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**SCOTLAND'S PLACE IN A NEW
UNION: URGENT QUESTIONS FOR A
SUSTAINED CONVERSATION**

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A note about the Authors

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1. Key questions for the Smith Commission

- 1.1 Policy Scotland was set up by the University of Glasgow to stimulate original policy research, new thinking and good practice in Scotland and to contribute to policy discussions at Scottish and UK levels. During the referendum process, Policy Scotland hosted a number of events involving academics focusing on key themes such as currency and regulation and also lectures by leaders from both sides of the debate.
- 1.2 The majority decision in September 2014 that Scotland should remain within the United Kingdom is an outcome of huge significance. Because of the remarkable upsurge of engagement in debate about the fundamental choice that lay before the Scottish people and the unprecedented levels of voter participation, it is a result which has a high degree of democratic legitimacy and is also associated with raised expectations about significant changes in constitutional and fiscal arrangements which will impact not only on Scotland but also on the rest of the UK.
- 1.3 The immediate task of developing and progressing a proposed new devolution settlement for Scotland has been handed to the cross-party Commission, chaired by Lord Smith of Kelvin. The UK government has given the Commission the challenging remit of delivering recommendations about stronger devolved powers for the Scottish Parliament within an extremely short timeframe. Broad ideas have to be set out by the end of November and proposals for legislation drafted by end January.

Scotland in the Union

- 1.4 The preliminary submissions to the Smith Commission from the political parties in Scotland and the Scottish Government have already been published. The UK party responses are re-statements of their political stances on the question of allocation of powers between Holyrood and Westminster from before the referendum. The Scottish Government position paper acknowledges the rejection of its independence proposal but seeks autonomy over tax and expenditure programmes to an extent unmatched by any other federation within the OECD. None of these submissions provide much evidence about how the additional powers they propose will contribute to achieving goals ascribed to Scotland such as increasing economic prosperity and fairness or about how significantly enhanced devolution could be made to work within the Union.
- 1.5 The deliberations of the Commission should not be a matter of horse-trading between the political parties to reach an agreement about what powers should be transferred to the Scottish Parliament. We are very conscious that defining and delivering the best form of further devolution for Scotland is in itself a formidable policy challenge, especially in the timetable set for the Smith Commission. As academics with expertise in the public policy and regional economics fields, we believe it is imperative that the evidence should be carefully examined around all

the options. The Commission should have regard not just to additional devolved powers but also to how the Union is constituted and the role that Scotland will play within it under new federal or quasi-federal arrangements that may be emerging.

- 1.6 It is inescapable that whatever the Commission recommends, if implemented, will provide important building blocks not only for Scotland but also for other UK changes. Further devolution to Scotland poses fundamental questions about roles and structures of government across the UK as a whole. The intensity of the referendum debate in Scotland and the implications for the rest of the UK means that any 'Scottish solution' will be brought forward in a context where other parts of the UK have shown a raised interest in Scotland and 'devolution'. Scottish issues, reflecting the majority preference for the Union, need to be resolved in the context of the interests, opportunities and difficulties of the Union if there is to be a lasting settlement.
- 1.7 We fully recognise the difficulties facing the Smith Commission in dealing with these issues when other parts of the UK political system lag so far behind in the change process. But, given the outcome of the referendum, Scotland now has an opportunity to lead the way in suggesting what the new coherence mechanisms within the UK might be. So alongside its role in identifying what additional powers, e.g. in terms of taxation and welfare arrangements, are consistent with the vow made by the three UK parties on the No side immediately before the referendum vote and the wishes of the Scottish people, the Commission should, in our view, explore the implications of varying tax and welfare provision for pooling and sharing arrangements within the Union.

Broadening the debate

- 1.8 In what follows, we set out our thinking about the issues that the Commission will have to address should it accept the premise that proposals for further devolution for Scotland should be framed and then set within a wider set of arrangements across the Union. Our submission identifies what sorts of evidence might be needed to make sound decisions and what issues need to be addressed. The allocation of tax and spend powers across different levels (orders) of government has fundamental implications for other devolved administrations of Wales, Northern Ireland and London as well as for Scotland. It also links with a broader, emerging debate about the enhancement of local autonomies at regional or conurbation level, e.g. via city deals which have spread over the border to Scotland from English core cities. The question of how local government forms part of an effective upward and downwards system of government was scarcely touched on during the referendum but it is an important question for Scotland and for other parts of the UK.
- 1.9 While any new fiscal arrangements are unlikely to be uniform across the Union, there are likely to be limits to tolerated interregional differences in local

autonomies. The processes of cross-regional political comparison and strategies for interregional economic competitiveness, especially if devolution to metropolitan areas or regions in England occurs, mean that differences in sub-UK fiscal autonomies will have to be attenuated to some extent for an effective Union to continue. Shaping a federation or a multiple, asymmetrically devolved set of regional arrangements cannot be done simply by looking at one part of a complex system. There needs to be some coherent statement on the synergistic gains from the Union that the people of Scotland have just voted to retain, on how functions will not only be split between Westminster and Holyrood but also between nation and (city) region and how effective structures will be put in place to share information and ideas and resolve disputes between national and other orders of government.

- 1.10 A coherent vision for taking devolution forward requires fresh thinking about relationships not only between devolved administrations (DAs) and Westminster, but across the DAs, across regions and major metropolitan systems and downwards from DAs to local governments and then into communities (see the discussion in the recent CoSLA 'Strengthening Local Democracy' report). Federal systems in jurisdictions like Canada and Australia have developed mechanisms and structures for resolving disputes between tiers of government - there is much to learn from these and other examples. Getting the most out of devolution in the longer term requires the exchange of ideas and the development of connections down to councils and communities, across regions and metros of similar scales as well as upwards to the nation and beyond.
- 1.11 The short timetable for the Smith Commission will mean, in all likelihood, a sequential rather than simultaneous rethinking of different 'levels' of government and governance. This implies that the Smith Commission has to be at least aware of major change possibilities outside the Holyrood-Westminster linkage and in its choices should consciously aim to cut across as few options within these discussions as is possible. Failure to recognise that Holyrood-Westminster is just one of the key governance issues that have to be resolved could sustain asymmetric and potentially inefficient and unfair outcomes in governance choices for similar sized places and regions and lead to instability in the agreed arrangements for Scotland. Hopefully the points made in the next sections of this submission, which deal with what constitutional change can deliver for Scotland and the UK and with multi-order systems of government will be helpful to the Commission.
- 1.12 We view the devolution question within the framework of an overall 'system of government' approach. This involves raising and probing difficult questions that arise from the interface of economics, politics and geography. Over the coming months, in conjunction with academics and practitioners from across Scotland and other regions of the UK, we aim to explore fundamental questions of territorial political economy that have been fudged in the UK for at least the last fifty years. Our work will focus attention on the similarities and difference of regions and city regions, looking upward from these meso entities to the nation

and the wider world, exploring the notion of metro-federalism but also to looking downwards from the region-city to smaller localities and neighbourhoods. The outcomes will be fed not only into the deliberations of the Smith Commission on devolution but also into other Parliamentary and governmental enquiries and academic investigation of similar or related questions. The draft programme for this work is set out in an appendix to this submission.

2. What can Constitutional Change Deliver?

Formal and Real Autonomies

- 2.1 In our view, the Commission should not be solely concerned with the formal autonomies to be written in a constitution. The imperative is to consider what greater real autonomies could help address the concerns of growth, fairness and sustainability that preoccupy effective modern governments. What are the powers that will enhance economic competitiveness for Scotland? What powers will help deliver effective interventions against poverty or embedded disadvantage, which in Scotland is heavily concentrated in Glasgow, Dundee and a few other local authority areas on Clydeside? How can additional powers enhance environmental sustainability when many key decisions – about energy markets for example – will continue to be made at Westminster, given that Scotland is co-located on a small island with a much more populous neighbour? To answer these types of questions requires a sophisticated, accurate and well-founded understanding of what economic powers actually work at regional scales and what constraints govern their use.
- 2.2 The distinction between formal (nominal) autonomy and real autonomy is a vital one. Small countries may have formal autonomy over fiscal matters, for example, but have little real control over currency and other levers if they are part of a larger monetary union. Even domestic monetary policies, in integrated international financial systems with instabilities and shocks prevalent, are tightly constrained. Regional governments with formal powers and propensities to cut business taxes may quickly find that exercising them leads to a multi-regional, competitive race to the bottom which results in reduced rather than increased local economic activity. Communities given powers to formulate and deliberate over local choices or neighbourhood strategies often discover that centralised budgetary controls at national or supra-national level leave few real choices available.
- 2.3 Distinguishing between nominal and real autonomy requires a combination of knowledge of the formal powers of different orders of government with an understanding of how real economic systems, subjected to the taxing and spending decisions of governments actually operate. The geographies of formal power over territories have to be meshed with an understanding of the local and regional functioning of economic systems. It is concerning that in Scotland we have seen very little evidence-based discussion as yet of the effects of key elements of devolution that parties are currently proposing, for instance the devolution of control over income tax or housing benefits. Policy comment has been limited to how mechanisms might be operated by bureaucracies rather than any informed analysis of how their assignment to Holyrood might impact on Scottish households and the wider economy.
- 2.4 In section 1 we argued that the Commission should link its deliberations and conclusions to the autonomy debates in Wales and Northern Ireland and the

emerging debate on the potential for metropolitan tax-spend changes in England. The West Lothian question, the debate about English votes for English laws and Welsh pressure for the scrapping of the Barnett formula are all germane to this discussion, even though they are outside the immediate remit of the Smith Commission. Critically, in any federal or quasi-federal system of government there has to be some workable view about the roles of national, provincial and local governments and, in particular, about the agreed roles in inter-regional redistribution, sharing and equalisation of tax revenues.

‘Exit’ voters and new policy regimes

- 2.5 The constitutional debate has so dominated Scotland for the last few years that ‘Independence’ and now ‘the Commission’ are offered as solutions to almost every issue facing Scots. One of the challenges facing Lord Smith is being able to convey a sense of the limits to what constitutional change may achieve as well as the opportunities. In retrospect, Hirschman’s exit-voice-loyalty model provides a useful thought frame for understanding what happened in Scotland in September 2014. The result did not simply reflect longstanding unionist or separatist political loyalties. The geographical pattern of voting shows that in areas where the SNP had won first past the post seats at Westminster and Holyrood elections at previous elections before 2011, there was a clear NO majority. On the other hand the votes of poorer residents in the areas where poverty was most concentrated (notably Glasgow, North Lanarkshire and West Dunbartonshire), regarded prior to 2011 as Labour heartlands, were predominantly cast in favour of YES.
- 2.6 It appears, from polling evidence, that many voters in these areas felt they had little prospect of improving their prospects within the existing political arrangements and, along with many younger people across the country, they supported independence as an exit box, a Tiebout-like route by which they could escape from an adverse set of national social and economic policies. The YES campaign offer included both more Scottish rather than UK preferences in choices and more resources to pursue these options (both for public and private spending). However there were tensions between budgetary prudence, embodied by John Swinney; reductions in corporation tax, as proposed by Alex Salmond; and increased welfare spending using taxes raised from North Sea Oil production, promised by the SNP but articulated most vociferously by the Radical Independence movement.
- 2.7 It is important to keep these ‘exit’ voters seeking new policy regimes in mind. Arguably they are part of an upsurge against mainstream politics that has swept across the UK and Europe in the aftermath of the recession. In Scotland they were persuaded that independence would deliver not just an end to the status quo but also policy changes that would advance their interests.

- 2.8 Devolution and federalism may better align local tax and spending choices but they do not inevitably lead to 'bigger states' or growing shares of public spending in GDP. Nor do they necessarily imply that more local levels of government will be 'real' autonomy gainers, in the sense that localism may make choices more local but constrain resource-choice sets, even as formal devolution is rolled out. In Canada, the devolution of powers to Provinces, long unmatched by significant decentralisation of elastic tax bases as federal cost sharing of programmes has fallen, has been at the heart of public service contraction. The Australian Commonwealth is currently heading in a similar direction. Ultimately the aspirations of exit voters amongst younger people and those living in Scotland's poorest places can only be met through significant shifts of policy. Whether independence would have been a catalyst for changes of that type remains unknown.

The Changing Global and Policy Context

- 2.9 A key challenge for the Smith Commission is for Scots to see the constitutional changes they seek within a realistic view of economic change and resources for policies. Amidst the referendum campaign Gordon Brown argued eloquently in the Guardian that as individuals we lead our lives, private and public, at different geographic scales. We have bonds of family, neighbourhood and local community, regional and national identities and connections to wider global scales. It is not just that our employment and consumption choices are impacted by influences from all of these scales but also that the impact of non-local influences in our lives is growing with globalisation and new communications technologies. We have multi (spatial) order identities and there is a need to see governance of these different scales connected, shaped and meshed together.
- 2.10 We need to link understandings of regional and metropolitan economic systems to this multi-order perspective. It challenges us to identify adequately the real functional geographies of what we regard as the key meso-level systems in the economy. That is, we need a quick check on the regional and metropolitan patterns of the UK economy. Further, the extent and pattern of the flows of connection, of trade, labour and capital, between the key meso blocks (regions or city-regions) needs to be understood in order to get a sense of what an effective system of localised/regional taxes might look like. The imperative of understanding the structure, openness and mobility patterns of capital and labour is even more critical within metropolitan areas.
- 2.11 A better described economic and social geography of British regions and metropolitan areas should inform debates about new fiscal system design. The interregional patterns of needs and resources, the consequent requirements and systems for equalisation (to potentially replace Barnett), the possibilities for local tax structures and the mechanisms needed for coordinating actions between different orders of government all need to be framed in the context of the real

spatial changes going on within the economy. As noted above, reform based simply on powers and not real places will fail to shape effective autonomies.

- 2.12 Growing global mobilities of financial capital, knowledge-based enterprise, ideas and people have changed the real autonomies that nations and regions have or think they have. Within the OECD, there is a growing income polarisation between very rich and very poor households and, in a period of fiscal austerity, governments have been put under pressure to reduce their share of spending as a percentage of GDP. Citizens are contesting this policy direction on grounds of fairness and the upsurge in anti-politics sentiment referred to earlier can be interpreted as an expression of their opposition.
- 2.13 Where national and federal governments have sought to contract their roles there has frequently been an associated process of devolution of key functions from the national to the sub-national orders of government. The highest orders of government have divested themselves of responsibility for delivering services whilst retaining the elastic segments of the national tax base. Debates on the proper balance between taxation rights and which responsibilities should rest with different tiers of government issues have been commonplace in federal systems over the last three decades. Resolving these issues or creating new federal constitutions requires clarity on the principles that underpin the distribution of powers and agreement on the role of the state in relation to the global economy.
- 2.14 Structures of government and governance within the OECD have been responding to shifting pressures as new patterns of globalisation and localisation have emerged. Canada, for example, through gas tax changes has reallocated tax points from federal to municipal governments. A Royal Commission has recently reshaped the government of the Auckland metropolitan area within New Zealand. New metropolitan and neighbourhood level partnerships have evolved across most of the OECD countries. Closer to home, in France there are currently extensive ongoing changes involving devolution to the Regions and Departments. And of course independence pressures continue in Catalonia and Wallonia. Within the UK there are already major difference to explore between England and the devolved administrations.

The Challenge of Missing Evidence

- 2.15 Our programme of work involves upward and downward scans, from the regional-metropolitan scale, of more effective government and governance possibilities for the UK by reviewing evidence from these wider, global examples, of shifting autonomies. Spending, taxing and equalisation in multi-order systems of government now lie at the centre of UK change debates but there is a dearth of evidence currently informing policy development in this area.

- 2.16 It might be assumed that the independence debate would have produced a coherent evidence base on how new powers might work for Scotland. However the debate focussed on questions of the currency, the price of oil, the Scottish fiscal surplus/deficit position, the future share and pattern of public spending in Scotland, rather than on the implications of transferring additional powers. Whilst devolution of income tax powers (to different extents) and the transfer of control over aspects of welfare systems (e.g. housing benefit and DWP funded training for work) have been consistently highlighted as options within any devolution settlement, research into the implications of these tax-benefit changes has been limited in scope and depth.
- 2.17 The constitutional solutions developed by the Commission should not be based upon the raw, short-term politics of specific territorial interests and issues. They need to be founded upon a much more explicit and considered vision for a multi-order (level) system of government within the UK. To make informed decisions, there needs to be a clearer, wider understanding of how tax powers and systems, expenditure choices and controls, and regulatory arrangements within different political jurisdictions can be devised that will serve (and balance) local, regional and national interests effectively. In many respects these are precisely the kinds of questions that the present system of government in the UK has ignored or obfuscated even as devolution has evolved. The need for an informed, principled approach to the Union rather than a quick political fix has never been greater than now.
- 2.18 In the next section of the paper we draw on applied economics research about multi-order and federal systems of government. The accompanying paper, *New Ideas for the New Scotland*, indicates major actions and events planned to inform the Commission and the subsequent considerations.

3. Multi-order systems of government.

Different Academic Approaches: A Thumbnail Sketch

- 3.1 The design and outcomes of federal, or multi-order, systems of government have been subject to extensive academic research and there is a plethora of comparative international research (including a collaborative network run by OECD). Political-economy research has developed a broad spectrum of work.
- 3.2 At one extreme, researchers assume well informed, and well intentioned, non-opportunistic policy makers at national and more local levels. In that approach policymakers are assumed to seek to arrange the allocation of tax, expenditure and regulatory powers so that the 'federation' can be best organised to the gain of local and national levels. At each level policy is designed to deal effectively with the spillovers (cross-level) effects that stem from actions at more local scales and to maximise the efficiency of programmes and tax systems at their own operational scale. This approach also assumes that there is an informed and principled approach to the agreed redistribution of resources between and national and more local levels.
- 3.3 At the other extreme, researchers focus on the realpolitik of how political and bureaucratic systems actually work, the nature of voting arrangements, the role of short-term opportunism and political vested interests and the possibilities of corruption. Policymaking is done by politicians and careerist rather than omniscient bureaucrats and involves less articulation of the pros and cons of different positions. It is the nature of 'realpolitik' decision taking that makes the role of more neutral, reflective spaces such as the Smith Commission and wider, informed public debate on policy so important.
- 3.4 Across this spectrum of approaches, researchers have been focusing on economies and polities that are no longer closed but that are connected to, and buffeted by, global and open economy considerations at local, metropolitan, regional and national scales. That is, the constitutional and governance arrangements that are now discussed in academic debate are not simply about allocating and distributing the resources the polity has but also about ensuring capabilities to compete and cooperate in wider, international environments. In general it is international comparative and case study research that appears to offer the most useful insights for change.
- 3.5 Policy Scotland will not ignore 'realpolitik' perspectives in our planned programme of work but its primary focus is on evidence based accounts of how multi-order or federal systems can be designed in more or less effective ways. Our approach will be to draw together expertise on the applied economic aspects of how federal systems are designed and operated. The special vehicle of a government Commission creates an opportunity for discussion that considers evidence, minimises opportunism and short-termism and emphasises actions

based on principles. Given the outcome focus to public policy in Scotland, it is particularly important to deal with questions of fitness for purpose of government arrangements rather than concentrate solely or mainly on powers.

The UK as a Centralised System

- 3.6 The UK has had, for a century, a strongly centralised structure of government. There have been tight central controls over localised government capital and current spending. There has also been a continuing interventionist history of central limiting the use of the only tax base devolved to municipalities, namely property taxes. Until the late 1960's Westminster reigned supreme over an essentially two level system of central and local, municipal government (although strategic regional or county authorities existed in some places over some periods, for example the 9 mainland, Scottish regional authorities which were abolished in 1996. Administrative decentralisation of a range of (non-reserved) central government functions to Scotland, Northern Ireland and Wales led, in the 1920's, to central government offices in Edinburgh, Belfast and Cardiff.
- 3.7 Over the last four decades there have been shifts in autonomy, or sovereignty, away from that simple two-level model. Significant powers have shifted upwards and away from Westminster to the EU. The 'rejection' of devolution for Scotland in 1978 was followed by the creation, in 1999, of the devolved administrations, all with different powers, for London, Scotland, Northern Ireland and Wales. Since 1999 there have been sustained pressures from within Scotland to widen the powers of the Scottish Parliament. Following the Calman Commission, legislative changes diversifying and raising the tax and borrowing powers of the Parliament were embedded in the 2012 Scotland Act and are set to come into play in 2016
- 3.8 Despite these shifts, the UK has remained an exceptionally centrally driven political-economic system. Devolution to London, Scotland, Wales and Northern Ireland has created some local variety and choice within the devolved administrations but, despite some recent incremental improvements, most notably the 2012 Scotland Act, their budgets and broad modus operandi have been shaped by decisions at Westminster. Despite the legislation of 1999 and 2012 Scotland still has fewer fiscal powers than, for example, Prince Edward Island or Tasmania.
- 3.9 Within the two-tier system in England, Westminster controls on local authority capital spending remain strong and more than four-fifths of revenue from services comes from central government grant. Local tax rates are strictly controlled centrally. In Canada, in contrast, almost four fifths of municipal spending is based on a local property tax. Within Scotland it can be argued that devolution has centralised power to Edinburgh, undermining governmental capacity at city-region level and reducing the real choices of councils and the engagement of community organisations. The new 'localism' rhetoric has, arguably, been matched by a continued centralism of control of budgets and taxes

both between Westminster and English municipalities and between Holyrood and Scottish councils (now approaching their eight year of council tax freeze).

- 3.10 A countervailing trend to this broad pattern has been that within England, more recently spreading into Scotland too, Westminster has encouraged cities, usually collaborations of adjacent municipalities within metropolitan areas, to develop central-local 'city deals'. These city deals have important positive attributes, but in essence are an 'upwards' generalisation of local, project specific tax increment financing schemes (TIFS) rather than a downward shift of tax powers or points from central to local governments. But they have given impetus, particularly in the northern cities of England (that have arguably restructured services and roles much more radically than their Scottish counterparts) to the notion contained in the Heseltine report that cities are 'growth drivers' that need new fiscal tools and resources.
- 3.11 The pressures for change are strengthening in England. The metropolitan areas that are making these cases are not small entities. The West Midlands/Birmingham area has a population greater than Scotland. Manchester, in partnership with 9 surrounding municipalities, has been the flagship of the city deal process for a metropolitan region that has a larger population than Wales and approximates the size of Northern Ireland. Whether they look to the devolved administrations at the edge of Britain or south to the devolved London authority at the core of the Southeast economy, these city regions and their peers recognise that to compete effectively in the future they will require significant local tax and spend powers. After a period during which more economic development responsibilities were pushed down to regions and cities throughout the UK, the regional economic development bodies were scrapped by the coalition government in England. Now, not only do cities want more local fiscal powers but they are also vigorous in ensuring that they do not lose capacity to compete with similar cities and regions elsewhere in the UK and in Europe.
- 3.12 Sub-national fiscal powers in the UK can no longer be distributed on an ad hoc basis and, given the metropolitan scale of the areas involved the traditional 'regional' and new 'city-region' entities cannot be viewed separately from each other. The Scottish independence debate and the pressures for change in other regions of Britain have created common cause in seeking to end the centralised nature of fiscal arrangements set at Westminster and to expand local autonomy across the UK. What does applied economics suggest are the key aspects and pros and cons of more local and central autonomies?

Pros and Cons of localisation/ centralisation

- 3.13 In economic perspectives on federalism and devolution the evidence suggests that there are advantages of more local autonomy in more local governments having better information both on what public goods and services to provide and how to produce them. More regional/local autonomy allows regional/local

governments to make different choices about the range of goods they will provide and policies they will pursue. This variety encourages innovation in provision and offers mobile households and firms a choice of public services, taxes etc. they might prefer (secured by residential mobility and firm relocations). Evidence broadly supports these advantages of localisation. Empirical evidence also suggest that the mobility of households and firms also sets limits to the extent to which local taxes and regulations can be used, especially if local taxes are used for redistributive purposes. In consequence progressive taxation and the financing of significant welfare benefit provisions are not usually pursued at the most local orders of government.

- 3.14 A key question, especially where there are inter-regional differences in the political choices of households about welfare and redistribution, is the extent to which welfare support and redistribution can be organised regionally within an integrated national economy with high personal and firm mobility rates. National or federal level governments, reflecting the potential spatial mobility of more local tax bases, have historically been the providers of redistributive services, welfare programmes and progressive taxation. Since the 1980's retrenchment in the role of the state, agreed upon by national majorities, have been resisted in particular localities within nation states.
- 3.15 Attitudes towards privatisation, public debt, redistribution and public service provision differ within nation states and not simply because of spatial concentration of low income and unemployment. Judging the extent to which 'pro-state' views within a sub-national polity reflect real willingness to pay for programmes by local populations as opposed to a bargaining game vis -a- vis national politics is also problematic. The hollowing-out of national or federal government spending and taxation on what had previously been core higher order programmes has greatly complicated optimal federal design.
- 3.16 The case for national or federal powers rather than local autonomies is typically driven by three economic questions. The first is that certain functions embody true economies of scale (national defence and broadcasting are the most commonly cited example) and require to be centrally provided. A second, that may now have greater salience at metropolitan and regional scales in relation to local governments, is the importance of agglomeration economies, whereby concentrating activities in particular places lead to higher productivity and creativity. Such concentrations can become problematic where the jurisdictions within which people live or work and where they pay taxes (a metropolitan level issue for households, and an interregional issue for multi-regional firms) differ. Taxpayers with such choices will have an incentive to locate activity where services are high and to have a tax address where taxes are low.
- 3.17 The third, common consideration is where policy choices at a local scale spillover into adjacent areas or across the nation as a whole. The creation of more local orders of government may produce positive or negative spillovers for wider areas and the nation. Where a core city cleans up its city centre and attracts new high

order stores, the wider regional set of residents benefit. Where a wider region pursues education policies at school or tertiary level for regional residents but where absence of job opportunities result in their rapid emigration then the region subsidises the development of human capital for the wider world. Equally, smoky cities can pollute the region and nation. Regions with excessive public borrowing can have negative impacts on national fiscal stability and interest rates for people and firms in other regions. Where there are significant functional spillovers from part of a federation to other localities then national provision and policy is often chosen.

- 3.18 There is an extensive literature in urban, regional and fiscal economics that addresses the pros and cons of localisation/centralisation in terms of whether they expand real local autonomies. A review of the evidence for Scotland is urgently needed. We also, returning to the redistributive roles of government, require a clearer understanding of different approaches to the equalisation or inter-government transfer of resources. Within most countries the disparities in resources within a fiscal union that might lead to substantial differences in incomes and employment, and in consequence localised tax bases, are dealt with at least three strands of (often) national government policies.
- 3.19 Regional or urban and rural policies usually redistribute national fiscal resources to increase, over the longer term, income in poorer areas. Welfare policies that may comprise public services such as health, education and housing may also be targeted so that at least some minimal level of provision exists nationwide, and (broadly) income related benefits programmes also redistribute to poorer localities and regions depending on where the incidence of welfare cases occurs. And, importantly, more local resource transfers take place through what are labelled equalisation arrangements, where higher order level tax resources are redistributed to more local orders of government to equalise the spending capabilities of governments in relation to the agreed needs they face.
- 3.20 Making sense of these complex and different flows of resources across orders of government, and identifying the incentives for opportunistic and efficient behaviour, requires a considerable research effort. Such considerations are at the heart of inter-government negotiations in, say, Australia and Canada. The almost complete devolution sought by the Scottish government needs to be examined through this lens of regional programmes, public spending flows and the Barnett formula (and potential replacements) and the localisation of the welfare system. If an exercise of this type has been conducted, e.g. by Scottish civil servants, it has not appeared in the public domain. There is a strong case for ensuring that the necessary work is done and the findings published. The last thing needed is an incomplete and piecemeal approach to a new federal approach in which the rules of the game by which Holyrood and Westminster agree changes to the Scottish Block are unclear.
- 3.21 Research overseas suggests that changing welfare systems and services to a local basis for financial support may be problematic in the longer term and have

unintended consequences. Amongst the responsibilities which it has been suggested are transferred from Westminster to Holyrood are housing benefit and training provision aimed at improving employability amongst unemployed people. While it is possible to shift responsibility for these matters from one level of government to another, any policy divergence could potentially have significant unanticipated consequences. These might include loss of entitlements to other, non-devolved benefits for the individual and costs then falling on the devolved government if the entitlement of the individual is to be maintained.

- 3.22 Piecemeal transfers inevitably lead to unanticipated outcomes and in the field of welfare in particular, they are likely to result in perceived unfairness between jurisdictions. Whilst Scottish, and other, reactions against the bedroom tax are understandable it is not clear what giving autonomy to the Scottish Parliament over housing benefit will achieve. The 'bedroom tax' may not be in place after the next general election. But can Scotland design an effective housing benefit system that is disconnected from other welfare payments and their thresholds and from parts of the tax system and its structure? Or will more local autonomy induce a better balance of capital and income subsidies in housing and induce some rationalisation of the distorted rent systems that play such a large part in Scottish housing outcomes. Scotland needs to look to the evidence of the complexity of resolving these issues in other federal systems before unreservedly grasping control of housing and other welfare benefits.
- 3.23 The complexities involved in these issues means that there is seldom the relevant information to 'calculate' the best set of policy measures and how to allocate them between federal, state and local levels. However in making the inevitably hard 'decision' to allocate between national and more local autonomy it would be folly for a region operating in open national and global economies to ignore whatever evidence does exist on effective equalisation approaches, scale economies, agglomeration effects and spillovers across jurisdictions. Much of the debate on Scottish Independence paid scant attention to the empirical evidence on these matters. The price of oil, the identification of Scottish public sector balance and projections of public spending totals dominated debate. There was little attention paid to how significant parts of a nation state could have real autonomy over taxation and spending without generating significant negative spillovers or inducing perverse fiscal competitions. Very little consideration was given to the practicalities of how variation in tax and benefit systems relative to the rest of the UK might be managed or what the implications might be - not only for individuals and businesses, but also for key governmental and third sector institutions.
- 3.24 As the Smith Commission deliberates it will have to disentangle the substantive economic and democratic 'wheat' from the opportunistic political 'chaff' embedded in the submissions it receives. In other countries such major changes in constitutional arrangements are not divorced from the reform of national to regional resource equalisation and grant arrangements. Nor is there, reviewing the figures in the OECD fiscal database, a single significant federal system in the world in which all core taxes are devolved down from the national level and the

federal government simply deals with the residual functions of defence and foreign affairs. But where on the spectrum of devolved/federal decentralisation should Scotland be, in the light of the result of the September referendum? In our view, that judgement must be informed by the best evidence available and not left to await the outcome of a bargaining process between different political actors.