

*The Scotland Effect*

Fiscal Autonomy

Part 1



Freedom  
It is so important

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## *Summary*

Fiscal autonomy is a process of raising money in order to pay for goods and services which a population has agreed are needed and where they have also agreed that the raising of finance and perhaps implementation should be managed through their government or government institutions. In a democracy the amount to be raised, means of collection and methods of application of such funds, which are paid for by people or by individuals and groups of people working in a corporate context, should reflect the free will of the self-governing community concerned.

A system of governance providing people with influence over the decisions which affect them causes all policies, including fiscal, to be subject to a decision and implementation cycle. This includes the identification of people's preferences for satisfying specific needs, the identification of the best policy solutions, electoral, parliamentary and legislative cycles to enact policy, the legal implementation and a follow up to assess their success in achieving objectives.

Fiscal policy, through Keynesianism & Monetarism, has been an instrument in macroeconomic management. In spite of the handing of interest-rate setting to the Bank of England economic activity in the government sector, some 40% of the economy, continues, through Keynesian determinants, to impact the performance of the rest of the economy.

There is a mismatch between the amount of revenue raised through an elastic pro rata "pennies in the pound" approach and the specific expenditures on different policies. In periods of economic growth, government revenue is bolstered by unauthorized windfall gains which permit "top ups" to policies "needing" further cash. This encourages fiscal creep and obscures the performance of policies.

The performance of any level of fiscal autonomy can be judged from the standpoint of:

- the degree to which policies represent the will of the people
- the degree to which policy implementation represents value for money

On the question of Parliamentary performance in representing the will of the people there are significant failures in the British system of governance with policy being imposed by a government party enjoying just 19% of the electorate's support. Value for money is more difficult to determine than is commonly admitted.

After 60 years of attempts at applying fiscal policy with an income redistributive role, this aim continues. This raises the question as to what degree such economic management has been successful.

The deviations of the size of the per capita payments from the Barnett formula envelope are more related to political interference than to problems with the formula which mathematically makes payments equal. The Barnett Formula of 1972 was an update on the Goschen formula of 1888, designed for similar reasons. They both preceded devolution and were never conceived with devolution in mind.

The issue of freedom is of fundamental importance and there is a need for people to be free to define their preferences and government, by reflecting such preferences, to uphold that freedom.

Britain faces a general problem in that its political parties are tiny and unrepresentative with no party having a membership exceeding 0.5% of the electorate. Policies suffer from lack of rigour in design and information in support of them is often partisan and biased. There is, under such a contentious system, tilted towards the gaining of power, an aversion to the application of more transparent and rational decision analysis. The main issue facing any people, however, has nothing to do with this vying for power but rather is more concerned with the identification of the

best solutions to serve the electorate's interests. Indeed, this is not a political power issue at all but rather one of allocation of responsibility to manage public resources to deliver goods and services.

Keynesianism and Monetarism in practice have both failed to incorporate in a systematic and transparent way the role of technology, innovation and technique in generating growth and real incomes. Fiscal policies have tended to be somewhat oblivious to the impossibility of creating a "level playing field" because of the wide variations in the specific conditions facing enterprises in all sectors, markets as well as countries. So-called market forces can be strongly influenced by fiscal policy. Within the European Union, national fiscal regimes suffer overlays of policy which interfere directly in markets and corporate and personal prospects.

The effects of globalization in the form of market effects can disrupt the survival of enterprises and cause unemployment. These effects can be more intense where fiscal policy operates solely on a revenue gathering basis. Multi-levelled governance and administrative structures, including those of the European Union, cause one to question the degree of autonomy of fiscal policy.

A country's constitution has direct economic impacts. Economic performance is not only determined by economic policies. The size of a country operating with fiscal autonomy has an important influence on the relative performance in international markets.

Under any circumstances there is a need for fiscal policies to not only limit their action to the raising of revenue but to also promote real incomes through innovation by incorporating means of:

- Encouraging change which drives down unit prices and raises real income levels through rational investment in technology
- Sustaining policies on national human resources deployment which provide for life-long learning

Lastly, there is a need to move away from partisan bias in information and to move towards a more open system where standards of information are raised through rational decision analysis as a basis for the population to mould their preferences and thereby make sound choices.

How these recommendations might be implemented is reviewed in the second part of this paper.

## *Introduction*

This paper is the first part of a review of the topic of fiscal autonomy. It describes how the objective of fiscal policy and the funding of policies are managed by British political parties and governance. This is contrasted with the theory of the purpose of fiscal autonomy being that of providing funds to support actions reflecting the free will of the electorate.

This paper attempts to cover all necessary aspects of the issue and therefore might be considered, at times, to be stating the obvious. No apology is made for this since it is important that on such an important topic the sense of what is being discussed is understood in unambiguous terms.

It is important to acknowledge that conventional systems of revenue collection and expenditure are very much based upon traditional practices and are also limited by the perceptions and assumptions prevailing in the macro-economic theory and practice of the day. Therefore, from the outset, there is a danger that by limiting the horizons of consideration of fiscal autonomy to current practice could cause the discussion to stagnate around variations on the existing techniques of policy and revenue management. Indeed, some alternative proposals, such as the Steel Commission Report<sup>1</sup>, were concerned with ways and means to augment fiscal autonomy under devolution and in essence extends existing patterns of public finance management.

In reply to the question, "Are there more economically productive options for fiscal management other than the traditional raising of revenues through conventional taxation and spending on policy implementation?" the answer is yes. One reason that such options have not been addressed is the result of limitations in the perceptions and assumptions of the prevailing approaches to macro-economic theory and practice. This is a residual outcome of practical failures in Keynesianism in the 1970s and a less than satisfactory subsequent operation of Monetarism to the present day. This state of affairs enforces a very strong limitation on fiscal options because the politicians and ministers are constrained by a lack of knowledge of options. This deficient intellectual grasp of the potential of macroeconomics and public finance is a direct result of a lack of articulation and explanation of what lies in approaches which are, for the most part, ignored by most economists and therefore, in terms of conventional counsel to government, considered to be risky.

However, such new territories contain new options for management of the political economy offering the promise of a more effective management of public affairs. The management of the political economy will be judged to be superior to current practice if it can increase the degree to which policy priorities reflect electorate preferences on the one hand and enhance the efficiency with which public funds are used in achieving policy objectives on the other.

How this can be achieved is the subject of the second part of this paper to be issued as a separate document.

## *Fiscal Autonomy*

Fiscal autonomy is a process of raising money in order to pay for goods and services which a population has agreed are needed and where they have also agreed that the raising of finance and perhaps implementation should be managed through their government or government institutions. In a democracy the amount to be raised, means of collection and methods of application of such funds, which are paid for by people or by individuals and groups of people working in a corporate context, should reflect the free will of the self-governing community concerned.

### *Part of a democratic process*

Policies define how much finance is raised and the methods used. These are introduced through legislative procedures in political assemblies. Therefore what constitutes the target of application of funds raised is not set in stone but can change as a result of proposals for changes in policy emphasis, policy cancellation or new policies and objectives. The operation of fiscal autonomy is dependent upon democratic processes including the electoral, government formation and legislative cycles and upon the application of the law.

### *Some considerations of the necessary steps upholding fiscal autonomy*

Fiscal autonomy needs to operate with an appropriate legitimacy gained through a participatory democratic process. In this sense, fiscal autonomy cannot be usefully defined in terms of a "block fund transfer" with which a government or an executive can do as it pleases. Fiscal autonomy brings with it a complex range of responsibilities which are satisfied only on the basis of governance upholding a mode of operation which sustains the coherence between its process of defining and justifying a policy proposition and gaining approval. Ideally the following activities would be included in the processes sustaining fiscal autonomy:

- identification of needs based on preferences
- identification of alternative solutions as policy options
- selection of the most appropriate options
- the quantification of necessary resources
- describing the benefits, neutrality and costs of the option proposed as policy
- setting out the proposed option in a policy document
- dissemination of this information as widely as possible
- securing the support and approval of the electorate through review, discussion and vote in a general election or to a voting assembly

On securing a mandate to implement a proposal the following downstream activities are required:

- the raising of financial resources
- the allocation of such resources to the implemented solutions
- management of the establishment of policy implementation
- ongoing assessment of the degree to which the original needs are being addressed
- ongoing assessment of the degree to which the original needs have changed
- managing the ongoing policy and reporting on results and lessons learned

### *Past, present & the future*

It is therefore evident that the ideal basis of management of a country's fiscal autonomy is not a simple matter. Above all an effective political management rests upon the degree to which such fiscal autonomy be applied with the approval of the will of the people.

The necessary steps described above for revenue raising for any particular community are principles to be applied in the case of the United Kingdom, to a nation such as Scotland, to regions, counties, towns and other possible community groupings.

In the case of Scotland the subject of fiscal autonomy is influenced by the constitutional history of the Union and later with devolution but its practical significance is also an outcome of less discussed matters of constitutional economics and are directly influenced by changes in the theory and practice of economics policy management.

### *Theory & practice*

The historic legacy from 1945 with Keynesianism<sup>2</sup> followed by Monetarism<sup>3</sup> when Keynesianism failed to resolve the slumpflation crisis in the 1970s<sup>4</sup>, has involved governments attempting to influence macroeconomic instruments<sup>5</sup> to "manage" the economy. In reality, governments have never managed this particularly well with under- and over-shoots creating what became known as stop-go policies. Even with the new brand of Monetarism the ERM fiasco in 1992 resulted in a million home owners facing repossession due to the imposition of high interest rates and the Conservatives losing the 1997 election<sup>6</sup>. Gordon Brown learned this lesson of the strategic exposure of political parties associated with a more proactive involvement in interest rate setting carrying an inherent political risk for the party. As a result he handed this responsibility to the Bank of England; political parties like to stay in power<sup>7</sup>.

For a decade the United Kingdom government has operated under a pro-forma budget system<sup>8</sup> where the Chancellor has established departmental limits based on the Treasury's view of feasible expenditure. The handing of interest rate setting to the Bank of England<sup>9</sup> some ten years ago changed the Treasury focus from broad macroeconomic issues<sup>10</sup> to one more focused on fiscal policy within a perspective of a tactical approach to revenue raising related to micro-economic questions. This pro-forma budget system was initiated by Gordon Brown before the 1997<sup>11</sup> election largely as an election winning tactic by enforcing an apparent reduction in the spending intentions of his colleagues in the shadow government. This was coordinated with Tony Blair's concentrated efforts on arranging for Clause IV to be so watered down as to mean nothing<sup>12</sup>. Also in 1995 there was a dilution in the union block vote by cutting it from 70% to 50% to provide parity with those of local party delegates. This served to lower the expectations that a Labour government would be overly-centralizing and to appear to be more business friendly. Following the election of Labour into power in 1997, Gordon Brown simply continued with this pro-forma budget system in Government.

### *Size of and therefore influence of government sector*

The UK revenue is somewhat like a big black box fed by several pipes, along which flows revenue raised through different rates of levy on many different items of economic activity. The Chancellor uses this money to fund policies and government sector activities to the tune of 40% of the GNP<sup>13</sup>. Although many consider Keynesianism to be dead, the significance of the direct and indirect impacts of Keynesian policy instruments<sup>14</sup> such as differentials in tax and government expenditures have never stopped influencing the performance of the British economy. Since the size of the government sector is so significant, the regulation of its cash flow and focus of expenditure has a direct impact on the general economy including pressure on interest rates. The fact that the Bank of England is responsible for the setting of interest rates does not mean that economic fluctuations are no longer attributable to government policy. Sometimes the Bank of England, contrary to the popular image, has to adjust matters attributable to government sector expenditures. The concept of having the Bank of England operate independently from the Government therefore conveys a false image of the degree to which, from time to time, the Bank will find itself "responding" to outcomes of Government policy especially in terms of public sector expenditure patterns.

Keynesianism tended to be associated with a perception of a large public sector and this image was encouraged by the nationalization of several industries by Labour governments. However, the subsequent denationalization of these industries was also associated with an increased involvement of the private sector in the delivery of public sector goods and services. As a result the size of the public sector as a percentage of GNP has hardly changed at all during the last 40 years, ranging between 36% and 42% of GNP or an average of around 40% of the GNP.

### *Pro rata revenue*

In terms of general election manifestos there generally remains a grey area in the information provided by political parties to the electorate. This avoids defining a transparent relationship between the revenue to be collected and any specific government sector expenditure<sup>15</sup>. Politicians are keener to talk of the cost of policies in terms of "pennies in the pound" levy or tax. However, these "pennies in the pound" add up to 40% of the GNP of the United Kingdom. The first drawback of this approach is that it is difficult for the electorate to relate any specific policy to a specific cost, that is the price paid for it by each person or family. This lack of transparency underwrites the political party expectation that people should vote on unknown quantities.

### *The population does not vary significantly - neither should policy budgets*

The ability to quantify a fixed budget with realistic contingencies for any set of policies requires a proficient application of decision analysis. This would identify and select the best options upon which to base calculations of the funds required to implement and sustain a policy. Most policies address issues of interest to the population and therefore involve a per capita transfer (public health for example). The segments of the population addressed are normally quantified on the basis of survey statistics. During the mandate of any particular government the population of the country does not change in any significant way nor do the segments of a population where certain actions are targeted change significantly either<sup>16</sup>. Because target populations for any specific policy do not vary significantly it is evident that policy budgets can be estimated on a per capita basis, with an allowance for any small changes in the size of that target according to expected changes in population or population structure. Policy costs need to be quantified and tied down more clearly so that the electorate, at least, know where they stand.

### *Elasticity of "pennies in the pound"*

Although, pennies in the pound sound like an absolute measure this expression represents a percentage of each pound earned going into tax or some levy. This measure is therefore a pro rata measurement generating income in proportion to the activity level in the economy. This results in an inexact and variable relationship between policies, their real costs and revenue. This provides ample room for a lack of discipline over an exact determination of the relationship between what a person's disposable income is and what is ending up in the central budget from all sources to fund a fixed set of policies. This is exacerbated by political party and government avoidance of restricting themselves to raising a fixed and agreed amount for each policy. This has become a convention and as a result no questions are raised when the media reports a Chancellor benefiting from "revenue windfall gains" arising from variations in the performance of the economy or that the Chancellor has "agreed" to pay out additional funds to help this department or another or to a policy which is running out of funds. Running out of funds normally reflects inadequate planning and implementation failing to achieve objectives. Therefore by not undertaking a more strict specification of policy tasks and therefore quantification of costs the government can and has raised revenues which have not been specifically authorized by the electorate. This is why restricting consideration to pennies in the pound has its benefits for the political party in power.

### *Double standards*

It is not unknown for governments to levy a special one-off, or new set of windfall gain taxes on the income of companies in economic sectors such as banking or oil/petroleum processing and distribution who have made windfall gains arising from changes in the value of the sector activity. Governments see this as their right to do this, even without any reference to the electorate. On the other hand they will see it also as their right not to pay back any windfall gains obtained directly from the electorate, as a result of rises in economic activity, to the electorate. This behaviour continues without any specific electorate approval.

### *Fiscal creep*

The tendency to use such unauthorized windfalls to political advantage, as opposed to paying the money back as a credit to the electorate, creates fiscal creep. This is a ratchet effect where some departmental expenditures tend to have a built-in expectation, on the part of ministers and their managers, that budgets will always rise or at least stay the same. This is particularly true of those activities favoured by a Chancellor or Prime Minister. By not quantifying expenditures more precisely at the time of elections a Chancellor has been able to pay out funds as he wishes but also in a way which no one in the electorate ever agreed to. In fact it would seem that there are many cases where the only person to agree was the Chancellor.

### *Growth in tax codes*

Many businesses complain about the administrative work associated with taxation and indeed, the reference manual published by LexisNexis (Tolley's Yellow Tax Handbook) has almost doubled in size between 2001 and 2007 to almost 10,000 pages and 4 volumes. This growth in "volume" is in spite of the publishers reducing the size of the print. Part of the reason for the increase in size is more explanation in Plain English but also a more recent introduction of rules designed to prevent tax avoidance. However, the fact that in order to operate the fiscal system the government requires rules and regulations of such length is clearly a sign of excessive regulation.

There is a need for revenue collection to be based upon some simple formulae helping business operate according to normal business principles as opposed to political and non-market driven objectives.

### *Performance*

By not defining policies at the stage of an election in precise terms and even less so in terms of quantified financial commitments and by sustaining the elastic "pennies in the pound" approach the performance of policies, that is the delivery of appropriate goods and services to the population in accord with expressed preferences, is difficult to assess. There are two fairly important aspects of performance arising under fiscal autonomy.

- Parliamentary performance in representing the will of the people
- Policy performance criteria and value for money

### *Parliamentary performance in representing the will of the people*

An essential measure of performance is that of the Parliamentary system in securing coherence between the voting at a general election and the voting by MPs in Parliament. In basic terms voters cannot know the full implications of any policy in a manifesto. As a result when they vote they take a pre-decision<sup>17</sup>. A pre-decision is the expression of an opinion on predefined preferences of political parties on the basis of imperfect information. Generally, political parties regard MPs as party as opposed to constituency representatives and they require that they vote in line with party preferences on each policy. The electorate is never provided with the opportunity to confirm their support for any particular policy once the full details and implications become more evident when it is finally unfurled in Parliament before MPs vote. Because of the sometimes significant differences between proposed policy at elections and the final form, the assumption that MPs voting on any policy reflects the will of the people is seldom a true representation of the facts. Given that policies under consideration are those preferred by a political party which, under the British first-past-the-post system, can gain governmental control with less than 25% of the vote of the electorate, currently 19%, then the performance of Parliament in achieving a vote on any policy which reflects the true will of the people is extremely low.

### *Policy performance criteria and value for money*

Therefore, even although policies might have the support of a significant Parliamentary majority they normally have a low recorded level of public support. In spite of this weak democratic performance in accepting the policy in the first place, other essential aspects of performance need to be addressed. These are ensuring that whatever is done, the objectives need to be achieved through the most efficient and appropriate methods so as to ensure that public money is used effectively. This at least will satisfy a general objective of improving the value of goods and services offered for any level of public expenditure. This in fact begs the question concerning whether or not people want the policy, but in terms of the system, value for money is important.

The electorate is distanced effectively from any decisions other than the use of a single vote at the time of a general election on roughly a 4-5 year cycle. This creates a situation where the party in power is provided with far too much discretion to influence information concerning the performance of policies including the use of carefully selected criteria which might exaggerate accomplishment. Indeed, sometimes these "performance criteria" actually depress real performance such as in the case of medical services where management objectives have on occasions over-ridden the objectives of medical practitioners in serving their patients. Adding to this sort of top down management and lack of public involvement in decision-making, the lack of fiscal discipline resulting from avoidance of fixed quantification and the convenience of using windfall gains to make extra financial allocations, without electorate approval, the matter of performance becomes a very grey matter.

By way of generalization the overall impact of this lack of discipline is that delivery of policies up to the point of meeting original objectives invariably costs more in financial terms than originally estimated. Any time delays in delivery, a common occurrence, also contribute to higher financial costs.

### *Redistributive role not an excuse*

Some political parties will argue that taxation has an important income redistributive role in the sense of taxing the rich to help the poor or in economic terms using funds of specific people to whom the marginal importance of such funds is low and redistributing these to people to whom such marginal benefits are important. Couched within this philosophy politicians argue that the pennies in the pound basis for defining policy costs is acceptable because you can't pay back taxes. It is certainly true that going to the trouble of trying to pay back taxes would probably be infeasible in cost terms however this should not remove the possibility of tax credits to be applied in the next accounting year.

### *A successful economy?*

The so-called unprecedented growth of the British economy has become oft-cited as being the result of sound macro-economic management under ten years of a Labour government. Indeed, the independence of the Bank of England in setting interest rates established as soon as Labour gained power in 1997 is considered to be the reason why there has been price stability and growth. However, this has promoted a misleading impression as to the degree to which government continues to influence the performance of the British economy on the one hand and ignores the relatively benign global conditions in terms of economic growth and interest rates that have prevailed for the last decade. Mention has been made that Keynesianism continues to explain variations in the British economic activities as a direct result of the sheer size of the government sector at 40% of the British GNP. Tax differentials and government sector regulation of its cash flow and focus of expenditure continues to impact directly the general economy including pressure on interest rates.

There is an alternative or rather more comprehensive explanation for steady growth in the British as well as other economies which is more related to so-called supply side issues falling into

place. Business has become better at gaining efficiency through changes in technology as well as through restructuring organizations and operations which are not related directly to any government policies. These have resulted in growth in activities in certain sectors and in particular service activities. The growth in real corporate profits have been real but one of the most significant parallel growth activities has been out sourcing to low wage countries as well as a sophisticated system of corporate revenue "optimisation" on a global basis designed to minimise their total contributions to fiscal commitments and the government's revenue black box, including that of the government of the United Kingdom. In other words, many medium sized and large firms are learning how to base activities where overall their tax regime represents the lowest "pennies in the pound" achievable.

If one combines these factors one can trace a reasonable growth in turnover, a somewhat unsteady cash flow in the public sector (especially public health), a widening in disparity of income levels, rising inner city social problems of which crime is a symptom and a persistent and significant percentage of the population who remain in need. It is therefore an open question as to whether an economy within which a considerable part of the public sector is based upon "redistributive" policies has succeeded in achieving a better balance in overall income levels. At the extreme, the dependency culture is an outcome of redistributive policies becoming self-justifying because of an underlying failure in development and economic performance securing a better practical redistribution of real income levels.

On this basis the economy has not been totally successful in social and welfare terms.

It is evident that an important challenge of those who have fiscal autonomy is to secure a performance of governance by identifying policy objectives which enjoy a broad electoral support and an ability to manage their implementation in a way which, over the long term, helps bring all people to attain acceptable relative real income levels.

#### *The mystery of the Barnett Formula*

One of the devices used to distribute government budget expenditures from central budget to countries operating under devolved executives, such as Scotland, has been the use of the Barnett Formula. The Barnett Formula came into being in 1978 and represented an updated version of the existing Goschen formula established for the same purpose some 120 years ago in 1888. It should be noted that both of these formulae came into being long before devolution existed. The Barnett Formula mathematically equates government direct payments on a per head basis to all<sup>18</sup>. In spite of the mathematics, the Treasury has actually stated to a Parliamentary Committee<sup>19</sup> that there was no expectation that the Barnett formula would lead to equality in payments. This was simply code to obscure the reality that the degree to which not only Scotland, but also Northern Ireland and Wales received amounts in excess of the equated amount, was a purely party political decision made by the Chancellor.

The original Barnett Formula was based upon the population of Scotland at the time of its introduction and since then the population of Scotland has declined<sup>20</sup>. As a result the Barnett Formula, without any "political" top-ups was for some time paying in excess. However, this was adjusted downwards to compensate for the decline in population numbers in 1992 and adjusted ever since for population changes<sup>21</sup>. In spite of this the Chancellor continued to pump money into the Barnett Formula envelope well in excess to that justified by the Formula<sup>22</sup>.

One very unfortunate outcome of this lack of clarity was the attraction of an unjustified criticism of Scotland which arose in the media when the mishandling of these funds by the largely Scottish Labour party in Holyrood should have been the focus of attention<sup>23</sup>. Indeed, Lord Barnett commented recently that the whole of the cost of the massive cost over-run of the infamous Scottish Parliamentary Building was all paid for, with no questions asked, by the Barnett Envelope<sup>15</sup>.

### *Upholding freedom*

Fiscal means, that is government finance, is supposed to address actions which have been formulated in response to needs of the population. In a democracy needs are defined through the identification of preferences of the electorate. The system of governance can only respond to preferences if it actively seeks to identify, understand and to respond to such preferences. In a free society preferences are best arrived at on an individual basis with freedom of access to relevant information, open questions, honest answers, reflection, analysis and conclusions leading to the expression, under no forces of coercion, of a preference. In other words there is a need for people to be free to define their preferences and government, by reflecting such preferences, to uphold that freedom.

### *Black box or transparency?*

In terms of fiscal affairs of governance, of any type, responding to the individual free expression of an electorate, as reflected in their preferences, considerations cannot be restricted to the identification of the most convenient means of arranging for the transfer of part of the UK Budgetary Black Box to a devolved government and to spend this as those in power think fit. All democratic governments need to raise their own funding through a legitimate process based upon electorate participation. The elements of this preferable transparent process were listed at the beginning of this paper.

This basis for raising revenue within a system of fiscal autonomy reflects the freedom of the will of the self-governing community concerned. On this basis governance gains the essential drive to respond to the needs of their electorate by upholding preferences and thereby reflects the free will of the people.

### *The political party system*

One of the most serious drawbacks with the United Kingdom party system, and this applies also to Scotland, is the fact that political parties are extremely small entities. The largest UK parties have memberships of less than 0.5% of the electorate and the SNP, for example, even less. And yet their policy proposals are drawn up by even smaller factions within these parties. Political parties therefore make proposals based upon the preferences of what are an unrepresentative segment of the electorate. Another issue is that by virtue of their very small size British political parties lack the intellectual critical mass to provide detailed assessments of policy options. Indeed, the information supporting their manifestos tends to assert a party position supported by incomplete information supporting partisan positions and is often fairly biased. On the other hand, during the process of general elections word of mouth and the media transmit messages which tend to present partisan positions in a populist propaganda form which ends up projecting these as being supportive of general wellbeing. It is as if the electorate is being asked to forget the details and to just accept the policy on the basis of faith.

This process has for many years hidden a basic truth that political parties are generally averse to supporting a system which ensures a rational decision analysis on policy free from partisan assertion. This is largely the result of their inability to contribute to such a rational approach but also because of the fear that such an approach might expose weaknesses in party positions and thereby interfere in their quest for power.

The main issue facing any people, however, has nothing to do with this vying for power but rather is more concerned with the identification of the best solutions to serve the electorate's interests. Indeed, this is not a political power issue at all but rather one of allocation of responsibility to manage public resources to deliver goods and services. In addition, a rational decision analysis would not have the typical political party preconceptions which drive policies towards centralization. This is a favourite of political parties since this way they can obtain power through influence over those who are funded to deliver activities using such resources. The public, on the

other hand, gain no particular advantages using the power gained from central budget revenues and quite often favour decentralized revenue raising and disbursement.

### *Scotland's neighbourhood*

Scotland is part of a population inhabiting a set of Islands making up the United Kingdom of England, Northern Ireland, Scotland and Wales. Surface, subsurface, marine and submarine resources overlap as do social relations and economic activities. It is therefore important to acknowledge that limiting this discussion to the specific interests of Scotland and expecting the outcomes to only apply to Scotland is not a practical way of starting out. Thus any good idea on fiscal autonomy arising from this discussion on Scotland might well be just as useful to the other communities on these Isles. Beyond, fiscal issues, the welfare and real income levels of all of the people on the Isles are related to the natural resources, the working population, the state of technology, the ability of people to learn and apply new techniques, that is the whole process of innovation, has a direct influence upon the economies gained and the cash flow generated. This is a common reality and not just a Scottish reality. Therefore by looking at how fiscal issues might have an influence on this whole process of innovation it becomes evident that lessons arising from an analysis of the Scotland's needs will, in most cases, be applicable throughout the Isles.

### *Innovation & economic growth*

With almost 300 years of technological experience following the industrial revolution, some 30 years after the failure of Keynesianism<sup>24</sup> in the 1970s and Black Wednesday's shaking of Monetarism<sup>13</sup> some 15 years ago we still operate under a notional Monetarism. Governments continue to fail, just as the Keynesian policy makers did, to manage fiscal policy in such a way as to be more adaptable to the immense social, economic and financial leverage possible through changes in technology and the ability of people to learn, adjust and apply new techniques<sup>14</sup>.

### *Non-neutrality of fiscal policy*

Fiscal policy is not neutral in its economic effects. The objective of creating a "fair" system or a "level playing field" on a centralized basis is not possible because all individuals and companies face different circumstances. In all cases fiscal policy is interacting with economic activities and influencing the level of financial reserves available to activities and as a direct outcome fiscal policy influences the prospects of economic units. With this in mind it is important to see the process of revenue collection as one designed to minimize any impacts which might deter corporate performance.

### *Sector distinctions*

The basis for macro-economic management perceives the economy to be inter-linked large sectoral reservoirs each concerned with their activities and buying and selling their inputs and outputs to other sectors including exporting and importing. The concept of the free market and lately on an international scale, globalization, assumes that participants in different sectors should respond to international competition in terms of unit prices and quality of goods and services through a timely investment in technology and modifications in technique. But the ability of different sectors to respond to a "new" competitive threats varies, not in terms of the skills and willingness of the people in the sector to change and adjust but rather related to the nature of the sector. Thus primary sectors such as mining, fisheries and agriculture are massively natural resource and capital intensive and rapid adjustments are extremely difficult because of the current cash flow commitment to paying for current investment. Across all sectors and within sectors across all companies there are significantly different capabilities in adjusting costs and quality in the short term and it is often possible for enterprises to respond if they have sufficient time to adjust.

### *Free market, competition & "neutral" fiscal policies*

Frequently, facing a new challenge no policy or fiscal adjustments are provided to assist in this process and as a result enterprises can be closed down and people put out of work. The reaction of the policy maker can be that the enterprise was "not competitive enough" so the failure of some companies and in cases almost whole sectors is the result of "market forces". Such a circumstance becomes a reason for concern when the origin of the "market forces" happens to be enterprises based in countries where there is overt or covert subsidy. Therefore the adherence to certain policies in the face of other countries not adhering to equivalent policies can result in loss of income and employment being declared to be the result of competition when in fact it is the result of lack of equivalence of treatment by fiscal regimes.

### *The European Union*

Politically driven as opposed to economically based policies can have a similar effect of introducing strong differentials between participants in specific sectors within a specific political system. The best examples of this are to be found within the European Union where a form of quota system operates based upon politically-derived distributions and, in particular, in the case of the management of output conditions enforceable through law, such as in the case of the Common Agricultural and the Fisheries policies. In the case of agriculture the imposition is essentially a control on production so as to enforce limitations in participation in the market and in the case of fisheries an enforced sharing of marine resources with other entities, on the basis of control on production and therefore an enforced limitation on market participation. In terms of returns to scale for national industries in the case of fisheries or optimization of production allocations in the case of agriculture these two sectors probably operate sub-optimally as a result of these policies. Contrary to most other sectors within the single market agriculture and fisheries do not benefit from freedom of operation and supply.

### *Global market and globalization*

Under such circumstances governance cannot legitimately "shrug its shoulders" and voice the fatalistic explanation that failures in sectors is a result of "globalization" when in fact the impacts are a result of a failure of equivalence in fiscal treatment of the home sector compared with the fiscal treatment of their foreign competitors. It is, however, not the purpose here to expand upon the very extensive and involved topic but rather to point out that fiscal autonomy has an important role, through appropriate policies, in defending the interests of national sectors and the people of the country who manage and are employed in those sectors. This is not a call for "protectionism" but more a pointer to the potential importance of fiscal policy in strengthening "onshore" activities by making it easier for them to respond to competition in a more timely and strategic manner.

### *Fiscal autonomy over what?*

The participation of a country in a Union such as the European Union complicates the meaning of fiscal autonomy. For example in the cases of agriculture and fisheries the performance of these sectors is a direct result of the impact of an elaborate fiscal policy which operates under multi-tiered subsidy, grants and quota policies. Under such circumstances one has to qualify the meaning of fiscal autonomy when most of the funds used under these policies are captured by the country concerned, passed on to the European Union Budget and then received back as policy packages. In terms of fiscal autonomy the question arises as to why such an elaborate routing of funds exists at all; indeed a true fiscal autonomy would be more efficient.

### *Constitutional economics*

As will be elaborated in part 2 of this paper the constitutional structure under which a nation operates has direct impacts on the economy. In other words, economic policies are not the only determinants of the performance of the economy. With or without a formal European constitution,

the progress of enforced European Law over British law in the context of the single market and now in an increasing range of issues means that there already exists a dominant European constitution significantly influencing the British constitution. The influence of the European constitutional structure on the British economy is significant so the concept of fiscal autonomy needs to be qualified by the impacts of exogenous (externally controlled) factors derived from European constitutional effects.

#### *Critical mass and national dimensions*

Two primary strategic risks relate to the ability of people to sustain a means of income and this in turn depends upon the degree to which the activities in which people participate evolve and adapt to changing circumstances and in people's ability to learn and innovate. When one looks at the markets of importance to any Scottish group or enterprise one can list these generally as Scotland, the rest of the United Kingdom, the European Union and the rest of the world. In economic terms smaller trading nations, if they can come up with price advantages, tend to gain a higher price elasticity of demand than larger traders. Put another way, strategic penetrations of products from small producers depress global market prices less than penetrations by large producers (e.g. China).

On the other hand, when it comes to imports, smaller trading nations face serious problems when competition comes from large suppliers. Basically the response by one's own customers to a far lower priced product from elsewhere is almost impossible to adjust to because the volume is too high, the market penetration too fast and there are invariably insufficient fiscal resources of facilities to provide any assistance with adjustment within the time necessary. This is the reality facing all small countries.

#### *Real incomes policy - Price performance fiscal policy*

On the other hand the degree to which this reality operates in making life hard for some sectors can be related to fiscal policy, not in terms of coming up with subsidy but rather in structuring fiscal policy to production and market policies, including international trade, in such a way that fiscal policy helps drive economic efficiency in the appropriate direction so as to strengthen "onshore" activities. This divides into two related questions:

- Encouraging change which drives down unit prices and raises real income levels through rational investment in technology
- Sustaining policies on national human resources deployment which provide for life-long learning

These combine to help refine capabilities in applying new innovative techniques as a basis for providing the best opportunities for individuals to secure higher real incomes.

How such a fiscal policy could operate is set out in Part 2 of this paper.

#### *Decision analysis*

Some emphasis has been given to the importance of the political system upholding the freedom of choice of the population by reflecting their preferences. People will normally adjust their expectations to where they think or know reality lies, the objective is to have realistic or feasible expectations. An objective process used to identify where feasible expectations or options exist is decision analysis. The role of decision analysis in supporting improving the effective management of fiscal autonomy is set out in Part 2 of this paper.

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