

THE STEEL COMMISSION

Moving to Federalism – A New Settlement for Scotland



Final Report of The Steel Commission to the
Scottish Liberal Democrat Spring Conference

March 2006

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Contents

The Rt Hon Lord Steel of Aikwood KT KBE	4
Introduction.....	6
A New Constitutional Convention.....	13
International Lessons for Scotland	21
Illustration 1– The German Constitution.....	24
Illustration 2 - The Canadian Constitution	26
Illustration 3 - Shared Competence in Germany.....	27
Illustration 4 – Tax Powers Spain.....	32
Illustration 5 – Tax Powers Belgium.....	34
Illustration 6 – Tax Powers Germany	35
Illustration 7 - Canadian Equalisation	43
Illustration 8 - Transitional Arrangements in Australia	44
The Case for a Modern Settlement for the UK.....	48
A Modern Relationship with the Rest of the UK.....	59
New Powers for the Scottish Parliament.....	66
The Principles of Fiscal Federalism.....	90
A New Fiscal Settlement for Scotland.....	99
Conclusions and Recommendations	110
The Remit of the Steel Commission.....	121
Membership of the Steel Commission	122



Foreword

The Rt Hon Lord Steel of Aikwood KT KBE

It has long been accepted that the Scotland Act should be reviewed a decade or so after it came into force in 1999. It has also been accepted that the so-called “Barnett formula” under which Scotland has, since the 1970s, received its share of public expenditure is due for re-examination. The first First Minister Donald Dewar himself declared that devolution was not an event but a process. In my Donald Dewar Memorial Lecture three years ago I said that no self-respecting parliament could exist permanently on a grant from another parliament. It is against all that background that this Commission came into being.

This report is not a party policy document, let alone a manifesto commitment (which parts the Liberal Democrats choose to adopt is for the Party to decide). It is our considered input into what we hope will be a second Constitutional Convention to be called together during the next Parliament, this time involving all the political parties, to chart the way forward in developing the powers of the Scottish Parliament. Our report focuses on three main areas: redefining and modernising the relationship between Scotland and the rest of the UK through a new federal settlement for Scotland; delivering new powers for the Scottish Parliament; and finally the matter of finance, where we proceeded on the principle that the Scottish Government should raise as much as practical of its own spending.

The UK is the developed country which takes the largest share of taxation centrally. Our determination to bring government as close to local control as possible leads us to question this approach. We have done so in the Scottish context, conscious that the English still have to make up their minds whether they wish democratic regionalism or an English component to the Westminster Parliament.

Transferring substantial revenue-raising authority to the Scottish Parliament should enable future Scottish Governments to have a free hand in developing policies which will stimulate growth in the Scottish economy and remove the democratic deficit which follows spending powers without revenue raising responsibility. (We reject the idea that it is necessary to have our own foreign or defence policies to be able to do this.) If they succeed, the benefits will be obvious to the people of Scotland. Equally if they fail, that will be more easily noted by the people, and that is what democracy should mean.

I wish to express my thanks to the talented team who gave of their time over the last eighteen months to this work, and especially to our secretary David Paterson for his remarkable skill in distilling our deliberations into this document.

David Steel
March 2006

Chapter 1

Introduction

This Chapter sets out the background to the establishment of the Steel Commission, our remit and approach.

Background to the Steel Commission

The Scottish Liberal Democrats have a long record of supporting Home Rule for Scotland and played a pivotal role in campaigning for, and ultimately delivering, the first Scottish Parliament in more than three centuries. Our support for Home Rule was, and continues to be, entrenched in our support for the principles of subsidiarity, democracy, accountability and power sharing.

These principles are important, but more than that, they are powerful when they are put into action. Their power lies in the ability to bring government closer to the people and to forge distinctive solutions to the real problems faced by the people of Scotland in everyday life. For Liberal Democrats, the establishment of the Scottish Parliament was a means to an end, not an end in itself. The 'end' that we seek is improving the lives of all the people of Scotland.

As the preamble to the Scottish Liberal Democrat Constitution states, we "exist to build and safeguard a fair, free and open society, in which we seek to balance the fundamental values of liberty, equality and community and in which no-one shall be enslaved by poverty, ignorance or conformity."

Already the Scottish Parliament has made a difference for the people of Scotland. Free personal care for the elderly, land reform, free nursery places for three and four year olds, abolition of tuition fees and reintroduction of student grants, new railways and transport infrastructure, a Bill to ban smoking in enclosed public places, tough new freedom of information laws, and fair votes for local government are just some examples of the 'ends' that the Parliament has achieved.

The Scottish Parliament has now established itself firmly in Scottish society. The broad outlines of the Home Rule settlement have been shown to be robust and have stood the test of time. The Parliament itself has matured as MSPs and Ministers have learnt their business. The Parliament's much-lauded Committee system, its innovative arrangements for public petitions including the use of e-government methods, and the extent and sophistication of its relationship with civic and business Scotland have been impressive success stories.

The Parliament is also developing positive and vibrant partnerships with United Kingdom and European institutions which themselves change and challenge established constitutional and political practice. Of course the Scottish Parliament continues to have its supporters and detractors, but it is undeniable that as an institution it has made an impact on wider civic society and holds a place in the common consciousness. Put simply, the Scottish Parliament is here to stay.

Time for a New Debate

Scottish Liberal Democrats believe that devolution is a process, not an event. Behind the establishment of the Steel Commission is the party's desire further to improve the Home Rule settlement in order to deliver real benefits to the people of Scotland. We believe in reform for a reason.

The debate about the future of the Scottish Parliament has perhaps suffered from a polarisation of views. We believe that it is important to put the debate in context. The issue of increasing political and fiscal powers is essentially about what point on a sliding scale is most appropriate and beneficial to Scotland. The debate is a far more sophisticated one than arguments for national independence, the status quo, or a return to Westminster rule suggest. In particular, arrangements categorised as broadly federal have been developed in many states around the world. Such solutions offer both stability and flexibility and are inclusive of various traditions. A broadly federal solution is one which suits Scotland very well and it can be found in successful states across the globe.

We have long held the view that this debate must be held in public – but at the right time. In our Manifesto for the 2003 Scottish Parliament elections, we wrote:

“The strength of the YES vote in the 1997 referendum reflected the support for the Parliament and contributed to high expectations for its first term. Scottish Liberal Democrats believe the Parliament has achieved a great deal, but must be given time to reach its full potential. We campaigned for a Parliament that will succeed over the long-term and do not favour hasty or destabilising changes in its powers.”¹

Our Manifesto went on to say:

“We will follow the success of the first Constitutional Convention by beginning preparation for a second Convention in 2009, seeking like the first to involve wider society. After ten years of experience we will be in a good position to see how the Scottish Parliament has worked to improve quality of life and governance in Scotland. The Convention will be able to identify any helpful improvements to the Parliament's powers and methods of working.”²

About the Commission

The Steel Commission was appointed in December 2003 by Scottish Liberal Democrat Leader, and Deputy First Minister of Scotland, Rt Hon Jim Wallace QC MSP. Under the Chairmanship of former federal party leader and Presiding Officer, Sir David Steel, the Commission was charged with preparing the Liberal Democrats for a second Constitutional Convention and developing the party's policies on the future of the Scottish Parliament.

The Steel Commission comprised 20 Commissioners representing a wide range of views and experience from within the Liberal Democrats. We began our work in earnest in the summer of 2004, producing an Interim Report which was approved by the Scottish Liberal Democrat conference in February 2005. This Final Report is the culmination of more than 18 months' work by the Commission and has been prepared for submission to the Scottish Liberal Democrat Conference and for wider discussion and debate. We hope that it will provoke a thoughtful and important debate across civic Scotland.

Terms of Reference

These are set out in full in Annex 1 to this report. Our remit covers a wide range of issues about the future of the Scottish Parliament and how we wish to develop a new modern settlement for the United Kingdom.

We were asked to investigate three specific aspects of Scotland's position within a modernised settlement: the constitutional principles; the fiscal principles; and the desirability of changes to the powers and legislative competences of the Scottish Parliament.

We were charged with producing a set of recommendations and a Final Report to be considered by the Scottish Liberal Democrats. This Report fulfils that obligation.

The Commission's Approach

In addition to consultative sessions and debates through Party Conference, the full Commission has met on a regular basis as well as through smaller working groups. The aim of these meetings was to draw together the expertise of our members who bring a wide range of experience of working in business, the voluntary sector, the legal profession, the media, academia, local government, the Scottish Parliament, the House of Commons, the House of Lords and the European Parliament.

The Scope of our Report

Our remit was far-reaching, ranging from the question of the voting system for the Scottish Parliament to Scotland's role in Europe and indeed the wider world as part of moving towards a more federal union. Our Report does address these areas, however we felt that it was important to focus primarily on three aspects: the case for a new modern settlement for the UK; the constitutional and fiscal options for achieving this; and a new system of finance that will work for the long term benefit of Scotland as part of the United Kingdom.

The Liberal Democrats have long campaigned to modernise the system of governance in the United Kingdom and our support for this stands. This Final Report makes the case for a changing role for Scotland within that modernised United Kingdom. In so doing we recommend: a new written constitution for the United Kingdom recognising Scotland's position within a modern union; increased policy and legislative powers for the Scottish Parliament; and a new finance system of fiscal federalism backed by a set of constitutional and fiscal principles that recognise Scotland's historic status in the UK. In a number of areas we have made very specific recommendations for action and change. In other areas we recognise that there are a number of options that a second Constitutional Convention should address and we offer our opinion on the way forward on those matters.

The Commission is conscious that the rejection – at least for the present – by the voters of the North East of England of a Regional Assembly changes the terms of the debate to some degree. Whilst we think that the scheme on offer to the North East – like the original Scottish Assembly plan of 1978 – was flawed, there is clearly a debate to be had in England about the future organisation of what is one of the most centralised countries in Europe.

The Party remains committed to modernising the governance of the United Kingdom but clearly there is a debate to be had within England as to the final configuration of English representation in a more federal United Kingdom. This is an important matter in which Scotland has a clear interest as a founding partner of the Union. However, our view is that this should not stop Scotland developing plans for its role and status within a modernised United Kingdom. Whether the end result is a truly federal or an asymmetric federal one is for the future.

The Structure of our Report

Chapter 2 - A New Constitutional Convention – sets out the arguments for a second Convention to build a political and civic consensus across Scotland on the options for changes to the Home Rule settlement.

Chapter 3 – International Lessons for Scotland – considers the key lessons that can be learned from political and fiscal systems around the world. Using academic research and case studies from a range of states, this Chapter attempts to demonstrate how federal systems can and do work and how Scotland can learn from international experience. It briefly considers political issues but is predominantly focused on fiscal matters.

Chapter 4 – The Case for a Modern Settlement for the UK – makes the case for a new modern settlement for Scotland and the UK. It considers the benefits to Scotland and the rest of the UK from a rejuvenated union based on federal principles.

Chapter 5 – A Modern Relationship with the Rest of the UK – restates the Liberal Democrat argument for a move towards a more federal system and sets out the vision and principles that should underpin it. It considers further the specific changes that would be required, including options for improving joint working between the Scottish and Westminster Parliaments.

Chapter 6 – New Powers for the Scottish Parliament – is concerned primarily with the principles that should guide decisions about allocating new policy and legislative powers to the Scottish Parliament. It begins a much-needed public debate about the appropriateness of the current powers under the Scotland Act. It calls for a formal system of partnership working to be developed to govern the future relationship between Scotland and Westminster in a number of key areas.

Chapter 7 – The United Kingdom as a Fiscal and Economic Union – considers the current fiscal relationship between Scotland and the rest of the UK and argues that a new system of fiscal federalism must be based on more than a simple narrow calculation of deficits and surplus. The UK is greater than the sum of its parts and this benefits Scotland as well as other parts of the UK. Nevertheless, there are clear arguments for modernising and redefining the Fiscal and Economic Union to bring benefits across the UK.

Chapter 8 - The Principles of Fiscal Federalism – begins with a discussion on the Core Principles that the Commission believes should form the foundation of a new fiscal federalism system for Scotland. Based on international experience and academic research, the Commission also considers a set of Key Criteria to guide decisions on the allocation of taxation powers.

Chapter 9 - A New Fiscal Settlement for Scotland – sets out the Commission’s recommendations for a new system of fiscal federalism for Scotland. It includes a discussion on how this system would work, its main benefits, and the practical steps necessary to make it a reality.

Chapter 10 – Conclusions and Recommendations – draws together the key lessons learned by the Commission and our recommendations for action, including the areas requiring specific consideration by a future Convention.

Annexes – included in the annexes to this Report is further information on the remit of the Steel Commission, its membership, and the principles it has followed.

Chapter 2

A New Constitutional Convention

The Scottish Constitutional Convention

The establishment of the Scottish Parliament in 1999 was the culmination of a long process in which the Liberal Democrats played a central role, continuously flying the flag for Scottish Home Rule while other political parties fell by the wayside or refused to participate.

The failure of the first referendum in 1978 led to much soul-searching in Scotland, but, out of this apparent setback, there came two seminal developments: the establishment of the first Scottish Constitutional Convention, and the assertion in the Claim of Right that sovereignty ultimately lay with the people of Scotland.

This assertion in the Claim of Right is also a central tenet of liberalism. The preamble to the Scottish Liberal Democrat Constitution states: "We believe that sovereignty rests with the people and that authority in a democracy derives from them. We therefore acknowledge their right to determine the form of government best suited to their needs."

The first Scottish Constitutional Convention had roots deep into Scottish history, but also drew some inspiration from the National Covenant of the 1950s. It was, however, hugely innovative in drawing together the bulk of civic Scotland with key political parties to develop a detailed and workable scheme for a Scottish Parliament which was the basis of the Scotland Act of 1998.

The Convention scheme also involved a political agreement, primarily between Labour and the Liberal Democrats, which underpinned the proposals (both the Conservatives and the SNP, for opposite reasons, decided to stay out of the Convention). The political agreement comprised a proportional system of election, an effective voice for all parts of Scotland, acceptance of the principle of tax raising powers, and acceptance of the principle of gender balance³ as being integral to the Parliament.

The mutually reinforcing partnership between civic and political Scotland was what gave the Convention its force. From it there developed the Constitutional Steering Group, established after

the 1997 general election, which agreed on founding principles for the Parliament. These have powerfully shaped the Parliament's work. They are that:

- the Scottish Parliament should embody and reflect the sharing of power between the people of Scotland, the legislators and the Scottish Executive;
- the Scottish Executive should be accountable to the Scottish Parliament and the Parliament and the Executive should be accountable to the people of Scotland;
- the Scottish Parliament should be accessible, open, and responsive and develop procedures which make possible a participative approach to the development, consideration and scrutiny of policy and legislation;
- the Scottish Parliament in its operation and its appointments should recognise the need to promote equal opportunities for all⁴.

The Challenge of a Second Convention

The first Scottish Constitutional Convention achieved a great deal and its legacy lives on today in the very existence of the Scottish Parliament and many of the positive aspects of its approach to power sharing, public access and transparency.

We believe that there is now a strong case for the establishment of a new Constitutional Convention. We therefore recommend that, following the Scottish Parliament elections in 2007, steps should be taken to form a second Convention to commence its work in 2009. This timescale will allow other political parties and organisations across civic Scotland to develop their thoughts and policy positions on the future powers of the Scottish Parliament.

We urge all of Scotland's political parties to learn the lessons of the first Convention and sign up to this proposal, at least in principle, as soon as possible. Equally we commend this proposal to civic Scotland and hope that they will see it as an important opportunity to shape the future of the nation.

The second Constitutional Convention will have a substantive and significant programme of work. It would be ill-advised and disappointing should political parties in Scotland fail to grasp the importance of reviewing the future of the Scottish Parliament based on our collective experience of ten years of operation.

However, the political context will be different. Unlike the first Convention, the new body will be able to call on both this experience of two terms of the Parliament and the resources of the Scottish Government to support its work. The Westminster Government itself is committed to a review of the Scotland Act.

There will, no doubt, be many disagreements on detail, but the strength that comes from the ability to agree a national consensus across political parties and civic Scotland cannot be overstated. Once again, the opportunity is there for Scotland to lead the United Kingdom in political and constitutional thought.

Why a Second Constitutional Convention?

The powers of the Scottish Parliament cannot be set in aspic. The procedures of the Scottish Parliament are not written in tablets of stone. The role of Scotland within the United Kingdom remains a matter for the Scottish people. Now that the Parliament exists and is delivering, these points go to the very heart of how the Scottish Parliament can better deliver for the people of Scotland.

Scotland has changed significantly since the establishment of the first Convention, and, indeed, since the election of the first Scottish Parliament in 1999. The very existence of a parliament elected with an element of proportional representation and the collective experience of its operation makes that self-evident. But there are other significant changes which are worthy of consideration and would be factors for the second Convention to address. In summary, these include reforms of governance in Scotland; incremental changes in powers of the Scottish Parliament; public support for additional powers; growing civic and political debate on the future settlement; the matter of changing identity both north and south of the border; and pressures from across the United Kingdom.

Governance Reforms

The Scottish Parliament has driven through a number of reforms that have radically changed the system of governance in Scotland. From a tough new freedom of information regime, to proportional representation for local government, Liberal Democrats have been the driving force behind a range of measures designed to improve governance in Scotland and to strengthen the democratic process.

Incremental Changes

The devolution settlement has proven more flexible than many envisaged it would be. The approach taken in the Scotland Act of specifying powers reserved to Westminster has been shown to be

generally sound and has given the opportunity for incremental changes to practice and powers.

In fact, Scotland has steadily gained powers and responsibilities over the years. This has happened in three ways: the transfer of formal powers, such as the transfer of new rail powers to Scottish Ministers in October 2005⁵; the use of the Sewel procedure to confer incidental powers on the Parliament; and informal measures agreed between the Executive and UK Government.

While the Sewel Motion (now officially known as a Legislative Consent Motion) process needs further reform, this does not negate the fact that in many instances it has worked to Scotland's advantage. The argument that Sewel motions have been used to subvert the policy making process of the Scottish Parliament does not stand up to close scrutiny. Independent academic research concludes that while there are "real objections" to Sewel motions, "there is.... no evidence that Westminster is using Sewel motions to impose policies on Scotland."⁶

The Parliament's Procedures Committee has also rejected claims that the Sewel Motion process has been used in any way to 'hand powers back to Westminster', concluding that "It is therefore incorrect to say that when the Parliament agrees to a Sewel motion to enable Westminster to legislate on a devolved matter, this somehow involves the Parliament handing back powers to Westminster. Such an assertion betrays a basic misunderstanding of devolution."⁷ The Procedures Committee's Report on the Sewel Motion process made a number of sensible recommendations to improve the system greatly (some of which have now been adopted) and this is to be welcomed.

Public Opinion – Support for Additional Powers

In a comparatively short space of time the Scottish Parliament has come to be at the heart of Scottish society. As an institution it is now embedded in Scottish life and increasingly is seen to be so by the people of Scotland.

The Scottish Parliament has substantial powers but it is not always clear to what extent the general public recognises this, and whether this leads some people to call for additional powers. Nevertheless, there is consistent evidence that people in Scotland do support additional powers for the Scottish Parliament.

The Scottish Social Attitudes Survey 2001 shows that 65% of people in Scotland agreed or strongly agreed that the Scottish Parliament should be given more powers. Further evidence can be seen in a recent opinion poll conducted for the Politics Now programme which showed a majority of people in favour of more powers for the Scottish Parliament. The survey of 1,007 adults by MORI Scotland asked “To what extent do you agree or disagree that the Scottish Parliament should be given more powers?” 22% strongly agreed, 36% agreed; 8% neither agreed nor disagreed; 13% disagreed; 11% strongly disagreed and 10% had no opinion. Therefore more than twice as many people agreed that the Parliament should have more powers than disagreed⁸.

This trend is particularly visible in the younger generation of Scots. Young people want more powers for the Scottish Parliament. In fact, 73% of those in the 18-24 age group surveyed by MORI Scotland agreed that this should happen with just 11% disagreeing⁹. This compares to 58% versus 24% for the whole sample.

But support for additional powers does not equate to support for independence. There is little evidence of any growing support for independence among the Scottish people. More than half of the people of Scotland (52%) report a constitutional preference for the Scottish Parliament, while only around a quarter would prefer independence (22%) or no devolution (24%)¹⁰. Independence, it would seem, is increasingly irrelevant in modern Scotland. The public will not swallow simplistic, separatist notions of independence.

Debate in Civic and Political Scotland

In a recent Sunday Times article a wide range of politicians, businessmen, church leaders, artists and academics backed a re-examination of the devolution settlement, with many supporting the call by Scottish Liberal Democrat Leader, Nicol Stephen MSP, that “The time is right to look again at the devolution settlement

to improve democratic accountability and to ensure that Scotland has the right powers to grow the economy and meet the challenges of the future.”¹¹

The existence of the Scottish Parliament has led to changes in the political landscape and to further debate across political parties about its future. The success of the Home Rule Parliament has since seen the SNP’s vote decline at four successive elections and their replacement as Scotland’s second Party by the Liberal Democrats at the 2005 General Election. This has led some in the SNP to look at options other than independence for Scotland’s future. The Conservatives too are endeavouring to rediscover a Scottish ‘narrative’ for their Party, with some looking again at the options for change to fiscal powers. There are also signs of stirrings within the Labour Party. Wendy Alexander MSP recently wrote the foreword to an Allander Series pamphlet on fiscal federalism. This followed the publication of a pamphlet on the same subject by Liberal Democrat Jeremy Purvis MSP.

It is to be hoped that these developments will allow Scottish politics to be freed of the seemingly interminable, distracting and destabilising debate for and against independence - a concept in any case increasingly meaningless in the age of globalisation.

Issues of Identity

There continues to be strong evidence that people in Scotland are comfortable with a set of multiple identities. Using the ‘Moreno’ scale to investigate the extent to which identities are not exclusive, the Scottish Social Attitudes Survey has shown that people in Scotland view their identity in different ways. 36% feel Scottish not British; 30% more Scottish than British; 24% equally Scottish and British; 3% More British than Scottish; and 3% British not Scottish.¹² The conclusion drawn from this by the ESRC programme on Devolution & Constitutional Change is that “In sum, while devolution may not have strengthened adherence to Britishness, it has certainly not eroded it sufficiently to threaten the cohesion of the UK Union.”¹³

Issues of identity in a changing world – which are by no means limited only to national identity – will lie at the heart of matters as we move towards a new, modern, federal relationship between Scotland and the rest of the UK.

Pressures from Across the United Kingdom

While the project to deliver Regional Assemblies across England may have faltered, there remains a desire south of the border to bring government closer to the people on a national or regional basis. Talk of an English 'backlash' to the devolution settlement is premature and overstated, but there is a likelihood that tensions will grow with time. This could happen in two ways. First, the current low level 'grumbles' occasionally emanating from areas of England that believe Scotland gets a better deal under devolution could develop into a more sustained and potent grievance. Witness the comments made by the Deputy Prime Minister in 2001 when he said there would soon be "blood on the carpet" on this issue.

Research by Iain MacLean of Nuffield College suggests that 'anti-Barnett' resentment is traceable in five English regions: North East; North West; Yorkshire and the Humber; South West; and London (not least in the form of Mayor Ken Livingstone)¹⁴.

Second, there is no guarantee that the relatively stable relationship between the Scottish and UK Governments will continue in the future. The potential problem posed by a change in the colour of administration north or south of the border is something to which a number of academic commentators have pointed.

It is also important to recognise that the establishment and work of the Scottish Parliament challenges and redefines both the relationship of England to the United Kingdom, and the policies of the United Kingdom Government more generally. For example, the abolition of student tuition fees by the Scottish Parliament led to pressures on the Government to provide a better deal for students in England. This was a driver of the debate over top-up fees in England which, in turn, increased the pressure for more support for Universities in Scotland. Following the report of the Richards Commission, the Welsh Assembly is to gain more powers and this will also have an impact on changing the position of England within the union.

According to the Programme Director for the ESRC Research Programme on Devolution and Constitutional Change, Professor Charlie Jeffery:

“Devolution has bedded in remarkably smoothly. But it remains a fractured project, a collection of separate initiatives which lacks an overarching sense of purpose. Enid Blyton might have called it ‘The Mystery of the Missing Centre’. UK Government in Westminster and Whitehall has been slow, complacent even, in thinking through devolution. No other decentralised system has been conceived and operated with such little conscious attention to statewide coordination of government activity. This is an omission that will become a problem when the current benign climate of Labour dominance and budgetary growth fades.”¹⁵

Professor Jeffery goes on to conclude:

“Devolution in all these senses – relations between governments, outputs of the state, public attitudes – is not about ‘either-or’ questions, but ‘both-and’ equations. But no government in the UK – in Westminster or beyond – has put much effort into defining the UK-level and UK-wide dimensions of any of these equations. Without such efforts devolution runs the danger of drifting into a centrifugal dynamic. And that is not what it was meant to be for.”

Conclusion

These trends and changes are all important considerations for a new Constitutional Convention – and they are too important to be left to politicians alone. The new Convention should have a strong remit to involve civic Scotland and beyond in its work. We believe that the future of the Scottish Parliament is a matter for all of Scotland’s people. We believe too that the Scottish Parliament on its own cannot be the custodian of this process. The daily cut and thrust of party politics is not conducive to dealing with the complex and wide ranging long term issues that must be addressed. The scope and nature of the debate on the future of the Scottish Parliament will require more time and scrutiny than the Parliament itself can give, and it will also require the active participation of civic Scotland.

For these reasons and more, it is important that Scotland, through a second Constitutional Convention, should begin to debate and discuss the future of the Scottish Parliament and its role within the UK. The potential is considerable for it to deliver consensus not division, and in turn to drive forward the process of constitutional reform of the UK.

Chapter 3

International Lessons for Scotland

The issue of how to increase fiscal decentralisation to better match political and administrative devolution is a key aspect of the work of the Commission. Therefore, this chapter sets out conclusions on the lessons that Scotland can learn from the wider international debate and the growing experience of political, administrative and fiscal decentralisation. We are conscious, however, that there is no ‘magic bullet’ for successful fiscal decentralisation. The success of a fiscal system does not come from one single aspect. While there are clear lessons to learn from other fiscal systems, we must conclude that despite similarities in function and form, each is unique and should be considered as a whole.

Political Decentralisation

Structure

One of our first tasks was to consider the varying state structures found in a range of countries, including states with federal, unitary and devolved settlements across Europe, North America and Australasia.

A detailed study of twenty countries by Pricewaterhouse Coopers¹⁶ examined the role of various tiers of government and compared grant distribution systems across these countries. This research confirms that most countries adopt a three tier structure of government: national, regional and municipal. In some cases an additional departmental component is added between regional and municipal; in others a parish commune or district structure is added below the municipal level.

The main structural trend is the development of a sub central tier of government with strong regional bodies in Germany and USA, with emerging regional tiers in France, Spain, Italy, and of course the UK, where devolution has brought a strong sub-UK national tier in the form of the Scottish Parliament and the developing Welsh Assembly (particularly post Richards Commission).

Across international comparisons, this basic three tier structure is generally mirrored by similarities in the services provided by each tier. This is called the beneficial principle (the “catchment areas” of service users). The municipality deals with matters of local

public goods; regions deal with national public goods such as health; and national tiers deal with matters of common or over-arching concern such as macro-economic policy, defence and foreign affairs.

Constitutional Considerations

In many states this division of power and responsibilities is given statutory backing by a written constitution.

Ford (1999) suggests that the following issues should be addressed when devising a constitution to provide a legal framework for reform:

- “Classification of local governments within tiers established under the constitution;
- Broad organisation structures and their roles and responsibilities;
- Terms of office, operating powers, procedures, and limitations on the political leadership, as distinct from the civil service;
- The degree of autonomy of personnel policies and administration of local governments;
- The taxing and fiscal administration authority of local governments;
- The borrowing authority and capacities of local governments;
- The distribution of budgeting, expenditure management, accounting, auditing and reporting requirements;
- Service provision and delivery authority;
- The mechanisms for citizen participation and voice.”¹⁷

Division of Powers

The past few decades have seen an international trend towards greater decentralisation of power. Examples include the increased responsibility of Danish municipalities post local government reform in the 1970s; decentralisation in Sweden where municipalities and counties now undertake 35% of public sector spending; major shifts in expenditure and progressive devolution of functions such as health and education to the Autonomous Communities in Spain; greater powers for Italian regions from 1970s onwards with primary responsibility for health, economic development and the environment; and greater devolution of spending powers to French regions, admittedly from a low base¹⁸.

Illustration 1– The German Constitution

Structure

The German system of government is a federal system comprising four tiers – federal, states/city states, rural/urban districts and the municipalities. It is laid out in the 1949 constitution, the Grundgesetz (Basic Law). Articles 20 and 28 of the constitution state that Germany shall be a democratic and social federal state. Subject to these conditions the Länder can shape their constitutions as they wish.

The German Länder have the status of states and can pass laws through their parliaments, execute them through their governments and have an independent judicial system. Each Länder has its own constitution, parliament and executive with the parliaments being directly elected.

A study for the Scottish Office notes the relationship between Länder and the National Parliament:

“If federal legislation concerns the Länder, the elected Bundestag (the supreme legislative authority) needs the consent of the Land government’s representatives in the Bundesrat. This is necessary for approximately 75% of federal laws. The Bundesrat has considerable veto powers but little initiation rights. Individual Länder send nominated party delegations (3-5 depending on Länder size). Therefore it is not directly elected and never dissolved (NB delegations are required to vote on Bloc)”²¹

Any amendment to the Basic Law must receive the support of at least two-thirds of the members in both federal legislative chambers - the Bundestag (Federal Diet or lower house) and the Bundesrat (Federal Council or upper house). Certain provisions of the Basic Law cannot be amended: those relating to the essential structures of federalism; the division of powers; the principles of democracy, social welfare, and fundamental rights; and the principle of state power based on law. Of the many amendments to the Basic Law, among the most notable are the "defense addenda" of 1954-56, which regulate the constitutional position of the armed forces, and the "Emergency Constitution" of 1968, which delineates wider executive powers in the case of an internal or external emergency. (Source: US Library of Congress)

The states have the majority of the decision making power as well as the power to influence the federal level through representation in the second chamber of the parliament.

Constitutional Division of Power

The German constitution is based on three concepts for the division of power. In the first instance it gives the Länder the power to legislate insofar as the "Basic Law does not confer legislative powers on the Federation." The Federation therefore has exclusive legislative power defined in the constitution, including foreign affairs and defence, citizenship, currency money and coinage, customs, federal railroads and air traffic, postal and telecommunications services, and aspects of crime and policing.

The constitution also sets out the concept of concurrent legislation, including civil and criminal law, registration of births, deaths and marriages, weapons and explosives, immigration and asylum, production and utilisation of nuclear energy for peaceful purposes, employment laws, promotion of agriculture and forest production, ocean and coastal shipping.

The Federation also has powers to establish framework legislation in areas including the general principles governing higher education, land distribution, matters relating to registration and identity cards.

The German system also employs the financing principle, ensuring that if the federal government asks a lower tier to act on its behalf it is constitutionally required to fund the accrued expense. The division of taxation powers, including the percentage split for joint taxes, is also set out in the constitution.

Illustration 2 - The Canadian Constitution

The Canadian constitution works on the principle that powers fall to the federal government unless specifically designated to provincial legislatures.

Illustration 3 - Shared Competence in Germany

“In Germany fiscal relations predominantly reflect the desire to create broadly equal living conditions across the Federation. Here areas of competencies tend to be shared among tiers of government. For example, on health care, the Federal government sets legal conditions, and provides the funds to finance operating costs for hospitals, while the Länder finance hospital investment and regulate capacity; and the Communities are responsible for delivery of local health care services, Wurzel (1999). There may be a trade-off if shared competencies obscure the accountability of local administrations to citizens.”²²

Fiscal Decentralisation

Measuring Fiscal Decentralisation

Over the last twenty years there has been increasing interest in the decentralisation of government across the globe²³. In fact, according to the Lead Economist of the World Bank Institute, Robert D. Ebel, “the pursuit of decentralization is widespread, as both developed and developing countries attempt to challenge central governments’ monopoly of decision-making power”²⁴.

The drivers for decentralisation vary across the world: improving public service delivery in developed Western countries; coping with the transition from communism in Central and Eastern Europe; reacting to political pressure for democratisation in Latin America; and as a path toward national unity in Africa²⁵.

It is arguable that although the UK came to the issue of decentralisation relatively late in the day, progress has been significant and swift. Nevertheless, it is also clear that the decentralisation / devolution debate in the UK has focused primarily on decentralising political and administrative power. Debate about fiscal decentralisation in its widest sense has been limited. Not only has political debate been muted, the UK Government has only just begun to put in place systems to measure spending across all regions of the UK – statistics that are necessary for an informed debate on the decentralisation of fiscal power.

The Index of Fiscal Control produced by the OECD can be used to measure the extent to which sub-central taxation is controlled locally and therefore the extent of fiscal decentralisation and

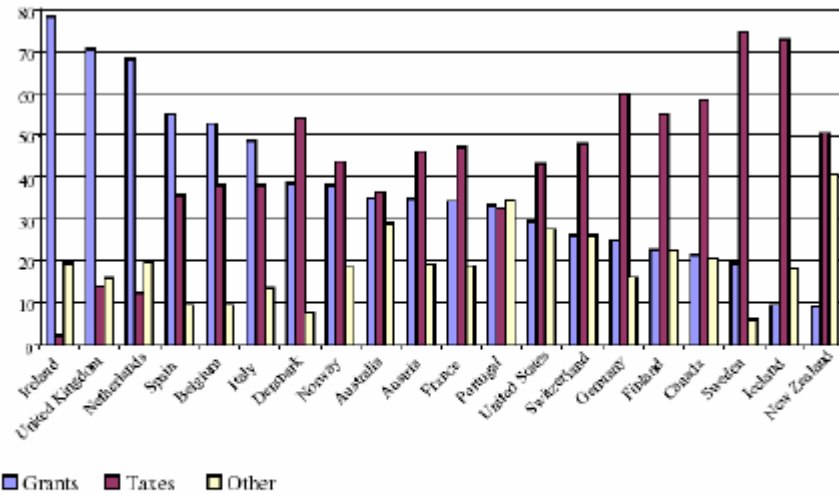
autonomy. It sets out a sliding scale of autonomy from category a) representing much greater fiscal control to e) which is much more limited²⁶:

- State/Local government free to set both tax rate and tax base
- State/Local government free to set tax rate only
- State/Local government free to set tax base only
- State/Local government able to determine revenue-split in tax sharing arrangement with higher levels of government
- Revenue split in tax sharing arrangement with higher level of government requires consent of State/Local government
- Revenue split in tax sharing arrangement is fixed, but can be unilaterally altered by higher level of government
- Revenue split in tax sharing arrangement is determined by higher level of government in their annual budget
- Higher level of government sets both tax rate and base

Therefore, sub central states with control over the tax rate and tax base (at least for some of the tax basket) have considerably more autonomy than those with tax sharing arrangements.

In the UK, devolved administrations are not funded through taxation in the same way as equivalent administrations in other European countries. The table below clearly shows how, in many countries, taxation and other revenues form a much higher proportion of revenue for sub central administrations than in the UK.

Composition of Sub-Central Government Revenues as a Percentage of General Government Revenues



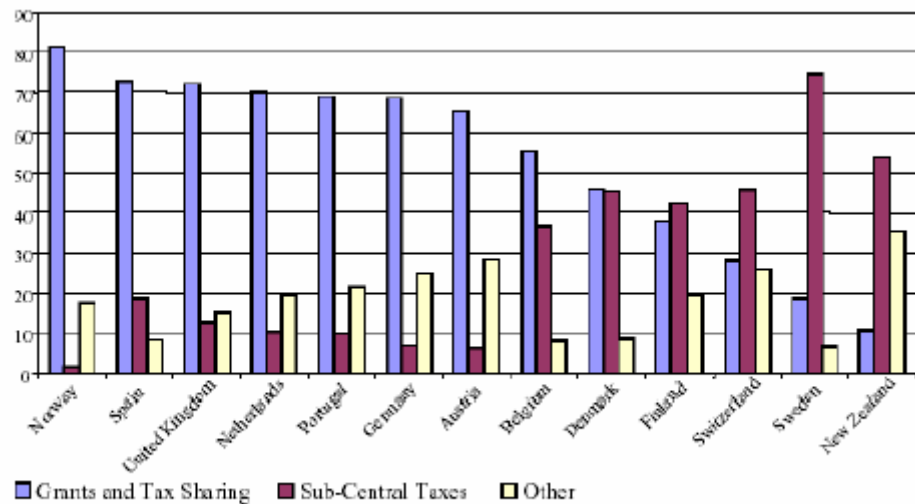
Source: IMF Government Financial Statistics 2001

Note: Figures relate to 2000 for Canada, Denmark and New Zealand; to 1999 for Australia, Austria, Sweden, Switzerland and the USA; to 1998 for Belgium, Finland, Germany, Iceland, Portugal, Norway, UK; and to 1997 for France and the Netherlands.

It is important to note that there are some exceptions which are not explained in the table above (Composition of Sub-Central Government Revenues as a Percentage of General Government Revenues).

Sub central administrations in countries such as Germany and Austria are given some share of the total tax yield through tax sharing, but, because they do not control the tax base or the tax rate, in practical terms they have very little fiscal autonomy. Tax sharing may not be real fiscal devolution, but these tables clearly demonstrate that, even allowing for this caveat, the UK still relies very heavily on a system of grant funding for devolved administrations' budgets when compared with other European and international examples.

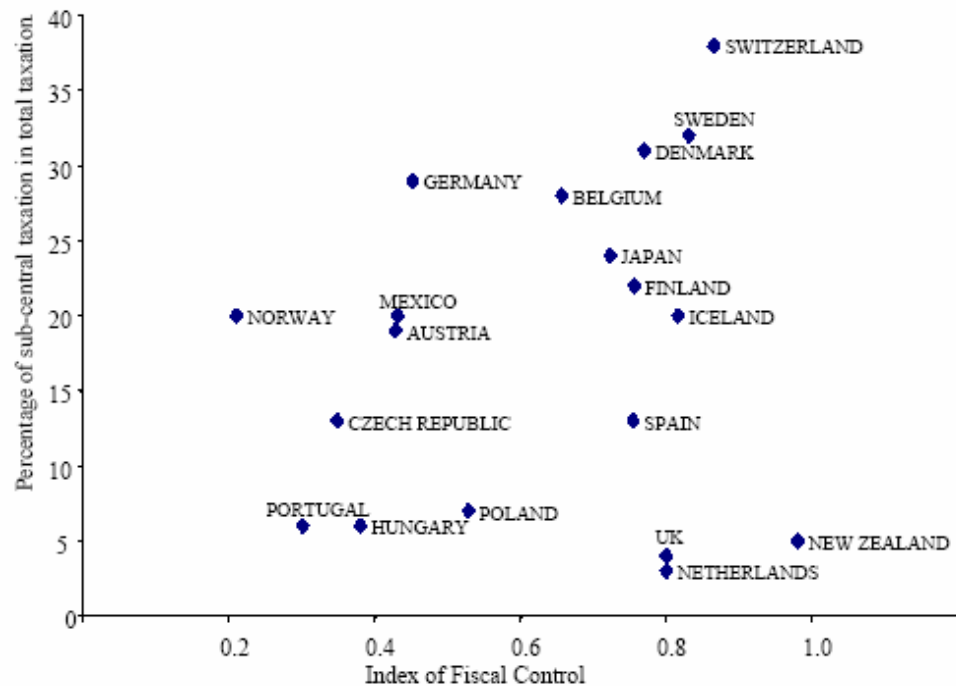
Composition of Sub-Central Government Revenues in 1995 as a percentage of General Government Revenues



Source: OECD (1999)

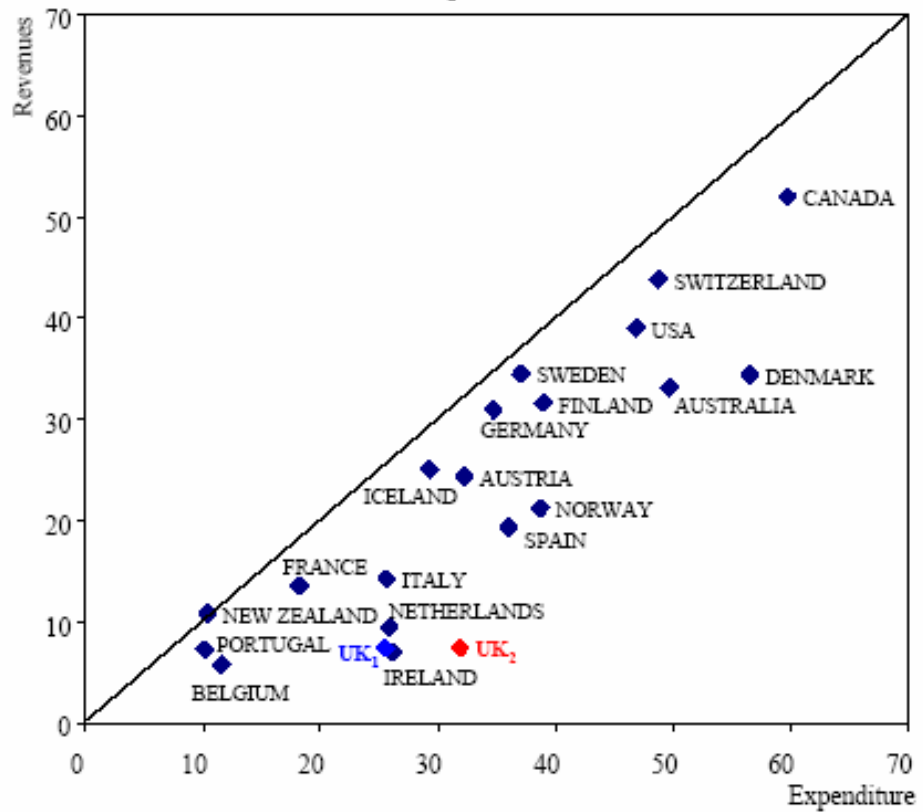
This point is confirmed by the following two Figures, which clearly show that fiscal control at the sub central level in the UK is much less than in many other countries and that direct tax revenues to the sub central level account for a much lower proportion of expenditure in the UK.

Figure 2: The Importance of Sub-Central Levels of Government and the Extent of Fiscal Control



Source: IMF Government Financial Statistics and OECD (1999)

Figure 3: Fiscal Imbalances
 Tax and Non-Tax Revenues and Expenditure of Sub-Central Governments



Source: IMF Government Financial Statistics

[Note: UK1 is pre devolution and UK2 is post devolution]

Illustration 4 – Tax Powers Spain²⁷

Like the UK, Spain has a system of asymmetric devolution where some regions, or autonomous communities, enjoy differing powers. The constitutional and fiscal arrangements employed give the autonomous communities responsibility for 'primary functions' and the constitution reserves a number of policy areas to the state government. Article 8 of the Spanish constitution allows for tax to transfer from the State government but also the transfer of their collection from the tax agency. The constitution also allows for regular, if not frequent, review and the system has been reviewed every five years.

A number of drawbacks were identified in the system leading to reform in 2001:

- Communities may receive differing per capita amounts of resources;
- If the national economy is thriving some regional economies may not be doing so well, creating an imbalance;
- The system has difficulty coping with demographic change; and
- There was concern about equality of public service provision across communities.

The Spanish government reviewed the system to take account of the concerns from the communities, in particular Catalonia. The Catalanian government argued for a system where the community would have a direct participation in the tax basket with the Catalan government (Generalitat) participating in 11 of the 13 taxes paid by Catalans.

In Catalonia in 1982 only 16% of revenues came directly from taxes paid by Catalans. The new model means the proportion reaches 86%. The remaining 14% of the Generalitat's revenues are transfers from the State and provide leeway for future modifications.

In the reviews of 1991 and 1996 there was participation in only income Tax; today the 'tax basket' includes the following with the percentage of authority over it:

- Income tax 33%
- VAT 35%
- Tobacco tax 40%
- Alcohol tax 40%
- Hydrocarbon tax 40%
- Energy tax 100%
- Succession duties and gift tax 100%
- Capital tax 100%
- Patrimony transmission tax and tax on documented legal acts 100%
- Gambling tax 100%

The Spanish system now incorporates a process for the 'tax basket' under which additional resources are obtained for the communities every time that changes in the basket exceed nominal GDP. The model complies with the conditions of the EU whose objective is to make intra state transactions more efficient.

Spain has created two new institutions to administer the new model. The first body is the Superior Management Council of the State Tax Administration Agency, with State representatives and six autonomous communities' representatives. Within Catalonia, the Catalonia Territorial Tax Management Council has three State representatives and three representatives from the Generalitat.

The new model has a "solidarity" measure to protect the level of funding and provide equalisation. The mechanisms to do this are:

- An adequacy fund, based on population distribution;
- Specific health funds for health cohesion;
- A relative revenue fund, for communities with lower per capita income;
- allocation of minimum levels of public services; and
- inter-territorial compensation fund.

Illustration 5 – Tax Powers Belgium²⁸

The Belgian regions enjoy considerable autonomy over a range of taxes and non-tax revenue sources, many of which have been handed down from the federal level over the years. Belgium uses a shared income tax between the federal government and the regions to transfer funds to the regions based on a predetermined share which evolves in line with the relative regional revenue of the personal income tax. Over the years the autonomy of the regions to vary this tax around the margins has increased.

In summary, the regions have almost complete autonomy over the following taxes:

- Gambling and betting;
- Tax on opening of drinking establishments;
- Transfer duty upon death and inheritance tax;
- Real estate tax;
- Registration fees on inter vivos donations of personal and immovable property;
- Taxes on use of vehicles;
- Vehicle registration tax and the Eurovignette;
- Radio and television fee.

The proceeds of these taxes are collected free of charge by the federal government and entirely attributed to the Regions. The regions can decide to collect directly certain groups of taxes.

There are some limitations to the power of the regions on some of the above taxes, namely: establishment of cadastral revenue on which real estate tax is based remains under federal control; and the tax base for vehicle related taxes is subject to a cooperation agreement between the regions and the federal level.

The regions also have the power to establish new taxes. They may levy a tax on any matter provided that there is no federal tax on this matter or that the federal government has not shown the need to levy such a tax – thus following the principle of no double taxing.

Illustration 6 – Tax Powers

Germany

The German fiscal system is quite complex. It comprises a range of taxes which are controlled by each tier of government, and a second set of taxes where revenues are shared between tiers on a predetermined share.

Taxes accruing to one level:

- Federal Taxes:
- Spirits monopoly
- Insurance tax
- Customs duties and other levies required by the EU
- Excise taxes on tobacco, coffee, sparkling wine and mineral oil

State Taxes:

- Inheritance tax
- Real property transfer tax
- Motor vehicle tax
- Beer tax
- Tax on betting and lotteries
- Gaming casinos levy
- Fire protection levy

Municipal Taxes:

- Municipal trade tax
- Real property tax
- Local excise taxes and taxes on certain non-essential spending

There are three main joint taxes which accrue to each level of government on a predetermined percentage share:

- Wages and income tax is split 42.5% federal; 42.5% Länder; 15% local
- Corporation Tax is split 50% federal; 50% Länder
- Turnover Tax is split 52.5% federal; 45.7% Länder; 2.1% local

Arguments for Fiscal Decentralisation

Academic debate on the benefits of fiscal decentralisation tends to focus on the issues of improving accountability, transparency, efficiency and driving economic growth. To some extent each is related to the other. This can be summed by the following quote from the Lead Economist of the World Bank:

“A carefully designed fiscal decentralisation policy should not only enhance local autonomy where sub national governments are allowed to act independently within their own sphere of competence in designing revenue and expenditure policies but also promote political accountability, economic efficiency and transparency.”²⁹

Accountability

“Each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise benefits and costs of such provision” (Oates, 1972)³⁰

This ‘beneficial’ principle can already be seen in the political decentralisation and devolution of power to Scotland – and indeed within Scotland. It is also clear from international experience that the primary reasons for decentralisation in most countries have also been political, not economic. However, that is not to say that the beneficial principle cannot be applied to fiscal matters. In fact, there is considerable academic debate on the link between fiscal decentralisation and economic growth.

There appear to be two related aspects here. First that greater fiscal responsibility is an important part of increasing political accountability and improving governance. Second is the argument about the relationship between increased fiscal responsibility and economic efficiency.

Efficiency

Efficiency is the economists’ *raison d’être* for fiscal decentralisation, with much of the fiscal federalism literature arguing that there are efficiency gains to be had from decentralisation (Ebel & Yilmaz). The argument goes that greater fiscal autonomy induces greater responsibility on local politicians. Essentially reliance on central grants can have two negative effects: allocation decisions that are not based on economic efficiency; and less pressure on local administrators to manage local spending effectively as “it is not apparent, at the margin, that an additional pound spent in local services will be equal to the benefit of an equivalent reduction in taxation”³¹.

Therefore it is suggested that efficiency gains from decentralisation can be allocative and managerial:³²

- Efficient allocation of resources will occur because “local governments have better information about their residents’ needs than the central government”.
- Competition among local governments will allow people to “vote with their feet” as fiscal decentralisation increases competition among the local governments for better use of public resources. In fact, as Brennan and Buchanan argue, “fiscal decentralisation promotes interjurisdictional competition that limits excessive taxing power of the governments”³³.

Economic Growth

Hard evidence on the link between fiscal decentralisation and efficiency and economic growth is hard to come by and can be ambiguous. Darby et al point to “indirect evidence” of sub central government in the United States behaving inefficiently when in receipt of central grants. This has come to be known as the ‘flypaper effect’ and is used to describe situations where local politicians do not feel compelled to cut taxes in response to increases in grant but behave differently when local income increases and raises taxation yields. However, as Darby et al also acknowledge, “there is little comparative empirical evidence across OECD countries”.

This ambiguity is also seen when seeking empirical evidence to support hypotheses on the impact of fiscal decentralisation on public sector size. The “Leviathan” hypothesis developed by Brennan and Buchanan (1980) builds on Tiebout’s analysis (1956) of tax competition and migration. It argues that fiscal decentralisation serves as a constraint on the behaviour of the revenue-maximising government. It therefore predicts that the overall size of the public sector should vary inversely with fiscal decentralisation, as competition among local governments will ultimately limit the size of the public sector. However, as Ebel & Yilmaz report, the empirical evidence to support the Leviathan hypothesis is often contradictory.

Empirical evidence on the link between fiscal decentralisation and economic growth is even harder to come by with relatively little research having been conducted. As Hallwood and MacDonald point out, there remains a real question as to whether fiscal decentralisation is a cause or consequence of economic growth³⁴. While Oates (1985) showed that industrialised countries had a higher degree of fiscal decentralisation than developing countries, this does not prove a causal link. Regression analysis such as Davoodi and Zou (1998), Xie, Zou and Davoodi (1999) and Zhang and Zou (1998) all found a significant relationship but this showed a negative relationship with fiscal decentralisation associated with slower economic growth³⁵. However, the lead economist of the World Bank comments that there are “serious methodological issues” confronting such empirical studies and concludes that “the theoretical underpinnings of the relationship between fiscal decentralisation and economic growth still need to be further developed”³⁶.

As Hallwood and MacDonald stated in their recent pamphlet, there are two further arguments made about fiscal decentralisation: first, that lessening the concentration of political power and promoting some tax competition could loosen the grip of vested interests on public policy which could promote longer term economic growth; and second, that decentralising fiscal power and bringing government closer to the people could lead to a growth in social capital through such things as confidence in government, civic cooperation and associational activity, which could boost growth³⁷.

Clearly the international and academic evidence on efficiency and economic growth is inconclusive, and claims that fiscal decentralisation alone can lead to significant savings in public spending and / or substantial growth in economic activity must be treated with caution. Nevertheless, the Commission is persuaded that there is a clear case for fiscal decentralisation having a strong impact on political accountability. We are also of the view that further consideration is required as to the extent to which Scotland could benefit from efficiency gains and how this might compare with other changes that would come from fiscal decentralisation, such as less certainty in public spending.

Innovation

Some academics have pointed to the opportunity for decentralisation to foster greater innovation as greater experimentation leads to potential improvements in policy design³⁸.

Other Key Considerations of Fiscal Decentralisation
Ebel and Yilmaz point to a report prepared by the US Advisory Commission on Intergovernmental Relations (ACIR) on Governmental Functions and Processes (1974) which lists four principles for setting proper incentives for efficient and equitable delivery of public services:

- fiscal equity;
- economic efficiency;
- political accountability; and
- administrative effectiveness.

These principles are referred to time and again in the fiscal federalism literature and are a crucial feature in fiscal decentralisation.

Common Features

Analysis of fiscal decentralisation across the world by the lead economist of the World Bank Institute suggests three generalisations which apply, no matter the specific governmental structures in place: vertical imbalances; horizontal imbalances; and lack of authority to raise buoyant taxes.

- “Sub national governments don’t have adequate levels of ‘own resources’”. In essence, their revenues are not enough to fund their own expenditure. This is known as a vertical imbalance, which is generally financed through intergovernmental transfers (which can vary considerably in how they are made and how they are formulated).
- “Striking variations appear in the size and capacity of sub national governments in all countries”. This is known as an horizontal imbalance. In international terms, the horizontal imbalance seen in the UK between Scotland and England, Wales and Northern Ireland or regions within these countries is considerably less than is seen in countries such as India, Russia or China where per capita sub national expenditure can vary immensely.
- “Sub national revenues are not adequately responsive to changing needs and sub national governments lack the legal authority to levy some taxes that yield enough revenue to meet their needs.” The pattern here varies widely across different countries depending on the particular settlement on who controls what taxes and the extent to which sub-central states control tax bases and rates.

Fiscal Equity

Fiscal equity is a crucial principle in any federal system. Academics are clear that no industrialised countries have opted for full fiscal autonomy. The reason for this is clear: to do so strikes against the principle of unity within states that sees an element of redistribution between areas with different levels of income and wealth³⁹.

All federal states include some form of intergovernmental transfers. It forms part of the social pact and in many cases the written legal constitution that binds the constituent parts of the state together. It recognises the benefits to all of the federal union and the need for solidarity. There are numerous options for achieving this goal.

There are two types of imbalance that occur: 1) vertical imbalance, where expenditure responsibilities of sub central governments do not match their revenue raising power; and 2) horizontal imbalance, where fiscal capacities to carry out the same functions differ across sub central governments.

The extent to which different transfer mechanisms such as sharing revenues and tax bases, ring fenced grants or non ring fenced grants, are used depends on the extent to which the aim is to reduce vertical and / or horizontal imbalances. Ahmad and Craig (1997) have identified three different policy responses to establishing the link between vertical and horizontal balances⁴⁰:

- Correct each imbalance by separate policy measures: the German system uses tax sharing or grant arrangements to resolve vertical imbalance while horizontal imbalances are resolved by payments from areas with higher fiscal capacity to poorer regions.
- An integrated system of equalisation grants: the Australian and Canadian approach is to deal with both imbalances simultaneously through a system of grants including equalisation payments and special purpose grants.
- Correct vertical imbalance and ignore horizontal: the United States approach is to resolve vertical imbalance through tax sharing and grants.

Sub Central Borrowing

Ebel and Yilmaz describe sub central borrowing as “an important component of the devolution of fiscal powers” and identify three primary reasons for it being an appropriate tool for sub central governments:

- Intergenerational equity: the benefit principle of taxation suggests that future residents should contribute to the cost of investment as it benefits people over a long period of time;
- Economic development: infrastructure investment can stimulate the regional economy and delaying this investment could have a negative impact on economic performance; and
- Synchronization of Expenditure and Revenue Flows: borrowing allows the sub central government to smooth out any mismatch in expenditure and revenue over a financial year, thus reducing scope for disruption to services.

However, sub central borrowing must be governed by rules which put some limits and conditions on the level of borrowing, so as to encourage responsible borrowing and to fit in with central government responsibility for macroeconomic stabilisation.

Key Criteria for Tax Decisions⁴¹

The academic literature points to a number of important factors which must be considered when taking decisions on the allocation of taxes within states:

- Tax Exportation – different types of taxes should be assigned to different levels of government so as to avoid tax exportation between sub-national jurisdictions and excessive taxing of the same base by different levels;
- Tax Competition and Migration of Factors of Production – the potential for tax competition to cause major migration in the tax base is often seen as something which should be limited and considered when allocating tax powers;
- Administrative Complexity – administrative costs and complexity can be increased by major variations across jurisdictions and the use of many shared taxes. However, as Darby et al point out, “there is no reason why one needs to decentralise the collection of taxes shared by different jurisdictions through a single national tax collection system”.

Illustration 7 - Canadian Equalisation

Federal government constitutionally required to make equalisation payments “to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation” and includes funds that recognise health, social issues and rurality need.

Illustration 8 - Transitional Arrangements in Australia⁴²

The Australian federal system has a much higher level of vertical fiscal imbalance than any other similar country. In 1999-2000, 77.7% of total Australian taxation was controlled by the Commonwealth with just 19.3% by the States and 3% by local government.

In 1999 a major package of reform of the fiscal system was agreed in the form of the Intergovernmental Agreement Reform Package. It raises a number of interesting points – not least that the overall effect has been to give States more access to a buoyant tax base with revenues from the Commonwealth General Sales Tax accruing directly to the States. However, at the same time this has reduced State autonomy as they do not control the tax base or rate (changes require the agreement of all levels). Furthermore, the package brought an end to many state taxes which were deemed inefficient but which had been under the sole control of the States.

It is interesting to note that the changes came with a Commonwealth guarantee that each State would not be worse off during the transition period than it would have been had the changes not been implemented. The transition period was approximately eight years and during this time States whose income fell below the guarantee level were given non ring fenced grants to maintain overall revenue levels.

Lessons for Scotland

Lesson 1: The current political and administrative powers of the Scottish Parliament compare well with most sub central states. Arguably, Scotland already has more political and administrative autonomy than most other comparable units within larger states. However, it is clear from other examples that there remain areas of policy which are decentralised in other states but which are currently reserved to Westminster.

Lesson 2: A shared approach to policy can be seen in many federal states. This can be a double edged sword: in some cases leading to reduced autonomy; in others giving the sub central state a genuine say in important policy areas. Scotland should consider what benefits would accrue from a more statutory role in some policy areas that are currently reserved.

Lesson 3: Political autonomy can be limited considerably by the fiscal system. On the one hand complete grant funding can limit the ability to pursue priorities. On the other hand, non ring fenced grant funding often offers greater overall autonomy than fiscal systems which include high proportions of ring fenced grants or restrictive tax sharing arrangements.

Lesson 4: Scotland is not afforded the same level of constitutional protection through the Scotland Act as is seen in many federal states which are governed by written constitutions. Although the Scotland Act is constructed in a similar way to some federal constitutions, it is unusual in that it still confers ultimate power to Westminster. While there has been, as yet, no sign of Westminster seeking to use this power to legislate in devolved areas without the consent of the Scottish Parliament, it is a constitutional anomaly – and perhaps a constitutional threat - that would be addressed by a written constitution for the UK.

Lesson 5: Political and policy autonomy can vary markedly across different states, including between the same kind of states whether federal or unitary. There is a general trend to maintain central control over matters like defence and foreign affairs, together with other areas where a common approach or economies of scale are important. There are also variations between states in terms of the extent to which the constitution either 'reserves' specific areas and 'devolves' everything else or sets out 'reserved', 'shared' and 'devolved' competences.

Lesson 6: Asymmetric federalism is not unusual, both in terms of the varying size of the component units and variations in the level of power and responsibility afforded to them. The example of a devolved state in Spain sees the autonomous communities have

significantly greater powers than other parts of the country. Therefore, while a more symmetrical system may be desirable, there is clear evidence that asymmetric systems can work too.

Lesson 7: Despite the decentralisation of political power since 1999, the UK remains one of the most centralised fiscal systems in the developed world. Sub central states in other OECD countries enjoy much greater fiscal power with central grant funding making up a much smaller portion of revenue.

Lesson 8: Many sub central states with less political power than Scotland have much greater fiscal autonomy and control over taxation than has Scotland.

Lesson 9: The greatest fiscal autonomy for sub central states comes from control over the tax base and tax rate. Tax sharing systems can work in some circumstances but this depends on the extent to which the sub central state is able to control the base, rate and split in revenues. Often tax sharing can be confusing and can actually limit autonomy.

Lesson 10: It is a common theme in sub central states with taxation powers that they are able to introduce new taxes as long as they accept certain rules, often based on the double tax principle that aims to avoid overtaxing the same base.

Lesson 11: Different countries collect sub central taxes in different ways but it is clear that in most cases there is no reason why tax collection cannot remain a central function while control over certain taxes is decentralised. In some systems there is a mix between centrally and locally collected taxes.

Lesson 12: The key arguments for fiscal decentralisation are improving political accountability, public transparency, efficiency in the allocation of resources and decision making and stimulating economic growth. There is also potential for greater innovation.

Lesson 13: The Commission believes that constitutional change does not bring about economic development on its own. Rather it can create a constitutional framework within which there is greater freedom to make policy decisions which can lead to economic growth. Fundamentally, the Commission believes it is the policy decisions taken by governments using such powers that are the greatest determinant of economic development.

Lesson 14: No industrialised country has chosen to pursue full fiscal autonomy.

Lesson 15: There are a number of factors which apply to nearly all systems: sub central governments do not have adequate levels of 'own resources' leading to vertical imbalances and the need for intergovernmental transfers; it is common for there to be major variations in the size and capacity of sub central governments leading to horizontal imbalances; sub central governments are often not given authority over those taxes which are likely to be buoyant.

Lesson 16: Major changes to fiscal systems have to be carefully managed. Reform of the Australian system included an eight year transition period in which states were provided with a guarantee of minimum income so as not to disrupt services if income was less than under the previous system.

Lesson 17: Equalisation and intergovernmental transfers exist in all federal systems. This is part of the social pact and in many cases the written legal constitution that binds the constituent parts of the state together. It recognises the benefits to all of the federal union and the need for solidarity. There are numerous options for achieving this goal depending on the extent of vertical and horizontal imbalances.

Lesson 18: The power to borrow money within agreed limits is an important part of fiscal decentralisation.

Lesson 19: There are a number of key criteria that are generally applied when deciding how to divide up the tax basket, including: tax exportation, tax competition and migration of the factors of production, and administrative complexity.

Chapter 4

The Case for a Modern Settlement for the UK

Background

This Chapter considers the case for a modern settlement for the United Kingdom which recognises the benefits to all parts of the Union from a continuing relationship.

The Case for the United Kingdom

This Report argues for changes in the powers of the Scottish Parliament, particularly in its fiscal and economic levels, but it does so against a recognition of the continuing value to Scotland of the United Kingdom, and, indeed, of the value of Scotland to the United Kingdom. A thriving, healthy, dynamic Scotland is good for the population of the rest of the UK, just as a thriving UK is good for Scotland.

The United Kingdom has been one of the great success stories of the world. The Union between England and Scotland joined together nations who had been warring with each other for hundreds of years. It took a small island country on the fringe of Europe to a position where its influence covered a quarter of the globe. It established a formidable commercial, industrial and financial position. It spawned new nations in all parts of the globe. Its language has become the lingua franca of the world. It developed ideas of liberty, democracy and the rule of law which were widely emulated. Its people produced much of the philosophy and many of the ideas which shaped the modern world. The contribution of Scots in philosophy, in science and engineering, in medicine, in administration and finance was disproportionately high. For example, it was a Scot, William Paterson, who was the principal driving force in the establishment of the Bank of England (1694), before playing an influential role in the establishment of the Bank of Scotland (1695). The Union enabled Scotland to punch above its weight on the world stage, and allowed Britain to be more than the sum of its parts.

Today, the United Kingdom continues to enhance Scotland's ability to achieve its aims in many ways:

The United Kingdom as a whole has a greater punch internationally than any of its constituent parts separately. This enables us to have more influence in Europe, the United Nations, NATO and other international bodies than we would otherwise. It is true that many people in Scotland criticise some aspects of how this power is exercised – the war in Iraq, our nuclear capability or the deployment of troops for example – but so do many people in England, Wales and Northern Ireland.

The United Kingdom Government is best placed to deal with issues that affect the whole island – foreign affairs, defence, immigration policy, macro-economic affairs, trade laws. While there may be questions as to the exact relationship between Scotland and the UK in areas such as macro-economic policy or trade laws, the Commission believes that this is an argument for modernising and redefining the relationship with the rest of the UK, and not a reason to break up the Union.

The United Kingdom as a whole has financial resources that can be directed to areas of need across Britain. The figures can be difficult to disentangle, but the Scottish Executive is enabled to spend more per capita than England on a number of social programmes - specifically health and education where per capita spending in Scotland is 16% and 7% higher respectively compared with the rest of the UK. This is justified in terms of greater current need, but, as has been pointed out, it is also a fleabite in terms of the effect on overall UK resources.

The ability of the United Kingdom Government to make common provision across the UK for pensions and social security benefits acts as an automatic support for those in greatest need, bringing the resources of the Union to bear in a way which supports areas of greatest economic and social need.

The United Kingdom has a network of Embassies and a range of diplomatic and commercial contacts across the world, which support Scotland's overseas trade and other interests in a way which could not be replicated so effectively by Scotland alone. This is supplemented by the work of organisations like the British Council.

The United Kingdom Government is able to concentrate resources to support research and development. This is of enormous benefit to Scotland which wins more than its pro rata share of university and other research funding. For example, the UK Government has increased the overall science budget from £1.3 billion in 1997-98 to £3.4 billion in 2007-08. The allocation for 2005-08 totals £10 billion, which is equivalent to almost half of the total Scottish

Executive budget for one year. A separate Scotland could not match this or have critical mass in key areas.

The United Kingdom is also associated with a number of key British institutions which are part of the national cement, and linked to the common national experiences of 300 years. These include the Crown, the BBC, the armed forces, the civil service, HM Revenue and Customs, the concept and tradition of a National Health Service, and, of course, the Westminster Parliament itself. It is true, of course, that many of these institutions are changing (although at varying rates and to different extents) as a consequence of devolution, but they remain important to our sense of Britain.

The relationship between Scotland and the United Kingdom Scotland and the United Kingdom work in partnership on far more issues than is commonly thought – on creating opportunity and employment, on efficiency in government, on tackling major crime, on supporting the voluntary sector through the Big Lottery, and many others. It might be thought that this is a product of the fact that Labour are in government in London and the larger partner in the Partnership Executive in Scotland, but, no doubt with greater tensions, it is evident that this would continue under other political dispensations too.

Changes since 1999

Concerns about Scotland's sluggish growth relative to the rest of the UK, and, even more so, to the rest of Europe, fuelled the demand for Home Rule in the latter part of the twentieth century. At the end of 2005, there are increasing indicators suggesting that this picture is at last changing. Excluding London and the South East, Scotland is now ranked 2nd in the UK in terms of Gross Value Added Index (GVA) - the most widely recognised measure of relative standards of living. Growth in the Scottish economy in the second quarter of 2005 was higher than across the UK as a whole. Scotland's employment rate is above that of the UK and is one of the highest in the EU. Scotland's economic activity rate is also above that of the UK as a whole.

It is difficult to confirm the extent to which the existence and activities of the Scottish Parliament and Executive have contributed to this situation, but it is not unreasonable to suggest a connection. The Scottish Executive has had, since 1999, control or substantial influence over a number of key economic levers and has claimed economic growth as its top priority. It also has the advantage of managing detailed decisions for a much smaller political unit.

The Framework for Economic Development in Scotland 2004 (FEDS) notes that economic growth is primarily determined by the success of private enterprises in developing products that can compete effectively both domestically and throughout the world. Increasing Scotland's economic growth rate will be secured only through sustained increases in competitiveness in international and domestic markets and this competitive edge will itself fundamentally depend on raising the underlying productivity of both private enterprises and the public sector.

FEDS therefore identified the priorities for economic development as being:

- Basic education and skills
- Research and development and innovation
- Entrepreneurial dynamism
- The electronic and physical infrastructure
- Managing public sector resources more effectively

It is worthwhile observing that the Scottish Executive has had these five priorities for economic growth increasingly in its sights. The most recent Scottish Economic Report, published in December 2005, comments on the increased spending on education and training since devolution, and on the economic value of improved infrastructure underpinning competitiveness. Building a Better Scotland: Spending Proposals 2005-2008, published in September 2004, locked in the objective of continuing to substantially increase net investment in infrastructure.

It is clear, though, that the composition and effectiveness of public spending is crucial, and this is much more difficult to measure on a short timescale.

The United Kingdom Context

The Scottish economy is a small, open economy, heavily influenced by wider international trends and heavily dependent on foreign trade. It operates within a macro-economic and fiscal environment set by the United Kingdom Government within the constraints of the European Union and of other international economic arrangements. It is also highly integrated with all other parts of the wider UK economy⁴³.

Importantly, the United Kingdom's monetary policy arrangements include the operational independence of the Bank of England to set short term interest rates to achieve the Government's inflation target. Fiscally, the golden rule states that, over the economic cycle, the Government will borrow only to invest and not to fund current expenditure; and the sustainable investment rule states that net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.

Finally, considerable change has taken place in recent years in the way in which the technical efficiency of spending is assessed: three-year budgets; HM Treasury's Green Book; Pre-Expenditure Assessments; Gateway Reviews. Much of this is driven by new and more rigorous technical guidance from the Treasury.

So Scotland has had the backdrop of being part of a relatively stable UK fiscal and economic union that has performed significantly better in recent years. Further, the UK fiscal union means that Scotland's tax burden is lower than the present level of public expenditure would imply, while issues like public sector net borrowing requirements are of little direct macro-economic consequence to Scotland as a result of the current system of funding by way of direct grant⁴⁴.

All Winners – How the United Kingdom benefits from Scotland
It is sometimes claimed that Scotland is a "cost" and a burden to the United Kingdom. This may be true to a degree at some points in time in a narrow accounting sense, but it was certainly not true when Glasgow was the second city of the Empire and the country contributed substantially to the national receipts, as well as supplying a major part of Britain's natural resources, her shipbuilding fleet and her armed forces.

The current financial and economic relationships between Scotland and the United Kingdom as a whole are extremely complex and cannot be reduced to a simple issue of whether Scotland has a fiscal deficit or a fiscal surplus, or what difference the inclusion of the revenue proceeds of North Sea oil might make at different points in time.

These abstruse calculations are, of course, of interest to Nationalists and others who see merit in breaking apart the network of relationships built up across Britain during 300 years of the United Kingdom. This Commission takes the more pragmatic view that the fiscal arrangements should be broadly equitable, that they should work in the interests both of Scotland and of the wider Union, and that they should encourage political accountability and economic efficiency.

In broad terms, Scotland has lower per capita income and higher social and health needs than the United Kingdom as a whole. Many of the most deprived constituencies in the UK are in Scotland. The inescapable conclusion must be that Scotland currently contributes less in taxes and receives more in benefits and social spending per head than the UK average.

The position is, however, far less clear if, as we saw earlier, London and the South East are removed from the picture. The UK position is heavily influenced by London which has a GVA per head 31.3% above that of the UK as a whole. London's economic strength, to quote the Scottish Economic Report 2005, is due to:

“a number of factors, including the economic benefits associated with being a capital city, proximity to key European markets, a developed transport infrastructure, the City's role as a global financial centre, the City's ability to attract skilled labour through higher wages and cultural and recreational activities; and the fact that London is the political centre of the UK⁴⁵.”

London as a driver of the UK economy is an important asset for the whole country, including Scotland, but it is also a phenomenon which needs to be counterbalanced by more centrifugal forces, including national and provincial devolution within Britain – one of the reasons behind the Home Rule settlement.

Since the 1970s, taxation derived from North Sea oil and gas revenues has made a significant contribution to the UK Exchequer. Its location is entirely fortuitous, but much of the oil (although less of the gas) has been extracted off the Scottish coast. Considerations of equity suggest that there should be both a Scottish and a United Kingdom benefit from these revenues.

Conversely, the greater resources of the UK Government have ensured broadly equivalent levels of social and benefit provision across the UK in times of economic restructuring, and have supported regeneration initiatives, most recently in paying off Glasgow's housing debt. There are other examples. The Treasury benefited substantially from the sale of mobile phone licences offered on a UK level, and accruing to the common benefit.

The apparent fiscal deficit accrued by Scotland needs to be substantially offset by wider considerations – the benefit London obtains as the capital city, an equitable interest in taxation derived from exploitation of natural or economic resources like oil, gas or indeed mobile phone licences, the bringing to bear of UK resources on major problems. Academic research would no doubt identify further issues.

The Case for Change

There is clearly a strong case for the continuing relationship between the nations of the United Kingdom. Yet, despite the mutual benefits that can be clearly seen from the current union, there remains a clear argument for further reform to move towards a new modern settlement.

Chapter 2 set out a number of reasons why a second Constitutional Convention is needed to consider the future powers of the Scottish Parliament. It pointed out a number of changes since the first Convention met, including: reforms of governance in Scotland; incremental changes in powers of the Scottish Parliament; public support for additional powers; growing civic and political debate on the future settlement; the matter of changing identity both north and south of the border; and pressures from across the United Kingdom.

These are undoubtedly contributing factors to the need for wider change across the United Kingdom. However the Commission believes that there are other crucial factors which increasingly support the move to a new modern settlement.

The Political and Democratic Case

Scotland now needs a more modern, flexible and sophisticated relationship with the rest of the United Kingdom. Before 1999, the institutions of the state had become somewhat clogged. A different and more community-based ethos, differences in political balance, a democratic deficit in consequence, and a changing sense of what it meant to be Scottish and British led to the establishment of the Scottish Parliament. The existence of the Parliament, and the logic of its actions have led to both new ways of doing things in Scotland, and a new dynamic in relationships with Westminster, much of it in unpredictable ways. We do not always recognise just how much the Parliament is changing both Scotland and Britain.

The Fiscal Case

In his Donald Dewar Memorial Lecture in 2003, the former presiding officer of the Scottish Parliament, Sir David Steel, said,

“No self respecting Parliament should expect to exist permanently on 100% handouts determined by another Parliament, nor should it be responsible for massive public expenditure without any responsibility for raising revenue in a manner accountable to its electorate.”

It is in the area of taxation powers that the Scottish Parliament is in most need of change – and for the reason laid down by David Steel. Greater accountability is not an abstract matter, but a principle of good and effective government.

It is questionable whether the current – and rather opaque – financial arrangements are unreservedly in the interests of either Scotland or the United Kingdom. There is little fiscal incentive to improve the efficiency of Scottish public spending. Nor is there any incentive for improvement, either in targeting spending or in the effectiveness of the spending. It is our view, therefore, that the tools must be developed to increase accountability of Scottish spending, to provide incentives for government to use its financial powers, and to identify a more equitable basis for needs-based support for Scotland and other parts of the UK.

Fiscal systems should be the financial means to implement political choices, not restrict them. As the Scottish Parliament is primarily a spending parliament, it has an inbuilt democratic deficit because of its lack of fiscal powers. Of course, Scottish MPs at Westminster represent Scotland on reserved matters and the system of planning and controlling public expenditure is a reserved UK matter. However, there is no clear linkage between the decision-making process that determines such UK policy in general elections and the setting of Scottish Executive budgets by MSPs after Scottish general elections. There therefore exists what might best be described as a deficit in fiscal legitimacy, whereby the public are excluded from the direct process of setting and spending budgets paid out of their own taxes.

The case for change can also be made with reference to the potential problems of not addressing existing issues. Authoritative research by Darby et al on the lessons to be learned in the UK from examples of fiscal federalism and fiscal autonomy in other countries concludes that there are two “potential dangers” in not reforming devolved financing:

“The first is that the electorate will begin to lose interest in the devolution process and electoral participation will continue to decline, instead of reinvigorating the local democratic process. The second is that pressures will develop to reform the system, and that regional tensions will emerge, especially once regional assemblies begin to be set up in England. This is exactly what has happened in some other countries (e.g. Italy, Spain) to date. Cross-country experience suggests that there may be considerable benefits to the UK (and Scotland) in confronting the issue of fiscal autonomy and inter-regional solidarity sooner rather than later.”⁴⁶

The Shape of Change

Liberal Democrats have long held that a more federal arrangement for the United Kingdom would best accommodate both the diversity of identities across the United Kingdom and the things which we hold in common. Federal systems are the normal constitutional set up in advanced political societies across the world - in Spain, Germany and Switzerland, in the United States, Canada, Australia and South Africa amongst many others. A federal system was the demand of the Scottish Commissioners at the time of the Union, while many Scots have contributed to federal constitutions the world over, starting with the constitution of the United States.

A more federal arrangement will require a clear set of principles and an understanding of how best to divide powers and responsibilities between different levels. Our contention is that this must be grounded in the principle of subsidiarity. It must build on the current settlement, making changes in the light of experience and based on the 'beneficial' principle of service provision (see Chapter 3 for further details and international examples).

Further, we need to be sure that any changes in the system have definable advantages for our people. There must be an idea of the policy options that might be available to Government, whether in Edinburgh or in London, which could improve our society or the working of our economy. They must be things which can change the destiny of Scotland in meaningful ways.

Opportunities for new Directions within a Modern, Federal Union

Growing the economy - The Scottish economy is currently seeing a degree of relative improvement but rates of growth in Scotland have lagged behind those of the UK as a whole for some years. Liberal Democrats believe that measures of economic growth do not tell the whole picture, and particularly do not measure quality of life aspects.

The Scottish Executive has invested massively and effectively in improving the business environment – in education and training, in building employability, in the transport infrastructure, in increasing investment in schools, hospitals and houses, in making trade links with other countries, and now in reducing the business rates. These are policies which pay off in the longer term, but there are growing signs that this investment is already having an effect.

There is a real opportunity to give the Scottish Government fiscal power suitable to influence the development of the Scottish economy. Greater powers over taxation and business regulation would allow Scotland the opportunity to differentiate itself from its neighbours and thus redress some of the disadvantages of size and location.

This is not a zero sum game where one area grows at the other's expense. A growth economy north of the border – a smart, successful Scotland – expands the economy of the UK to everyone's advantage.

Improving the environment – Liberal Democrats have given a consistent “green” thread to Scottish Executive policies. As a result, sustainability in Government is much higher up the agenda of all Departments, and recycling levels are at last beginning to rise towards European standards. The ability to use taxation as a lever of environmental policy could be helpful – a carbon tax, for example, might be introduced more readily in a small country like Scotland and with greater effect.

Building Sustainable Investment – Back in the 1970s, the Scottish Liberal Party and our then Leader, Russell Johnston MP, called for the setting up of a Scottish Oil Development Corporation to provide an investment fund for Scottish industry, funded by a share of the oil revenues. The opportunity was missed (except by Shetland Islands Council) and the money failed to make an impact as the country fell into recession and manufacturing decline. There is a case for looking again at how Scotland shares in the revenues from the North Sea.

The debate on oil aside, such opportunities provide the setting for innovative new partnerships between Scotland and the United Kingdom which could go to support improvements in Scotland's business environment and which would reduce the fiscal burden on the UK Treasury. For example, energy grants to support urban green energy projects could both reduce business energy costs and contribute to meeting important environmental targets.

Conclusions

In conclusion, reforming the financial arrangements supporting the Scottish and United Kingdom Parliaments is desirable in itself, but should also have demonstrable benefits for our citizens. One of these is the opportunity for the Scottish Executive, within the common constraints of agreed fiscal arrangements at UK and EU level, to have fiscal powers suitable to influence the direction of the Scottish economy, to sustain the environment and to invest in the future. The potential prize for Scotland of improving democratic accountability, increasing efficiency and growing the economy is considered later in this Report in Chapters 8 and 9.

Chapter 5

A Modern Relationship with the Rest of the UK

Modern government is a complex and sophisticated matter. On the one hand, the exercise of power should be as local and as near to the people as possible; on the other hand, we operate increasingly in a global environment where important decisions affecting us are made by big international corporations or by other governments across the world. The effects of climatic disasters, nuclear accident, or even the decline in fishing stocks, do not stop at community or even national boundaries.

It is no wonder, then, that federal systems are the normal way in which countries across the world organise themselves – from Australia, Canada, the United States or South Africa to Switzerland or Germany or Belgium. Indeed, as we have commented, a federal union was the objective of the Scottish Commissioners of Union in 1706.

The journey towards a federal system will be uneven and is likely to go at a different pace in different parts of the UK. Home Rule for Scotland and Wales, the Northern Ireland Assembly and the London Assembly has established the basis of asymmetrical federal arrangements across much of Britain. It is time to look more closely at both a Scottish and a British level at how these might be developed in a better and more transparent way.

The Federal Vision

Liberal Democrats have a broad and inclusive view of the federal relationships we seek between the nations and regions of the United Kingdom. Their purpose is to empower citizens, providing the fullest opportunities to fulfil their potential – which tends towards both individual and common good.

For further details of the principles that lie behind the Commission's support for a more federal UK please see Annex 4 – Statement of Constitutional Principles Agreed by the Steel Commission.

Liberal Democrats have long supported a more federal solution for the United Kingdom. Full details of our policy and how this would work across the UK can be found in “Reforming Governance in the UK; Policies for Constitutional Reform” in Policy Paper 40 by the Liberal Democrats.

A Written Constitution for a Federal System

Liberal Democrats want to see a more federal United Kingdom, with a written constitution setting out the limits of the powers of the federal institutions and recognising the diverse constitutional rights of the federal nations and regions. Scotland is a founding partner in the United Kingdom and is entitled to recognition of her particular status within the federal union.

It is longstanding Liberal Democrat policy across the UK that: “the constitution would set out the powers and responsibilities of Parliament, the executive, the judges, the Head of State, set out the right to self-determination of the peoples of England, Scotland, Northern Ireland and Wales, entrench the Human Rights Act and establish the independence of local government.”⁴⁷

The approach taken by federal states to the division of powers between federal and sub central levels is widely divergent. In the case of Canada, the constitution works on a reverse Scotland Act principle: setting out the exclusive powers of the provincial legislatures with everything else falling to the federal government. Other countries such as Germany use the constitution primarily to set out the areas of exclusive competence for the federal government along with those areas of shared competence.

The Commission believes that the correct relationship for Scotland and the UK in a new more federal system should begin with recognition of Scotland’s status. It should reject the idea of power being ‘devolved’. This relationship would no longer be based on an Act of the Westminster Parliament – which retains the right to withdraw its consent for devolution – but rather would operate within the legal framework of a new constitution which recognises Scotland’s position and status as a founding partner in the United Kingdom⁴⁸.

The new constitution should therefore operate in two ways. First, by entrenching the rights of Scotland within a new constitutional framework. This will also involve detailing the relationship between the various spheres of government in the UK. Constitutional entrenchment means of course, that the constitution could not be abrogated or amended without the consent of both Scotland and the UK.

Second, the new constitution must clearly set out the limits of power of the various partners in the Union. The Commission believes this is best achieved by setting out the specific powers that are the exclusive domain of the UK Parliament; introducing a category of formal partnership working in other specified areas; and allocating all other areas to be within the competence of the Scottish Parliament.

It is worth recalling that the first Constitutional Convention made a similar point about the need to entrench the rights of Scotland and the status of the Scottish Parliament. 'Scotland's Parliament, Scotland's Right' stated: "In order to ensure successive Westminster Parliaments do not attempt to dismantle a Scottish Parliament the Convention expects the Westminster Parliament to move a special Declaration before passing the legislation creating the Scottish Parliament. This Declaration will state that the Westminster Parliament will not remove or amend the Scottish Parliament without consulting directly the people of Scotland and the Scottish Parliament itself."⁴⁹

The Commission prefers a written constitution for the UK. However, we recognise, as did the first Convention, that political reality can be as powerful as legal process. Therefore we would also support measures to bring about a quasi-entrenchment through a review of the Scotland Act including a new mechanism requiring the consent of the Scottish Parliament to measures which would significantly change the Home Rule settlement. This is an important point as many of the recommendations on new legislative, policy and fiscal powers in this Report could be achieved through revision of the Scotland Act.

The Commission believes that under the new system, the phrase "Scottish Executive" should be replaced by "Scottish Government" in line, for example, with the practice in the Canadian or Australian Provinces. This is more than just symbolic, as it recognises not just the increased powers for the administration in Scotland but also the fact that its existence and status would be entrenched in a written constitution rather than existing only with the consent of Westminster.

A written constitution should build in the principle that a more federal United Kingdom should be less centralised in London than at present. It would be important to locate as much of the Government machine across the whole of the United Kingdom as possible, and to spread the locations of the headquarters of bodies like the Supreme Court across the country. There is no reason, for example, why the UK Supreme Court or the Office of UK Statistics could not be based in Edinburgh, Cardiff or Belfast, or indeed in Glasgow, Aberdeen or Newcastle.

There would be a number of key institutions to serve the interests both of the United Kingdom and of its constituent nations and regions. The status of some of these should be defined and protected within the constitution.

The written constitution should also enshrine the principle of proportional representation for elections in Scotland including the introduction of STV (Single Transferable Vote) for Scottish Parliament elections.

The constitution should be based on the principle of subsidiarity and should also therefore recognise the status, democratic legitimacy and role of local government. There would be merit in further work on how all three spheres of governance interact under the new system.

Partnership Working

One of the key principles of a federal union would be support for partnership working between different levels of government. A constitutional provision supporting joint working might be a powerful tool for innovative practice in good government and Chapter 6 makes specific recommendations on this. This ethos of partnership working should apply not just to legislative and policy matters but should also feed through to fiscal issues too. For example, policies such as free personal care for the elderly saves the UK Government on benefits payments; a reduction in unemployment through action by the Scottish Executive saves the UK Government unemployment benefit. A provision for a two-year bonus to a devolved body for initiatives which saved the Federal Government money could be worthwhile and dynamic.

UK Federalism within Europe

One purpose of this Report is to progress the serious and timely debate about Scotland's role within, and contribution to, the United Kingdom. Such an issue, particularly as it relates to the principles of true federalism, cannot then be separated from a similar debate about Scotland and the UK's role within the European Union of today. Indeed, there may be other models of true federalism within the EU, such as Germany or Austria, which can provide useful pointers to Scotland for the next steps in federal matters, particularly as this relates to EU funding.

In less than a decade, the UK has seen substantial constitutional reform. However, the fiscal element is the most obvious omission from this process. In looking at a federal model for the UK, there should be realism in recognising what does and does not work in other devolved legislative regions within other Member States. Scotland's ability to work and compete with these countries may depend upon that. Likewise, in many ways, the current relationship between the UK and Scotland works well for both sides, and we have to be careful that the informal networks which exist at present are not damaged by the instigation of more formal national arrangements in a more federal system.

It is a time of genuine soul-searching and constitutional hiatus within the EU as to the purpose and outer limits of the project of interdependence. This Report demonstrates that the Party has something constructive to say about the possible extension of a successful process of devolution in the form of a more federal UK. There are clearly lessons from our own devolution settlement for the wider Europe.

The founding principles of the Consultative Steering Group – accountability, accessibility, equality, power-sharing – are as good a starting point as any for a new Constitutional debate in the EU. Likewise, Scotland is in a unique position today to send out a statement of intent on how best to establish and explain the balances of competences between central and regional government, the centre and the periphery. To an extent, the EU of 25 (and rising) is already looking at variable, regional responses to regional problems.

Other Changes for the Scottish Parliament

In considering other changes in the way the Scottish Parliament might operate in the future, we have limited ourselves to two specific suggestions which we believe have a wider constitutional implication and which would fit with our proposals for moving towards a more federal system (the electoral system and operational procedures of the Scottish Parliament are referred to later in this chapter).

Annual Review of the CSG Principles

In the first Parliamentary session, the Procedures Committee undertook a review of the implementation of the four guiding principles laid down in 1998 by the Consultative Steering Group. There principles were:

- that the Parliament should embody and reflect the sharing of power between the people of Scotland, the legislators and the Scottish Executive;
- that the Executive should be accountable to the Scottish Parliament, and the Parliament and Executive should be accountable to the people of Scotland;
- that the Scottish Parliament should be accessible, open, responsive and develop procedures which make possible a participative approach to the development, consideration and scrutiny of policy and legislation;
- that the Parliament in its operations and its appointments should recognise the need to promote equal opportunities for all.

The hearings conducted by the Procedures Committee attracted considerable attention and led to a useful, far-seeing and self-critical report.

The Commission believes that there is merit in building on this process through an annual hearing on the fulfilment of the CSG principles. This annual event would require the First Minister and Deputy First Minister, and other Ministers to attend as witnesses with the First Minister concluding the hearings with a major speech on Scotland's progress towards this definition of democracy - a speech which would have the weight and status of a yearly "State of the Nation" address. There would be a clear role for the Presiding Officer in managing the yearly review of the CSG principles and in chairing the hearing. This event would also allow for discussion on the position of the Scottish Parliament in a Federal UK and provide the opportunity to build on the successful approach taken by the Convention of the Highlands and Islands.

Joint Committee of the Scottish and UK Parliaments

Constitutional matters are a reserved subject. Nevertheless, it is plainly absurd that responsibility for monitoring the relationship between Scotland and Westminster - or between Scotland and the rest of the United Kingdom - should be held by the Scotland Office, now a wizened relic of its former self. This relationship is complex and manifold, and may well become politically inflamed in the future - for example, when the inevitable day arrives on which opposed parties dominate government at Westminster and Holyrood.

The Scotland Office should be abolished and replaced by a UK Department of the Nations and Regions responsible to a Secretary of State for Constitutional Affairs. The Scottish Executive would have an important relationship with this Department, but would also continue to have a direct day-to-day relationship with other UK Departments.

It is also anomalous that a Committee for European Affairs exists at Holyrood, but no forum exists in which the Scottish Parliament can debate problems and proposals affecting Scotland's place in the United Kingdom. There is also a need for a forum for the Scottish Parliament and UK Parliament jointly to consider issues of importance to Scotland (often where responsibility is shared). Mechanisms do exist for Ministers and civil servants in the form of Joint Ministerial Meetings and through departmental concordats, but it is important to note that there is no similar mechanism for parliamentarians who are not executive members.

While there is already an argument for such a forum to have a role in scrutinising 'Sewel' motions (now Legislative Consent Motions), the case for a Joint Committee of the Scottish and UK Parliaments is even stronger in a federal system. We therefore recommend the creation of an open, inclusive body involving MSPs, MPs and if appropriate, MEPs, to meet on a regular basis as a Joint Committee of the Scottish and UK Parliaments. The Scottish Select Committee should be abolished with MP members sitting instead on the new Joint Committee. In addition to the ability to hold inquiries into issues of shared concern, including taking evidence from both UK and Scottish Ministers, the Committee could have a role in improving the scrutiny of Legislative Consent motions and would have an oversight role in improving co-ordination and debate between the two Parliaments. The Committee would also have a role in scrutinising those areas that in a federal system are deemed to be areas of partnership working (see Chapter 6).

Chapter 6

New Powers for the Scottish Parliament

Chapter 5 set out the Commission's recommendations for a new written constitution which would clearly identify the powers and jurisdiction of the UK Government and the Scottish Government. This Chapter details our recommendations for changing the balance of power as currently defined in the Scotland Act. It focuses primarily on policy and legislative powers rather than fiscal issues which are dealt with specifically in Chapters 8 and 9.

The Commission believes that, while there are clearly a number of areas of policy where a UK wide approach offers the most efficient, effective or desirable outcome, in some areas we believe that there is a strong case for the Scottish Parliament to obtain new powers. The Commission also believes that there should be a further new category of powers in the constitution covering those areas which require more formalised partnership working between the UK and Scottish Governments.

In considering the case for redistributing the current powers of Westminster and the Scottish Parliament in a new modern settlement, the Commission has taken a pragmatic approach. We tested the case against a range of criteria:

- Subsidiarity – what is the most local appropriate level at which action should be taken, including applying the principle of subsidiarity within Scotland itself?
- Efficiency – are there strong arguments in terms of efficiency and economies of scale for dealing with an issue at the UK / Federal level?
- Principles of Decision Making - are there legitimate reasons for the sub central level having a power even if it may follow the same or similar policy as the federal level? Is there a good reason why decision making on the matter should be for the federal level only?
- Policy Outcomes – does the reservation of power to the federal level limit the ability of the sub central level to achieve legitimate policy outcomes in its areas of responsibility?

Matters for the Federal Level

The Commission is of the view that the current 'Reservations' in the Scotland Act form a good basis for a new written constitution assigning specific powers to the UK level.

In the areas of defence, foreign affairs, and national security, the Commission is of the clear view that responsibility should be retained at the UK level. There are significant benefits to Scotland in terms of our ability to act on the international stage as part of the United Kingdom. That is not to say that we will always agree with the policy decisions, such as the war in Iraq, which might be taken by the UK Government. However, there must be a distinction made between the appropriateness of the division of powers, and the appropriateness of decisions taken. The solution to such matters is for Parliament to control the government more effectively or to select a government of a different political persuasion, not to make an unnecessary constitutional change.

Similarly the nature of the UK economy is such that there remains a good case for many financial and economic matters to be decided at UK level. An obvious exception to that would be the ability to control some taxation levels. In Chapter 9 we discuss further how, under a system of fiscal federalism, changes would be desirable to the balance of tax raising powers between the United Kingdom and Scotland. There is also a strong argument for taking a UK wide approach to issues such as immigration and asylum, but that does not mean that the Scottish Government cannot or should not be given a greater, more formalised say in setting such a policy.

A New Constitutional Category of Partnership Working

The Commission is of the view that, in general, the relationship between the Scottish Executive / Scottish Parliament and the UK Government / Westminster has worked relatively well since 1999. There is little evidence to suggest that the system of concordats between departments has failed or been particularly strained. However, at the same time the Commission recognises that this is a view borne more from anecdotal evidence and experience than from detailed evidence.

Despite the existence of concordats, the actual relationship between the Executive and the UK Government and its Departments is not particularly transparent. Concordats are publicly available, but there are few ways of measuring the extent to which they have been adhered to by either side and although they generally have provision for regular review (e.g. Treasury Concordat is to be reviewed every 3 years) this remains an internal process. Freedom of information has offered, and will continue to offer, some public insight into discussions between the two, but this has been on a piecemeal basis focusing solely on high profile areas such as immigration where media reports suggest tensions.

As we have argued elsewhere with regard to the need for a written constitution, there is no guarantee that future administrations of different colours at Westminster and Holyrood would continue the generally constructive relationship seen to date. There is also a question as to how Scotland can 'beef up' its position vis-à-vis the UK Government in areas which impact on devolved services or devolved policy goals. Should Scotland seek to increase the tools in its armoury and how might this be best achieved in a political culture in the UK where power sharing remains a relatively new and alien concept to many?

Some federal states, such as Germany, operate on a constitutional basis with a third category of 'shared competence'. In essence this means that there is shared responsibility between the federal government and Länder for certain policy areas. This shared competence is backed up by statutory provisions and through the direct representation of Länder in the Bundesrat⁵⁰. However, it is important to note that the power of veto masks the fact that the Länder (through the Bundesrat) have few powers of initiation in such areas.

The Commission has considered and rejected such a system (based on Germany). Instead we believe that there is more to be gained from pursuing a new system of formalised partnership working.

This would build on the existing system of concordats – recognising that when implemented correctly these can play an important role in ensuring that decisions made north and south of the border are considered for their impact elsewhere. However, one of the main provisions would be to give a statutory backing in the constitution, thereby changing the current position of concordats as “non-statutory and not legally binding”⁵¹.

In a number of new areas, this would include a legal requirement to consult the Government and Parliament before progressing beyond specific legislative stages. There would be further provision to ensure that appropriate timing mechanisms are agreed to allow the Scottish Government and Parliament time to consider properly the impact of policy proposals from the UK Government. This would also give more weight to the dispute resolution process. There would be a corresponding role for the new Joint Committee of the Scottish and UK Parliaments to provide much needed public and parliamentary scrutiny to such processes. Further measures would be put in place to increase the transparency of relations between the two governments in these key areas.

We believe that this style of partnership working, backed up by statutory protections and involving much greater public accountability and transparency, offer the protection Scotland may require should relations between a future UK Government and Scottish Government become strained. At the same time it recognises that both Scotland and the UK have more to gain from constructive cooperation and partnership working – some of which might be eroded were less flexible measures introduced. A formalised system of partnership working would improve the ability of the Scottish Parliament to deal with impacts on devolved services or to limit the extent to which federal policies frustrate legitimate policy aims in devolved areas. Importantly it would also give Scotland a statutory force in its discussions with the UK in areas where a UK wide approach is appropriate but where Scottish sensitivities require to be recognised.

Extending ‘Devolved’ Powers

The Commission believes that, on balance, the existing division of powers has served Scotland well to date. Scotland has wide ranging powers to act on the key issues of importance to the people of Scotland. Areas such as health, education, justice, environment, rural development, land use planning, and increasingly transport matters all fall within the ambit of the Scottish Parliament and Scottish Ministers. The Commission is clear that the Scottish Parliament has already delivered real advances in many of these areas, but there remains much to do and much that can be achieved within existing powers.

The Commission is of the view that there are some clear anomalies in the current Scotland Act settlement and the new Convention should argue for the following powers to be given to Scotland and to be entrenched in a new written constitution:

Electoral System – In much the same way as it is inappropriate for Westminster to retain a veto over decisions taken by a democratically elected Scottish Parliament (at least in theory if not in practice), the Commission believes that decisions about the voting system for the Scottish Parliament can and should be taken by the Scottish Parliament alone. It is bizarre that the Scottish Parliament can vote to change the method and even date of elections for local government, but requires Westminster to legislate for its own elections to be held on the same day. It will be important further to entrench the principle of proportionality in the constitution so that decisions on the electoral system are not open to abuse by the administration of the day.

The Operation of the Scottish Parliament – Many of the rules governing the operation of the Scottish Parliament were decided at Westminster and require amendments to be made at this level before the Scottish Parliament can change its working practices. This may have been appropriate in the early years of devolution and had the benefit of allowing the Scottish Parliament to get to work more quickly than if it had to spend its first year designing standing orders. Nevertheless the Parliament is approaching its seventh year and is now more than competent to consider its own destiny. On considerations of both principle and convenience (Westminster has less time available and less inclination to consider such matters) such powers should be devolved.

Transport Powers – The Scottish Parliament has already been granted increased powers over rail in Scotland and the Commission is of the view that there are few good reasons for most of the remaining transport powers to remain reserved to Westminster. It is perfectly possible for the Scottish and UK Government to continue to agree to retain agreed standards in certain areas.

Medical Contracts – In view of the fact that almost all aspects of health are devolved, there appears to be no overwhelming reason why medical contracts should remain reserved. The Commission recognises that there could be issues arising from such a decision but believes that this is a natural consequence of decentralisation of power. There would remain considerable scope for co-operation north and south of the border, but Scotland should have the flexibility to ensure that it is able to meet its specific needs should these vary from the NHS in England and Wales.

Energy Policy – The Commission believes that there should be further devolution of energy powers to the Scottish Government. Decisions on nuclear power policy in Scotland, for example, should be taken by Scottish Ministers, following the same principle that sees management of radioactive waste falling to the Scottish Executive. Scottish Ministers should also have full control over renewable energy matters so that Scotland can grasp the economic and environmental opportunity of this new technology.

Civil Service – The Commission believes that there should be a separate Scottish Civil Service, but there should continue to be full opportunities for civil servants to move to posts throughout the United Kingdom, as we recognise the benefits that such cross-pollination brings.

Areas for Further Discussion

Notwithstanding these conclusions, there are some areas of policy where the case for more exclusive powers for the Scottish Parliament, or a clearer and enhanced role through formalised partnership working, is less clear cut and should be subject to public debate as part of the second Constitutional Convention.

Betting and Gaming – The Commission believes that there is a strong argument for devolving betting and gaming powers to the Scottish Government.

Public and Bank Holidays – At present the Scottish Government's ability to designate holidays is limited. There is an argument for devolving all relevant powers in this regard.

Human Rights and Equalities – This is already an area which straddles reserved and devolved competences. Some of the current issues revealed during consideration of the Scottish Commissioner for Human Rights Bill and of the UK Equalities and Human Rights Bill suggests that this area could profitably be further considered – and reviewed also from the perspective of whether some provisions require to be entrenched in a future written constitution.

Marine Policy – There is a growing argument for Scotland to take more powers over marine policy. This could be done within an overall policy framework agreed with the UK Government but which sees the Scottish Government gain significant powers.

Broadcasting – The Commission supports the retention of a truly British Broadcasting Corporation; however we believe that the role of the BBC in Scotland must be considered carefully and that the case, first made by the original Constitutional Convention, for the Scottish Parliament to “be able to promote broadcasting in Scotland, and ensure that it remains sensitive to Scottish needs”⁵² should be revisited. The Convention’s conclusion that “To keep pace with developments in Scotland, the UK and internationally, these roles will develop within the UK regulatory framework and must be kept under review” remains the case. In particular, there should be much greater accountability to the Scottish Parliament and regular reporting from the BBC. This should include a formal role for the Scottish Parliament in the charter renewal process.

Regulatory Powers – The Commission believes that since regulatory powers can have such a significant impact in areas such as energy and enterprise, consideration should be given to increasing the role of the Scottish Government both in setting policy, and in terms of the reporting structure for regulatory bodies.

Misuse and Control of Drugs – The Commission has not taken a specific view on the matter of control over drug policy. Nevertheless we recognise that it is an area of legitimate public debate particularly considering the impact that drug use has on other areas of public policy which are devolved to the Scottish Government. Decisions on classification of drugs can also have a knock-on impact on policing in Scotland. We recommend that the second Convention considers this matter in further detail.

Control of Firearms – The Commission is generally sceptical about the need to devolve control of firearms to the Scottish Government. There are clear benefits to a UK wide approach particularly relating to the proliferation of firearms. There may be, however, the opportunity for Scotland to develop a more formalised role in the discussion of policy in this area. Formalising the role of Scotland on matters such as the recent debate on airguns could be helpful in the future.

Asylum and Immigration – The Commission does not believe that asylum and immigration policy should be devolved, but we do believe that there could be merit in including it as an area for formalised partnership working. We base this view on the fact that aspects of asylum and immigration are of crucial importance to Scotland’s ability to meet challenges such as growing the economy and reversing population decline.

National Security – There could be benefit from a more formalised system of partnership working where national security relates to the involvement of Scottish police forces and the introduction of new offences under Scots law.

Strategic Planning of Welfare Services – There is a clear link between the ability of the Scottish Government to improve the health of the nation and grow the economy and the operation of the welfare system. While the Commission believes that social security should remain a UK responsibility, we believe that there is merit in the recommendation of the first Constitutional Convention that the Scottish Government should have a role in the strategic planning of welfare services. Again the formalised system of partnership working suggested could facilitate this. It would be interesting to consider whether under such an arrangement, the Scottish Executive would still have lost out on funding following its policy decision to implement free personal care for the elderly.

Competition and Mergers – While the Commission does not wish to question the need for a UK market, we are reminded of the recommendation of the original Constitutional Convention that “Scotland's parliament will also have the right of representation on issues affecting Scotland arising from mergers, competition policy and monopolies and, in order to ensure that the economic and social consequences for Scotland are properly considered when mergers affecting Scottish based companies are proposed, the Scottish parliament will have powers to report on such mergers to the Monopolies and Mergers Commission.”⁵³ The second Convention should reconsider this to see whether it should also be included as one of the areas for formalised partnership working.

Employment Law –The Commission believes that the second Convention should consider the extent to which the Scottish Government should have a say in the development of employment law as it impacts on businesses in Scotland. Clearly employment law is a crucial issue to business and therefore to the Scottish economy. It remains to be seen to what extent Scotland could develop a stronger role without undermining the current UK wide system. Nevertheless, this is an area worthy of further public debate and consultation with the business community and employee representatives.

Chapter 7

The United Kingdom as a Fiscal and Economic Union

This Chapter examines the workings of the current grant mechanism, the effect of the adjustments made by the Barnett formula, and the available information on Scottish revenue and expenditure. It is important to stress that immediate fiscal considerations form only part of the story,

The Barnett Formula

The current funding system for the Scottish Parliament relies, predominantly, on a grant with accountability over how the money is spent given to the Scottish Executive, answerable to the Scottish Parliament. The Barnett formula has been in operation since 1978 in preparation for devolution that never happened. It is often incorrectly considered to be the mechanism under which the Scottish block grant is determined, but rather it is the population based formula that determines the adjustments added to the grant when changes in expenditure are announced for England (or England and Wales in some expenditure areas). The Barnett formula therefore does not determine overall budget levels. It is used to share out changes in public expenditure between the countries of the UK, based on their population share. These adjustments are commonly known as Barnett consequentials.

It is important to note that it is not a needs-based formula – in fact it was an interim measure put in place until a needs-based formula could be agreed between the Treasury, Scottish Office and Welsh Office. This never happened and Barnett has been in place ever since. The difference in levels of per capita public spending between Scotland, England and Wales is essentially a historical legacy of the “success of each of the territories in striking a favourable deal with the Treasury when it was set up in the late 1970s and on slight bending of the rules, such as how to calculate population shares.”⁵⁴

There are increasing calls for it to be updated or scrapped, including a call for change from its creator Lord Barnett, who in 2002 said, "As the founder, I readily admit to having given no consideration to needs, or where public resources should be allocated, not just in Scotland and Wales, but in Great Britain generally".

Convergence and Need

Public spending in Scotland and Wales is higher on a per capita basis than in England, however this greater expenditure in Scotland does not come from the Barnett formula, but from the existing expenditure levels when the block formula arrangements were established⁵⁵. In principle, in a situation where public expenditure continues to grow, the operation of the Barnett formula would, in the long-term, tend to reduce these differentials – as Scotland and Wales would only gain their per capita share of any new resources⁵⁶. However, there has not historically been much empirical evidence that this actually happened in practice. Professor David Heald suggests three reasons for this: bypass of the formula particularly during the 1980s; relatively low growth in nominal public expenditure in the 1990s; and continuing falls in Scotland's relative population. However, he further argues that there is likely to be more evidence of convergence in future as the devolved settlement reduces the opportunities for formula bypass, as a result of unprecedented high rates of growth of comparable public expenditure in England, and because of annual updating of the formula to reflect population changes⁵⁷.

Economists such as David Bell and Alex Christie suggest that recent examples of developments which have masked the 'Barnett squeeze' include the increases in agriculture spending (which is largely outside Barnett due to CAP) and the £1.4bn Glasgow Housing Stock Transfer funded directly by the Treasury and not through Barnett.

Recent research has suggested that since devolution the Barnett formula does appear to have been operated in a stricter manner. Research for the ESRC Research Programme on Devolution and Constitutional Change concludes that "noticeable convergence can be expected in the medium term" and "this may produce a greater potential for conflict over resource allocation."⁵⁸

The report continues:

“If the formula continues to be strictly applied, economic modelling suggests that the long-term effect would be to produce a contraction of employment in the Scottish economy of up to 5%. Projections of the effect of levying the ‘tartan tax’ (the power of the Scottish Parliament to vary UK income tax rates by +/- 3%) are that it would lead, in the long term, to contraction in Scottish GDP, employment and population, assuming that workers would seek to restore their post-tax wage either through pay demands or migration.”⁵⁹

Points in favour of the Barnett Formula

- Simple and easy and cheap to administer
- Avoids the need for annual negotiations
- Has contributed to general stability in financing of the Scottish Parliament
- Allocates undivided blocks of money, allowing the Scottish Parliament to set its own spending priorities without reference to the Treasury
- Has generally protected the higher per capita expenditure seen in Scotland compared with England and Wales

Criticisms of the Barnett Formula

- Too crude – based entirely on population statistics
- Lack of transparency and political accountability across the UK
- Does not reflect need or other elements such as inequalities in health, rurality etc
- Increases are dependent on increases being awarded to English ministries as part of the UK Spending Review Process – therefore having the potential to impact on the Parliament’s own spending priorities

Further Barnett Issues

Public Expenditure Statistical Analyses (PESA) figures suggest lower rates of growth on spending in Scotland than the UK in key policy areas – it is unclear at this stage whether this is due to different policy choices or due to constraints from Barnett. Christie and Bell suggest five areas where the current Barnett / Scotland Act settlement might restrict policy divergence between Holyrood and Westminster⁶⁰:

- Limitations on borrowing powers
- Labour north and south of border keen to limit divergence
- Treasury powers to intervene if, for example, the devolved bodies raised local taxation to punitive levels
- Postcode lottery issues
- Incremental budgeting has limited ability to alter significantly spending between public services

Expenditure & Revenue in Scotland

Expenditure

The most definitive figures in terms of expenditure and revenue in Scotland come from the Scottish Executive's Government Expenditure and Revenue in Scotland 2003-2004 report (GERS). These are examined further below.

We noted earlier that we would expect per capita public expenditure in Scotland to be higher than in the UK as a whole as a result of socio-economic factors, and the results of existing Scottish bloc allocations combined with differential population changes. This is borne out by the known figures. GERS confirms that Scotland's identifiable expenditure on services per head is about 19 per cent higher than in the UK on average.⁶¹

Table 3.1 Identifiable expenditure on services by country, 2003-04

	Total		Per head	
	£ million	percentage of UK total	£	relative to UK (UK = 100)
England	296,131	80.7%	5,940	96.4
Scotland	37,152	10.1%	7,346	119.2
Wales	20,277	5.5%	6,901	112.0
Northern Ireland	13,527	3.7%	7,945	128.9
UK	367,086	100.0%	6,164	100.0

Source: Public Expenditure Statistical Analyses 2005, Tables 8.1, 8.2.cited in GERS 2003-2004

Aggregate expenditure per head in Scotland is estimated at £8,948 in 2003-04. This is 17.3 per cent higher than the equivalent UK figure of £7,626 per head⁶².

Table 3.7 below shows the extent of spending by the UK Government and Scottish Executive in Scotland for both identifiable and non-identifiable items⁶³

Table 3.7 Expenditure in the UK and Scotland, 2003-04

	United Kingdom		Scotland		
	Expenditure, £ million	Share of aggregate expenditure	Expenditure, £ million	Share of aggregate expenditure	Share of UK expenditure
I. Identifiable 1	367,086	80.8%	37,152	82.1%	10.1%
of which:					
Scottish Executive 2	-	-	24,803	54.8%	-
Social protection	151,853	33.4%	14,537	32.1%	9.6%
II. Non-identifiable 3	70,546	15.5%	5,706	12.6%	8.1%
III. Accounting Adjustments 4	16,539	3.6%	2,392	5.3%	14.5%
Aggregate Expenditure	454,173	100.0%	45,250	100.0%	10.0%

Sources: Public Expenditure Statistical Analyses 2005, own calculations cited in GERS 2003-04.

Notes: 1 Identifiable expenditure on the UK level excludes identifiable spending outside the UK, which is included in non-identifiable expenditure. - 2 Includes Local Authorities and Scotland Office. - 3 Scottish number includes share of identifiable spending outside the UK. - 4 Includes timing reconciliation and non-market capital consumption.

Revenue

The GERS report also provides information on the revenue collected in Scotland from various sources including income tax, corporate tax and VAT receipts⁶⁴. Table 4.1 below demonstrates that, excluding North Sea oil revenues, Scotland raises some £34 billion - equivalent to 8.2% of total UK receipts.

Table 4.1 Revenue in the UK and Scotland 1, 2003-04

	United Kingdom	Scotland	
	£ million	£ million ²	Share of UK
Income tax (after tax credits)	113,968	8,340	7.3%
Corporation tax (excluding North Sea)	24,985	2,380	9.5%
VAT	69,075	5,680	8.2%
Social Security contributions	72,457	5,790	8.0%
Local Authority revenues	37,353	3,240	8.7%
All other revenues ³	97,044	8,600	8.9%
Total receipts ⁴	414,882	34,030	8.2%

Sources: UK figures from ONS, HMRC and Treasury cited in GERS 2003-04.

Notes: 1 The figures for the individual items in the table are on a cash basis; an accruals adjustment is included in all other revenues. For a list of all the taxes included under this category and an explanation of how the individual estimates were derived, see Appendix B. - 2 Rounded to the nearest £10 million. - 3 Includes adjustment deducting EU contributions with respect to VAT, customs duties, and agricultural and sugar levies. - 4 Excludes North Sea revenues.

Surplus or Deficit?

GERS clearly shows Scotland to be in deficit with net borrowing (excluding North Sea revenues) of £11.2 billion in 2003-04 – some 12.9% of GDP compared with the UK borrowing figure of 3.7%. This latter point is important. A net borrowing requirement is commonplace, but it is the relative size of Scotland's borrowing requirement which is the issue here.

Table 5.1 Net Borrowing, 2003-04 (excluding North Sea revenues)

	United Kingdom £ million	Scotland	
		£ million 2	Share of UK
Aggregate expenditure 1	454,173	45,250	10.0%
Aggregate receipts 2	414,882	34,030	8.2%
Net borrowing	39,291	11,220	
NB as a percentage of GDP ³	3.7%	12.9%	

Sources: UK figures from ONS, HMRC and Treasury cited in GERS 2003-04.

Notes: 1 As reported in table 3.7. - 2 As reported in table 4.1. - 3 Excluding Extra-regio GDP.

North Sea Oil Revenues

There has been considerable debate about the potential benefit to Scotland of revenues from North Sea oil and the extent to which this revenue, if attributed to Scotland, would reduce Scotland's deficit or contribute to a surplus.

The question arises due to the fact that:

"In the Regional Accounts, the UK Continental Shelf is included in a separate region of the UK (the Extra-regio territory) and is not allocated to specific geographic regions. Following this convention, North Sea revenues are excluded from the allocation of revenues to Scotland. However, previous GERS reports have shown the effect of incorporating different assumptions about the allocation of North Sea revenues on the Scottish fiscal position."⁶⁵

Before considering the impact that including North Sea Revenues would have on the deficit, it is worth noting that they have been highly volatile over the past two decades as seen in the table and line chart below. Revenues peaked at £12 billion in 1984-85 reaching a low point of £1 billion in 1991-92, rising to £4.9 billion in 2002-03 and dropping back to £4.3 billion in 2003-04.

Table 4.2 North Sea Revenues 1

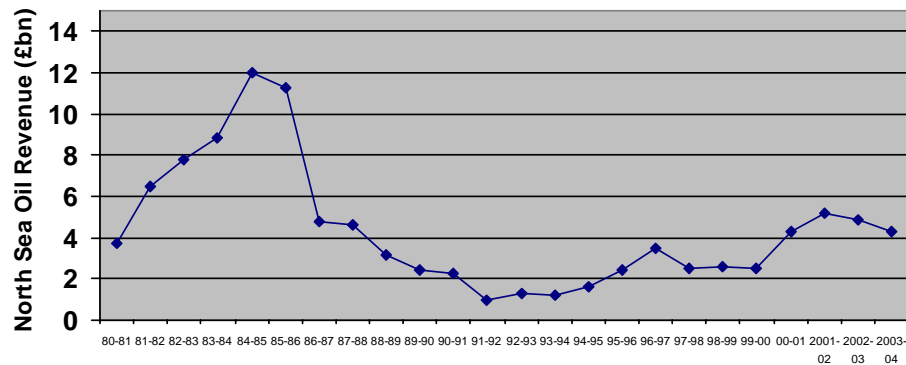
Year	£ billion	Year	£ billion	Year	£ billion	Year	£ billion
1980-81	3.7	1986-87	4.8	1992-93	1.3	1998-99	2.6
1981-82	6.5	1987-88	4.6	1993-94	1.2	1999-00	2.5
1982-83	7.8	1988-89	3.2	1994-95	1.6	2000-01	4.3
1983-84	8.8	1989-90	2.4	1995-96	2.4	2001-02	5.2
1984-85	12.0	1990-91	2.3	1996-97	3.5	2002-03	4.9
1985-86	11.3	1991-92	1.0	1997-98	3.3	2003-04	4.3

Source: ONS cited in GERS 2003-04

Note: 1 Consists of North Sea (ring fence) corporation tax, petroleum revenue tax, supplementary charge (from April 2002), and royalties (abolished on 1 January 2003).

The extent of the variations in revenues is best illustrated by means of a line graph as below.

North Sea Revenues by year



There is further debate about the extent to which Scotland should be allocated a specific share of all of North Sea revenues. Table 5.2 below plots the effects on net borrowing from a range of shares of North Sea revenues. The key message is that even with all revenues accruing directly to Scotland there would remain a net deficit figure of some £4 billion per annum. Nevertheless, the Commission believes that there may be a case under a new system of fiscal federalism for considering the merits of a sharing arrangement of some sort.

Table 5.2 Fiscal position for Scotland, 2003-04: Effects of different allocations of North Sea revenues, £ million

	North Sea revenues ...					
	wholly excluded	66% included	75% included	90% included	100% included	allocated by GDP share
Aggregate expenditure	45,250	45,250	45,250	45,250	45,250	45,250
Aggregate receipts	34,030	36,860	37,200	37,890	38,320	34,380
Net borrowing	11,220	8,390	8,050	7,360	6,930	10,870
NB as a percentage of GDP1	12.9%	8.1%	7.7%	6.8%	6.2%	12.2%

Notes: 1 Scottish GDP including relevant proportion of oil output.

Source: GERS 2003-04

The Table below sets out the net borrowing figures for Scotland over a five-year period (excluding North Sea revenues). Again it shows an increasing deficit of just over £4.4 billion in 1999-2000 to just over £11 billion in 2003-04. In the past four years UK net borrowing has also increased significantly from –1.5% seen in 1999-00 to 3.7% in 2003-04. However, this remains almost four times less as a percentage of GDP than is the case for Scotland. Clearly allocation of North Sea oil revenues would reduce this differential but would not eradicate the deficit.

Table 6.9 Net Borrowing Estimate for Scotland, 1999-2000 to 2003-04

	1999-2000	2000-01	2001-02	2002-03	2003-04
Aggregate expenditure					
£ million	33,986	36,190	38,846	41,445	45,250
Aggregate receipts 1					
£ million	29,570	30,750	31,520	31,810	34,030
Net borrowing					
£ million	4,420	5,440	7,330	9,640	11,220
%of GDP2	6.0%	7.1%	9.2%	11.6%	12.9%
UK Net borrowing					
£ million	-13,144	-11,486	5,485	29,476	39,291
%of GDP2	-1.5%	-1.2%	0.6%	2.9%	3.7%

Source: GERS 2003-04

Notes: 1 Excludes North Sea revenues. - 2 Excludes Extra-regio GDP.

A Note on GERS

The methodology of the Government Expenditure and Revenue in Scotland report is now accepted by economists in Scotland, the Treasury, and the Library of the House of Commons. Yet it continues to attract criticism from some quarters – particularly those arguing for independence.

The GERS report itself highlights the difficulties involved in calculating an exact figure for net borrowing in Scotland – often because the UK Government has consistently failed to provide a detailed breakdown by region of income and expenditure:

“For a variety of practical and theoretical reasons, estimating revenues for the individual countries of the UK is generally more difficult than estimating expenditures.

“UK national taxes cannot usually be allocated directly to a region, although Inland Revenue can provide estimates of income tax liabilities and of inheritance tax relating to Scottish deaths. Some other taxes can be reasonably readily estimated for Scotland. For example, most taxes on products can be estimated based on Scottish shares of UK consumers’ expenditure on certain goods and services. Other revenues are more difficult to apportion, either because of a lack of detailed information to form the basis of estimation, or because of conceptual difficulties. Included here are capital gains tax, and central government interest and dividend receipts.”⁶⁶

The 2003-04 GERS report states that:

“The calculations to derive a fiscal position for Scotland are subject to inevitable imprecision due to the need to estimate a number of elements of both expenditure and revenue. The calculation of expenditure for Scotland (specifically the non-identifiable and other expenditure components) cannot be carried out with the same accuracy as that for the UK as a whole. Moreover, there are practical and theoretical difficulties in determining an appropriate share of UK revenues to allocate to Scotland.”

“Variation in the choice of alternative assumptions would inevitably change the detailed arithmetic of the fiscal position. As a result, the NB estimate presented here should be regarded as indicative rather than precise.”

Nevertheless, the GERS report is clear about its methodology and assumptions and uses official figures. The economist David Heald has criticised the political abuse of GERS and it is true that each year the latest figures are used by each political party to try and suit its constitutional arguments: “Some of the inflammatory language is so outrageous as to be humorous. Although Scottish Executive economists must feel battered by this exposure, they deserve credit for persisting with GERS.”⁶⁷ The critics of GERS have consistently failed either to rebut its findings effectively or to provide a coherent alternative assessment of Scotland’s fiscal position within the UK.

The Current Position

The Commission is of the view that there is considerable public confusion over the current fiscal powers of the Scottish Parliament. This confusion can make the debate about changing the fiscal system complicated and inaccessible for the general public.

Some argue that the Parliament has no real power over taxation at all but this ignores its responsibility over local government taxation, its powers to levy charges and the power to vary the basic rate of income tax by up to 3 pence in the pound. The economists Heald and McLeod identify the following current composition of funding the Scottish Administration for devolved spending in 2002-0368:

Source	Composition
Central government transfers and non-cash items	77%
Own taxes	15%
Borrowing	3%
EU financed	2%
Assigned revenues	3%

Of course the Parliament does not rely entirely on grant funding as it can choose to exercise its tax varying powers and has powers over local taxation. Nevertheless, it is the case that the Parliament does not have major strategic powers over the size of its budget and how to raise it.

However, as we identified earlier, the Scottish Parliament has very significant autonomy and discretion because of the fact that the block grant system does not ring-fence spending areas. In comparison with most other federal or quasi-federal systems, the extent of real power over policy and decision-making is considerable.

All government budgets are, of course, limited by the fact that significant proportions are already committed before any annualised budget process begins and the Scottish Budget is no different. For example, public sector pay and long term capital programmes mean that the budget process is concerned inevitably with a small proportion of the Budget. In addition, bigger strategic decisions for Scotland are made more difficult in the absence of a choice at elections of tax raising as well as tax spending policies.

Even with such powers, radical decisions over the shape of a Budget year on year are inevitably limited, given the pre-committed expenditure. Nevertheless, greater financial powers would give the Scottish Parliament greater choice over a wider area to use financial incentives as well as legislative measures to achieve its policy aims.

The Tax Basket

It is helpful to identify the receipts on a UK and Scottish basis of existing taxes. The significant taxes are income tax, social security contributions, VAT, Corporation tax, fuel duties, and local non domestic rates and Council Tax.

Table B.1 Receipts for UK and estimates for Scotland, 2003-04

	UK	Scotland		
	Revenue, £ million	Revenue, £ million	as a share of total revenue	as a share of UK revenue
Income tax (after tax credits)	113,968	8,340	24.5%	7.3%
Corporation tax (excl North Sea)	24,985	2,380	7.0%	9.5%
VAT	69,075	5,680	16.7%	8.2%
Social security contributions	72,457	5,790	17.0%	8.0%
Non-domestic rates	18,637	1,710	5.0%	9.2%
Council Tax	18,716	1,530	4.5%	8.2%
Capital gains tax	2,225	190	0.6%	8.5%
Inheritance tax	2,504	140	0.4%	5.6%
Stamp duties	7,544	540	1.6%	7.2%
Fuel duties	22,786	1,320	3.9%	5.8%
Tobacco duties	8,091	990	2.9%	12.2%
Alcohol duties	7,565	720	2.1%	9.5%
Betting and gaming duties	1,347	120	0.4%	8.9%
Customs duties and agricultural levies	1,941	160	0.5%	8.2%
Air passenger duty	791	70	0.2%	8.8%
Insurance premium tax	2,294	190	0.6%	8.3%
Climate change levy	832	80	0.2%	9.6%
Aggregates levy	339	50	0.1%	14.7%
Landfill tax	607	50	0.1%	8.2%
Vehicle excise duties	4,664	340	1.0%	7.3%
Other taxes and royalties	11,044	880	2.6%	8.0%
Interest and dividends	4,853	400	1.2%	8.2%
Gross trading surplus, rents & misc transfers	22,236	2,740	8.1%	12.3%
Other revenue 2	-4,619	-390	-1.1%	8.4%
Total	414,882	34,030	100.0%	8.2%

Notes: Figures exclude North Sea oil revenues (North Sea corporation tax, petroleum revenue tax, supplementary charge and oil royalties). Individual tax items are on a cash basis. - 1 Rounded to the nearest £10 million. - 2 Includes accruals adjustments, tax credits scored as public expenditure, as well as VAT and 'own resources' contributions to EU budget.
Source: GERS 2003-04

Reforming the UK Economic and Fiscal Union

Different constitutional provisions for the United Kingdom would be based on different underlying principles.

Bigger Picture – The continuing relationship between Scotland and the rest of the UK must recognise that there is more to the union than a simple accounting exercise about deficits or surplus.

Fiscal and Economic Union - Fair and equitable treatment of the different parts of a unitary United Kingdom is not normally a predominant issue since the same economic and fiscal regime applies across the whole country. This can produce pressure for greater support for regional regeneration if employment, prosperity levels or standards of living become substantially disproportionate in different regions.

Independent Nations within the UK – The underlying principle here is that, while there might be mutual benefits in certain partnership arrangements, no favours are owed between national states which stand or fall on their own endeavours. On any view, the existing fiscal deficit, the loss of key United Kingdom investment in areas like research and defence and the loss of common UK funding for pensions and benefits would provide an independent Scotland with an almighty economic and financial headache.

Fiscal Federalism – Economic and fiscal arrangements appropriate to a more federal set up for the United Kingdom are defined later. We describe these generally as “fiscal federalism”. Their essence is that the Scottish Government would have substantially greater economic and fiscal powers but within certain constraints arising from participation in the United Kingdom.

The view of the Commission is that fiscal federalism will provide the best mixture of economic stability, financial and political accountability, and scope for innovative action to secure the most promising future for the Scottish economy, and for the circumstances of a prosperous, socially inclusive and environmentally sound life and life-opportunities for the people of Scotland in the open global economy of the 21st century. Later in this paper, we expand on options to develop fiscal federalism.

Chapter 8

The Principles of Fiscal Federalism

Earlier Chapters set out the lessons that can be learned from international experience, the case for moving towards a more federal United Kingdom, and how this could be applied to reforming and improving the fiscal arrangements between Scotland and the UK. Chapter 7 also looked at some of the implications of the current United Kingdom economic and fiscal union. This Chapter sets out the Core Principles and Key Criteria that should form the basis of a new system of fiscal federalism for Scotland.

The question of a new fiscal system for Scotland is undoubtedly a technically complex area, but the first essential is to build a consensus in support of the idea of fiscal federalism.

This Chapter therefore begins by considering what is meant by fiscal autonomy and fiscal federalism. It then sets out the principles of fiscal federalism that we believe should be applied in Scotland.

The Fiscal Autonomy Debate

If there is a level of public confusion about the operation of the current system, then the position is worse as regards the recent debate around fiscal autonomy. In much the same way as there is confusion and misrepresentation of the operation of the Barnett formula and levels of expenditure and revenue in Scotland, systems of fiscal autonomy are not well understood.

Under full fiscal autonomy, Scotland would raise and retain all taxation in Scotland. It would then be for the Scottish Parliament to agree with Westminster what services, if any, should be shared and to agree to remit an amount to Westminster to pay Scotland's share of these services.

In the often very complex and jargon laden world of public financing, full fiscal autonomy offers a straightforward proposition that most people will understand. However, the Commission rejects full fiscal autonomy in this form. Rather than being a simple concept, it is a simplistic concept. Time and again academic studies on fiscal autonomy have concluded that full fiscal autonomy does not operate in any industrialised country⁶⁹.

Indeed, the pressures of adapting the system to the artificial constraints of full fiscal autonomy are likely to have the paradoxical effect of substantially reducing the scope for real policy discretion for many years to come.

The Commission is of the view that full fiscal autonomy is not in the interests of Scotland – in fact it would be extremely damaging to Scotland. It also ignores the considerable benefits, both to Scotland and to the rest of Britain, of being part of the United Kingdom. It exists in no other industrialised country in the world and it is clear that such a system effectively negates any meaningful role for a wider UK state.

Full fiscal autonomy is argued by those who want to make the case for independence and the destruction of the United Kingdom – but who want to wrap it up in comfortable-sounding language. Full fiscal autonomy (also known as fiscal freedom) is, in fact, no more and no less than a Trojan horse for independence.

Darby et al clearly point out in their analysis of fiscal autonomy across the world that such a system of full fiscal freedom falls foul of the problems of equity. It also risks problems of tax exportation and migration of factors of production if it fails to take place within an appropriate UK framework. Hallwood and McDonald reject full fiscal autonomy for 3 reasons: first the British economy is highly integrated and therefore it is important for direct macroeconomic stability to remain within the UK; second, without fiscal transfers, equity in the distribution of public goods and services will be ended; and third, such a system risks the loss of economies of scale in provision of some services.

These arguments against full fiscal autonomy are also arguments against independence, demonstrating from yet another angle why independence is not in the interests of Scotland.

The Commission believes that the time is right to move the artificial debate on fiscal powers forward into the real world. We recognise that, in its academic sense, fiscal autonomy is essentially a sliding scale ranging from full fiscal autonomy to the current position of limited autonomy through limited tax varying powers.

Fiscal federalism, on the other hand, offers the opportunity for Scotland to bridge the gap in accountability from which the current system suffers. Yet it does so within a framework of a renewed and refreshed set of relations between the constituent parts of the United Kingdom. It is clear from examples from across the world that such a system can and does work in a range of states with a range of characteristics. The Commission is of the clear view that fiscal federalism offers substantial flexibility and would work well for Scotland and the rest of the UK.

The Concept of Fiscal Federalism

Fiscal federalism is the financial underpinning of the move to a more federal United Kingdom. It recognises the need for a greater link between the expenditure that the Scottish Parliament controls and how that expenditure is raised. It also recognises that Scotland has its own distinctive needs that require to be balanced against those in other parts of the United Kingdom. But it also identifies the central paradox that a rejuvenated and modern United Kingdom requires more sophisticated partnership arrangements with its component parts.

There are a number of aspects to consider in terms of the extent of financial powers which are desirable and useful for Scotland within a federal state. We discussed at some length in Chapter 3 how to measure autonomy using the Index of Fiscal Control in terms of revenue raising powers. This offers a sliding scale of autonomy based on the mix between the following:

- specific grant funding;
- general purpose (non ring fenced) grant;
- shared taxes (nationwide base and rates but with fixed proportion of tax revenue);
- non tax revenues (fees and charges);
- overlapping taxes (nationwide tax base but rates controlled locally); and
- own taxes where both the base and rate are under local control.

Principles of Fiscal Federalism for Scotland

Core Principles

The Commission believes that a successful system of fiscal federalism for Scotland should be grounded in the following core principles:

1. Changes to the system must result in greater transparency and political accountability

The primary objective of the financial arrangements of the future constitutional settlement is to provide adequate, stable and sustainable funding for the necessary duties of Government in as transparent and efficient a way as possible, ensuring proper accountability of each level of Government to the people. Fiscal powers are the financial means of implementing political choices and the fiscal system should support transparency and accountability in this regard.

The debates that have taken place in recent years in Spain, Germany, Italy and Canada over moves to decentralise fiscal control have had the accountability of the sub central administration at their core. The argument presented on an indirect democratic deficit has been discussed elsewhere in this Report.

2. The Scottish Government should raise as much as practical of its own spending.

No Parliament should expect to be funded predominantly through grants determined by another Parliament, nor should it be responsible for massive public expenditure without any responsibility for raising revenue in a manner accountable to its electorate. It is desirable to have better aligned financial authority and accountability, with each level of government raising as much as practical of its own spending.

3. The Scottish Government should have substantial authority over those levers of power which most affect the Scottish economy and which increase its ability to meet key policy objectives such as protecting the environment or improving health.

Reforming the financial arrangements supporting the Scottish and United Kingdom Parliaments is desirable in itself, but should also have demonstrable benefits for our citizens. One of these is the opportunity for the Scottish Government, within the common constraints of agreed fiscal arrangements at UK and EU level, to have fiscal powers suitable to influence the development of the Scottish economy. Greater powers over taxation and business regulation would allow Scotland the opportunity to differentiate itself from its neighbours and thus redress some of the disadvantages of size and location. Scotland must be able to retain its entrepreneurial talent and attract inward investment.

But the exercise of these fiscal powers also has economic and business effects. It can differentiate the business environment in Scotland within certain limits from that of our competitors – not least our nearest neighbour. It allows a choice of direction between enlarging or reducing the size of the state, and between increasing or reducing investment in public services. The use of fiscal powers can also influence the relative success or failure of energy policy.

To be able to differentiate itself strongly and positively from its neighbours, Scotland needs its hands on a number of levers of power which are currently in the domain of Westminster. There are four areas of public policy of critical importance to the business community and to Scotland's ability to influence the direction of the economy:

- infrastructure
- education and skills
- business regulation
- taxation

Only the first two are now substantially within the competence of the Scottish Parliament and Executive. For the Scottish economy to achieve its full potential, for Scotland to become a country of real opportunity, which retains its entrepreneurial talent and naturally attracts inward investment, there is a need for Scotland to have its hands more effectively on these four key levers and be able to pull all of them together.

In terms of policy control and autonomy, in comparison with some federal states, Scotland has significant policy autonomy, mostly from the non-ring fenced block grant system. One of the key elements of fiscal federalism is that it should give the Scottish Parliament the opportunity to enhance and improve its policy control in key areas. In general terms, fiscal federalism should give the Scottish Parliament the ability to control and introduce new incentives, charges or taxes to:

- Enhance and protect Scotland’s environment;
- Achieve radical health improvement through preventing illness and promoting good health;
- Promote education and enterprise

4. The Scottish Government should have borrowing powers and fiscal responsibility which fit into an agreed UK system.

It would be necessary to develop “Golden Rules” governing the way in which the UK Government and the Scottish Government exercise their fiscal powers. These would be practical and technical rules akin to the current Chancellor’s Golden Rule or the European Union’s rules for the Euro. They would cover such things as prudential limits to borrowing powers, the need to avoid overtaxing a particular tax base, and the need for technical advice from the Finance Commission for the Nations and Regions / Department of Customs and Revenue on the effects of specific tax proposals, etc.

5. Equalisation on the basis of need

Fiscal federalism should also be based on an equitable distribution of resources between different parts of the country based on their respective needs.

A new needs-based system would benefit the whole of the UK in the long term.

Throughout the original Constitutional Convention, Liberal Democrats espoused the need for equalisation and although the Parliament will set itself on many differing policy paths from Westminster, the principles underpinning our partnership in the United Kingdom remain the same.

6. Subsidiarity

Fiscal federalism should also adhere to the principle of subsidiarity in as much as devolving taxation powers to the Scottish Government is concerned.

The Scottish Parliament should have a general competence over taxes and charges, other than those taxes or portions of taxes specifically reserved to the United Kingdom Parliament.

7. Stability

There are always challenges involved in moving to any new system of funding. It is important that a system of fiscal federalism recognises this and builds-in certain guarantees on levels of public expenditure during the transition period.

Other Criteria for Decisions on Taxation

In addition to applying the Core Principles to the overall system of fiscal federalism, the Commission is of the view that questions of transparency and accountability, policy control and autonomy, and equity should be applied when taking decisions on which taxes should be devolved and which reserved. Furthermore, the Commission is of the view that decisions on individual taxes should also have regard to a number of other key factors⁷⁰:

- Clarity and simplicity
- Limiting of tax exportation
- Limiting of migration
- Efficiency and limiting of administrative complexity

Clarity and Simplicity – Although the current system of funding the Parliament is highly reliant on central grants, it is also relatively straightforward to understand. At the same time, taxation in the UK has progressively become more complex since 1997 with the introduction of tax credits. There are accordingly inherent difficulties in transparency and operational efficiency. Any system to provide the Parliament with more powers should seek not to be complex.

Tax Exportation – There is an inherent danger that differing taxation regimes could lead to the same tax base being over exploited by differing levels of government. There must therefore be a balance between, on the one hand, allowing Scotland to differentiate itself from the rest of the United Kingdom, and on the other, ensuring that Scotland continues to operate within a wider set of UK golden rules.

Migration – If there are wide variations in tax rates within the UK there could be excessive tax competition within the country. With fiscal federalism, differing tax rates would be expected but very wide variations could militate against business planning and stability.

Efficiency and Limiting of Administrative Complexity

– Administrative costs would increase with the complexity of fiscal powers or tax sharing agreements between administrations but there are many countries that operate a system of central taxation collection. Inherent inefficiencies in the tax varying powers of the Scottish Parliament mean that it is unlikely that any Parliament would favour a variation of one penny (of the 3 penny power that exists). The Audit Commission has also pointed out that the Council Tax is a deeply inefficient system of local taxation. Any new model should aim to be as efficient as possible.

Fiscal Issues and Europe

The fiscal aspect of federalism, discussed at length elsewhere in this Report, is of key importance for our relations with the EU, both formal and informal. As the debate under the UK Presidency on the overall EU budget has shown, the EU's role in funding for specific lagging regions and for developing economic sectors is under substantial pressure following EU enlargement. In addition, there is growing pressure under the "Lisbon" Jobs and Growth strategy for funding streams such as the Framework Programmes for Research etc. to be increased substantially in a way that will benefit those areas in Europe of academic excellence and market commercialisation most adapted to use them.

In principle, if there is enthusiasm for a more federal structure to be developed domestically that allows each constituent part of the UK to play an active part in the development of economic and social well-being, then each part might also be expected to have a proportionate and focused involvement in EU funding. However, this has to be both in terms of contributions as part of the Member State, and in terms of the support that may come as a result from the EU for specific regions, sectors or projects.

This in turn requires an honesty and rigour when it comes to the possible economic impact, both positive and negative, of full devolution of EU funding, (administration is substantially devolved already) particularly as it relates to additionality, SRA, state aids, etc. If the principle of solidarity across the poorer areas of the continent remains a shared priority, and if some form of progressive distribution of funds is to continue, UK federalism could suggest pro rata contributions to UK budgetary support as well as accepting subsequent EU receipts.

Taking a federal approach to outgoing funds, as well as incoming ones, is a challenge in terms of public support. However, it is one issue on which the UK has to be seen to hold its nerve, for the sake of its partners as well as itself. Another issue is the division between social funding which is predominately urban and projects that support diversification, infrastructure and agricultural support in rural areas.

In truth, what both the two-way flow of funding, and the rural/urban balance demonstrate is that it is always important to keep in mind what EU funding is actually aiming to achieve. It is the view of the current UK Government that the majority of CAP and Structural Funding is actually delivering domestic national priorities, and as such could substantially be returned, or devolved, to national administration from the EU level. If it remains true that there ought to be a wider issue of continental cohesion that is fostered by EU funding, then that is something which a truly federal party should be seen to support.

Chapter 9

A New Fiscal Settlement for Scotland

There is, as we have seen, widespread support for increased fiscal powers for the Scottish Parliament. Our recommendation is that the future fiscal arrangements should be based on a system of fiscal federalism suited to Scotland's needs. Such a system, we believe, will be a practical, stable and adaptable foundation for Scotland's reformed relationships within the United Kingdom.

Fiscal federalism meets the criteria, both of principle and effectiveness, we set out in Chapter 8 but there are of course many options that could be adopted which could be seen as being within the description of fiscal federalism.

The Steel Commission relied heavily on the seven Core Principles and the Key Criteria listed in Chapter 8 in considering the various options for such a new fiscal settlement for Scotland.

In settling on a preferred system of fiscal federalism, the Commission considered and rejected a number of options as they failed to meet sufficiently the criteria set out in the Core Principles. In summary, the systems considered and rejected by the Commission include:

- The status quo of predominantly grant funded expenditure
- A system of tax sharing based on predetermined shares of revenue
- A combined system of tax sharing with each level of government able to levy taxes within certain constraints – e.g. income tax levied by UK, Scotland and local government
- A system of full fiscal autonomy where Scotland is responsible for all taxation and remits a sum to Westminster to pay for reserved expenditure

Summary of the Steel Commission's Preferred System

The Commission supports the introduction of a system of fiscal federalism based on a significant increase in the taxation powers of the Scottish Parliament, coupled with a new needs-based equalisation system for the UK.

The Commission believes that it has a number of advantages, key among them being:

- A significant increase in the accountability of the Scottish Parliament and Scottish Executive, undoing the democratic deficit inherent in the current system
- A significant increase in transparency
- The opportunity to improve efficiency in the use and allocation of public sector resources
- Allowing the Scottish Parliament to have its hands on the fiscal levers necessary to influence the direction of the Scottish economy
- The opportunity for greater innovation and for the Scottish Government to increase the tools available to it to meet its policy objectives
- Ensuring stability in public finances during the transitional period

The new system of fiscal federalism can be summarised by the following ten point plan:

1. The Scottish Parliament should be given responsibility for all taxes except for those reserved to the UK.
2. The Scottish Parliament should have the ability to vary the tax rate for each of the 'devolved' taxes.
3. The Scottish Parliament should have the ability to vary the tax base for each of the 'devolved' taxes.
4. The Scottish Parliament should have the ability to abolish existing 'devolved' taxes or to introduce new taxes, subject to specific criteria and advice provided by a Finance Commission for the Nations and Regions.
5. Administration and collection of taxes should be undertaken by the Inland Revenue / federal body on behalf of Scotland.
6. Tax revenues for those 'devolved' taxes should be automatically allocated to Scotland while tax revenues for 'reserved' taxes should be automatically allocated to the UK Government.
7. The Scottish Parliament should have the power to borrow, subject to specific criteria and advice provided by the Finance Commission for the Nations and Regions within the UK system.

8. A new needs-based equalisation formula should be established to allocate grant funding across the UK, recognising the advantages to the UK of ensuring that all areas benefit from being part of the Union.
9. The new system should take current expenditure levels as the base point thereby ensuring stability of public finances for a defined period. This should include a federal safety net which would guarantee expenditure levels during the transition period.
10. The new system should also provide incentives for measures which lead to sustainable economic growth.

We have made specific, and indeed radical, proposals for change. Our proposals are intended to go with the grain of Scotland's needs and situation, but the detailed arrangements for allocating taxation powers remains a matter for debate and further consideration by the second Constitutional Convention.

We are clear, however, that change must not just be for change's sake, but to allow the achievement of real and tangible benefits for the people of Scotland. The Commission believes that further detailed work is required by the second Constitutional Convention on the matter of how the existing UK tax basket is divided up under the new system of fiscal federalism.

This Report does not therefore contain final recommendations on individual taxes. However, the Commission takes the view that there is a strong argument for devolving taxation powers to the Scottish Parliament in areas that would allow it to influence the direction of the Scottish economy. It is also important that the Parliament has taxation powers which allow it to pursue policy objectives within its areas of policy and legislative competence, such as environmental taxes.

This could mean, for example, that the second Constitutional Convention would conclude that there is a strong case for devolving direct taxes, such as income and corporation tax, alongside those which can act as policy levers, such as climate change levy and landfill tax. Equally the Commission believes there may be a case for a specific tax sharing mechanism for North Sea oil revenues.

Such an arrangement would allow the Scottish Parliament to meet the second Core Principle set out by the Steel Commission; namely that the Scottish Government should raise as much as practical of its own spending. However, it must be noted that there are other tax configurations that could produce a similar result and the Commission believes that final recommendations can only be made after detailed analysis by the second Constitutional Convention.

The Commission considered a further option for the new system of finance which it rejected as a long term aspiration but which it recognises could offer a stepping stone towards its preferred system. This option is essentially a radical increase in the tax varying powers of the Scottish Parliament while retaining a block grant system. The existing power to vary income tax by up to three pence would be extended further and could be applied to a number of other taxes, giving the Scottish Parliament much greater scope to vary taxation across the board. The Commission does not believe that this should be the final settlement for Scotland, but we recognise that it could offer a stepping stone towards a more accountable and flexible system in the longer term.

Benefits of the Recommended System of Fiscal Federalism

The Commission carefully considered the extent to which fiscal federalism meets the Core Principles which it set for any new fiscal system. In this section we set out how our recommended system fits with these.

1. Changes to the system must result in greater transparency and political accountability

Fiscal federalism significantly increases both transparency and political accountability. With Scottish Ministers responsible for setting the tax rate and tax base for a range of taxes which are currently reserved to Westminster, fiscal federalism will ensure that there is at least a direct link between revenue raising and expenditure. Put simply, Scottish Ministers will be held accountable to the Scottish Parliament and, crucially, to the people of Scotland through the ballot box for the decisions they take.

The system offers considerably more transparency, as voters will know that decisions taken by Scottish Ministers on taxes within their control will have more direct impact on public expenditure.

2. The Scottish Government should raise as much as practical of its own spending

The Steel Commission is not making specific recommendations on which taxes should be devolved and which reserved, as we believe that this requires more detailed analysis by the second Constitutional Convention. However, it is clear that fiscal federalism offers the ability for Scottish Ministers to obtain tax raising powers that could see them responsible for raising the bulk of Scottish expenditure from taxes over which they have control.

3. The Scottish Government should have substantial authority over those levers of power which most affect the Scottish economy and which increase its ability to meet key policy objectives such as protecting the environment or improving health

Fiscal federalism meets this criterion as it offers the opportunity for Scottish Ministers to control key taxes such as income tax or corporation tax, which could, as part of a wider economic strategy, be used to influence the direction of the Scottish economy. This would allow Ministers to choose to take Scotland down a different path to the rest of the UK, using taxation powers to differentiate itself strongly and positively from its neighbours.

Equally the system would allow Ministers to use the taxation system to meet specific policy objectives. At present Ministers are unable to use changes in tax rates, tax allowances, tax breaks or other incentives in order to change behaviour and encourage positive practices while penalising others. For example, in order to encourage further sustainable development, there could be considerable benefit to Scotland in having the ability to introduce a new system of taxes which reward environmentally sustainable practice and penalise polluters.

This is an important tool in the armoury of Ministers as it provides additional options not available at present and offers an alternative to using public expenditure alone to influence behaviour.

4. The Scottish Government should have borrowing powers and fiscal responsibility which fit into an agreed UK system

Under the fiscal federalism system Scotland would be able to borrow money on the international finance markets, backed up by the credit status of the UK. The Commission is of the view that such an arrangement would allow Scotland to borrow at prime market rates.

Such borrowing would be regulated by the new Finance Commission of the Nations and Regions as part of a UK wide system. This would again increase the options available to Scottish Ministers for the financing of public expenditure. Borrowing would be regulated by the equivalent of the current UK Golden Rules.

5. Equalisation on the basis of need

Under this system of fiscal federalism, the Commission recommends the creation of a new needs-based equalisation formula to replace eventually the current Barnett Formula.

The Commission is strongly of the view that equalisation is an important part of the Union. It recognises the fact that under the new system of fiscal federalism the people of Scotland will continue to pay taxes which are set, are collected and accrue directly to the UK Government. It is to the benefit of all areas of the United Kingdom that there is an element of redistribution between the regions of the UK and that resources are directed to areas of greatest need. The Commission believes that Scotland has nothing to fear from a new needs-based equalisation system. Redistribution systems are a common feature of most developed countries.

The Commission believes that this new formula should take a number of factors into account using an agreed set of indicators of need. These could include indicators relating to: geography; rurality; distance from markets; health; state of infrastructure; housing; crime and law and order; education; poverty and deprivation; employment levels; and the cost of delivering services. There may be others and clearly there would be a number of indicators within these categories.

There is also an argument for considering a system which recognises the increasing policy divergence in different regions of the United Kingdom. Of course, the counter argument to this is that policy decisions taken in different parts of the UK should not be a measure of need. Rather, need should remain focused on more objective statistical indicators.

There appear to be two main options for operating the new needs-based formula and the Commission believes that this is an area requiring further consideration by the second Constitutional Convention before settling on a preferred option:

To use a new needs-based formula to calculate a new block grant with subsequent variations made on a population basis. The block would then be recalculated on the basis of need after a defined period (say 5-7 years)

To use a new needs-based formula to update the block grant on a regular basis (perhaps following the principle of three year budgets).

The Scottish Government would continue to receive an element of grant funding from the UK Government, but this would be calculated in a fairer manner. Furthermore, such grant funding would no longer form the bulk of the expenditure of the Scottish Executive – rather it would represent a much smaller proportion, as the majority of Executive expenditure would derive from taxation controlled by Scottish Ministers with revenues which were directly assigned to the Scottish exchequer. Similarly the needs based formula could be used to allocate grant funding in England and Wales.

In any equalisation system there is a balance to be struck between equity and accountability. For example, the Commission believes that it is important that there are incentives in place for Scotland to improve its economic performance. Therefore it is important that the new needs-based formula does not create any perverse incentives. The Commission recommends that an element of 'economic effort' is built into the formula. If Scottish Ministers succeed in growing the Scottish economy, they should not be penalised by losing large amounts of grant funding from the needs-based formula. Clearly if economic performance improves significantly, Scotland could expect to see reductions in grant – however, it is important that the incentive remains in place. One option might be a formula which reduces grant funding by a smaller proportion than any increase in revenue.

6. Subsidiarity

The system of fiscal federalism advocated by the Commission is grounded on the basis of subsidiarity. This is true in two ways. First, we recognise that it is appropriate for certain aspects of taxation, such as administration and collection, to be undertaken on a UK wide basis as this is the most efficient and effective method; Second, we believe that, in considering the division of tax powers, the second Constitutional Convention should follow the principle that taxes should be the responsibility of the Scottish Parliament unless there is good reason for them to be the responsibility of the UK. The Commission recognises, however, that the United Kingdom Government also requires to be accountable and to have revenue streams appropriate to its expenditure requirements.

7. Stability

The challenge of moving to a new fiscal system cannot be underestimated. It is a complex process. It is crucial to Scotland and to the rest of the United Kingdom that changes are brought in gradually so as not to threaten stability. For instance, administrations across the UK have made forward plans for expenditure based on the current system and abrupt changes to funding levels could be problematic. While we do have the GERS estimates of taxation revenues available, actual definitive figures on the amount of revenue raised by a specific tax from Scottish taxpayers do not exist. Clearly transitional arrangements must therefore be put in place.

The Commission recommends that the new system should take as its starting point the current level of public expenditure. Under this scenario, the UK Government would effectively provide a federal guarantee of a financial safety net for a defined period. This safety net would be deployed should Scotland experience a significant decline in public expenditure due to a) a decline in revenues accruing directly to the Scottish exchequer under its new taxation powers; and / or b) a decline in grant funding owing to a major reduction in grant funding through the new needs based formula. Clearly over time the need for such a guaranteed safety net would reduce.

Next Steps

Clearly there are a number of practical steps that require to be taken in order to make the Commission's recommended system of fiscal federalism a reality:

- Establish the second Constitutional Convention with input from all political parties and civic Scotland, backed by the resources of the Scottish Government.
- Build a consensus through the Convention to make the case for change at Westminster. The political reality being that legislation or government action will be required at Westminster level.
- A review of the methodology of the Inland Revenue and Treasury in order to measure more accurately the revenues raised in specific geographic regions for specific taxes.
- Negotiations leading towards the establishment of a written constitution for the UK.
- The Commission recognises that this may not be achievable in the short term, but notes that much could be achieved through a review and quasi entrenchment of a new Scotland Act.
- A Finance Commission of the Nations and Regions should be established between the United Kingdom and Scotland and other federal units.
- The FCNR should conduct its affairs in accordance with principles and protocols of good financial and fiscal practice to be agreed and which might cover such issues as the limits on the total tax and debt burden, and incentivising economic improvements by the federal units. We take a common sense approach which rejects high administrative costs and promotes business confidence. The FCNR would:
 - Have a constitutional status, enshrining the principle of equity of finance across the UK's nations and regions. The FCNR would be charged with agreeing rules governing revenue support and borrowing, using the principles of fiscal federalism that have been outlined in this paper
 - be chaired by an independent and respected individual
 - be composed of representatives of the UK government, representatives from the National Assembly for Wales, Northern Ireland Assembly and the Scottish Parliament as well as the London Assembly and those representing English regional chambers or assemblies once they are established
- have recommendations reached by consensus and ratified by the respective executive bodies

- The FCNR will be under a duty to ensure a fair distribution of resources, and will identify and determine the basis on which the specific needs of rurality, peripherality, deprivation or other cause should be supported by the UK Government by additional grant to Scotland and other parts of the United Kingdom.
- The FCNR should also have responsibility for a new institution, incorporating the Department of Revenue and Customs, and responsible for collecting all appropriate taxes for all levels of government. It would be subject to a duty to advise on best practice and administer the tax collection machinery efficiently. Its operation and accountability to the United Kingdom and Scottish Parliaments and other equivalent bodies should be prescribed in the future constitutional settlement.
- Negotiations and design of a new needs-based equalisation formula should begin once the FCNR is established.

- In our earlier analysis, we indicated that an equitable fiscal relationship between the United Kingdom and Scotland in a more federal system would take account, not just of the funding mechanism of the Scottish Parliament, but of broader factors such as the treatment of oil revenues, and the capital city effect of London. Much more work will need to be done over a period of years to establish a broadly equitable basis for the future. It seems likely, however, that there would still remain a fiscal deficit of some sort, albeit of a much smaller size. This current fiscal deficit is a reflection of weaknesses in the Scottish economy as it has moved in recent years from the economic, social and structural legacy of de-industrialisation towards a healthier, more competitive, more service and knowledge-based environment.
- Accordingly, eliminating the deficit is not just a painful accounting exercise – it is also a vital economic strategy necessary to securing Scotland's future. The objective is to grow the Scottish economy in a way which is increasingly sustainable, raising more revenue ourselves in a higher wage, lower unemployment, high knowledge, modern, liberal economy and society, where we are able to utilise our whole potential workforce and to eliminate the current challenge of the excess number of people who are not in education, employment or training. Such a society will provide increasing opportunity, particularly for our young people, in a Scotland which builds on its historic reputation for education, innovation, and dynamism – a Scotland of ideas, which contributes well above its size to the knowledge, ability and life-enhancing skills of the world.
- There should be constitutional provision for funding for national emergency requirements.

Chapter 10

Conclusions and Recommendations

This Chapter sets out the main conclusions and recommendations of the Steel Commission.

A New Constitutional Convention

The first Constitutional Convention achieved a great deal and its legacy lives on today in the very existence of the Scottish Parliament. Scotland has changed a great deal since the Convention met. Devolution was always a process not an event and that is reflected in a number of significant changes. The Scottish Parliament has undertaken major reform of governance in Scotland with tough new Freedom of Information laws and fair votes for local government. We have witnessed incremental changes in the powers of the Scottish Parliament, as seen in the transfer of powers over rail. There is consistent evidence of public support for additional powers and a growing civic and political debate on the future settlement with politicians from across the parties looking for reform. There is an ongoing question of how best to reflect the changing identity of people north and south of the border in the form of the state. Finally there is the question of finishing the devolution project and the extent to which the current settlement adds to pressures from across the United Kingdom.

Recommendation 1 – A second Constitutional Convention should be established to review the powers of the Scottish Parliament in the light of the experience of two full terms. The challenge is for all Scotland’s political parties to learn the lesson of the first Convention and to join the new Convention in order to build a consensus on the way forward.

International Lessons for Scotland

Over the last twenty years there has been increasing interest in decentralisation of government across the globe. The Commission is of the view that Scotland can learn a number of lessons from international experience of political and fiscal decentralisation:

Lesson 1: The current political and administrative powers of the Scottish Parliament compare well with most sub central states but there remain areas of policy which are decentralised in other states but which are currently reserved to Westminster.

Lesson 2: A shared approach to policy can be seen in many federal states. Scotland should consider what benefits would accrue from a more statutory role in some policy areas that are currently reserved.

Lesson 3: Political autonomy can be limited considerably by the fiscal system with high proportions of ring fenced grants or restrictive tax sharing arrangements reducing effective autonomy.

Lesson 4: Scotland is not afforded the same level of constitutional protection through the Scotland Act as is seen in many federal states which are governed by written constitutions. This is a constitutional anomaly – and perhaps a constitutional threat - that would be addressed by a written constitution for the UK.

Lesson 5: Political and policy autonomy can vary markedly across different states, with variations in terms of the extent to which the constitution either 'reserves' specific areas and 'devolves' everything else or sets out 'reserved', 'shared' and 'devolved' competences.

Lesson 6: While a more symmetrical system of government may be desirable, there is clear evidence in areas such as Spain that asymmetric systems can work too.

Lesson 7: Despite the decentralisation of political power since 1999, the UK remains one of the most centralised fiscal systems in the developed world. Sub central states in other OECD countries enjoy much greater fiscal power with central grant funding making up a much smaller portion of revenue.

Lesson 8: Many sub central states with less political power than Scotland have much greater fiscal autonomy and control over taxation than has Scotland.

Lesson 9: The greatest fiscal autonomy for sub central states comes from control over the tax base and tax rate.

Lesson 10: It is a common theme in sub central states with taxation powers that they are able to introduce new taxes as long as they accept certain rules, often based on the double tax principle that aims to avoid overtaxing the same base.

Lesson 11: Different countries collect sub central taxes in different ways but it is clear that in most cases there is no reason why tax collection cannot remain a central function while control over certain taxes is decentralised.

Lesson 12: The key arguments for fiscal decentralisation are improving political accountability, public transparency, efficiency in the allocation of resources and decision making and stimulating economic growth. There is also potential for greater policy innovation.

Lesson 13: The Commission believes that constitutional change does not bring about economic development on its own. Rather it can create a constitutional framework within which there is greater freedom to make policy decisions which can lead to economic growth. Fundamentally, the Commission believes it is the policy decisions taken by governments using such powers that are the greatest determinant of economic development.

Lesson 14: No industrialised country has chosen to pursue full fiscal autonomy.

Lesson 15: There are a number of factors which apply to nearly all systems: sub central governments do not have adequate levels of 'own resources' leading to vertical imbalances and the need for intergovernmental transfers; it is common for there to be major variations in the size and capacity of sub central governments leading to horizontal imbalances; often sub central governments are not given authority over those taxes which are likely to be buoyant.

Lesson 16: Major changes to fiscal systems have to be carefully managed. Reform of the Australian system included an eight year transition period in which states were provided with a guarantee of minimum income so as not to disrupt services if income was less than under the previous system.

Lesson 17: Equalisation and intergovernmental transfers exist in all federal systems, recognising the benefits to all of the federal union.

Lesson 18: The power to borrow money within agreed limits is an important part of fiscal decentralisation.

Lesson 19: There are a number of key criteria that are generally applied when deciding how to divide up the tax basket including: tax exportation, tax competition and migration of the factors of production, and administrative complexity.

Recommendation 2 – The new Constitutional Convention should consider these lessons for Scotland and evidence from international experience with regard to the provision of taxation powers to sub central governments.

The Case for a Modern Settlement

The United Kingdom has been one of the great success stories of the world. Today it continues to bring benefits to all its founding partners. In areas such as international representation, foreign and defence policy, the UK allows Scotland to punch above its weight. In other areas there continues to be real benefits to all areas of the UK from taking a shared approach. There is a strong case for the Union to continue to be more than the sum of its parts. However, there is also a clear argument for it to be founded on a new modern settlement.

The current settlement has improved the ability of Scotland to address its own problems with its own solutions, however it has not solved the problem of a deficit in accountability caused by the UK's highly centralised fiscal system. No self respecting Parliament should expect to exist permanently on 100% handouts determined by another Parliament, nor should it be responsible for massive public expenditure without any responsibility for raising revenue in a manner accountable to its electorate. Greater accountability is not an abstract matter but a principle of good and effective government.

Recommendation 3 - The second Convention should consider the case for a move towards a new modern settlement based on more federal principles and backed by a new fiscal system to address the issue of a deficit in accountability.

A Modern Relationship with the Rest of the UK

Liberal Democrats have long held that a more federal arrangement for the United Kingdom would best accommodate both the diversity of identities across the United Kingdom and the things which we hold in common. Federal systems are the normal constitutional set up in advanced political societies across the world - in Spain, Germany and Switzerland, in the United States, Canada, Australia and South Africa amongst many others. A more federal arrangement will require a clear set of principles and an understanding of how best to divide powers and responsibilities between different levels.

Recommendation 4 - There should be a new written constitution for the UK which entrenches the rights of Scotland within a new constitutional framework rather than through an Act of the Westminster Parliament.

Recommendation 5 - The new constitution must: clearly set out the limits of power of the various partners in the Union; set out the specific powers that are the exclusive domain of the UK Parliament; introduce a category of formal partnership working in other specific areas; confirm that all others areas are within the competence of the Scottish Parliament.

Recommendation 6 - The Commission prefers a written constitution for the UK. However we recognise, as did the first Convention, that political reality can be as powerful as legal process. Therefore we would also support measures to bring about a quasi-entrenchment through a review of the Scotland Act, including a new mechanism requiring the consent of the Scottish Parliament to measures which would significantly change the Home Rule settlement. Such a review could include changes to the powers of the Scottish Parliament but should not replace the longer term goal of a new written constitution.

Recommendation 7 - Under the new settlement, the term "Scottish Executive" should be replaced by "Scottish Government".

Recommendation 8 – The principle of proportional representation for elections in Scotland, including STV for Scottish Parliament elections, should be enshrined in the constitution.

Recommendation 9 – The constitution should be based on the principle of subsidiarity and should also therefore recognise the status, democratic legitimacy and role of local government. There would be merit in further work on how all three spheres of governance interact under the new system.

Recommendation 10 - There should be an Annual Review of the Constitutional Steering Group (CSG) principles with the weight and status of a ‘State of the Nation’ address.

Recommendation 11 – The Scotland Office should be abolished and replaced by a UK Department of the Nations and Regions.

Recommendation 12 – A Joint Committee of the Scottish and UK Parliaments should be established and the Scottish Select Committee should be abolished.

New Powers for the Scottish Parliament

The Scottish Parliament already has significant powers which allow it to act in major policy areas. There are clearly a number of areas of policy where a UK wide approach offers the most efficient, effective or desirable outcome. However there is a need for the Scottish Parliament to have a more formalised role in working with the UK Government in some areas currently reserved to Westminster. The Commission believes that there is a strong case for considering extending some powers to the Scottish Parliament.

Recommendation 13 – There should be a new constitutional category of partnership working to give the Scottish Parliament a more formal role in certain policy areas currently reserved to the UK. This would include a legal requirement to consult before progressing beyond specific legislative stages and allowing time for the Scottish Government and Scottish Parliament to consider properly the impact of policy proposals from the UK Government.

Recommendation 14 – Scotland should have exclusive competence over: the electoral system; the operation of the Scottish Parliament; transport powers; medical contracts; energy policy; and the civil service.

Recommendation 15 – In addition to the powers in recommendation 14, the Commission recommends that the second Constitutional Convention should pay particular attention to the strong case for Scotland gaining additional powers over: betting and gaming; public and bank holidays; human rights and equalities; marine policy; and an increased role in governance of broadcasting.

Recommendation 16 – The second Constitutional Convention should consider the case for extending the role of the Scottish Government, perhaps through the new system of formalised partnership working, in the following areas: regulatory powers; misuse and control of drugs; control of firearms; asylum and immigration; national security as it relates to Scottish police forces; strategic planning of welfare services; competition and mergers in terms of the Parliament's power to report to the relevant UK bodies; and employment law.

The United Kingdom as a Fiscal and Economic Union

The current funding system for the Scottish Parliament relies, predominantly, on a grant with accountability over how the money is spent given to the Scottish Executive, answerable to the Scottish Parliament. The Barnett formula does not determine overall budget levels. Rather it is used to share out changes in public expenditure between the countries of the UK based on population share. It is not a needs based formula. There have been growing calls, not least from its founder Lord Barnett, for it to be updated or scrapped.

Public expenditure in Scotland is around 17% higher than per head spending for the UK as a whole. Scotland raises 8.2% of the total UK revenue (excluding North Sea oil revenues). As a result, the Scottish Executive's Government Expenditure and Revenue in Scotland 2003-04 (GERS) Report puts the net deficit (excluding North Sea oil revenues) at £11.2 billion. This deficit is reduced to just under £7 billion if all North Sea revenues were allocated to Scotland.

The GERS report has been widely accepted by economists, but the report itself recognises that it has limitations, not least that it is based on estimates of revenue as the UK Government does not measure actual tax revenues by area. While Scotland has the power to vary the basic rate of income tax by up to 3 pence in the pound, Scotland receives around 77% of its revenue from central government transfers.

Recommendation 17 – There should be reform of the UK economic and fiscal union which recognises that the financial and economic relations between Scotland and the UK as a whole are extremely complex and cannot be reduced to a simple issue of whether Scotland has a fiscal deficit or a fiscal surplus.

Recommendation 18 – The UK Government should make the changes necessary at the Inland Revenue to measure actual tax revenue receipts for the different areas of the UK. This will assist in informing the debate on the division of tax powers and the extent or otherwise of a fiscal deficit or surplus.

The Principles of Fiscal Federalism

The Commission believes that the time is right to move the debate on fiscal powers forward and believes that fiscal federalism offers the opportunity to Scotland to bridge the gap in accountability seen in the current system but within the framework of a renewed and refreshed set of relations for the UK.

It is instructive that full fiscal autonomy (where Scotland raises and retains all tax revenue and remits an agreed sum to Westminster for shared services) does not operate in any industrialised country. In contrast, fiscal federalism can be seen to work well in countries across the world. Therefore the Commission rejects the case for full fiscal autonomy. .

Recommendation 19 – Scotland should support a new system of fiscal federalism based on the following core principles:

- Changes to the system must result in greater transparency and political accountability
- The Scottish Government should raise as much as practical of its own spending
- The Scottish Government should have substantial authority over those levers of power which most affect the Scottish economy and which increase its ability to meet key policy objectives such as protecting the environment or improving health.
- The Scottish Government should have borrowing powers and fiscal responsibility which fit into an agreed UK system
- Equalisation on the basis of need
- Subsidiarity
- Stability

A New Fiscal Settlement for Scotland

The Commission supports the introduction of a system of fiscal federalism based on a significant increase in the taxation powers of the Scottish Parliament, coupled with a new needs-based equalisation system for the UK. The Commission believes that this will bring a number of advantages:

- A significant increase in the accountability of the Scottish Parliament and Scottish Executive, undoing the democratic deficit inherent in the current system
- A significant increase in transparency
- The opportunity to improve efficiency in the use and allocation of public sector resources
- Allowing the Scottish Parliament to have its hands on the fiscal levers necessary to influence the direction of the Scottish economy
- The opportunity for greater innovation and for the Scottish Government to increase the tools available to it to meet its policy objectives
- Ensuring stability in public finances during the transitional period

Recommendation 20 – There should be a new system of fiscal federalism for Scotland summarised by the following ten point plan:

1. The Scottish Parliament should be given responsibility for all taxes except for those reserved to the UK.
2. The Scottish Parliament should have the ability to vary the tax rate for each of the 'devolved' taxes.
3. The Scottish Parliament should have the ability to vary the tax base for each of the 'devolved' taxes.
4. The Scottish Parliament should have the ability to abolish existing 'devolved' taxes or to introduce new taxes, subject to specific criteria and advice provided by a Finance Commission for the Nations and Regions.
5. Administration and collection of taxes should be undertaken by the Inland Revenue / federal body on behalf of Scotland.
6. Tax revenues for those 'devolved' taxes should be automatically allocated to Scotland while tax revenues for 'reserved' taxes should be automatically allocated to the UK Government.
7. The Scottish Parliament should have the power to borrow, subject to specific criteria and advice provided by the Finance Commission for the Nations and Regions within the UK system.
8. A new needs-based equalisation formula should be established to allocate grant funding across the UK, recognising the advantages to the UK of ensuring that all areas benefit from being part of the Union.
9. The new system should take current expenditure levels as the base point thereby ensuring stability of public finances for a defined period. This should include a federal safety net which would guarantee expenditure levels during the transition period.
10. The new system should also provide incentives for measures which lead to sustainable economic growth.

Recommendation 21 – Further detailed work is required by the second Constitutional Convention on the matter of how the existing UK tax basket is divided up under the new system of fiscal federalism.

Recommendation 22 – Under this system of fiscal federalism the Convention may consider the case for giving the Scottish Parliament authority over direct taxes such as income and corporation tax, alongside those which can act as policy levers such as climate change levy and landfill tax. There may also be a case for a specific tax sharing mechanism for North Sea oil revenues. However, there may be other tax configurations that could produce similar results and the Commission believes that final recommendations can only be made after detailed analysis by the second Convention.

Annex 1

The Remit of the Steel Commission

1. To examine the powers, responsibilities and financial powers of the Scottish Parliament and its relationship to the United Kingdom Parliament and Government and to the European Union.
2. To consider how to move forward to a fully federal structure for the United Kingdom (including consideration of the relationship between the Scottish Executive and local government in Scotland).
3. To identify what changes to the powers and legislative competences of the Scottish Parliament are desirable.
4. To identify the potential advantages of greater fiscal and economic powers for the Scottish Parliament.
5. In the light of the Party's traditional commitment to strong fiscal powers for the Scottish Parliament, to consider the fiscal and economic relationship between the Scottish Parliament and the United Kingdom Government, and to identify and present proposals for fiscal federalism to the Party.
6. To consider the implications of moving from the current Block grant system based on the Barnett formula to such a new system of financing the Parliament.
7. To consider how to maximise the benefits of being part of the United Kingdom, including improving partnership working between the different levels of Government.
8. To take account of external relations issues, particularly the appropriate relationships with European institutions.
9. To make proposals for the future electoral system for the Scottish Parliament.
10. To produce recommendations.

Annex 2

Membership of the Steel Commission

Convener: Lord Steel of Aikwood

David Steel was MP in the Scottish Borders from 1965-97, Leader of the Liberal Party 1976-88, co-founder of the Liberal Democrats in 1988, co-chair of the Scottish Constitutional Convention 1989-99, and Presiding Officer of the Scottish Parliament 1999-2003. He has been awarded honorary doctorates by nine universities, and recently appointed by the Queen a Knight of the Thistle.

Members: Robert Brown MSP

Robert Brown was elected as MSP for Glasgow in 1999 and joined the Scottish Ministerial team as Deputy Minister for Education in 2005. He is Policy Convener of the Scottish Liberal Democrats. He was elected as the first Liberal Councillor on Glasgow District Council in 1977 and was Leader of the Liberal Democrat Group from 1977-1992. Robert Brown is a solicitor and was formerly deputy procurator fiscal at Dumbarton before working in private practice. He was senior civil partner with Ross Harper and Murphy before becoming an MSP.

Neal Ascherson

Neal Ascherson, born in Edinburgh in 1932, is a journalist and writer. From 1975-79, he was the Scottish Politics correspondent of The Scotsman. His latest book is 'Stone Voices: the Search for Scotland' (2003). In 1999, he contested the constituency seat of Renfrewshire West for the Scottish Liberal Democrats.

John Barnett

John Barnett graduated in Law from University of Dundee in 1979. Until 2001, he worked in the City of London in international corporate, institutional and investment banking and in project finance. He is currently Executive Director of a Fife-based charity. He has been an active Party member at all levels since 1974. He is currently a member of the Scottish Party Executive, Prospective Candidate Policy Assessor, and a member of the Party's Federal 'Meeting the Challenge' Working Group.

Petra Biberbach

Petra Biberbach is Executive Director of Planning Aid for Scotland and a keen advocate of making the planning system more accessible to all people living in Scotland. With a working background in Sustainable Development, she used to be COSLA's Local Agenda 21 Adviser and served as a Secretary of State appointed member on the Northumberland National Park Authority. She is founder member of the Campaign for Borders Rail and chair of the Waverley Route Trust. She is also a company director of a tourism business in the Harz mountains. Originally from Germany she has lived and worked in Switzerland and England and is now settled in Scotland.

Malcolm Bruce MP

Malcolm Bruce was elected as MP for Gordon in 1983 and is president of the Scottish Liberal Democrats. He has held various positions within the party including Trade and Industry Spokesperson, Scottish Affairs Spokesperson, Shadow Chancellor and Chair of the House of Commons Parliamentary Party. Amongst others he has sat on the Scottish Affairs Select Committee from 1990 -1992, the Treasury & Civil Service Select Committee 1994-1997 and is currently chair of the International Development Select Committee. He was a member of the Scottish Constitutional Convention and the Parliamentary Assembly of the Council of Europe.

Chris Butler

Chris Butler is a Director and Head of Research of an international investment management firm. He is a member of the Chartered Institute of Financial Analysts and co-manages a global equity fund, specializing in resources. Chris has held various offices for the Liberal Democrats in East Lothian and contested the Westminster Parliamentary seat in 2005

Sir Graeme Davies

Sir Graeme is currently Vice-Chancellor of the University of London. He was Principal of the University of Glasgow from 1995 to 2003. He was Chief Executive of the Higher Education Funding Council for England from 1991 until 1995 having been Vice-Chancellor of the University of Liverpool from 1986 to 1991. He was Professor of Metallurgy in the University of Sheffield. He was educated in the School of Engineering of the University of Auckland, New Zealand.

He is a Fellow of the Royal Academy of Engineering, a Fellow of the Royal Society of Edinburgh and has held Visiting Professorships in New Zealand, Brazil, China, Argentina, South Africa, Israel and India.

He is now the Chair of the Higher Education Policy Institute.

Councillor Jenny Dawe

Dr Jenny Dawe is leader of the Scottish Liberal Democrat Group for Edinburgh Council. She is Councillor for the Ward of Gyle, Edinburgh and is a Member of the Standards Committee and a member of Head Teacher Appointments Committee - Core Group and an additional member of The Edinburgh Council Executive (Educational Matters).

John Edward

John Edward has been the Head of the European Parliament's Office in Scotland since 2003. Prior to that he was Parliamentary Manager for Scottish Enterprise, and previously EU Policy Manager for Scotland Europa in Brussels from 1996 to 2001. His work in Brussels also includes the editorial board of the European Policy Centre and the European Community Humanitarian Office. His membership of the Steel Commission is in a personal capacity.

Councillor Graham Garvie

Graham Garvie runs his own international management consultancy business and has worked extensively in the Balkan countries and Eastern Europe. Elected a Councillor in May 2003 on the Scottish Borders Council he represents the Council on the Convention of Scottish Local Authorities. He is the COSLA spokesperson on Arts and Sport, and a member of the EU Committee of the Regions. He was Chief Executive of Tweeddale District Council for 11 years and has served on the Board of the Borders General Hospital NHS Trust.

Chris Huhne MP

Chris Huhne was elected as the MP for Eastleigh in 2005 and is currently shadow chief secretary to the Treasury, dealing with tax and public spending. He formerly chaired the Liberal Democrat Public Services Policy Commission and the expert group on Britain's adoption of the Euro. He was co-chairman of the policy panel on global sustainability, stability and security and the party's economic adviser during the General Election campaign of 1997.

Chris Huhne was previously an award winning economic journalist on The Guardian, The Independent and The Economist, and also wrote a weekly column about Europe for the business pages of the London Evening Standard after his election as an MEP. He has also written four books mainly on the themes of third world debt and development and European integration.

Councillor Paul Johnston

Paul Johnston is Councillor for Tarves, Aberdeenshire.

John Lawrie

John Lawrie is a former Treasurer and Chairman of the Scottish Liberal Party. He was a Liberal Councillor in Edinburgh from 1971-75. He was a member of the Scottish Constitutional Commission and has recently been a member of the Arbuthnott Commission. A retired investment manager, he was chair of the Samaritans for Britain and Ireland from 1996-99.

Councillor Joan Mitchell

Joan Mitchell is the leader of the Liberal Democrat group for Dumfries & Galloway Council and Councillor for Cree. She also chairs the Planning & Environment Committee for Dumfries & Galloway Council. Additionally, Joan Mitchell is a former member of the EU Committee of Regions and the National Committee of Scotland Forward.

Jeremy Purvis MSP

Jeremy Purvis is Scotland's youngest constituency MSP. He was elected MSP for Tweeddale, Ettrick & Lauderdale in 2003. He was formerly a member of the Scottish Parliament's Finance Committee and Finance Spokesperson for the Scottish Liberal Democrats. In June 2004 Jeremy Purvis was the first Scottish politician to seriously apply the concept of fiscal federalism to Scotland with the publication of a policy pamphlet on the subject.

Sheila Ritchie

Euan Roddin

Euan Roddin is a graduate of the University of Edinburgh and the Johns Hopkins University School of Advanced International Studies. He has published a number of articles, including a piece on Scotland's experience of coalition government in the academic journal Scottish Affairs. He currently works in the Scottish Parliament for Margaret Smith MSP.

Tavish Scott MSP

Tavish Scott was elected MSP for Shetland in 1999 and went on to be appointed Deputy Minister for the Parliament for 2000 – 2001. He has formerly held the posts of Enterprise and Lifelong Learning Spokesperson, Highlands & Islands Spokesperson and Convenor the Scottish Liberal Democrats. He also held the post of Deputy Minister for Finance, Public Services and Parliamentary Business from May 2003 – June 2005 before being joining the Scottish Cabinet as Minister for Transport in June 2005.

Lord Vallance of Tummel

Iain Vallance has held a wide range of business appointments, including President of the CBI, Chairman of BTplc, Vice-Chairman of the Royal Bank of Scotland Group and member of the boards of Siemens AG and the Mobil Corporation. He has also served on the board of Scottish Enterprise. He became a peer in 2004 and is a member of the House of Lords Select Committee on Economic Affairs.

Secretary: David Paterson

David Paterson is Head of Communications for the Scottish Liberal Democrats.

Annex 3

Motion Adopted by the Scottish Liberal Democrat Party Conference, February 2005

The Steel Commission - "Moving to Federalism"

This Conference:

- welcomes the continuing development of the Scottish Parliament, built on the principles laid down by the Scottish Constitutional Convention in which Scottish Liberal Democrats played such a leading part;
- notes the increasing powers given to the Parliament in the light of experience, and the increasing role played by the Parliament and the Executive in establishing links of all sorts across the world;
- notes the long standing support of the Scottish Liberal Democrats for greater fiscal powers for the Scottish Parliament;
- endorses the long-held view of the Party that the Home Rule settlement should be reviewed after two full terms of the Parliament; and
- welcomes the work being done by the Steel Commission on the future powers of the Parliament and its relationship to Westminster in the context of a developing asymmetrical federal structure for the United Kingdom.

Conference further:

- approves the Statement of Constitutional Principles agreed by the Scottish Liberal Democrat Commission on Moving to Federalism (the Steel Commission) as the basis of the future relationship we seek between the Scottish Parliament and the United Kingdom;
- the Fiscal Principles agreed by the Steel Commission as the proper basis of reform of the tax raising powers of the Parliament; and
- instructs the Commission to continue its work and to report to a future Conference with its final report.

Annex 4

Statement of Constitutional Principles agreed by the Scottish Liberal Democrat Steel Commission on "Moving to Federalism"

- These principles are the basis of the federal relationships we seek between the nations and regions of the United Kingdom.
- Our primary aim is to build a liberal society, which is fair, free and open, balancing our fundamental values of liberty, equality and community, and in which no-one shall be enslaved by poverty, ignorance or conformity.
- Power and authority derive from and flow upwards from the people. Government is multi-layered and pluralist and should be exercised at the most local appropriate level. The State has to be broad-based, inclusive and liberal, in this modern and complex age.
- Liberal Democrats believe in ensuring strong, vibrant and independent Local Government to protect and advance local communities.
- Scotland has an ancient cultural, political and national identity, with separate legal, educational and religious structures and traditions, and a strong emphasis on community, where local and regional rights and diversity should be recognised and promoted.
- Scotland also shares values, history and language with other parts of the United Kingdom, and increasingly relates to the developing democratic polity of the European Union. People in Scotland, regardless of their origins, recognise these diverse but compatible Scottish, British and European identities.
- Such identities are for individuals to affirm and the State to recognise, but, while national and cultural identity is an important part of individual freedom, it is only part. As with government, our individual identities are often multi-layered - arising from a community, national, cultural or religious basis, or from more individual family or life experiences or beliefs.

- A federal union best accommodates this diversity. Federal solutions are normal and commonplace in advanced political societies across Europe, the Commonwealth and the Americas. The federal institutions should reflect the geographic and cultural diversity of the United Kingdom.
- We have a modern, liberal vision of Scotland - generous, innovative, offering wide opportunity to its citizens, building on its specific values of civic freedom and community, and looking outwards to the world.
- We have a dynamic concept of the United Kingdom - inclusive, committed to liberal values, a force for peace and understanding in the world, built on the firm partnership of our ancient nations and regions, and on our long and distinguished history of civil and parliamentary democracy.
- We want an active and vibrant relationship with Europe that recognises the importance of the EU for Scottish citizens. We want the European Union to be more open, democratic and decentralised. We believe that the active participation of Scotland in the European Union ensures our long-term peace, security and prosperity.
- A written constitution should set out the limits of the powers of the federal institutions, and should recognise the diverse constitutional rights of the federal nations and regions. Scotland is a founding partner in the United Kingdom, and is entitled to recognition of her particular status.
- Liberal Democrats assert "the sovereign right of the Scottish people to determine the form of government best suited to their needs" as declared in the 1988 Claim of Right. The Scottish Parliament was built on the broad civic foundations of the Scottish Constitutional Convention and was confirmed as "the settled will of the Scottish people" by the 1997 Referendum. The federal settlement we seek should likewise be founded on a suitable and participative democratic constitutional process.

Annex 5

Fiscal Principles agreed by the Scottish Liberal Democrat Steel Commission on "Moving to Federalism"

- The primary objective of the financial arrangements of the future constitutional settlement is to provide adequate, stable and sustainable funding for the necessary duties of Government in as transparent and efficient a way as possible, ensuring proper accountability of each level of Government to the people. Fiscal powers are the financial means of implementing political choices.
- Reforming the financial arrangements supporting the Scottish and United Kingdom Parliaments is desirable in itself, but should also have demonstrable benefits for our citizens. One of these is the opportunity for the Scottish Executive, within the common constraints of agreed fiscal arrangements at UK and EU level, to have fiscal powers suitable to influence the development of the Scottish economy.
- There should be an institution of the federation, responsible for collecting all appropriate taxes for all levels of government and subject to a duty to advise on best practice and administer the tax collection machinery efficiently. Its operation and accountability to the United Kingdom and Scottish Parliaments and other equivalent bodies should be prescribed in the future constitutional settlement.
- No Parliament should expect to be funded predominantly through grants determined by another Parliament, nor should it be responsible for massive public expenditure without any responsibility for raising revenue in a manner accountable to its electorate. It is desirable to have better aligned financial authority and accountability with each level of government raising as much as practical of its own spending. The Scottish Parliament should have a general competence over taxes and charges, other than those taxes or portions of taxes specifically reserved to the United Kingdom Parliament.

- There should be constitutional provision for funding for national emergency requirements.
- Citizens in the nations and regions of Britain should be able to recognise that there are substantial benefits to all parts of the United Kingdom from working together within a federal union.
- There requires to be a federal system of "needs based" fiscal transfers to ensure access to sufficient funding for basic public service provision across the United Kingdom. These needs include population, rurality, peripherality and access to markets, social and economic deprivation and the need to counterbalance the "capital city effect" of London and the south east.
- A Joint Exchequer Board (otherwise referred to as the Finance Commission of the Nations and Regions) should be established between the United Kingdom and Scotland and other federal units. The J.E.B. will ensure a fair distribution of resources, and will identify and determine the basis on which the specific needs of rurality, peripherality, deprivation or other cause should be supported by the UK Government by additional grant to Scotland and other parts of the United Kingdom.
- The J.E.B. should conduct its affairs in accordance with principles and protocols of good financial and fiscal practice to be agreed and which might cover such issues as the limits on the total tax and debt burden, and incentivising economic improvements by the federal units. We take a common sense approach which rejects high administrative costs and promotes business confidence.
- The Scottish Parliament should have powers to borrow within the framework of the agreed financial protocols.
- The fiscal settlement under the new federal arrangements should have the prevailing level of resource distribution as its initial basis. This will be adjusted from time to time by a Revenue Distribution formula as may be agreed to reflect the needs of all the federal units.

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- ² Scottish Liberal Democrat Manifesto for the 2003 Scottish Parliament Elections "Make the Difference: Fresh Thinking for Four More Years"
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- ⁹ MORI Scotland opinion poll conducted for Scottish TV's and Grampian TV's Politics Now programme on the powers of the Scottish Parliament. Fieldwork 24/8/05 – 30/8/05, 1,007 adults polled by telephone. 18-24 age group: 27% agree strongly; 45% agree; 4% neither/nor; 10% disagree; 1% disagree strongly; 14% don't know.
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- ¹⁸ See Julia Darby, Anton Muscatelli and Graeme Roy, University of Glasgow, September 2002 "Fiscal Federalism and Fiscal Autonomy: Lessons for the UK From Other Industrialised Countries".

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²⁴ Robert Ebel & Serdar Yilmaz, "Concept of Fiscal Decentralization and Worldwide Overview", September 2001, International Symposium, Quebec Commission on Fiscal Imbalance.

²⁵ Robert Ebel & Serdar Yilmaz, "Concept of Fiscal Decentralization and Worldwide Overview", September 2001, International Symposium, Quebec Commission on Fiscal Imbalance.

²⁶ The Index of Fiscal Control, OECD 1999, reproduced in Darby et al 2002. "The index of fiscal control comprises a weighted average index measuring the tax raising autonomy of state and local governments, multiplied by the magnitude of these respective taxation revenues."

²⁷ Source material for this illustration: "The Funding of Autonomous Communities in Spain". Pere Gali, Secretary General for Economic Promotion, Ministry of Economic Affairs and Finance, Government of Catalonia, 2002

²⁸ This illustration is based on material from the following source: Marcel Gerard, "Fiscal Federalism in Belgium", paper to the Conference on Fiscal Imbalance, Sep 2001

²⁹ Ebel & Yilmaz 2001

³⁰ Oates, 1972 quoted in Ebel & Yilmaz 2001

³¹ Darby et al citing work of Gramlich, 1984

³² Ebel & Yilmaz 2001

³³ Brennan and Buchanan, 1980 cited in Ebel & Yilmaz 2001

³⁴ Paul Hallwood and Ronald Macdonald, Fiscal Federalism, The Allander Series cited in Ebel & Yilmaz 2001

³⁵ Ebel & Yilmaz 2001

³⁶ Paul Hallwood and Ronald Macdonald, Fiscal Federalism, The Allander Series citing De Mello (2000) with regard to social capital and his use of the three social capital indicators.

³⁷ Julia Darby, Anton Muscatelli and Graeme Roy "Fiscal Decentralisation In Europe:

A Review Of Recent Experience", April 2003

³⁸ See Darby et al

³⁹ Ahmad and Craig (1997) cited in Ebel & Yilmaz 2001

⁴⁰ Based on discussion in Julia Darby, Anton Muscatelli and Graeme Roy, University of Glasgow, September 2002 "Fiscal Federalism and Fiscal Autonomy: Lessons for the UK From Other Industrialised Countries".

⁴¹ Source for this illustration: David J Collins, "The 2000 Reform of Intergovernmental Fiscal Arrangements in Australia", September 2001

⁴² McGregor & Swales (2003) – The Economics of Devolution/Decentralisation in the UK: Some Questions and Answers – University of Strathclyde Discussion Paper No 03-13

⁴³ Scottish Economic Report (December 2005) pp 87-8

⁴⁴ Scottish Economic Report (December 2005) p 3

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- ⁴⁶ Julia Darby, Anton Muscatelli and Graeme Roy, University of Glasgow, September 2002 "Fiscal Federalism and Fiscal Autonomy: Lessons for the UK From Other Industrialised Countries".
- ⁴⁷ Reforming Governance in the UK; Policies of Constitutional Reform, Liberal Democrat Policy Paper 40, June 2000
- ⁴⁸ Note the Commission recognises in Chapter 5 that a form of quasi-entrenchment is possible following a review of the Scotland Act.
- ⁴⁹ Scotland's Parliament, Scotland's Right (http://www.almac.co.uk/business_park/scc/backg.htm)
- ⁵⁰ Summary of Devolved Parliaments in the European Union, Unite for the Study of Government in Scotland, University of Edinburgh, August 1998, Published by The Scottish Office.
- ⁵¹ "CONCORDAT BETWEEN HM TREASURY AND THE SCOTTISH EXECUTIVE", February 2005, <http://www.scotland.gov.uk/Publications/2005/03/concordats>
- ⁵² Scotland's Parliament, Scotland's Right (http://www.almac.co.uk/business_park/scc/scc-rep.htm#Powers_and_Responsibilities)
- ⁵³ Scotland's Parliament, Scotland's Right (http://www.almac.co.uk/business_park/scc/scc-rep.htm#Powers_and_Responsibilities)
- ⁵⁴ David Bell & Alex Christie, "He That Pays the Piper Calls the Tune: Has the Barnett Formula Constrained the Autonomy of the Devolved Institutions?", January 2004
- ⁵⁵ David Heald and Alasdair McLeod (2002), "Public Expenditure" in Constitutional Law, 2002, The Laws of Scotland: Stair Memorial Encyclopaedia, Edinburgh, Butterworths, paras 530, 532-536
- ⁵⁶ The Barnett Formula, 12 January 1998, Robert Twigger, House of Commons Library
- ⁵⁷ Op cit
- ⁵⁸ Interim Findings from the ESRC Research Programme on Devolution and Constitutional Change, "Delivering Public Policy after Devolution: Diverging from Westminster" February 2004.
- ⁵⁹ Interim Findings from the ESRC Research Programme on Devolution and Constitutional Change, "Delivering Public Policy after Devolution: Diverging from Westminster" February 2004.
- ⁶⁰ David Bell & Alex Christie, "He That Pays the Piper Calls the Tune: Has the Barnett Formula Constrained the Autonomy of the Devolved Institutions?", January 2004
- ⁶¹ The difference in the figures on per head spending for identifiable expenditure and aggregate expenditure occur because aggregate expenditure includes identifiable expenditure, non-identifiable expenditure and accounting adjustments.
- ⁶² The difference in the figures on per head spending for identifiable expenditure and aggregate expenditure occur because aggregate expenditure includes identifiable expenditure, non-identifiable expenditure and accounting adjustments.
- ⁶³ The GERS report 2003-04 gives the following definitions for identifiable and non-identifiable expenditure: "Identifiable expenditure is defined as expenditure that can be identified as having been incurred for the benefit of the population of a particular country/region. This is the fundamental "who benefits" principle. Alternatively, expenditure could be allocated to the country where it is incurred. In the latter case, the location of the beneficiaries of the service is not explicitly taken into account. In practice, the allocation under the two approaches is similar for most kinds of spending. By convention, all Scottish Executive spending is regarded as being for the benefit of Scotland. In practice some expenditure, classed as "identifiable", will inevitably be to the benefit of people residing outside of Scotland. For example, health facilities are not used solely by the residents of the region where they are located, and roads serve the needs of people beyond the area where they are built."

" "Non-identifiable" expenditure is expenditure generally incurred on behalf of the UK as a whole. There are a number of possible ways in which to allocate Scotland a share of UK non-identifiable expenditure. The Scottish share of the UK population (8.5 per cent in 2002) or of UK Gross Value Added⁵ (8.1 per cent in 2002) or a more specific method, if available, could be used.

Scotland's share of non-identifiable service spending has been allocated primarily, but not exclusively, on a population basis"

⁶⁴ For detailed explanations on how these figures are calculated please refer to GERS Report 2002-2003 at

<http://www.scotland.gov.uk/library5/government/gers05-06.asp>

⁶⁵ GERS 2002-03

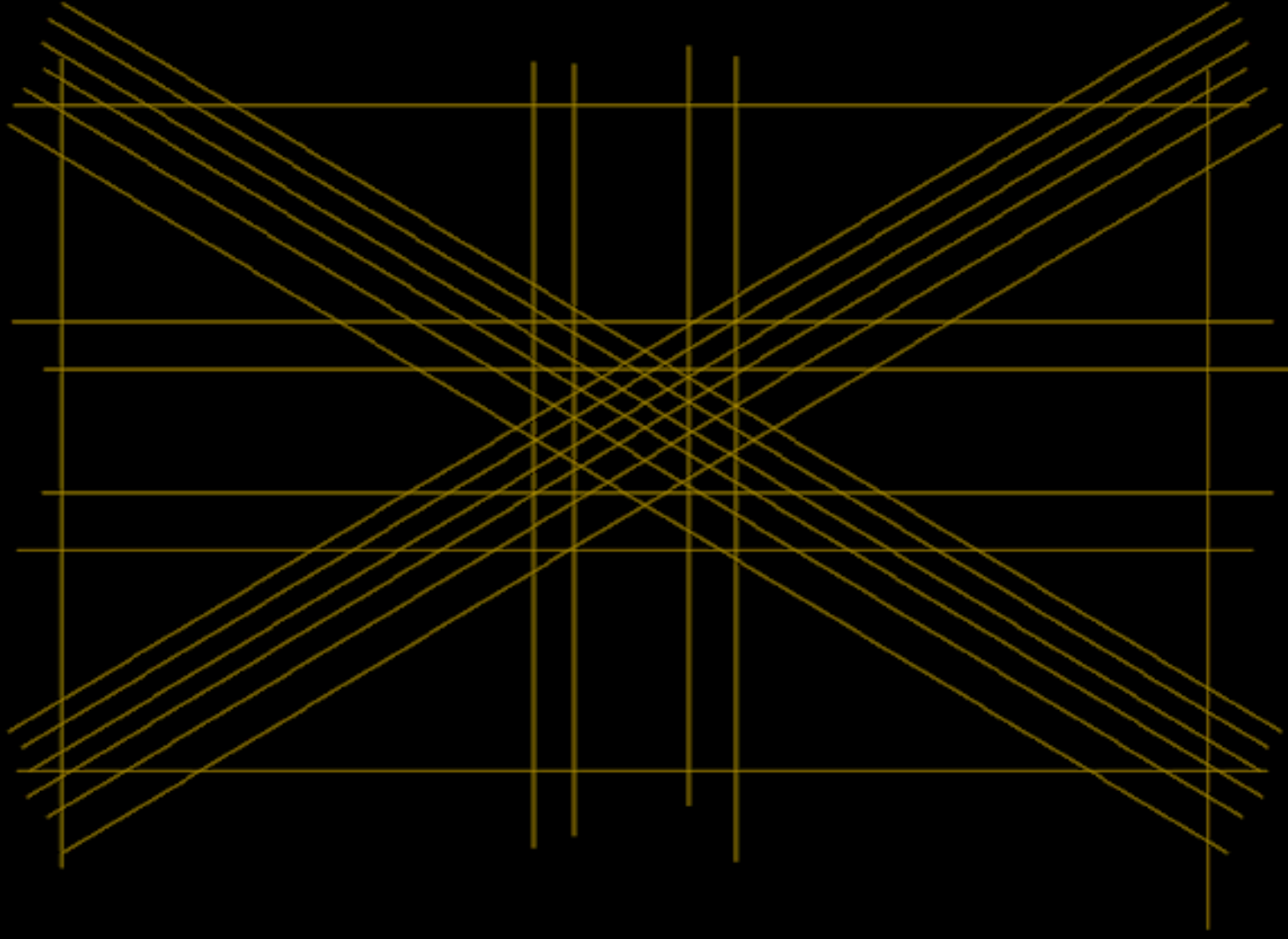
⁶⁶ GERS 2002-03 <http://www.scotland.gov.uk/library5/government/gers05-06.asp>

⁶⁷ (Decentralisation in Some Non-Federal Countries: The Case of the United Kingdom. Heald, D. Quebec Commission sur le Desquilibre Fiscal, 13-24 September 2001)

⁶⁸ Fiscal Autonomy under Devolution: Introduction to Symposium. Heald, D and McLeod, A. Scottish Affairs, 41, pp 5-23

⁶⁹ See for example Darby et al University of Glasgow, September 2002 "Fiscal Federalism and Fiscal Autonomy: Lessons for the UK From Other Industrialised Countries". who state that "no industrialised countries, not even federal states, have opted for complete fiscal autonomy". Equally Paul Hallwood and Ronald MacDonald consider a number of problems with full fiscal autonomy and conclude that "These kind of difficulties in implementing full fiscal federalism are presumably why we do not observe it in practice in any other nation state." Ronald MacDonald and Paul Hallwood, "The Economic Case for Fiscal Federalism in Scotland", The Allander Series, September 2004.

⁷⁰ These are based in part on a number of core principles identified by Darby et al in Julia Darby, Anton Muscatelli and Graeme Roy, University of Glasgow, September 2002 "Fiscal Federalism and Fiscal Autonomy: Lessons for the UK From Other Industrialised Countries".



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Scottish Liberal Democrats
4 Clifton Terrace
Edinburgh EH12 0PQ

www.scotlibdems.org.uk