Negotiations about the fiscal framework for the Scotland Bill are becoming high political drama

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The Scottish government has set a St Valentine's Day deadline for the end of negotiations over the fiscal framework for the Scotland Bill but the two sides are struggling to read a deal. In this article, ***Jim Gallagher*** *discusses the sticking points, and writes that the fiscal framework is of constitutional significance because it sets out what is shared across the nations of the UK, what is not, and potentially allows us to deduce why.*

Credit: William Warby CC BY 2.0

What might have been a technical negotiation about the fiscal framework for the Scotland Bill is becoming high political drama. The two governments are locked in negotiations, but seem unable to reach a deal. With the Scottish elections looming in May, the Scottish government has set a St Valentine's Day deadline for the end of negotiations. Otherwise they will not seek the Scottish Parliament's consent for the new powers in the Bill, and the edifice of further devolution negotiated in the Smith Commission will come crashing down.

In truth, this was never just a technical matter of how much should be taken away from the Barnett grant to account for new tax powers and how much added to account for new welfare responsibilities. That's the arithmetic, but there is more to it than just sums. The fiscal framework is of constitutional significance: it sets out what is shared across the nations of the UK, what is not, and perhaps lets us deduce why.

During the Scottish independence referendum campaign Scots were promised two things. First, they would retain Barnett. Promising to retain something which gives Scotland an exceptionally good deal in public spending was no surprise. Devolved public spending is about 20% higher than the UK average. But Scots were also promised a much more powerful Parliament, setting all income tax rates and bands, and assigned half of the yield of value-added tax, as well as running some other small taxes. It's not immediately obvious how both commitments can be met.

Arithmetically, the way to do it is to adjust the block grant calculated under Barnett down to take account of the new stream of tax revenue; and up to reflect the welfare responsibilities. That's quite easy to do in the very first year, but thereafter the changes need to be updated, and the question arises which risks fall to which government. Various methods have been suggested, and the outcomes analysed, notably by the Institute for Fiscal Studies and Stirling University. In a recent paper published by Nuffield College, I have been looking for guiding principles to decide which is right.

In fact, there is already one long-standing way of doing this. Council tax and non-domestic rates have been devolved since Holyrood was created. Barnett has always dealt with them, simply by leaving them out of account in the calculation. At the moment they fund local government expenditure, and so that is straightforward to do (though the Treasury did manage to get it wrong, to Scotland's lasting advantage, over non-domestic rates). This is scrupulously fair to taxpayers north and south of the border: devolved taxes only go to support spending in the place where they are raised, and if they yield more revenue, whether from economic growth or increase in tax rates, the excess also gets spent there. So if Scotland imposes a freeze on the council tax, it is only public services in Scotland which suffer.

It would be entirely possible to apply this principle to the new devolved taxes too. So if the rest of the UK cut income tax, but Scotland did not, there would be no effect on the Scottish budget. This has been described (not all that helpfully) as a "levels" approach to adjusting the block grant. A UK Treasury that wanted to be consistent, and absolutely fair to English taxpayers, would advocate this approach. Income tax would no longer be shared across the UK, as it was now devolved.

Surprisingly, however, one can make an argument that even though income tax is devolved some of it *should* still be shared across the UK. That is because Scotland starts out with a lower tax yield than the UK average. So to raise the same amount of money, it would have to increase tax rates more. Arguably that's unfair, and would represent something the Smith commission said shouldn't happen – "detriment" from the move to this new system. There is a way of avoiding this, which was agreed between the two governments for the partial devolution of income tax under the Scotland Act 2012. Each year the reduction to the Scottish block grant increases by the same percentage as the comparable taxes in the rest of the UK. It's described as "simple indexation". So if Scotland raises more tax than the rest of the UK – whether through economic growth or increasing tax rates – it will have more money to spend.

How is that fair to the rest of the UK? If Scotland were successful and became richer, the money would flow in the other direction. This is a form of tax equalisation, so that the less well off part of the country doesn't have to work harder just to deliver the same amount of public spending.

This is all assuming that the Barnett formula is used, as it has always been, to share out common UK taxes. It's the UK equivalent of a needs formula, something of a historical accident, which suits Scotland really very well, but which was promised during the referendum campaign. And on top of Barnett there is some equalisation so the inherited income tax shortfall doesn't disadvantage Scotland. That at least sounds like a constitutional principle.

It seems, however, that this time round the Scottish government are not satisfied with this. They want to be insulated not just from the effect of Scotland's inherited lower tax base, but against the risk that Scotland's population will in future grow more slowly than the rest of the UK's. This is what has happeed in recent years, and is one of the reasons why under Barnett Scottish public expenditure has remained so relatively high. The SNP seem to be arguing that since Barnett has this effect, it would be "detriment" for the new tax arrangements not to do so. So instead of simple indexation there would be per capita indexation.

Simple indexation transfers some rUK devolved tax income to equalise the tax base. Per capita indexation would draft in some rUK taxpayers as well, so that some of their income tax supplemented Scottish income tax if there was a relative population decline. But the public spending demanded by those taxpayers would fall to the rest of the UK. It's hard to see how that could be explained to sceptical English voters. It's one thing to share out common UK taxes in this way, but another to apply it to devolved taxes. When tax is devolved the Scottish government takes the risk that it will yield more or less – from tax rates, and economic change, which includes more or less taxpayers.

The Kremlinologists who study St Andrews house are divided about what's going on. Some think this is merely the cautious John Swinney holding out for the best deal he can get, using the leverage of the Scotland Bill while he can. Others think something more Machiavellian is going on. Elections are coming up, and the SNP has to decide whether to promise another independence referendum in its manifesto. The signs are it won't. But then it faces a whole term of government with no constitutional agenda at all: just governing, with the new tax powers under the Bill. Momentum towards independence might seem to stall. Better, maybe, to reject the powers for now. Westminster can always be blamed for selling Scotland short on the fiscal framework, and the next Parliament spent demanding a better deal, without having to take the fiscal responsibilities. Politics one, economics nil.

We will know in the next week or so which interpretation is the right one.

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For more detail on The Scotland Bill's fiscal framework, read Jim Gallagher's Gwilym Gibbon Centre Working Paper here.

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