1. Introduction

Since the re-establishment of a Scottish parliament in 1999, there has been considerable debate regarding the issue of the devolution of taxes, and more general revenues, raised in Scotland to the Scottish Government. This debate, prominent in the Scottish media, is usually along political lines. The case for fiscal autonomy – in essence the devolution of all taxes – is often argued to be synonymous with full political independence for Scotland, while the argument against it is generally cast as inconsistent with the political union of the UK. In this book we try to move the debate about tax devolution away from the highly contentious discussion that links it with political independence towards an economic analysis of the case for it. If we take it that Scotland remains in the UK, we can seek out arguments based on economic and public finance theory relating to tax devolution within the Union although these arguments, especially at the fiscal autonomy end, applies a fortiori if Scotland decides to become independent. In particular, we use the ‘traditional’ and ‘new’ fiscal federalism literatures, the optimum currency area literature, some game theory applied to Scotland’s political context within the union, and we draw on time consistency issues from the macroeconomic literature to make the case for greater tax devolution to Scotland.

Tax devolution in the Union can run along a spectrum from the current Barnett formula status quo through ‘fiscal federalism’, and on to ‘fiscal autonomy’ with or without independence. By ‘fiscal federalism’ we mean the partial devolution to Scotland of policy-control over taxes: that is, choices over which taxes to raise, and the setting of tax rates and tax bases – with an emphasis on the assignment of taxes paid from Scotland into the UK’s consolidated fund and apportioned back to the Holyrood government. By ‘fiscal autonomy’ we mean more complete devolution to Scotland of powers over these matters, with more emphasis on the setting of taxes than fiscal federalism and less emphasis on the assignment of taxes.

To many people these are arcane matters, but for Scotland not to secede from the Union they are matters that must be considered. Without increased tax powers for the Scottish parliament the UK with Scotland in it may not survive. We are aware that some unionists are of the opinion that greater tax devolution to Scotland is just another step on the way to
The political economy of financing Scottish government

independence (although the establishment of the Calman Commission in 2008 suggests that is probably now a minority view even within the unionist camp) and, therefore, should be resisted. We think that the reverse is true – an argument that we spell out at length in Chapter 2. Thus, when it comes to public finances, what Scotland needs is a new and better system that will be viewed as acceptable, or, legitimate, by Scottish voters (in particular, the median voter in the terminology of political theory). The problem with all of the other reform ideas mentioned in the Preface (and referred to later in the book) is that if they came to pass they would all lack legitimacy and would not bring Scotland to a new political equilibrium. All they offer the Scottish voter is less public money from Westminster – something that is hardly likely to be welcomed, especially when oil prices are high.

While we argue that public funding reform in the form of tax devolution is likely to be seen as legitimate, we also argue that it has the best economic efficiency properties. Tax devolution has the great advantage of making those at Holyrood who spend taxes also bear the political cost of raising those taxes – a vital characteristic required for economic efficiency that none of the other reform proposals offer. It also has important efficiency implications for the private sector which we also discuss at some length in this book.

Thinking about the legitimacy issue, one can ask where on the spectrum from the status quo, through various degrees of fiscal federalism, and on to fiscal autonomy, with or without independence from the UK, does legitimacy begin? Anybody worried about the survival of the UK with Scotland in it, but wanting to keep the UK as nearly a unitary state as it now is, would want to find this point on the spectrum. We don’t know for sure where it is, and we don’t take a view on the validity of finding such a position, but we are convinced that it is not at the end of the spectrum where Scotland currently finds itself – with the barest minimum of tax devolution. Most surely, the fact that in 2009 the SNP forms the Scottish Government bears this out.

So what we will do in much of the rest of this book is to lay out the economics and some of the politics involved in the main bands on the spectrum from Barnett (the current funding system) through fiscal federalism, to fiscal autonomy, both with and without independence.

A ‘little’ fiscal devolution could mean that only a limited range of policy control over taxes is devolved; say, control over rates of income tax between narrow limits – which, indeed, is allowed for under the Scotland Act. A greater degree of fiscal devolution could mean that control over a greater range of taxes is devolved, say, unrestrained control over income tax rates and income tax base, as well as Holyrood’s control, partial or
complete, over a range of other taxes, such as fuel duty, stamp duty and betting tax.

A SPECTRUM OF TAX DEVOLUTION SYSTEMS

Here we outline the current funding system for Scotland and then we will briefly describe the fiscal federalist and fiscal autonomy alternatives to it that are the subject matter of the rest of this book.

Bloc Grant

The current bloc grant funding arrangements for Scotland: the Barnett formula

UK government policy towards financing the devolved administrations of Scotland, Wales and Northern Ireland was stated by HM Treasury in March 1999 as follows:

1. All UK tax revenues are collected into the UK Consolidated Fund (excepting, that is, any taxes collected under the Scottish variable tax rate which would be Edinburgh’s own funds).
2. Decisions on the allocation of public spending between the four member countries of the UK rest with the Westminster Parliament.
3. Change in the sizes of the budgets of the devolved governments is governed by the Barnett formula – see below.
4. The devolved administrations are responsible for allocating public expenditures between areas of public spending that is devolved to them. This spending includes that for operational and capital costs. Taking the Scottish case, in Figure 1.1 public spending in Scotland includes both central and local government. This breaks down into three parts: ‘identifiable’ (as providing services in Scotland), ‘non-identifiable’ (spending in Scotland that benefits the UK as a whole), and ‘other’ – such as general debt interest. Then identifiable government spending in Scotland is further broken down – that part directed by the Scottish Government, the other by other government departments in Scotland. Finally, Scottish Government spending breaks down into the total assigned budget under the control of the Scottish Parliament, and the non-assigned budget (such as money raised through the non-domestic rates) which is also under the control of the Scottish Parliament.
5. The UK government retains the right to reduce bloc grants to the three regions if self-financed expenditure grows more quickly than in
England and threatens UK public expenditure targets. This does not apply to expenditures in Scotland financed by the Scottish variable rate of income tax.

6. Across the board reductions in spending by the devolved governments can be made by the UK government as a matter of UK government policy – that is simultaneously applied to the four member countries.

7. If spending decisions in a devolved administration has a knock-on cost for some other UK department or agency the devolved administration shall pay that cost.

**Barnett formula**

The Scottish Parliament Information Centre (2000) defines the Barnett formula as follows:

The [Barnett] formula is designed to automatically apply a proportionate share of any increase (or decrease) in comparable English spending programmes to Scotland. It was introduced in 1978 and has assisted in determining government expenditure in the non-English territories. . . . [Thus], there are essentially two main components to Scottish public expenditure: The inherited expenditure base (including new functions since devolution). Incremental expenditure changes (this is the part determined by Barnett).

It follows therefore the Barnett formula governs the size of increases in the Scottish budget. The size of the Scottish budget in 1978 set the absolute
level of the Scottish budget to which the annual Barnett increases have been applied. Once public money is allocated the Scottish parliament is free to determine its allocation between the devolved spending departments.

**Administrative advantages of the Barnett formula**

But why have a ‘Barnett formula’ at all? Historically, from 1888 to 1957 public spending in Scotland was largely governed by the ‘Goschen formula’ – introduced by G.J. Goschen when he was Chancellor of the Exchequer. Funding was in the proportions 80:11:9 respectively to England, Scotland and Wales. However, from 1958 until the introduction of the Barnett formula by Joel Barnett when Chief Secretary to the Treasury in 1978, funding of public spending in Scotland was a matter of political in-fighting and compromise – as it continues to be between UK spending departments. Administrative convenience largely explains the re-introduction of a formula-based system to replace a system of haggling in the political market place. Thus, Twigger (1998) listed three advantages of the Barnett formula: it protected public spending per head in Scotland above the English average; the Scottish Executive was freed from having to negotiate with the UK Treasury; and Scotland was left free to allocate public money channelled to it as it saw fit, at least within and between the devolved spending departments. Of course, the introduction of the Barnett formula was itself a political decision, one that was made acceptable to Scotland by the first of its listed advantages. Indeed, Midwinter (1999, p. 87) has argued that ‘the objective of the approach . . . [was] to prevent further Scottish gains through bargaining’. Such gains may well have been made given that toward the end of the 1970s the Scottish Nationalists, claiming that it was ‘Scotland’s oil’, were riding high in the opinion polls, and could have been used as a side-threat by the Scottish Office to extract even larger transfers of public funds to Scotland. This said, according to the ‘needs assessment’ exercise undertaken in 1979 by HM Treasury, on the basis of greater needs in various areas of public spending – due for example to poorer health in Scotland, public spending per head of 116 per cent of the English level was said to be justified.

Even so, early thinking on the Barnett formula pointed to a disadvantage for Scotland. First, contrary to Twigger (1998), there was fear of a Barnett ‘squeeze’ as public spending per head in Scotland converged toward the UK average. Thus, Kay (1998, p. 33) argued that ‘Scottish public spending increases more slowly relative to England and Wales over time, and is more quickly overtaken by inflation. In real terms, Scottish levels of public expenditure per head of population will be pulled inexorably towards convergence with the levels set down south’. In fact, the so-called Barnett ‘squeeze’ is mostly marked by its absence. As Heald pointed
out as early as 1994 a potential squeeze has been offset by adjustment in
the populations ratios – with Scotland’s share of the UK population being
adjusted downward but not as quickly as its actual population; and by
something called ‘formula bypass’ which has moved money to Scotland
outside of the Barnett formula.

Fiscal Federalism

The term ‘fiscal federalism’ is usually applied in Federal states such as
the United States and Australia, where sub-central government has
Constitutional rights over devolved taxes that cannot be simply revoked
by the Federal (central) government without a change in the Constitution.
For example, the United States Constitution reserves certain rights to
the States and a Constitutional Amendment would be needed to change
those rights – the making of a Constitutional Amendment itself being a
complicated process that involves decision makers other than the Federal
government itself. The UK, however, is a unitary state in which powers
granted to lower tiers of government are at the wish of central government
(Westminster), and are not protected by a written Constitution: a simple
majority vote in the Westminster parliament would be sufficient to revoke
the taxation powers (if any) of a sub-central government – such as that
defined in the Scotland Act. Even though the UK is a unitary state, we will
use the term ‘fiscal federalism’ in a UK context.

Fiscal Autonomy

We will also discuss the case of ‘fiscal autonomy with independence’ –
full fiscal autonomy – and we will show that in fiscal matters there are
some important differences with the case of ‘fiscal autonomy within
the UK’. For example, under the latter arrangement Scotland could be
required to pay for public goods – such as national defence – provided by
Westminster; while with independence this and other public goods would
have to be provided directly though the Scottish parliament, not indirectly
through Westminster and Scotland would have control over VAT rates
something precluded by remaining in the Union.

Equity, Efficiency and Stabilization

In this book we address the issue of the devolution of tax, or more gener-
ally revenue, powers from the perspective of the economics literature.
There are other approaches, such as a political science approach, that can
be brought to bear on the issues of tax devolution. We venture into this
Efficiency

Efficiency relates to how the fiscal system is designed to ensure that government expenditure is allocated efficiently and incentives to the public and private sector agents are not blunted. In terms of the public sector, this boils down to the issue of accountability: are the politicians accountable to the electorate for their spending decisions, both in terms of the overall spending figure and also the way in which the budget is allocated amongst different spending categories? In terms of the private sector, can the fiscal system be used to counter or modify evident distortions, or, in more colloquial terms, to ensure that winning companies in the private sector maintain a competitive advantage? Efficiency has both a static and dynamic aspect for both the public and private sectors. The static aspect is to find the right balance between the different areas of public spending, and between the relative sizes of the public and private sectors in Scotland. The dynamic aspect is to design a fiscal system that is less burdensome on the private sector so that it promotes economic growth in Scotland and the rest of the UK.

Equity

However, the exclusive focus on efficiency could be to the detriment of the equity function of fiscal design – that households in Scotland should have a comparable provision of public services to households in the rest of the UK (it need not be to the detriment depending on the size of the putative fiscal position post independence or in the presence of fiscal autonomy and on the preferences of the politicians). Inevitably, and in practice, there is a trade-off between efficiency and equity. However, we note – and this is one of the key themes of this book – that the current fiscal settlement for Scotland focuses almost exclusively on the equity function of fiscal policy to the detriment of the efficiency function.

Macroeconomic stabilization

The macroeconomic stabilization role relates to the inbuilt insurance function of a tax system: if income falls in Scotland relative to the rest of the UK, are there mechanisms in place which automatically compensate Scottish households for this fall? In the current system there are – for example, with a fall in income the tax-take falls and social security
The political economy of financing Scottish government payments are likely to rise. Although the stabilization role is often ignored in discussions of the devolution of fiscal powers it seems to us important to consider it, particularly when considering the more radical proposals for fiscal autonomy and full fiscal autonomy, since they involve the devolution of oil revenues to Holyrood, thereby opening up the important possibility of asymmetric shocks between Scotland and the rest of the UK (that is, how correlated is the intra-UK business cycle?).

Overall
This book is about judging how various proposals for a fiscal settlement for Scotland fare against the criterion of legitimacy as well as the three key economic elements in the design of a fiscal system and, specifically, given legitimacy how to find an appropriate mix of the three key economic roles of fiscal policy within a given fiscal system, namely:

- the allocation, or efficiency, role;
- the equity, or income equality, function;
- and the macroeconomic stabilization role.

Trade-offs
In designing a fiscal system there is inevitably a trade-off between these three functions. And the different systems discussed in this book involve different trade-offs of these functions. What we are looking for is a fiscal system for Scotland which provides the best trade-off between these three functions while being accepted as legitimate by the Scottish voter.

Static efficiency
Static efficiency in the public spending aspect, as we have seen, is not the only aspect of efficiency which a fiscally devolved tax system can address, but it is the one on which the media most often focuses and we pursue it here in a little more detail (the other efficiency aspects are considered in greater length later in the book). The following quote from a leading textbook on public finance nicely illustrates the efficiency argument:

Our task . . . is to extend the economic principle of efficient resource use to the public sector. Some believe this to be a hopeless task and hold that the determination of budget policy is a matter of politics only, not amenable to economic analysis, a view that is unduly pessimistic. Budget policy has a difficult task and will hardly realize a perfect solution. But not all feasible policies are equally good. Efficiency of resource use, here as in the private sector, is a matter of degree, and economic analysis can help us in seeking the best answer. The task is to design a mechanism for the provision of social goods which operating in a democratic setting will be as efficient as feasible. (Musgrave and Musgrave, 1989, p. 41)
The present Barnett bloc grant system leaves Holyrood the choice, within any administrative constraints set by Westminster, of how to spend the grant across the spectrum of public goods supplied by government. The whole of the grant is spent, or nearly so, as there is little or no obvious benefit to Scotland of returning an unspent portion to Westminster. This system gives the Scottish Government and Parliament little incentive to choose the right balance – as they would if they had to think about it, between the supply of private goods and the supply of public goods in Scotland. That is, to get the relative size of the private sector in Scotland right. Indeed, MacKay and Bell (2006) calculate that about one-tenth of the Scottish budget is wasted money – and that is a calculation based mainly on the fact that Scotland’s population is shrinking while the size of the Barnett bloc grant is not. Had they been able to do more detailed analysis of labour productivity in the Scottish public sector (which in some sectors they find is lower than in comparable sectors in England), then the percentage of wasteful spending would most probably be higher than their rough estimate. This is surely a matter of importance. Some in Scotland argue that the public sector is too large and stultifies private enterprise. (Others would argue for a larger public sector, something that we think is not credible.) However, the present public sector funding system in Scotland largely makes this important debate moot. What would be the point of having such a debate when Westminster under the rigid Barnett formula largely sets Scottish public spending?

Under the present bloc grant system there is little connection between spending decisions taken by the Scottish Government and Parliament and decisions on how and from whom to raise the necessary revenues. Pressure for more government spending in Scotland can always blame Westminster and the Barnett formula for squeezing Scottish public funds. Thinking about government spending in Scotland would change dramatically if the Scottish polity had also to consider the revenue side of its political calculus. We argue that the main problem with financing public spending by Edinburgh – governed as it is by the Barnett formula, to put it politely, is that it is almost entirely concerned with equity – or horizontal balance – in the UK, to the detriment of efficiency. Or, to put it impolitely, the size of the bloc grant is influenced by concern for buying off the Scottish electorate to remain in the Union – see Chapter 2. After all, the Barnett formula was devised in the 1970s, at a time when the Scottish National Party was riding high in the opinion polls, and the idea that it is ‘Scotland’s oil’ was indeed influential in Scotland and it is now widely accepted that Scotland could have been very wealthy indeed if North Sea oil had been put to good use and its proceeds invested in an oil fund rather than the revenue generated being spent as it was pumped out of the ground, which is short sighted.
Introducing a harder budget constraint than exists at present could have beneficial advantages for Scotland. First, and most simply, improved alignment of decision making by the government with the preferences of the electorate should improve the use of financial resources – this represents a static improvement in efficiency. Second, Holyrood does not at present have strong incentives to use tax revenues to raise economic growth in Scotland because increased tax revenue from a faster-growing tax base would be paid to Westminster and not channelled back to Holyrood – an improved growth performance would represent a dynamic improvement in efficiency. The present incentives for greater efficiency in public spending – that is, cutting the costs and raising the productivity of public services such as health and education – are also probably deficient (although, of course, there are other ways in which public sector efficiency could be improved – see Crafts, 2004). While it is true that under the bloc grant, cost saving in one area of public spending can be used for greater spending in another, it is broadly true that cost savings will not show up as lower taxes. There is of course the ‘tartan tax’ that could indeed be cut to reflect lower expenditure needs, but the amount of variability is not great. Under a fiscal federalist tax devolution arrangement greater variability in the tartan tax, from ±3 per cent to, say, ±7 per cent would be desirable. Moreover, with fiscal autonomy limitations on income tax variability could be done away with. The Scottish parliament would then have full responsibility for income taxation in Scotland – just as is the case with parliaments in other countries.

**Brief Outline of a Fiscal Federal System**

Although we will be dealing with different variants of tax devolution in the following chapters, we give a flavour here of what we mean by a fiscal federal tax system, which is, perhaps, one of the most popular alternatives, especially for unionist parties, to the current Barnett arrangements (see, for example, the Steel Commission Report) although it is not our preferred system. For a federal tax system to function effectively it should address the following key issues:

- how to assign expenditure responsibilities between the respective levels of government;
- define how those expenditures are financed in terms of tax and revenue raising by the different levels of government;
- specify the nature of intergovernmental transfers;
- address the ability of sub-national governments to borrow.
The first of these issues was initially defined with the establishment of the Scottish parliament and this represents a significant step towards fiscal devolution. However, the other issues have not so far been properly addressed in a Scottish context. At present, the Scottish Government has the power to change personal income taxes by plus or minus three pence in the pound, the so-called tartan tax, and to set and raise non-domestic rates – the proceeds of which accrue to local government – in addition to setting a range of user charges such as the student tuition fees. However, as has been widely noted, the ultimate effect of this in terms of its revenue raising powers is likely to be limited, as are its effect on incentives. This follows because any cut in taxes would result in the expenditure equivalent amount being clawed back by Westminster and with no ability to borrow on capital markets, spending may have to be decreased as tax rates fall (depending on whether the bloc grant revenue was above, below or equal to the total annual spend of the parliament) and of course any improved growth performance resulting from the tax cut would also not accrue to the Scottish government.

Vertical imbalance
The phenomenon of central government having greater ability to obtain income through taxes that it levies than it actually needs for the exercise of its authority, while the sub-central level has less power to raise income than it needs, is referred to in the fiscal federalism literature as ‘vertical imbalance’ or ‘fiscal mismatch’. Really, an imbalance should be resolved if the sub-central level of government is to exercise its authority with an eye on the efficiency of its spending decisions. By ‘efficiency’ we mean finding a balance between the provision of publicly provided and privately provided goods that the electorate and tax payers support, as well as cost efficiency in the provision of those public goods. One of the anomalies in the current UK system is that this vertical imbalance has been partially resolved for the lowest tier of government – local authorities – who can tax, spend and borrow, but not for the Scottish parliament.

Horizontal balance
However, an exclusive focus on vertical imbalances could result in ‘horizontal imbalance’, in terms of transfers from the centre being inappropriate to deal with the principle of equalization of resources based on needs at the regional or local level. Needs equalization exists in all federal systems that we know of. The question is the extent to which this equalization occurs. In all real world cases intergovernmental grants from central to sub-central government range from a low of 22 per cent in the Canadian Provinces to approximately to 80 per cent in Scotland. In a federal system
The political economy of financing Scottish government

of tax devolution, some equalization is inevitable to finance common services. This equalization mechanism may be directed to a specific service, such as health, education or social security – or, as in the case of Scotland, through the overall bloc grant.

Trading off efficiency and equity

In essence, and assuming that Scotland remains within the UK, the challenge facing Scotland is to find the most satisfactory trade-off between equity and efficiency objectives. Achieving this will require improving the vertical and horizontal balance on the revenue side. Scotland’s current financing system is characterized by a high level of equity equalization and a high level of vertical imbalance. Hence the choice is: how much horizontal balance and, therefore, needs equalization with the rest of the UK, is Scotland willing to give up in exchange for more self-financing and so a reduction in vertical imbalance?

As we have seen, at the moment, the allocation of additional revenues to Scotland is based on an unconditional grant – the Barnett formula. This formula is regarded by many as favouring Scotland since it delivers a higher per capita level of revenue to Scotland than to most other regions of the UK (with the exception of Northern Ireland). The argument that Scotland requires higher per capita spending relative to the rest of the UK is based on the perceived greater needs in Scotland due, for example, to its poorer health record and the sparsity of its population. However, the argument that Barnett favours Scotland ignores the missing revenue from North Sea oil – a factor which would have had a very significant impact on the Scottish economy, especially in the 1970s and throughout the 1980s, had the oil revenues been used for the advantages of the Scottish people since its discovery – and that point has been made forcibly in the McCrone (1975) memo; a document which was kept a secret from the general public because it claimed North Sea oil would make Scotland a very wealthy country and England would be transformed into a ‘basket case’ economy if Scotland had been able to make good use of the oil revenues such as other countries and regions in the world have been able to do. We return to this point later in the book.

Indeed, much play is made in the general literature on fiscal federalism about the equalization, or equity, function of a vertical imbalance. In other words, in the interests of equity between regions the central government should distribute more spending per head on things such as health, education and social services to poorer regions than to richer regions. This argument is well and good, but its relevance to Scotland and the UK is questionable. The simple fact is that public spending on devolved services such as these across UK regions pays virtually no attention to the issue of
interregional equity. Thus, using data in McLean and McMillan (2002, table 1), the correlation across the 12 regions of the UK between regional GDP per head and regional public spending on devolved services per head (using 1999–2000 data) is –0.16. In other words, variation in regional income/head explains almost none of the variation in regional per capita public spending.

Our point about the ‘vertical imbalance to promote inter-regional equity’ argument is that it should not be used now by others in an effort to head off greater devolution of direct fiscal powers to Holyrood – simply because this is not how interregional fiscal spending in the UK actually works.

There are two other points concerning Scotland’s current perceived favourable standing in the Westminster public spending per head allocation game. First, as the ‘Barnett squeeze’ is set anyway to reduce Scotland’s favourable position, Holyrood might as well make the most of it and ask for more devolved fiscal powers even if it does mean something of a less favourable position in the public spending game (although this is not clear given the uncertainty surrounding the Scottish budgetary position).

A payday for Westminster

Secondly, it might by now have come to the notice of some that the issue of devolved fiscal policy is not one so much of persuading Holyrood of its merits as one of persuading Westminster. To give the UK Treasury something – over time, lower public spending per head in Scotland – in return for handing more fiscal powers over to Holyrood might look like a good bargain. In simple terms the deal is: Holyrood will stop bleating about the Barnett squeeze in exchange for Westminster devolving more fiscal powers and some of the revenues from oil that Westminster has persistently used short sightedly over the years.

A related point is that Scotland is receiving such large fiscal transfers from Westminster that it is at least implicitly being recognized that it is indeed ‘Scotland’s oil’. An implication of this is that an independent Scotland, or Scotland within the Union with access to North Sea oil revenues, while being able to tax directly North Sea oil revenues, would face a volatile oil price which could be dealt with through an oil fund, much as occurs in Norway, Alberta and Alaska. Such a fund could in all probability allow Scotland to enjoy public spending which is at least as favourable as the current Barnett-driven settlement, and of course spending from the income accruing from an asset makes much more economic sense than spending the asset itself which is simply bad economics and what has been effectively happening since the discovery of North Sea oil.

Moving to a fiscal federalist structure in Scotland (that is, Scotland in the United Kingdom) would mean moving the efficiency–equity trade-off
in the opposite direction: sacrificing some equity in favour of potentially greater efficiency. Moving even further along the spectrum to fiscal autonomy would mean sacrificing even more equity for even greater efficiency. This could produce fluctuations in income categories that would not have occurred under the current system. However, it could produce an improved allocation of resources in the longer run and the opportunity potentially to incentivize growth and ultimately generate additional revenues for spending functions.

Two points should be noted. First, superior allocative efficiency on the spending side, or on the matching of costs and benefits across expenditure categories, is not inevitable, and second, a reduction in horizontal balance is likely to reduce resources in the short term. On the first of these points, increased efficiency depends largely on how Scottish politicians react in the new revenue and tax environment; and they are more likely to respond positively the greater is transparency and accountability in the system.

As to fiscal autonomy, where tax transfers between Scotland and Westminster largely or completely cease, and could be reversed to pay for public goods supplied to Scotland by Westminster, the incentivizing effects would be further increased, while equity within the union issues would potentially be set aside. The financing of public spending in Scotland would be a matter for the Scottish Government and Parliament. This is, of course, the case for independent countries – except to the extent within the European Union that inter-regional transfers take place under EU law to support low income areas. Whether Scotland wants to go down the route to independence is, of course, highly contentious, and the politics of this is something that we do not address although we do discuss the political economy of achieving the kind of fiscal autonomy we favour without more political independence in Chapters 6 and 7.

There are other arguments for fiscal federalism in Scotland which, although related to the economic argument, are more to do with democratic, or political, accountability. We note two such arguments. David Heald (1990) eloquently expressed one aspect of the democratic accountability view:

Such an arrangement [a fiscal federalist arrangement] is essential for the constitutional accountability of a Parliament which would possess extensive legislative responsibilities and expenditure programmes. Moreover, there would be much stronger incentives to fiscal responsibility under a financial arrangement whereby a Scottish Executive must justify to a Scottish Parliament, electors and taxpayers, its chosen trade-off between services and taxes.

The last sentence of this argument is of course similar in spirit to our economic analysis of fiscal federalism.
A second argument in this vein relates to the constitutional settlement in the UK and, in particular, the possibility of a political party of one colour being in office in Westminster and a different party in Holyrood, which of course is currently the position in the UK, although for the first eight years following the establishment of the parliament the same party held sway in both Holyrood and Westminster. Since under the current settlement, funding for the Scottish parliament is essentially at the behest of the political party in office at Westminster, a constitutional crisis could arise if there was disagreement between the two parties over the bloc grant allocation. To avoid such a potential conflict the Edinburgh parliament should have appropriate tax and spending powers to minimize the scope for unilateral rewriting of the financial dimensions of the settlement.

**OUTLINE OF THE CHAPTERS**

Anybody wearilying of the more theoretical and policy-related discussion of tax devolution might well refresh themselves by jumping ahead to Chapter 9 which discusses ‘Empirical evidence: tax devolution and prosperity’. There we examine the empirical evidence on the economic effectiveness of tax devolution as experienced in many countries around the world. Some people have responded to our arguments set out in earlier publications saying that there is ‘no’ empirical evidence supporting them. In fact, this is a mis-reading of what empirical evidence was available even six or seven years ago. Today it is fair to say that the claims that we make for the economic effectiveness of tax devolution does receive some support from the empirical evidence, namely that tax devolution promotes investment, cuts government spending and to some degree, raises the rate of economic growth.

Returning to the thread of this book, in Chapter 2 we argue that what some view as overly-generous funding of the Scottish parliament results from Scotland’s credible threat to secede from the Union. Using some basic game theory, we argue that high public spending in Scotland is due to Scotland choosing second in what amounts to a non-cooperative sequential game. That is, for as much as a century, Westminster decides how much money to allocate to Scotland, and Scotland then chooses between accepting the offer or seceding from the Union. As Westminster governments have not wanted Scotland to secede, over this long period of time, they have always made an offer so large that Scotland would not refuse it. Using this analysis we dismiss the various reform proposals mentioned earlier for not recognizing that reform of Scottish government finances must be consistent with Scotland’s credible threat to secede from
the Union. Although, of course, as those who have lived in Scotland through the key referenda on devolution for Scotland and, more generally, at times when the SNP threat was very real in Westminster elections, will realize, the credible threat we refer to has been greatly blunted by the false threats from both key elements in the business sector and unionist politicians on the implications of Scottish secession. Also, in Chapter 2, fiscal autonomy is demonstrated to be a viable reform within the existing political context and, in likely circumstances, could remove Scotland’s second mover advantage. We also use a cooperative bargaining game model to demonstrate that an Australian style grants commission – an idea that is being pushed in some quarters, would not be a viable reform in the British context.

In Chapter 3, on the economic advantages of fiscal devolution, we flesh out the economic theory of fiscal federalism that supports the case for greater (vertical) balance between Scottish public spending and the financing of this spending. The thrust of this body of theory – which comes in two flavours, ‘traditional’ and ‘new’, is that decision makers (the Scottish electorate and its agents the Scottish Executive and Parliament) will make more efficient decisions concerning the use of public money if they have to face the full opportunity costs involved. This means that public spending by Holyrood needs to be more closely aligned with taxes raised in Scotland, and less reliant on a bloc grant from Westminster. If so, the true tax burden of public spending will become more apparent, and decision making should be better informed. In this chapter we support the idea of ‘competitive’ federalism – as opposed to ‘cooperative’ federalism. The main problem with the latter is that fiscal jurisdictions, in harmonizing their tax rates and other features of their tax systems, do not allow competition between these jurisdictions, and nor do they allow ‘a thousand flowers to bloom’ seeking superior fiscal arrangements. Indeed, on the European Union level the British position has been consistently against tax harmonization between the members, and the advantages of tax competition are often cited in support of this position (this being one of the key criteria for judging if the UK should relinquish the pound sterling and join the euro). It is somewhat inconsistent therefore that until recently the Westminster government has been against fiscal competition within the UK, but not between the UK on its European partners.

We emphasize in Chapter 3, that fiscal federal systems that retain a significant bloc grant element can contain residual inefficiencies. One problem is that of ‘moral hazard’ which arises if a sub-central government operates in the expectation that fiscal mismanagement will be bailed out by central government. Moreover, we argue that it may be difficult to get around moral hazard because it may be difficult for central government to
credibly commit not to bail out a sub-central government facing a fiscal crisis – this is the so-called ‘time inconsistency’ problem. It is problems such as these with fiscal federalism that lead us on in later chapters to assess the case for fiscal autonomy.

Finally, Chapter 3 also contains an overview of the recent literature on social capital and fiscal federalism. The key argument is that decentralized fiscal policy, by bringing government closer to the people, can be a key element in strengthening social capital. To quote one specialist in this field, social capital is ‘the trust, norms and social networks that foster mutually beneficial cooperation in society’. The basic idea is if more fiscal responsibility is given to people the more economically and socially responsible they will become. The benefits of this are many, and we emphasize that there will be a tendency for efficiency in public policy to increase. In turn, this will improve economic growth and welfare in the long term. Supporting evidence for this is reported.

Possible devolution of tax powers to Scotland under fiscal federalism is outlined in Chapter 4. Our discussion here is informed by our thinking on tax assignment as well as our marginal tax rule. Under fiscal federalism, a lesser degree of tax devolution than fiscal autonomy, we argue that greater efficiency in public finance, especially in inducing a non-distorted balance between the respective sizes of the public and private sectors, can be induced by tax assignment. Thus, even if control over some tax rates and tax bases is not devolved to Scotland, assigning tax revenues raised in Scotland (and paid into the Westminster consolidated fund) back to Holyrood provides incentives in Scotland to grow the Scottish economy and tax base. These incentives are entirely missing in the extant bloc grant system as the size of the bloc grant is virtually invariant with respect to the size of the Scottish tax base. Our marginal tax rule also has efficiency properties for Scottish public finances. The idea is that extra public spending on some given project in Scotland has to be matched with higher tax revenues (or reduced public spending on other things). Such a system forces politicians to think about the respective marginal benefit of extra public spending (on the new project) and its marginal cost measured in terms of reduced private spending or reduced public spending on other public sector projects.

In Chapter 5 we consider the present fiscal arrangements in Scotland and sketch out how fiscal federalism might look based on the various economic criteria discussed in earlier chapters. We argue that ‘tax assignment’ (Scotland retaining a portion of taxes raised in the country rather than sending them directly to the consolidated fund) would force decision makers to consider carefully their spending decisions ‘at the margin’. This is our marginal tax rule.
In Chapter 6 attention turns to an examination of fiscal autonomy in Scotland. This is the case where most public spending in Scotland is financed only by taxes raised in Scotland, and may be supplemented by borrowing by a Scottish Treasury. In this chapter we argue that fiscal autonomy creates the ‘cleanest’, most rigorous, incentives for efficiency in the level and allocation of public spending in Scotland.

Chapter 7 further develops the themes introduced in Chapter 6 on fiscal autonomy. One of our main concerns in this chapter is to compare fiscal autonomy with the status quo, Barnett bloc grant formula, that some authorities continue to argue is best for Scotland. We very much disagree.

Chapter 8 presents our first consideration of the main features of devolved fiscal arrangements in several other countries besides the UK. The main point emphasized is that the UK stands out as the country with the least devolution of powers over regional taxation – that is, the UK has the most extreme degree of vertical imbalance. We think that the UK has a lot to learn from these other countries, and that it should join in with the international learning process that is now going on between countries. Our discussion of fiscal devolution to the Basque Country in Spain is meant to highlight that extensive devolution has already occurred in Europe and that the UK–Scotland would not be the first to move significantly toward fiscal autonomy.

As mentioned earlier, Chapter 9 presents the empirical evidence supporting the case for tax devolution.

Chapter 10 discusses whether an independent Scotland would be better off with its own currency, or, to be a part of a monetary union, either continuing with the pound sterling or adopting the euro. Our view is that Scotland is too small to justify having its own currency. This leaves an effective choice between the pound and the euro. Our view is that a transition from one to the other would be difficult.

Finally, Chapter 11 concludes with a summary of our case for fiscal autonomy along with a word of warning that any fiscal reform that increases the degree of responsibility at sub-central tiers of government will not work well unless the electorate knows what it is getting into and elects politicians that are prepared to work wholeheartedly with the new system.

NOTES

1. Previous work focusing on the economics of fiscal federalism for Scotland include Bell and Christie (2002), Darby et al. (2002), Hallwood and MacDonald (2004), MacDonald and Hallwood (2006) and Steel Commission (2005).
2. For this listing see Scottish Parliament Information Centre (1999).

3. The areas are health and social services (Scottish spending justified on the basis of needs at 107 per cent of the English level), education and libraries (107 per cent), housing (130 per cent), other environmental (133 per cent), roads and transport (144 per cent), and law and order etc. – excluding police (108 per cent).

4. Nor is it achieving its declared objective of equalizing Scottish per capita public spending with the rest of the UK; and there is concern in Scottish political circles that funds from other sources, such as Objective One money from the European Union, are not the net additions to the Scottish budget as they are intended to be.

5. See The Economist, 9 April 2004, for a discussion of this issue.

6. We note that in certain periods of the Labour administration the government underspent its bloc grant allocation to the tune of £135 million – £623 million.

7. It has not been fully resolved since 80 per cent of local government revenues are in the form of a direct grant from the Scottish Parliament. Council tax, which is under control of the local authority only contributes 20 per cent of revenues and non-domestic rate income is harmonized and pooled centrally and redistributed in the bloc grant.

8. For data on Scotland’s budget balance including oil revenues see The Economist, ‘History repeats itself’, 26 June 2008.