fiscal powers

reform scotland

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About Reform Scotland

Reform Scotland is an independent, non-party think tank that aims to set out a better way to deliver increased economic prosperity and more effective public services based on the traditional Scottish principles of limited government, diversity and personal responsibility.

About the authors

Ben Thomson is the Chairman and Geoff Mawdsley is the Director of Reform Scotland.

Reform Scotland engaged the expertise of Graeme Blackett, an economist, and James Aitken, a lawyer, in helping to shape a workable scheme which would make the Scottish Parliament more financially accountable within the context of the United Kingdom.

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Executive summary

Objective

Reform Scotland's first report 'Powers for Growth' recommended that the Scottish Parliament should be given greater responsibility for raising its own revenues. This was because these greater financial powers could be used to achieve the other policies recommended by the report, namely a lower overall tax burden and a significant reduction in the proportion of public spending as a share of GDP. If used in this way, greater fiscal responsibility would provide Scotland with a platform for higher economic growth and so help the economy in Scotland to match the performance of the best performing world economies.

This study examines and assesses the current financial relationship between Westminster and Holyrood. It looks at which taxes are devolved and how much is raised and spent at the Scottish and UK levels as well as the problems associated with the current system. It then suggests how the Scottish Parliament could be made more financially accountable within the context of the United Kingdom and assuming, as a starting point, that there is no other change to the respective functions of Westminster and Holyrood. At the same time, it provides a few examples of ways in which the additional financial powers of the Scottish Parliament could be used to stimulate economic growth and drive social policies.

Findings

- The Scottish Parliament is currently responsible for spending in Scotland of around £28 billion, while a further £19 billion approximately is spent in Scotland by the UK Government (both of these figures exclude accounting adjustments). The taxation powers of the Scottish Parliament are limited by the Scotland Act to control over local authority taxes (currently council tax and business rates) and the ability to raise or lower the basic rate of income tax in Scotland by up to 3p in the pound, although the Scottish Parliament does have the power to introduce new taxes in devolved areas, such as a plastic bag tax. The power to vary income tax has never been used and the vast bulk of the Scottish Parliament's revenue comes in the form of a block grant from Westminster largely determined by the application of the so-called 'Barnett Formula' – a population-based formula which gives Scotland a share of any increases in corresponding departmental budgets in England. As a result, the Scottish Parliament currently has control over taxes which raise only 13 per cent of the money spent at a Scottish level.

- As was pointed out in Reform Scotland's paper, 'Local Power,' councils in Scotland currently have total discretion over only 9 per cent of their tax income stream (and 19 per cent of their own revenue when sales, fees and charges are taken into account) – one of the lowest levels in Europe. This was identified as the fundamental weakness of the local government finance system in Scotland as it undermines councils' autonomy and accountability. The same concerns apply to the Scottish Parliament which, arguably, has even less control over raising its own income than local councils in Scotland.
- The current financial relationship is unpopular on both sides of the border. In England, it is believed by many to give Scotland more than its fair share of funding, particularly in comparison to regions in the north of England, whereas many in Scotland would argue that North Sea oil revenue makes Scotland a net contributor to the UK budget. In addition, the Scottish Parliament's almost total reliance on the block grant is seen as limiting its accountability. Furthermore, it provides no incentive for politicians in Scotland to come up with innovative ideas to boost economic growth or improve public services as however poorly the economy performs the money still rolls in via the block grant. If the economy did grow faster the benefits would accrue to the Chancellor at Westminster and not the Scottish Government.
- The devolution settlement in the UK is unusual in that although the Scottish Parliament and Welsh and Northern Irish Assemblies have varying degrees of autonomy, no power is devolved to a body representing only England. This contrasts with other countries where power has been decentralised. Whether unitary or federal states, the common feature is that power is divided between the centre and authorities which represent the interests of all the different geographical areas of a country. There is evidence that such an approach is practical and that greater fiscal powers can help the constituent parts of a country to improve their economic performance.

Policy Recommendations

Greater financial accountability: We would recommend that, as a principle, all levels of government in Scotland – UK, Scottish and local – should have the power to raise the bulk of the money which they are responsible for spending. This is important because it would increase the autonomy of these institutions and enable them to pursue policies which they believe to be in the interests of people living under their jurisdiction. It would make the different tiers of government accountable to their electorates for the financial decisions they take – the overall levels of taxation and spending as well as how revenue was raised and on what it was spent.

UK-wide solution: We would recommend a new financial settlement, set out in legislation, for the whole of the United Kingdom. This would set out which taxes were UK taxes and what they were funding. These functions would correspond to those set out in Schedule 5 of the Scotland Act which details the powers reserved to Westminster. All remaining functions would be devolved. How these devolved functions were funded would vary in different parts of the UK, as is the case in Spain. For example, in Scotland the block grant from Westminster largely determined by the application of the so-called 'Barnett Formula' would be replaced by a system in which devolved functions were funded by taxes set and raised in Scotland. The other parts of the UK could go down this route if they wished. However, in the short term they might like to stick to a system in which non-UK taxes were pooled at the centre and then redistributed to the Welsh and Northern Irish assemblies and a body representing England. This could be done on the basis of assigned revenues reflecting the amounts raised in the different parts of the UK, topped up using a needs-based funding formula as happens in Spain. The system would be flexible enough to allow England and Wales to pool their resources in areas such as justice if they so wished. This would entail the establishment of a body to represent English interests. The lack of such a body has unbalanced the constitution and made it impossible to disentangle spending on functions reserved to the UK Government from those which are devolved. The exact form of such a body would be a matter for people in England. However, it could be achieved by simply changing the way Westminster works, thus avoiding the establishment of a separate Parliament with separate elections.

Scottish financial settlement: We would recommend that the Scottish Parliament and the UK Parliament would become responsible for raising the money they spend, currently approximately £28 billion and £19 billion respectively. Both levels of government should have the flexibility to set a range of taxes in order to cover their spending, with an agreed starting point which enabled them to cover their existing share of spending in Scotland. There are a number of ways of achieving this based on the most recent figures. However, our preferred option would give the UK Government control over all National Insurance contributions; 40 per cent of Income Tax revenues from Scotland; 40 per cent of Scotland's geographical share of North Sea oil revenues; together with additional income from TV licences, passport fees and the National Lottery tax. The Scottish Government would set the rates for all other taxes, except for VAT which would be set at a UK level with 40 per cent of the revenue from Scotland going to Westminster and the remainder assigned to the Scottish Parliament. Crucially, this new financial relationship must be flexible enough to meet any future contingencies or take account of any further devolution of power. For this reason, both the Scottish and UK Governments would be able to change existing taxes or levy new ones they needed to meet their spending commitments. However, they would have to justify such changes to the electorate. This rebalancing of the financial arrangements underpinning devolution would ensure greater financial accountability at both levels of government, is based on the experience of what other countries have found to be practical and is fair to all the constituent parts of the UK.

Scottish Exchequer: We would recommend that the remit of the Scottish Government's Finance Department is increased to include most of the powers and responsibilities presently held by HM Treasury and HM Revenue & Customs. The greater fiscal powers of the Scottish Parliament would make this necessary. This new body would be responsible for collecting the revenue from all taxes levied in Scotland on behalf of the UK and Scottish Governments unless specifically reserved to Westminster.

Lower, simpler taxes: We would recommend that the overall burden of taxation in Scotland is lowered and that the whole system is simplified. Our first paper, 'Powers for Growth', set out the correlation between a lower overall tax burden and faster economic growth. Greater financial accountability would provide the scope to create a fiscal framework in Scotland that is conducive to economic growth. It would also provide the opportunity to look at how taxes could be simplified and made more efficient.

Conclusion

The fundamental defect of the current devolution settlement is its lack of financial accountability. One way to remedy that as far as Scotland is concerned would be outright independence. However, this paper looks at the question of how this goal might be achieved within the United Kingdom.

Within the context of the United Kingdom, Scotland cannot achieve greater financial accountability by acting unilaterally. It requires the UK Government to put in place new financial arrangements which are fair to the governments of both Scotland and the UK. That requires us to address the position in England, as it is the lack of a body to represent English interests that is the Achilles' Heel of the current devolution settlement. Such a body would enable a clear and transparent system, which sets out clearly the responsibilities of the different levels of government, to be put in place. This is the best way to achieve greater financial accountability in both Scotland and the United Kingdom.

1. The current devolution settlement

1.1 Introduction

Since 1997, the United Kingdom has undergone a process of asymmetric devolution which has seen varying powers handed over to new bodies in Scotland, Wales and Northern Ireland. Only the constitutional settlement in England has remained unchanged during this period with power continuing to reside at Westminster.

This section examines the devolution settlement in Scotland, Wales and Northern Ireland, outlining the different powers devolved to each constituent part.

1.2 UK and Scottish powers

The constitutional relationship between the Scottish Parliament and Westminster is governed by the Scotland Act 1998. This sets out the powers of both the Scottish Parliament and Scottish Ministers.

The Scottish Parliament may legislate in any area that is not 'reserved' to Westminster and the same principle applies to the executive powers of Scottish Ministers. In other words, anything that is not reserved is effectively devolved. The specific powers reserved to Westminster are set out in Schedule 5 of the Scotland Act. However, the following is a summary of the reserved areas:

- Defence and National Security
- Constitution
- Foreign Affairs
- Fiscal, Economic and Monetary System
- Social Protection
- Broadcasting
- Trade & Industry, including competition and customer protection
- Immigration & Nationality

- Civil Service
- Medical Ethics: abortion; human fertilisation & embryology; genetics; xenotransplantation and vivisection
- Energy: electricity, coal, gas, oil, nuclear energy
- Employment
- Equal Opportunities

The devolved areas of policy are those which do not either come into the reserved categories or fall outside the legislative competence of the Scottish Parliament for other reasons (for example, if they have effect outside Scotland or are incompatible with Human Rights or EU Law). They include:

- Health
- Education & Training
- Local Government
- Housing
- Planning
- Law & Home affairs including most aspects of civil and criminal law, the prosecution system and the courts
- Police and Fire Services
- Environment
- Tourism, Economic Development and Financial Assistance to Industry
- Scottish aspects of Transport in relation to the road network, bus policy, ports, harbours and railways
- Natural & Built Heritage
- Agriculture, Fisheries and Forestry
- Sport and the Arts
- Statistics, Public Registers and Records

Although the UK Parliament technically retains the power to legislate for Scotland on all matters, it does not normally legislate on devolved matters without the consent of the Scottish Parliament. This involves the passing of a Legislative Consent Motion by the Scottish Parliament which allows Westminster to pass legislation in a devolved area.

The Scotland Act allows for powers to be transferred from the UK Parliament and Government to the Scottish Parliament and Ministers. Under Section 63 of the Act, responsibilities can be transferred from UK Government Ministers to Scottish Ministers. This does not transfer legislative competence to the Scottish Parliament, however Scottish Ministers can be held to account by MSPs at Holyrood for the way in which they use such powers.

Section 30(2) of the Scotland Act allows for Schedules 4 and 5 of the Act to be amended to transfer legislative competence over previously reserved areas to the Scottish Parliament. Since the Scottish Parliament was established such changes have been rare, although an order was made under Section 30(2) of the Scotland Act to extend the Scottish Parliament's competence over railways.

Financial arrangements

The money to fund the functions of the Scottish Parliament and Ministers currently comes, in large part, via a block grant from HM Treasury. This block grant comes from money raised through UK taxes which apply equally right across the United Kingdom and the revenue from which is collected centrally by HM Revenue & Customs on behalf of HM Treasury. The rates at which taxes are set are laid out by the Government in its Finance Bills and approved by a vote in the UK Parliament.

HM Treasury then allocates money to the relevant spending departments and determines the level of the block grants to the devolved administrations in Scotland, Wales and Northern Ireland. The initial level of the block grants to Scotland, Wales and Northern Ireland is calculated using rules applied to other spending departments, typically a percentage increase on spending in the previous year.

To finalise the block grant for Scotland, the so-called 'Barnett Formula' is then applied. This looks at changes to spending in English programmes that are comparable to the spending areas covered by the Scottish block grant. Scotland will then receive a fixed proportion of any increase in spending on comparable programmes in England based on its population. Thus Scotland receives around 10 per cent of any spending increase in comparable areas in England. The application of the 'Barnett Formula', therefore, determines the overall size of the block grant. However, the devolved administration in Scotland is free to spend that money as it wishes.

The bulk of spending under the control of the Scottish Parliament and Ministers in devolved areas has been determined by historical decisions about what the level of funding in Scotland should be. Many of these decisions were taken before the 'Barnett Formula' was introduced in 1978. It is important to note that the 'Barnett Formula' only determines the amount of additional changes to spending in Scotland and that because it is population-based it does not directly reflect need. It also has no statutory basis.

The Scottish Parliament and Ministers have no borrowing powers, although under sections 66 and 67 of the Scotland Act the Secretary of State for Scotland does have emergency powers to let the Scottish Government borrow. This means that, in addition to the money the Scottish Government receives in the form of the block grant, their only other sources of revenue are the limited powers of taxation derived from the Scotland Act. For example, all local authority taxes (currently council tax and business rates) are controlled by the Scottish Parliament and it can introduce new taxes in devolved areas. The Scottish Parliament also has the power to raise or lower the basic rate of income tax in Scotland by up to 3p in the pound. If the power to vary income tax was ever used, the resources available to the Scottish Parliament would be adjusted upwards or downwards by the appropriate amount.

1.3 Wales

Welsh devolution started from a very different base than in Scotland. While there had been growing support for devolution in Scotland since the mid-nineties, support for devolution in Wales was never so strong; indeed the referendum on the introduction of a National Assembly for Wales was passed by a very slim margin of 50.3% in favour to 49.7% against. There was no vote on granting tax varying powers to the Assembly and the Assembly has never had that power.

Initially power in Wales was limited to secondary legislative powers with no neat split, as in Scotland, between those powers reserved to Westminster and powers that are devolved. In 2006, the Government of Wales Act enabled the Welsh Assembly Government to bring forward its own programme of legislation covering areas such as health, education, social services and local government. These are a new category of Welsh laws called Assembly Measures. However, before making Measures in relation to a particular area of devolved government, the National Assembly for Wales has needed to obtain 'legislative competence' on a case-by-case basis from the UK Parliament.

The first elections to the National Assembly for Wales were held in 1999 to elect 60 Assembly Members (AMs) – 40 elected first-past-the-post with an additional 20 through the additional member system. This means that a higher proportion of politicians are elected first-past-the-post in Wales than they are in Scotland. In each of the elections held in 1999, 2003 and 2007 Labour has remained the largest party and is currently in coalition with Plaid Cymru, whose support comes on the condition of a referendum on granting further power to the Welsh Assembly.

Enthusiasm for devolution in Wales has grown since the early days – in 1997, 36% of the population were against any form of devolution in Wales, by 2008 this had more than halved to 15%. Indeed, there is a growing level of support within Wales for the Assembly to have greater power – in 1997, only 18% favoured a Welsh Parliament, by 2008 this had reached 39%.[1]

The Welsh Assembly is funded mainly from the Welsh Consolidated Fund. The Fund was established under the Government of Wales Act 2006. Amounts are paid out of the Fund to Welsh Ministers, the First Minister and the Counsel General (the Welsh Assembly Government), based on a Budget Motion. Other payments are made separately out of the Fund to the Assembly Commission, the Auditor General for Wales and the Public Services Ombudsman for Wales.

The budget is fixed for three years and a Whitehall Spending Review takes place every two years, which makes adjustments to it. Any adjustments that are made to the budget are carried out according to the Barnett Formula.[2]

1 National Assembly for Wales, "Public attitudes 2008", October 2008

2 How is the Welsh Assembly funded?: http://new.wales.gov.uk/funding/howassemblyfunded/?lang=en

1.4 Northern Ireland

Devolution in Northern Ireland is completely different from both Scotland and Wales mainly as its establishment was so tied up with the Northern Ireland peace process which began in the 1990s. The new Northern Ireland Assembly was established as part of the Belfast Agreement in 1998. The Assembly is also unique in that it has been suspended periodically since powers were transferred to Stormont in 1999.

The Northern Ireland Assembly consists of 108 elected Members – six from each of the 18 Westminster constituencies. Its role is primarily to scrutinise and make decisions on the issues dealt with by Northern Ireland Government Departments and to consider and make legislation.

As with Scotland, the Northern Ireland Assembly is responsible for all non-reserved matters as set out in Schedule 3 of the Northern Ireland Act 1998.

However the running of the Assembly, including the appointments of First and Deputy First Ministers, is tied up in a power sharing deal where there must be cross-community support.

Funding settlements in Northern Ireland are similar to those in Scotland and Wales and are based on the application of the Barnett Formula.

2. Expenditure and revenue in devolved Scotland

2.1 Introduction

The Scottish Government produces estimates of revenue generated from taxation and government expenditure in Scotland on an annual basis in a publication known as GERS[3] with the latest estimates (for the year 2006/07) produced in June 2008. Each year, these figures generate debate on whether Scotland is in surplus or deficit with the UK. GERS for 2006/07 showed that current revenue gathered in Scotland for 2006/07 was £49.915 billion (including a geographic share of North Sea revenue) while total public expenditure for Scotland was £49.895 billion. These are the latest figures publicly available, although early indications suggest that in 2007/08 expenditure in Scotland might exceed revenue while in 2008/09 revenue might exceed expenditure (not least due to historically high oil prices).

Government expenditure in Scotland and on behalf of Scotland is incurred by the UK Government, the Scottish Government and by local government. The GERS figures tell us about expenditure and revenue in Scotland under the current constitutional circumstances. They tell us little about the position Scotland would be in if greater fiscal powers were to be devolved to Holyrood or about independence since government expenditure and revenue in these circumstances would depend on the policies of the Scottish Government and the impact of these policies on economic performance and, therefore, revenues generated. However, they do provide a useful starting point for considering the possible models for greater fiscal powers.

3 Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008

2.2 Expenditure

Almost two-thirds of public spending in Scotland is accounted for by the three largest categories: social protection (£16.2 billion, 32% of all spending); health (£9.1 billion, 18%) and education (£6.9 billion, 14%). Three-quarters of social protection spending is by the UK Government (mainly pensions and social security payments) while health and education spending is devolved to Holyrood (and spent by the Scottish Government and, in the case of education, local government).

A further 20% of public spending in Scotland is accounted for by defence (£2.7 billion), transport (£2.6 billion), public sector debt interest (£2.4 billion) and public order and safety (£2.3 billion). The UK Government spent approximately £20 billion in and on behalf of Scotland in 2006/07, 60% of which was on social protection, 13% on defence and 12% on public sector debt interest (Figure 1).

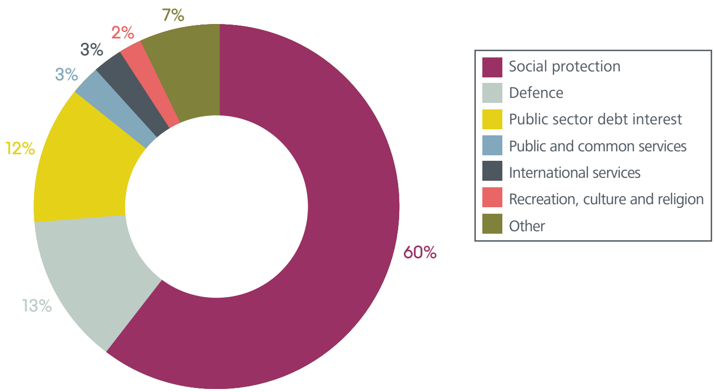
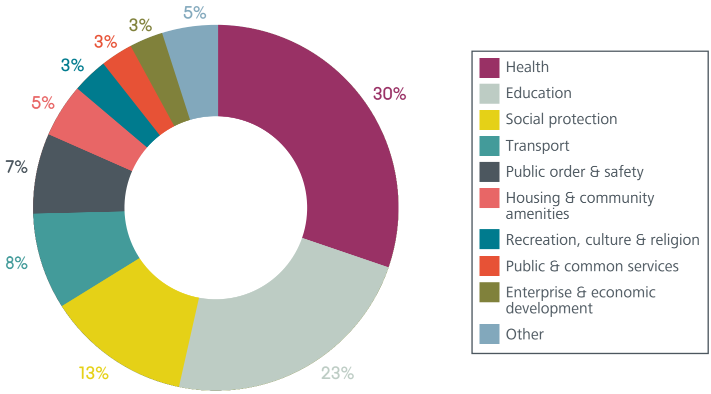


Figure 1: UK Government expenditure in and for Scotland (£m), 2006/07

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008

The Scottish Government spent approximately £30 billion in 2006/07, 30% of which was on health, 23% on education and 13% on social protection (Figure 2).

Figure 2: Scottish Government expenditure (£m), 2006/07



Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008

The expenditure included in the above figures includes accounting adjustments. Excluding these accounting adjustments gives a total government spend in Scotland of £47.2 billion in 2006/07, of which £18.9 billion was by the Westminster Government and £28.3 billion devolved to Holyrood (Table 1).

Table 1: Expenditure by UK and Scottish Government in/for Scotland, 2006/07 (£m)

	£m	%
Scottish Government	28,277	60%
UK Government	18,945	40%
Total	47,222	100%

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Accounting Adjustments of £2,673 million)

2.3 Revenue generated

There are more than 30 sources of taxation revenue collected in Scotland – a full list is included in the Appendix. Of these, nine raised more than £1 billion in Scotland in 2006/07 and a further 11 raised more than £100 million. In the same way as accounting adjustments were excluded from the expenditure totals above, gross operating surpluses have been excluded from these revenue totals.

The tax that generated the greatest revenue in 2006/07 was income tax at £10.3 billion, 22% of taxation revenue generated (Table 2). Other important sources of revenue were oil revenues[4] (£7.6 billion, 16%), national insurance (£7.5 billion, 16%), VAT (£7.5 billion, 16%), corporation tax (£3.0 billion, 6%) and fuel and excise duties (£2.4 billion, 5%).

Table 2: Taxation revenue from Scotland, 2006/07 (£m)

	£m	%
Income Tax	10,338	22%
Oil Revenues (Scottish Geographic share)	7,563	16%
National Insurance	7,465	16%
VAT	7,449	16%
Corporation Tax	3,019	6%
Fuel Duty & Vehicle Excise	2,358	5%
Council Tax	1,833	4%
Non Domestic Rates	1,812	4%
Alcohol & Tobacco Duties	1,749	4%
Stamp Duties	686	1%
Capital Gains	308	1%
Other	2,582	5%
Total	47,163	100%

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

Of these taxes, Council Tax and Non Domestic Rates are devolved to Scotland, a total of £3.6 billion in 2006/07 or 8% of all taxation revenue generated from Scotland. The other 92%, some £43.5 billion, is collected by the taxation powers reserved to Westminster (Table 3).

4 The oil revenues included are the estimated Scottish geographical share of UK Government revenues from royalties and licence fees, North Sea corporation tax and petroleum revenue tax. The geographic share estimates are based on detailed analysis by Kemp and Stephen (The Hypothetical Scottish Shares of Revenues and Expenditures from the UK Continental Shelf 2000-2013, Professor Alex Kemp and Linda Stephen, University of Aberdeen, 2008). In 2006/07 the Scottish geographical share represented 83.3% of total UK revenues.

Table 3: Taxation revenue from Scotland, reserved & devolved, 2006/07 (£m)

	£m	%
Reserved to Westminster	43,515	92%
Devolved to Scotland	3,645	8%
Total	47,163	100%

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

2.4 Expenditure and revenue at different levels of government

The current devolution settlement is unbalanced in that the Scottish Government has control over 60% of government expenditure in Scotland but very limited responsibility for raising the revenue required to meet those expenditure commitments, other than the local taxes collected by local government. As shown in Table 4, revenue generated by taxation powers devolved to Scotland accounts for only 13% of the expenditure that is devolved to Scotland.

Table 4: Expenditure and taxation revenue by level of government, 2006/07 (£m)

	Expenditure (£m)	Revenue (£m)	Revenue as % of Expenditure
UK Government	18,945	43,515	230%
Scottish Government	28,277	3,645	13%

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Accounting Adjustments of £2,673 million)

2.5 Problems with the current arrangements

The current financial arrangements underpinning the devolution settlement have attracted criticism on both sides of the border.

A poll, reported in The Herald newspaper in April 2008, found that the number of people in England who thought that 'Scotland gets more than its fair share of public spending' had increased from 20% eight years previously to 33%. This is in line with earlier polling by YouGov in January 2007, which found that 34% of the English adults consulted thought that 'Scottish people get more than their fair share of public money at the expense of English taxpayers'.

A survey published by the Sunday Times and conducted by YouGov in April 2007 asked a sample of adults throughout Britain the question 'Some people have claimed that English taxpayers are subsidising Scotland, Wales and Northern Ireland. Do you think this is true or false?' 59% thought it was true.

A YouGov poll conducted for the Daily Telegraph in Scotland in April 2007 showed the other side of the coin. When asked 'Which of these statements comes closer to your view?' 48% said 'The tax revenues from North Sea Oil belong to Scotland; when these are taken into account, Scotland subsidises the rest of the UK' and only 23% that 'At the moment, Scotland's public spending is subsidised by English taxpayers'.

This polling data sums up the problem as opinions divide depending on whether people live in Scotland or England. People in England tend to believe that the Scottish Parliament cannot meet its own spending commitments from revenues raised in Scotland and that English taxpayers are funding expensive commitments such as free personal care and free prescriptions. The resentment is exacerbated because these benefits are not available to people in England.

Equally, many people in Scotland believe that, as the oil revenue is almost all Scottish, it is people in England who are subsidised.

This confusion has arisen precisely because there is a lack of financial accountability within the system. The Scottish Parliament and Government have total discretion over their spending decisions, but very limited power to raise the necessary revenue themselves.

The budget of the Scottish Parliament is currently around £28 billion. Yet, the Scottish Parliament currently has control over taxes which raise only 13 per cent of the money spent at the Scottish and local level. These taxes are the local taxes i.e. council tax and business rates, and although the Scottish Parliament does set the business rate poundage for the whole of Scotland, council tax levels are a matter for local authorities. As has been shown recently though, the Scottish Government can exert influence over council tax levels as it has done in its negotiations to engineer a freeze in levels for this year.

It is, therefore, arguable that the Scottish Government has control over raising even less of its own revenue than councils in Scotland. This fundamentally undermines the autonomy and accountability of the Scottish Government and Parliament. The lack of borrowing powers makes this worse as it limits the Scottish Government's room for manoeuvre and makes it harder to pay for important infrastructure projects.

The Holyrood budget is determined neither by an assessment of need in Scotland nor by an assessment of what the Scottish electorate may be able and willing to contribute to the state in terms of taxation. Rather the budget is largely determined by a formula that is based on the decisions taken about the level of public spending in the rest of the UK.

There is also no direct relationship between the money received by the Scottish Government and the performance of the Scottish economy. Even if tax revenues to HM Treasury from Scotland go down, the money will still roll in via the block grant. This provides no incentive to boost economic growth in order to increase revenues as even if the economy did grow faster the benefits would accrue to the Chancellor at Westminster and not the Scottish Government.

So if the Westminster Government decides to increase or reduce the level of public spending in the rest of the UK, it is automatically increased or reduced in Scotland, whether or not the Holyrood Government and Parliament agree and whether or not there is an economic or social case for such a policy in Scotland.

The debate during elections to Holyrood and in the Scottish Parliament is, therefore, dominated by discussions about how to divide the cake rather than by the size of the cake itself. There is a temptation for political parties to attempt to outbid each other in terms of spending promises while knowing the responsibility for raising the taxation revenue required lies elsewhere.

The lack of tax and fiscal powers at Holyrood also limits the ability of the Scottish Parliament and Scottish Government to act in important ways:

1. There are some limits on the powers that are already devolved. For example, while health is devolved, Holyrood has limited power to introduce fiscal measures in pursuit of health policies. This has recently been highlighted by the debate on alcohol pricing within the Scottish Government. Similarly, while the environment is a devolved area, environmental taxes (such as landfill tax) and other fiscal measures (such as the renewables obligation regime) are powers reserved to Westminster.
2. The lack of fiscal powers limits the Scottish Government's ability to respond to changing circumstances such as those caused by the "credit crunch". With no borrowing powers and the total budget for Holyrood determined at Westminster, there is little that can be done by the Scottish Government to provide a stimulus to the economy such as cutting taxes or increasing public sector spending or bringing forward public sector investment.

3. The situation in Spain

3.1 Introduction

Historically in Spain there was a degree of devolution of powers from the centre to the different regions, particularly in the Basque Country, Navarre and Catalonia prior to the start of General Franco's rule. During Franco's time, devolution arrangements only remained in Navarre as the region was a supporter of the dictator. However, following his death in 1975 and the introduction of the new Spanish constitution in 1978, Spain has been transformed from one of the most centralised countries in the world to one of the most decentralised.

It is useful to examine the situation in Spain as part of a discussion on the United Kingdom because, as in the UK, the process of decentralisation has been asymmetric with different parts of Spain being granted different powers and at different rates. While the UK has seen different powers devolved to three of its four composite countries, Spain has seen greater devolution, and at a faster speed, within two of its 17 autonomous communities.

Every part of Spain is covered by a representative body or Autonomous Community as they are called. This is not the case in the UK as there is no body to represent England. However, Spain has engaged in asymmetric devolution of powers which has led to the Basque Country and Navarre having different fiscal powers to the other autonomous communities. The exact powers granted to the Basque Country and Navarre do not match our recommendations as to which powers are passed to Scotland vis-a-vis the rest of the UK. However, the brief explanation of the situation in Spain does set out an example of how devolution of power on an unequal basis could also be organised within the UK.

3.2 Spanish devolution

Although Spain has many of the features of a federal state, it continues to be formally identified as a unitary country. The country of 40.5 million people is split into 17 autonomous communities. Between 1978 and 2003, reforms led to the principle that all responsibilities not expressly reserved to central government by the Spanish Constitution were delegated to the autonomous communities. The following are the main responsibilities at the regional and central government levels (other responsibilities are devolved to local government):[5]

Central Government	Autonomous Communities
Defence	Education
International representation	Health
Justice	Agriculture
National police	Industry, energy & mines
Regulation & economic planning	Environment
Financial system regulation	Tourism & domestic trade
Customs	Social Services
Income & wealth distribution	Historical & artistic patrimonial protection and own region's language protection
Social security	Housing and territorial arrangement
National infrastructure	Regional infrastructure

Membership of the Euro has meant that some monetary policy decisions are taken outside Spain; however, the Spanish constitution established two forms of financing autonomous communities – the common regime and the charter regime.

5 Shah, A. "A global dialogue on federalism: volume 4", Program of the Forum of Federations and the International Association of Centres for Federal Studies, 2007.

3.3 Charter regime – areas with greater fiscal powers

The charter regime applies only to the Basque Country and Navarre which have complete responsibility for "agreed taxes" and pay a subsidy to the central government for public services provided by the centre. This is agreed through a complex formula which is renewed every five years. The only taxes which are outside the list of agreed taxes are import duties and payroll taxes for social security. The finance departments in these areas have full control over all direct taxes as well as administrative responsibilities for indirect taxes. They don't have regulatory powers for indirect taxes mainly due to EU restrictions covering harmonisation of those taxes. The two regions have used their powers to reduce tax burdens within their borders, including lowering corporate income tax, making them more attractive places fiscally than other areas in Spain. However, it is important to note that the two areas which have the greatest financial powers are also among the wealthiest areas of Spain.

3.4 Common regime

The common regime applies to the other 15 autonomous communities. Initially, in the late seventies and eighties the common regime was based on lump-sum general grants from central government to the autonomous communities calculated to cover the expenditure needs arising from devolved responsibilities. Under this scheme the autonomous communities were entirely reliant on grants, similar to the situation in which the devolved administrations in Scotland, Wales and Northern Ireland find themselves today. This scheme was replaced in the 1980s by introducing assigned revenues from a set of devolved taxes to the regions along with an equalisation transfer.

Reforms beginning in 1997 led to varying degrees of discretion being passed to the regional governments giving them a degree of autonomy over some devolved taxes, including setting tax rates and establishing tax credits and allowances. The reforms also gave the power to create discretionary taxes, for example on betting. However, the law prohibits regional governments from using the same tax bases or types of taxes already assigned or used by central and local governments which means that in reality there are relatively few new taxes they can create. Despite the fact that both central and regional governments can control elements of tax, taxpayers only need to fill out one tax return which incorporates both regional and central taxes through a central collection agency.

In 2004, the autonomous communities' own revenues, including revenues from ceded taxes and those from regional taxes, amounted to 34% of revenue within the 15 regional areas. Shared taxes represented 21%, equalisation grants 24% and conditional grants 21%.[6] The equalisation grant is a formula based on the fiscal gap between the expenditure needs and fiscal capacity of a region. For richer regions, such as Madrid, the grant is negative and an amount is taken from the autonomous community and given to the centre.

Income tax under the common regime

The situation regarding income tax within the 15 autonomous communities operating under the common regime is of particular note. The law splits personal income tax into a central government schedule (67%) and a regional government schedule (33%), which is then allocated to the relevant level of government. Autonomous communities have the ability to vary the rate or establish their own tax credits which only affect their 33% of the tax. However, the definition of taxable income is the same for both regional and central governments.

3.5 Summary of tax powers[7]

The following table provides a summary of how the fiscal regimes work in Spain and what powers each gives to the different groups of autonomous communities.

6 Shah, A. "A global dialogue on federalism: volume 4", Program of the Forum of Federations and the International Association of Centres for Federal Studies, 2007.

7 Shah, A. "A global dialogue on federalism: volume 4", Program of the Forum of Federations and the International Association of Centres for Federal Studies, 2007.

Table 5: Current revenue assignments to regional governments (2004)

	Sharing of collections (%)		Administered by regional governments		Discretion by regional governments	
Tax	Common Regime	Charter Regime	Common Regime	Charter Regime	Common Regime	Charter Regime
Personal income tax	33	100	No	Yes	Tax schedule & tax credits	Full
Tax on net wealth	100	100	Yes	Yes	Threshold, tax schedule & tax credits	Full
Inheritance & gift tax	100	100	Yes	Yes	Allowances, tax schedule, tax credits, administration & collection	Full
Corporate income tax	-	100	-	Yes	-	Full
Non-resident income tax	-	100	-	Yes	-	Full for permanent establishments
Capital transfer tax, taxes on the raising of capital & stamp duties	100	100	Yes	Yes	Tax rates, tax credits, administration & collection	Full with some exceptions
Gaming taxes	100	100	Yes	Yes	Allowances, taxable base, tax rates, administration, collection and inspection	Full with some exceptions
Vehicle excise	100	100	Yes	Yes	Tax rates	Tax rates, declaration & payment forms and payment periods
Hydrocarbon, retail sales tax	100	100	Yes	Yes	Tax rates, administration, collection & inspection.	Tax rates, declaration & payment forms and payment periods
VAT	35	100	No	Yes	No	Tax declaration and payment forms & payment methods.
Excise duties (alcohol, tobacco and petrol)	40	100	No	Yes	No	Tax declaration and payment forms & payment methods.
Electricity tax	100	100	No	Yes	No	Tax declaration and payment forms & payment methods.
Tax on insurance premiums	-	100	-	Yes	-	Tax declaration and payment forms & payment methods.

3.6 Lessons for the UK

The proposals being put forward in this report by Reform Scotland do not suggest that the UK follows what has happened in Spain to the letter. However, the experience of Spain shows that it is perfectly possible for different parts of the country to exert differing levels of control and responsibility over fiscal arrangements. Equally, the notion of splitting income tax into a devolved and central element can be done and happens in many other countries as well as Spain.

4. A new model for Scotland

4.1 Possible models

There are a number of possible models for fiscal and tax powers including:

- The status quo, with only local taxation powers devolved and all other taxation and fiscal powers reserved to Westminster.
- Independence, with full taxation powers for the Scottish Government, subject to any constraints from international treaties.
- Full fiscal autonomy, with full taxation powers devolved to Holyrood. In these circumstances the Scottish Government would decide on the range, structure and extent of taxation. The main difference from independence is that, as Scotland remained part of the UK, there would be a requirement on the Scottish Government to make payments to the UK Government to cover the costs of the UK Government's expenditure in and on behalf of Scotland.
- Assigned tax revenues, with the power to decide what taxes are raised and at what level remaining reserved to Westminster. However, the taxation revenues collected would be assigned to Holyrood. While this option would create a link between the state of the economy and the budget available to Holyrood, this would really be a change in accounting and collection systems with no devolution of taxation powers. So, for example, a Scottish Government would still not have the power to decide the overall size of the tax burden in Scotland. As with full fiscal autonomy, this model would require the Scottish Government to make payments to the UK Government to cover the costs of the UK Government's expenditure in and on behalf of Scotland.
- Limited devolution of some tax powers, with, for example, devolution of taxes to Holyrood where the associated functions have already been devolved. However, unless the taxation powers devolved were sufficient in terms of revenue raised to meet the spending requirements of Holyrood, such a model would still require a revised version of the Barnett Formula. So such an approach would tackle few, if any, of the problems associated with the current system.

- Substantial devolution of tax powers, so that both Westminster and Holyrood would have powers over taxation similar in scale to powers over spending. This model is described in more detail below.

There is currently an appetite for change in Scotland with none of the major political parties supporting the status quo.

This paper does not take a position on the most appropriate future constitutional arrangements for Scotland. Rather, it starts from the assumption of the current constitutional arrangements in terms of the functions devolved to Holyrood in the Scotland Act. The proposed model is designed to increase the accountability of the current constitutional arrangements by linking the level of taxation powers to the level of spending powers already devolved.

4.2 Principles and starting point

The starting point for a new model where the Westminster and Holyrood Governments both raise broadly what they spend requires an analysis of the taxation revenues gathered from Scotland. As discussed earlier in this paper, more than £47 billion is raised each year. In developing recommendations for the best way to split up the different taxes, the following principles have been adopted:

- The starting point is on the basis of the current devolved settlement in terms of the functions devolved and reserved and the associated expenditure – that is 60% of government spending in Scotland is devolved and 40% reserved;
- Taxation revenue should equal expenditure for both Westminster and Holyrood;
- Both Westminster and Holyrood should have a sufficient range of tax revenues from income and wealth, business, consumption and other sources to allow for changes in tax revenue and expenditure over time, without the need to renegotiate the range of tax powers devolved and reserved on an annual basis;
- Tax revenues should accrue to the level of government where there is a relevant power (for example, broadcasting is a reserved power at Westminster so TV licence income is a reserved tax revenue at Westminster);

- There should be enough clarity to those paying the taxes, in terms of which taxes are funding Westminster expenditure and which are funding Holyrood expenditure, to ensure that accountability is increased (for Westminster as well as Holyrood).

There are a number of options for dividing the £47 billion taxation revenues from Scotland between Westminster and Holyrood in proportion to their spending responsibilities – that is 60% Holyrood and 40% Westminster. Four alternative options are summarised in Table 6.

These options involve reserving some of the following taxes to Westminster: a share of income tax, a share of the Scottish geographic share of North Sea oil revenues, National Insurance, Value Added Tax and a range of "other" taxes.

The £1.5 billion of "other" taxes reserved to Westminster in these options includes income from TV licences, national lottery tax and passport fees and the £4.7 billion "other" devolved to Holyrood includes council tax, business rates, inheritance tax, insurance premium tax, betting & gaming duties, landfill tax, climate change levy and aggregates levy.

Table 6: Summary of options for a starting point

Option A Reserved to Westminster: – 40% income tax – 40% of oil revenues (Scottish geographic) – 40% of VAT – National Insurance – £1.5 billion other Everything else devolved to Holyrood	**Option B** Reserved to Westminster: – 40% oil revenues (Scottish geographic) – National Insurance – VAT – £1.5 billion other Everything else devolved to Holyrood
Option C Reserved to Westminster: – 20% income tax – National Insurance – VAT – £1.5 billion other Everything else devolved to Holyrood	**Option D** Reserved to Westminster: – 30% income tax – 40% of oil revenues (Scottish geographic) – National Insurance (employees) – VAT – £1.5 billion other Everything else devolved to Holyrood

Table 7: Option A

	Reserved to Westminster (£m)	Devolved to Holyrood (£m)
Income Tax	4,135 (40%)	6,203 (60%)
Oil Revenues (Scottish Geographic share)	3,025 (40%)	4,538 (60%)
National Insurance	7,465	-
VAT (Assigned Revenue)	2,980 (40%)	4,469 (60%)
Corporation Tax	-	3,019
Fuel Duty & Vehicle Excise	-	2,358
Alcohol & Tobacco Duties	-	1,749
Stamp Duties	-	686
Capital Gains	-	308
Other	1,523	4,704
Total	19,128	28,034
"Surplus" ("Deficit")	*183*	*(243)*

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

Table 8: Option B

	Reserved to Westminster (£m)	Devolved to Holyrood (£m)
Income Tax	-	10,338
Oil Revenues (Scottish Geographic share)	3,025 (40%)	4,538 (60%)
National Insurance	7,465	-
VAT	7,449	-
Corporation Tax	-	3,019
Fuel Duty & Vehicle Excise	-	2,358
Alcohol & Tobacco Duties	-	1,749
Stamp Duties	-	686
Capital Gains	-	308
Other	1,523	4,704
Total	19,463	27,700
"Surplus" ("Deficit")	*517*	*(577)*

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

Table 9: Option C

	Reserved to Westminster (£m)	Devolved to Holyrood (£m)
Income Tax	2,068 (20%)	8,270 (80%)
Oil Revenues (Scottish Geographic share)	-	7,563
National Insurance	7,465	-
VAT	7,449	-
Corporation Tax	-	3,019
Fuel Duty & Vehicle Excise	-	2,358
Alcohol & Tobacco Duties	-	1,749
Stamp Duties	-	686
Capital Gains	-	308
Other	1,523	4,704
Total	18,505	28,658
"Surplus" ("Deficit")	*(441)*	*380*

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

Table 10: Option D

	Reserved to Westminster (£m)	Devolved to Holyrood (£m)
Income Tax	3,101 (30%)	7,237 (70%)
Oil Revenues (Scottish Geographic share)	3,025 (40%)	4,538 (60%)
National Insurance	3,509 (Employee, Self Employed)	3,956 (Employer)
VAT	7,449	-
Corporation Tax	-	3,019
Fuel Duty & Vehicle Excise	-	2,358
Alcohol & Tobacco Duties	-	1,749
Stamp Duties	-	686
Capital Gains	-	308
Other	1,523	4,704
Total	18,608	28,555
"Surplus" ("Deficit")	*(338)*	*277*

Source: Data from Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 (Excluding Gross Operating Surplus of £2,757 million)

4.3 Features of the new model

The four options set out above provide only a starting point for a new model which devolves taxation and fiscal powers to Holyrood, to match the expenditure powers already devolved. This model abolishes the Barnett Formula and replaces it with a system that ensures greater accountability for both the Holyrood and Westminster Governments. The model delivers greater clarity on which government is raising which taxes and what those taxes are paying for.

All four options would achieve those aims. However, Reform Scotland's preferred starting point is Option A which best meets the criterion of giving both Westminster and Holyrood a sufficiently wide range of tax revenues to ensure that they have the flexibility required to meet their spending needs. It also splits income tax, North Sea oil and VAT revenues on a 60:40 basis which matches the respective spending responsibilities of Holyrood and Westminster.

Once the starting point has been established, both Westminster and Holyrood would be responsible for raising the taxes that they believe are required to provide public services and then securing the necessary political majority for such measures. The level of taxes raised in Scotland would, for the first time in modern history, be inextricably linked to the decisions made in the Scottish Parliament on expenditure as well as spending decisions made at Westminster.

The new model would give both Westminster and Holyrood the powers to set new taxes and abolish existing ones. In practice, some co-operation would be desirable when major changes were proposed by either government to ensure that the taxation system does not become even more complicated than it is already.

The proposed new model devolves not just taxation powers but the wider fiscal powers that would be necessary to allow the new system to operate effectively and efficiently. These would include borrowing powers for Holyrood so that the Scottish Government would be in a position to plan revenue and expenditure over a number of years. This would allow the Scottish Government to borrow in years when expenditure exceeded revenue with borrowing repaid in years when revenue exceeded expenditure. There would be an expectation that the Scottish Government only made spending commitments in line with revenue raised over the economic cycle.

The main benefit of the model would be the increased accountability of both the Westminster and Holyrood Governments. There will be no obligation on Westminster to bail out an overspending Scottish Government and no requirement for a prudent Scottish Government to return surpluses to Westminster – surpluses in the Scottish budget would, amongst other things, provide scope for cutting taxes, repaying debt or increasing capital investment.

Scottish Exchequer

The greater fiscal powers of the Scottish Parliament would make it necessary to enhance the remit of the Scottish Government's Finance Department. The enhanced remit of the Finance Department, potentially called the Scottish Exchequer, would be a combination of most of the powers and responsibilities presently held by HM Treasury and HM Revenue & Customs. We propose that these functions are combined within one department rather than as at present split between HM Treasury and HM Revenue & Customs.

The Scottish Exchequer would be responsible for the collection and administration of all taxes unless specifically reserved to Westminster. That said, there would still be a role for HM Revenue and Customs in Scotland under this model as it will still be responsible for a number of benefits including tax credits and child benefit.

UK and non-UK spending

For the proposed model to work, there is a need to identify the proportion of UK Government spending that is for the entire UK and the proportion that applies only to the UK's constituent countries. The GERS publication provides a starting point for this analysis – suggesting that 40% of all Scottish public spending is at the UK level. However, a more fundamental review of UK Government spending would be desirable to determine what is UK-wide spending and what is national or regional spending.

Each spending review cycle and each year, the UK Chancellor would set out his or her spending proposals, clearly identifying what elements of those spending proposals were whole-UK spending. The taxation raised in Scotland by the Westminster Government would be to cover only Scotland's share of whole-UK spending requirements.

While political accountability would act as a constraint on any UK Chancellor tempted to maximise the proportion of spending commitments he or she considered to be whole-UK, there may be a need for joint bodies to resolve any dispute that arose. The existing Joint Ministerial Committee system could fulfil this role.

This new model would provide the structures for other parts of the UK to go down the same route if they wished. However, in the short term they might like to stick to a system in which non-UK taxes were pooled at the centre and then redistributed to the Welsh and Northern Irish assemblies and a body representing England. This could be done on the basis of assigned revenues reflecting the amounts raised in the different parts of the UK, topped up using a needs-based funding formula as happens in Spain. The system would be flexible enough to allow England and Wales to pool their resources in areas such as justice if they so wished. This would entail the establishment of a body to represent English interests. The lack of such a body has unbalanced the constitution and made it impossible to disentangle spending on functions reserved to the UK Government from those which are devolved. The exact form of such a body would be a matter for people in England. However, it could be achieved by simply changing the way Westminster works, thus avoiding the establishment of a separate Parliament with separate elections.

4.4 Benefits of the new model

As previously stated, the main benefit of the new model is the increase in accountability of both the Holyrood and Westminster Governments.

This should change the nature of the political debate in Scotland from one where political parties each make a case for why they might be the best managers of the Scottish budget to one where the role and nature of government itself in a modern Scotland is the central issue.

The new model deals with the asymmetry in devolved powers and deals with objections and opposition to the current system on both sides of the border by abolishing the Barnett Formula.

The new model provides a basis for a new approach to taxation in Scotland. This approach would depend on the view taken on the role, scope and size of government and the nature and scale of taxes that should be levied.

Reform Scotland will return to this topic in a future paper that will present recommendations for a detailed budget for Scotland.

However, the approach to the taxation system should be based on the principles of taxation that were originally devised in Scotland by Adam Smith. In the Wealth of Nations [8], Smith noted that: *"The private revenue of individuals, it has been shown in the first book of this Inquiry, arises ultimately from three different sources; Rent, Profit, and Wages. Every tax must finally be paid from some one or other of these three different sorts of revenue, or from all of them indifferently."*

Smith proposes four "maxims":

- Equity – *"The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."*
- Certainty – *"The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person."*
- Convenience – *"Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributors to pay it."*
- Efficiency – *"Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."*

Smith concludes: *"The evident justice and utility of the forgoing maxims have recommended them more or less to the attention of all nations. All nations have endeavoured, to the best of their judgment, to render*

8 In Book V, Chapter 2, Part 2 "Of Taxes"

their taxes as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and, in proportion to the revenue which they brought to the prince, as little burdensome to the people."

Reform Scotland endorses these sentiments and recommends that the taxation system should be reformed, on the basis of these principles, to reduce the overall tax burden and simplify the system.

Devolving taxation powers to Holyrood would give the Scottish Government the power to redesign the taxation system to promote sustainable economic growth by creating the conditions for the private sector to realise the potential that lies in Scotland's competitive advantages.

Adam Smith's "maxims" point to a vast array of improvements that could be made to the current system. Some examples of the kind of detailed changes that future Scottish Governments might consider, building on some recent policy priorities, might include:

- Reducing or abolishing air passenger duty for trips that might be considered to be life line routes (for example from the Scottish mainland to the islands) and increasing duty for routes where alternative modes of transport are available (for example, between Edinburgh or Glasgow and London).
- Increasing taxation on alcohol to fund the increasing costs of the provision of health services associated with diseases whose instance are associated with increased consumption.
- Changes to corporate or energy-related taxes to promote the development of new renewable energy technologies and their commercialisation (such as lower business taxes for the sector or higher taxes on non-renewable generation).

While these examples help to demonstrate the range of fiscal levers that would be available to future Scottish Governments under this model, the bigger picture is the potential for lower, simpler taxes.

5. Conclusions

The current devolution settlement is unbalanced in that the Scottish Government has control over 60% of government expenditure in Scotland but no responsibility for raising the revenue required to meet those expenditure commitments, other than the local taxes collected by local government. Revenue generated by taxation powers devolved to Scotland accounts for only 13% of the expenditure that is devolved to Scotland.

This lack of financial accountability is the fundamental defect of the current devolution settlement. One way to remedy that as far as Scotland is concerned would be outright independence. However, this paper looks at the question of how financial accountability might be achieved with Scotland remaining part of the United Kingdom.

Within the context of the United Kingdom, Scotland cannot achieve greater financial accountability by acting unilaterally. It requires the UK Government to put in place new financial arrangements which are fair to the governments of both Scotland and the UK. Reform Scotland believes that the starting point for such a new system of greater financial accountability is one where the UK and Scottish Governments are both responsible for raising the money that they spend in or on behalf of Scotland. The new model outlined in this paper sets out how this can be done.

However, a genuine UK-wide solution requires us to address the position in England, as it is the lack of a body to represent English interests that is the Achilles' Heel of the current devolution settlement. Such a body would enable a clear and transparent system, which sets out the responsibilities of the different levels of government, to be put in place. This is the best way to achieve greater financial accountability in both Scotland and the United Kingdom.

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7. Appendix

Government revenue from Scotland by source

Table 2: Government revenue Scotland by source 2006-07 (£m)

Source	£m
Income tax	10,338
North Sea revenue (Geographical share)	7,563
VAT	7,449
National insurance employer contributions	3,956
National insurance employee contributions	3,253
Corporation tax (excl North Sea)	3,019
Fuel duties	1,958
Non-domestic rates	1,833
Council tax	1,812
Tobacco duties	981
Alcohol duties	768
Interest and dividends CG	422
Stamp duties (land & property)	405
Rent and other current transfers CG	400
Vehicle excise duty	400
Capital gains tax	308
Stamp duties (stocks & shares)	282
National insurance self & non employed contributions	256
TV licences	244
Inheritance tax	228
Insurance premium tax	195
Company income tax receipts net of repayments	140
National Lottery (tax)	135
Interest and dividends LG	127
Betting and gaming and duties	95
Air passenger duty	94
Interest and dividends PC	79
Landfill tax	75
Climate change levy	73
Reliefs	61
Corporation Tax Credit Expenditure	55

Aggregates levy	50
Betting & gaming duty	46
Passport fees	29
Levy Funded Bodies	26
Renewable Energy Obligations (fines)	23
Consumer credit act fees	20
OFGEM tax on NFPA renewable energy income	10
Rail franchise premium	10
Horserace Betting Levy Board	9
Regulatory Fees	6
Inland Revenue - company IT withheld	3
Rent and other current transfers LG	3
Company tax credits	-13
NPISH tax credits	-63
Total	47,163

Source: Government Expenditure & Revenue Scotland 2006-07, Scottish Government, June 2008 with additional detail provided by Scottish Government Analytical Services