REPORT

FUNDING DEVO MORE

FISCAL OPTIONS FOR STRENGTHENING THE UNION

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Alan will be working on the 'Devo More' project (see below) with IPPR.

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I am of course responsible for any remaining errors or infelicities.

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ABOUT DEVO MORE

This report is the first output from IPPR's Devo More programme. Devo More aims to develop a model of enhanced devolution that meets the needs of the constituent nations of the UK within a UK-wide framework.

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For more information about the Devo More project visit http://www.ippr.org/research-project/44/10218/devo-more-extending-devolution-and-strengthening-the-union

IDEAS to
CHANGE BRITAIN

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PREFACE

The publication of this paper marks the start of IPPR's 'Devo More' project.[1] The project is intended to examine how devolution can be extended, not just for Scotland but for Wales and Northern Ireland as well, in a way that also strengthens the union.

Debates about the future of the United Kingdom have centred on Scotland since 2007. Wales has been involved as well, but is less at the forefront of public or political attention, though that has changed somewhat with publication in November 2012 of the Silk Commission's report. What has been missing from these debates are two dimensions: what is desirable from the point of view of the UK as a whole, and what is practicable given how the UK works presently. The UK is a highly centralised state, with many institutions that have proved strongly resistant to change; these factors need to be taken into account in framing any proposal for enhancing devolution that is actually to be implemented.

This paper examines the question of fiscal devolution from these two points of view, and considers possible options for a viable approach to extending devolution that is also designed to help achieve the political goal of maintaining the union of England, Scotland, Wales and Northern Ireland. In addition, it draws on lessons from federal systems that resemble the United Kingdom, or the sort of system that the UK is in the process of becoming. This represents a wide range of experience, which has been explored to only a limited extent in the debates so far.

This paper draws on my background as a lawyer and student of how governments work, more than as an economist. Given the extent to which fiscal debates have so far been dominated by economists rather than those concerned with other practical matters, I regard this not as a weakness but as a strength.

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1 For more, see http://www.ippr.org/research-project/44/10218/devo-more-extending-devolution-and-strengthening-the-union

EXECUTIVE SUMMARY

- There will be a referendum in 2014 on Scottish independence. As part of their response, all three unionist parties have suggested they are prepared to strengthen the powers of the Scottish parliament after a 'No' vote. This paper makes a contribution to this debate by reviewing comparative evidence to help inform possible options for extending fiscal devolution in UK, which – unlike many other proposals – work for the UK as whole.
- The UK is exceptional in conferring limited revenue-raising capacity on its devolved governments, although their spending responsibilities are at least as extensive as those of state or regional-level governments in many federal systems.
- Reliance on a block grant has attracted widespread criticism. It limits the responsibility and accountability of devolved governments, and implicitly ties them to the same model of public services as applies in England even though political preferences in Scotland and Wales appear to be for more social democratic policies.
- Fiscal devolution is not straightforward, and much of the UK's debate about it has overlooked the lessons that can be learned from federal and decentralised systems around the world.
- Greater fiscal autonomy will enhance the ability of devolved governments to adopt different policies within the framework of the United Kingdom, while also enabling the UK government to pursue redistributive policies if it wishes.
- A package of devolved fiscal powers needs to encompass a range of taxes, to spread risks. It also needs to address practical considerations, including the burden of paying taxes by taxpayers and of collecting and administering taxes by government. It should also pay regard to the principles of fiscal federalism, by devolving tax bases that are relatively immobile or which relate to devolved functions, as well as ones that are relatively stable.
- These factors suggest there is a case for the outright devolution of personal income tax. They also support the principle of assigning a large proportion of value-added tax (VAT), as that cannot be devolved for legal reasons. It would be desirable to devolve taxation on alcohol and tobacco, given the relationships with devolved functions such as health, but there are formidable legal and administrative problems with doing so and this area needs further work.
- In addition, all land taxes should be devolved: landfill tax and stamp duty land tax (as is happening under the Scotland Act 2012), air passenger duty and aggregates levy (as recommended by the Silk and Calman commissions but not implemented for Scotland). HM Treasury should adopt a permissive approach to the establishment of any further tax relating to land, and look at the practicalities of devolving capital gains tax in relation to land.
- Corporation tax is not a suitable tax for devolution, at an early stage, for administrative and practical reasons as well as fiscal ones. It is a small but highly volatile source of revenue, and one that is particularly burdensome for smaller companies to comply with.
- A further source of taxation that could be devolved if needed would be employer's national insurance contributions, which would account for nine to 13 per cent of current devolved spending.
- A package including local taxation, personal income tax, an assigned share of 10 'points' of VAT, alcohol and tobacco duties and land taxes would put around 55 to 60 per cent of devolved public spending directly in the hands of devolved governments.

Between 43 and 50 per cent of that would be taxes fully under the control of devolved governments. This contrasts with the Scotland Act 2012, which puts around 30 per cent of devolved spending under devolved control.

- The remaining part of devolved spending would continue to be funded by a grant from the UK government, which for the time being would most effectively be calculated on the basis of spending need rather than fiscal equalisation. Such a grant provides a key underpinning for cohesion and fairness across the UK.
- That level of fiscal responsibility would enable devolved governments to make their own policy choices, so that public services would reflect the preferences of Scottish, Welsh or Northern Ireland voters rather than policy led by English choices.
- Such a devolved tax package would not affect the ability of the UK government to control the UK macroeconomy, or to carry out redistribution across the UK.

1. INTRODUCTION

The purpose of this paper is to outline an approach to how devolved government in the United Kingdom could be funded, drawing on the lessons and experience of federal systems around the world and the practicalities of the UK's public spending and tax systems.

It starts by sketching the UK's system as it stands presently, and the key principles of fiscal federalism. It then looks in detail at how a comparable system might be established in the UK, with both extensive fiscal devolution and a grant to assure a measure of UK-wide equity, to bring the UK's financial arrangements better into accord with its constitutional framework (and with aspirations for these to develop further). It concludes by looking at the institutional changes that would be necessary for such a system to work.

2. DEVOLUTION AND THE UK'S FISCAL SYSTEM

2.1 Debates about reforming devolution finance

The developing constitutional debates in Scotland have put issues of devolution finance at the centre of wider constitutional debates about the future of the United Kingdom for some years. While this was a topic of only limited interest between 1999 and 2007, the election of a Scottish National Party (SNP) minority government in 2007 triggered two sets of debates. The minority SNP government started a 'national conversation' on the Scottish constitution, which included extensive discussion of finances and argued for 'full fiscal autonomy', within the union if not outside it. In response, the unionist parties (Labour, the Conservatives and the Liberal Democrats) set up the Calman Commission (properly, the Commission on Scottish Devolution) to look at possible extensions of devolved powers. That commission recommended ultimately a limited measure of fiscal devolution, involving partial devolution of income tax and some small taxes relating to land, which was largely enacted through the Scotland Act 2012. These proposals for tax devolution are already being brought into effect, but the limited devolution of income tax will not be fully in effect until 2019 or perhaps even later.

Scotland Act 2012

The Scotland Act 2012 provides for three significant financial changes.

- The Scottish rate of income tax: UK income tax for those defined as 'Scottish' taxpayers will be reduced by 10 pence on each of the three tax rates (standard, higher and upper). The block grant will also be reduced by an 'equivalent' amount. The Scottish parliament will have to set its own Scottish tax rate, unless it wishes to cut spending to take account of the revenue foregone. That Scottish rate must be the same across all three UK rates. This change is expected to start in 2016. The Scottish rate of income tax will be collected and administered by HM Revenue and Customs (HMRC).
- From April 2015, stamp duty land tax and landfill tax will be devolved; the existing taxes will cease to have effect in Scotland, and the Scottish parliament will have the power to set its own taxes in their place. The Scottish government proposes that these taxes will be administered by a new body, Revenue Scotland.
- The Scottish parliament will also acquire the power to establish new devolved taxes. These will require the consent of the UK government, and must not have a disproportionate negative impact on UK macroeconomic policy or impede, to any degree, the single UK market, including economic distortions or disincentives.

The developing constitutional debates in Scotland have led to an acknowledgement by all three unionist parties that there needs to be further financial and fiscal devolution, if the vote in the 2014 referendum on independence results in a vote to stay in the United Kingdom. Several such initiatives are presently underway. A Liberal Democrat commission on home rule and community rule published its report in October 2012, which was endorsed by the Scottish Liberal Democrat conference.[2] A Labour devolution commission, chaired by Scottish leader Johann Lamont, was unveiled at the Labour conference in September 2012. A 'civil society' process led by the Scottish Council for Voluntary Organisations is also underway, though it appears to be making halting progress. Devo Plus, a cross-party initiative with links to the Reform Scotland thinktank and chaired by former Lib-Dem MSP Jeremy Purvis, has published three reports on an enhanced

2 *Federalism: the Best Future for Scotland,* available at http://www.scotlibdems.org.uk/homerule

package of devolution, including recommending a package of tax devolution that would see income tax, corporation tax and ultimately oil revenues devolved, and leave (in particular) VAT and national insurance contributions in UK government hands.[3]

In Wales, establishing an independent commission to review funding and finance was a key commitment of the One Wales coalition agreement between Labour and Plaid Cymru in 2007, and resulted in the establishment of the Holtham Commission. That commission's first report showed that Wales suffered from a limited degree of 'underfunding' given Wales's relative needs, which would grow worse if the convergence effect of the arithmetic underpinning the Barnett formula continued.[4] It also investigated the possibility of tax devolution, and recommended a package of tax devolution substantially resembling that of the Calman Commission. This was reinforced by the work of the Commission on Devolution in Wales, chaired by Paul Silk and established following a commitment in the Coalition government's *Programme for Government*. The Silk Commission published its first report on finance in November 2012, and came to very largely the same conclusion.[5] A second report, considering whether further functions should be devolved, is due in the summer of 2013. The Silk Commission recommended that 10 'points' of income tax should be devolved using the Calman model, along with stamp duty land tax, landfill tax, aggregates levy and air passenger duty on long-haul flights. There were two major differences from Calman in its recommendations. First, income tax devolution should only take place following approval at a referendum (a long-standing Welsh Labour requirement), and second, there should be a power to set different rates of tax on each tax band. (This was recommended by Holtham but not by Calman.)

In Northern Ireland, there has been a reluctance to engage in the financial debates save on the issue of devolving corporation tax and air passenger duty. Corporation tax devolution was promoted by Owen Paterson as shadow secretary of state, included in the Conservative/UUP manifesto for the 2010 UK election, as well as those of the DUP and SDLP, and became part of the Coalition's *Programme for Government*. Despite an active discussion, enthusiasm from the Northern Ireland parties was evidently not shared by HM Treasury, and has made slow progress to date, although latest reports suggest a decision is near.[6] Air passenger duty on long-haul flights departing from Northern Ireland has already been reduced, and powers regarding it will be devolved from April 2013.

London has also jumped into the debate, with the mayor of London, Boris Johnson, establishing a London finance commission to look at financing options for the Greater London Authority (GLA), and the mayor himself calling for assignment to the GLA of stamp duty land tax revenues from property transactions in Greater London in place of a grant.

A major problem with these debates is that each has developed with little regard to the others. The UK has continued to manage its relations with each devolved government bilaterally, with little sign of any overarching strategy let alone a 'plan for the union'. While this has enabled a flexible response to the distinctive circumstances of each devolved government and its political demands, it has also led to the debate about devolution finance lacking structure or coherence. A UK government keen to help preserve the integrity and stability of the union for the medium and longer term would want to ensure

3 The Devo Plus group reports are available at http://www.devoplus.com/downloads/. Financial issues are considered particularly in its first report, *A Stronger Scotland within the UK*.

4 See Independent Commission on Funding and Finance for Wales, 2009 and 2010

5 See Commission on Devolution in Wales 2010 (the Silk Commission report)

6 Belfast Telegraph 2012; for further comment, see the Devolution Matters blog: http://devolutionmatters.wordpress.com/category/northern-ireland/n-ireland-corporation-tax-devolution/

that solutions adopted for one part of it were at least potentially capable of being applied to other parts as well. It would also ensure that the solutions adopted for one part did not undermine solutions being applied to other parts of the union. In other words, the UK would acknowledge the existence of asymmetry in relations between the UK level of government and the three devolved governments, but would seek to ensure that there was a thread of consistency that enabled the UK to point to an identifiable UK form of devolution that went beyond merely responding, in haphazard ways, to demands emanating from the devolved administrations. Ongoing work as part of IPPR's Devo More project will seek to develop a model for extending devolution in a way that meets the needs of the constituent nations of the UK within a UK-wide framework.

2.2 The present system of devolution finance

The UK's present system of devolution finance relies very heavily on a block grant which derives from the operation of the Barnett formula.[7] The grant is an unconditional one which in principle the devolved governments are free to allocate as they see fit. In practice, there are a number of practical and administrative constraints, most notably established patterns of public spending and the policy programmes that underlie them. Devolved governments nonetheless have considerable scope to allocate the grant as they see fit.

The Barnett formula applies, strictly speaking, only to changes in devolved public spending. When spending on functions in England which are 'comparable' to devolved functions changes, a proportional change is made to the devolved governments' block grants. The comparability percentages are set at each spending review, and vary from UK department to department; the current ones are set out in table 2.1 below. The population figures for the coming spending review period are similarly set at each review (and so are slightly out of date at the time the review period starts and nearly four years out of date by its end). The formula uses the total of spending allocated as the baseline for spending in the next year, and adds to that an adjustment determined by changes in comparable spending in the current year. That total level of spending (inherited baseline plus incremental adjustment) becomes the baseline in spending for the following year.[8] This arrangement makes for administrative simplicity, and means that the Barnett formula system can be used without needing to make periodic adjustments to take account of spending need or other changes.

Table 2.1
Block grant comparability percentages, 2010–2013

	Scotland	Wales	Northern Ireland
Education	100	100	100
Health	99.1	99.1	99.1
Transport	98	73.1	100
CLG Communities	99.5	99.5	99.3
CLG Local Government	17.3	100	17.3
BIS	79.1	78.4	79.2
Home Office	76	0	76
Justice	99.7	0	99.5
Law Officers	100	0	94
Energy and Climate Change	20.6	20.6	20.7
Environment, Food and Rural Affairs	93.2	91.6	98.7
Culture, Media and Sport	96	90.2	96
Work and Pensions	0	0	100
Chancellor's departments	0.5	0.5	0.7
Cabinet Office	7.4	6.3	14.3
Independent bodies	0.3	0.3	37.1

7 For the operation of the Barnett formula, the best introduction remains Heald and McLeod 2002; see also House of Lords Select Committee on the Barnett Formula 2009.

8 These arrangements are set out in the Treasury's *Statement of Funding Policy*, issued after each spending review since 1999, its current incarnation being HM Treasury 2010.

The formula was first introduced in 1976, for the 1976/77 spending round for Scotland, and subsequently applied to Wales and Northern Ireland, and to an increasing range of services. By the mid-1990s it applied to most of the funding of the Scottish and Welsh Offices and spending by the Northern Ireland departments. Its adoption as the basis for funding devolved governments was a decision taken in 1997, very shortly after the UK general election, seemingly by Gordon Brown on his own.[9] While well suited to allocating finance within a single government, with common political composition, it was much less suited for funding devolved governments with distinct political priorities. Those involved seem split between those who expected this status quo to continue indefinitely, and those who expected there to be change after a period of 'bedding-in'.

The result of such reliance on the block grant system has been that devolved governments have minimal control over their own revenues. They are spending agencies, with minimal responsibility for raising the money they spend.

Two sources of revenue are available to the devolved governments at present. All three devolved governments are responsible for local government, including its finance. It would be open to devolved governments to increase the overall resources available to them by reducing the block grants they pay to local authorities and requiring local authorities to increase council tax and business rates instead. There are restrictions on how far this could be used, as the *Statement of Funding Policy* provides that the block grant may be reduced if levels of 'self-financed spending' grow significantly more rapidly than in England over a period, and that threatens public finance targets used to manage the UK economy.[10] Moreover, the Scottish experience of considering replacing council tax with a local income tax of three pence in the pound, blocked by various practical problems raised by HM Treasury, gives further reason to question whether this can be regarded properly as a devolved tax rather than as a delegated source of revenue.

The second source of revenue is the Scottish variable rate: the power, never used, to vary the standard rate of income tax by up to three pence in the pound. This power ceased to be available for administrative reasons in 2007, but figures in the 2010 budget suggested it would have been worth £350 million per penny in 2010/11, in the context of a total devolved Scottish budget of £29.71 billion. Its use would have occasioned a great deal of political pain for little financial gain.

2.3 Problems with the UK's system of devolution finance

The UK's present system of devolution financing has come under extensive criticism in recent years. Criticism has particularly focused on the following issues:

1. **Misallocation of resources:** The block grant is seen as treating Scotland and Northern Ireland unduly generously, and Wales harshly. There are further arguments about allocations within England.[11] This argument started in academic discussions, in which context one author has treated it as a first-order 'fiscal crisis'.[12] It has also attracted the concern of parliamentary committee inquiries.[13] It was an important element of the work of the Holtham Commission in Wales. Concerns about this – usually simplified to reflect higher levels of public spending in one part of the UK than

9 See Trench 2007, particularly pp88–92
10 HM Treasury 2010: para 6.2
11 See McLean et al 2009
12 See McLean 2005
13 In particular, House of Lords Select Committee on the Barnett Formula 2009

another, rather than a disparity between levels of relative need and actual levels of spending – have become a focus for public debate as well.[14] There are clear public perceptions in England of the 'unfairness' of the system as a result.

It is clear that Scotland receives a higher amount of per capita public spending, both for devolved services and overall, than its level of relative needs would indicate. Northern Ireland was similarly 'overfunded' for some time, though now appears to receive about the level of spending that its needs would entail. Wales receives slightly less than its relative needs. Growth in public spending would make this problem worse for Wales (and create a problem for Northern Ireland), as the convergence of public spending on the overall 'English' level – taking no account of needs in those parts of the UK – would create serious problems.

2. **The lack of fiscal accountability:** This was the key issue as far as the Calman Commission was concerned; devolved governments are responsible for raising only a small proportion of the money they spend. They are responsible for distributing that spending, but have no interest in how much tax revenues are generated by their actions nor how taxpayers in their parts of the UK respond to their policies. As policymaking always involves a balance between the cost of a policy and the benefits it offers, this leads to a serious imbalance in the politics of devolved policymaking. Those benefiting from devolved policy choices like free prescriptions, tuition fees or care for the elderly do not experience any impact on their tax liabilities as a result.
3. **The lack of levers to shape economic policy:** Most aspects of economic policy remain in the hands of the UK government, consistent with an institutional design that has emphasised the importance of a single UK economy managed from Westminster. Thus key aspects of macroeconomic policy (including currency, interest rates and borrowing) have remained at UK level. Regulatory and supply-side policies (employment and company law, for example) are also regulated at UK or EU level. At the same time, devolved governments have a limited role in encouraging economic development, mainly through the offering of practical or financial assistance to locate. However, this has had only a modest effect in spurring economic development. There are strong arguments that more effective levers are needed. This has led both Northern Ireland and Scotland's devolved governments to seek devolution of corporation tax, in particular.
4. **The implicit link to an 'English' model of the welfare state:** Devolved policy is largely concerned with distributive aspects of the welfare state: health, education, housing and local government are the largest devolved spending areas (and health and education account for around two-thirds of devolved spending). In Scotland and Northern Ireland, devolved institutions are also responsible for policing, criminal justice and prisons. In all these areas, political dynamics – skews of party systems to the left, in particular – mean that devolved policy preferences tend to be considerably more social democratic than those for England. (Voters are more likely to vote for left-of-centre parties in Scotland and Wales, for example, and those governments are therefore to the left of the centre of gravity at Westminster, even though attitudes surveys suggest only marginally stronger support for more ample and better quality public services when the implications for taxes are made clearer.)

   However, the block grant and formula system works by allocating shares of changes in spending in England on functions which are devolved in Scotland, Wales or

14 For example, the English and Welsh editions of the *Daily Mail* led on 30 August 2011 with a story headed 'A deeply divided kingdom: Scots each get £1,600 more state cash a year spent on them than the English', followed by a leader comment the next day. The story appeared in the Scottish edition of the paper, but on the inside pages.

> Northern Ireland, known as 'Barnett consequentials'. Those shares can reflect reductions in spending as well as increases, and if the UK Coalition government succeeds in its aspiration to restructure the UK state and reduce public spending, that will result in English spending assuming a very different profile to that desired by voters in Scotland, Wales or Northern Ireland. That puts serious pressure on devolved governments to follow suit, or to make painful choices to allocate their funding in such a way as to protect particular areas. This can mean 'robbing hospitals' to fund universities, for example, and doing so in a highly visible way. Higher education funding, particularly in Scotland, illustrates this point clearly. This means that devolved governments are not, in fact, in the same position to make policy choices as the UK government is, although the success of the union depends on its ability to accommodate differing visions of the welfare state.

Cumulatively, these factors suggest a need for extensive reform of the working of the block grant, at the very least. However, it is very hard to see how a reconstruction of the block grant to remove the problems outlined above would be workable, or fair to the UK government's right to choose other policies for England. This becomes a strong argument for enabling devolved governments to rely much more on tax revenues that come to them directly, and ideally under their own control, rather than on a block grant allocated from the UK government.

2.4 The distinctive character of the UK's tax system

The UK's tax system is central to the character of the UK as a state. Even before the union of Scotland and England in 1707, England was notable for its centralised tax system and efficiency in managing its public finances. This is often argued as being one of the reasons for the UK's success economically and militarily, during the 18th and 19th centuries. Fiscal centralisation was a key element of the Anglo-Scottish union; many of the articles of union were concerned with matters of tax and the public revenue, and integrated Scotland into the English system of public finance even as Scotland retained autonomy in areas including banking, the law, education and the church.

This high level of fiscal centralisation is deeply entrenched administratively. HMRC collects taxes across the whole of the UK; unlike the National Health Service (NHS) or even the various arms of the Department of Work and Pensions, it is a UK-wide body. (Welfare benefits are separately administered in Northern Ireland; the DWP only operates in Great Britain.) HMRC has no need to establish which part of the UK a company trades in, in order to collect VAT or corporation tax, or where individuals live or work in order to collect income tax. The principle of having potentially different income tax rates in Scotland compared to elsewhere has caused considerable difficulties. The provisions for identifying 'Scottish' taxpayers in the Scotland Act 1998 were never brought into effect, and the register identifying those taxpayers was already inaccurate by the time it was abandoned in 2007, after the Scottish government declined to pay HMRC to fund an upgrade of its computer system. The definition of a 'Scottish taxpayer' was wholly rewritten in the Scotland Act 2012, introducing a new test of whether a UK taxpayer's 'closest connection' is with Scotland or another part of the UK. That test itself was revised extensively during the bill's progress through parliament. The introduction of the new arrangements will not start until 2016, and its implementation may reveal flaws in how that definition works. Nonetheless, it appears to offer a practicable approach to identifying Scottish taxpayers, which is more robust than any other presently on offer.

The high level of fiscal centralisation in the UK is not only to be found in the institutions of public finance and tax administration. It also dominates the thinking of those involved in tax policy, whether in HMRC, HM Treasury, or among tax specialists in the legal and accounting professions or in academia. For all the thoughtful and informed consideration of how to improve the tax system in the recent Mirrlees Review, undertaken under the aegis of the Institute for Fiscal Studies (IFS), it failed to consider this dimension anywhere in its work. The closest the Mirrlees Review got was to note that '[h]ighly federalized countries will have tax systems in which the setting of taxes at the subnational level is a major concern'.[15] It notes two major recent changes that do affect the tax system: the increase in inequality in the labour market, and the shift from manufacturing to services in the structure of the macroeconomy. The constitutional changes started by devolution are wholly overlooked, even though Sir James Mirrlees was a member of the Scottish first minister's Council of Economic Advisers. Adapting to running a fiscally decentralised UK would, among other things, require a huge shift in outlook from tax specialists within government and outside it.

The Pay As You Earn system

The UK's Pay As You Earn (PAYE) system means that for the vast majority of taxpayers, it is unnecessary ever to fill out a tax return or formal assessment. Tax is deducted at source from earned income, and by a different mechanism from dividends and interest on savings. The system is intended to ensure that the tax so collected equals the amount the taxpayer is due to pay, for standard-rate taxpayers and many higher-rate ones. Any failure to do so means that the incorrect amount of tax may be collected, and HMRC may not become aware of that for some considerable time. The working of this system depends on the taxpayer ensuring that HMRC are aware of the taxpayer's employment and personal circumstances, and any changes in those. The onus of making the system work then passes to employers and HMRC. The evidence suggests that PAYE means employers incur heavy compliance costs, comparatively speaking. On the other hand, it has significant advantages: it is cheap for HMRC to administer, and suffers low levels of non-compliance. Over 98 per cent of the tax due under PAYE is collected, compared to only around 85 per cent for self-assessed income tax.[16]

There are clearly problems for HMRC in making the system work, given the state of the computer systems HMRC uses and staffing problems. In the last few years these have resulted in particularly serious problems when HMRC's records have been inaccurate, whether because of inaccurate or incomplete data supplied by taxpayers or employers, or failure on HMRC's part to ensure that such data was duly entered into its systems.

PAYE has no parallel in federal systems. While withholding arrangements for income tax are universal, so that the bulk of collection is done from each instalment of pay during the year, there is also a general obligation for taxpayers to submit tax returns at the end of the year to assess the total amount of tax due, and to trigger liability for any top-up payment if insufficient tax has been withheld, or a refund if the amount already remitted exceeds the taxpayer's total liability. In some systems, one tax return is sufficient, either because one authority collects tax for all tax-levying governments, or because all the levying governments use the same information presented in the same way. In other systems, it is necessary for taxpayers to submit multiple tax returns. To give a few examples: Revenue Canada, a federal government agency, collects all personal taxes due from taxpayers in

15 See Institute for Fiscal Studies 2011: 8

16 See Shaw et al 2010: table 12.2, p1128

all Canadian provinces save Quebec, including both federal taxes and tax it collects on behalf of provincial governments. In Quebec, each government levies taxes separately, and Quebec taxpayers therefore have to submit both federal and provincial tax returns. The same applies in the United States. A single tax collection agency means that a single tax return is needed in Germany and Australia. Submitting multiple tax returns – sometimes requiring different information about substantially similar activities (for example, if there are different rules about the deduction of employment-related expenses) – obviously adds to the compliance burden on taxpayers. This is common feature of federal fiscal systems from the point of view of the citizen.

There is a debate in tax circles in the UK about moving to universal self-assessment. Such a move would facilitate the operation of a more decentralised tax system. A decentralised tax system might also add to the factors weighing in favour of universal self-assessment, since universal self-assessment would make it easier. However, that would significantly add to taxpayers' burdens,

For all the problems PAYE creates, it offers very real advantages to a large number of taxpayers. A reconstruction of the tax system that undermined PAYE would be generally undesirable. That would be so even if the difficulties related chiefly to taxes collected for devolved governments, and the system could be left intact as regards England (where the bulk of the UK's taxpayers live). It appears that most payroll-management computer programmes now used by employers to administer PAYE can cope with multiple tax rates and different allowances, according to the status of the taxpayer. That suggests one set of potential problems with income tax devolution will not pose serious difficulties in practice. However, other practical constraints with outright income tax devolution will arise if PAYE is retained, because of how it operates within HMRC's systems. While modernisation of HMRC's systems is underway, it is unclear how well it could cope with such changes, or indeed how well the modernised systems will work in practice. If HMRC remains a single, UK-wide tax collection agency at least for income taxes, these will act as limits on what use devolved governments may make of devolved income tax powers. What becomes important is that these limits go no further than necessary for operational reasons, and do not become a means of imposing wider restraints on devolved autonomy.

National insurance

The UK's system of national insurance dates back to the National Insurance Act 1911, implementing Lloyd George's 'people's budget' (and predating the Beveridge report). It has been significantly expanded over the years, and involves two streams of revenue from those in employment, paid by both employers and employees, as well as by the self-employed. Its place in the UK's system of public administration is such that it has proved very hard to alter.

The structure of national insurance poses a number of challenges. In principle, it is hypothecated to pay for the purposes of national insurance: meaning old age pensions, contributory social security benefits (which are now the contributory elements of jobseekers' allowance and employment support allowance), but also some costs of running the NHS as well as a variety of smaller benefits such as widows' bereavement benefits or pensioners' Christmas bonuses. National insurance contributions (NICs) of course come from both employees and employers (and the self-employed), and NICs paid for those in employment are accounted for as a single source of revenue with no distinction drawn between those paid by employees (effectively an income tax). Indeed, national insurance has been widely criticised for its character as a disguised form of tax (or taxes) on income.[17] However, unlike other taxes that are paid into the Consolidated Fund, all forms of NICs are paid into the National Insurance Fund (NI Fund). The NI Fund pays for a range of benefits including pensions and other social security benefits, but also makes a contribution toward the running costs of the NHS. (It is unclear how this is apportioned territorially, that is, how that contribution goes toward health costs in the four parts of the UK.) Despite that, the NI Fund only occasionally runs at a surplus, and usually the costs of paying for these benefits are topped up from general taxation which has been paid into the Consolidated Fund.[18] As the NI Fund operates largely on a 'pay as you go' basis, funding current liabilities from current income without building up any substantial reserve for the future, an ageing population means it faces significant challenges in the future to discharge its current responsibilities.

In short, the working of the NI Fund reflects a long-past way of funding the welfare state, which bears little relation to how it now works in general terms, and does not relate to how the welfare state functions in a devolved UK. Its present structure has proved highly durable, however little it serves current purposes, and there remains a clear public attachment to the underlying contributory principle, particularly in relation to the old age pension, even if the present arrangements may apply that principle poorly in practice.

Tax administration, collection and compliance issues

In designing tax systems, it is easy to overlook the importance of administration and compliance issues. It is one thing to come up with solutions that by economic criteria work 'well'; raising adequate amounts of tax in fiscally neutral, stable and simple ways. However, such taxes may well impose burdens in unexpected ways or unexpected places. In that context, it is necessary to bear in mind administration issues (connected with what government has to do to collect tax revenues) and compliance ones (the costs and other burdens that fall on taxpayers in satisfying their obligations to pay tax). The areas of administration and compliance costs have been burgeoning areas for economic research over the last 20 years or so, producing a large number of single-country analyses and a smaller amount of comparative work.[19] That work is still patchy and incomplete, and illustrates the methodological problems that come with trying to gauge the burdens on business and personal taxpayers of complying with the requirements of a tax system.

Identifying clear lessons, let alone hard comparative data, from such a literature, is difficult. However, some points are clear.

- Tax compliance costs are substantial, in all systems; the impact on taxpayers cannot be neglected from an economic point of view, let alone a political one.
- Value-added taxes are particularly burdensome; they have, however, a high compliance rate and are hard to avoid, so they are attractive to a government if not business.
- The compliance burden of all taxes is regressive, and falls particularly heavily on small business taxpayers. For this group, the compliance costs of VAT, corporation tax and PAYE, and income tax for the self-employed, in particular, is a heavy one. They can also be, in Cedric Sandford's term, 'capricious'.
- The UK does not appear exceptional in terms of compliance costs for its tax system. Its administration costs seem to be rather high (though the costs of collecting income tax via self-assessment are much higher than for tax collected through the PAYE

17 See Institute for Fiscal Studies 2011: 129–32

18 On the operation of the NI Fund, see *Simon's Taxes*, part A8, 'National insurance contributions' (consulted May 2012).

19 For a comprehensive if slightly dated overview, see Evans 2003

system). Costs are particularly high when it comes to dealing with taxpayers who submit self-assessment tax returns, rather than having their taxes dealt with through the PAYE system.

PAYE of course makes life very simple for the vast majority of taxpayers who do not have to fill out self-assessment returns. There are recurrent problems with that system, with tax due being underpaid or overpaid, and not identified for some time, usually because of changes in income or in status (either in employment or in personal circumstances).

The factors discussed above create a powerful set of constraints on what can be done, at least in the short and medium term, to develop an approach to financing devolved government that draws on federal principles and is workable in a UK context. Such a system needs to be able to work with existing administrative structures, not destabilise the finances of either the UK government or the devolved governments, and improve political responsibility and accountability.

3. FISCAL FEDERALISM AND FINANCING FEDERAL SYSTEMS

Since the early years of devolution, there have been many attempts to compare the UK to federal systems, at least in describing the relationship between devolved Scottish and UK institutions. As devolved government in Northern Ireland has become more stable (following the St Andrews Agreement), and since the expansion of the law-making powers of the National Assembly for Wales which followed the 2011 referendum, all three devolved parts of the UK now have a largely similar relationship with the UK level of government, even though significant constitutional and political differences remain. With the revived constitutional debates, calls for the UK to develop in a more federal direction can be found across the political spectrum, with advocates including figures from the right like Tim Montgomerie and commentators such as Philip Stephens of the *Financial Times*, as well as being supported by Liberal Democrat policy and a range of Labour figures.

Whether the UK might develop along federal lines is a difficult question. Key to this is what happens regarding how England is governed. However, whether or not federalism in the UK happens, a great deal can be learned for financing devolved governments from practice in federal systems. Successful federal systems have managed complex relationships between the central/federal government and the constituent parts for decades if not centuries, suggesting that even allowing for the significant differences that do exist, federal systems offer valuable models from which lessons can usefully be learned by the UK.

The OECD and IMF are often keen to point to the success of federal systems. They appear to generate higher-than-average levels of GDP and growth in GDP. Other aspects of the evidence about the performance of such systems are more ambivalent (Triesman 2007). What is hard to dispute is that there are many prosperous, successful federal systems around the world, which combine 'self-rule' for some purposes with 'shared rule' for others (Elazar 1987), through having 'distinct but coordinate governments' (a definition of federal government, per Wheare 1963).

The group of federal systems with most to teach the UK are those most like the UK: medium-sized, developed world federal systems. 'Medium-sized' means both population and the number of federal units. Comparisons with the United States (50 federal units and a population four or five times the UK's) are hard to sustain, in contrast with systems such as Canada (14 units, about half the population) or Germany (16 units, population about a quarter larger). Yet there are telling differences between the UK and federal systems, as shown in table 3.1 (over).

In comparison with regional-level governments in other systems, the UK's devolved administrations have extensive spending responsibilities.[20] These exceed those of US states or Spanish autonomous communities, in the aggregate, and are only a little smaller than those of Canadian provinces. However, in contrast to constituent-unit governments with such levels of spending responsibility, they raise only a tiny proportion of their own spending. Even that amount they raise only indirectly, as it is local taxation subject to the limits discussed in section 2.2.

20 In this paper, 'regional-level governments' is used as a convenient shorthand to cover the governments of constituent units, such as states in Australia or the US, provinces in Canada, autonomous communities in Spain or cantons in Switzerland, as parallels for the devolved level of government in the UK.

Table 3.1 Expenditure responsibilities and revenue-raising by regional-level governments in selected systems

Country	Expenditure by regional-level governments (% of total public spending)	% of own spending raised by regional-level governments
Australia	46	55
Canada	63	80
Germany	63	56
Switzerland	68	75
Spain	49	23
United States	46	70
UK (Scotland)	70	12
UK (Wales)	56	11
UK (Northern Ireland)	53	10

Source: For overseas countries, from table 11.3 in Watts 2007
Note: Data relates to 1995/96 (for Canada, Australia and the US), 2000/01 (for Germany, Switzerland and Spain) or 2007/08 (for the UK devolved administrations). Authors' calculation for Scotland and Wales uses data from PESA 2011. Revenue raised by regional governments includes local government spending in all cases except Spain, as local government is within the constitutional responsibilities of regional-level governments in all those systems. Northern Ireland excludes social security spending, administered by the Northern Ireland executive but subject to rules of 'parity' with Great Britain.

Federal systems are highly varied.[21] Some, like Canada, Belgium and arguably Switzerland, are multinational states, and their federal structures reflect underlying differences between its constituent national groupings as well as between different regions. Some systems encompass wide gaps in income or prosperity across their territory, while others such as Australia show much less regional inequality. While 'policy learning', and the adopting of mechanisms and techniques from one system by another takes place, each system has developed its own approach to addressing its own policy problems. Given that, it is striking how that group of medium-sized federal systems have converged on substantially similar approaches to managing financial relations between the federal tier of government and regional-level ones.

One can induce from these systems an approach to fiscal federalism that draws on a number of common elements.

- There is a substantial level of sub-state fiscal autonomy, so that regional-level governments raise substantial amounts – more than half – of their own spending from taxes under their direct control. Taxpayers therefore pay taxes to two governments (more, if local authorities are included) as a matter of routine.
- Sub-state regional governments commonly have control over taxes on land, and share taxes on sales and consumption, personal income, and sometimes on business profits. Central governments share access to business profit and personal income taxes, sometimes to sales taxes, as well as having a monopoly on external trade (customs duties).
- Tax bases available to the central government are greater than it needs for its own spending commitments, creating a 'vertical fiscal gap', while those available to regional-level governments are seldom equal to what they need for their commitments. This can become the subject of heated controversy, but also means that a central government is likely to have the means available to it to effect redistribution.[22]

21 The academic literature on fiscal federalism is large, and often highly technical. Useful starting points include Boadway and Shah 2009, a textbook, and Shah 2007, a collection of short studies of various systems. Also helpful are Ahmad and Brosio 2006 and the more dated Ter-Minassian 1997. There is also a valuable repository of work from the OECD's Fiscal Federalism Network, available at http://www.oecd.org/department/0,3355,en_2649_35929024_1_1_1_1_1,00.html .

22 A notable example was the Commission on Fiscal Imbalance (Commission sur le déséquilibre fiscal) chaired by Yves Séguin and established by the Quebec government in 2001. In the Canadian case, the existence as well

- There is a system of equalisation funded by the central government to ensure that certain minimum levels of public services are available to all citizens, wherever they live. Equalisation grants are unconditional, and can be spent as the recipient regional government sees fit.
- Central governments may also provide various sorts of conditional grants, which are tied to providing certain sorts of services or delivering certain policies, such as special purpose payments in Australia or the Canada Health Transfer, which helps to fund health services operated by provincial governments, provided those services comply with the requirements of the Canada Health Act.

What federal systems do, therefore, is have a substantial level of fiscal autonomy at regional level, and use the resources available because of the vertical fiscal gap to reduce the impact of horizontal inequalities between regional-level governments. That assures both a measure of state-wide equity, and enables the central government to identify an important role for itself in ensuring that regional governments have the means to provide similar levels of public services. The extent to which regional governments do so is a matter for themselves; however, the central government has given them the means to do so.

It is important to emphasise that this is a broad, general model, and what happens varies considerably from system to system. In some systems, equalisation arrangements are limited to revenue-raising capacity: that is, the size of the tax base in each sub-state unit which is available to the regional-level government. In others, notably Australia, a wider range of factors affecting the costs of services (whether affecting demand for services or the costs of providing them) are taken into account. Tax bases available to regional-level governments vary from system to system. In the United States, sales taxes are purely levied at state level, and there are no equalisation grants (but many conditional grants). Switzerland has no conditional grants at all, and the only one still used in Canada relates to the Canada Health Act, the foundation of the Canada-wide system of public health care. Spain has a baroquely complicated system involving varying combinations of shared taxes and grants which are underpinned by the historic costs of services, with minimal equalisation arrangements. Nonetheless, there is a broad degree of commonality in how such systems work, which suggests that their mutual resemblance is not an accident but is because such arrangements are the best answer to what is a similar problem in all such systems.

Adopting the principles that underlie financial arrangements of federal systems involves a system that combines both a grant element and a substantial degree of revenue-raising by devolved governments on their own account. A grant is not a residual element of funding, but a way that the central government ensures a measure of equity across the state as a whole. Revenue-raising is as much about ensuring that devolved governments are responsible for their actions, and can be held accountable for those actions at the ballot box. Both are positive elements of such a system. They are not the only ones, however. Putting such a system in place will require the UK government to make extensive changes to long-established institutions and administrative practices.

as size of such a 'gap' was highly controversial, and the commission prompted an active debate that abated with the devolution of tax points by the federal government to Quebec.

4. APPLYING LESSONS FROM FEDERAL SYSTEMS: TAX DEVOLUTION

4.1 Designing and redesigning tax systems

There is no shortage of advice on how to structure tax systems. The UK is fortunate in having guidance from the recent Mirrlees Review, which identifies three general 'rules of thumb' as instrumental guidelines in designing a tax system.[23]

1. **Neutrality** means that the system treats similar activities in similar ways, and so minimises distortions in people's choices or behaviour arising from tax considerations. This means not only deterring decisions made to obtain a tax advantage, but also ensuring consistency over time so that, for example, the decision whether to save money for the future or spend it now is fiscally neutral. This is essentially an economic criterion, but it also generally necessitates greater simplicity and fairness in the tax system as well.
2. **Simplicity** is deployed not only as an adjunct to or consequence of fairness, but to increase transparency of the tax system and reduce compliance costs.
3. **Stability** ensures that the system is consistent and predictable, and that it facilitates the making of long-term plans.

The review acknowledges that these rules of thumb are subject to other policy considerations, and that there may be cases where adhering to them will be a matter of judgment and may even be undesirable (using the tax system to increase the cost of substances that cause harm to the individual using them, like tobacco, will require a tax that is the opposite of neutral; that is its point). They are put forward as yardsticks by which to assess a tax system or changes to it, rather than as absolute values which ought to be embodied in any system.

There are other reasons why such principles are worth seeking to apply in practice, so far as that is consistent with other policy goals. As Shaw et al (2010) note:

> **'Administrative and compliance costs are generally lower for simpler taxes – those with fewer rates, borderlines and reliefs. Less effort is required to understand how to comply, the mechanics of fulfilling obligations takes less time and there is less for the tax authority to record and monitor. If there is overlap between the bases of different taxes, the use of common definitions and procedures across taxes reduces costs by decreasing the number of calculations that to have to be made ... Complexity and lack of clarity in tax law in general will make for higher administrative and compliance costs.'**
> Shaw et al 2010: 1119

They emphasise the value of increasing the probability of detecting non-compliance (rather than fines) as a way of ensuring maximum compliance and minimising evasion, while also not alienating taxpayers as that can reduce the 'moral worth' of paying tax and taxpayers' sense of duty in doing so.

4.2 Principles for allocating taxes to various levels of government

The fiscal federalism literature has developed a number of criteria for determining which taxes are most suitable for devolution to subnational levels of government.[24] There are many iterations of the criteria, but Sandford's is a neat and concise one.

23 See Institute for Fiscal Studies 2011

24 'Fiscal federalism' is concerned not just with relations between central and regional governments in federal systems (or even in non-federal, regionalised ones), but also between central and regional levels of government and local ones.

1. Devolved taxes, particularly local rather than regional ones, should have a tax base that is evenly distributed across the country.
2. Taxes should be economical to operate and collect on a small scale, and be difficult to evade.
3. The tax base should be localised, and not relate to something easily transferrable across jurisdictional boundaries.
4. The tax should generate a high and reliable yield.
5. The tax should not exaggerate local disparities of wealth.
6. It is desirable that the tax be exclusively reserved for local use, not shared with central government.
7. The tax should be perceptibly and identifiably a local one, used for local purposes.
8. The tax should promote local accountability and so improve decision-making.[25]

These criteria help emphasise why taxes on land are most suitable for funding local governments. They are hard to evade, as land is readily identifiable, as usually are its owners, and it cannot be moved. It is also as evenly divided across the country as it could be. Greater difficulties arise when it comes to other taxes, and particularly those for funding a regional-level government. In reality, the difficulty of identifying taxes suitable for devolution helps explain why vertical fiscal gaps are commonplace. It suggests, however, that regional-level taxes should be levied on less mobile objects rather than more mobile ones. Land is the least mobile factor; people are more mobile, as are transactions in daily necessities; companies are more mobile; and financial transactions the most mobile of all (hence the ease of corporate tax avoidance through the use of tax havens). That suggests that land taxes, personal taxes and taxes on consumption are most suitable for devolution, and corporate taxes among the less suitable.

Underlying these considerations, however, needs to be an understanding of what services devolved governments provide. This affects both the amount of revenue that devolved governments need to pay for those services, and the sorts of taxes that ought to be devolved. Where possible, devolved taxes should also relate to devolved services; for example, taxes on land have a natural connection to environmental and transport functions. At present, devolution means that devolved governments provide distributive public services, such as education, housing, transport and health care, but not redistributive ones such as pensions or social security benefits. While that division of powers has not been altered to date, it no longer appears to accord with what Scottish voters wish (as they seek extensive devolved control of both taxation and welfare).[26] The impact of the UK Coalition government's policies may affect support for Westminster domination of those in Wales and Northern Ireland as well. Any new system has to be capable of adapting to changes in the allocation of functions that may take place in the future, whether because of schemes to enhance devolution in Scotland, perhaps by way of some form of welfare devolution, recommendations to devolve additional functions in Wales by the Silk Commission in its Part 2 report, or other as-yet-unforeseen changes. That in turn may lead one to seek to extend fiscal devolution further, to help pay for such further functions.

25 See Sandford 2000: 22–24

26 The 2010 Scottish Social Attitudes survey showed that nearly as many Scottish voters want welfare and taxation to be devolved to the Scottish parliament (62 per cent and 57 per cent, respectively) as think health or education should be (66 per cent and 62 per cent); see Park et al 2012: table 7.5.

In the UK context, a further factor needs to be considered; the extent to which fiscal devolution contributes to preserving the United Kingdom. That has two effects. It reinforces the need to seek to devolve taxes which work well at lower levels, so as not to increase centrifugal pressures. It also has the negative effect of seeking not to devolve taxes which might increase such pressures, whether in the short or the longer term. However, this is no easy task, given how unevenly tax revenues are distributed across the UK. As table 4.1 shows, while the UK as a whole has currently a significant fiscal deficit, this is somewhat worse in Scotland, and significantly worse for Wales and Northern Ireland. Any UK-wide, union-preserving solution which does not take into account the limited tax bases of Wales and Northern Ireland and ensure that they will continue to have the resources to pay for public services on a comparable basis to the rest of the UK will have failed to achieve that objective.

Table 4.1
Fiscal deficits across the UK

	Per capita fiscal deficit (2010/11, (£)	Current fiscal deficit as percentage of total managed public spending (2010/11)	Current fiscal deficit as percentage of GDP (2010/11)
UK	2,426	-21.2	-9.2
Scotland	3,515	-29.2	-15.6
Wales	5,567	-48.9	-38.5
Northern Ireland	5,848	-45.3	-38.3

Sources: UK and Scotland revenues, *Government Expenditures and Revenue Scotland 2010/11*; Wales spending data, Silk Commission report and PESA 2012; Northern Ireland data, *Northern Ireland Net Fiscal Balance Report 2009/10–2010/11*.

4.3 Choosing which taxes to devolve

The choice of which taxes might be devolved is not an easy one. While some taxes are well suited to being allocated to a regional or even local level of government, many more are not. In most federal systems, this results in many tax bases being shared between federal and state governments, and sometimes with local government as well. The reasons for this are often more historic than anything: tax bases were allocated to a particular tier of government at the time the constitution was framed, even if the role of government and its spending responsibilities were very different at that time. Subsequent developments take place around this constitutional framework. In the UK context, the approach is quite the opposite, as what is at issue is decentralising an already centralised system.

It is also important to bear in mind the wider objective: of ensuring that devolved governments have in their hands sufficient revenues to make their own choices about the public policies they pursue.[27] That means that attention needs to be focused first and foremost on the major sources of revenue, rather than smaller taxes which may serve a useful policy purpose in themselves but which do not in fact generate substantial funds. Table 4.2 shows overall tax revenues for 2010/11 for Scotland, Wales and Northern Ireland. This is the most recent year for which data is available for all three devolved parts of the UK. It indicates the heavy reliance on a small number of taxes as the major sources of revenue in the UK, particularly personal income tax, VAT, employers' and employees' national insurance credits, and local taxation. By contrast, corporation tax and alcohol and tobacco duties generate only modest amounts of revenue, and their impact is more as policy levers than as sources of revenue.

27 See also Mellett 2009

Table 4.2: Major taxes and their revenues, 2010/11

	United Kingdom		Scotland		Wales		Northern Ireland	
	Revenue (£m)	% of overall current revenues	Revenue (£m)	% of overall current revenues	Revenue (£m)	% of overall current revenues	Revenue (£m)	% of overall current revenues
Overall current revenues (excluding North Sea)	542,877		45,177		18,041		12,703	
Personal income tax	146,628	27.1	10,717	23.7	4,850	26.9	2,575	20.3
VAT	97,277	17.9	7,481	16.6	3,485	19.3	2,898	22.8
Corporation tax	34,661	6.4	2,791	6.2	1,005	5.6	775	6.1
Employee's NI contributions	53,321	9.8	4,373	9.7	1,896	10.5	1,061	8.4
Employers' NI contributions	44,434	8.2	3,645	8.1	1,580	8.8	885	7.0
Fuel duties	27,256	5.0	2,339	5.2	1,310	7.3	928	7.3
Alcohol and tobacco duties	18,565	3.4	1,880	4.2	855	4.7	759	6.0
Local taxation (council tax and non-domestic rate)	48,412	8.9	3,877	8.6	1,881	10.4	1,028	8.1
These taxes as percentage of overall current revenue		**86.7**		**82.1**		**93.5**		**85.9**

Sources: For UK and Scotland, *Government Expenditure and Revenue Scotland 2010/11*, table 3.1; for Wales, the Silk Commission report, annex D, table D1 (for UK taxes) and *Welsh Local Government Financial Statistics 2010* (for non-domestic rate and council tax revenues); for Northern Ireland, *Northern Ireland Net Fiscal Balance Report 2008/09*, table 4.1.
Note: National insurance is not identified in those sources as relating to employees and employers, but can be identified in *HM Revenue and Customs Receipts* which suggest apportioned between employees and employers in the ratio 6:5 is appropriate, which has been applied here.

These revenues indicate the importance of a small number of large taxes, particularly personal income tax. These taxes differ in the extent to which they are suitable for devolution, as discussed further in section 4.5. Identifying current revenues gives a good indication of the sort of revenues a devolved government would be likely to enjoy if they were devolved, and of the overall sufficiency of its revenues as a result. However, no proposal for tax devolution can offer precision about the revenues a devolved government would enjoy if particular taxes, or a particular combination of taxes, were devolved. If devolved, these taxes might well produce different yields – whether more or less – to those they presently do. The dynamic effect of setting different tax rates, or of different thresholds, exemptions and reliefs, mean that revenues can change. This also means that actions taken by one government can affect the revenues of another, making for a windfall gain or loss, which can have significant effects if two levels of government have access to the same tax base. Present revenues, and what we know of the behaviour of those taxes in recent years, give as good an indication as there can be of how well or badly devolution of particular tax bases might work.

4.4 The issue of volatility

Much of the discussion below of which taxes might or might not be devolved raises the issue of tax volatility. It is worth developing this point further. One of the virtues of the present block grant and formula system is that it provides stable and predictable funds to devolved governments, which enables them to plan for the delivery and development of services some years in advance. *Any* system of fiscal devolution will result in less stability and predictability; devolved governments will have to take on the risk of variations in the resources available to them, which at present remain with the UK government.

Volatility is a serious problem when it comes to paying for public services, particularly if the cost of providing those services is neutral or counter-cyclical across the economic cycle (that is, their costs remain constant or go up in an economic downturn). Services like health and education are pro-cyclical, in the sense that the amounts spent on them will increase when economic times are good and revenues are buoyant; they can absorb available spending without difficulty, even without such factors as increasing costs of providing care or an ageing population. But they can also be counter-cyclical: when times are bad, demand also increases. Unemployment may lead to young people staying in education when they might have entered the labour market, for example, and demand for health services is constantly increasing, whether because of ageing populations, new and more expensive treatments, or other factors. Managing such fluctuations in revenue will be a major challenge for any devolved finance minister and his officials if taxes are devolved.

The figures below give an indication of the scale of that challenge for three major taxes in Scotland, Wales and Northern Ireland, compared with the UK as a whole. The data is not sufficient to draw firm conclusions, especially as they relate to the last few years which has been one of the troubled times for public finances since the 1930s. However, it indicates the scale of the problem with devolving a relatively volatile tax like corporation tax, as well as the greater vulnerability in a downturn of those parts of the UK with weaker revenue bases: Wales and Northern Ireland.[28]

Table 4.3
The volatility of revenues from major taxes

	2006/07	2007/08	2008/09	2009/10	2010/11	% change (high to low)	% change, 2007/08–2010/11
Value-added tax†							
UK	87,739	89,878	85,350	83,616	97,277	-14.0	+8.2
Scotland	7,677	7,972	7,481	7,348	8,560	-14.2	+7.4
Wales	*	3,585	3,275	2,930	3,485	-18.3	-2.8
Northern Ireland	2,082	2,328	2,360	2,478	2,898	-19.7	+2.4
Income tax							
UK	141,226	151,746	144,459	140,955	146,628	-7.1	-3.4
Scotland	10,466	11,244	10,717	10,405	10,634	-7.4	-5.4
Wales	*	5,150	4,850	4,710	4,850	-9.1	-5.8
Northern Ireland	2,788	2,816	2,816	2,469	2,575	-12.3	-8.6
Corporation tax							
UK	37,156	40,017	32,493	29,968	34,661	-25.1	-13.4
Scotland	3,217	3,465	2,791	2,597	3,114	-25.9	-10.1
Wales	*	1,425	1,120	1,005	1,170	-29.5	-17.9
Northern Ireland	890	952	711	665	775	-30.1	-18.6

Sources: For UK and Scotland, *Government Expenditures and Revenue Scotland*, successive editions; for Wales, Silk Commission report, annex D, table D1; for Northern Ireland, *Northern Ireland Net Fiscal Balance Reports 2006/07, 2009/10, 2010/11.*
Notes:
† VAT rates varied during these years considerably; the point here is not the aggregate revenues but differences in volatility.
* Data not available.
There are material discrepancies between the figures given in Government Expenditures and Revenue Scotland and the Northern Ireland Net Fiscal Balance Reports for UK tax income. These appear to relate to whether the figures used are net of the cost of collection or not. None are given in the Silk Commission report. The Scottish figures (which are net of costs of collection) have been used here. This means it would be inappropriate to compare the Northern Ireland figures with the Scottish ones as shares of revenue generated, as the bases are different, but internal consistency means comparison across a single time series (as shown here) is possible.

28 There are serious problems regarding data about the financing of devolution. These problems are troubling as far as spending is concerned, but very serious regarding revenues. For Scotland, there has been decent data since 2003/04; for Northern Ireland, reasonable data since 2006/07, but only in late 2012 was data of reasonable quality about tax revenues in Wales published, thanks to the Silk Commission.

Heavy reliance on volatile sources of revenue also creates the risk of having to make substantial cuts in public spending in a downturn, as demand for services increases. The effects of such volatility can be mitigated if they are accompanied by other, less volatile taxes. For that reason, a package of fiscal devolution should include a range of more and less volatile taxes, rather than create a reliance on just one major source.

The most usual way of addressing volatility in revenues is what has happened on a UK-wide scale since 2008/09: using public sector borrowing to maintain current spending on public services. If services are to be maintained, that is unavoidable in the short term even if it creates longer-term problems. That, of course, contributes to increasing the overall amount of public debt. If devolved governments had the unrestricted power to borrow, relying on the UK's overall credit rating, they could possibly do so to unsustainable levels over an extended period of time, threatening not just their own finances, but those of the UK as a whole.[29]

As a result, devolved borrowing powers need to be seen as the other side of the same coin as fiscal devolution. Devolved tax-setting powers without borrowing powers expose devolved governments to serious risk without giving them one of the tools necessary to manage that risk. In a devolution context, creating the scale of devolved borrowing power necessary to enable a devolved government to compensate for a significant shortfall of revenue would imply a significant ceding of power by HM Treasury, which would have to yield a degree of control over both borrowing and revenue powers. However, it is hard to see how such borrowing would threaten borrowing targets to a meaningful extent, or related matters for the UK as a whole, particularly over the whole of an economic cycle, given the relatively small size of the devolved parts of the UK and the limited extent to which they would need to borrow. Devolved borrowing powers are part of devolving fiscal responsibility, though this is not the place to address in any detail the devolved issues borrowing would raise.

There is no such thing as a major 'counter-cyclical' tax (although revenues from alcohol and tobacco duties have continued to go up since 2007/08, unlike most other taxes). But VAT and personal income tax are much more stable than other major taxes, particularly corporation tax, as table 4.3 shows. Given the nature of services to be funded, it is obviously desirable that more stable revenue sources be devolved. Moreover, to the extent volatile revenue sources are devolved, these should account for only a limited proportion of devolved revenues, and should form part of a wider package of devolved taxes to minimise volatility in the funds available to pay for public services.

4.5 Identifying taxes to devolve

Having identified some criteria by which to establish better and worse taxes to devolve, what are the factors that help identify which of the major sources of revenue could be devolved, and which would be better not devolved?

Taxes on land

The most obvious taxes suitable for devolution are those on land, as land is immobile and the scale for causing economic distortions is minimal. The largest such taxes in the UK are council tax and non-domestic rates, which are regarded as being devolved already. This can be questioned, as the present arrangements for operation of the Barnett formula limit the extent to which council tax and non-domestic rate might be increased

29 See Rodden 2006

if a devolved government saw fit (though these provisions have not been invoked to date).[30] In any case, there are already meaningful differences in how council tax works. A revaluation, with the introduction of new tax bands for higher value properties, took place in Wales in 2005. Council tax has been frozen in Scotland since 2007, where property values dating back to 1991 are still in use.

Other taxes relating to land – notably stamp duty land tax, landfill tax and the aggregates levy – could also be devolved, and this was recommended by the Calman Commission for Scotland and the Holtham Commission for Wales. However, these taxes generate relatively little revenue (at least as matters stand). In Scotland in 2008/09, the largest of them – stamp duty land tax – raised 0.7 per cent of revenues, and in Northern Ireland 0.6 per cent. Stamp duty land tax and (in a different way) air passenger duty might be useful as levers to shape economic policy, but only to a limited extent, and with a possible increase in harmful effects on the environment in the case of air passenger duty. They do, moreover, expose the government controlling them to a volatility risk, particularly in the event of bubble in property prices.[31] The aggregates levy and landfill tax are more instruments of environmental policy than anything, and as such are appropriate for devolution because of their relationship with other devolved policy functions rather than for revenue-raising reasons.

The present taxes on land are not the only ones that would be possible. There would be good fiscal arguments for further taxes, such as a land value tax advocated by Welsh national assembly member Mark Drakeford as a replacement for the council tax. The Scotland Act 2012 allows for such further taxes, subject to approval by HM Treasury. There would be attractions in taxes on tourist visits (a hotel 'bed tax'), or properties used as second homes (beyond present council tax arrangements). The decisions about such taxes should be a matter for devolved discretion, with any role for HM Treasury in approving or blocking them kept to a minimum. In some cases, there would be arguments for these to be levied at local level rather than by a devolved government for the whole of its territory; though the legislation permitting them would need to be passed by a devolved legislature first, of course.

One further potential tax base relating to land raises problems in the shorter term. That would be capital gains tax on transactions in land. Capital gains tax is a comparatively small tax but rather volatile, accounting over the last four years for between 0.6 and 1.7 per cent of total HMRC receipts.[32] It is therefore of limited importance as a source of revenue, even if it were an appropriate policy lever to devolve, so that all land taxes were under the control of devolved governments. At present, the capital gains tax regime does not differentiate between transactions in land and those in other items – whether chattels like furniture or paintings, or financial investments such as shares – except when it comes to specific exemptions and reliefs. These other items are more mobile and therefore more likely to generate spillovers or tax-avoiding behaviour.

30 The *Statement of Funding Policy*, chapter 6, provides for reduction in amounts payable through the block grant if levels of 'self-financed spending' grow significantly more rapidly than equivalent spending in England over a period, so as to threaten targets set for the public finances as part of the management of the UK economy.

31 Factors that drive property bubbles include overall interest rates and the supply of credit, and the supply of property which is regulated by planning policies and to an extent land law. Planning control is a devolved matter in all three devolved territories, though with some restrictions for energy projects in Wales. Land law is a devolved matter in Scotland and Northern Ireland, but not Wales. That raises questions about whether devolving such a tax to Wales would be appropriate while land law remains a non-devolved matter.

32 This volatility would appear to relate to changes in the incidence of the tax and exemptions, rather than changes in the underlying volume of taxable transactions.

If the logic of devolving land taxes were to be followed, capital gains tax might need to be restructured so the tax in relation to (immobile) land can be devolved, even if that in relation to (much more mobile) chattels and financial instruments were not. That would also imply some common approach to defining the incidence of the tax for collection purposes, if HMRC were to continue to be responsible for collecting it.

Taxes on income

Income taxes are commonly a state-level tax in federal systems, though often this large tax base is shared with the federal government. The result is that both orders of government tax personal incomes. This practical outcome reflects an intellectual division, regarding just how mobile people are and therefore how suitable it is to tax their incomes at a lower level of government, as well as a practical one that income tax is such a large source of revenue in any developed country. Sandford's criteria are ambivalent about income; the tax base is reasonably evenly distributed, but shows clear differences reflecting local disparities of wealth. Whether it can be an exclusive tax is an open question; the Scotland Act 2012, of course, has assumed that only partial devolution of it can deliver meaningful political accountability.

In the UK, the situation is complicated by the fact there are two taxes on income, not one. One is the personal income tax, readily identifiable as such. The other is the employee's element of national insurance contributions, treated as a tax by most payers but accounted for separately and still subject to distinct rules about its incidence and collection, though rules about the operation of NICs are to be integrated with those for income tax.

The case for outright devolution of personal income tax (as it currently is defined) is a strong one. This is a large source of revenue, and relates closely to the sorts of personal public services that are devolved. Applying Sandford's criteria, it has a relatively evenly distributed tax base, generates a high and reliable yield, and its visibility promotes local accountability, making it suitable for local control. Thanks to PAYE, it is easy to collect and hard to evade; it does generate a high and reliable yield, and its visibility is such that it is capable of promoting local accountability. Doing so does not undermine the ability of the UK government to undertake redistribution, whether between richer and poorer people or between richer and poorer parts of the UK, since the existence of a vertical fiscal imbalance – as well as geographical imbalances in where tax revenues are generated – means that the UK level retains the means to do so, and would do so under all realistically imaginable circumstances. Income tax devolution would still leave the UK government able to provide interpersonal redistribution (through the social security benefits system and old age pensions) as well as supporting redistribution to devolved governments for the services they provide to people living in those parts of the UK. At the same time, devolving the tax outright enables a devolved government to adopt different rates, bands or reliefs; it could seek to extend the Coalition government's policy of 'taking the low-paid out of tax' by increasing the personal allowance, introduce different personal allowances for such groups as the elderly, or give itself extra resources to spend by reducing thresholds or removing exemptions. The point is that these choices would be open to the devolved government, which would be able to make a much wider range of policy decisions, but would also have to accept political responsibility for their social and economic effects.

There are issues about the costs of collection and possibility of avoidance, and about ascertaining which taxpayers are liable to which band of tax. However, the 'closest connection' test set out in section 25 of the Scotland Act 2012 provides a relatively simple and clear measure of identifying 'Scottish' taxpayers, which could be adapted to identify 'Welsh' and 'Northern Ireland' taxpayers too.

It would therefore be possible and desirable to devolve personal income tax to devolved governments, outright.

The implication of that devolution would be that it would be open to devolved governments to set not only tax rates, but also thresholds, exemptions, and reliefs. They would be able to use income tax as an instrument of social policy as well as a way of generating revenue to pay for public services; and in generating revenues, to choose to encourage some behaviour and discourage others. What would need to remain in common would be the definition of who constituted a UK taxpayer, and what constituted 'income', both to minimise tax avoidance and (if HMRC were to act as the collecting agency; see section 7.2 below) to simplify administration. Following the Canadian precedent, there might be reasons for there to be certain limits on how thresholds, exemptions and reliefs could be structured by devolved governments for that to work as well. These would need to relate solely to administrative considerations, and not serve as a way for HM Treasury to assert control over devolved functions through the back door. There would also be issues of the costs payable by devolved governments for being permitted to change the system in substantial ways.

National insurance should also be viewed as a tax on income. However, its structure poses a number of challenges. These have already been discussed above (in section 2.4). The working of the NI Fund reflects a long-past way of funding the welfare state, which bears little relation to how it now works in general terms, and does not relate to how the welfare state functions in a devolved UK, or indeed contemporary welfare systems more generally.

One can conceive of other ways of using national insurance. It would be perfectly appropriate for employees' NICs to remain as a UK-wide tax on incomes, to pay for UK-wide aspects of the welfare state, notably non-devolved aspects of welfare. That would entail taxpayers paying two taxes on their income, one clearly linked to devolved governments and the services they provide, and the other going to the UK government to help pay for UK-wide aspects of the redistributive welfare state. When federal systems distinguish between 'social' taxes and federal income taxes, such social charges are usually levied by the federal or central government.[33] Such an approach matches the present division of powers, and so (*pace* Sandford) would help ensure that the local tax was perceptibly so and could affect accountability. This is largely a view based on practical and political considerations rather than fiscal or economic ones, but it matches practice in many federal systems where different taxes are levied on such a major source of revenue.

When it comes to the other part of national insurance, the employer's contribution, a case can be made either way. In effect, it is a 'payroll' tax, and there is no clear pattern in federal systems about which government should have control of such taxes. In some they are exclusively federal; in others, shared between federal and regional-level governments. While it is a tax that directly relates to employment, it is also of the character of a tax on income albeit one paid by employers rather than employees, which leaves equally the issue of whether it should be devolved open. In the Mirrlees Review, the IFS recommends that if it were possible, national insurance should become a tax borne directly by employees rather

33 This is notably the case in Spain and Belgium, for example.

than employers, given that character.[34] However the IFS concedes that this would cause excessive pain for taxpayers. If regulation of the economy in general, and the labour market in particular, were to be devolved, there would be very strong arguments on the ground of linking fiscal and legal powers to devolve the tax. In the absence of that, there are still arguments for doing so, particularly if further expensive functions were to be devolved. If significant elements of social security were to be devolved, this would appear to be the most suitable tax to devolve to help support them because of the revenue involved, there being no overriding objection of principle to doing so.

Employers' NICs are also one of several taxes on business, and so affect the wider economic environment. Their devolution would therefore deliver to devolved governments a significant business tax without devolving the more problematic corporation tax. Its characteristic as a business tax means that there is a risk of triggering 'beggar thy neighbour' competition, though this risk is more limited than with corporation tax and also by the need of governments to secure revenue. On a practical level, computerised payroll systems designed to cope with differential rates of income tax (as many now are, and as will be needed to cope with the new Scottish rate of income tax) should be able to cope equally with different rates of employer's NICs.

Value-added tax

The next most obvious candidate for devolution would be sales taxes. Such taxes are commonly a regional-level matter in most federal states.[35] In a UK context, however, it is impossible to devolve value-added tax, as VAT must as a requirement of EU law be levied at a single rate across the territory of a member state. The closest that one could come to devolving VAT would be to assign its revenues in the devolved parts of the UK.

Assignment of VAT revenues was considered, and dismissed, by both the Calman Commission for Scotland and the Holtham Commission for Wales. Their reasons varied somewhat, but both shared a view that assignment would involve an asymmetric transfer of risk; that is, that the recipient devolved governments would be at risk of substantial swings in the revenue produced by the tax without having the power to vary its rate or incidence to compensate for that. That is true, but there are other factors that make assignment of VAT attractive.

1. Problems could be caused by dependence on a block grant tied to service provision in England, as discussed in section 2.3. Assignment of revenue of such a tax would overcome the problem of this connection to English policies, though not in itself address problems of limited tax bases in Wales or Northern Ireland. (These were not present in the minds of either commission.)
2. It can also be seen as a 'fair' tax if used to fund regional-level services, as it means regional governments share with central government changes in revenues, whether these increase or reduce revenues, and in both good times and bad. In addition, the tax base is a relatively evenly distributed one. Where the tax is assigned without power to set the rate – notably Brazil – this rationale of tax sharing is widely used to justify that.

34 Institute for Fiscal Studies 2011: 129–132

35 Sales taxes are exclusively state taxes in the US. In Australia, goods and services tax (GST) is set at federal level, but its revenues are allocated to the states through the equalisation mechanism supervised by the Commonwealth Grants Commission. In Canada, there is also a federal GST, set at a uniform rate across the whole country, as well as provincial sales taxes, and in some provinces there is a harmonised sales tax incorporating both. In Switzerland, VAT is a federal tax. They are also central/federal taxes in EU systems such as Belgium, Germany and Spain.

3. Over time, sales taxes have proved to be a growth tax (unlike, for example, corporation tax or income taxes). This was a significant factor in Australia in the deal that led to creation of the goods and services tax as the chief source of revenue for equalisation payments to the states.
4. In the shorter term, VAT receipts are relatively stable. Indeed, in recent years they have grown across the UK in almost the same proportion as tax revenues as a whole. They have been affected to a relatively limited extent in the downturn. That is important for those responsible for planning and providing public services, especially as the stability and predictability of the present block grant arrangements are frequently cited as key advantages of it.
5. While assignment does not give devolved governments any direct control of the tax, it does give them an interest in increasing the size of the *tax base* and so their revenues. In the case of VAT, this means increasing the number of transactions in VAT-able goods or services, which in effect means the size of the economy of that part of the UK more broadly.

Assignment would of course mean that the same rate of VAT would continue to apply across the UK, and it would continue to be levied on the same items. Applying Sandford's criteria, this would avoid problems of increasing local wealth disparities and of taxing highly mobile items (relocating transactions to low-tax areas), as well as keeping collection and administration costs to a minimum. However, VAT would still not be a perceptibly devolved tax, and so would make only a modest contribution to local accountability and decision-making.

It would not be practicable to assign all of VAT in any event. Three VAT points are hypothecated to the European Union, as the system of 'common resources'. The present rate of 20 per cent is the highest the UK has had. While it has been 17.5 per cent since 1991, it was 15 per cent before then and between 1 January 2008 and 1 January 2010, in response to the economic downturn following the credit crunch. A future UK Labour government might wish to reduce the rate. However, assigning 10 VAT points (of the present 20) would produce a substantial block of income for devolved governments, not subject to the constraints and problems of the block grant, and one which is both likely to grow over time and which gives them a direct incentive in securing further economic growth. Increasing that amount of assignment would put further revenues in the hands of devolved governments directly, but would constrain a future UK government that wished to reduce VAT.

Corporation tax

A case for devolving corporation tax has been made in a number of quarters. In a Scottish context, the argument has been made by the thinktank Reform Scotland, as well as by the SNP Scottish government.[36] There are also calls for devolving it to Northern Ireland, started initially by various economic research groups and business lobbies, with it subsequently being taken up by all the major parties and the secretary of state.[37] At the time of writing, the proposal was under consideration by HM Treasury, with work on the practical aspects of it under consideration by a Joint Ministerial Working Group of UK and Northern Ireland ministers. The case for its devolution is rooted in the idea that reducing the rate of corporation tax can be used to spur economic growth, both through

36 See Reform Scotland 2008 and Scottish Government 2011a, 2011b, 2011c

37 See NI Economic Reform Group 2010, HM Treasury 2011 and House of Commons Northern Ireland Affairs Committee 2012

helping locally-established business to grow, and by attracting foreign direct investment. Advocates of its devolution point to these potential advantages; critics, to the risk of triggering tax competition which would lead to a 'race to the bottom'.

Sandford's criteria suggest it is not a high priority for devolution in any event. The tax base is not evenly distributed across the UK, given how much depends on financial services based in London and south-eastern England; it is not economical to collect, at least on a small scale; it relates to activity that can easily be transferred across boundaries (whether within the UK, or between states), and it is highly volatile and does not generate a reliable yield. It is also hard to see how such a tax would be perceptibly local, or how a tax on business profits would improve political decision-making.

In any event, devolving corporation tax is far from straightforward. Some problems have been thoroughly discussed in a Scottish context. EU state aids rules, following the European Court of Justice's judgment in the 'Azores' case, provide that devolution of corporation tax must create a hard budget constraint, with no prospect of bailout from the central state if there should be any shortfall in tax receipts.[38] In addition, decisions regarding corporation tax must be taken by a separate order of government, with both constitutional power and political mandate to do so. These requirements rule out some possible ways of approaching devolution of corporation tax, including partial devolution of it by the UK vacating a certain 'tax space' and allowing a devolved legislature to set its own rate in that space (the approach taken to personal income tax by the Calman Commission). They also rule out any system of fiscal equalisation that takes into account a corporation tax base or revenues.[39]

There is a further implication of those rules. Cuts in corporation tax to spur economic growth would have to be paid for by increased revenue from other sources or reductions in public spending and in public services. The scale of such a cut in Scotland would be considerable; a cut to 20 per cent (from the current 24 per cent) would reduce spending there by £890 million, and to 12.5 per cent (the level in the Republic of Ireland) by £1,724 million, even excluding offshore oil and gas revenues. (The amounts would be much larger if oil and gas were included.) The amount of extra growth in GDP required to compensate for such a loss is considerable; 2 per cent in the former case, 4 per cent in the latter.[40] To make a substantial cut in corporation tax, a government would need to be very confident indeed that it could generate such a high level of growth, if it also wants to maintain existing levels of public services.

It would be practicably possible to devolve corporation tax within a UK-wide framework, with different rates levied in particular parts of the UK. The difficult issue is to determine how much profit is generated in or attributable to the various parts of the UK. This cannot be done simply on the basis of where a company happens to have its registered office, as that only rewards 'brass-plating' (the practice of moving a company's registered office without moving real economic activity, or encouraging growth in a business). Even if one finds a way of more closely tying registration of a company to a particular part of the UK, larger companies are likely to seek to use transfer pricing of company or group services and supplies to minimise profit in those parts levying a higher tax, and increase profit in those levying lower tax, to reduce the overall amount of tax they pay. That would again depress overall tax revenues without spurring real economic growth.

38 Case C-88/03 *Portugal v. Commission* [2006] ECR I-7115
39 See Greaves 2009
40 See Schmuecker et al 2012

The best way to devolve corporation tax would be to apportion the profits generated by a company, in accordance with the proportion of the company's payroll arising from that part of the UK.[41] Different rates could then be levied on – and paid to – the respective governments, in accordance with those shares of profit. This approach would (of course) complicate tax calculations both by HMRC and companies or their tax advisers. However, it would enable many of the advantages of a single corporation tax to be retained, including a single definition of taxable profit, and a single return to be submitted to HMRC, while enabling different governments to set different rates of tax. However, there would be significant administrative downsides, as taxpayers would need to identify the proportion of their payroll employed in each part of the UK where corporation tax was devolved. Submitting corporation tax returns is already very burdensome for many smaller companies, and there would be serious obstacles to setting different exemptions or reliefs (for undertakings in various sectors or for specific activities, for example) which would be part of a 'full' devolution of the tax. This could be avoided by allowing companies to opt out into the 'devolved' regime, with the default being the UK rate of tax; businesses could choose to limit compliance costs, at the expense of foregoing the tax advantage of the lower rate. That would, however, also limit the benefit of corporation tax devolution for smaller companies.

A further problem with corporation tax devolution is that it is a highly volatile tax. As table 4.3 showed, revenues from it grew rapidly during the economic boom of the early 2000s, but collapsed with the onset of the recession.

A devolved government reliant on corporation tax revenues for a significant part of its spending would be at risk of such changes, and would need to have ways to manage those risks, whether by encouraging economic growth, cutting public spending, or borrowing. The practicalities of devolving control of corporation tax mean that it is a relatively unattractive prospect for fiscal devolution. It is particularly unattractive at this stage in the process of fiscal decentralisation within the UK; it would entail transferring substantial risks to devolved governments, without them necessarily being in a good position to manage those risks. For example, there might be arguments to devolve company law to enable a devolved government better to control the entities responsible for this source of revenue (as is the case in the United States and Canada); 'business associations' are a reserved matter in Scotland and are not devolved in Wales, though they are devolved in Northern Ireland.

Tobacco, alcohol, gaming and fuel duties

Excise duties are among the principal indirect taxes (that is, taxes where the tax burden does not fall directly on the payer of the tax, as the charge is levied before the final sale to the consumer). Some excise duties are not suitable for devolution. Fuel duties are a major source of revenue, but by definition are highly mobile, and there is a high risk of overspill if they are devolved. (There would be a high likelihood of people seeking to buy fuel in cheaper jurisdictions, undermining the policy goals and adding to the environmental impact as well.) Betting duties are also not suitable for devolution. Betting has become a highly mobile activity with the rapid growth of internet gambling, and there are questions about how effectively the UK government can regulate or tax it at present as a result. Regulation of betting remains reserved in Scotland, and betting does not have the same overlap with devolved functions that alcohol or tobacco do.

However, as taxation on alcohol and tobacco overlaps with devolved policy functions, there are many attractions in seeking to devolve this.

41 This approach was recommended by the Holtham Commission: para 7.9.

Alcohol is often consumed where it is sold (in pubs, bars or restaurants), or nearby (when sold in off-licences, supermarkets and so forth). Consumption of alcohol has a direct bearing on such devolved matters as health and drink-related crime and domestic violence. One obvious way of trying to address these problems is through increasing the cost, whether by taxation or regulatory measures (such as the policy of minimum pricing already adopted by the Scottish parliament). Tobacco similarly causes problems that bear directly on devolved areas of policymaking, notably health services. Doing so by taxation is an appropriate way of doing so, as it means the tax revenues can be used to redress the consequences of consumption, as well as give government a wider range of tools with which to address problems caused by tobacco or alcohol. Against this, there is a risk that differential rates of tax could lead to personal importation to avoid duty, as was found in southern England following the opening of the Channel Tunnel, leading to a leakage of tax revenue (though only when the imported supplies are then unlawfully sold on does this subvert the social policy goals of differential tax rates).

The use of 'minimum pricing' has come about as a response to the desire to use price as a way of reducing alcohol consumption, given how low retail prices often are. However, this is indirect way of using price, as the financial beneficiaries are not governments but rather retailers, particularly supermarkets. There may be ways to recover that benefit for the public purse, such as supplemental business rates or other charges relating to licensed premises, but those are also indirect and raise legal questions. While price has not been used by devolved governments to try to reduce tobacco consumption, the Scottish government has sought to introduce other restrictions on the conditions of sale, which are presently subject to challenge before the courts.

However, there are serious problems with devolving alcohol and tobacco duties, as these are levied at the point of production or importation into the UK, not the point of sale to the consumer. That will seldom be the same part of the UK as where it is consumed, so devolving the duty outright would create huge problems of calculating and levying differential charges, and significant costs for both government and suppliers of alcohol. Devolving excise duty would therefore not be an effective way of tackling problems in Scotland, as it could only apply to alcohol or tobacco produced in Scotland, not that brought in from other parts of the UK or in free circulation in the UK. This would mean Scotch whisky would become more expensive, but not gin or Irish whiskey. Taking this a stage further, and treating Scotland (or Wales and Northern Ireland) as separate jurisdictions for excise purposes and levying excise duties when alcohol or tobacco is brought into them from other parts of the UK, is even less attractive an option; it would be highly expensive, for both government and suppliers of those goods. As it would fragment the UK internal market, it would be contrary to the terms of the union of Scotland and England, as well as being probably unlawful under EU law.[42] Devolving excise duty in its present form is therefore not an appropriate way of addressing the social policy problems governments may wish to tackle.

In the longer term, this may support a fundamental shift in how alcohol excise duties are calculated. In the shorter term, a way forward might to reduce rates of duty, and allow devolved governments (and the UK government in relation to England) to charge a duty on sales of alcohol, whether for on-premises consumption or off-sales. This could be calculated and collected through a similar mechanism to VAT, but (in devolved parts

42 Article XVIII of the Treaty of Union provides that 'the Laws concerning Regulation of Trade, Customs and such Excises to which Scotland is by virtue of this Treaty to be lyable be the same in Scotland from and after the Union as in England'.

of the UK) be explicitly for devolved purposes and so be set by devolved legislatures. This is an area that needs further consideration, as it also raises legal questions: the EU Sixth VAT Directive only permits member states to have a single VAT (as well as a single rate across the state's territory), and the criteria set out by the European Court of Justice in the Italian 'IRAP' case suggest such a tax might well be another VAT and therefore unlawful.[43]

One way to resolve these difficulties might be for the tax simply to be a sales tax, without the characteristic of a VAT of being levied at each stage in the production process before the product reaches the consumer. Such a tax would simply be levied by a retailer on sales to a person buying a product. That, however, would increase the risk of fraud in the system, and create complexities for sellers of alcohol in establishing the status of each of their customers (as sales by a wine merchant to restaurants would not be liable to the tax but those for personal consumption would be). It is hard to see how this would be practicable, never mind attractive.

Another possible solution would be to split the existing duties on alcohol and tobacco, and create two forms of excise duty; a 'UK' one, for all products of the class produced or imported into the UK, and a 'devolved' one, for products of that class produced or brought into that devolved territory for final sale. (There would be a similar tax for England as well as for Scotland, Wales and Northern Ireland; the UK government would in this respect act as both 'union' and devolved government.) Two forms of excise duty would add considerably to the administrative complexity of dealing with alcohol and tobacco duties, however, and the risk of duty evasion by fraud as well as of compatibility with EU law and the Treaty of Union. It is not an attractive option.

Short of that, the best option may be the use of the power to charge for premises licences to sell alcohol to reflect more than the costs of administrating the licensing system.[44] This could be accompanied by the introduction of a licensing regime in relation to tobacco sales. In each case, licence charges could be related to the volume of sales of licensed goods over a relatively short period (say, every three months), to reflect changing patterns of consumption, and nonpayment of licence fees would be sufficient grounds for suspension of the licence. This approach is far from perfect. It would be an indirect way of addressing the underlying problem rather than a direct one, and choices about how such costs were passed on to the buyers of alcohol or tobacco would be in the hands of retailers rather than government. While a charge for premises licences would be a blunt instrument rather than a precise one, it would also address EU legal concerns about the charge's status as a turnover tax. It would also involve considerable bureaucracy, and a markedly different approach to the administration of premises licences to the present one. This approach cannot be regarded as desirable, even if it is the best that can be devised, given the practical and legal constraints.

43 See Case C-475/03 *Banca popolare di Cremona Soc. coop. arl v Agenzia Entrate Ufficio Cremona* [2006] ECR I-9373. The IRAP was an Italian turnover tax levied by regional governments on economic production within their region. The key issue before the European court of justice was whether the amount of IRAP included in the price of the product was identifiable by the final consumer (it was not), and therefore whether the cost was identifiable by the final consumer (which it also was not). In the case of a supplemental tax on alcohol and tobacco, the whole point would be that it could be identified.

44 England and Wales, Scotland and Northern Ireland each already have their own distinct licensing systems, and alcohol licensing is a devolved (non-reserved) matter in Scotland and Northern Ireland but non-devolved in Wales. All three systems resemble each other in requiring a licence both for premises where alcohol are sold, and for the persons authorised to sell it. Premises licences last indefinitely, while personal licences are subject to periodic review.

Assignment of alcohol and tobacco duty revenues would be an appropriate measure, if a tax or duty on alcohol or tobacco were to be devolved fully in due course. However, assignment only makes sense as a transitional step pending some fuller devolution. Otherwise, all one has done is to transfer to devolved governments a tax base which they should seek to reduce (by reducing consumption). Moreover, they would have no control over the tax more generally, which obviates the policy objective of putting all the instruments to deal with the consumption of health-damaging goods in the hands of the government otherwise dealing with the effects of that damage.

5. APPLYING LESSONS FROM FEDERAL SYSTEMS: GRANT FUNDING

5.1 The advantages of a grant element of funding

There are a number of reasons why it would be appropriate to retain an element of grant funding for the devolved governments. As noted in chapter 4, it is hard to provide adequate funding for devolved functions from tax sources that it is administratively practicable or fiscally sensible to devolve. This is the case with the present division of powers between devolved and UK levels of government; it would be even more so if further functions were to be devolved as well. Even if other considerations permitted it, it would be hard to avoid a grant element, particularly for Wales and Northern Ireland which have large and structural fiscal deficits. In the real world, and in the absence of 'devolution max' and full fiscal autonomy for Scotland, there need to be grants to all three devolved governments. The question is how one calculates it.[45]

A second reason is the unequal pattern of prosperity across the UK. Historically and by convention, the allocation of public spending across the UK has been allocated according to the principle of *relative need*; more funding has been allocated to areas with higher levels of need, and less to ones with lower levels of need. The aim has been to ensure that similar public services are available to all UK citizens, wherever in the UK they live. In practice, this principle has not been strictly complied with, and even where detailed formulae are used within England to underpin funding allocations, a range of factors have distorted the outcome that strict application of the formula would produce. [46]

Commitments to use transfers from the central or federal tier of government can be found in most federal systems. The US excepted, all developed-world regionalised or federal systems have explicitly redistributive grants to fund regional-level governments. Many of these explicitly seek to translate formal commitments to some form of equality in public services into practice. Few go as far as Germany, which entrenches into the Basic Law a constitutional commitment to ensure 'equivalent living conditions throughout the federal territory'.[47] Perhaps more helpful is the provision in Canada's Constitution Act 1982 that 'Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonable comparable levels of public services at reasonably comparable levels of taxation'. The Australian Commonwealth Grants Commission has no constitutional mandate; its work results in advice (always followed in practice) to the federal treasurer, underpinned by an intergovernmental agreement between the federal government and the states.

The key choice about a new approach to grant funding is whether that grant allocates according to the need for resource, and relative need, or according to fiscal capacity. The more decentralised federal systems (notably Switzerland and Canada) are concerned solely with fiscal equalisation. More centralised (and homogeneous) ones are concerned with resource equalisation instead; that applies to Germany and Australia. A key decision of principle about how the devolved UK understands its commitment to interterritorial solidarity therefore underpins this choice about the technical means of calculating a grant.

45 While Scotland runs a fiscal deficit in most years, according to *Government Expenditure and Revenue Scotland*, this depends partly on (a) how one regards North Sea oil revenues, and (b) the fact that the amount spent on public services in Scotland is considerably higher than its relative needs. If Scottish services were funded on the basis of relative needs, the fiscal deficit would be much narrower, and in some years a surplus.

46 For forceful criticism of how such formulae affecting schools, health and local government spending in England have been applied, see House of Commons Committee of Public Accounts 2011.

47 Article 72; see also article 106, implementing this through a system of fiscal equalisation

Any reconstructed grant must, of course, remain a *block* grant. That is, it must constitute a block of funding which devolved governments are free to allocate as they see fit, without any elements being hypothecated or allocated to particular functions.[48]

5.2 Resource equalisation and relative need

Any approach that seeks to equalise for spending rather than revenue differences needs to be rooted in *relative need*. We cannot understand 'need' as an absolute: understandings of need vary from person to person, from place to place and across time. We understand and operationalise need as meaning that anyone in need of (say) a heart operation should be equally placed to obtain that operation, whichever part of the UK they live in. It may be that a devolved government will prioritise some forms of treatment at the expense of others, or other areas of spending at the expense of health. But these need to be choices open to the devolved government, made in response to the various political pressures on it (and capable of changing in response to those pressures). The government itself must be able to provide similar levels of services to individuals, whether it has a high rate of demand for health care or not, and whether it incurs higher or lower costs in providing that sort of care.

To understand the difference between the two approaches of equalisation based on resource need or on fiscal capacity, it is necessary to understand the concept of relative need. This is widely (and perhaps sometimes deliberately) misunderstood. Relative need is a way of looking at the differences in demand for public services in particular parts of the UK, or the costs of providing services in different parts of the UK, or both. For example, the west of Scotland has serious health problems, with high rates of incidence of cancer and heart disease, high mortality rates as a result, and much greater need to provide hospital and other forms of medical care to treat or perhaps even prevent such illnesses. Any formulation of relative need would have to take that into account. Similarly, governments responsible for areas with larger numbers of young people will have higher spending on education; those with larger numbers of older people, on healthcare. Other factors may affect the cost of providing services, rather than demand for them, sparseness of population being an obvious one.

One of the key issues with relative need is that there must be a reference point: need is *relative to* something. In the UK case, relative need has been understood as applying in relation to England; that is, it means that Scotland, Wales or Northern Ireland would need £Y to provide a similar level of public services to what £X pays for in England.

Table 5.1
Assessments of relative need, 1979 and 2009, and actual spending

	Needs assessment, 1979	Actual spending, 1979	Relative needs, 2009	Actual spending, 2008/09
England	100	100	100	97
Scotland	116	122	105	115
Wales	109	106	115	111
Northern Ireland	131	135	121	123

Sources: Columns 1 and 2 derive from table 5 in House of Lords Select Committee on the Barnett Formula 2009, p21; column 3 from Holtham Commission report, p28; column 4 from *Public Expenditure Statistical Estimates 2011*, Cm 8104, table 9.2.
Note: This table relates to overall public spending, not only devolved services subject to the block grant system.[49]

48 This principle has been repeatedly endorsed at UK level, in parliament as well as by successive governments; see, for example, House of Lords Select Committee on the Barnett Formula 2009.

49 This table needs to be treated with a measure of caution, particularly as the fourth 'actual spending' column uses data from HM Treasury's *Public Expenditure Statistical Estimates*, which reflect total identifiable public spending in each part of the UK and not just those services to which the block grant applies. (Social security accounts for the bulk of the difference.) There is no authoritative published source showing the overall block

Assessing relative need is not straightforward. The only governmental attempt to do so in the UK was in the late 1970s and took several years. It looked at a huge range of factors affecting demand for or cost of providing the services involved (in areas such as health, education, transport and the environment). The figures it came up with were never used.

The methodology for working out the amount of a block grant could be quite straightforward. The Holtham Commission has developed the mechanism for applying a simple needs assessment, needing relatively little data and using seven indicators or variables that explain over 95 per cent of the factors affecting spending need. This overall approach was also endorsed by the House of Lords Select Committee on the Barnett Formula in 2009. This contrasts with the complicated, data-hungry and time-consuming approach of the 1979 needs assessment undertaken by HM Treasury, which looked at every significant needs factor affecting each major area of domestic public services. If implemented in practice, such an approach would also be open to manipulation by the various interests involved. The simplicity and explanatory power of the Holtham approach also contrasts with the data-hungry approach used by the Commonwealth Grants Commission in Australia. The use of increasing numbers of indicators considerably complicates the task of calculating grants. It also makes it much easier to 'game' or manipulate the system, with governments seeking to improve their standing by having indicators favourable to them used.

The reliance on policy standards for England as the yardstick for deciding what is 'relative' need is both a strength and a weakness of this approach. It is a strength because it is a conveniently available measure, and it means that redistribution from richer parts of the UK to poorer ones can be justified on the grounds that the poorer parts are being given no more and no less than the resources necessary to have similar levels of public services to those people have in England. Devolution would therefore confer no advantage on the people of Scotland, Wales or Northern Ireland that did not also apply to people in England. To the extent they would have different public services, this would either be because their governments had different spending priorities, or made greater tax effort within the scope of devolved tax powers. Free prescriptions in Scotland or Wales would be paid for by obtaining greater revenue, or by reducing spending on other areas. That would remove a great deal of the political objection to such redistribution.

However, reliance on English levels of public services is also a problem when devolved governments wish to go beyond that. There is a clearly stronger support from devolved governments in Scotland and Wales for a more generous, social democratic approach to public services than there is England (and that appears likely to continue into the future). That applies both to the overall scope of such services, and the ways in which they are managed and provided. The English preference led, under Labour governments, to a more target-driven approach to services, underpinned by ideas of the New Public Management; under the Coalition, it has led to talk of the 'Big Society' and drastic changes to the NHS, schools, higher education, policing and welfare benefits. Except for the universal credit, the working of the block grant system transmits the financial effect of those English policies to the devolved governments, even if they wish to adopt a different approach. While devolved fiscal powers of the sort discussed in chapter 4 would help alleviate that effect to an extent, these policies would continue to have a significant impact on the devolved governments, particularly the poorer ones (Wales and Northern Ireland).

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grant in comparison with the comparable functions to which it relates in England, although that data must be available within HM Treasury's public spending database. The point of the table is to indicate in broad terms the extent to which there continues to be a disparity between relative need and actual public spending.

5.3 Fiscal equalisation

Fiscal equalisation (sometimes also called revenue equalisation) implies a different approach to calculating a redistributive grant. It has as its underlying assumption that each state/regional government should use its own tax revenues to pay for the services for which it is responsible. Therefore, to the extent its own revenues are insufficient compared to the system-wide average, there is compensation for that. In most systems, the federal compensation is paid for out of federal resources, drawing on the vertical fiscal imbalances that exist between the two orders of government. (Germany is an exception, as it operates a system of horizontal equalisation, where richer *Länder* directly provide funding to poorer ones.)

A redistributive grant can be calculated on a fiscal basis by looking at the fiscal capacity of the various parts of the UK, and providing them with compensation for any difference between their tax base and 'average' tax base of the UK as a whole. This approach would mean that each devolved government is treated as being equally able to provide the same services, regardless of their tax base (but also regardless of their relative needs). It entails computing a standard, system-wide yield of revenues from a particular state/regional tax base; working out the difference between that and the yield actually produced in each state or region; and compensating for the overall balance between the state/regional tax base and the 'national' average. The 'standard' level of resources (and therefore implicitly standard of services) is defined by the 'national' tax revenues. Equalisation revenues are payable whatever level of services the state/regional level of government chooses actually to provide. If a state/regional government chooses to provide more limited services than the implicit national norm, it can return the money saved to its taxpayers, creating a political incentive to cut taxes. But that incentive puts the recipient state or region in no better (and no worse) a position to adopt that approach than a prosperous region. It means reducing tax levels is as attractive to poorer governments as richer ones, so ensuring a substantial level of equity across the country as a whole. However, it also means that the compensation provided to regions with high demand for services and smaller tax bases only relates to the limited tax base and not the cost of providing services. The Australian system addresses this issue by taking both into account, and treating a range of resource-related 'cost' factors as fiscal disabilities in the same way as questions of limited fiscal capacity.[50]

The advantage of an approach based on fiscal rather than resource equalisation is that it adopts as its reference point the tax base of the whole UK. It does not use spending by the UK government for England, and the English model of public policy, as the way of assessing the appropriate level of devolved public services. All fiscal equalisation does is compensate those parts of the UK with weaker tax bases for that weakness, without there being any implicit judgment about what levels of service should be provided. That is, however, also a political weakness, as this approach means one might potentially be asking English voters to help support higher levels of public services provided by devolved government than they themselves enjoy. This is a potential, not an actual question; the devolved parts of the UK all have both higher levels of needs and smaller tax bases than the UK as whole, if only slightly in the case of Scotland, and it assumes that England is both economically prosperous and parsimonious in public spending, which may match Conservative party aspirations but is unlikely to materialise in reality.

50 Roughly one-third of the funds allocated by the Commonwealth Grants Commission are allocated according to spending need, and about two-thirds are allocated according to variations in tax-raising capacity. It helps that Australia is relatively homogeneous in both the demands for public services and tax bases.

The easiest way to operationalise fiscal equalisation in this sense is to assess the overall per capita tax base of the relevant devolved territory, subtract that from the UK per capita revenue from that tax base, and pay grant accordingly. A worked example of this calculation for Scotland is shown in table 5.2. For the purposes of this table, it is assumed that the major sources of devolved income would be all personal income tax, an assigned share of 10 points of VAT, stamp duty land tax and alcohol and tobacco duties. That is not to imply that these taxes need necessarily be devolved for this approach to work, but this approach indicates the overall impact of this sort of fiscal devolution. In order to provide a degree of fiscal stability, it would be advisable for such a system not to be based on just the most recent year for which figures about UK and devolved government revenues were available, but a three- or even five-year rolling average.[51]

A fiscal equalisation approach would, at this stage, be highly problematic politically. It would imply considerable overall reductions in public spending in all three devolved parts of the UK, with the consequent political and public reaction. This ought to outweigh its political attractions, even to supporters of the free market, and even to Scotland (which would be the least badly affected of the devolved governments). It might be workable in conditions where devolved economic growth was stronger, but it is hard to regard this as a viable approach in the short term.

Table 5.2
A worked example: fiscal equalisation and selected devolvable taxes, Scotland, 2010/11 (£m)

	2008/09				2009/10				2010/11			
	UK per capita yield	Scottish per capita yield	Diff. UK v Scottish yields		UK per capita yield	Scottish per capita yield	Diff. UK v Scottish yields		UK per capita yield	Scottish per capita yield	Diff. UK v Scottish yields	
Income tax	2359.7	2062.5	297.2		2344.7	2003.2	341.5		2465.2	2036.3	428.9	
VAT (HMRC UK estimate	1142.7	1439.1	-296.4		1135.4	1414.7	-279.3		1341.1	1639.2	-298.1	
VAT (GERS UK estimate)	1390.1		-49.0		1354.7		-60.0		1562.4		-76.8	
Stamp duty land tax	79.7	76.7	3.0		79.1	66.1	13		95.7	76	19.7	
Alcohol and tobacco duties	290.3	320.6	-30.3		288.5	339.4	-50.9		297.8	360	-62.2	
Council tax	399.7	379	20.7		397.2	377.3	19.9		413.3	380.3	33	
Non domestic rates	357.1	335.8	21.3		366	351	15		364.3	362.1	2.2	
Total per capita equalisation needed (£)			**15.5**	**262.9**			**59.2**	**278.5**			**123.5**	**344.8**
Total equalisation needed			**80.1**	**1358.8**			**307.5**	**1446.5**			**644.9**	**1790.9**
For equalisation on a 3-year running average basis – per capita			3.9				14.8				61.7	
For equalisation on a 3-year running average basis – total			20.0				76.9				322.5	
Equalisation on 3-year running basis – per capita												**80.4**
Equalisation on 3-year running basis – total												**419.4**

Sources: Author's calculation. Data: HMRC for UK receipts, GERS for Scotland, NI Net Fiscal Balance reports for Northern Ireland, and ONS mid-year population estimates.
Note: There are substantial discrepanices between the VAT receipt figures for the UK as a whole given by HMRC and those shown in GERS.

Another difficult question arises where the devolved tax base is *larger* than that of the UK as a whole. As the numbers below show, at present this is a hypothetical question; even Scottish fiscal capacity on the most 'devolvable' of taxes is smaller than that of UK as a whole. Should that devolved government then pay negative equalisation? That is, should it be due to pay part of the revenue from devolved tax bases to the UK government? Or should it be allowed to keep that extra revenue, once its fiscal capacity equals that of the UK as a whole? Requiring payment of such negative equalisation

51 Canadian practice since 2006 has been to use a three-year average, weighted in favour of the last year. If one uses a five-year average, one might want to introduce a degree of weighting to reflect inflation factors as well.

would be a way of ensuring that the UK adheres to the principle of redistribution to maintain union-wide equity. It would, however, be politically contentious, and would remove an incentive for devolved governments to seek to increase their tax bases. For that reason, the balance of political advantage would seem to favour paying no 'negative equalisation', and allowing a devolved government that has succeeded in producing a larger-than-UK-average tax base to enjoy the fiscal benefits of doing so; from which, of course, the UK exchequer would also benefit as far as non-devolved tax receipts were concerned.

6. OPTIONS FOR REFORM: A PACKAGE FOR FUNDING DEVOLVED GOVERNMENTS IN THE UK

6.1 Tax devolution

The discussion in chapter 4 suggests that extensive tax devolution is both possible and desirable in principle. The question is what it means in practice. That analysis suggests that, for devolution as it presently stands, a range of taxes comprising at least half of devolved spending should be devolved, and more if possible. It is important to ensure that devolved governments have a reasonably stable tax base, but also a diverse one. Diversity in the tax base gives devolved governments capacity in growing the overall economy as well as levers with which to achieve that, and also helps spread the risk if one devolved tax base does poorly. Given the different behaviour of personal income tax and VAT over the last four years, this would help smooth the revenues flowing into governments from those two major sources of revenue.

The analysis presented in this paper suggests that the prime candidates for allocating to devolved governments are:

- personal income tax
- an assigned share of VAT
- taxes on land, including stamp duty land tax
- taxes on alcohol and tobacco, which could be assigned in the short term, pending devolution
- as well as local taxation, and air passenger duty.

In effect, this is the 'Calman package' augmented by adding all personal income tax, and assigning a substantial proportion – 10 points of the 20 in the current rate – of VAT.[52] If a way could be found to do it, it would also include alcohol and tobacco taxation.

The effects of this are set out in table 6.1. Using 2010/11 data, this would have meant Scotland receiving 60.6 per cent of its devolved spending from devolved or assigned taxes, Wales receiving 62.2 per cent and Northern Ireland receiving 55.6 per cent. Wholly devolved taxes (not assigned ones: the VAT share or alcohol and tobacco duties) would contribute 42.1 per cent of Scottish devolved spending, 44.2 per cent of that in Wales and 34.3 per cent of that in Northern Ireland. These proportions would increase as tax revenues increased; the 2007/08 data shows that this package would have meant that 70 per cent of Scottish devolved spending, 68 per cent of Welsh devolved spending, and 65 per cent of Northern Ireland's devolved spending would flow directly into devolved Consolidated Funds, and that taxes wholly under devolved control would account for just under half of Scottish spending, 48 per cent of Welsh and 43 per cent of it in Northern Ireland. This approach achieves a substantial degree of fiscal devolution, in a way that is largely achievable in a relatively short timescale given the magnitude of the change involved. In due course, the proportion of tax directly under devolved control could be increased by restructuring duties on alcohol and tobacco, so that these became consumption taxes.

This contrasts with the Scotland Act 2012, under which devolved tax powers would account for about 30 per cent of devolved spending in Scotland, and those of the Silk Commission which account for about 25 per cent of devolved spending in Wales. Given the constraints on local taxation in Scotland, even that figure could be regarded as an overstatement. The Silk Commission proposes the remaining restrictions on local taxation in Wales be removed as part of its proposals.

52 The VAT rate has fluctuated from 15 to 20 per cent since 2007. The figures in table 6.1 have been adjusted to reflect a constant 10 points of VAT, even as the headline rate has varied.

Table 6.1
Tax revenues and devolved spending, 2010/11 (£m)

	Scotland	Wales	Northern Ireland
Personal income tax	10,634	4,850	2,575
Assignable VAT (10 points)	4,739	1,929	1,604
Land taxes (stamp duty, landfill tax, aggregates levy)	451	195	120
Air passenger duty	183	10	63
Alcohol and tobacco duties (assignable in short term)	1,880	885	759
Council tax	1,986	1,056	504
Non domestic rates	1,891	825	524
Total 'devolvable' sources of revenue	**21,764**	**9,750**	**6,149**
Total taxes directly under devolved government's control	**15,145**	**6,936**	**3,786**
Devolved government spending	35,932	15,675	11,053
Percentage of devolved government spending from devolvable/assignable taxes	60.6	62.2	55.6
Percentage of devolved government spending from taxes under devolved government's control	42.1	44.2	34.3

Sources: For tax revenues, GERS for Scotland; Silk Commission report for Wales; Northern Ireland Net Fiscal Balance report 2009/10 and 2010/11 for Northern Ireland. Devolved government spending for Wales and Northern Ireland calculated using DEL figure plus local tax revenues.

Among other advantages, as table 6.2 (over) illustrates, these are relatively stable sources of revenue. Devolution of these taxes, rather than more volatile ones such as corporation tax, therefore helps ensure the maximum level of continuity in funding devolved public services that is possible in the real world.

Of course, the dynamic effects of changes in taxation by devolved governments could not be predicted. Over time, devolved governments would levy different taxes in different ways, raising differing amounts of revenue from them. But the evidence suggests that they would be able to start out from a position that enhanced their control over their own spending, without damaging public services or undermining the union on a constitutional level or other parts of the union economically.

If an additional 'devolvable' major tax were sought, the prime candidate on grounds of minimising harmful fiscal spillovers and compliance costs would be employers' national insurance contributions. That would add to devolved resources in the most effective and least damaging way possible. The effect of doing that is illustrated in table 6.3 (over). For all three devolved governments, it accounts for around 10–13 per cent of devolved spending, and would mean that they would have around 70 per cent of funding flowing directly to them. Devolution of this would also put a business tax in the hands of devolved governments, a key argument for devolving corporation tax, but one that was also less volatile, more closely related directly to economic activity, and (given the relationship with income taxes) easier to administer. This would be particularly important if further functions were to be devolved as part of schemes to enhance devolution.

Table 6.2: Scottish taxes and their volatility

	2006/07	2007/08	2008/09	2009/10	2010/11
Taxes potentially suitable for early devolution					
Personal income tax	10,445	11,267	10,609	10,119	10,634
Assigned amount of VAT	4,342	4,527	4,245	4,700	4,582
Wealth and income taxes	258	246	249	213	362
Stamp duties	709	893	595	515	595
Other land taxes	130	148	135	137	153
Council tax	1,859	1,936	1,960	1,960	,1986
Non domestic rates	1,741	1,724	1,736	1,822	1,891
Total taxes suitable for early devolution	**19,484**	**20,741**	**19,529**	**19,466**	**20,203**
Percentage change in size of 'devolvable' tax base from prev. year		6.5	-5.8	-0.3	3.8
Percentage change in personal income tax receipts from prev. year		-7.3	6.2	4.8	-4.8
Percentage change in assigned amount of VAT from previous year		-4.1	6.6	-9.7	2.6
Overall UK tax receipts	406,337	431,800	416,512	382,331	419,580
Percentage change in overall UK tax receipts from previous year		6.3	-3.5	-8.2	9.7
Scottish government's total spending	30,261	32,360	33,492	35,066	35,932
'Devolvable' taxes as percentage of Scottish government spending	64.4	64.1	58.3	55.5	56.2
Taxes for later devolution					
Alcohol duties	725	745	764	884	895
Tobacco duties	966	894	893	942	985
'Sin taxes' (alcohol + tobacco duties)	1,691	1,639	1,657	1,826	1,880
Scottish per capita share of North Sea oil revenues	754	629	1087	545	736
Percentage change in alcohol and tobacco duties from prev. year		-3.1	1.1	10.2	3.0
Percentage change in per capita share of North Sea revenues		-16.6	72.8	-49.9	35.0
Scottish corporation tax receipts	3,254	3,525	2,841	2,678	3,114
Percentage change in Scottish corp. tax receipts from previous year		8.3	-19.4	-5.7	16.3

Source: Government Expenditure and Revenue Scotland 2010/11
Note: VAT data reflects reduced VAT rate from 1 December 2008 to 31 December 2009.

Table 6.3: The impact of devolving employers' national insurance contributions

	Scotland		Wales		Northern Ireland	
	2008/09	2010/11	2008/09	2010/11	2008/09	2010/11
Percentage of devolved government spending from devolved taxes (table 5.1)	44.8	42.1	43.1	44.2	40.1	34.3
Percentage of devolved government spending from devolved and assigned taxes (table 5.1)	62.3	60.6	61.9	62.2	62.6	55.6
Employers' NICs as percentage of devolved government spending	13	12.2	12.3	12.1	11.3	9.6
Percentage of devolved government spending from devolved/assigned taxes if employers' NICs added	75.3	72.8	74.2	74.3	73.9	65.2

6.2 Calculating the devolved government's overall resources

The first step in applying a system that combines a grant with extensive devolved capacity is to work out how much devolved budgets should be notionally, at least in the first year governed by the new system. This is not entirely straightforward, as it involves making judgments about how much devolved governments should spend, before looking at how much they can raise from their own fiscal resources. The most convenient starting point would be what they currently receive, but although (as discussed above) that advantages Scotland and slightly disadvantages Wales from the outset. Another approach would be to apply a notional budget, calculated on the basis of relative needs (a resource-oriented approach). The introduction of a new system would provide a convenient opportunity to do so, but would entail a substantial reduction in the funding allocated to Scotland.

In either case, having worked out the overall notional spending envelope for year 1, the appropriate figure for that government's fiscal capacity is deducted. The difference needs to be filled by a grant, which can be calculated using either of the two approaches outlined in chapter 5. Of those, the balance lies clearly at present in favour of an ongoing use of resources rather than fiscal equalisation for the time being. However, the political implication of that would be difficult. This may therefore be a medium-term plan rather than a short-term one, and would only take effect after a transition period of five to seven years.

In subsequent years, the grant would be calculated on a rolling average of fiscal capacity in relation to the grant baseline of (say) three years. In the case of Scotland, given the disparity between its present level of finance and what a needs assessment would justify, using that level of spending as a baseline, there would need to be a cushioning mechanism to manage the adjustment over a number of years. It would be open to the Scottish government to decide whether it wanted to raise more revenue from the tax bases available to it to continue to pay for higher levels of public services, or to reduce spending to match that 'standard', need-related, level of spending.

7. INSTITUTIONAL IMPLICATIONS OF REFORM

7.1 Tax collection and HM Revenue and Customs: the position at present

HMRC is constituted as one of the chancellor's departments: the chancellor of the exchequer is responsible for it and accountable to the UK parliament for its management. While it has long had its own board, as did its predecessors (the Inland Revenue and HM Customs and Excise), it is an integral part of the UK government. The revenues collected by HMRC are paid into one of several funds maintained by the chancellor (the Consolidated Fund or the NI Fund, for the most part). From there, they are disbursed to spending ministers, in accordance with parliamentary authority given through 'votes' in the Appropriation Acts. At present, that is as true for spending by the devolved governments as by (say) the Department of Work and Pensions. Funds, calculated in accordance with the *Statement of Funding Policy*, are appropriated to the secretaries of state for Scotland, Wales or Northern Ireland, who in turn pass them on to the devolved administrations' Consolidated Funds after deducting the cost of running the Scotland, Wales or Northern Ireland offices respectively.

The sort of model sketched above is, however, one in which several governments would be entitled to tax revenues collected under parliamentary authority, in some cases delegated to the devolved legislatures.

The question is what sort of arrangements there should be for the collection of taxes in such a system. There are essentially two options. Each government could set up its own system for collecting the taxes due to it, or a single agency could collect them on behalf of both governments involved.

7.2 Separate collection agencies, or a shared agency?

The establishment of separate collection agencies would enable each taxing government to have complete control over tax collection policies and practices. It would enable them to maximise their revenue (or make their own choices about which revenues to forgo), without being subject to decisions made by another government. Such an approach would be attractive for any devolved government seeking to maximise its policy autonomy; for nationalist governments, it would have considerable symbolic importance too.

However, such an approach would have several significant disadvantages.

- It would require the establishment of wholly new agencies in Scotland (and in other parts of the UK with the power to set taxes). This would involve considerable cost, and be an administrative challenge as much of the expertise in the collection of taxes is to be found in HMRC. While staff transfers or recruitment from recently-retired or redundant HMRC staff might offer some access to that sort of expertise, it would still be necessary to establish the new agency from scratch, a significant undertaking.
- It would require some taxpayers to account for the taxes due from them to two tax collection agencies – a very considerable burden, especially as the majority of taxpayers do not presently submit self-assessment tax returns but simply pay through the PAYE system.
- It would create opportunities for 'leakage' of tax revenue, when taxpayers moved from one part of the UK to another during the course of a tax year. A single agency is better placed to ensure all taxpayers pay the tax due from them, as it has better information about the extent of their obligations and payments.
- It would be hard to make the present PAYE system operate with two different tax-levying governments, each setting different rates of tax on differently-defined taxable incomes. That would imply the establishment of different PAYE systems for each

taxing government, a significant burden not just for them but also for employers managing a payroll, including employees in Scotland and elsewhere this system operates. For large employers with staff in more than one devolved jurisdiction, the practical implications are particularly daunting.

The idea of operating two separate but parallel tax collection systems and agencies is therefore not an attractive one, as it likely to prove costly, cumbersome and inconvenient, for government, employers and taxpayers alike.

The alternative to having multiple tax collection agencies is for one agency to do that, and HMRC is obviously well positioned to do that. However, it is doubtful whether HMRC as presently constituted – as a department of one government, but responsible for paying taxes to two or more – is appropriately structured.

This difficulty manifests itself in a number of respects.

1. The setting of all matters relating to taxes – rates, exemptions and reliefs – are presently wholly in the hands of one government. The measure of fiscal self-government described above requires that these cease to be a unilateral matter. HMRC would have to administer different fiscal policies.
2. Similarly, the determination of practical policies relating to tax collection are presently a matter for one government. Deciding what categories of taxpayers should be pursued and how is similarly not simply a matter for one government to decide unilaterally and impose on the others.
3. HMRC needs to be in a position to give effective and authoritative advice about tax administration issues to governments. That would entail access to information about policy proposals being considered by the various governments at an early stage. It would be entirely reasonable for devolved governments to have misgivings about sharing such information with an agency of another government, especially at the early stages when options are being considered in an informal way and when advice can be most effective.

Lessons can be learned here from Canadian practice. While the Quebec government collects all provincial taxes itself, the English-speaking provinces all have provincial income taxes collected on their behalf by Revenue Canada, the federal government agency that also collects federal taxes. Revenue Canada then remits the provincial tax to the provincial governments. These arrangements are set out in detailed tax collection agreements between the federal government and the provincial governments involved. As a result, taxpayers outside Quebec only need to complete a single tax return (Quebec taxpayers must complete two), making compliance simpler and easier. In order for the federal government to undertake this work, provincial governments are required to use the same definitions as the federal government for what constitutes taxable income or charges, and some limitations on the exemptions, reliefs and thresholds they can set. The federal government makes only a modest, even nominal charge for the revenues it collects, officials saying that they prize the convenience of simplifying collection arrangements for taxpayers over the revenues they might charge provincial governments.

To put HMRC in a position to be able to act properly as a single tax collection agency for the whole UK will require considerable changes. Constitutionally, it will need to become fully accountable to, and fully subject to direction from, each legislature on whose behalf it collects taxes. This means going considerably further than the 'clear line of sight' promised in the 2010 command paper *Strengthening Scotland's Future* (Scotland Office 2010: 40–41).

Rather than a non-statutory promise, there needs to be clear statutory provision so that, in relation to all devolved tax-related matters, HMRC is as accountable to the Scottish parliament and Welsh and Northern Ireland assemblies as it is to the UK parliament at present. To accompany this, there needs to be a power for devolved institutions to appoint members to the bodies that control HMRC. There are two of these: the commissioners (three at present) and the board, which includes a number of senior HMRC managers and external non-executive directors as well as two of the commissioners. There is a question whether this power of appointment should be exercisable by devolved executives or legislatures, a separation-of-powers point. However, as HMRC's commissioners are at present appointed by the Queen on advice from the chancellor, and the board by the commissioners, this would require some significant change in the framework within which it operates. There would need to be some representation of devolved governments for whom taxes were collected at the highest levels of HMRC. At the least, this should include each recipient devolved government having the power to appoint a member of the HMRC board.

There will be some cases where HMRC may be an appropriate body to collect taxes, but this is not the only possible choice. Examples would include the land taxes to be devolved under the Scotland Act 2012 (stamp duty land tax and landfill tax), as well as other similar taxes which might be devolved in future. The Scottish government is already seeking to establish a new agency, Revenue Scotland, to collect these. When a tax has been wholly devolved, it should be for the devolved government to determine how and by whom it should be collected. HMRC should be able to undertake such work, if it wishes (and if the devolved government in question wishes it to do so). Part of that agreement would, of course, be an agreement about cost; but how effectively HMRC would be able to collect taxes and its ability to comply with collection policies of a devolved government might also feature. As governments with the power to tax, devolved governments need also to be able to make the decisions about collection: whether they undertake it themselves, whether they commission HMRC to do so, or whether they engage some other body.

7.3 Administering the system: a devolution finance commission?

At present, the UK has a highly centralised system of managing devolution finance. The basis of the Barnett formula is that it is the policy applied by HM Treasury. Its embodiment is the *Statement of Funding Policy,* and the spreadsheet used to implement that on HM Treasury's computer network. HM Treasury is the chief decision-maker if not the sole one. The two intergovernmental forums that exist – the Finance Ministers' Quadrilateral meeting, which usually happens twice a year, and the Joint Exchequer Committee of Scottish and UK Ministers that oversees implementation of the Scotland Act 2012 tax proposals – are both consultative and consensual in nature. The first of these arrangements have been widely criticised as under-institutionalised and inadequate.[53] The second is too new to form a view, though both (understandably) operate in conditions that make it hard for outsiders to assess their effectiveness.

In addition, the Office for Budgetary Responsibility (OBR) is to assume the role of forecasting tax revenue for the Scottish rate of income tax under the Scotland Act 2012. The Silk Commission proposes that it assume a similar role for the Welsh rate of income tax. There are questions about the impartiality of the OBR, and the accuracy of its forecasts, which will affect other governments more than the one which created and appointed the OBR.

53 For example House of Lords Select Committee on the Constitution 2003, House of Lords Select Committee on the Barnett Formula 2009

Change to the existing arrangements will mean significant further institutional change. It will be necessary to have statutory authority for new arrangements for devolved tax-raising powers; the opportunity could also be taken to put arrangements for an equalisation grant – whatever form that might take – also on a statutory basis. Even if only done in general terms, as the Canadian commitment does, it would emphasise the commitment of the UK government to a measure of UK-wide equity and risk-sharing, through the funding it would be undertaking to provide to devolved governments.

Beyond that, it is hard to see how HM Treasury could command authority if it were solely responsible for administering a system that combined devolved tax setting with tax assignment and an equalisation grant. HM Treasury is not only a department of one government that would be involved in allocating finance to others, but it would have direct interests in seeking to minimise expenditures from its sources and perhaps in seeking to shape devolved spending policies. That is not a recipe for good relations between governments; rather, it is a latent source of tension and discontent, which would run counter to the goals of the system outlined in this paper.

The obvious solution to this – again, adopted by the Lords Barnett Formula Committee, among others – is to establish an independent body to supervise the system and advise the UK government on how to allocate grant funding, as well as to act as mediator in the event of any disagreements. The institutional model of the Australian Commonwealth Grants Commission has much to commend it in this regard; although there are significant flaws in the Australian system, there are few criticisms of the impartiality of the CGC or the authority of its advice to the federal treasurer.

By the same token, it will be necessary to put key elements of the new system – notably the entitlement to a block grant, the fundamental principles concerning its calculation, and the arrangements for changing on it – onto a statutory footing. Essentially, the new system will become a part of the devolved constitution of the United Kingdom, and it must be beyond the authority of the UK level unilaterally to alter it.

8. CONCLUSIONS

The UK has managed its first decade and a half of devolution with minimal change to the financial arrangements which previously were used to run a much more centralised system. The mismatch between the financial framework of devolution and the constitutional powers and political accountability of devolved governments has reached a point where it is clearly no longer sustainable. At this juncture, the UK government has a choice of how to respond.

One option is to try to resist further change, and maintain the status quo. That has already caused huge political problems, both by governments seeking wider powers, and governments that have regarded devolution as a matter of distributing public services without wider accountability or responsibility. It is hard to see how that option remains viable, let alone attractive.

A second option is to respond to pressures for financial and fiscal devolution, in an ad hoc way. That may produce outcomes that are 'appropriate' to particular parts of the UK, but it stores up further problems for the future, not least because it becomes increasingly hard for citizens to identify what being part of the United Kingdom means, other than a shield on a passport. It is difficult to see how a sequence of variable devolution arrangements would prove a sustainable basis for the union in the longer term.

The third option is to seek to establish a measure of commonality in arrangements across the UK, so that they can respond to calls for greater self-government and policy differentiation, but also show in practical ways what the union as a whole does for citizens in each part of it. Some of what it does will relate to non-devolved matters, but by actively supporting the ability of devolved governments to make their own policy choices it will also enhance the ties that bind the UK together.

This paper seeks to establish what options would be practicable to deliver the third option. A package of devolved taxes, including personal income tax, an assigned share of VAT, and smaller taxes with connections to devolved services would offer an approach that would be as sensible as is possible in terms of managing devolved budgets, relating to devolved policy functions, and not having adverse fiscal results. In that respect, it offers a way forward. Further work is needed, to look in more detail at such issues as how borrowing powers might work under such arrangements, and the treatment of North Sea oil and gas. However, this should serve as the start of a more clearly defined option for enhanced devolution within the United Kingdom, designed to serve the interests of all parts of the UK.

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