

Options For Scotland's Future: Alternative Funding Mechanisms

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Lessons from this section

1. Political devolution without matching economic devolution is an unstable equilibrium, and will sooner or later need to be revised. *Illustration*: the experience of Spain (or Canada).
2. Different financing methods have different characteristics and satisfy different criteria. Selecting one is a matter of priorities and preferences. There is no one best method.
3. The choice of funding method is primarily about its properties as a means of economic management (stability, incentives, the needs of the economy, discipline) and its ability to handle risk; not about simplicity, regional equity or procedural convenience.
4. It is important to distinguish transfers made for social support or redistribution, from those undertaken for regional stabilisation. Fairness in one usually excludes the other. A choice between regimes involves trading social equity (needs) for regional equity.

Lessons (2)

5. Assigning taxes would involve assigning all taxes including oil and corporation tax. If that is not possible, then a top up grant or a degree of fiscal autonomy is inevitable.
6. The lack of risk sharing in assigned taxes, or a grant-based scheme (Barnett), requires Scotland to have debt issuing powers. The same is true for full fiscal autonomy; but it may not be true with partial autonomy depending on the degree of centralisation and size of automatic transfers.
7. If no debt issuing or management facilities are permitted, anything beyond Barnett will become an unstable system driving us back to a grant scheme, or on to greater autonomy – depending on whether central government tries to minimize the debt issued, or the time it is held.
8. Automatic loans or grants from central government create moral hazard and incentives for free riding, but automatic (temporary) transfers do not.

Standard criticisms of the status quo

- **politically deficient:** a) inequitable, inefficient, arbitrary allocation of spending; b) procedurally unfair, being based on events, policies, spending levels outside the region; c) without any obvious input by the Scottish Parliament or electorate.
- **institutionally deficient:** it is not transparent; imposes little accountability; fails to align incentives with public preferences or the needs of the economy (long term development, stability or growth); imposes discipline in Scotland, not London (the lack of convergence in spending, or squeeze, implies it is subject to political adjustment: the overspends).
- **deficient as a tool of economic management:** a) weak risk sharing in a currency union where shocks or structure differ from those of its partners; b) gives no ability to save for a rainy day or allow inter-temporal smoothing in its plans; c) hence does not provide funds for, or allow for, investment or development spending (except as specific earmarks); d) fails to account for the distribution of activity (incomes) within a region.

Additional points to keep in mind

- Difference between long run redistributions to a region, and short term transfers between regions (for regional stabilisation). Some authors refer to the former, systemic transfers via upper levels of government, as *vertical imbalances*; and to the latter, short run transfers between regions, as *horizontal imbalances*.
- Hence a social equity (needs) vs. regional equity trade-off. The choice of one financing rule over another will favour one criterion over the other: regional equality over needs-based equity.
- Any grant or permanent transfer will create perverse incentives: net donors resenting the extra financial burden, and recipients subject to free-riding and dependency. The result: distortions and inefficient outcomes. These distortions will be smaller, and political support firmer, with devolution; and if the transfers are temporary, automatic, and may go in both directions.
- The need for fiscal discipline, and new institutions to provide the necessary support, increases with devolution. In practice, anything beyond Barnett requires the ability to issue/manage debt. Debt rules a grants commission?

Additional points (2)

The Barnett formula calculation:

change in the Scottish department's funding = change to the UK department funding x associated comparability percentage x relevant population proportion.

EU rules on state aid:

(a) Sub-state tax authorities set tax rates or tax bases that diverge from the national level *and*

(b) The central government applies a nondiscretionary equalisation payments [nondiscretionary = they are obliged under current rules to provide] by direct transfer in order to make good any shortfall in revenues raised by local taxation (shortfall meaning a subvention is needed for the regional government to finance spending programmes to which citizens are entitled under national rules).

(c) That UK rather than Scotland should be the relevant “reference area” for questions of state aid.

Alternative financing models for Scotland

1. **A block grant** from London determined by a formula similar to Barnett – but transparent, accountable, and needs based to deal with the equity issue.
2. **Assigned taxes:** some or all taxes raised in Scotland accrue to Scotland; the remainder to London. Unless central government gives a top-up grant or debt is allowed, expenditures must match revenues. This regime makes it possible to choose what proportion of tax or spending is devolved, and what proportion reserved, *on average*. But,
 - a. because future tax revenues are always uncertain, the ability to maintain a balanced budget cannot be guaranteed in any year;
 - b. forward planning becomes uncertain; leads to restrictions on spending and a deflation bias.
 - c. Scottish Treasury to determine what is due to Scotland, and what is not. Endless disputes? The way out is apportioned taxes....back to Barnett
 - d. The tax rates in assigned functions are chosen centrally (as in Canada, Germany, Australia, South Africa).

Alternative financing models (2)

- 3. Fiscal federalism:** assigned taxes plus assigned expenditure functions. But this time some or all taxes and expenditures are assigned up to the central budget. Tax and expenditure rates are all decided centrally, so there is no guarantee that regional budgets will be balanced even if the central one is. Hence automatic fiscal transfers between regions are both possible and likely; this provides the balancing. There is the ability to choose what proportion of tax and spending is devolved, and what proportion is centralised.
- 4. Partial fiscal autonomy:** as in fiscal federalism where the UK and Scottish authorities first agree which taxes and expenditures are to be devolved and which reserved. Then Scottish authorities decide the tax and expenditure rates to be applied to their part. Again the Scottish budget may not be balanced, and automatic fiscal transfers between regions are likely.

Alternative financing models (3)

5. Full fiscal autonomy.

a. full devolution if this happens within a political union; or fiscal independence if an independent country within an economic union.

b. In either case the Scottish authorities choose all tax and expenditure rates (including the tax bands, the tax base and exemptions); and it extends devolution to include social security, unemployment benefits, sales taxes, corporation tax, other business taxes, carbon taxes, etc.

c. But, because there is no central budget, there are no fiscal transfers – *either* between upper and lower levels of government as in regimes 1) , 2); *or* between regions or national economies as in regimes 3) and 4).

d. Covers the case of Scotland in the UK or in the Euro, but falls short of full independence.

Summary

- Each regime has different characteristics and satisfies different criteria. So to pick one out is a matter of preferences. Nevertheless, some financing schemes are more sensible than others.
- The advantages of a grant regime, such as Barnett, are simplicity, stability of revenues (there are no risks to public spending except in the case of political disagreements with London), a clear distinction between reserved and nonreserved expenditures, centralised control of taxes. The disadvantages are the arbitrary grant allocations; a lack of transparency; a dependence on conditions/policies in another economy; no responsibility for raising revenues; and hence inefficient decisions – most obviously in the lack of incentives for growth, savings or capital investment.
- The obvious disadvantage of grants or assigned taxes they allow no devolution in decision making, unless the Scottish parliament sets its own taxes. For devolution – that is some autonomy/accountability in decision making, not just implementation – we have to connect the spending decisions with the revenue raising decisions.
- That makes the link clear between the provision of public services and the cost of providing them. Hence we cannot assign taxes and have devolution without the right to set tax rates; and we cannot assign spending without the right to set spending rates.

Summary (2)

- Assigned taxes raise problems beyond devolution. There is no risk sharing; uncertain revenues; uncertain spending; and an inability to plan. This leads to the need to issue debt, a need for debt management, greater discipline, and possibly new institutions (a Treasury) to manage these aspects of policy and represent Scotland in UK policies that affect Scotland's revenues (the "West London question"). We could also expect disputes over how much tax actually arose in each jurisdiction. As a result, assigned taxes are likely to prove to be an unstable system politically – with central government oscillating between minimising the assignments to prevent debt, and maximising them to help manage it.
- The remaining regimes involve differing degrees of autonomy. Fiscal federalism is a regime of assigned taxes with assigned expenditures, in which the decision to assign up to the central government ensures that the central budget and regional budget remain linked. That takes care of the risk sharing problem through automatic regional transfers via the central budget.
- Fiscal autonomy, partial or full, then provides for increasing degrees of devolution, while retaining risk sharing via automatic transfers. Tax and spending decisions would be more efficient since those spending the taxes are responsible for raising them.
- This would increase accountability and transparency. It would create an incentive to increase growth as a means to expand tax capacity, and to find more effective ways to provide public services. The counterpart is that greater fiscal discipline would be needed: an internal stability pact, debt targets, or an independent fiscal watchdog like the Australian grants commission.

Squeeze and overspend

Index of identifiable public expenditure per head in the Nations of the UK, not including social protection and agriculture, UK = 100

