

THE CONVERSATION

Scottish income tax control needn't raise UK borrowing costs

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David Comerford

Research Fellow in Economics, University of Stirling

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Is former Better Together leader right about consequences of income tax devolution? Chris Boland, CC BY-SA

Alistair Darling, writing in the Financial Times, warned this week that the full devolution of income tax to Scotland would increase UK borrowing costs and expose Scotland to the destabilising ups and downs of tax revenues during changing economic times. With the Smith Commission expected to announce such a plan on November 26, are these concerns justified?

As ever, the answer is maybe. When the international markets lend money to the UK government, the rates are based on how much tax revenues they think the UK will generate in order to pay it back. A poorly designed system of income-tax devolution would change this calculus and lead them to expect a smaller tax base that is less under the UK government's control. If so, they would then demand a higher premium for their finance.

But income tax raised from Scotland (**estimated at £11bn in 2012-13**) does not even come close to funding Scottish government and Scottish local authority expenditures (**estimated at £39bn in 2012-13**). So if the Scottish government were funded by a combination of Scottish income taxes and a grant to make up the difference that was fully under UK government control (**the Barnett formula**), then the security held by international markets over UK government tax revenues could be unaffected. The UK government could simply reduce Scotland's funding to ensure that it still paid its share.

The fix

A sensible system would bring the equivalent tax revenues in the rest of the UK into line with the Scottish system. If Scottish income tax is levied explicitly to pay for Scottish public services, then the income tax raised in England should be for English public services even if this is to be administered by the UK government rather than an English parliament. It should not be the case that Scottish income taxes are used to fund Scottish public services while English income taxes are used by the UK government to repay UK public debt.

And international investors are not daft. They will be aware that the security of their lending depends on the overall size of the UK government's tax resources and spending commitments. So as the UK government loses Scottish income taxes, it also loses responsibility for funding some Scottish public services. This means that the claims of international markets can be left unaffected.

Scotland will meanwhile continue to contribute to non-devolved tax revenues including VAT and corporation tax. If the UK government uses these revenues to fund UK expenditures such as defence, foreign affairs and national debt repayments – but not public services in England – then Scotland will be continuing to play its part.

The economy factor

What about the claim that full devolution of income tax exposes Scotland to the destabilising peaks and troughs of the economy? It is true that negative economic shocks in Scotland will lower income tax revenues and put pressure on public sector finances – especially if welfare is partially devolved.

This is what currently happens in the UK as a whole, and it is dealt with by borrowing. The solution for Scotland is for the Scottish government to have access to its share of what the UK government borrows in leaner economic periods (“countercyclical borrowing,” as economists call it).

This would mean that the UK government would borrow in response to negative shocks and distribute to Scotland, the other devolved administrations, and to itself (wearing its “English government” hat). This would take place according to some pre-specified formula that should compensate for the automatic fall in devolved tax revenues and the automatic rise in devolved expenditures that has been caused by the downturn in question.

This borrowing would be repaid with the taxes that are reserved for the UK government, to which Scotland will have fully contributed. Scotland could also borrow on its own account for public investment in Scotland, but borrowing for recessions should be done at the UK level (the fact that the equivalent is not done in the eurozone is the source of many of that area's problems).

So Alastair Darling is correct to highlight concerns with rushed devolution proposals, but it's not correct to say that income tax cannot be devolved in full without leading to the problems that he outlined. A sensibly designed proposal could achieve the full devolution of income tax and welfare.



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