

The Real Cost of the Calman Proposals

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No one can expect to escape the effect of the huge cuts in UK Government spending set in train by last week's emergency Budget. But in Scotland, if the Calman proposals for financing Scotland's budget are adopted, the impact is bound to be even more severe.

The cuts will certainly result in a significant reduction in the block grant that finances devolved spending in Scotland for the foreseeable future. Although the precise consequences for Scotland's economy remain unclear, and will do so until the results of the Comprehensive Spending Review are announced in October, Scotland's proportionally higher public sector employment leaves us especially vulnerable to a double dip recession and rising unemployment. Of course Scotland is not alone in this regard. A range of leading economists and commentators have pointed to the potentially damaging impact of the budget for a number of the UK's other regions. But closer to home, it is clear that all local authorities are preparing to shed jobs in the expectation of lower government funding in the future, and undoubtedly other publicly funded agencies are drawing up their own contingency plans.

It is against this rather bleak economic backdrop that Scotland's political parties are debating how best to reform the way in which the devolved Holyrood government is financed. Our view is that the Scottish Government should be responsible both for levying the majority of taxes that apply in Scotland as well as most of the public expenditure undertaken in Scotland. As we demonstrated in a recent paper, not only will this produce more efficient (and potentially lower) public spending in Scotland but, crucially in the current economic climate, it will provide the Scottish Government with the economic policy levers it requires to increase growth in the economy. This latter point is important when one recognises that Scotland's economy performs in a significantly different manner to the UK average, meaning that the fiscal policies that are "right" for the rest of the UK are typically not appropriate for Scotland.

If speculation is correct however, the new UK government may implement the seriously flawed financial recommendations of the Calman Commission. We advise against this. Under Calman Scotland is bound to experience even deeper cuts in public spending than those already in the pipeline. Under Calman part of Scotland's budget would be dependent on income tax revenues raised in Scotland, with the Scottish Parliament having the power to raise or lower a Scottish element of income tax should it wish to increase or decrease its spending. If we look at the recently published national accounts for Scotland – the Government Expenditure and Revenues Scotland report – then the budgetary implications of Calman's proposals become alarmingly clear. In the year 2008-2009 (the latest data available) income tax revenue raised in Scotland fell by £549 million on the previous year meaning that – under the Calman's model – the total revenue accruing to Scotland's budget would

have been approximately £275 million lower than it actually was if departmental spending were untouched. That is the entire budget for employment policy. Preliminary UK data shows that income tax receipts in year 2009-2010 fell a further 8% implying a Calman-shortfall of approximately £400 million that year. These cuts to Scotland's budget do not reflect any change in policy either in the UK or in Scotland, and cannot (under Calman) be offset by temporarily borrowing funds. They are simply the consequence of proposals that tie Scotland's budget revenue to receipts from income tax, and they will leave the Government no alternative but to slash spending or raise (by close to 2p) the rate of income tax applying in Scotland. Needless to say this would serve only to impart a further deflationary shock, and another fall in income tax revenues, to Scotland's economy. It is difficult to imagine any economist endorsing a financing regime under which revenues and spending are both so uncertain and vary in a way that exaggerates the economic cycle.

In addition to this problem, last week's budget demonstrated yet another costly defect in Calman's proposals. The UK Government's decision to raise the income tax threshold for those paying the basic rate by £1000 is estimated by the Institute for Fiscal Studies to reduce income tax revenues UK-wide by £3.5 billion. This implies an annual reduction in income tax revenues in Scotland of £297 million, one half of which will be raised by the levy of the Scottish segment of income tax. Accordingly the effect purely of the UK Government's decision to raise the income tax threshold will be to reduce Scotland's budget by £150 million. At the UK level this tax concession will be paid for by the higher rate of VAT. But, of course, under Calman Scotland does not receive any share of that additional revenue. Scotland alone will have to fund the full cost of the UK tax cut out of current spending or higher income tax – and still pay the higher VAT rate into the bargain. Needless to say any decision by the UK Government to increase income tax thresholds above the new level – and we are promised a further increase of £2300 – inevitably will reduce revenues flowing from income tax to the devolved administration.

It is therefore irrefutably the case that, should the Calman recommendations be implemented, and should Scotland's economy fail to grow extraordinarily quickly out of the current downturn, Scotland will suffer an unavoidable and very tough spending squeeze *in addition to* that already forecast in the Chancellor's budget statement and the impending Comprehensive Spending Review. This would represent a very serious financial "double whammy", and one that we consider is likely to damage further Scotland's economic prospects and ability to emerge from recession.

Surprisingly thus far there has been no comment on these vital issues from those supporting Calman's financial proposals. To be sure there will be some who argue that public spending in Scotland presently is much too high and that the financial shock therapy to Scotland's public sector implicit in the Calman model is to be welcomed. However regardless of the position one takes on that question, and the economic evidence is certainly contestable, it is difficult to believe that Scotland's politicians and business community is ready to endorse a financing arrangement that is virtually certain to impose on Scotland a scale of fiscal cuts that no other part of

the UK will experience. But that is the very real implication of legislating the Calman proposals as they stand.

Under greater fiscal responsibility, on the other hand, a Scottish administration will have at its disposal the economic policy levers necessary to encourage economic growth, support job creation, and therefore contribute more to resolving the “black hole” in UK public finances than otherwise it will be in a position to do.

Moreover it will be able to do so by adopting policies that continue to respect the economic and social needs of the most vulnerable in our society – those we believe to be most at risk from Sir Kenneth Calman’s flawed proposals.

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