

THE DAVID HUME INSTITUTE



PAYING FOR DEVOLUTION

Proceedings of a Seminar

Edinburgh, 28 May 1996

Edited by Hector L MacQueen

Hume Occasional Paper No.49

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1996

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## FOREWORD

This is one of two Occasional Papers on the subject of devolution which The David Hume Institute is publishing simultaneously. The first contains the proceedings of a seminar on the subject mounted by the Institute on 28 May 1996 in conjunction with The Constitution Unit, London; the second is a personal response by Sir Alan Peacock to the proposals of the Unit for Scottish devolution as discussed in the seminar and published on 25 June 1996. The Institute is pleased to acknowledge financial support from the Esmée Fairbairn Charitable Trust for these and other planned publications on the subject of devolution.

The seminar of which this Occasional Paper is a record was based upon the prior circulation of two draft chapters from The Constitution Unit's then unpublished report entitled *Scotland's Parliament: Fundamentals for a New Scotland Act* (1996). That report was itself a discussion of how the proposals of the Scottish Constitutional Convention for a devolved Scottish Parliament might be implemented and what the implications might be. It has therefore seemed appropriate to begin this record of the seminar with the Convention's own summary of its proposals as general background material, following that with The Constitution Unit's summary of its chapters and the questions raised thereby, materials which were also circulated at the seminar.

The seminar was attended by around 35 invited persons, drawn from the worlds of business, academe, journalism and politics, representing a cross-section of opinion, and was ably chaired by Mr Peter Jones of *The Economist*. It was conducted under "Chatham House rules". Proceedings opened with presentations by Professor David Bell of the University of Stirling on Financing Devolution and by Professor Gavin McCrone of the University of Edinburgh on the Economy and Industry, and these presentations are reproduced here (Professor McCrone's in summary form). There then follows a summary of the discussion at the seminar. A first draft was prepared by the editor, circulated amongst participants for comment, and finally revised again by the editor in the light of those comments.

Although it must be emphasised that there were and are divisions of view amongst the participants in the seminar, and that none should be seen as committed to any of the various points made in the summary of the discussion, the collection is a serious and critical look at what the implications of devolution may be for Scotland and the United Kingdom,

with especial emphasis on the costs of devolution or, as we have put it in the title, paying for devolution. In particular the seminar ranged over major topics such as levels of public expenditure, the tax-raising powers of the Parliament, and the consequences of change in these areas for the private sector. Since the seminar was held, the Labour Party has announced further proposals in connection with its devolution plans, namely the holding of a referendum upon two questions: should there be a Parliament, and should it have tax-raising powers? If the Labour Party forms the next government of the United Kingdom and implements these proposals, there will be a need for an informed public debate on these two questions, and it may be said that this Occasional Paper presents the issues in a short and accessible way.

Although The David Hume Institute holds no view on the question of the future government of Scotland, it has already made a contribution to the debate with its *Scotland and the Union* (1994), published in the **Hume Papers in Public Policy** series, while a much fuller version of David Bell's paper in the present Occasional Paper will soon appear in that other series. The importance of the question is by no means limited to Scotland, and it is with pleasure that we commend this contribution to the debate to our readers.

Hector L MacQueen and Brian G M Main  
Directors  
September 1996

## The Scottish Constitutional Convention

### **Scotland's Parliament, Scotland's Right**

*An Executive Summary*

#### **Why Scotland Needs A Parliament**

Scotland needs its own Parliament to meet the demands of the people of Scotland for a greater say in their own affairs; to make government more accountable and its policies better tailored to Scotland's concerns; to remove a source of tension between Scotland and other parts of the UK; to counter electoral disillusionment, and to give Scotland a clearer voice in Europe and the rest of the world.

#### **The Work of the Scottish Constitutional Convention**

The Convention is a broadly based representative organisation in Scotland comprising political parties, the majority of Scottish MPs and MEPs, trades unions, the churches, local authorities, the business and industrial community and other national organisations. The Convention has undertaken its work on a basis of consensus and agreement, and believes that this approach provides a model for the better government of Scotland.

#### **Powers and Responsibilities of the Scottish Parliament**

##### **The Scope of the Parliament**

Scotland's Parliament will have extensive powers and responsibilities, including all those that currently lie within the remit of the Scottish Office. These will enable it to make an immense impact on the life of Scotland. It will exercise policy authority over Scotland's economic development, health and social welfare, education, leisure, media, civil and criminal law, judiciary, police and penal system.

##### **Principal Responsibilities**

Some of the main areas which fall within the responsibility of the Scottish Parliament will be -

**Economy and business**, including industrial development, the enterprise networks, tourism development, energy, agriculture, forestry and fisheries.

**Health and social affairs**, including the health service, housing, social welfare, adoption, child welfare, the elderly and community care.

**Infrastructure**, including transportation, roads, harbours, inland waterways, planning, land use water and sewerage.

The primary matters to be retained by the Westminster Parliament will be defence, foreign affairs, immigration, nationality, social security policy, and central economic and fiscal responsibilities.

The principle of subsidiarity will be embodied in the Act which will mean that decisions are taken as closely as possible to the people they affect.

Scotland's Parliament will be established by an Act of the Westminster Parliament which will define its powers and responsibilities. The Act will provide for responsibilities to be shared where appropriate between Scotland's and the UK Parliaments.

Scotland's Parliament will be entitled to debate, and issue statements on, any matter.

### **Making the Parliament truly representative**

The Convention is resolute that Scotland must have a Parliament whose membership reflects the regional diversity of its communities, one in which men and women are fairly represented in numbers broadly proportionate to their shares of the population and one which actively encourages the participation and involvement of all groups, including ethnic minority groups, in its consultative processes.

Scotland's Parliament will have a total of 129 members, and each elector will be entitled to cast two votes. The first vote will be for one of the 73 constituency MSPs, who will be elected on the present "first past the post" voting systems. The second will be cast for a local party or group list of additional members. There will be 56

additional members, seven from each of eight areas corresponding to the present European Parliament constituencies. The names on each list will be published ahead of the election, and detailed on the ballot paper. The seven seats will then be allocated so that the total representation from each area - including MSPs returned for individual constituencies - will correspond as closely as possible to the share of the vote cast for each party in the area.

The Convention regards equal representation of men and women in the Scottish Parliament as a central pillar of Scotland's Parliament. It endorses the cross-party agreement reached between Convention partners on this objective, and urges other political parties to implement the principles of the agreement.

The Scottish Parliament will be presided over by a Speaker, elected by and from the full Parliament.

The administration will be headed by a Chief Minister, who will normally be leader of the largest party in the Parliament. A Cabinet will be drawn from MSPs in the party or parties which form the administration, and confirmed by the full Parliament. Law officers need not be MSPs.

Being an MSP will be a full-time appointment. The Parliament will sit for a fixed term of four years, and may be dissolved early only in exceptional circumstances and with the agreement of two-thirds of MSPs.

The Convention expects the Parliament to enshrine in its Standing Orders a number of key principles: that MSPs devote themselves to the business of the Parliament and the interests of the electorate; that the Parliament conduct itself as openly as possible, for example by enabling electors directly to petition it, by consulting widely before and during the legislative process, and by making appointments to public bodies open and democratic; that the Parliament operate a system of powerful committees, empowered to initiate as well as amend legislation and to undertake wide-ranging investigative functions; that the Parliament promote and practice all aspects of equal opportunities; and that the Parliament encourage constructive, rather than confrontational, debate and discussion.

The Civil Service in the Scottish Office will be recognised to serve all areas for which Scotland's Parliament will be responsible. The House of Lords will play no part in the Parliament's legislative process.

### **Secure and stable finances**

Scotland will be guaranteed a fair share of UK resources according to its relative need and as of right. This objective will be attained by basing the financial settlement for the Parliament upon a continuation of the principle of equalisation of expenditure within the UK. This means resources will be pooled on a UK basis and distributed on the basis of relative need. The current formula for the calculation of government expenditure in Scotland - the Barnett/Goschen formula - will continue to be used as the basis for the allocation of Scotland's fair share of UK resources. Scotland's Parliament will have autonomy over how the resources assigned to Scotland are used, and will thus be able to determine its own priorities in public expenditure.

Scotland's Parliament will additionally have the power to vary the basic rate of income tax for Scottish taxpayers by up to 3p in the pound. This power will stand distinct from the formula used to calculate Scotland's assigned share of UK resources. Scotland's Parliament will have no powers to vary corporate taxation.

### **Conclusion**

These proposals are a practical response to the consistently expressed wish of the people of Scotland for a Scottish Parliament. They show that the Parliament can work, that it can meet Scotland's needs much more effectively than do the present arrangements, and they show how. They are the property of no single party or interest group, but have been reached by negotiation and agreement between the Convention's diverse membership. They are that perhaps unique political phenomenon, a true consensus. All the Convention partners are prepared to work with enthusiasm to bring it into effect. It is in that spirit that they commend this report, with pride, to the people of Scotland.

## The Constitution Unit

### SCOTLAND'S PARLIAMENT: FUNDAMENTALS FOR A NEW SCOTLAND ACT

#### Discussion Paper

1. The Constitution Unit, University College London, published on 25 June 1996 a detailed report on *Scotland's Parliament: Fundamentals for a New Scotland Act*. The background papers for this seminar were draft chapters from the Unit's report on "Financial Provisions" and "Economic and Industrial Policy". A summary of the main points in the chapters, and questions which might arise, follows below.

#### Financial Provisions

2. The chapter notes that the financial provisions will be the heart of the devolution settlement. If there is tension between Edinburgh and London it is more likely to be over money than, say, the division of legislative competences. The arrangements proposed by the Scottish Constitutional Convention are a sensible basis on which to establish the Parliament, but seem unlikely to provide stability in the longer term.
3. The Barnett formula, by which changes in the Scottish budget are related to changes in plans for English equivalent spending, is already under pressure. It has not brought about convergence to the level of spending assessed in 1976 as matching Scottish need. It has been recalibrated once already, in 1992, to reflect population change, and Scotland's share of GB population continues to fall. The formula will come under intense public, political and technical scrutiny after devolution. There will be pressure to review it.
4. The chapter suggests the establishment of an independent Commission, with members appointed by both the Scottish and the UK Governments, as the key to maintaining confidence in any formula-based system of allocation post-

devolution. The role of the Commission in the allocation process might be three-fold:

- to conduct a UK-wide needs assessment in order to provide objective data, and to place a new floor under the amount of 'convergence' the formula should aim to deliver.
  - to make recommendations about the allocation formula in the light of that assessment.
  - to conduct an independent audit of the results of applying the formula each year in order to ensure the objectivity of the data and the process, and to highlight any areas of difficulty in the strict application of the formula (eg changes of policy in England meaning that there is no 'English equivalent' to which to apply the formula).
5. The chapter argues that autonomous revenue raising powers are essential to achieve a sense of fiscal responsibility and accountability to the Scottish electorate for decisions about spending priorities. The proposed power to vary the basic rate of income tax by three pence is a modest power (with no significant macroeconomic effects for the UK as a whole) and is intended to spread any tax change widely and visibly. But it is a blunt instrument as it stands to achieve those purposes: both the level of the basic rate of the income range to which it applies will be determined by Westminster, and there are no proposals to vary other elements in the tax system.
6. As devolution extends throughout the UK, there may be scope for thinking more imaginatively about revenue raising. Just as for expenditure, a first requirement will be accurate data about the revenues derived in Scotland from the various forms of taxation. Tax sharing or 'assignment' might find a place in a longer term settlement, once reliable data are available and familiar.

## Economic and Industrial Policy

7. This chapter suggests that the link between devolution and increased prosperity is not made as strongly today as it was in the 1970s. Concerns now are more democratic than economic. Partly that may represent a greater realisation that the scope for Scotland to pursue an independent economic or industrial policy within the context of UK policy (which will become increasingly shaped by the European Union) is limited.
8. Among the potential economic benefits of devolution, there will be advantage in the ability to review the institutions of economic development (Scottish Enterprise, Highlands and Islands Enterprise, the LECs etc), in an enhanced capacity for strategic planning, in giving incentives and support for SMEs, and in fostering a closer relationship between business people and decision makers (geographically - the presence of the decision makers in Edinburgh and psychologically - potentially the presence of local business people among them). The ability of the Scottish Parliament to implement EC directives in Scotland might also demonstrate the advantages of having a Government more accessible and possibly more responsive to Scottish needs.
9. But control of macroeconomic policy will remain at Westminster, and the risk of competitive bidding between UK nations and regions argues for the framework for incentives to inward investment and domestic regional investment to be set by central government too. The EU dimension is significant, especially given the rules on matching EU grant funding (additionality) and the gap between the level of state aid permitted under EU rules and the lower (cost per job) limits set by the UK government. Tolerance and mutual accommodation will be required to preserve the benefits for Scotland of the present UK regional assistance regime, perhaps embodied in a formal agreement between the DTI, the Welsh Office and the Scottish administration.
10. Similar arguments apply in the treatment of the privatised utilities. Although the Scottish Executive will have a strong

interest in regulation arrangements and should be involved in their design, overall responsibility for the utilities (including the railways) should remain at the UK level. Likewise in agriculture and fisheries, given that the EU is the main source of policy, and of spending obligations, in these areas, it would be better for formal responsibility to remain at the UK level, but with input from the Scottish Executive. Otherwise Scotland will have to take on responsibility for substantial mandatory expenditure in a policy area over which the Executive will in practice have little control.

11. Finally, the chapter notes that perhaps the biggest economic worry posed by the prospect of devolution is the uncertainty that it has introduced into the present financial climate.

### Questions Arising

12. The aim of the seminar was to stimulate a cool, analytical discussion of the issues raised in these two chapters, on the basis of presentations by Professors David Bell and Gavin McCrone. Some of the questions which might arise are:
  - How durable is the Barnett formula; and how strong the pressure to change after devolution?
  - Will a new needs assessment exercise, up-dating the Treasury assessment in 1976-79, be necessary; and would it be in Scotland's longer term interests to advocate one?
  - How will the politics of the Scottish allocation develop, in particular in relation to the English regions?
  - Is an independent Commission with the three roles suggested a sensible addition to the Convention's proposals?
  - Is the Parliament's modest revenue raising power right in principle; and in practice?
  - Is it right that economics plays less of a role in the devolution debate today than in the 1970s?

- Are there advantages in proximity of government: greater responsiveness, Scottish policies to match Scottish needs?
- Is the continuation of UK co-ordination of incentives for inward investment and domestic regional investment feasible - or desirable - after devolution; and what is the alternative?
- Macroeconomic policy will be the responsibility of the UK Government: what does that mean? What are the essential elements of policy that have to be retained at the centre?
- What is there in the Convention's proposals to frighten the horses, or the markets?

## Financing Devolution

*David Bell*

I begin this talk by assuming that a Scottish Assembly will be created within the next two years. What will the bulk of the Scottish electorate make of this development? My contention is that their reaction will principally depend on any changes which they notice in the provision of public service such as health, education, transport etc. An Assembly which is seen to impose, or acquiesce to, school closures, health service cuts and falling levels of policing is unlikely to be popular. Nevertheless, such changes may be unavoidable if the finance available to the Assembly is insufficient to meet the demands being placed on it. Thus, the financial arrangements for the Assembly will be crucial to its popularity, and hence to its long-term prospects.

The proposal from the Constitutional Convention is that Assembly funding will be based on a Block Grant arrangement similar to the present one. In addition, it is suggested that a 3 pence in the pound variation on the standard rate of income tax should be available to enable the Assembly to directly raise some of its own resources.

Let me make two initial points: first, the resources available to Scotland are likely to come under pressure irrespective of the creation of an Assembly; second, the funding arrangements between the Assembly and Westminster cannot duplicate present arrangements.

The consensus view now suggests that Scotland has historically been given favourable treatment from the public purse. Estimates of identifiable expenditure per head have typically suggested that, in recent years, spending in Scotland outstripped that in the UK as a whole by 14 to 20%. Even though the composition and the calculation of the "Block" i.e. the functions funded through the Barnett formula, has changed through time, Scotland's relative advantage has changed very little.

Although it might appeal to more Machiavellian minds that this has been due to the success of some "Tartan conspiracy", which has pulled the wool over the eyes of the Treasury, the reality favours the

cock-up rather than the conspiracy theory of political life. The funding of the Scottish Office through the Barnett formula is essentially a by-product of negotiations between the spending ministries in England and the Treasury. For example, if the government chooses to protect resources going to the NHS, Scotland benefits because of the historically high health spending.

In principle, the Barnett formula should lead to an equalisation of per capita spending. In practice, the rate at which equalisation takes place is dependent on both the overall rate of growth of real government spending and on the rate of inflation. Both of these fell sharply during the 80s and 90s compared with the 1970s. Combined with a failure to adjust for slower Scottish population growth, the result has been a continuation of relatively high levels of public spending in Scotland. Seeing the rather haphazard outcome of the Barnett formula has been to Scotland's advantage, the Scottish Office has successfully fought to retain it.

However, Scotland's financing arrangements are coming under ever closer scrutiny. Political pressure in England from both parties may well lead to a reappraisal. This is more likely when an election campaign focuses minds on the issue of public finance. Recall that the Barnett formula itself was a by-product of the 1979 election and the most recent adjustment for population shares by Michael Portillo occurred in 1992. This issue will arise again at the next election and further pressure to reduce public spending in Scotland can be expected whether or not an Assembly is established.

However, if an Assembly is set up, the allocation of finance to Scotland will have to be more transparent. Instead of being an intra-government transfer, the block grant will become an inter-government transaction. Both governments will be keen to establish that they are robustly defending public spending amongst their own electorate. At present, the Scottish Office receives a certain amount of "formula-bypass" funding. This occurs when contingencies arise for which the Barnett funding would be inadequate. The exact amount and nature of such funding is difficult to pin down, but it clearly provides a useful flexibility in the system.

If Assembly funding was based on a rigid set of rules negotiated between Westminster and Edinburgh, this flexibility would

disappear. Unless some alternative short-term financing mechanism could be found, the likelihood of high-profile political conflict between Westminster and Edinburgh will be high.

The obvious danger for Scotland is that the creation of an Assembly will result in a rigid new scheme of regulating public sector finances, accompanied by downward pressure on resources based on the premise that its treatment is far too generous compared with England and Wales. How would we seek to lessen this danger? We would make a number of arguments.

First, we would accept that the Barnett formula is an *ad hoc* and unsatisfactory solution to allocating resources between the "territories" - England, Scotland, Wales and Northern Ireland. Its inevitable eventual outcome is equalization of *per capita* spending across the whole of the UK. This cannot be defended as just. There are many areas of public spending where equal *per capita* spending cannot be readily defended. For example, in the road building programme, equal *per capita* spending would probably leave the South-East of England covered in tarmac while in Scotland there would be no roads north of Inverness. Perhaps more importantly, there are many social and health problems which are not evenly spaced throughout the UK and which will therefore require some concentration of resources if they are to be combatted effectively.

In its place, the only defensible principle that can be applied to allocating public resources is that of equal spending to meet equal need. For example, areas with severe health problems might expect to receive a larger grant than areas where the populace is more healthy. This principle is already used to determine local authority spending in both Scotland and England and Wales and has gained, albeit grudging, acceptance. However, though it will provide a more solid foundation for funding the Assembly, there are many issues surrounding its practical implementation which will have to be settled before the Assembly first meets. Before dealing with these, however, let me make the further point that allocating resources on the basis of need is a principle which could be extended to other parts of the UK, should there be pressure for the extension of devolved powers in Wales and regions of England.

Let me now deal with the practical issues. First, it is clearly imperative that some assessment of need is made: but who is to make the assessment? What needs are to be assessed? What methods are to be employed? And how often will a reassessment be necessary? These are arrangements which will have to be recognised in the enabling legislation but probably cannot be fully established before the Assembly is created. A needs assessment exercise was carried out by the Treasury in 1976-77 in anticipation of devolution. Its results were published in 1979. Given this experience, it is unlikely that a needs assessment could be carried out in time to meet Labour's proposed timetable for the establishment of an Assembly. Consequently, some transitional arrangements, based on the current Barnett formula would be required. The Treasury study suggested that Scotland's relative need in the services which were to be devolved was 16% greater than the rest of the UK in 1976-77, but expenditure was some 22% higher. Many of the reasons why one might expect an assessment to demonstrate higher need in Scotland have not changed: clearly problems associated with having a much more dispersed population are little altered; similarly, Scotland's health problems, though arguably self-inflicted, show little sign of improvement relative to the rest of the UK. However, there has been substantial relative improvement in some economic indicators, such as unemployment which is now below UK rates. My suspicion, therefore, is that a new needs assessment would result in a somewhat lower figure than the 16% of 1976-77. However, I would repeat my earlier view that continuing pressure on the Scottish Office budget is likely, even without devolution.

Let me now return to the practical problems of implementing a needs assessment. First, there is the question of who is to make the assessment. Our view is that the balance of power between the Treasury and the Assembly is heavily tipped in favour of the former. Allowing it to lay down the rules and play the game would mean the Assembly has a very weak hand. Further, the Treasury may be charged with carrying out the policies of a Westminster government of a different political persuasion from that in Edinburgh. To "hold the ring" we propose the creation of a Commission whose principal role would be to conduct impartial assessments of relative need throughout the UK. Its membership would come from central government and the Assembly. It would be an advisory body; with

the ultimate decisions on public spending still being the responsibility of central government.

As implied earlier, it would have a number of tasks. First it would carry out periodic needs assessments. These would primarily require the collection and collation of statistical information which reflects levels of need in different parts of the country. Its job would be to assess relative not absolute need, and thus it could not interfere with central government's fiscal stance. It therefore could not be deemed to be interfering with macroeconomic policy.

Second, it would be involved in the design and review of the methodology for conducting the needs assessments. There are many issues relating to the range of indicators selected to assess need, the accuracy with which they can be measured and the weight to be placed on each which will require detailed study by the secretariat of the Commission.

Third, it would devise methods of dealing with the problems which arise when differences between the Assembly and Westminster arise about the range and scope of public service provision. Were it given complete control of the financial provision, the Westminster government could place enormous pressure on the Assembly to follow its policies regarding those services to be provided by the public and private sectors respectively. For example, if Westminster decided to privatise the NHS to fund tax cuts, and in consequence forced the Assembly to accept a much reduced block grant, the administration in Edinburgh would have little option but to also move in the same direction if it could not find savings elsewhere. Note that the Assembly might react by arguing that Scotland would be prepared to miss out on the tax cuts, but this would create a separate set of difficulties.

This is an extreme example. One could not expect the Union to survive a long period in which different parts of the UK hold radically different views of the role of the state. Nevertheless, the boundaries of the public sector are now much more fluid than they were in 1976. We already have some quite significant differences between Scotland and the rest of Great Britain, such as the water industry, and we cannot expect that further differences will not arise.

Thus the Commission will have an important role in investigating and reporting on such differences. It will need to devise a *modus operandi* for dealing with them and will have to make the Westminster government aware of the implications for Scotland of moving the boundaries of the public sector.

Moving on I would want to make some further points:

First, on taxation. There will be practical problems of implementing a tax variation power. These should be surmountable, but the private sector is becoming increasingly sophisticated in tax avoidance, as the recent article by Professor Alan Walters demonstrated. Thus revenues which would have been of the order of £400m-£500m in 1993-94 may well fall short of expectations.

The effects of taxation will depend on its incidence. If it is perceived as a one-off payment for a particular project, then employees may be more prepared to accept the loss in real income. On the other hand, if it becomes part of general revenue raising, then employees are more likely to increase their wage claims, so that employers bear some of the costs.

The net effect will depend on the balance of activity gained through increased public works relative to that lost through falls in consumer spending. The effects of an increase in spending matched by an increase in taxation are measured by what is termed a balanced budget multiplier. The larger UK models show that these are largely neutral. One final point: taxation may also have a distortionary impact if only levied on the standard rate of income tax.

I have not said anything about borrowing by the Assembly, which would provide a further source of finance: all public authorities require some kind of overdraft facility, even if just to meet short-term capital requirements. Though the Constitutional Convention ruled out borrowing by the Assembly, I think it is acknowledged that some kind of facility is essential. It would be good for that to be held by a Scottish bank.

# The Economy and Industry

*Gavin McCrone*

(Summary)

The possibility of devolution in Scotland has been with us for a long time. Much of the original pressure for it arose from discontent with the state of the economy. Now it is more related to the issue of the perception of a democratic deficit in Scotland, and is seen as essentially an exercise in democracy. Administrative decentralisation - an odd system - has gone as far as it can, and is not democratically accountable to the Scottish electorate.

The paradox is that devolution is unlikely to mean very much on the economic front. The threats of companies to leave Scotland if there is devolution are therefore astonishing. Devolution is likely to be much less significant for Scotland than, say, a distancing of the UK from the European Union. Business is tending to direct its fire at devolution when what it should really be concerned about is separation from the rest of the UK. Of course, some business people perceive devolution as the first step on the slippery slope to such separation. Will devolution lead to separation? In fact, it may well do the reverse. Failure now to implement devolution might well lead to separation, as would a failure on the part of UK politicians to make devolution work. Goodwill is essential to make any system work.

## **Economic issues**

It is proposed that the following matters continue to be dealt with at a UK or European Union level:

- macroeconomic policy (i.e. monetary, exchange rate and fiscal policy - budget deficits)
- regulatory standards (i.e. financial sector, food standards, pharmaceuticals, etc)
- monopoly and competition policy (although this perhaps to be regretted; however, the Scottish Executive will be able to make

representations to the regulatory authorities, as the Scottish Office does now)

- sectoral policy (schemes of grants or other assistance, if they still exist)

Broadly the matters which are presently the responsibility of the Secretary of State for Scotland will be transferred to the Assembly. These are divided into *institutional arrangements* and *levels of assistance*. Institutional arrangements in the economic field include Scottish Enterprise, Locate In Scotland, Highlands and Islands Enterprise, the Scottish Tourist Board, and the delivery of training systems. Grants and assistance can be made under regional policy but are subject to an agreed EU and UK framework. Promotion of inward investment, with assistance provided by Scottish Enterprise, Highlands and Islands Enterprise and others, is also subject to UK agreement. The assisted areas map will be subject to discussion and agreement with Whitehall and Brussels, as at present. Training and education will fall to the Assembly, along with the presentation of bids for EU structural funds and general lobbying of the EU.

The UK and EU constraints are unavoidable because competition within the UK and the EU has to be fairly determined; otherwise areas with minor problems will outbid those with real difficulties, or a free-for-all bidding-up will break out, to nobody's advantage. The Competition Directorate of the European Commission set maxima for different categories of area in the 1970s, and the Industry Act 1972 set the UK limits to make full use of these maxima. Since the abolition of the Regional Development Grant, and with stronger use of Cost per Job limits for regional selective assistance, the UK ceilings are below those for the EU. UK regional assistance in Scotland is in real terms now only 28% of what it was in 1983-84. Attempts by a Scottish Executive to raise levels of assistance would only lead to demands for the same from other UK regions. And in the end the UK Treasury holds the purse strings.

Relatively Scotland is not as disadvantaged as it was. The GDP per head is almost at the average UK level, while until March 1996 unemployment was *below* the UK average and is now only very slightly above.

Where aid is given to small and medium-sized enterprises (SMEs), local flexibility is more possible, thanks to the recognised need to encourage SMEs and entrepreneurship. But new schemes proposed by the Scottish Executive would still need to be cleared with the UK and the EU before legislation. With regard to training, where training assistance takes the form of grants to firms, UK and EU clearance is necessary, but not where the aim is to get unemployed people back to work. Training policy has been one of the greater disasters of the UK economy. There should be scope to make major improvements in Scotland, linked to education. But this could result in pressure to spend less on universities (where there is also the question of whether proper allowance will be made in the budgetary settlement for English students in the system), in order to provide resources for schools and vocational training schemes.

Scotland has done well in obtaining monies from the EU Structural Funds in recent years (£1.5 billion since 1979). But this has been spent mostly on infrastructure. The additionality question could become a bone of contention between the Scottish Executive and Whitehall. Further, beyond 1999, EU structural funds are unlikely to be so generous towards Scotland, especially if central European countries join the EU.

### **The financial question**

This has already been covered in David Bell's presentation. But the financial settlement has economic implications which are probably more serious than changes in regional or industrial policy. It is an uncomfortable fact that Scottish identifiable public expenditure is about £600 per head higher than in England, or around £3 billion more than its population share. There are good reasons for a difference, but not for such a big difference. Bringing down the Scottish figure from 21% above that for England to 16% (the needs assessment) would still mean a cut of about £890 million. This is still a very large figure and compares with the £100 million or so spent each year on regional policy. Such a cut is bound to impact on the quality of the services being provided, and upon employment.

The tax-raising powers of the Assembly are minimal as proposed. I originally took the view that they were unlikely to be used. But I now think that a Scottish Executive may be forced to use them if, say,

a Portillo government were to enforce a draconian financial settlement that would leave Scotland having to impose unacceptable cuts in public services (we are already very near the wire now in health and education).

This is not a good basis upon which to float a major initiative on constitutional reform. With an unsympathetic Westminster government, it could play right into the hands of the SNP.

### **Summing up**

Independence is a major issue for the Scottish economy. Devolution is not. Business should ensure that it fires at the right and not the wrong target. If businessmen are concerned about separation, they should help to ensure that devolution works and does not become a slippery slope. Opposing it will either mean that devolution goes ahead without their input, or that the debate polarises, making separation more likely. The potential plus factors in devolution are institutional control and the psychological impact of self-government (see the example of Catalonia). The potential negatives are the budgetary hole and the financial settlement generally. A neutral factor is that it is unlikely that there would be substantial changes in regional policy or assistance from the EU that would not occur anyway.

## The Seminar Discussion

The discussion focused on three principal themes:

- public spending
- taxation
- general economic impact

### Public spending

The Constitution Unit document had highlighted Scotland's relatively higher levels of public expenditure per head than in England, apparently beyond what can be justified by relative need. It was generally felt that the issue was a problem for Scotland whether or not there was devolution. As the Constitution Unit had pointed out, the existing Barnett formula was designed to depoliticise the process of allocation and was intended to promote convergence (although not equalisation) of Scottish and English spending levels. The extent of divergence is dependent upon the inexact science of "needs assessment"; the key questions are the extent to which a higher expenditure per head can be justified, how any required convergence is to be achieved, the pace of convergence implied, and whether devolution would tend to make differences more transparent and so risk accelerating convergence.

The Barnett formula had so far largely failed to achieve convergence, and on its own the formula was not an adequate basis for the settlement of public expenditure following devolution. Even retaining the present formula could have uncomfortable results, giving a reducing return for Scotland. 35% of the Scottish Office budget goes to local government and 30% to the National Health Service, and, further, much of the expenditure is on pay, the settlement of which is a highly political issue. In the context all other public services would have to fall behind if these politically sensitive areas were to keep pace with spending increases in England.

There was discussion of and support for the Constitution Unit's view that the establishment of a Scottish Parliament would make the

process of setting Scotland's public expenditure budget more transparent. The debate will however raise the political temperature in England as well as in Scotland, since it will become more widely apparent that there is a relatively greater amount of public expenditure per head north of the border (while also making the level of subsidy to poorer English regions more evident).

The establishment of a Commission to carry out an assessment of needs, as suggested in the Constitution Unit document, would produce transparency, although not de-politicisation. It would also face problems in a difficult political atmosphere in which nobody trusts anyone else's figures. It was observed that "needs assessment" was at best an imperfect process because any measurement of need is highly subjective (although it was not clear whether there was any better alternative approach). But if a public expenditure system was based on need, work done in the late 1970s suggested that this would result in a substantial cut for Scotland as compared with the present provision, although not such a big cut as a reduction to population share would involve - perhaps from the present +22% to +16%. Any new "needs assessment" would probably still produce a subsidy to Scotland. It was observed that if Scotland remains part of the monetary union, cross-subsidy is an integral effect.

There was some discussion of what would happen if the pace of transition to convergence in spending levels were speeded up. It was suggested that the Scottish Executive would have to encourage private provision and charging for public services while also managing public expectations of services downwards.

It was possible to see the growth of a system arising out of the proposals for public expenditure, which enabled the fiscal position of all UK regions to be better understood and the taking of more rational decisions. Australia was quoted as an example, where there is equalisation of public expenditure between states on a programme by programme basis.

The implications for the private sector of a fall in Scottish public expenditure were discussed. Much of the effect would be on capital projects; in particular reductions in road building or retrenchment in the health service or education would have significant effects on levels of economic activity and employment. It was unclear what

might be the effects of the changing boundary between the public and the private sectors (e.g. the Private Finance Initiative (PFI), under which more and more capital activity will classify as private spend but have recurrent cost implications on the public side).

The purpose of cutting public expenditure was discussed. If it was a matter of balancing the budget, should the possibility of increasing revenue, so that the Scots, through their elected representatives, can spend what they want to spend, also be taken into account? It was observed, however, that the problem arose on the expenditure side, because revenue in Scotland was at approximately its per capita UK level in Scotland. The possibilities of raising (or cutting) tax were constrained by issues of practicality for taxes such as VAT, excise duty and corporation tax, and by equity and incentives for personal taxation, where the main problem would be asymmetry in the UK. The best approach would be to establish a UK regional basis for public expenditure and, as far as possible, needs assessment, de-politicise the issue, and manage expenditure more effectively.

## Taxation

The question of whether the tax-raising powers of the proposed Parliament are right in principle was discussed. There seemed to be general acceptance that such powers would ensure a disciplined approach by the Parliament, particularly if the power was not exercised immediately upon its establishment, since it would be more difficult to blame Westminster for inadequate funding every time a problem had to be faced. It would require clarity in showing how the revenue raised through the power would be used. The yield from exercise of the power at a level of 3% on the basic rate of tax would however be minimal, probably of the order of £450-500 million.

There was a fair degree of consensus that a power of up to 3 pence in the pound on the basic rate of taxation would be manageable for business, although a survey of businesses in Scotland had shown 70% against any tax-raising powers for the Parliament. It was noted that another survey published in *The Scotsman* had shown that a majority of Scots favoured tax-raising powers for the Parliament but that an equal majority would not vote for a party wishing to exercise

the power. This underlined the political discipline which the tax-raising power would create.

The effect of differential tax-rates on the willingness of people to work in Scotland - the incentive effects of regionally different tax rates - was discussed. It was suggested that the remuneration of mobile labour would need to be increased to compensate for any differential tax, but that businesses would generally be unable to pass on to customers their resulting costs; on the other hand it was argued that the willingness of people to live and work in Scotland would not be affected any more than it was by local taxation. The tax-raising power had to be confined to supplementing the basic rate on earned income, however, and should not encompass powers with regard to progressive taxation. A move outside the basic rate would have serious disincentive effects for people coming to work in Scotland. Local taxation should be reviewed; but the reimposition of the power of local authorities to determine business rates would be a major issue for business.

### **General economic impact**

Devolution was seen as a political rather than as an economic event. The main business fear was that, because it would draw attention to differences in public expenditure between Scotland and England, the Parliament would be in danger of starting with a very adverse public expenditure prospect which could undermine the constitutional settlement and therefore prove to be the top of the slippery slope to independence. A comment in response to this was that the best way of keeping off the slippery slope was to have substantial business participation in the Parliament; the speaker knew half a dozen business people (some at least Conservatives) who were considering standing for the Parliament.

The potential number of MSPs (129) was questioned as too large. In response it was said that this was the minimum number required for the proposed proportional representation system to be used in the elections to the Parliament, which would also prevent any party from forming a government on its own, perhaps producing less adversarial government. The capacity of the Parliament to intervene would be limited by the finance available and the European Union's controls on state aids.

## Conclusions

**Professor Bell** suggested the following conclusions:

- (1) In the short term, the Parliament would have little economic impact. Interventionism would be very difficult.
- (2) The Commission on Needs Assessment would make a useful contribution (with some reservations).
- (3) Management of public expectations by the Parliament would be very important.

**Professor McCrone** commended the realism of the discussion. The creation of the Parliament was an exercise in democracy, not in economic improvement. The financial problem needs to be dealt with, or contained. Business should worry less about devolution than about the possibility of the UK's withdrawal from the European Union.

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The David Hume Institute was registered in January 1985 as a company limited by guarantee: its registration number in Scotland is 91239. It is recognised as a Charity by the Inland Revenue.

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