Foreword

In the May 2007 elections to the Scottish Parliament the Scottish National Party (SNP) won the largest number of seats and formed Scotland’s first nationalist government, albeit a minority one, since the launch of devolution in 1999. A key election pledge made by the SNP in the run-up to the election was to conduct a referendum on Scottish independence in the lifetime of the next parliament. And while the result of that referendum would have no formal bearing on Scotland’s constitutional future, undeniably it will carry considerable political weight and, if won, will trigger an unprecedented debate over the future of Scotland in the Union.

In August 2007, and as a prelude to the independence referendum expected in 2010, the SNP Government launched a National Conversation designed to consult the Scottish people about their constitutional future. The options on the table ranged from maintaining the status quo, through an increase in the range of devolved competences, to outright independence. At that time it appeared that only the SNP was prepared to engage the Scottish people about their future constitutional preferences. The opposition parties – especially a Scottish Labour Party still reeling from the shock of electoral defeat – seemed unable to develop a coherent strategy to counter the rising popular appeal and apparent relevance of the new Government to the political mood in Scotland. However early in 2008, and doubtless in an attempt to reclaim the constitutional debate from the SNP, Wendy Alexander – Labour’s then Scottish leader – called for the creation of an independent Commission to review the powers of the devolved government in Scotland some ten years after the initial devolution legislation had been drafted. With support from the other opposition parties, the Scottish Parliament established this Commission under the chairmanship of Sir Kenneth Calman. Its terms of reference were:

To review the provisions of the Scotland Act 1998 in the light of experience and to recommend any changes to the present constitutional arrangements that would enable the Scottish Parliament to serve the people of Scotland better, improve the financial accountability of the Scottish Parliament, and continue to secure the position of Scotland within the United Kingdom.

Unsurprisingly the Calman Commission did not enjoy the support of the SNP Government which regarded it not only as unnecessary in the
context of the ongoing National Conversation, but as partial in remit because it excluded independence from the range of constitutional options on which it would take evidence. Indeed the terms of reference given to the Commission go farther than excluding independence by requiring the Commission only to reflect upon reforms that do not compromise the position of Scotland within the UK. The difficulties inherent in these terms of reference are fairly obvious. Two examples will suffice to illustrate the point. First, if one assumes that devolution itself was intended to secure Scotland’s position in the UK by undermining the appeal of the SNP then clearly this strategy has failed. Accordingly by what criteria might the Commission gauge the extent to which a further devolution of policy competences would ‘secure’ – or otherwise – Scotland within the UK? Second, how are the trade-offs between, say, improving the financial accountability of the Scottish Parliament by further devolving fiscal responsibility to the Scottish Government to be set against the political implications fiscal decentralization may have at some point in the future for the constitutional integrity of the United Kingdom?

Self evidently the work of the Calman Commission is of the highest constitutional sensitivity at this juncture. Yet significant as this might be in political terms, at least some of the issues that the Commission is tackling lend themselves to a degree of objective economic analysis. This is particularly the case when seeking reforms that will increase the accountability of the Scottish Parliament for monies allocated, under the Scottish budget, for spending on devolved policies. As is well known, the current arrangements provided for little if any accountability in this regard. Devolved spending is financed through a block grant assigned by the UK Government to the Scottish Government. The annual amount of the block grant (currently around £30 billion) varies according to the Barnett Formula which links changes in the block grant to changes in spending allocations made to UK Government spending departments whose counterpart spending in Scotland has been devolved. If Whitehall departments’ spending rises (falls) then so too does the block grant by an amount determined by Scotland’s share of the UK population, currently fixed at 10.23 per cent. However it is entirely a matter for the Scottish Government and Parliament how the block grant is spent; there is no requirement that the pattern of spending on devolved policies in Scotland follows counterpart spending by Whitehall departments. It is this aspect of devolution that has attracted most criticism, at least from economists, because the separation of ‘spending’ from ‘taxing’ decisions means that there is no incentive for the Scottish Parliament to reduce public spending below the level of the block grant, even if so doing would be beneficial in economic terms (for example the ‘crowding out’ argument). Critics also argue that the system
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whereby almost all tax revenues raised in Scotland are transferred directly to the UK Treasury provides little incentive for a Scottish Government to assign local expenditure in a way that maximizes economic growth in Scotland as it will not benefit from the (income, corporation, VAT) tax dividends that accrue.

It is this central issue of financial (non-)accountability and its consequences that form the primary focus of this volume. As is clear, Hallwood and MacDonald conclude that, from an economic perspective, only under a regime of full fiscal autonomy will the economic problems that result from an absence of financial accountability on the part of the Scottish Parliament as described above properly be resolved. If one wishes to locate the intellectual tradition within which this book sits then it would be what Wallace Oates has described as Second Generation Theories (SGT) of fiscal federalism (Oates, 2005). These SGT share an analytical approach in which the fiscal centralization versus decentralization debate is couched not only in the basic (allocation, distribution, stabilization) policy ‘assignment’ rules originally elaborated by Musgrave and which dominated the First Generation Theory (FGT) of fiscal federalism, but which now incorporate more recent contributions from public choice theories that stress the role of incentives on the part of decision makers (whose behaviour is part of the SGT research endeavour) and the impact of information asymmetries at different levels of government on the processes of decision making. It is fair to say that contributions within the SGT qualify many of the conclusions reached by scholars working within the FGT, not least in respect of the overall economic gains that can accrue as a result of fiscal decentralization that goes far beyond that advocated by the FGT. Indeed, a degree of decentralization that approximates to full fiscal autonomy on a subnational basis.

The importance of this book lies not only in the intellectual contribution the authors make to the SGT of fiscal federalism. Each chapter has a resonance closer to ‘home’ – that is in the work of the Calman Commission in Scotland. Many of the arguments contained here address precisely the dilemma of improving the financial accountability of the Scottish Parliament. It is therefore very surprising that none of the chapters compiled in this volume – many of which have already been published in other forms and are in the public domain – were cited by the Independent Expert Group of economists that the Calman Commission established to give advice on improving the financial accountability of the Scottish Parliament (the relevant papers are cited in, for example, Jeffrey and Scott (2007)). Explaining this omission is remarkably straightforward as it is directly addressed within the report of that Expert Group at para 6.3.11:
A key consideration is whether a region with full fiscal autonomy, thus having different fiscal and economic policies as well as its own tax (and possible benefits) system, is to all intents and purposes, independent. If this is the case, full fiscal autonomy would not be compatible with continuance of the union that is the United Kingdom.

The problem with this explanation is that it constitutes a political judgement made by an independent group of economists rather than the conclusions reached by an independent expert group after a careful review of the economic analysis and evidence underpinning the case for (and against) ‘full’ fiscal autonomy. And while some of the pros and cons of fiscal autonomy are reviewed in subsequent paragraphs, this is done in a somewhat selective fashion which fails properly to reflect the considerable body of work within the relevant SGT of fiscal federalism. However what remains unexplained in the report of the independent group is why full fiscal autonomy is incompatible with UK union. Instead this is presented as a self-evident truth.

There are two further quibbles one can make with the conclusions reached by the independent expert group. The first relates to its comments on the situation in the Basque Autonomous Community where, under historic rules, the Basque government enjoys a situation that approaches full fiscal autonomy, yet the Basque Country remains part of Spain. As the report notes (para 6.3.4) reconciling fiscal autonomy with its constitutional position as an integral part of Spain is achieved by an economic agreement whereby fiscal policy in the Basque Country is coordinated with fiscal policy elsewhere in Spain including, of course, the fiscal policy of the Spanish government. Rather than establishing an argument against fiscal autonomy, the example of the Basque Country offers a clear case study of how a very high degree of fiscal autonomy on the part of a subnational government can exist within a unitary state. The second quibble refers to the rather confused discussion in the Expert Group report about the relevance of EU law to the fiscal arrangements within any single member state. Whilst it is true that EC state aid rules do have a bearing on infranational tax rules, the case law of the European Court of Justice clearly sets out three ‘tests’ of the autonomy of a subnational government such that, if met, permit the subnational government to enjoy discretion over its tax arrangements even where this creates a situation in which that tax regime differs from the regime prevailing elsewhere in the same member state.

There is, to my mind, a powerful economic case to be made for reforming the fiscal arrangements of the UK such that the Scottish Government and Parliament enjoy full fiscal autonomy. Of course this does not imply an absence of policy coordination between the devolved Scottish authorities and UK Government over the disposition of the various fiscal policy
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The nature of the UK ‘internal market’ makes such coordination not only desirable from a social point of view, but essential from an economic one if economic welfare is to be maximized. An absence of policy coordination would simply mean that subsequent policy shifts would be required to offset the unanticipated external consequences of your initial fiscal policy decisions. But policy coordination of this type does not impose insuperable difficulties, particularly in the context of the policy gains that are identified as being on offer from a situation of full fiscal autonomy in the chapters contained in this volume.

Of course critics might continue to insist that full fiscal autonomy is not compatible with Scotland’s continued membership of the United Kingdom. But such an assertion is not a matter for economists to dwell upon. It is one for politicians. The economic arguments revolve instead around what economic theory and evidence suggests being a fiscal policy arrangement that best delivers efficiency in the application of public spending and can maximize rates of economic growth. No arrangement will be without particular challenges, full fiscal autonomy included. And these challenges are fully addressed in the chapters that follow. However no informed discussion should proceed without all of the economic alternatives being fully debated and that is the clear risk in the debate that is underway in Scotland at the present time. The arguments rehearsed, and conclusions reached, in this book should play a central part in better informing that debate.

Drew Scott
Professor of European Union Studies
Europa Institute, School of Law
University of Edinburgh

REFERENCES