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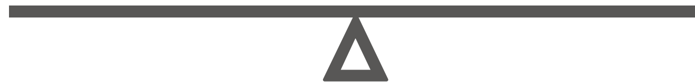
Common Weal Policy

THE TURKEY THAT VOTED FOR CHRISTMAS (TWICE): HOW POOR NEGOTIATION OF THE FISCAL SETTLEMENT HAS FAILED SCOTLAND



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AUTHOR

Jim Cuthbert a statistician and former Head of Statistics at the Scottish Office

KEY POINTS

— The process for conducting the recently announced review of the fiscal settlement was not conducted in line with the arrangements set out by the then Finance Secretary in June 2022.

— The outcome of the review – which largely amounts to continuation of the status quo – leaves Scotland exposed to the same dangers as the original settlement. These include being forced into sub-optimal decisions on capital expenditure. Most serious, however, is the likelihood of Scotland being forced into a cycle of relative economic decline, comparative to the rest of the UK.

— Because the review was conducted in secrecy, we do not know how these damaging outcomes came about. It appears likely, however, that inadequate consideration has been given to the risks to Scotland resulting from the sub-optimal performance of the UK monetary union which is inherent in the implementation of the review measures.

— The following steps should now be implemented:

The Scottish and Westminster Governments should explain why the fiscal settlement review was not conducted along the consultation lines originally outlined. They should also release a full account of the negotiations leading to the agreement.

One of the original Smith Commission recommendations - consideration should be given to a wider scheme of prudential borrowing in Scotland - should be carried out.

There should now be a wider debate about the extent of the detriment Scotland will incur through the sub-optimal performance of the UK monetary union which is implied by the current fiscal settlement: and how this should be compensated for under a reasonable interpretation of the Smith Commission principles.

And the fiscal settlement itself should be re-opened, as allowed for under the Joint Exchequer Committee arrangements: and this should be done in a way which allows properly for public consultation and transparency.

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THE NEW FISCAL FRAMEWORK

On 20th July this year, with very little fanfare, the Westminster and Scottish Governments announced that they had reached agreement on the review of the fiscal settlement: that is, a review of the financial arrangements which govern the funding of the Scottish Government. This fulfilled a pledge made at the time when the original post-referendum fiscal settlement was agreed in 2016, that the arrangement would be reviewed in five years. As we will see, however, the way this review has been conducted is highly unsatisfactory: and the outcome is damaging for Scotland.

In June 2022, Kate Forbes, then the Cabinet Secretary for Finance and the Economy, had written to the Convenors of the Finance and Social Justice Committees, informing them about how the review was planned to proceed. The first step would be the production of an independent report, which would focus on the arrangements for the Block Grant Adjustment, (BGA), element of the fiscal settlement. (The significance of the BGA will be explained later.) This independent report would then inform a broader review of the fiscal settlement. It was clearly intended from the Kate Forbes letter that the independent report should inform some process of wider consultation before the fiscal settlement review itself was finalised. As the Kate Forbes letter says, "I look forward to continuing engagement with both the Finance and Public Administration and Social Justice, and Social Security Committees on both the independent report and the Fiscal Framework Review". It was also clear from the Kate Forbes letter that, at that stage, the Scottish Government were looking for significant improvements to emerge from the overall review process: as the letter also said, "my view is that the scope of the review should be broad in order that the current arrangements are thoroughly assessed to ensure they are fit for purpose".

In the event, the review did not proceed on anything like this basis. After inviting views to inform the independent report, there was then silence – until it was announced on 20 July 2023 that the review had been finalised: and that the independent report was also being published on the same day. So the intention in the Kate Forbes letter that the independent report should form the basis of some wider consideration before the broader review was finalised did not take place, at least in any public sense. Furthermore, the review conclusions themselves were essentially confirmation of the status quo: effectively, there would be some modest adjustment to the Scottish Government's limited borrowing powers: (these changes are explained in more detail in the next paragraph). But as regards the key issue, the question of how to index the BGA element, the decision was to maintain the present approach: that is the application of the so called Indexed Per Capita, (IPC), indexation method. As will be argued here, the fiscal framework as it now stands has very adverse consequences for Scotland.

Note that neither the headline capital borrowing or resource borrowing limits to which the Scottish Government is subject have altered. On capital, the original overall borrowing limit of £3 billion overall, and the annual limit of £450 million within that, remain the same: and on resource borrowing, the total limit of £1.75 billion, and the annual limit of £600 million within that, also remain the same. The main changes are that, for both capital and resource borrowing, these limits will no longer be eroded by inflation after 2023/24: and the annual £600 million limit on resource borrowing, which is intended to cover in-year cash management or forecast error in relation to devolved taxes or welfare spend, will now be somewhat easier for the Scottish Government to access in full.

To see why the fiscal framework that we now have is damaging, it is useful to consider two aspects. First of all, how the current framework forces the Scottish Government into making sub-optimal decisions. And secondly, we consider the dangers of an unstable dynamic implicit in the IPC approach to BGA indexation.

HOW THE FISCAL SETTLEMENT FORCES SUB-OPTIMAL DECISIONS.

The Scottish Government naturally has ambitious plans for investment in public infrastructure, but is constrained by the limited capital borrowing powers available to it under the fiscal settlement. The Scottish Government's capital borrowing limit is £3bn under the original fiscal settlement, and is now uprated for inflation under the July 2023 agreement: in addition, it has a capital budget of something under £6 billion per annum. One way to get round the constraint implied by these figures is to engage in some form or other of public-private partnership, (PPP). Under this type of arrangement, the private sector builds the relevant asset, which appears on its books, and so does not count against the Scottish Government's capital budget or borrowing limit. The private sector contractor is then reimbursed through a series of long-term payments out of the public sector's revenue budget. PPPs, (of which the original form was PFI), were very popular throughout the UK as a means of getting round the constraints implied by limited capital budgets. However, it was not long before it became apparent that there were inherent problems with the private sector financing approach. In particular, PPP schemes tended to deliver buildings which were inflexible, of poor quality, and in some cases unsafe. And, critically, such schemes were often very poor value for money, and frequently resulted in the private sector contractors cashing in large windfall profits. As the Public Accounts Committee of the House of Commons said about PFI, "It is unacceptable that almost 30 years since the first PFI projects were initiated, the Treasury cannot produce evidence to support its claims that PFI is worthwhile for any reason apart from the fact that it takes debt off the balance sheet". (PAC: "*The private Finance Initiative: time for honesty*": published 9th July 2018)

As a result, such schemes were abandoned by the UK Government – but not in Scotland (or Wales, which is subject to similar fiscal settlement constraints). In Scotland, the Scottish Government retains the option to use a form of PPP called the Mutual Investment Model, which is acknowledged to be more expensive than conventional procurement, and is also likely to share many of the problems of PFI: and the reason the Scottish Government made this decision is precisely because of the constraints implied by the fiscal settlement. As a report by the Scottish Futures Trust on the MIM model stated "The Scottish and Welsh Governments are proceeding with this type of investment model where borrowing is constrained, and additivity is a key factor. The UK Government which does not have the same constraints on borrowing has decided not to proceed with this type of investment model at present." (Scottish Futures Trust: "An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model": published 2019.)

The MIM model is therefore one example where the constraints imposed by the fiscal settlement have forced the Scottish Government to make a sub-optimal decision. Another similar example is the recent announcement by the Scottish Government of what is effectively a PPP or PFI type scheme worth £2 billion to fund the planting of trees. The financial details of this scheme have not been released: but it would be very surprising, given past experience, if this scheme represents value for money.

Another area where the present fiscal settlement forces the Scottish Government into a sub-optimal approach is in relation to prudential borrowing. Local authorities in Scotland (as in the rest of the UK) have the power to borrow prudentially for capital expenditure. That is, provided they are satisfied that the resulting loan charges can be accommodated safely within their prospective revenue budgets, they can borrow without the direct approval of central Government, and without the resulting borrowing counting against any capital limit. This prudential borrowing power has been used to good effect in Scotland with the introduction of the Learning Estate Investment Programme, (LEIP), as a new funding model for building schools. Unlike local authorities, however, the Scottish Government itself does not possess prudential borrowing powers under the current fiscal settlement: so the extension of a LEIP type approach beyond the local authority sector is not possible. This restriction exists despite one of the original Smith Commission recommendations, (number 95(5)), stating that "The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with the overall UK fiscal framework".

All of the above examples were flagged up in a recent Jubilee Scotland report, ("*A proposal for an alternative to Public Private Partnerships*", 2022), as areas where the constraints of the current fiscal settlement prevented useful developments in Scotland, and forced sub-optimal decisions. It was suggested in that report that these issues should be addressed in the wider review of the fiscal framework that was then in prospect. The 20th July announcement that the review had been concluded without any of the expected public consultation has effectively stymied this possibility.

THE LONGER TERM RISKS OF A CYCLE OF RELATIVE DECLINE.

We now turn to the second area where the recently announced fiscal settlement decision has adverse consequences. This relates to the implications of the decision to continue use of the IPC model for indexing the BGA element of the fiscal settlement: and the way this is likely to introduce an unstable dynamic into the finances of the Scottish Government.

To understand why this is the case, it is necessary to give a little more detail on how the fiscal settlement works. In fact, these arguments have been thoroughly rehearsed previously (see, for example my note "Responsibility without power", published by Commonweal on 22 June 2022), so I will keep the detail to a minimum. Under the post-referendum fiscal settlement agreed in 2016, and continued essentially unchanged in the light of the 20 July 2023 announcement, the Scottish Government continues to receive a block grant calculated in line with the Barnett Formula. However, there is a deduction to the block grant to allow for those revenues (like income tax on non-savings, non-dividend income) which are now devolved to Scotland. This adjustment to the block grant, which is part of the so-called BGA, is increased each year by the percentage growth in corresponding tax rates in England, adjusted for the relative growth rates of population in Scotland and England. This means that if Scotland grows its per capita devolved tax receipts at the same rate as England, then Scotland would receive the same funding as it would have under the old Barnett Formula. Scotland will do better if it has a higher growth rate. But if the rate of growth of per capita tax receipts lags behind England, Scotland will be penalised. Effectively, the fiscal settlement thrusts Scotland into a fiscal race with England, where, if Scotland wants to do as well as it would have done under Barnett, it has to grow its per capita tax receipts as fast as England.

It has been a long standing policy of the SNP that they should use their ability to change devolved tax rates overall as a way to generate extra revenues for socially desirable purposes. This is an unexceptionable, indeed, praiseworthy, policy objective. The potential difficulty arises when one attempts to implement this policy while at the same time engaged in a fiscal race with the rest of the UK. If the Scottish economy, for whatever reason, fails to keep up with the rest of the UK, then Scotland will lose, through the BGA indexation mechanism, some or all of the extra revenues raised by higher Scottish taxes. This could happen, for example, because of an adverse economic shock – or if higher Scottish taxes themselves inhibited relative economic growth. The danger is that a perverse negative feedback loop then kicks in. If the response to loss of revenues through the BGA mechanism is to further raise Scottish taxes, then this could lead to further inhibition of relative economic growth: hence catalysing a more severe BGA squeeze, and so on, ultimately resulting in a cycle of relative economic decline for Scotland compared to the rest of the UK.

Is there a real danger that a negative feedback loop like this becomes established? There are a number of indications that the danger is indeed real.

First of all, it is instructive to look at the Treasury attitude when the original fiscal settlement was being negotiated. When, in 2015, just before the original settlement was finalised, I put it to a very senior Treasury official that Scotland did not have sufficient economic powers to make the proposed fiscal settlement work satisfactorily, and to enable it to keep up with the rest of the UK in the prospective economic race, he disagreed. What Scotland would need

to do, he said, was to cut taxes, so making itself an attractive location for high earners, thereby boosting the tax base and the economy. In other words, the Treasury view was that the new fiscal settlement would work for Scotland only if Scotland adopted a low tax, small state economic model. Whether such a neoliberal approach could have been made to work in the context of the other constraints imposed by the fiscal settlement is in itself highly doubtful – but that is not the current point. The relevant point for present purposes is that it was the view of the Westminster side in the original fiscal settlement negotiations that Scotland was unlikely to be able to keep up in its economic race with the rest of the UK unless it adopted low tax, small state fiscal policies which were the diametric opposite of the policies that the SNP Government intended to, and has, pursued.

Second, the increased tax revenues raised by the Scottish Government's devolved tax powers have already been eaten up by adverse BGA effects to a worrying extent. Research by the Scottish Parliament Information Centre (SPICe), published in 2021 indicates that over the first three years of income tax devolution, namely 2017/18 to 2019/20, the different income tax policy adopted by the Scottish Government generated an additional £900 million in revenue than if the income tax policy of the rest of UK had been implemented in Scotland. However, the net benefit to the Scottish budget over this period was much smaller, at £170 million, because of offsetting losses through the BGA mechanism. Weaker growth in Scottish income tax receipts per head compared with the rest of the UK meant that most of the extra revenue generated by the different income tax policy in Scotland was offset. (SPICe: "Income tax in Scotland: using the powers": August 2021.)

Third, looking ahead, the Scottish Fiscal Commission's (SFC) Fiscal Sustainability Report of March 2023 projects that the Scottish Government will face significant challenges in funding the provision of devolved public services in Scotland. The SFC report is based on current population projections, and on making assumptions about factors like productivity growth, so it does not allow for the kind of dynamic BGA feedback effects being postulated here. But what the SFC report does indicate is that, to maintain current levels of public services, and assuming the continuation of present tax policies, the Scottish Government would face an average fiscal gap of 10.1% of total spending each year over the next 50 years. Given the scale of this gap, the pressure for future Scottish Governments to keep increasing devolved taxes will be considerable, hence increasing the likelihood of falling into an adverse cycle. The implications for Scotland are particularly stark, because, other than its limited £1.75 billion resource borrowing limit, the Scottish Government is legally required to balance its budget each year. The resource borrowing limit will quickly be used up, and once this happens, the fiscal gap will have to impact immediately, and directly, on taxes or services, in a way which would not happen in a more mature government with realistic borrowing powers.

Overall, therefore, the Scottish Government will be under intense pressure to continue raising devolved taxes – while engaged in an economic race with the rest of the UK in which, in the Treasury's view in 2015, Scotland was only likely to win if it managed to reduce relative taxes. In these circumstances, the chances of a negative feedback loop becoming established are considerable. Note that I am not using the above scenario as an argument for cutting devolved taxes; the mistake is not with Scotland's desire to use higher taxes for socially beneficial purposes. The original sin, and one that has been repeated in the recently announced fiscal settlement review deal, is in Scotland having signed up to such a fiscal settlement deal in the first place.

HOW DID WE GET HERE?

Which raises the very good question; how did the Scottish Government, which turkey-like, voted for Christmas in the shape of the original 2016 fiscal settlement, manage to repeat the trick, and vote for Christmas again in the 2023 review? Not many turkeys get the chance to vote for Christmas twice: but the Scottish Government has managed it.

So how did this come about? At one level, of course, we don't know. Because the

independent report was plucked rabbit-like from the hat on 20th July, without any public consultation thereafter, we have no idea of what deals were done in the broader fiscal settlement negotiations, or what pressures the Treasury brought to bear. This is worse than unsatisfactory. An immediate requirement should be a full report from the Scottish and Westminster Governments on what factors were considered in the negotiations.

However, if we can assume that the independent report was indeed a foundation on which the final deal rested, then we can infer something about what is likely to have happened. In this case, it appears likely that the Treasury may well have been successful in repeating the same negotiating trick that worked for them in 2016. In 2016, the Treasury managed to focus attention on a very narrow interpretation of the principles laid out in the Smith Commission report on taxpayer fairness, and no detriment. Implicit in the negotiation was the idea that Scotland should bear most of the risks (or possible benefits) of relative under- or over-performance of the Scottish economy compared to the rest of the UK – with the possible exception of the consequences of Scotland’s long-running population decline compared to the rest of the UK. The debate then proceeded on whether it was more appropriate to use the Comparable Model (CM) indexation method for the BGA, which would not compensate Scotland for relative population decline: or the Indexed Per Capita, (IPC), method, which would compensate for relative population decline. Eventually, the Treasury ‘reluctantly’ conceded that the IPC method should be used: but reserved the position to revert to the CM model at the five-year review stage.

This is where the independent report goes badly wrong. It is worth quoting in full the following paragraph from page 23 of the independent report:

> “Strictly speaking the Smith Commission did not say that the Scottish budget should bear the risk of all divergence in tax revenue growth – it only explicitly said that the Scottish budget should bear responsibility for divergence in revenue growth that is the result of ‘policy decisions’. In practice, however, given the impossibility of identifying the causes of divergent revenue growth, it is inevitable that tax devolution has been designed to imply that the Scottish Government bears all risks associated with divergence in revenue growth once a tax has been devolved.” (Bell, Eiser and Phillips: “Analysing the options for Scotland’s block grant adjustments”: July 2023)

This is a highly significant conclusion for the independent report to have arrived at – and on the basis of little or no justification. If this principle is accepted, then it puts Scotland at significant risk relative to its position under the original Barnett Formula. To see why, it is worth looking at the UK as a monetary union – which, of course, it is. A standard feature of monetary unions is that the one-size-fits-all monetary policy implicit in a monetary union will not be optimal for all areas within the union at the same time. This means that fluctuations in relative economic performance between different parts of the union are a virtually inescapable feature. Because of the free movements of capital and labour which will also be typical in a monetary union, these variations in relative economic performance will often be accompanied by significant internal flows of capital and labour.

It is common within monetary unions to try to balance this tendency towards regional imbalance with some compensating mechanism – often in the form of countervailing transfers of public expenditure. Within the UK monetary union, there has not been any such mechanism in an explicit form: but it turned out, more or less by accident, that the Barnett Formula provided a partial compensatory mechanism as regards Scotland. The effect arose because of the way relative population movement interacts with the Barnett Formula. The algebra of the effect was set out in a paper of mine published in 2002 (“The effect of relative population growth on the Barnett squeeze”: Fraser of Allander Quarterly Economic Commentary, vol 27, no 4). Under ‘normal’ conditions, if the overall rate of growth of public expenditure is relatively high, and if relative rates of population growth are similar in Scotland and the rest of the UK, then the Barnett Formula will behave as originally expected, leading to convergence of per capita levels of public expenditure in Scotland and the

rest of the UK. However, if Scotland is relatively depressed, and this shows up in slower relative population growth: and if the overall rate of nominal public expenditure growth in the UK is not too high, then relative levels of public expenditure per capita in Scotland and the rest of the UK will not converge to equality, but to a limit which is somewhat higher in Scotland – perhaps significantly higher.

By accident, therefore, and imperfectly, the Barnett Formula meant that the UK monetary union did have some of the characteristics which would be expected in a properly functioning monetary union. By contrast, if the independent report principle that Scotland should bear all risks of relative under-performance in devolved tax receipts is accepted, then this means that the compensatory Barnett mechanism is greatly weakened. Acceptance of this principle, therefore, means that Scotland moves from being part of a fairly inefficient, but somewhat functioning monetary union, to being a member of a very inefficient and malfunctioning monetary union. The greater risks inherent in this latter position represent a clear detriment to Scotland; and any proper consideration of the wider implications of detriment under the Smith principals should have considered this effect.

We now have some inkling, perhaps, of how the review of the fiscal settlement led to its flawed conclusions. If the unjustified independent report conclusion that Scotland should bear all risks associated with relative tax underperformance is accepted, then that immediately focuses the debate back onto consideration of the limited range of options considered in the original fiscal settlement negotiations. This basically boils down to an argument as to whether Scotland should be penalised if its rate of growth in overall devolved tax receipts falls below that of the rest of the UK (which is what happens under the CM approach) or the slightly more generous position that Scotland should be penalised if its rate of growth in per capita devolved tax receipts falls below the rest of the UK (which is what happens under the IPC approach). Once this restricted area is conceded as the appropriate field for debate, the Treasury can again graciously concede continuation of the IPC approach: and the Scottish Government can claim what is a bad outcome as a negotiating success.

WHAT NEEDS TO BE DONE

This is a depressing state of affairs. What should be done? Four steps should now be taken:

1. The Scottish and Westminster Governments should explain why the fiscal settlement review was not conducted along the lines promised in the Kate Forbes letter. And they should release a full account of the negotiations leading to the 20th July agreement.

2. On a point of relative detail, but nevertheless important: the original Smith Commission recommendation that consideration should be given to a wider scheme of prudential borrowing in Scotland should be picked up again.

3. There should now be a wider debate about the extent of the detriment Scotland will incurr through the sub-optimal performance of the UK monetary union which is implied by the current fiscal settlement: and how this should be compensated for under a reasonable interpretation of the Smith principles.

4. And the fiscal settlement itself should be re-opened, as allowed for under the Joint Exchequer Committee arrangements.