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Scotland’s Public Finances after Brexit

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Brexit and UK public expenditure policy (1)

- Hood and Himaz (2017) note that the present UK fiscal squeeze, though not deep on an annual basis, is the longest running for a century. Usually fiscal squeeze episodes last for two or three years, then the brakes come off
- Until after the 2015 UK General Election, George Osborne (then Chancellor) claimed that public services were not being adversely affected by austerity, a view that was not effectively challenged. The 2016 EU referendum and 2017 UK General Election provide evidence that the public mood has changed. Pressures for spending increases (NHS, education, defence etc) and tax cuts build up; yet the post-2008 repair job on UK public finances is far from complete
- This is a period of massive uncertainties, scenarios including:
    - Brexit galvanises the UK economy in the medium/long term, freed from EU regulation, with or without a state-shrinking agenda
    - Brexit does long-term damage to UK economic growth and productive capacity, thereby producing an affordability crisis for public spending
- Whichever scenario, the UK public expenditure climate will be harsh in the short to medium term. Tax revenue generation faces multiple threats; the ‘revolt of the rich’ has territorial as well as interpersonal dimensions; and there is widespread technological disruption, yet stagnant measured productivity

Brexit and UK public expenditure policy (2)

- The period since the June 2016 EU Referendum has been dominated by diversions, particularly the Divorce Bill which, though politically toxic, is minor in terms of the big public expenditure and net debt numbers
- Two confusions have been rampant, to some extent cultivated:
    - public expenditure savings to the UK from not making net contributions to the EU after Brexit/end-of-the-transition-period **versus** lower affordability because of higher costs due to exchange rate depreciation and lower taxation revenues due to lower GDP growth. The Institute for Fiscal Studies states that the latter is much bigger than the former
    - government finance <u>statistics</u> (which in the UK are of a high standard thanks to accounting reform and Eurostat's ESA10) **versus** fiscal <u>forecasts</u> which depend on models and are inherently uncertain. Forecasts become more problematic when they have high political salience (eg 'Project Fear' before the Scottish Independence Referendum and Treasury forecasts before the EU Referendum). Both statistics and forecasts have become caught up in rejections of 'experts' and in the different versions of 'truth' characteristic of divided societies
- My judgement is that the UK has reached a decision point. Either, higher levels of taxation for most citizens have to be accepted or what the UK state provides will have to be cut back in unprecedented ways. Otherwise, perceptions of public services quality decline will turn into reality. Brexit dramatises this choice, yet paralyses Westminster decision-making

Implications for Devolved Public Finance (1)

- The 1998 devolution settlement now seems a long time ago. Scotland has had the Calman and Smith Commissions, as well as the 2016 Scottish Independence referendum. Wales has had the Holtham and Silk Commissions, resulting in a revised devolution settlement. Northern Ireland has been more complicated, with Corporation Tax devolution dominating fiscal debates
- The block-grant model (Barnett plus add-ons) looks less secure. Since 1998 the UK Treasury has played the non-statutory formula reasonably straight. For complicated internal reasons, Scotland has sacrificed stability and predictability for legitimacy and self-esteem. This exposes the Scottish Government to macro-fiscal and revenue risks, coincidental with oil sector decline and Brexit. Will this lead to more fiscal accountability, or will the ‘fiscal trap’ (“powers designed to be unusable”) interpretation prevail?
- This is also relevant to Wales and Northern Ireland because of their tendency to converge on whatever is then the Scottish model, yet tax devolution in those countries is more problematic (lower fiscal capacity per head and border issues)

Implications for Devolved Public Finance (2)

- Of direct concern to all three devolved administrations (the Northern Ireland Executive currently not functioning) is what happens after Brexit to what is currently EU spending in their jurisdictions
- The Scottish and Welsh Governments have jointly accused the UK Government of a ‘power grab’ in the field, for example, of agriculture which is more EU-subsidised in the devolved administrations than in England. This is a reflection of the tension between (a) the necessity for a common framework across the UK, and (b) the fact that the UK Parliament and Government sees them as subordinate legislatures and governments, not as equal partners
- In the long-term, it is not clear whether present levels of subsidy will be maintained. Trade negotiations with the EU and international agreements might constrain subsidy policy. In the short-term, the subsidy money could be (a) held centrally by HM Treasury; (b) devolved as Annually Managed Expenditure outside the block; or (c) put into the Barnett-controlled block
- On past Treasury practice, existing spending would be transferred into the blocks, future changes in England then producing positive or negative Barnett consequentials. In future, subsidies for sheep would compete with salaries for nurses. This is the risk from ‘Barnettising’, not that existing spending would go down immediately to the Barnett proportions

Implications for Devolved Public Finance (3)

- Brexit has coincided with (a) weak fiscal recovery from the 2008 global financial crisis, and (b) fundamental changes to the financing of the Scottish Parliament as a result of the *Scotland Act 2016*. About half of Scottish Government revenues now depend on money raised in Scotland, albeit with markedly varying degrees of policy control. The 2016 Fiscal Framework was rushed out before the EU Referendum, leaving the long-term future of the Block Grant Adjustment unresolved
- Budget discussions in Scotland will now focus much more on revenue-raising. The Holyrood parliamentary arithmetic means that most governments will have to seek support from an opposition party to get the budget through
- Cumulative real-terms reductions in ‘Scottish Government Funding’ from 2010-11 to 2019-20 will be 5.1% (nominal increase 12.4%). Holding down public sector wages has protected service levels. Scotland does not have the population growth of England, but demographic trends put pressure on public services
- There are three possibilities:
    - Scotland will not make significant use of its taxation powers
    - Scotland will diverge from RUK, probably in the direction of higher taxes (though voices urging the reverse will be heard), especially if UK governments through choice or necessity continue with austerity
    - Both Scotland and RUK will move towards higher income taxation, breaking taboos on personal taxation

Conclusion

- The transactional basis for the UK's EU membership no longer looks sustainable, in light of the integrationist tendencies, particularly within the Eurozone
- A big test will be whether the devolved administrations have the confidence to constructively use the tax powers they have made such efforts to obtain. Otherwise, these will atrophy and devolved funding will be less secure than under the 1998 block grant
- The coincidence of factors makes predictions insecure:
    - The weak economic and fiscal recovery from 2008
    - Disruptive technology and its labour market and fiscal implications
    - Uncertainties about the UK's future trading relationship with the EU
    - Uncertainties about whether the UK will keep to the European social and economic model (already the UK public expenditure/GDP ratio is relatively low), or there will be a fundamental transformation accompanying Brexit, on the lines of minimal social and economic regulation, and lower levels of public services and social protection