0.0%
Public sector debt interest	7.7%	5.1%	5.0%			
Defence	6.5%	5.0%	4.3%	0.0%	0.0%	0.0%
Public order and safety	4.0%	4.3%	3.9%	7.0%	6.5%	6.1%
Economic affairs				0.0%	0.0%	0.0%
Enterprise and economic development	2.2%	1.1%	1.8%	3.4%	1.9%	2.0%
Science and technology	0.6%	0.5%	0.7%	0.6%	0.0%	0.0%
Employment policies	0.6%	0.7%	0.3%	0.0%		
Agriculture, forestry and fisheries	1.5%	1.4%	1.3%	2.7%	2.3%	2.1%
Transport	2.6%	4.2%	5.2%	4.2%	6.6%	6.0%
Environment protection	1.2%	1.8%	1.7%	1.9%	2.5%	2.2%
Housing and community amenities	2.3%	2.6%	2.6%	3.5%	4.4%	4.4%
Health	14.4%	16.5%	17.5%	26.0%	27.3%	29.6%
Recreation, culture and religion	2.6%	2.2%	1.9%	3.2%	2.6%	2.2%
Education and training	12.5%	11.6%	11.4%	22.6%	19.3%	19.5%
Social protection	32.5%	31.7%	32.1%	13.1%	12.8%	12.5%
EU Transactions	-1.3%	-1.2%	0.2%			
Accounting adjustments	6.8%	9.1%	6.9%	9.0%	10.9%	10.9%
Total Expenditure (£ billion)	**32.852**	**66.452**	**73.398**	**18.104**	**39.549**	**42.848**

Source: Scottish Government (2018)

Table 28.2: Devolved and Assigned Taxes

Tax	Council Tax	Non-Domestic Rates	Income Tax	VAT Assignment	Land and Buildings Transaction Tax	Minor Taxes
Origin	Long-established means of financing local government and fully within the control of the pre-devolution Scottish Office and of the Scottish Government	Long-established means of financing local government and fully within the control of the pre-devolution Scottish Office and of the Scottish Government	1. Scottish Variable Rate (tartan tax) of *Scotland Act 1998* never used 2. Scottish Rate of Income Tax proposed by Calman Commission and enacted in *Scotland Act 2012* 3. Scottish Income Tax proposed by Smith Commission and enacted in *Scotland Act 2016*	Rejected by the Calman Commission but later proposed by the Smith Commission. Enacted in *Scotland Act 2016*	Calman Commission proposed devolution of Stamp Duty Land Tax (SDLT) and enacted in *Scotland Act 2012*. Replaced by Land and Buildings Transaction Tax (LBTT) in *Land and Buildings Transaction Tax (Scotland) Act 2013*. Administered by Revenue Scotland	The Calman Commission proposed devolution of three other minor taxes, Landfill Tax; Aggregates Levy and Air Passenger Duty. Scottish Landfill Tax enacted in *Landfill Tax (Scotland) Act 2014*, and administered by Revenue Scotland. Aggregates Levy can be devolved under the *Scotland Act 2016*. Replacement Air Departure Tax in the *Air Departure Tax (Scotland) Act 2017*
Implementation Date	Not relevant	Not relevant	Scottish Rate of Income Tax on a neutral basis in 2016-17; Scottish Income Tax on non-neutral basis from 2017-18	2019-20 was planned, but uncertainties about data raise doubts about whether this will ever go live	1 April 2015	Scottish Landfill Tax implemented 1 April 2015
2019-20 Forecast Revenue	£2,088 million	£2,803 million	£11,703 million	£5,707 million (but not yet assigned)	£616 million	Scottish Landfill Tax: £109 million Air Passenger Duty: £295 million (not devolved) Aggregates Levy: £54 million (not devolved)
Comment	Mismanaged by Scottish Government. Council Tax bands still based on 1991 values. Increases in the multiplier on the top four bands from 1 April 2017. A seven-year period in which the Scottish Government effectively imposed a Council Tax freeze. Fundamental reform difficult without comparable change in England	Property valuations problematic because of economic change such as the growth of online retailing. Unlike England, Scotland continues to fully pool revenues. Problems with the system highlighted by the Barclay Report (2017)	Tax base and Personal Allowance are not devolved. Only Non-Savings and Non-Dividend income is devolved. Dysfunctional relationship with National Insurance Contributions	Partial VAT assignment increased the headline self-financing percentage to over 50%. It adds little to fiscal accountability because there is no policy control. Cyclical fluctuations and data uncertainties could make the Block Grant Adjustment for VAT highly volatile	LBTT adopted a graduated schedule in place of the 'slab' system of SDLT. Rest of UK quickly moved to graduated schedule. Scotland followed rUK in introducing Additional Dwelling Supplement. Transaction taxes on property distort property and housing markets but are less visible to taxpayers	Calman Commission sought to maximise the package. The small amounts of revenue are not the main motivation for devolution. Successful environmental taxes will produce less revenue. EU state aid issues are unavoidable even after Brexit. Air Departure Tax shows conflict between economic growth and environmental objectives and the Scottish Greens have vetoed implementation

Source: Author compilation from multiple sources.

Table 28.3: Scottish Income Tax compared to Rest of United Kingdom, 2019-20

	rUK Tax Bands	rUK Tax Rates
Personal Allowance	12,500	
Basic Rate	From 12,501 – 50,000	20%
Higher Rate	From 50,001 – 150,000	40%
Additional Rate	Over 150,000	45%

	Scottish Tax Bands	Scottish Tax Rates
Personal Allowance	12,500	
Starter Rate	From 12,500 – 14,549	19%
Basic Rate	From 14,550 – 24,944	20%
Intermediate Rate	From 24,945 – 43,430	21%
Higher Rate	From 43,431 – 150,000	41%
Top Rate	Above 150,000	46%

Note: The Personal Allowance is reduced by £1 for every £2 earned over £100,000.

Source: Official websites.