CIPFA The Chartered Institute of Public Finance & Accountancy

Scottish Parliament, Finance Committee : Devolution of further fiscal powers

A Submission by:

The Chartered Institute of Public Finance and Accountancy

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the people in public finance

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. CIPFA shows the way in public finance globally, standing up for sound public financial management and good governance around the world as the leading commentator on managing and accounting for public money.

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Any questions arising from this submission should be directed to:

Don Peebles
Head of CIPFA Scotland
CIPFA in Scotland
Beaverbank Business Park
22 Logie Mill
Edinburgh
EH7 4HG
Tel: 0131 550 7543
Email: don.peebles@cipfa.org

Dr Ellie Roy
Research Consultant (Devolved Regions)
CIPFA
Tel: 07951 81 66 79
Email: eleanor.roy@cipfa.org

1. EXECUTIVE SUMMARY

1.1 CIPFA welcomes the opportunity to contribute to the work of the Committee on further fiscal devolution. CIPFA's previous work on constitutional change recognised three things:

- The Scottish Government is responsible for approximately 60% of all public spending in Scotland, most of which is financed by a block grant system which was designed some twenty years prior to devolution;

- The wider present control framework does not provide the devolved Scottish Government with all the necessary financial levers for optimum financial management and accountability; and that

- Despite significant policy divergence, the current financial framework does not require the financial position of a devolved Scotland to be separately reported to the people of Scotland.

1.2 CIPFA's submission builds on these findings and presents evidence in support of:

- A principled approach to devolved taxation. CIPFA has identified a number of principles against which a system of devolved taxation could be assessed. This would enable any taxation proposals to be tested in an objective and transparent manner;

- Proposed powers which would serve as the basis for improved financial levers, which in turn would provide a sound basis on which to assess the future affordability and sustainability of Scotland's public services. These powers include the ability of the Scottish Government to hold reserves, and enhanced powers to borrow for capital purposes based on affordability; and

- Improved accountability to the people of Scotland with the introduction of a requirement for a Scottish balance sheet which reports the assets and liabilities of a modern devolved Scotland.

1.3 CIPFA also presents in this paper a summary of the results from research of international practices for the benefit of the Committee. Finally we introduce the necessary preliminary discussion on the need for a modernised system of block grant transfer funding which interfaces with new taxation powers.

1.4 We would welcome the opportunity to engage further with the Committee to explain further the comments in this submission.

2. SCOTLAND'S FINANCES AS A DEVOLVED NATION – THE CURRENT SITUATION

2.1 Devolution has led to significant divergence in policy choices between Scotland and the rest of the UK.[1] Such local policy choices lead to different financial commitments, and so the landscape of public spending across the UK is no longer uniform. Despite this divergence, the UK-wide financial management framework does not distinguish the overall financial position of any devolved nation.

2.2 Regardless of improvements in recent years, the current financial reporting arrangements for the devolved governments remain closely linked to the UK framework and are not designed to demonstrate an all-Scotland position. In itself this is not a weakness, but it prevents us seeing a clear picture of a devolved Scotland's financial position.

Limitations of the Current System of Funding

2.3 Strong public financial management[2] is essential for all public sector bodies. It:

- ensures that the public finances are under control – the ability to 'balance the books'
- maximises value for public money, and
- supports improvements and service changes needed for the future.[3]

2.4 So does Scotland currently have the necessary tools available to ensure good financial management, ie to 'balance the books' and ensure that value for money is obtained from use of public funds?

2.5 Funding sourced by a block grant from the UK provides some certainty over levels of funding for Scotland; but it does come with some associated limitations in financial management terms, as described below.

[1] Such divergence is recognised in the Institute for Fiscal Studies, Taxation, government spending and the public finances of Scotland: updating the medium term outlook, 4 June 2014.

[2] CIPFA considers strong public financial management (PFM) to be of utmost importance. PFM is the system by which financial resources are planned, directed and controlled to enable and influence the efficient and effective delivery of public service. It spans a range of activities – including planning and budgeting, management accounting, financial reporting, financial controls, and auditing, all of which contribute to effective, transparent governance and strong public accountability for the use of public money. Further information on financial management can be found in CIPFA, Public Financial Management: A Whole System Approach.

[3] As set out in the CIPFA Financial Management Model.

Summary of Limitations of The Current Funding System

Block grant calculated by Barnett formula	The Scottish Government has no control over the level of block grant available and must ensure public services are affordable within the overall funding provided. Although some control can be exercised over levels of local taxation and other funding sources, the block grant provides the majority of Scotland's income. Although some tax powers are being devolved via the Scotland Act 2012, the block grant will still provide the majority of funding, with corresponding offsets for devolved tax revenues.
Limitations on how block grant can be spent	As the UK Government retains control over fiscal policy, HM Treasury imposes controls on the block grant. Although the Scottish Government has discretion over how to spend the majority of the block grant in relation to devolved areas,[3] some more volatile elements of expenditure are restricted.[4] Spending in these areas is not within the discretion of the Scottish Ministers, and this funding must be used for the purpose for which it is provided, or returned to HM Treasury. Although this provides the Scottish Government's funding with an element of protection from the risks associated with such volatile, demand-led elements of spending, it also removes an element of control over the totality of their available funding.
Inability to hold reserves	Funding received in the block grant cannot be held in 'reserve' to be carried over into future financial years. Any unspent grant must be returned to the Treasury at the end of the financial year. There is a system by which the Scottish Government can ask to carry forward any under spend, the budget exchange mechanism.[5] However, this is subject to limits, and is designed to avoid the 'use it or lose it' effect, rather than to manage financial pressures across years. This does not enable the funds to be held in a 'reserve' but rather allows access to the agreed amount in the next financial year.
Inability to borrow over the long term	Local government in Scotland can borrow money, as long as this is affordable and prudent.[6] This enables authorities to spread the cost of capital investment in schools, roads and other infrastructure, over a number of years. Under the current settlement, the Scottish Government has only limited ability to borrow money, with the power to borrow up to £500M to cover temporary shortfalls.[7] Since devolution this power has never been used.

	The Scotland Act 2012 will enable a moderate level of borrowing for capital purposes up to a prescribed annual level of £296M.
Limited information on future funding levels	In terms of financial planning for the future, the Scottish Government has only restricted information on its future level of funding. Although the block grant does provide a level of certainty, the amount of grant to be received is indicated as part of the UK Government's Spending Review process.[8] However, the timing and lengths of Spending Review periods have varied, with the Spending Round 2013 providing figures for only two years (2014-15 and 2015-16), with no forecasts for financial years beyond the next UK general election. Spending Reviews provide an indication of what the block grant is likely to be, but these plans are often altered by decisions in UK Government Budgets and Autumn Statements, and therefore the block grant figures are subject to change, in either direction. These issues of timing and changes to the level of grant present difficulties in the ability of the Scottish Government to establish medium or long term financial plans.

Table Notes:

1. Scottish Government, Scottish Variable Rate.
2. Devolution Matters, The uselessness of the Scottish Variable Rate, November 2010.
3. The departmental expenditure limits (DEL).
4. Included in the annually managed expenditure (AME).
5. As detailed in HM Treasury's Consolidated Budgeting Guidance 2013 to 2014.
6. SSI 2004/29 The Local Government Capital Expenditure Limits (Scotland) Regulations 2004.
7. Scotland Act 1998, Section 66.
8. Three year plans apply to the bulk of the grant, the departmental expenditure limit (DEL). However, the more volatile annually managed expenditure (AME) is planned for on an annual basis.

2.6 Together, these limitations impose restrictions on the choices available to 'balance the books'. As the Scottish Government has little control over its overall level of funding and there are restrictions on how some of it can be used, it has no choice but to balance the books annually. This creates difficulties in financial planning for the sustainable delivery of public services in future years.

2.7 The inability to borrow or to hold money in reserve can be compared to that of an individual. An individual can save money for the future and can borrow money for a large investment. But these basic tools are not available to the Scottish Government under the current settlement.

2.8 Despite the limitations inherent in the current funding system, successive Scottish Governments under devolution have managed to balance the books and manage their finances. The block grant provides Scotland with some certainty over the level of funding it will receive but the wider control framework does not provide the Scottish Government with all the necessary financial levers required for optimum public financial management and accountability.

Borrowing By The Scottish Government

2.9 The *Scotland Act 2012* provides new capital borrowing powers from April 2015 for investment in infrastructure. The Scottish Government will be able to borrow up to 10% of their capital budget[4] in any one year, with a cumulative limit of £2.2BN over ten years.

2.10 The UK Government has announced that the capital borrowing limit for 2015-16 will be £296M, and the Scottish Government has indicated that it intends to utilise the entire amount to support capital investment.[5]

2.11 The UK Government has also announced that the Scottish Government will be able to issue bonds. This will not alter the levels of borrowing available, but provides an additional source of borrowing, allowing the Scottish Government to directly access the capital markets and issue its own debt.[6]

2.12 This capital borrowing power will impact, in terms of both increased assets (the infrastructure investment) and increased liabilities (the obligation to repay debt). The power will also mean a commitment to meet repayments on borrowing in the future, and so will impact on the financial sustainability of public services going forward.

2.13 The borrowing limit is not based on affordability or the ability of the Scottish Government to repay debt and to afford interest charges. CIPFA have previously suggested that arrangements for borrowing limits should be based on a 'prudential approach',[7] with a requirement to demonstrate the prudence, or affordability, of borrowing costs being the prime determinant of borrowing capacity.

2.14 This approach to limiting borrowing has applied to Scottish local government under legislation passed by the Scottish Government in 2003,[8] and is governed by CIPFA's 'Prudential Code' framework[9]. Legislation[10] restricts borrowing to use for funding capital expenditure or for specifically approved purposes. Additionally the same legislation[11] specifies that interest and dividends have 'first call' against the rates and revenues of an authority.

2.15 HM Treasury reserves the right to impose a total borrowing limit on the Scottish public sector, and therefore Scottish local government. This power has not been exercised by HM Treasury since introduction of the Prudential Code.

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[4] Capital departmental expenditure limit (DEL).

[5] Scottish Parliament, Finance Committee, Official Report, 4 September 2013.

[6] HM Treasury and Scotland Office, Scotland to be given powers to issue its own bonds, 19 February 2014.

[7] CIPFA submission to Commission on Scottish Devolution, 2008

[8] Local Government in Scotland Act 2003, Part 7

[9] As specified by Scottish Statutory Instrument 2004/29 The Local Government Capital Expenditure Limits (Scotland) Regulations 2004

[10] Primarily The Local Government (Scotland) Act 1975 schedule 3

[11] The Local Government (Scotland) Act 1975 schedule 3 para 8 (2)

The Power to Hold Reserves

2.16 The Scottish Government does not currently have the power to hold reserves, but relies on the limited flexibility of the budget exchange mechanism. This impedes the financial management capacity of the Scottish Government. For example it restricts:

- the scope for medium and longer term financial planning by limiting the ability to build up financial resources for future planned spend on services;
- the ability to deal with unexpected events, such as severe weather conditions, since there is no ability to carry forward a 'contingency' level of resources to support expenditure to deal with these events; and
- the financial tools which the Scottish Government may, in future, need to manage tax revenue volatility or variations. In particular an inability to hold reserves while relying on potentially variable tax revenues means that there are limited financial resources available to absorb the impact of lower than expected tax revenues. Consequently, in the event of lower tax revenues reliance is more likely to be placed on immediate budget reductions or on the use of borrowing. In the event of higher than expected tax revenues there is, equally, limited ability to carry forward the resources to support longer term planned expenditure, which could result in a 'use it or lose it' incentive.

2.17 The restriction on the use of reserves by the Scottish Government can be contrasted to the powers of local government, which can hold usable reserves. Typically usable reserves are held for planned (ear-marked) future spending or as a contingency for unexpected events. An indication of the use of reserves, and the considerations affecting the level of reserves held, is provided by CIPFA's bulletin on 'Local Authority Reserves and Balances'[12].

The Requirement to Publish a Scottish Public Sector Balance Sheet

2.18 The importance of financial reporting at a total 'Scottish public sector' level has been clearly stated by both CIPFA[13] and Audit Scotland.[14] The application of recognised accounting standards to provide a 'Scottish Whole of Government Accounts', similar to the UK Whole of Government Accounts (UK WGA)[15], would provide such benefits as:

- audited, and therefore verified and unbiased, financial information to demonstrate Scottish public sector accountability to the Scottish people for the use of taxpayer funds;
- a means for market lenders to the Scottish Government to assess the financial position and financial management of the Scottish public sector as a whole,

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[12] Local Authority Accounting Panel, Bulletin 99, (CIPFA), 'Local Authority Reserves and Balances'
[13] The Scottish Referendum: Scotland's Future in the Balance, CIPFA, June 2014
[14] Developing Financial Reporting In Scotland, Audit Scotland, July 2013.
[15] UK Whole of Government Accounts 2012-13, HM Treasury

thereby affecting the interest charges likely to be incurred for borrowing;

- the clear identification of assets and liabilities controlled by the Scottish public sector on behalf of the Scottish people;
- support for long term financial planning, for instance by providing information to ensure that sufficient liquid future assets are available to settle liabilities and to help assess the sustainability of current service provision;
- informing Scottish Asset Management Planning processes with the relative values of differing assets used for services (for example the road network, the NHS estate, the schools estate and other assets essential for providing services to the Scottish people); and
- assessment of the condition and suitability of public assets for continuing use (e.g. through the requirement to review assets for impairment in the event of damage etc).

2.19 The first publication of UK WGA was for the 2009/10 financial year[16]. The publication of UK WGA has strengthened the accountability of the UK government to the Westminster Parliament, with the Public Accounts Committee undertaking scrutiny of the UK WGA.[17] Improvements continue to be made to enhance the reliability and usefulness of the financial statements.[18] CIPFA therefore considers that Scottish 'whole of public sector' accounts would equally support accountability to the Scottish Parliament, and therefore to the wider Scottish public, for the use and stewardship of taxpayer funds.

Financial Planning and Budgeting Arrangements

2.20 Tax powers will give the Scottish Government more control over the amount of revenue they raise (offset by a reduction from the block grant) and make them more financially accountable to Scottish taxpayers. Borrowing powers will enable greater flexibility to spread the costs of infrastructure investment, and so service provision, over financial years, but will result in an accompanying commitment to repay the debt in future years. However the majority of Scotland's income will still be in the form of the block grant, with the accompanying restrictions and limitations on financial planning and management.

2.21 For areas in which the Scottish Government has adopted different policies from the rest of the UK (such as prescription charges, higher education tuition fees and social care), funding for such policies is not 'built into' the block grant, (which is calculated on the basis of UK spending policies) but must be found from within the available funding.

2.22 This means that the Scottish Government must prioritise and make choices to fund such policies, possibly at the expense of other areas. These policies also commit to meeting costs in future years, and as we have seen previously, assessing their

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[16] HM Treasury Whole of Government Accounts 2009/10
[17] PAC Inquiry into the 2012/13 UK WGA announced, See also the report on the WGA 2009/10 Scrutiny process
[18] For example by faster publication after the financial year end, and by seeking to reduce the number and severity of audit qualifications.

sustainability going forward is limited by the information available on future years' funding. Given the reductions to public spending in recent years, and indications that such cuts are likely to continue over the next UK Parliament,[19] assessing the affordability and financial sustainability of such differing policies is of increasing importance.

2.23 The potential for tax volatility or variation suggests that budget adjustments may be required to address both short and long term sustainability. This implies that the public sector budgeting system must be flexible and adaptable enough to react within appropriate timescales to changes in tax yields to ensure that public service expenditure is affordable and sustainable. Assessment of whether the current budgeting system would fulfil this requirement is suggested.

2.24 The new financial powers under the *Scotland Act 2012* will increase the financial responsibility and the accountability of the Scottish Government, and will provide some but not all of the levers that are required.

2.25 CIPFA recommends that:

- **Improved accountability is a feature of the fiscal devolution settlement, with a statutory requirement to produce Scottish 'whole of public sector' financial statements – a Scottish balance sheet;**

- **In the event of further tax devolution and to ensure that the Scottish Government has sufficient powers to manage any potential volatility in tax revenues:**

    - **Enhanced borrowing powers should be underpinned by a 'prudential' framework based on affordability;**

    - **the power of the Scottish Government to hold reserves should be introduced; and**

    - **the ability of the existing budgeting system to respond to tax volatility should be assessed.**

- **The arrangements for borrowing powers should be transparently set out in an agreement between the Scottish Government and HM Treasury. This should include clarity on whether repayment of borrowing would take 'first call' on resources.**

[19] HM Treasury, Budget 2014, March 2014 (para 1.69).

3 A PRINCIPLED APROACH TO POWERS OF TAXATION IN SCOTLAND

3.1 During the passage of the *Scotland Act 2012*, the UK Government set out three general principles of devolution. These were that any proposal for devolution should:

- have cross-party support;
- be based on evidence; and
- not be to the detriment of other parts of the UK.

3.2 In the recent command paper published by the UK Government in relation to further devolution, it is stated that these principles continue to hold true and should form part of the consideration of the devolution of further powers to Scotland.[20]

3.3 Further fiscal devolution is likely to result in calls from a range of stakeholders for a further series of taxation powers. It is essential that any proposals can be objectively assessed. CIPFA has previously developed[21] a suite of principles which we consider that any system of taxation should be assessed against. These principles are:

- Accountability
- Fairness
- Stability and predictability
- Buoyancy of the tax base
- Transparency and clarity
- Ease of collection and administration

3.4 **Accountability**: In any democratic society, the first requirement of any system of taxation is that the government (whether central, sub-national or local) should be accountable to the electorate for the tax it raises and how it is spent.

3.5 **Fairness**: There are at least 3 ways to consider fairness. Firstly fairness between individuals, in that those in similar circumstances should be treated equally. Secondly, fairness between areas, which takes account of variances in needs and circumstances across regions/nations. Thirdly, the assessment of fairness should include the consideration of the wider tax environment as appropriate.

3.6 **Stability and predictability**: Taxpayers, all levels of government and civic society in general should be able to rely on reasonably firm expectations of future commitments. Public services require predictability of income in order to set budgets. Individual taxpayers should reasonably expect to incur tax rates which do not fluctuate, other than marginally, between fiscal years.

[20] HM Government, The parties' published proposals on further devolution for Scotland, Cm 8946, October 2014
[21] CIPFA A Fairer Local Tax for Scotland

3.7 **Buoyancy of the tax base**: Generally considered to be the relationship of the tax yield to economic conditions. For example, changes in levels of income or property valuations. Whilst buoyancy is generally considered to be more evident in relation to an income-related tax, it can also be detected in other taxes.

3.8 **Transparency and clarity**: Taxpayers should be able to easily understand how their tax liability is determined. If there are related systems of discounts, exemptions, allowances or other reliefs, this should not hamper the clarity of how much taxpayers will be liable for. This is of particular importance where powers to vary rates are devolved, but powers over allowances and reliefs may be retained by the UK Government. The entire system must be transparent and easily understandable.

3.9 **Ease of collection and administration**: This principle applies equally for both the taxpayer and collector. The design of the taxation system should ensure that it is difficult to evade payment and allow for ready identification of those who have not paid. Again, this is of paramount importance where taxes are partially devolved and different agencies may be responsible for different aspects of tax collection and administration.

3.10 CIPFA recommends that:

- **Each proposal for tax devolution, as well as the resulting tax regime in its entirety, is tested against CIPFA's principles of taxation:**
  - **Accountability**
  - **Fairness**
  - **Stability and predictability**
  - **Buoyancy of the tax base**
  - **Transparency and clarity**
  - **Ease of collection and administration**

4 TAX DEVOLUTION – THE INTERNATIONAL EVIDENCE

4.1 Evidence from the OECD[22] suggests that the greater the share of taxes which forms part of the funding of sub-national (or devolved) governments, the more efficiency and democratic accountability are enhanced. It can also provide greater incentive for developing the economic and tax revenue base.

4.2 There is also a growing body of literature which suggests that decentralisation and greater tax autonomy may be conducive to 'social capital' by encouraging participation in devolved government decisions and strengthening accountability.[23]

4.3 CIPFA's focus is on the changes in financial control which greater fiscal freedom will bring. We consider that there is scope to ensure that increased fiscal autonomy can be balanced with improved financial management and accountability.

Tax autonomy of sub-national governments – Tax Revenue as a Proportion of Total Tax Revenues

4.4 From our research we have observed that internationally, sub-national tax revenue is an important factor in accountability, although there is variation in the levels of revenues raised by sub-national governments as a proportion of total government tax revenues.

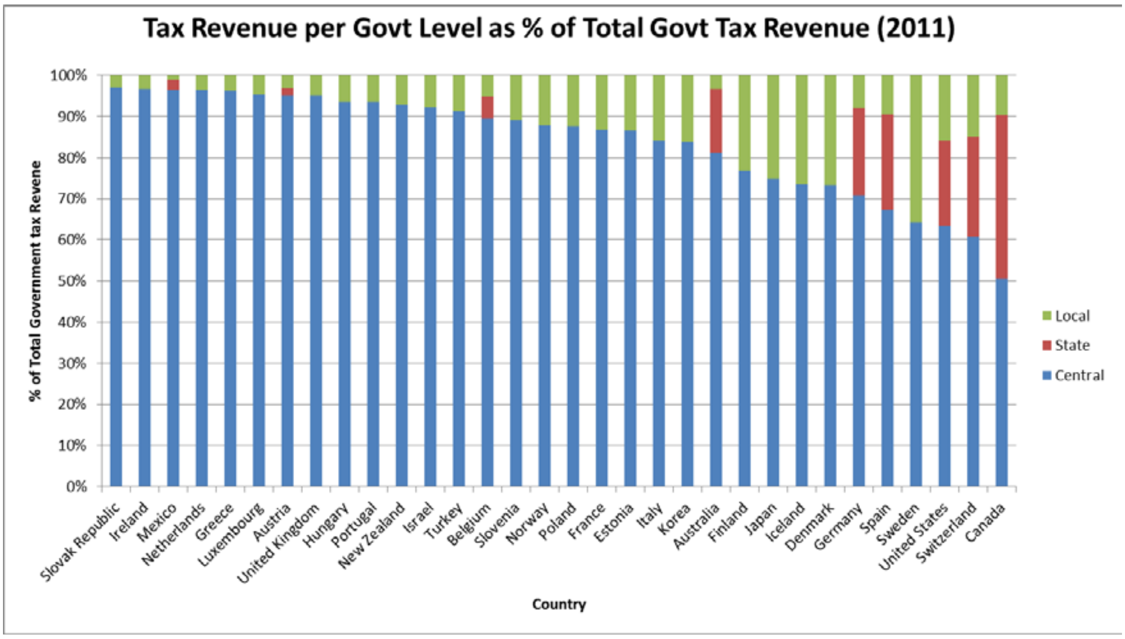
4.5 Tax revenues raised by sub-national government, unsurprisingly are highest in federal states (eg Canada) or in those with a decentralised system of public services (eg Spain), and lowest in unitary states such as France. Figure 2 below summarises these trends by showing the share of sub-national tax revenues raised by central, state or local government, as a share of total tax revenues.[24]

[22] Blöchliger, H. and J. Rabesona (2009), The Fiscal Autonomy of Sub-Central Governments: An Update, OECD Network on Fiscal Relationships Across Levels of Government

[23] De Mello, L. (2004) Can Fiscal Decentralisation Strengthen social Capital? *Public Finance Review,* Vol. 32, pp.4-35 and De Mello, L. (2010), Does Fiscal Decentralisation Strengthen Social Capital?: Cross-Country Evidence and the Experiences of Brazil and Indonesia, *OECD Economics Department Working Papers*, No. 825, OECD Publishing

[24] Graph based on data from OECD, Fiscal Federalism Network, Tax revenue as percentage of total general government tax revenue

Figure 2



4.6 The UK, which despite devolution remains a unitary state, has a low level of tax autonomy, with only around 5% of total tax revenue currently collected at the sub-national level. This is well below the average for the OECD countries of around 16%. Similar to the model in Nordic countries, the UK has higher levels of tax autonomy at local level (i.e. the council tax system). However, with the powers devolved in the *Scotland Act 2012*, this will change from 2015, as devolved tax powers come into effect.

Tax autonomy of sub-national governments – Tax Revenues as a Proportion of Total Revenue

4.7 The composition of total sub-national government revenues also varies across countries. On average, around 40% of all sub-national government revenue (at both state and local level) is generated by tax revenues.[25]

4.8 Again, the UK is well below average with only around 14% of local government revenues being currently raised by taxation.[26]

Tax autonomy

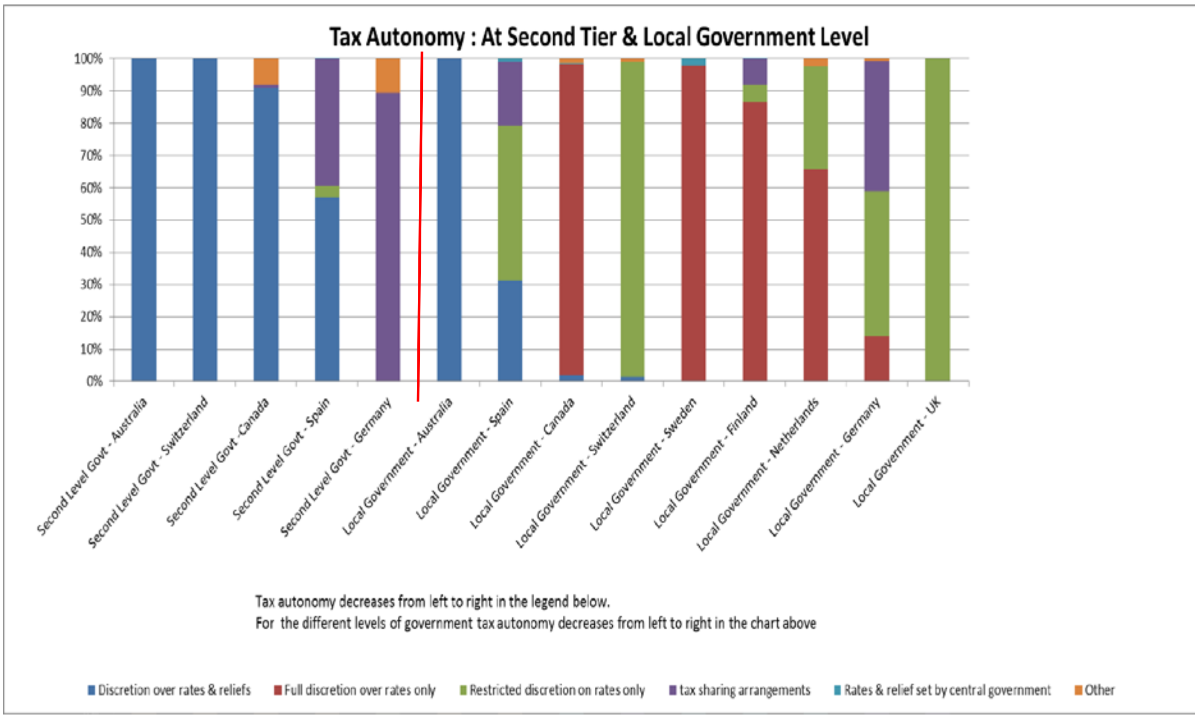
4.9 Tax revenues at sub-national level as a proportion of total tax revenues is frequently used internationally as a measure of tax autonomy and of fiscal powers for sub-national government. This measure provides no indication of the true powers of discretion over tax rates and the tax base, and provides no indication of how the tax revenues are raised. For example tax revenues may flow to sub-

[25] Per OECD, Fiscal Federalism Network, Tax revenue as percentage of total revenues for each level of government (2011 data)
[26] Per OECD, Fiscal Federalism Network, Tax revenue as percentage of total revenues for each level of government (2011 data)

national government by way of a tax sharing or assignment arrangement, where revenues are shared amongst the tiers of government, but the decisions on rates, etc lie wholly with central government.

4.10 Figure 3[27] demonstrates how tax autonomy varies greatly across countries, and that those with the greatest revenues at sub-national government levels are not necessarily representative of those with the greatest powers or discretion over taxes, and vice versa.

Figure 3



4.11 Most sub-national governments have considerable discretion over rates and reliefs, or rates alone, with tax sharing generally accounting for the remainder of tax revenues. Such tax sharing models are generally intended to balance fiscal autonomy with retaining stability in the overall fiscal framework. These models can involve an agreement between the tiers of government on how revenues are shared, or the split can be determined by central government alone.

4.12 Such tax sharing arrangements are commonly used in relation to sales taxes, where there is a high degree of mobility in the purchase of goods/services. However, such tax sharing models do not provide the same level of accountability as where discretion is allowed over rates and reliefs.

[27] Based on data from OECD, Fiscal Federalism Network, Tax autonomy indicators (2008 data)

Taxes appropriate for devolution

4.13 CIPFA agrees with the general principle identified by OECD research,[28] that the taxes most suited for devolution to sub-national governments are those which are 'benefit taxation'. That is, those which provide a direct link between taxes paid and public services delivered, thus providing a direct line of accountability.

4.14 Taxes most suitable for devolution would demonstrate characteristics which are non-mobile, non-redistributive, non-cyclical and that are not exported to other regions.

4.15 Research demonstrates that,[29] across OECD nations in 2005 the types of taxes devolved to sub-national governments were as follows:

- Property 34%
- Income – individuals 34%
- Income – corporate 9%
- Sales 20%
- Other 3%

4.16 Property-based taxes are likely candidates as they most closely match the criteria above. The redistributive aspects of income taxes can be mitigated against by retaining central government control over the tax structure and rate setting. Sales taxes run the risk of exporting revenues due to high mobility, but again this can be reduced by retaining central control over rates and reliefs. Corporate taxes, whilst attractive for devolution on economic grounds, tend to be mobile, cyclical and can potentially shift the tax burden to non-residents.

4.17 CIPFA recommends that:

- **Proposals for tax devolution should be tested against CIPFA's principles and be informed by international comparisons.**
- **Taxes most suitable for devolution are 'benefit taxes', which provide a direct line of accountability.**

[28] Blöchliger, H. and O. Petzold (2009) Taxes or Grants: What Revenue Source for Sub-National Governments? *Economics Department Working Paper* No.706, OECD Publishing
[29] Blöchliger, H. and O. Petzold (2009) Taxes or Grants: What Revenue Source for Sub-National Governments? *Economics Department Working Paper* No.706, OECD Publishing

5. DEVOLUTION FINANCE – THE BALANCE OF FUNDING

Tax devolution and the need for equalisation

5.1 The devolution of tax powers will not remove the need for some form of transfer or grant from the UK to provide the balance of funding for Scotland. The devolution of taxation is strongly linked to the mechanics of UK grant distribution and it is therefore desirable to consider the combined effect of these, rather than to view each in isolation. CIPFA considers that any debate on further powers should be conducted concurrently with consideration of the overall system for funding devolution.

5.2 This brief commentary sets out some points for preliminary discussion.

5.3 Inter-governmental transfers can be viewed as aiming to subsidise devolved government services and/or to equalise for variations in tax revenues. For example, vertical equalisation grants are common, to re-distribute the much greater tax revenues collected by central government. Often these two objectives overlap. The objective of subsidisation may result in less incentive for devolved government to maximise its own tax revenues, whilst the rationale for equalisation may be seen to be subjective.

5.4 Internationally, a wide range of inter-governmental grants are used, with different purposes and effecting different behaviours of sub-national governments. Similarly the level of hypothecation of such transfers vary, the majority can be used at the discretion of the devolved government (as in the case of the majority of the Scottish block grant).

5.5 There is a general consensus that the success of tax devolution is dependent on the existence of a well-functioning equalisation system to distribute the balance of funding to the devolved governments.[30] In some nations, the distribution of resources amongst the different tiers of government is overseen by a body independent of government. For example, in Australia, there is a separate Commission[31] which determines the annual allocation of general revenue assistance to the states and territories.

The Barnett Formula – fit for purpose?

5.6 Currently, the devolved administrations receive their funding via a block grant from the UK, calculated on the basis of the non-statutory Barnett formula. This operates incrementally in that it determines changes to the devolved administration's block grant on the previous year, but does not determine its overall size. When the UK Government reviews its spending plans,[32] the devolved

[30] Blöchliger, H. and J. Rabesona (2009) The Fiscal Autonomy of Sub-Central Governments: An Update, OECD Network on Fiscal Relationships Across Levels of Government
[31] Commonwealth Grants Commission
[32] Generally through spending reviews although other spending announcements, such as those made by the Chancellor of the Exchequer in his Budget and Autumn Statement, also impact on allocations to the Welsh block.

administrations receive a population-based proportion of the changes in planned spending on comparable government services in England.[33]

5.7 A recent report on fiscal devolution concluded: ‘for a system of fiscal devolution to balance equalisation and incentives it has to: start with an assessment of need and resources; have a mechanism for reallocating disproportionate tax yield growth; and include periodic reassessments.’[34] The Barnett formula does not meet these criteria, as it is population based.

5.8 The Barnett formula was introduced in the late 1970’s, and despite the advent of devolution and significant constitutional changes in the late 1990s, there have been no changes made to this funding mechanism. During this period there have been a number of reviews of the funding mechanism although no replacement has been satisfactorily identified. Most of the reviews have called for the introduction of funding on the basis of needs.[35]

5.9 Devolution in the UK provided the devolved administrations with powers to pursue their own policy in devolved matters. However, the funding which allows them to do so is inherently linked to spending on those comparable matters by the UK Government. Therefore, although the devolved administrations are free to spend the block grant at their own discretion and to pursue the policies they determine, the overall level of resource they have available to them is still directly linked to UK Government policy decisions on comparable devolved matters.

‘No detriment’ principle of tax devolution

5.10 In order to comply with EU rules under the Azores Criteria a devolved tax must be accompanied by a corresponding offset to the funding received from central government, and the recent command paper on further devolution states that: ‘*any further devolution of powers should not of itself confer any systematic financial gain or loss to either Scotland or the rest of the UK or the UK as a whole.*’[36] Therefore, the devolution of any tax will be accompanied by a corresponding reduction to the grant from the UK to offset against the devolved tax revenues.

5.11 The manner in which such a deduction is calculated will have implications for the overall levels of funding available to Scotland. The importance of this can be observed from the debate during consideration of the *Scotland Act 2012*.[37]

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[33] As detailed in HM Treasury’s *Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy*, October 2010
[34] House of Commons, Communities and Local Government Committee Report, Devolution in England: the Case for Local Government, June 2014
[35] Including: House of Lords Barnett Formula Select Committee, The Barnett Formula, HL Paper 139, July 2009; House of Commons Justice Committee, 5th Report of Session 2008/09 Vol I, Devolution: a Decade On, HC 529-I, May 2009; Commission on Scottish Devolution, Serving Scotland Better: Scotland and the United Kingdom in the 21st Century. An Overview of the Final Report, June 2009; and both reports of the Holtham Commission: Independent Commission on Funding and Finance For Wales, First Report, Funding Devolved Government in Wales: Barnett and Beyond, July 2009 and Final Report, Fairness and Accountability: a New Funding Settlement for Wales, July 2010
[36] HM Government, The parties’ published proposals on further devolution for Scotland, Cm 8946, October 2014
[37] Scottish Parliament Finance Committee, *8th Report 2013 (Session 4) Report on implementation of the financial powers in the Scotland Act 2012*, 2013. House of Commons, Welsh Affairs Committee, Fourth Report of Session 2013–14, Pre-legislative scrutiny of the Wales Bill, February 2014

5.12 We acknowledge that any modernisation of the block grant transfer arrangements will have implications beyond Scotland but nevertheless consideration of the devolution of further financial powers provides the opportunity for wider consideration of the overall system of funding devolution to ensure it is both fit for purpose and sustainable for the future.

5.13 CIPFA recommends:

- **that the Committee consider the consequences of the potential mechanisms by which the block grant may be adjusted in respect of further devolved taxes;**
- **the Committee takes the opportunity to consider the overall mechanisms of funding devolution alongside the potential for further financial powers, to ensure that the overall system is effective and sustainable for the future. This may include the potential for moving towards a reformed system of resource equalisation based on relative needs; and**
- **consider the establishment of an independent commission to advise on methodologies and decisions on funding distribution across the UK.**