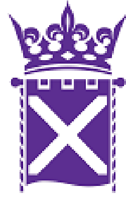
David Heald's contribution appears at pages 33-37 of this document.



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Finance and Constitution Committee
Social Security Committee

Scottish Government

The Rt. Hon. Stephen Barclay MP
Chief Secretary to the Treasury
UK Government

The Scottish Parliament
Edinburgh
EH99 1SP

By email

Finance.constitution@parliament.scot

28 October 2020

Dear Chief Secretary,

Review of Scottish Government's Fiscal Framework

As you are aware, the Fiscal Framework states that it will be reviewed following the Scottish Parliament elections in 2021. The review will be informed by an independent report with recommendations presented to both Governments by the end of 2021. The technical annex to the Fiscal Framework states that issues "to consider under the review could include operation of the fiscal framework including the BGA and indexation methods, no detriment and spillovers, borrowing limits and, if used, operation of dispute resolution procedures."

To inform the scope and terms of reference of the body tasked with delivering the independent report, please find attached a report jointly agreed by the Cabinet Secretary for Finance, the Finance and Constitution Committee and the Social Security Committee. The report identifies a number of issues arising from the operation of the Fiscal Framework to date that, in our collective view, should be considered by the body tasked with delivering the independent report. At the same time, the Scottish Government and both committees will continue to closely monitor the operation of the Fiscal Framework and may separately make further recommendations regarding the scope and terms of reference of the independent report and review.

The agreed timing of the planned review of the Fiscal Framework predates the significant impact of COVID-19. To deal with the COVID-19 emergency the Devolved Administrations have requested limited and temporary fiscal flexibilities that are not provided for in the Fiscal Framework. Since then HM Treasury has provided an upfront guarantee for Barnett consequentials to

support the Coronavirus recovery, but it has not, so far, agreed the temporary flexibilities the Scottish Government requests.

The agreed timing of the planned review of the Fiscal Framework predates the significant impact of COVID-19. We therefore believe that

- that the Governments should agree a clear timeline for the review of the framework as soon as possible;
- the experience of addressing COVID-19 should now be part of that review;
- that the body tasked with producing the independent report on the operation of the Framework should be established and begin its work as soon as possible.

We look forward to hearing from you.

Yours sincerely,

Bruce Crawford MSP
Convener of the Finance and Constitution Committee

Bob Doris MSP
Convener of the Social Security Committee

Kate Forbes
Cabinet Secretary for Finance

The scope and terms of reference for the independent report and review of the Fiscal Framework

Introduction

1. The devolution of further fiscal powers through the Scotland Act 2016 and the operation of the Scottish Government's Fiscal Framework are intended to incentivise "the Scottish Government to increase economic growth, while allowing Scotland to contribute to the United Kingdom as a whole."[1] The Fiscal Framework states that the "Scottish Government will be able to exercise its fiscal powers fully and flexibly while operating within a sustainable fiscal framework for the whole of the UK."[2] It also states that the "Governments have agreed a set of fiscal tools to enable the Scottish Government to manage the additional risks and volatility associated with the devolution of these powers."[3]

2. Built into the Fiscal Framework are arrangements for its review. It states that this will be carried out for the first time following the Scottish Parliament elections in 2021. The framework states that "its effective operation should not require frequent ongoing negotiation, but that the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective."[4] The review will be informed by an independent report with recommendations presented to both Governments by the end of 2021. The technical annex to the framework states that issues "to consider under the review could include operation of the fiscal framework including the BGA and indexation methods, no detriment and spillovers, borrowing limits and, if used, operation of dispute resolution procedures."

3. The Cabinet Secretary for Finance and the Finance and Constitution Committee (FCC) have examined the operation of the Fiscal Framework. The Social Security Committee has also considered questions about the operation of the Framework, in the context of its scrutiny of the Scottish Government. We have also sought evidence from a number of stakeholders and their written submissions are attached as Annexe A.

4. More recently, the impact of COVID19 on the operation of the current Fiscal Framework has been considered.

5. This report summarises our findings and is intended to inform the scope and terms of reference of the body tasked with delivering the independent report. It is not intended to comment on all aspects of the Fiscal

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf paragraph 3
[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf paragraph 5
[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf paragraph 61
[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf

Framework but rather identifies a number of initial areas where the Committees and the Scottish Government recommend that the review and the independent report should have a particular focus.

Structural Risks

6. There are two potential structural risks that have been identified from the operation of the Fiscal Framework to date. These relate to differences in the Scottish income tax base relative to rUK and divergence in social security expenditure over time:

   - Demographic risks;
   - Distributional risks.

Demographic Risks

Income tax

7. The annual adjustment to the block grant using the indexation per capita method is based on the overall population growth in Scotland and the rest of the UK. It does not account for the relative growth in the working-age population or the 'old-age dependency' ratio, which is defined by the Scottish Parliament Information Centre as –

   > "the ratio between the number of people aged 65 and over (the age when people are generally 'economically inactive') and the number of people aged 16-64 (the so called 'working-age population')."[5]

8. Evidence from the Office of National Statistics suggests that Scotland is forecast to have a higher dependency ratio than the rest of the UK for around the next 25 years.

9. The Scottish Fiscal Commission notes that while Scotland's overall population is expected to grow over the next five years, "the population aged 16 to 64 is expected to start to shrink from 2018 onwards. This is in contrast to a growing 16 to 64 population in the UK and places a particular drag on growth in GDP in Scotland." [6]

10. The FCC noted that there is a strong evidence base that points to a real risk to the size of the Scottish Budget arising from Scotland's population ageing faster than the rest of the UK. In particular, there is a real risk from a higher growth in the old age dependency ratio in Scotland relative to the rest of the UK.

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[5] https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutiny-report-2/FCCS052018R12Rev.pdf paragraph 26

[6] http://www.fiscalcommission.scot/media/1300/ scotlands-economic-and-fiscal-forecasts-may-2018-full-report.pdf

11. This raises two fundamental questions –

    - Does the Scottish Government have sufficient policy levers to address this risk?

    - Does the Fiscal Framework sufficiently recognise demographic divergence?

12. The FCC has also noted that, given the way in which the Fiscal Framework operates, there is a real risk to the size of the Scottish Budget if there is a fall in Scotland's working-age population due to a disproportionate decline in immigration relative to the rest of the UK. The Committee recognises that migration policy is a reserved matter and that the UK Government does not agree with the need for a specific migration policy for Scotland. However, within the context of Brexit and a different demographic dynamic within Scotland relative to the rest of the UK, the Committee has previously recommended that the review of the Fiscal Framework should fully consider the impact of immigration policy following the UK's departure from the EU.[7]

13. Written evidence from Cardiff University points out that although Scotland's Fiscal Framework currently accounts for population growth risks, "it does not account for structural shifts in demographics such as a population ageing more quickly than the rest of the UK."

14. Professor Jim Gallagher of Nuffield College, Oxford however, suggests in written evidence that arguing for the use of weighted population "implies a needs calculation, and therefore is relevant not only to the increment to the Scottish Budget but the Scottish budget as a whole." In his view, if the FCC's "objective is to open up the question of a needs assessment and a very significant cut in the Scottish budget, then arguing for a weighted population approach in the fiscal framework is a good place to start."

Social Security

15. The BGA calculation uses the rate of change in spend in England and Wales (together with relative population growth) as a proxy for 'what would have been' spent in Scotland on social security in the absence of devolution. Given the majority of spend relates to disability benefits, the following focuses on this aspect of devolved social security.

16. Without devolution, the difference in expenditure in disability benefits is likely to reflect demographic and health differences between England and Wales and Scotland. Changes in expenditure on disability benefits have been similar in Scotland to those in England and Wales over the last 20 years or so, suggesting that these differences have not been significant so far.

[7] https://www.parliament.scot/S5_Finance/Reports/report.pdf paragraph 51

17. Applying the BGA calculation to historic data back to 1996/97 suggests the calculation[8] has not, so far, created a systematic over or under-funding of social security. On the scale of the total spend on disability benefits, the BGA is a fairly close match to spending. The differences between the BGA and actual spend range over the period from +£49m (2.3% of total Scottish spend on disability benefits in that year) to -£27m (2.0% of total Scottish spend on disability benefits in that year) per year. The question then is, whether this is an acceptable degree of variation in the wider context of the budget.

18. However, the issue of future divergence of population structure (discussed above) may have an impact on future trends – particularly given the increased likelihood of disability in old age.

19. **While the Smith Commission concluded that the block grant from the UK Government to Scotland will continue to be determined via the Barnett formula, the review should consider whether the Fiscal Framework sufficiently recognises the impact of demographic divergence on income tax and social security, including the impact of immigration policy and more generally the demographic differences between Scotland and RUK.**

20. **The review should also consider whether the Fiscal Framework provides sufficient policy and budget management tools to address the potential risk arising from demographic divergence in Scotland relative to the rest of the UK.**

Distributional Risks

21. Distributional risk primarily refers to differences in the composition of the Scottish tax base relative to the rUK. Particular focus has been on the risk driven by–

    - The extent to which the distribution of the income tax base is more unequal in the rUK relative to Scotland;

    - The extent to which differences in average earnings growth, and income tax liability growth between Scotland and the rUK is driven by differential growth at the top end of the income distribution.

22. For example, in 2017-18, the SFC estimated that while average earnings grew by 2.7% in the UK, they only grew by 1.0% in Scotland[9]. The SFC's view is that the "likeliest single explanation" of this differential growth is that the rest of the UK "has a higher concentration of higher-rate taxpayers

[8] SPICe internal analysis based on expenditure on Disability Living Allowance, Personal Independence Payment and Attendance Allowance.
[9] Scottish Fiscal Commission, Forecast Evaluation Report, September 2019, Table 2.5

and the recent growth in UK income tax revenue has been concentrated among them."

23. This then raises two questions –

- If economic growth in rUK disproportionately benefits higher-rate and additional-rate taxpayers relative to the distribution of the benefits of economic growth in Scotland, what does this mean for Scotland's public finances?
- What policy responses are available to the Scottish Government to address any impacts?

24. Professor Gallagher's view is that, given the Scottish Government accepts the risk of different tax rates, then "it follows that it must accept risk from the tax base…because the tax rate has a direct influence on the tax base." He also points out that Scotland benefits from growth in rUK revenue through increases in the block grant (which is based on reserved taxes). He explains that if income tax revenues grow "more in England, where it starts from a higher base, some of that growth leaks through into the Scottish budget, to the advantage of Scottish taxpayers."

Welsh Government's Fiscal Framework

25. An important difference between the Scottish Fiscal Framework and the subsequent Fiscal Framework agreed for Wales was the creation of a separate BGA for each band of income tax in Wales, albeit under comparable model —

> "As the composition of the income tax base in Wales is significantly different from the UK average, the two governments have agreed that the Comparable model will be applied separately to each band of income tax (basic, higher and additional rate). This ensures the new funding arrangements will deal with any UK government decisions to change the UK-wide income tax base (for example changes to the personal allowance) entirely mechanically. It will ensure the Welsh Government's tax revenues are broadly unaffected by UK government policy decisions." [10]

26. The submission from Cardiff University suggests that this approach was intended to better reflect the distributional differences in the Welsh tax base compared with England and Northern Ireland. In their view this "protects the Welsh Government from UK-wide factors which disproportionately affect one part of the income distribution." They also state that although "it is too early to conclude definitively, the separate BGAs for each band may protect the Welsh Government from the recent growth in income tax from the very highest earners across the UK."

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[10] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/578836/Wales_Fiscal_Framework_Agreement_Dec_2016_2.pdf paragraph 32

27. This recognises the significant difference in the Welsh income tax base compared with the rest of the UK. A much greater share of Welsh taxable income is earned at the basic rate of income tax, compared with the rest of the UK.

28. The review should consider whether there are potential structural risks inherent within the Fiscal Framework arising from the distribution of the tax base in Scotland relative to the rest of the UK. In particular, the Review should consider –

- **The nature of the relationship between the incentive that tax devolution presents to raise economic growth and the structure of the tax base in Scotland relative to the rest of the UK;**
- **In particular, whether there is a structural risk to the Scottish Budget because of how the benefits of economic growth in rUK and Scotland accrue across the tax base and are reflected through tax revenues and the operation of the Fiscal Framework. For example, as noted above, if earnings were to grow more quickly for higher-rate and additional-rate taxpayers on a persistent basis, what does this mean for the relative position of Scotland's public finances?**
- **Whether the Fiscal Framework provides sufficient policy and budget management tools for the Scottish Government to address the potential risk arising from the distribution of the tax base in Scotland relative to the rest of the UK?**

Forecasting Risks

29. The Auditor General for Scotland, in 2018, highlighted a number of risks inherent in forecasting tax revenues as follows –

- The extent of underlying uncertainty about the economy;
- The availability of relevant and robust data;
- The robustness of the OBR and SFC's respective methodologies and judgements;
- Differences in methodologies and judgements between the SFC and OBR;
- Forecast horizons.

30. She also pointed out that in "a period of significant economic uncertainty, forecasting is inherently more challenging and forecasting risk increases."[11]

31. The SFC have looked at nearly 30 years of UK revenue forecasts (although it should be noted that the OBR as an independent fiscal

[11] http://www.scottish.parliament.uk/S5_Finance/General%20Documents/Roundtable_evidence.pdf

forecaster has only provided forecasts since 2010) and found an average absolute forecast error of 3.3% across all one-year-ahead forecasts. They point out that, while highly illustrative, "applying the average UK revenue forecast error to Scotland suggests it is not unreasonable to expect an average one-year ahead error in our tax forecasts of around £530 million."[12] They also highlight that of "the 53 UK tax forecasts we looked at, there was an error of more than 5.0 per cent, or £810 million in a Scottish context, on 11 occasions."[13]

32. Furthermore, given the more limited data at the Scottish level relative to the UK, it is not unreasonable to expect larger forecast errors than those identified at the UK level. Indeed, SFC in its Forecast Evaluation Report 2019 notes that:

> "Where taxes and benefits have been devolved recently, or are still to be devolved, data are not always available to produce forecasts with a similar level of certainty. Any forecaster would therefore expect a higher forecast error when first estimating Scottish taxes and benefits rather than their UK equivalents. In time, we will be able to analyse our forecast errors against our own past errors as well as OBR errors"[14]

33. Professor Heald of the University of Glasgow states in his written submission that a key task of the review of the Fiscal Framework "should be to document and assess forecasting experience to date, in light of the damage that such budget hits might do to the credibility of tax devolution."

34. The FCC has noted that although there is not yet sufficient outturn data to support specific changes to how the Fiscal Framework operates, there is nevertheless an emerging pattern of a high degree of volatility.[15] This, the FCC considers, raises two fundamental questions.[16] First, whether there is scope to have a provisional reconciliation process in advance of the final reconciliation between the forecasts and outturn figures. Second, whether the borrowing powers to deal with forecast error are sufficient, which is discussed in more detail below.

35. In addition, having different forecasters for the BGA and revenue components of the Scottish Budget has been identified as a further source of potential forecast risk and is considered later in this report.

36. Forecast error also applies to social security, albeit the scale of social security expenditure is smaller when compared to tax revenues. The annual budget for social security is in the region of £3.5bn and rising over the next few years. Analysis of UK historical trends show an average error

[12] http://www.fiscalcommission.scot/media/1435/scotlands-economic-and-fiscal-forecasts-december2018-full-report.pdf box 1.1
[13] Ibid
[14] SFC Forecast Evaluation Report 2019, para 9
[15] https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutiny-report-2/FCCS052018R12Rev.pdf
[16] https://www.parliament.scot/S5_Finance/Reports/Budget_Report_201920_-_FINAL.pdf

for one-year-ahead forecasts of 3.7 per cent. Applying the average forecast error figure to the £3.5 billion-worth of expenditure that is within the Scottish Government's responsibility could translate into a forecast error of ±£130 million for the block grant adjustment, before any consideration is given to forecast error in relation to expenditure.[17]

37. Annual resource borrowing capacity for forecast error for all devolved taxes and benefits is £300m. Therefore a negative social security forecast error of £130m would represent 43% of this capacity. Borrowing powers are discussed in more detail later in this report.

38. The BGA calculation is initially based on forecast spend of equivalent benefits in England and Wales and is then reconciled in two stages. There is an in-year reconciliation in-year, on the basis of the most recent OBR forecasts, and a final reconciliation once outturn figures are available. For example, the initial budget for 2020/21 will have an in-year reconciliation in winter 2020 and final reconciliation in winter 2021 (which will be applied to the 2022-23 Budget).[18] The reconciliation process adds further volatility to the Scottish Budget as any negative in-year reconciliation for the BGA has to be managed in-year as part of the budget management process. The same reconciliation process applies to the fully devolved taxes.

39. The Review should consider whether the reconciliation processes within the Fiscal Framework should be revised to better enable the Scottish Government to manage forecast error.

Forecast Bodies

40. The risk from forecast error increases if there is a divergence in the extent of forecast error between the SFC and the Office for Budget Responsibility (OBR). As Audit Scotland explained in their written submission –

> "Critically the effect of forecasting risk will be limited where the SFC and OBR forecast errors are correlated, offsetting one another, and significantly greater where they move in opposite directions, amplifying one another."

41. The written submission from Cardiff University makes a similar point –

> "Suppose that the Scottish Fiscal Commission overestimates Scottish tax revenue and the OBR underestimates growth in rUK tax revenue. This negative correlation between forecast errors would result in lower than expected devolved tax revenues and a larger than expected block grant adjustment – a "double whammy" for the Scottish Budget."

[17] Cabinet Secretary col 23, Social Security Committee, Official Report 10 October 2019
[18] Scottish Government (2019) Fiscal framework technical note

42. The Welsh Fiscal Framework stipulates that the OBR is responsible for forecasting devolved revenues as well as growth in rUK revenues. The written submission from Cardiff University points out that since “both forecasts are produced using similar models, this increases the likelihood of positively correlated errors and reduces the frequency and likelihood of negatively correlated forecast errors in any given year.”

43. The Scottish Government have emphasised the additional uncertainty arising from different sets of forecasts being produced by the OBR and the SFC on the basis that “there are many factors that may contribute to differences in these forecasts.”[19] For example, the forecasts are produced “at different times using different methodologies, assumptions and input data.”[20] The previous Cabinet Secretary for Finance, Economy and Fair Work explained to the FCC that while the “OBR has taken a top-down approach to the Scottish economy; the SFC…has taken a bottom-up component approach to the Scottish economy.”[21]

44. The Review should consider the extent of the risk arising from the potential divergence in forecast error between the SFC and the OBR.

Data

45. A corollary of the risk arising from having two separate forecast bodies is the extent to which they have access to similar sets of data. The technical annex to the Fiscal Framework states that –

> “The Scottish Government and Scottish Fiscal Commission will work with the UK government to explore options to ensure that appropriate provision can be made for the Scottish Government and Scottish Fiscal Commission to have access to the necessary data, information and models held by the UK government to support policy development and produce forecasts of a comparable quality to those produced by the OBR.”[22]

46. This is an issue which has been explored in some detail by the FCC. The OBR and SFC in a joint response to the FCC stated that “there are several sources of income tax data, with different coverage for Scotland and the UK and with availability at different times.” While the SFC “has access to Scottish data of comparable quality and timeliness to that available to the OBR…there are richer and more timely data available for the UK as a whole than there are for Scotland.”

UK Monthly Cash Receipts

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[19] https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-five-year-financial-strategy/
[20] Ibid.
[21] Finance and Constitution Committee. (2018). Official Report, 6 June 2018, Col. 21
[22] http://www.parliament.scot/20160315_DFMletter_FFannex_comp.pdf paragraph C.77

47. HMRC publish monthly data on all UK tax receipts, covering receipts up to and including the preceding month. This includes both PAYE and SA receipts for the whole of the UK. These data give the OBR its most timely indication of movements in UK-wide PAYE and SA receipts, which it uses to adjust its forecasts. No breakdown for Scotland is possible from this source, even internally within HMRC. The SFC does not adjust its forecasts on the basis of these UK-wide data.

48. The OBR and the SFC explained to the FCC that the former's –

> "use of UK monthly cash receipts outturns may account for a significant proportion of the (relatively modest) difference between the OBR's and SFC's forecasts of Scottish income tax, particularly in the early years of the forecast."[23]

Real Time Information (RTI)

49. The SFC and the OBR both receive monthly estimates of Scottish liabilities from the PAYE element of income tax from HMRC, collected via RTI (this covers around 90% of liabilities). This is the timeliest source of receipts data for Scotland, although slightly less timely than the monthly cash estimates for the UK. Neither forecaster currently uses RTI directly in its forecasts, but both advise that they "actively monitor it and are keen to make more use of it in future."[24]

Earnings Data

50. The SFC explained that quite small errors in the earnings forecasts are driving quite a lot of the reconciliation errors and that they have been asking for better and more timely earnings data for Scotland, as this is not available to the same extent as it is for the rest of the UK.

51. The Review should consider whether the Scottish Government and Scottish Fiscal Commission have access to data of a comparable quality to that available to the OBR and whether there is the same level of transparency regarding the publication of Scottish data.

Budget management tools

52. The Smith Commission recommended that the Scottish Government should be provided with "sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public

[23] https://www.parliament.scot/S5_Finance/Reports/Letter_from_Dame_Susan_Rice_and_Robert_Chote_to_the_Finance_and_Constitu...(2).pdf
[24] https://www.parliament.scot/S5_Finance/Reports/Letter_from_Dame_Susan_Rice_and_Robert_Chote_to_the_Finance_and_Constitu...(2).pdf

spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework."

53. The Fiscal Framework agreement extended the fiscal tools available to the Scottish Government to manage the increased budget risk and volatility associated with the devolution of new powers. The Scottish Government has the power to borrow up to £600m resource borrowing each year, within a statutory overall limit of £1.75bn.

54. Resource borrowing can only be undertaken for the following reasons:

- For in-year cash management, with an annual limit of £500m;
- For forecast errors in relation to devolved and assigned taxes and social security expenditure, with an annual limit of £300m (increasing to £600m in the event of Scotland-specific economic shock).

55. The Scottish Government also has the ability to smooth expenditure, manage tax volatility and determine the timing of expenditure through building up funds in, and drawing down funds from, the Scotland Reserve. The Reserve is capped in aggregate at £700m and is split between resource and capital. Annual drawdowns are limited to £250m for resource, and £100m for capital. There are no annual limits for payments into the Scotland Reserve.

56. The Scotland Reserve also replaced the Budget Exchange Mechanism which allowed the Scottish Government to manage underspend between financial years. The Reserve is therefore also used to manage expenditure between years.

57. As set out earlier in this report, the level of forecast error expected through the operation of the Fiscal Framework exposes the Scottish budget to increased uncertainty and budget volatility. The resource borrowing powers and Scotland Reserve can support the management of this budget volatility.

58. In addition to income tax reconciliations, the Scottish Government also has to manage reconciliations in relation to fully devolved taxes and social security, which will increase budget volatility in future years. In particular, the SFC explains that it is expected that there will be "some volatility around and fairly large forecast errors for social security, as more benefits are devolved and the Scottish Government introduces reforms to them"[25].

59. The SFC also notes that the size of the forecast reconciliations, while small in terms of forecasting errors, is large relative to the Scottish Government's borrowing powers.[26] For example, the current forecast reconciliation for income tax receipts for 2018-19 is -£555m to be applied

[25] SFC at Finance Committee, 11 September 2019
[26] SFC at Finance Committee, 11 September 2019.

to the Scottish Budget in 2021-22. On that basis, the borrowing powers and Scotland Reserve would be insufficient to address forecast error. The previous Cabinet Secretary for Finance, Economy and Fair Work has already written to the Chief Secretary to the Treasury to request that the limits on the Scottish Government's borrowing and reserve powers are raised.

60. Stakeholders have also commented that there is link between the choice of BGA method and budget management and borrowing arrangements. The closer the likelihood of the BGA 'automatically' matching the trends in devolved revenues, the less need there would be for tools to smooth asymmetric shocks to revenues.[27]

61. Furthermore, the written submission from Cardiff University notes that:

> "Relative to the respective size of devolved budgets and the amount of tax revenues devolved, the Scottish Government's budget management tools and borrowing limits appear somewhat more restrictive than in the case of the Welsh Government. This should clearly be a consideration for the fiscal framework Review, especially given the increased possibility for forecast error volatility from separate forecasts being produced for devolved revenues and the BGAs in Scotland".[28]

62. Beyond the forecasting risk issues identified, since the borrowing and reserve powers are set out in nominal terms in the Fiscal Framework, there is no mechanism to adjust the limits as the Scottish Budget changes year-on-year.

63. Based on outturn data from the ONS and the OBR and SFC forecasts in March and May 2019 respectively[29], raising the £300m resource borrowing limit for forecast error in line with inflation since the 2016 implementation year would increase the limit to £328m by 2020.[30] On the same basis, the £700m reserve cap would increase to £764m. This represents a cumulative increase of 9.2% for both limits.

64. As a consequence of not protecting borrowing and reserve powers against inflation, the real-term cash value of the Scottish Government's borrowing and reserve powers has therefore fallen over time.

65. The review should consider the limits and caps on the resource borrowing powers and reserve to ensure they are sufficient to manage the volatility created by the Fiscal Framework.

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[27] Wales Fiscal Analysis, para 3.16
[28] Wales Fiscal Analysis.
[29] OBR and SFC forecasts, March and May 2019.
[30] Scottish Government analysis.

66. **At the same time, the Review should consider whether the Scottish Government's borrowing and reserve powers should be protected in real terms, and if so, whether this should also apply retrospectively**.

Capital borrowing powers

67. The Scottish Government can borrow up to £3bn for capital spending, with an annual limit of £450m.

68. As with the resource borrowing and reserve powers the capital borrowing limits do not adjust as the Scottish Budget changes year-on-year. Based on outturn data from the ONS and the OBR and SFC forecasts from March and May 2019 respectively[31], raising the £450m capital borrowing limit in line with inflation since 2016 would increase the limit to £491m by 2020.[32]

69. Beyond the limitations of the existing powers, the Smith Commission previously suggested that the Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime.

70. The review should re-examine the capital borrowing arrangements and merits of a prudential borrowing regime.

Fiscal Framework Flexibility

71. The impact of the COVID-19 pandemic on the economy and the public finances inevitably raises questions about whether the Fiscal Framework is flexible enough to address the unprecedented levels of uncertainty and volatility. It is essential, therefore, that the review includes an analysis of the lessons learned and considers what if any changes need to be made to deal with both the ongoing crisis and any future crises.

72. In particular, consideration should be given to whether the borrowing powers within the Fiscal Framework are adequate in responding to a crisis such as COVID-19. This should include whether changes to the Scottish Government's borrowing powers may be appropriate given the following reasons–

- The rules on borrowing were not designed for the current situation including the need to develop, cost and announce new measures very rapidly and the potential for each of the four nations of the UK to be affected by coronavirus in very different ways;
- The Fiscal Framework is behaving as it was intended to do, though there are some respects in which the Scottish government might seek to negotiate temporary alleviations from HM Treasury;

[31] OBR and SFC forecasts, March and May 2019.
[32] Scottish Government analysis.

- The rules preclude borrowing to fund new policy measures in response to the health pandemic which means the devolved governments are very reliant on Barnett consequentials arising from the UK Government policy response;
- Giving the devolved governments greater access to borrowing via the National Loans Fund in emergency situations would allow devolved governments to develop, cost and announce plans more quickly than if they have to wait until UK government plans for England have been announced before a tailored support for Scotland can be developed;
- To address an immediate shortfall in receipts from Land and Buildings Transaction Tax which is collected by Revenue Scotland and which will be much lower than the SFC forecasts due to the crisis;
- To address a differential public finance impact in Scotland compared to rest of the UK arising a different policy response in Scotland or a differential impact of the pandemic on the Scottish economy or a combination of both.
- The existing provisions within the Fiscal Framework to address a Scotland specific economic shock were not designed to deal with a crisis such as COVID19.

73. Although HM Treasury has provided an upfront guarantee for Barnett consequentials to support the Coronavirus recovery, it has not, so far, agreed the limited and temporary fiscal flexibilities the Scottish Government has requested.

74. There continues to be a pressing need to reach agreement regarding the debate over additional flexibilities and powers in the short term so that each of the devolved governments can more effectively manage their respective budgetary response to COVID-19. At the same time it is also essential that the review of the Fiscal Framework considers the experience of the governmental response to COVID-19 and whether any changes are required for the long term.

No detriment as a result of the decision to devolve further power

75. Aside from the block grant adjustment arrangements covered earlier in this report, the Smith Commission principles also noted that there should be an increase to the block grant in relation to any identified administrative savings arising to the UK Government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved, sufficient to support the functions being transferred, at the point of transfer.

76. Under the Fiscal Framework, all administration and programme costs incurred by the Scottish Government, due to the creation of new welfare benefits or making discretionary payments, will be met by the Scottish Government. Similarly, under paragraph 38 of the Fiscal Framework, any

costs incurred by UK Government as a "direct result of devolution" will be recharged to the Scottish Government. To end-financial year 2018/19, the Scottish Government paid a total of £10.7m for social security implementation costs to DWP. Costs are forecast to rise significantly through the life of the devolution programme, in part due to the complex IT landscape in DWP.

77. The Fiscal Framework agreement included a one-off transfer of £200m to the Scottish Government to implement the Scotland Act 2016 powers, and a baselined £66m (to be subject to indexation annually) per year for administration. The scale of the implementation costs UK Government are seeking to recharge as a proportion of the implementation transfers could not have been anticipated until the programme of work had been jointly agreed between the two governments, in particular the cost of changes to DWP IT systems or staff employed by DWP that indirectly carry out work for the Social Security Programme.

78. The review should consider whether the implementation costs agreed as part of the Fiscal Framework are sufficient given what is now known about the scope of the recharges. This should include whether it remains reasonable that the Scottish Government should cover all the costs to the UK Government of devolution of the social security powers within the funding envelope already agreed for implementation and administration.

No detriment due to policy spillovers effects

79. The Fiscal Framework agreement sets out a number of provisions detailing how the UK and Scottish Governments will account for policy spillover effects, which is the term given to the financial consequences of policy decisions.[33]

80. The provisions in the Fiscal Framework respond to the Smith Commission principle that there should be no detriment as a result of UK Government or Scottish Government policy decisions post-devolution. Specifically, where either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost or receive a transfer from the other if there is a saving.

81. The Fiscal Framework divides these policy spillovers into two categories:
- Direct effects - these are the financial effects that will directly and mechanically exist as a result of the policy change (before any associated change in behaviours); and
- Behavioural effects - these are the financial effects that result from people changing behaviour following a policy change.

[33] Fiscal Framework Agreement, paragraphs 44-53.

82. The two governments have agreed to account for all direct effects. Behavioural effects will only be considered in material, demonstrable and exceptional circumstances. However, ICAS have noted that the notion of spillovers and more generally the BGA are confusing. ICAS also comment that how policy spillovers operate in practice will be challenging. They argue that this lack of understanding undermines the purpose of the Scotland Act 2016 which was to bring greater accountability between the public and the Scottish Parliament.[34]

83. The Scottish Government has requested that a spillover be considered in relation to the UK Government's decisions to increase the Personal Allowance. However, the process has not yet led to the successful resolution of the matter and challenges remain over the interpretation of what falls within the scope of these provisions.[35]

Policy autonomy and policy risks

84. Stakeholders have raised concerns that the spillover provisions, and lack of clarity around the scope of their application, might limit the policy autonomy of the Scottish Government. For example, some stakeholders have raised concerns that these provisions could impact on decisions of Scottish Ministers to pursue policies in relation to promotion of the take-up of benefits.[36] Similarly, other stakeholders question the coherence of the no detriment principle, noting that it might discourage divergence, running counter to the logic of tax devolution.[37] While other commentators have raised the issue of the Scottish Government having to react, often at short notice, to UK Government policy in relation to the devolved taxes, because of the potential financial or policy impact. For example, as happened with the introduction of the Additional Dwelling Supplement.[38]

85. The review should re-examine how policy spillover effects are accounted for through the Fiscal Framework and should consider the flexibilities and constraints of the Fiscal Framework in responding to policy changes at Scottish or rUK level. For example, it could consider whether the spillover provisions can be simplified or clarified; whether the provisions should be revised in light of concerns in relation to policy autonomy; or whether other elements of the Fiscal Framework should be modified to mitigate policy and policy spillover risk e.g. the BGA mechanism or process.

Intergovernmental relations and dispute resolution

[34] ICAS, 4.1
[35] Cf Letters to Finance and Constitution Committee from CST and Cabinet Secretary
[36] Joseph Rowntree Foundation submission. See also Social Security Committee evidence sessions.
[37] David Heald, page 2
[38] ICAS, para 26

86. Should the governments be unable to reach agreement on different interpretations of the Fiscal Framework, either government can seek to progress the matter using the dispute resolution provisions in the Fiscal Framework. However, as neither government has escalated an issue through the dispute resolution process to date, it is difficult to make any assessment of the effectiveness of the dispute resolution provisions.

87. As noted in the example of the introduction of the Additional Dwelling Supplement, the implications of how two different tax regimes interact through the fiscal framework raise the question of whether there is a need for better policy co-ordination between the governments.

88. The review should consider –

- **the effectiveness of the dispute resolution provisions, to the extent that an assessment can be made at the time of the review.**
- **the effectiveness of the governance arrangements to ensure that both Governments have the opportunity to respond in a timely way to each other's policy decisions, taking into account the operation of the Fiscal Framework.**

Transparency and accountability

89. The Fiscal Framework has introduced a greater degree of volatility and uncertainty into the budget process. The FCC has noted that, for proper public scrutiny and to secure public confidence in the operation of the Fiscal Framework, full transparency of its operation is essential.

90. New outturn data is published throughout the fiscal year and reconciliations are applied at the time of the Scottish Budget. In addition, OBR and SFC forecasts determine the net contribution of the new fiscal powers to the Scottish Budget.

91. The Scottish Government provides comprehensive information through its Fiscal Framework Outturn Reports and associated documents. The SFC produces wide-ranging documentation and commentary on its own forecasts and methodology. The complexity of the Fiscal Framework makes the interpretation of this information challenging. In particular, the FCC has stressed the need to explain year-on-year changes to the adjustments to the block grant and the different drivers behind the changes.

92. There are some immediate improvements the Committee has proposed for HM Treasury to make to its Block Grant Transparency document in order to promote greater transparency. The Scottish Government and Parliament can also work together to promote greater clarity of the operation of the framework and to provide information and explanation at the relevant points in the fiscal cycle.

93. Beyond the improvements that can be made now, the review should consider:

- **the scope for simplifying the operation of the Fiscal Framework;**
- **the timely provision of information on the operation of the Fiscal Framework including the reconciliation process;**
- **how the Scottish Parliament can be given enhanced opportunities to scrutinize decisions by the UK Government that have a direct bearing on the operation of the Fiscal Framework;**
- **the scope for HMRC to publish tax outturn data in a way that allows proper scrutiny by the Scottish Parliament at the relevant times in the budget cycle.**

94. While the review itself might involve sensitive negotiations between the two governments, the review process should provide an opportunity for input by the public and the two parliaments from the outset.

Annexe A

Written submission from Audit Scotland

Fiscal Framework Working Group Written submission by Audit Scotland on the key risks arising from the operation of the fiscal framework

Introduction

1. The Scottish Parliament's new financial and social security powers and responsibilities from the 2012 and 2016 Scotland Acts are fundamentally changing the Scottish public finances. Many of the components of the Fiscal Framework are now operating, including tax raising, borrowing and reserve powers – as well as some social security powers. Others including further devolution of social security and VAT assignment are coming into force over years ahead.

2. The Scottish budget is becoming increasingly complex. It is also subject to greater uncertainty and volatility than when the majority of its funding was relatively fixed through the block grant from the UK Government. The way the Scottish economy performs relative to the rest of the UK is having a greater influence on public finances than ever before. The Scottish Government has more choice over tax and spending, and more decisions to make about how and when to use its financial powers.

3. Understanding the opportunities and risks inherent in the operation of the Fiscal Framework, and how these are being experienced and managed in practice, is critical to the effective oversight of the Scottish public finances. The Scottish Parliament's revised budget process is designed to respond to these new fiscal challenges. This includes an increased focus on fiscal sustainability – taking a long-term outlook and addressing fiscal constraints, alongside a greater focus on prioritisation and the impact of increasing demand for public services.

4. Audit Scotland published a briefing on the operation of the fiscal framework in October 2018. This reflects on experience during 2017/18, the first full year of operation of income tax, borrowing and reserve powers. We are currently preparing a further briefing which draws on experience since then, including financial outturns for 2018/19 and the first Scottish income tax reconciliation. We expect to publish this in October 2019, and once available we will share with the Group for its consideration.

The nature of budget risk

5. This submission provides a brief overview of the main risks that are now affecting the Scottish budget. Budget risk is often seen in solely negative terms,

but over time there may be either downside or upside outcomes. Downside risks increase the pressure on the available public resources, limit the range of policy choices available and curtail the effectiveness of the public spending programmes being pursued. Upside risks reduce the pressure on resources, enable a greater range of policy choices and extend the effectiveness of spending programmes.

6. Budget risk affects the level of resources available to enable policy choices about tax and spending. It also affects the extent to which unexpected changes in available resources may impact on their economic, efficient and effective use. For example, if available funding was significantly less than planned in any financial year, the spending reductions necessary to accommodate this in year might cause significant disruption to the spending programmes and public bodies affected or lead to unintended consequences. Equally, if available funding was unexpectedly greater than planned this could lead to public money being spent quickly without full value for money being achieved. In both cases the risk of poor value for money decreases the further ahead a change in funding can be anticipated.

7. A lot of moving parts now affect the Scottish budget. Each carries a degree of risk and uncertain financial impact. Where the effects offset one another, the overall impact may be limited. If the effects are predominantly in one direction, the aggregate effects may be significant and difficult to manage. Good medium-term financial planning is essential to help with this.

Forecasting risk

8. Forecast error is the difference between what was forecast and what happens. The likely size of forecasting errors is affected by the extent of underlying uncertainty about the economy and other areas subject to forecasts. The uncertainties inherent in the forecasting process mean that the actual amounts ('final outturns') will differ from the initial forecasts, and the Scottish budget will be adjusted to reflect final outturns. The net effect will depend on forecast errors for both devolved revenues (or expenditure) and the corresponding BGA.

9. Critically the effect of forecasting risk will be limited where SFC and OBR forecast errors are correlated, offsetting one another, and significantly greater where they move in opposite directions, amplifying one another. The Scottish Government has to manage the effect of having more or less resources than was anticipated in original forecasts, as these adjustments ('reconciliations') are made. The greater the range of possible outcomes, the greater the forecasting risk. In the early years of implementation, forecasting risk may be greater because, for example, forecasting methodologies are new and there is less historic trend data available for forecasters to use.

10. Forecasting risk that affects budgets during the year is likely to be more difficult to manage than that which affects future budgets through the reconciliation process. This is because the Scottish Government has less time to consider how best to adjust its plans. This will become an increasing challenge as the level of devolved social security spending grows, with variances in spending requiring to be managed in year.

11. Important aspects of forecasting risk include:

    - The extent of underlying uncertainty about the economy and other areas subject to forecasts. In a period of significant economic uncertainty, forecasting is inherently more challenging and forecasting risk increases.
    - The availability of relevant and robust data about the UK and Scottish economies, tax and social security spending. Investment in new data sets and surveys will help, but there are limited opportunities to improve historical information.
    - The robustness of methodologies and judgements made by the SFC and OBR. A key aspect of the process is for forecasters to be able to compare actual experience to forecasts, learning from this and refining their methodologies and judgements as a result. This can be expected to improve forecasts and reduce this aspect of forecasting risk over time.
    - Differences in methodologies and judgements between the SFC and OBR. Different conclusions about underlying economic performance and the effect on tax and spending will have a direct impact on the initial Scottish budget, and subsequent reconciliations.
    - How far ahead forecasts look. The longer the period between forecast and outturn, the greater forecasting risk is likely to be. This means that updated forecasts for the same measure are likely to be a better indication of the final outturn than those prepared at an earlier date. Updated forecasts help clarify the likely extent of emerging budget pressures.

Economic performance risk

12. The Fiscal Framework is intended to incentivise the Scottish Government to increase economic growth. Where the Scottish economy is performing relatively well, tax revenues will be higher and pressures on spending will ease. Where it performs relatively less well the effect will be to squeeze the budget, reducing available funding and increasing spending demands. The extent of this risk will grow as further components of the Fiscal Framework come on stream, particularly VAT assignment and the full extent of devolved social security spending. Economic performance risk is the extent to which Scotland's economic growth will affect the budget available to the Scottish Government to pursue its policy objectives.

13. Economic performance also affects the demands placed on public sector spending programmes. The devolution of social security powers will increase this effect. Where the economy is doing less well, it is likely that spending pressures will increase. The overall effect is that the Scottish budget is now more closely linked to Scotland's economic performance relative to the rest of the UK.

14. Where differences in growth rates between Scotland and the rest of the UK continue over an extended period, the cumulative impact on future Scottish budgets is likely to be increasingly significant. Enhanced short-term resource borrowing powers are available in the case of defined economic triggers ('a Scotland specific shock'). But these are not designed to insulate the Scottish budget from any structural differences in economic performance that continue over a number of years.

15. Important aspects of economic performance risk include:
    - The extent of structural and cyclical differences between the Scottish economy and the rest of the UK, and how these affect tax and public spending demands.
    - Underlying economic factors; such as employment, wage levels, productivity, demand and government spending.
    - Differences in the tax base and in underlying social security needs between Scotland and the rest of the UK.
    - The point in the relative economic cycles of Scotland and the rest of the UK at which baselines for block grant adjustments are established.

Policy risk

16. The way that block grant adjustments for both taxes and social security operate means that different tax and spending policy choices in Scotland compared to the rest of the UK directly affect the Scottish budget. Clearly, if the Scottish Government changes its own policies to raise more or less taxes, or to spend more or less on social security, the budget is affected. But UK policy changes in relation to non-savings non-dividend (NSND) income tax, devolved taxes and social security spending also have a direct effect on the Scottish budget. For example, if the UK Government decided to raise UK tax rates in a devolved area, such as by changing the base rate of income tax, and the Scottish Government retained its existing rates, the overall Scottish budget would be less as a result.

17. Maintaining the status quo between Scotland and the rest of the UK through the Fiscal Framework now means matching UK tax and social security policy. The Scottish budget will be larger or smaller than it would otherwise be as a result of any policy divergence in such areas. The Scottish Government must manage

the implications for its budget arising from any relevant UK policy changes alongside its own policy decisions. Greater uncertainty about future UK Government policy in devolved areas potentially increases policy risk for the Scottish budget.

18. Important aspects of policy risk include:
    - The extent of policy divergence over time in areas such as tax rates or spending changes in devolved areas. Measures designed to increase or decrease the Scottish budget may be neutralised by similar changes at a UK level.
    - Decisions taken by the UK Government about the mix of tax and spending measures between reserved and devolved areas may have a disproportionate effect on the Scottish budget. For example, a shift in tax raising between personal and corporate taxes that is budget neutral at a UK level would impact the Scottish budget. This is because the BGA associated with income tax would be affected, but there would be no Barnett consequential impact on the baseline block grant.
    - The extent of any 'policy spillover' agreed between the Scottish and UK Governments. Changing policies in either Scotland or at a UK level may produce a fiscal impact within the other jurisdiction. For example, increasing tax in Scotland may lead to more universal credit payments being required to Scottish people from the UK government.[39] The Fiscal Framework includes provisions to adjust for this where an effect is demonstrated to the satisfaction of both parties.
    - The extent of any changes to social security entitlements and benefit levels in areas prior to devolution, which would impact on baseline block grant adjustments. A similar risk applies in relation to the taxes that have yet to be devolved.

Budget management risk

19. The Scottish Government continues to be required to operate a balanced budget. This means matching its spending to available sources of funding each year, including any borrowing and the use of reserves within the provisions of the Fiscal Framework.

20. The risks arising from the operation of the Fiscal Framework need to be managed by the Scottish Government as part of its overall management of the Scottish budget position. Effective budget management is required to ensure the sustainability of the Scottish public finances over the long term, enable the Scottish Government to deliver its policies and minimise disruption to public services. It also needs to ensure that public spending programmes provide value

[39] *Essentials of the Fiscal Framework*, David Eiser, Adviser to the Finance Committee.

for money, while remaining within authorised budgets and the limits in the Fiscal Framework.

21. Because the budget process is more complex, and subject to greater uncertainty and volatility, the Scottish Government has to manage its financial position closely. This will include planning for the changes that will affect the budget across current and future years and responding to unexpected events. The extent of the budget management challenge in any one year will depend on the interaction of all the factors affecting the Scottish budget. Where various risks crystallise in a way that the effects offset one another, the overall impact may be limited. If the effects are predominantly in one direction, the aggregate effects might be significant and more difficult to manage effectively.

22. The risks arising from the operation of the fiscal framework require to be considered alongside those arising from the Government's approach to financial management. For example, where the Government plans to use the Scotland Reserve to carry forward significant amounts of budget and spending power to one financial year to the next, this will limit the extent to which the reserve is able to operate as a buffer against unplanned budget pressures. Similarly, the Government may be more reliant on the flexibilities within the fiscal framework where all of its spending programmes are relatively inflexible.

23. Key aspects of budget management risk include:
    - How well risks can be accommodated within the flexibilities in the fiscal framework, including resource borrowing facilities and the Scotland Reserve.
    - The extent and nature of long-term commitments, including capital borrowing, contractual commitments and policy priorities.
    - The Scottish Government's ability to control spending programmes in the short term, and the impact of this on the delivery of public services.
    - The quality of in-year estimates and provisional outturns to support effective monitoring and forward planning.
    - Understanding the underlying financial position of the devolved public sector as a whole. Currently Scotland does not have public consolidated accounts to show a comprehensive picture of public revenues, spending, liabilities and assets.

Conclusion

24. The Smith Commission agreement set out a number of measures aimed at strengthening the financial responsibility of the Scottish Parliament. In his introduction Lord Smith noted that, "Complementing the expansion of its powers will be a corresponding increase in the Parliament's accountability and responsibility for the effects of its decisions and their resulting benefits or costs."

25. The Fiscal Framework is an important component of the arrangements established to deliver on this. But it doesn't sit in isolation, working alongside the application of the powers set out in the 2012 and 2016 Scotland Acts and the Scottish and UK Government's broader approaches to financial and fiscal management.

26. This paper sets out the risks for the Scottish budget that arise from the whole system of public finances. This is based on experience to date and our assessment of how these risks are likely to develop as all the elements of the Fiscal Framework play through. The devolution of the full extent of social security powers envisaged from April 2020 and the plans for the assignment of VAT will mean that the overall budget risk will continue to grow significantly in the years ahead.

27. In reviewing the Fiscal Framework it is likely to be important to consider the extent to which the risks now inherent in the Scottish budget are consistent with what was agreed by the Smith Commission. In doing so care should be taken to distinguish between the rules and approaches set out in the Framework, and the effects of the Scottish Government's approach to financial management.

Mark Taylor CPFA
Audit Director
Audit Scotland

30 September 2019

Written submission from Professor David Bell and Willem Sas

“Starting From Scratch? A New Approach to Subnational Public Finance”

is available online at: https://willemsas.files.wordpress.com/2020/01/starting-from-scratch-v4.6.pdf

Written submission from Professor J D Gallagher CB FRSE

This short note sets out for the committee what I think are some of the key points in considering a review of the fiscal framework for tax devolution under the Scotland Acts. I regret I am unable to give evidence in person.

The basics

The basic proposition of the fiscal framework is and must remain consistent with the application of the Barnett formula. That is to say, its objective must be to decide how much should be deducted from the Barnett-calculated transfer from central UK funds to the Scottish budget to take account of the stream of tax income which the Scottish government now receives. I remind the committee that the Barnett system produces a Holyrood budget which is approximately 25% per head higher than comparable spending in England. This is substantially driven by relative Scottish population decline over a prolonged period [40] Radical changes to the structure of the fiscal framework are unlikely therefore to be in the interests of the Scottish budget, though, as discussed below, some adjustments may be justified.

Data and timing

Although there was an agreement to review the fiscal framework after five years, for reasons which the committee may be aware of, at today's date in the implementation of a new funding system there is likely to be insufficient data to review the effects of the framework in different economic or demographic circumstances. As of today, the main thing which is been happening is the transition from estimated Scottish tax receipts (which were all that were available to kick the framework off) to actual Scottish income tax receipts. As was agreed, the transition from estimates to actual is not a risk which the Scottish budget has borne, but the identification of actuals and their likely future growth has demonstrated that the Scottish tax base is not as robust as had previously been assumed. Coming to a view on how to change the detail of the formula on the basis of the experience so far might be premature, and at least one full year's more data would be helpful.

Formulae, indexation etc

Given the structure of the fiscal framework, the main issue for debate is which risks to the income stream the Scottish budget should bear, and which, if any, should be borne by the UK Exchequer. A full analysis of these issues can be found here. www.nuffield.ox.ac.uk/media/1752/gallagher-wp-algebra-and-the-constitution.pdf. This analysis was done while the fiscal framework was being developed, and the deal agreed between the governments did not accept all of its conclusions, but they remain relevant, and the committee may find the following key points helpful.

[40] The detailed calculation of this are to be found here: www.nuffield.ox.ac.uk/media/1972/2017-10-public-spending-in-scotland-relativities-and-priorities.pdf

Given that the Scottish government accepts the risk or benefit of different tax rates (that's the whole point of tax devolution) it follows that it must accept risk from the tax base, that is to say the amount of taxable income, in the case of income tax. That's because the tax rate has a direct influence on the tax base. It is tempting to argue that, because it looks as if the growth in Scottish income tax will be lower than the growth of UK income tax the Scottish budget will be disadvantaged and so this basic principle of tax devolution should be reversed. But that is not a sustainable position, and in any event the Scottish budget does in fact benefit from growth in rUK revenue; it does so through UK grant (which is based on reserved taxes) but also through the operation of the fiscal framework it does also benefit from the growth in rUK income taxes, as explained in the paper referenced above and the text below.

The one historic example of tax devolution is council tax and nondomestic rates, which have been wholly devolved since 1999, and outwith the Barnett system entirely. So the Scottish budget has always borne this risk completely, and is completely unaffected by what happens to the same taxes in the rest of the UK. The same system could have been adopted for income tax, but since rUK income tax funds the rUK services on which the Barnett formula is calculated there was a case for not doing so.

Instead, the formula operates on the relative growth of Scottish and rUK income tax revenue, a method described as "indexation". This means that, although income tax is substantially devolved in Scotland, if it grows more in England, where it starts from a higher base, some of that growth leaks through into the Scottish budget, to the advantage of Scottish taxpayers.

The main issue of dispute when the framework was set up was whether the indexation should be "*per capita*" or not, i.e. whether if the number of taxpayers in Scotland grew more or less than the number of taxpayers in England the Scottish budget should be affected. If the Scottish population grows more than England's, should the Scottish budget not keep the resultant extra revenue? After all, it will have to provide the services for the extra people. If the Scottish population grows more slowly than England's the opposite point arises. In the event, the Scottish government foresaw a relative population decline, and so demanded *per capita* indexation so as not to lose the revenue. This was a tactical rather than a principled choice, although one can understand why.

It resembles the Barnett formula, which is pretty insensitive to population decline, as population operates only on the marginal changes not the baseline. Hence the 25% lead in Scottish devolved public spending. But it's actually quite hard to argue that if the number of Scottish taxpayers declines relative to the rest of the UK, some of the extra English taxpayers should be, in effect, drafted into Scotland to make up the shortfall, and to fund services in Scotland and not the services they need in England. If it were the other way around, and increases in Scottish tax revenue were funding extra English services, the Scottish Parliament would be up in arms. (The approach adopted was justified by reference to the ill-defined principle of 'no detriment' enunciated by the Smith Commission: the Barnett formula deals badly with relative population change, and as it happens that has suited Scotland well, so the Fiscal

Framework should deal with it badly too. That is a rotten argument.) This is likely to be the most difficult issue in the forthcoming review.

Population Composition

It may also have been suggested, I understand, that instead of basing the calculations on population some account should be taken of the different population structure of Scotland compared to the rest of the UK, and, it is suggested, greater Scottish spending needs. This is, first of all, based on a misunderstanding of what the fiscal framework does, confusing the deduction from the Barnett calculation with the Barnett calculation itself, and secondly likely to open up the whole question of needs-based formula to replace Barnett.

To deal with the technical question first: we use population in the fiscal framework (as opposed to the Barnett formula) essentially to calculate how much income tax Scotland would raise, if its income tax growth *per capita* were the same as the rest of the UK's. This already implicitly takes account of differential population structure, as if, say, the proportion of elderly people in Scotland grows more than in England, the likelihood is that the growth in Scottish income tax will be smaller. So there is no need to use a weighted population of any sort in the calculation, as that would double count the effect.

More substantially: the Barnett formula itself works only on unweighted population, and uses population only to calculate the annual change in the Scottish budget. As noted above, this is why public expenditure under Holyrood's control is 25% higher per head than in England. The use of weighted population however implies a needs calculation, and therefore is relevant not only to the increment to the Scottish budget but to the Scottish budget as a whole. It is a long time since any needs assessment has been done by government, but those needs assessments which were done in the 1970s and 1990s suggested that the then spending lead of the Scottish Block (as it was at the time) was hard to justify on the basis of a weighted population approach. The Scottish budget’s lead over the rest of the UK has increased since then. If the committee's objective is to open up the question of a needs assessment and a very significant cut in the Scottish budget, then arguing for a weighted population approach in the fiscal framework is a good place to start.

VAT Assignment

One unfinished piece of business from the Smith Commission is the assignment of 50% of the yield of VAT to the Scottish budget, substituting for more of the Barnett grant. As I understand it, this has not been agreed because the two governments cannot agree what deduction should be made under the fiscal framework to reflect it. If one accepts that assignment of VAT is a good idea in principle (which I do not) then the argument about what formula to use is exactly the same as in respect of income tax. Dealing with VAT as we deal with council tax and nondomestic rates would be a complete tax devolution, and is defensible in principle, but there is an argument for

indexation in the same way as for income tax, as this reflects the underlying greater strength of the rUK economy and the pooling of resources which underlies the Barnett principle. As for the simple indexation versus *per capita* the arguments are exactly the same: simple indexation is right in principle because extra relative growth in Scottish tax revenue from extra relative growth in the Scottish population will be matched by extra relative growth in the need for Scottish public services.

There will undoubtedly be issues of data. Because VAT is not devolved, we will not have actual Scottish VAT revenue, as we have actual Scottish income tax revenue, so the whole business will be based on arguments about estimates. As we have seen with income tax, even the best estimates can be seriously wrong. VAT is likely to be harder to estimate, as it has to take account not only of the VAT charged, but also of input VAT. There is therefore quite a serious risk that the Scottish budget could be subject to fluctuations as estimates change. In my view, this is a pointless exercise. Tax devolution matters: tax assignment is presentational, especially in a system where it is a balancing item inside a grant calculation.

Written submission from Professor David Heald

1. This memorandum responds to a request by the Co-Chairs of the Working Group of Scottish Parliament and Scottish Government officials to respond to three questions ahead of the independent review of Scotland's Fiscal Framework.

2. My written evidence to the Scottish Parliament's Devolution (Further Powers) Committee meeting on 3 March 2016 cautioned that the 2016 Fiscal Framework was cultivating illusions and kicking issues into the long grass (Heald, 2016). I understood the political urgency when the UK Government wished to to settle ahead of the Brexit Referendum on 23 June 2016 and when expectations had built up in Scotland after the Independence Referendum, the 'Vow' and the Smith Commission (2014).

QUESTION 1: WHAT ARE THE KEY RISKS TO THE FISCAL FRAMEWORK?

3. Devolving tax powers and assigning revenues from UK taxes exposes the Scottish Budget to (a) macro-fiscal risk, and (b) tax-policy risk.

4. Taking on macro-fiscal risk is the counterpart of asking the Scottish Parliament and Scottish Government to strengthen their accountability for Scotland's public finances and for the performance of the Scottish economy. Within the circumstances of the United Kingdom, the difficulty is knowing how much macro-fiscal risk can be managed by the Scottish Government and how much depends on decisions by the UK Government, which still controls most of the relevant policy levers. A key issue is differential responses by Scottish and Rest-of-UK (rUK)[41] tax revenues to macro-fiscal developments, understood to include economic cycles, structural change and demographic trends. The Brexit Referendum, and much that has followed since, highlights these issues of (a) differential responses, and (b) attribution of responsibility as a route to enhanced fiscal accountability.

5. Taking on tax-policy risk is a fundamental consequence of tax devolution. If Scotland were to adopt a significantly more progressive income tax structure than England, then there would be behavioural consequences in terms of actual and purported changes in taxpayer residence. This matters because Scotland's income tax revenues depend heavily upon revenues from a relatively small proportion of total taxpayers. There could also be effects on incorporation and on the conversion of income into capital

[41] I refer to rUK, but – depending on tax devolution elsewhere – the comparator could be different.

gains, with the resulting revenues going to the UK Treasury. It would be a political judgement whether benefits in terms of less post-tax income inequality in Scotland outweighed the revenue losses to the Scottish Budget.

6. The operation so far of the *Scotland Act 2016* powers results in Scotland having five income tax bands compared with three in rUK, the driver for which has mostly been presentational. Moreover, the implications of the UK Treasury controlling the Personal Allowance and linking National Insurance Contributions (NICs) to rUK income tax thresholds have become manifest in terms of indefensible marginal tax rates at sensitive points in the income distribution.

7. The Muscatelli Expert Group Report (2008) for the Calman Commission stressed 'Simplicity/Transparency' as a key principle of devolved taxation. In the event, Scottish income tax has become more complex and less understandable. This is partly a consequence of what has or has not been devolved, and partly of how those powers have been used. The presumed Accountability benefits of tax devolution will not be achieved if few can understand what is happening. The developed consensus in favour of the Scottish Parliament raising a substantial share of the public money it spends might well be lost if these issues are not addressed.

QUESTION 2: WHAT SHOULD THE FISCAL FRAMEWORK REVIEW INCLUDE?

8. The Annexe "Fiscal Framework Working Group – Determining the scope of the Fiscal Framework Review" (Fiscal Framework Working Group, 2019) defines the scope well. Therefore, I will not unnecessarily repeat what already appears there:

9. The Review provides an opportunity to think through the application and implementation of the Smith Commission's 'No Detriment Principles':

   a) **No detriment as a result of the decision to devolve further power**: I strongly support this principle, without which tax devolution would never happen. This means that the Block Grant Adjustment (BGA) represents the revenue foregone of the UK Government

   b) **No detriment as a result of UK Government or Scottish Government Policy Decisions Post-Devolution**: I have always regarded this principle as incoherent and likely to generate confusion and conflict. Taken seriously, it would discourage any divergence between Scottish and rUK taxes, running counter to the logic of tax

devolution. A more progressive Scottish income tax might increase rUK tax revenues (residence changes) and low rates of Air Departure Tax in Scotland might reduce Air Passenger Duty revenues in rUK (traffic diversion). The Fiscal Framework Review should consider how to minimise damage from this principle having been part of the Smith Commission recommendations.

10. Public understanding of the Barnett formula has always been low, a condition exacerbated by the genuine complexities introduced by tax devolution. It is vital to recognise that there are two separate issues:

    a) **Structural factors**: Scotland's population share has been on a downwards trajectory since the Act of Union 1707, and there are no reasons to believe that this will change. The economic dominance of London and the South-East also affects other parts of the UK, but it is tax devolution that makes a decreasing population share so important for Scotland. In practice, the 2016 Fiscal Framework set the BGA on a per capita basis and applied multipliers to reflect the lower revenue productivity of Scottish taxes. These arrangements have not been established as the default position when it comes to indexing the BGA to achieve a current value for the UK Treasury's revenue foregone.

    b) **Forecasting errors**: Responsibility for forecasting tax revenues has been outsourced to the Office for Budget Responsibility and to the Scottish Fiscal Commission. Paragraph 1.1 of the briefing document (Fiscal Framework Working Group, 2019) refers to current forecast reconciliations for the 2018-19 and 2019-20 income tax years of negative £608 million and negative £188 million, respectively. A key task of the Review should be to document and assess forecasting experience to date, in light of the damage that such budget hits might do to the credibility of tax devolution.

11. The UK effectively has two income taxes, the first mostly devolved to the Scottish Government, the second being UK-controlled NICs. The interactions are little understood by politicians, the media and the public, but have significant effects on the distribution of the tax burden in terms of effective marginal and average tax rates. Moreover, fundamental change is unlikely: other countries have social security taxes and a unified UK tax would look high on international comparisons. Differential

demographic risk is likely to discourage the devolution of NICs to Scotland. However, the commitment of UK Governments since 2010 to a much higher Personal Allowance (and phased withdrawal on incomes over £100,000) affects both tax revenues (differential profile of income earners) and effective marginal rates. Neglecting these issues will not only cause economic damage, but will also reduce the credibility of the devolved tax system.

12. The partial assignment of Value Added Tax (VAT) was part of the Smith Commission recommendations, later enacted in the *Scotland Act 2016*. Tax assignment is fundamentally different from tax devolution, with much of the claimed benefit being presentational, as in headlines that the Scottish Parliament would fund more than 50% of its spending. Before devolution in 1999, I devised a scheme in the context of the Scottish Constitutional Convention which involved partial VAT assignment, but there was an explicit equalisation scheme that would have acted as a buffer for variation in revenues (Heald, 1990). Given the administrative structure of VAT, Scottish VAT revenues have to be estimated from survey data, and the current postponement of implementation results from the difficulties of establishing reliable and stable data.

13. In light of experience to date, the adequacy of buffers such as the Scotland Reserve and resource borrowing should be investigated.

14. I have long argued for greater transparency about the operation of the Barnett formula (Heald, 1994; Heald and McLeod, 2002) and slowly some progress has been made, for example, in the periodic publication of how formula consequences are generated (Treasury, 2017).

QUESTION 3: WHY SHOULD THE FISCAL FRAMEWORK REVIEW ADDRESS THOSE ISSUES?

15. With regard to the No Detriment Principles, these form part of the system architecture and involve legacy commitments that need to be carefully addressed.

16. With regard to the Block Grant Adjustment, negotiations with the UK Government and Treasury will take place in a very different political context than that of early 2016. How to deal with the structural issues and how to minimise disruptive reconciliations are core tasks. Tax devolution inevitably exposes the Scottish Parliament to greater macro-fiscal risk, raising the issue of how much can be borne and how that can be

managed. Disputes are likely about which revenue losses are due to macro-fiscal risk and which to tax-policy risk.

17. With regard to Personal Allowance and NICs, the salience increases if it is accepted that the devolution of either is unlikely. My expectation is that the UK Government will not concede a role to the Devolved Administrations.

18. With regard to VAT, negative impacts on the Scottish Budget deriving from questionable data would be damaging to the legitimacy of the funding system. Moreover, it is important to avoid the impression of drift and of putting off decisions about whether VAT assignment is viable.

19. With regard to buffers, these have to be sufficiently large to accommodate economic shocks and unexpected data, while not creating perceptions of a soft budget constraint.

20. With regard to transparency and accountability, a devolved funding system in the context of asymmetric devolution has to build consent, not only in the devolved nations but also in England. There are always temptations to proceed non-transparently in order to achieve short-term objectives, but this could come at a heavy price in terms of legitimacy and sustainability.

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Written submission from the Institute for Chartered Accountants in Scotland (ICAS)

1. The following submission has been prepared by the ICAS Scottish Taxes Committee and the Public Sector Panel.

2. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 22,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.

3. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

Background comments

4. ICAS is grateful for the opportunity to **contribute** its views on the Fiscal Framework, as requested by the Co-Chairs of the Working Group in August 2019.

5. We understand the fiscal framework - 'The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework' - to be an agreement to:
   - Coordinate sustainable fiscal policy within the UK, and
   - enable the practical operation of the legislative provisions in the Scotland Acts.

6. The current fiscal framework was put in place in February 2016, based on the recommendation (paragraph 95) in the Smith Commission[42] report, and elaborated upon in the Command Paper '*Scotland in the United Kingdom: An enduring settlement*[43],' chapter 2.

7. The agreement itself states '…. the two governments have agreed that these arrangements will be reviewed following the UK and Scottish Parliament elections in 2020 and 2021 respectively, allowing an assessment at that time, and in the light of a Parliament's worth of experience, of the best way of achieving a fair, transparent and effective outcome in line with all of the Smith principles.' (paragraph 21[44])

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[42] https://webarchive.nationalarchives.gov.uk/20151202171029/http://www.smith-commission.scot/wpcontent/uploads/2014/11/The_Smith_Commission_Report-1.pdf
[43]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/397560/Scotla nd_Settlement_print_ready.pdf
[44]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal _framework_agreement_25_feb_16_2.pdf

8. Given that the fiscal framework is based on an agreement between the Scottish and UK governments, there should be some scope to revisit it and revise it if this would help the effective operation of the devolved powers.

Future reviews

9. There have been some issues in the initial years with forecasting. A lack of sound data at the outset is in part the consequence of there not having been a need for certain data prior to the Scotland Act 2016 powers being implemented. And it is clear that the forecasting of devolved benefits, especially where they interact with other UK benefits, is at a very early stage and early forecasts can vary significantly from outturn.

10. At the same time, interactions of benefits, tax revenues and expenditure are likely to become more volatile in the early years following EU exit, therefore, it is vital that any revision to the Fiscal Framework is not seen as setting a framework in stone. There should be explicit provisions for either a further review or, preferably, regular reviews for at least the next decade as it may well take this long for all the impacts of devolution of tax and social security, and the effect of EU exit, to be fully worked through and understood.

11. Our summary views in relation to the three questions posed in the request for evidence are noted immediately below. The points are expanded upon further below under the headings discussed in the Annex to the letter calling for evidence.

12. **What are the key risks to the Fiscal Framework?**

- Understanding, or lack of it, amongst the wider population which therefore detracts from transparency and accountability.
- The proposals for VAT assignment which we believe introduce risks into the Scottish budget without any corresponding controls.
- The size and shape of the Scottish income tax base, which is relatively small in relation to the population of Scotland.
- Increasing misalignment between social security and income tax and related responsibilities.

13. **What should the Fiscal Framework Review include?**

- The manner in which the block grant adjustments are made.
- A re-examination of the tax measures, in particular those that are not yet working and why this is so.

14. **Why should the Fiscal Framework Review address those issues?**

- The complexity, and hence lack of understanding, around the fiscal framework and block grant adjustments, which form the underlying framework of the funding package, means that arguably there is a failure to provide clear public accountability – how much funding is in the control of the Scottish Government and what are the factors that influence this? The purpose of the Scotland Act 2016 was to bring greater accountability between the public and the Scottish Parliament, but this is undermined if it's not understood. This should be addressed because otherwise it weakens the devolution settlement.
- Some of the taxes, and in particular VAT assignment, may not be satisfactory. The aim of the Smith Commission was to align a source of tax revenues with the performance of the Scottish economy but, despite much negotiation, a satisfactory methodology has yet to be identified.
- VAT assignment cannot be clearly linked to the Scottish Government's economic policy – and it is a moot point as to whether VAT assignment brings any benefits to either government (UK or Scottish).

Further discussion

15. The points above, that we believe need to be addressed in the Fiscal Framework Review, are expanded upon further below under the headings discussed in the Annex to the letter calling for evidence.

1. Key risks associated with the Fiscal Framework

1.1 Budget volatility – income tax

16. There have clearly been issues around aspects of the forecasting of Scottish income tax, as discussed in the Scottish Parliament's Finance and Constitution Committee report 'Pre-budget scrutiny report'[45]. There seems to be a lack of sound data, as revealed by the differences between the forecast and actual numbers of higher and additional rate taxpayers in Scotland (paragraph 73).

Table 5. Number of Income Taxpayers, 2016/17

	Higher Rate	Additional Rate
SFC May Forecast	308,500	15,500
HMRC Outturn Figure	294,000	13,300

17. Longer term, this volatility should lessen as the processes settle and the data improves. A lack of sound data at the outset is in part the consequence of there not having been a need for certain data prior to

[45] published 7 November 2018 https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutinyreport-2/FCCS052018R12Rev.pdf

the Scotland Act 2016 powers being implemented. Now however, the gaps have been shown up and the relevant data needs to be collected and, if this is done, this should help to reduce budget volatility especially around forecasting income tax revenues.

18. There is also the need for close working across government and its agencies. HMRC's identification of Scottish taxpayers is a basic example of an area where accurate and comprehensive information flow is essential to the Scottish Government. Clearly, the information flow should be barrier-free and mutually recognised as beneficial, to ensure that tax revenues on both sides can be optimised and any potential loopholes identified and resolved expeditiously.

1.1 Budget volatility – VAT

19. The proposals for VAT assignment if implemented will bring volatility, and the volatility will be outwith the Scottish Government's control. This is because the assignment formula is to be based on a regional version of HMRC's VAT Theoretical Tax Liability (VTTL) model – a model used in the HMRC calculations of the tax gap analysis. In our view, it is difficult to see the direct links between the model's components and the Scottish economy and hence any volatility cannot be readily controlled by the Scottish Government.

1.2 Structural Economic and Policy Risks

20. The size and shape of the Scottish income tax base is relatively small in absolute terms and in relation to the population of Scotland, which is a structural risk. The income tax base is smaller than perhaps originally anticipated and there are factors that shape the base that sit with the UK Government. It is not always clear that the latter are adequately considered when UK policy is established, for example, around the personal allowance or other thresholds.

21. The UK Government has direct influence over the amount of Scottish income tax available to the Scottish Government. The personal allowance is set by Westminster and applies to all UK taxpayers, with the effect that a significant proportion of the Scottish population are lifted out of income tax (44.6% in 2019/20[46]), in turn making the Scottish taxpaying base smaller. (It may be that 'tax' is recouped through a 'spill-over' calculation but this would be a less clear, less direct link to Scottish Government decision making.)

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[46] https://www.gov.scot/binaries/content/documents/govscot/publications/factsheet/2018/12/scottish-income-tax-2019-2020/documents/analytical-note-on-impacts-onincome-levels-and-equality/analytical-note-on-impacts-on-income-levels-and-equality/govscot%3Adocument see key findings

22. There are 2.5 million income taxpayers in Scotland and median annual salary is estimated to be £25,000. Furthermore, in 2019/20 7.7% of Scottish adults (351,000 in absolute numbers) were expected to pay higher rate and 16,000 adults (0.3%) the top 46p rate. Taxpayers liable at the higher tax rates may be more mobile than others and thus could potentially cease to be liable to Scottish income tax.

23. There are constraints and challenges in the size, shape and potential mobility of the Scottish income tax base which needs to be factored in when developing tax policy, and these are more limiting than many appreciate.

2. Operation of the Fiscal Framework

2.1 Block Grant Baseline

24. We have no comments on the baseline adjustment.

2.1 2.2 Block Grant Adjustments

25. ICAS members have had an interest in, and input to, the Smith Commission, the Scotland Act 2016, and subsequent ‘Scottish taxes’ work. However, it remains the case that as tax and financial specialists, the block grant adjustments (BGAs) remain a mystery to many.

26. For instance, there is a lack of clarity around the role of BGAs in relation to the Land and Buildings Transaction Tax Additional Dwelling Supplement (ADS). There are commentators who believe that this tax was introduced in Scotland because, without the introduction of a similar tax to that in England, the corresponding BGA would be such that there would be a reduction in the block grant – ADS was essential to replace this reduction. This cannot be right – it negates the ability to implement a separate tax policy in Scotland. And it demonstrates that either the BGA is wrong in principle or that there is great confusion over it.

2.3 Implementation Costs

27. We have no comments on this section.

3. Powers yet to be implemented – VAT

28. The Smith Commission led to the Scotland Act 2016, and section 16[47] provides the legislative requirements for VAT assignment: so 10p in the standard rate and also the first 2.5p of the reduced rate, of VAT is to be assigned to the Scottish Government. The methodology identifying the

[47] http://www.legislation.gov.uk/ukpga/2016/11/section/16/enacted

amount to be assigned was to be agreed by the Treasury and the Scottish Ministers, and the principles of this are laid out in the Fiscal Framework.

29. The problems come in finding a methodology.

30. The power to set VAT rates remains reserved to the UK Government (and will do as long as the UK is in the EU). As such, the Scottish and UK Governments have agreed that requiring businesses to report their VAT separately for Scotland and the UK would impose an unwanted administrative burden (and ICAS agrees with this analysis), and have agreed that VAT raised in Scotland will instead be estimated.

31. The Scottish Government is working with HMRC and HM Treasury to produce a model of VAT liabilities in Scotland. This consists of producing a regional version of HMRC's VAT Theoretical Tax Liability (VTTL) model – a model used in the HMRC calculations of the tax gap analysis.

32. The proposed model is based on a VAT total theoretical liability, which is the total value of VAT that could be theoretically collected from the tax base across various sectors.

33. There are a number of risks attaching to this model:
    - the proposed methodology relies heavily upon survey data, particularly the Living Costs and Food Survey
    - the proposed sample is small – 360 households in Scotland – and not known if this is across the income spectrum
    - there may be areas where the underlying economy in Scotland differs from the rest of the UK, such as
        - household spending models – there may be a higher proportion of zero rate/low income households
        - impact of tourism/hospitality sector ○ impact of financial services sector.

34. With this type of model, one cannot produce actual outturn data and if the model does not properly reflect 'Scottish VAT', there is no means of checking this – it is what it is!

35. It should be noted however, that ICAS members in their capacity as both agents and businesses do not want any extra burdens around VAT collection.

VAT - Post Brexit

36. As EU law limits a Member State to a single scheme of VAT rates which cannot be varied regionally, Scotland cannot currently set its own

VAT rates. Therefore, the opportunity for, and impact of, devolution of VAT to date is strictly limited.

37. Some argue[48] that devolution of VAT delivers accountability and is related to the performance of the economy. Others are concerned[49] that the UK single market will be damaged if powers to change VAT rules are devolved, and this in turn could damage the Scottish economy. Post Brexit, we would call for further work to inform any decision making, before considering whether VAT should be devolved. Further devolution would not necessarily be the remedy to the problems of VAT assignment.

4. Process improvements

38. From 6 April 2018, Scottish income tax rates and bands diverged from UK rates and bands for the first time. This divergence has implications for tax reliefs available in two policy areas:
    - Gift Aid whereby charities can increase the value of donations received from UK taxpayers by 25% based on the UK basic rate of tax
    - Pensions tax relief whereby pension savers receive tax relief on pension contributions at their marginal rate of tax

39. In relation to charitable donations the challenges are somewhat in abeyance for the time being, as the UK Government's position is that charities should reclaim Gift Aid at the UK basic rate. There is a theoretical risk at the margins as someone paying tax at the starter rate may not have paid enough tax to cover a Gift Aid claim made on their donation at the UK basic rate.

40. HMRC had to issue a Newsletter setting out how pensions tax relief would operate to address the impact of differences between Scottish income tax and UK income tax rates and bands, including on the following key matters.

    - Starter Rate taxpayers. Taxpayers whose earnings fall into the starter rate band and go no higher will pay income tax at 19% on their earnings but the payments they make into a pension scheme will be eligible for tax relief at 20%. Even though more tax relief is given than has been paid, HMRC will not be clawing this back from the taxpayer or pension provider.
    - Tax Relief at Source Arrangements. Pension scheme operators have been advised by HMRC to continue to claim 20% tax relief on any tax relief at source pension payments which are

[48] See paper by Reform Scotland issued in April 2018
https://reformscotland.com/wpcontent/uploads/2018/04/The-VAT-opportunity.pdf
[49] See comments from the Scottish Retail Consortium
https://www.insider.co.uk/news/retailing-group-rejectscall-vat-12372849

made by starter rate taxpayer scheme members. HMRC will not recover the 1% difference and the Scottish Government will bear the cost of this additional tax relief.

- Intermediate, Higher Rate and Top Rate Taxpayers. Tax relief will be given at 20% in tax relief at source arrangements (see below) and the additional 1%, 21% and 26% tax relief can be claimed under Self-Assessment if the taxpayer is already within the Self-Assessment regime. However, if the taxpayer is not already within Self-Assessment, there is no need for them to register for Self-Assessment just to claim the additional tax relief. The taxpayer can simply contact HMRC directly and claim the relief. ICAS has a concern that pension savers will miss out on the full tax relief they are entitled to unless they are in Self-Assessment. This is because it is difficult to conceive of a communications strategy which would be capable of alerting non-Self-Assessment taxpayers that they need to contact HMRC. In all likelihood, most will have no idea what a relief at source arrangement is.

41. The above points illustrate the need for new guidance (i.e. HMRC Newsletters) and processes to be introduced to manage the impact of diverging income tax regimes in the different jurisdictions within the UK.

42. To date, pragmatic approaches have been taken and these represent a trade-off between delivering the objectives of a particular UK policy and managing the complexities arising from the exercise of devolved income tax powers.

43. We discuss this further in the paper 'Devolving Taxes Across the UK: Learning from the Scottish Experience' published by the Scottish Taxes Policy Forum (October 2018), a joint collaboration by ICAS and the CIOT.

4.1 Policy spillovers and dispute resolution

44. If block grant adjustments cause confusion, so too do the notion of ‘spillovers’ and their calculation will not be straight forward.

4.2 Transparency and Accountability

45. Devolution has introduced new opportunities, but also new complexities, with many moving parts to manage – with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions. It is complicated and anecdotal feedback, and experience when presenting to ICAS members and others, suggests that the various component parts are not well understood.

46. The topic least understood is the block grant adjustments.

47. Understanding, or lack of it, amongst the wider population therefore detracts from transparency and accountability.

48. Easy access to high quality, transparent, complete and understandable information is an essential tool to enhance accountability, scrutiny and to support effective decision making on public finances. This is increasingly important in the context of devolved powers and increasing volatility of revenue.

49. The GERS publication is a useful official source of financial information which is used by various stakeholders to inform analysis. It forms part of a broader suite of financial information used by stakeholders supporting analysis across a range of areas such as the economy, performance and financial sustainability. This broader suite is informed by a combination of statistical, accounting, budgetary and forecasting information. A clear explanation of how this all fits together would be helpful to the wider public.

5. Capital Borrowing

50. We have no specific comments on this at present.

6. Any other issues

National insurance

51. For some years the upper NIC threshold has been tied to the rest of the UK income tax higher rate threshold.

52. It is a matter that goes virtually unnoticed but in the rest of the UK if the 20% band is extended, so is NIC at 12%; less income tax may be collected, whilst more NIC is payable.

53. In relation to the Scottish revenues that means more will be collected through NIC by the UK government, whilst less income tax is collected in Scotland. At the same time, Scottish income tax is meant to pay for health and social care, and, increasingly social welfare benefits. There is a mismatch here.

5. Communications

54. It is incumbent on all parties to seek to explain and communicate the devolution settlement and its constituent parts so that citizens can hold decision makers to account. We understand that the Scottish Government fiscal division has implemented a project to support this; we support this work.

Written submission from the Joseph Rowntree Foundation

This contribution from the Joseph Rowntree Foundation draws attention to what we believe are the unintended consequences of the “no detriment” principal with relation to actions taken by the Scottish Government that could increase take-up for reserved benefits.

It is our understanding that the principal of no detriment was to allow some security over the implications of changes to the eligibility or generosity of devolved benefits that may raise the demand for reserved benefits.

However there appears to be a belief that this applies to take-up as well as demand. That is, if Scottish Government takes out an action that encourages more people to take-up reserved benefits then some are implying that the Scottish Government should compensate the UK Government.

This was most recently seen in evidence exchanges at the Scottish Parliament’s Social Security committee (official report available here: http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12239&mode=pdf)

The relevant text of the fiscal framework is copied below:

44. The Smith Commission stated that there should be no detriment as a result of *UK government or Scottish Government policy decisions post-devolution.*

45. Specifically, where either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.

46. These financial consequences of policy decisions have been termed policy spillover effects.

47. The main categories of these can be divided into:
Direct effects – these are the financial effects that will directly and mechanically exist as a result of the policy change (before any associated change in behaviours); and Behavioural effects – these are the financial effects that result from people changing behaviour following a policy change.

48. Other indirect or second-round effects may also arise from policy changes, and the Governments have agreed that the financial consequences of these should not be included in the scope of the “no detriment” principle. This is because of the difficulty in demonstrating and agreeing both causality and the scale of any financial impact.

49. The UK and Scottish Governments have agreed to account for all direct effects.

50. Behavioural effects that involve a material and demonstrable welfare cost or saving will be taken into account where these are in exceptional circumstances. Behavioural effects that impact tax revenues can be taken into account where, in exceptional circumstances, they are demonstrated to be material and both governments agree that it is appropriate to do so.

51. Assessment of causality and of the scale of any financial impacts will be based on and supported by a shared understanding of the evidence.

The above is copied from:
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf

There is currently uncertainty over how, for example, a new campaign to encourage take-up of Universal Credit, would fit within the principles in the fiscal framework.
This is notwithstanding the fact that there is currently little evidence on take-up rates of reserved benefits in Scotland and hence proof of financial effects would not be possible.

It is also difficult to understand how the principal of “no detriment” can apply when such action by the Scottish Government would be helping the UK Government to meet its policy aim of providing support to eligible groups.

Regardless of the principle, the mechanism for resolving ambiguity of this type, which appears to be leading to hesitation from Scottish Ministers in pursuing policies that will help people on low incomes claim what they are entitled to, should be covered in the review.

Written submission from Dr Ed Gareth Poole, Guto Ifan and Cian Siôn

Executive Summary

- Elements of the Welsh fiscal framework agreement may well be used as a precedent for the re-negotiation of the Scottish fiscal framework. This evidence submission therefore analyses the key differences between both fiscal frameworks, to outline what may be 'on the table' during the Scottish review and renegotiation. Assessing the strengths and weaknesses of both fiscal frameworks should be an important part of reviewing the Scottish Fiscal Framework.
- The IPC method for determining Scottish BGAs currently insulates the Scottish Government from revenue risks associated with a slower-growing population, while the CM used for Wales' BGA does not.
- The Welsh fiscal framework agreement created separate BGAs for each band of income tax (i.e. the basic, higher and additional rate), in order to better reflect the distributional differences in the Welsh tax base compared to E&NI. This protects the Welsh Government from UK-wide factors which disproportionately affect one part of the income distribution.
- Concerns have been raised that the current Scottish fiscal framework does not reflect differences in the structure of the Scottish economy and tax base. The Welsh agreement may provide a basis for introducing a similar adjustment to better reflect the likely trends in the Scottish tax base and the ability (or lack thereof) of the Scottish Government to influence them.
- The Welsh fiscal framework agreement also introduced the first major reform of the Barnett formula since its introduction in the late 1970s. This may have implications for the Scottish fiscal framework review process, if block grant funding arrangements also come under review as a result of social security devolution and the potential EU replacement funding.
- Relative to the respective size of devolved budgets and the amount of tax revenues devolved, the Scottish Government's budget management tools and borrowing limits appear somewhat more restrictive than in the case of the Welsh Government. This should clearly be a consideration for the fiscal framework Review, especially given the increased possibility for forecast error volatility from separate forecasts being produced for devolved revenues and the BGAs in Scotland.
- The capital borrowing powers of the Scottish and Welsh governments were initially linked to the devolution of tax revenues, creating an independent revenue stream for repayment. Relative to the amount of tax revenues devolved, the Scottish Government has a lower capital borrowing limit compared to the Welsh Government. This may be a subject for the Review, especially given the change in UK government fiscal policy since the time of George Osborne's UK-wide strict fiscal rule, which was in place during the Scottish fiscal framework negotiations.

Scottish Fiscal Framework Working Group – written evidence submission

29 SEPTEMBER 2019

1. Introduction

1.1 The funding arrangements for the three devolved countries of the UK have become increasingly asymmetric, reflecting the ad-hoc way in which devolved public finances are being reformed. There are now significant differences in the scale and composition of devolved and reserved taxes across each country; in how their block grants are determined, allocated and adjusted over time; and in the borrowing and budget management capacity of each devolved government.

1.2 The exact scope of the review of the Scottish Fiscal Framework remains uncertain, so too the political context in which it will take place. Methods of adjusting the Scottish Block Grant and borrowing limits will certainly be considered. It may also prove difficult to disentangle these 'narrow' considerations from broader issues, such as the replacement of EU funding and the further devolution of taxation and spending powers.[50] It may also trigger a wider discussion around how devolved governments are funded across the UK.

1.3 The Scottish Fiscal Framework Agreement of February 2016 provided context and precedent to the Welsh fiscal framework negotiations later that year, though the eventual agreements diverged considerably in terms of block grant funding arrangements. Elements of the Welsh settlement may well be used as a precedent for the re-negotiation of the Scottish fiscal framework. This evidence submission therefore analyses the key differences between both fiscal frameworks, to outline what may possibly be 'on the table' during the Scottish review and renegotiation. Assessing the strengths and weaknesses of both fiscal frameworks should be an important part of reviewing the Scottish Fiscal Framework, as well as for the coherence of devolved funding arrangements across the UK.

2. Background: tax devolution in Scotland and Wales

2.1 In 2008, the Independent Commission on Funding and Finance for Wales (also known as the Holtham Commission) was established by the Welsh Government to examine Welsh funding arrangements and the scope for tax varying powers for

[50] Eiser, D. and Roy, G. (2019) The Fiscal Framework: 2021 Review, *Fraser of Allander Economic Commentary*, April 2019.

Wales. It recommended the introduction of a needs-based formula for determining the Welsh block grant, alongside significant tax devolution. Following the 2010 UK General Election, the Coalition Government made a commitment that a process similar to the Calman Commission in Scotland would be established for Wales, resulting in the Commission on Devolution in Wales (also known as the Silk Commission). Its recommendations for fiscal devolution — closely resembling the powers contained in the Scotland Act 2012 — formed the basis for the Wales Act 2014. A requirement for a referendum to be held before the partial devolution of income tax was dropped by the UK government in November 2015.

2.2 The tax devolution measures implemented in Wales over recent years therefore include:

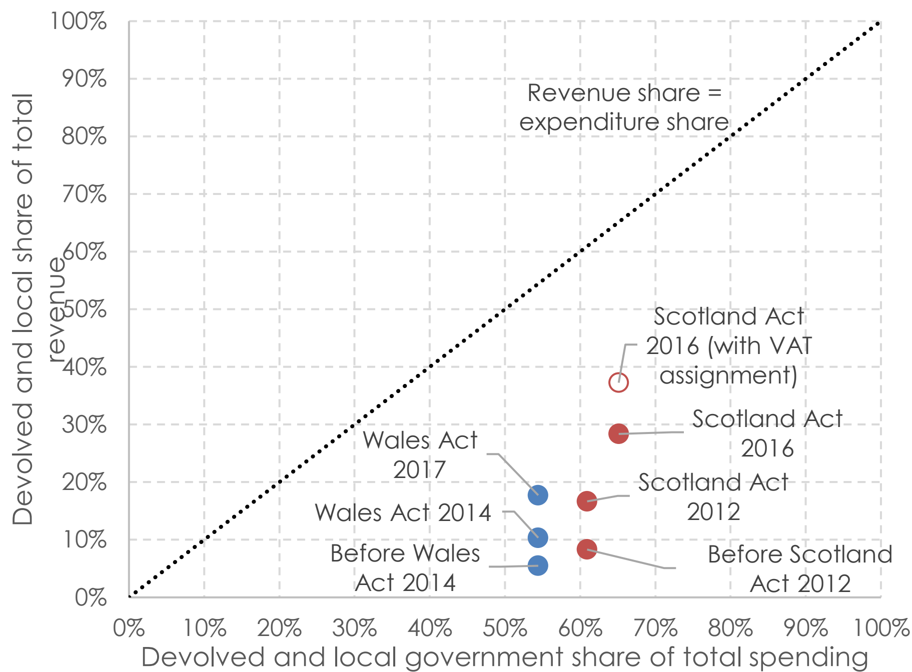
- Full devolution of non-domestic rates from April 2015 (Wales Act 2014)
- Stamp Duty Land Tax replaced by the Land Transaction Tax from April 2018 (Wales Act 2014)
- Landfill Tax replaced by the Landfill Disposals Tax from April 2018 (Wales Act 2014)
- 10p of the UK government's income tax in each band replaced by the Welsh Rates of Income Tax (WRIT) from April 2019 (Wales Act 2017)

One important difference from the Scottish Rates of Income Tax (SRIT) powers is the absence of the so-called 'lock-step' – the Welsh Government will be able to change each rate of income tax separately by any amount.

2.3 Of course, the Smith Commission report and the resultant Scotland Act 2016 devolved significantly greater taxation powers to the Scottish Government, most significantly the full devolution of the NSND income tax base to Scotland. **Figure 2.1** summarises the movements in the shares of total revenue and spending under devolved and local control for Wales and Scotland over time. Ironically, the longest-lasting legacy of the Calman Comission proposals will be on the Welsh rather than Scottish fiscal framework.

Figure 2.1

Devolved and local government share of total revenue and expenditure, Wales (2017-18) and Scotland (2018-19)



Source: Scottish Government (2019) Government Expenditure and Revenue Scotland; Ifan, Sion and Poole (2019) GERW 2019

3. Differences in Block Grant Adjustment methods and fiscal risks borne by Scottish and Welsh Governments

Comparable method v Indexed Per Capita

3.1 For both Wales and Scotland, the initial baseline adjustment for devolved taxes matched revenues foregone by the UK government at the point of devolution. Subsequent changes to the block grant adjustment (BGA) are similarly being determined by **changes in comparable UK government taxes in England and Northern Ireland (E&NI).** However, the exact methods for determining BGAs differ.

3.2 In the Welsh case, changes to the BGA are determined by a *tax-capacity adjusted population share of the change in equivalent UK government revenues in E&NI.* This is the so-called Comparable Method (CM), captured by the following equation:

Cash change in equivalent UK government tax in E&NI	X	**Comparability factor**	X	**Population ratio**

The 'comparability factor' reflects the level of revenues per person in Wales as a proportion of comparable revenues per person in E&NI.

3.3 This contrasts with the *Indexed Per Capita* (IPC), which currently determines the Scottish BGAs. The key difference with this approach is that it insulates the Scottish Government from revenue risks associated with a slower-growing population, by indexing the BGA to growth in revenues per head in the rest of the UK. As in the case of the Scottish population, the Welsh population has also been growing - and is projected to grow - at a slower than the UK population. The Scottish Government (2019) notes that BGAs determined by CM would grow substantially quicker than BGAs determined by the IPC approach. The difference between the two methods is projected to amount to £82 million a year in 2019-20 and £211 million a year by 2023-24.

3.4 The key argument in favour of reflecting population growth was that a devolved government had insufficient policy levers to address population-based risk.

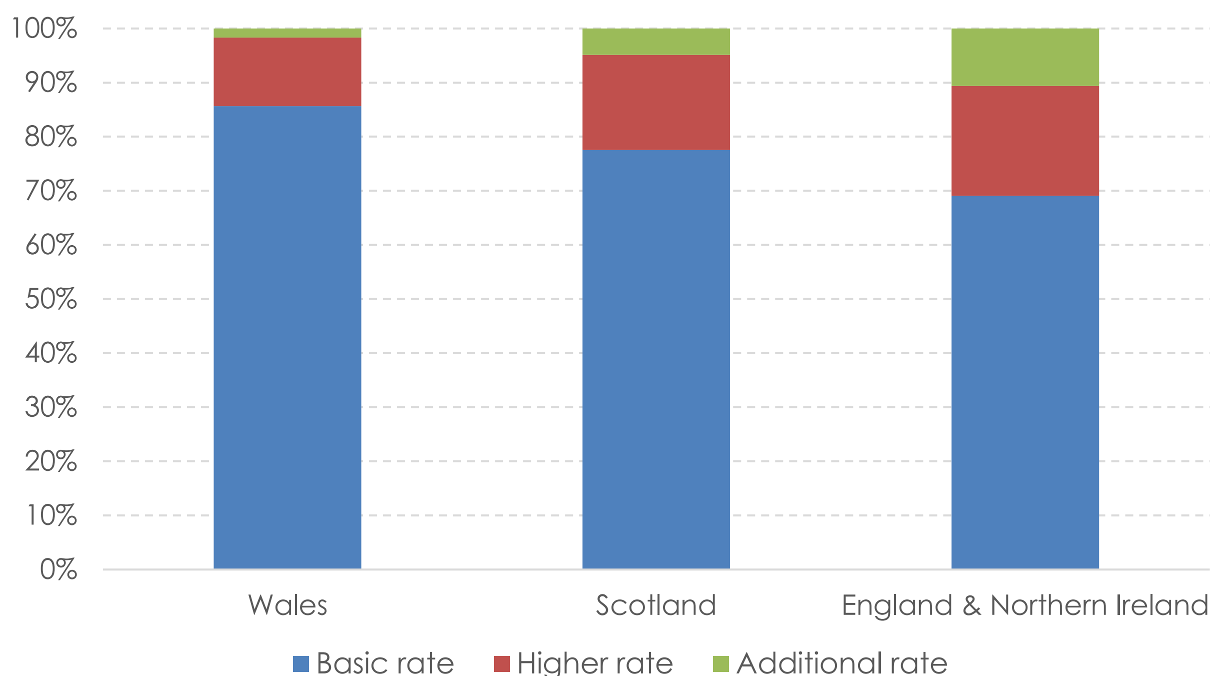
3.5 The Welsh fiscal framework agreement stated that the CM delivers **consistent treatment of population change** on both the expenditure and revenue side, and that "any impacts of differential growth will offset within the Welsh Government's funding". However, the effect of differential population growth will not be totally symmetric on the expenditure and revenues side. The 'bonus' from slower population growth on the expenditure side is dependent on the rate of growth in comparable expenditure in England.

3.6 It is useful to consider why the Welsh Government decided to accept the population-based risk, whereas the Scottish Government refused. Firstly, the more limited extent of tax devolution left the Welsh Government relatively less exposed to population-based risk in absolute terms. Secondly, the Welsh fiscal framework agreement recognised differences in Wales' income tax base (discussed below). Thirdly, the agreement also fulfilled a long-standing demand for reform of the Barnett formula in Wales (discussed in the next section).

Reflecting tax base differences

3.7 An important departure from Scottish fiscal framework agreement for Wales was the creation of **separate BGAs for each band of income tax** (i.e. the basic, higher and additional rates). This was to reflect the significant differences in the Welsh tax base compared with the rest of the UK. As shown in **Figure 3.1**, because of lower levels of taxpayer incomes in Wales, a much greater share of Welsh taxable income is earned at the basic rate of income tax, compared with E&NI. The Scottish tax base is also different from E&NI, though to a lesser degree. It should be noted that the chart is based on the 2015-16 Survey of Personal Incomes (SPI) data, which overestimated revenues from Scotland compared with actual outturn figures, especially for the incomes of higher earners. The actual differences in the Scottish tax base compared with E&NI could therefore be greater than shown in **Figure 3.1**.

Figure 3.1
Taxable non-savings non-dividend (NSND) income by income tax band, 2015-16



Source: HMRC (2018) Survey of Personal Incomes Public Use Tapes and authors' calculations

3.8 The three BGAs insulate the Welsh Government from UK-wide factors which disproportionately affect one part of the income distribution. For example, the rapid increases in the personal allowance significantly reduced taxable income at the basic rate, resulting in a much more pronounced impact on total Welsh revenues than in the rest of the UK. Conversely, the much greater share of taxable income earned at the additional rate in the rest of the UK means that UK-wide factors which influence very high incomes will have a much greater impact on total revenues in the rest of the UK than is true for Wales. Although it is too early to conclude definitively, the separate BGAs for each band may protect the Welsh Government from the recent growth in income tax from the very highest earners across the UK. In March, the OBR (2019) noted that the incomes of the top 0.1% grew by nearly 6%.

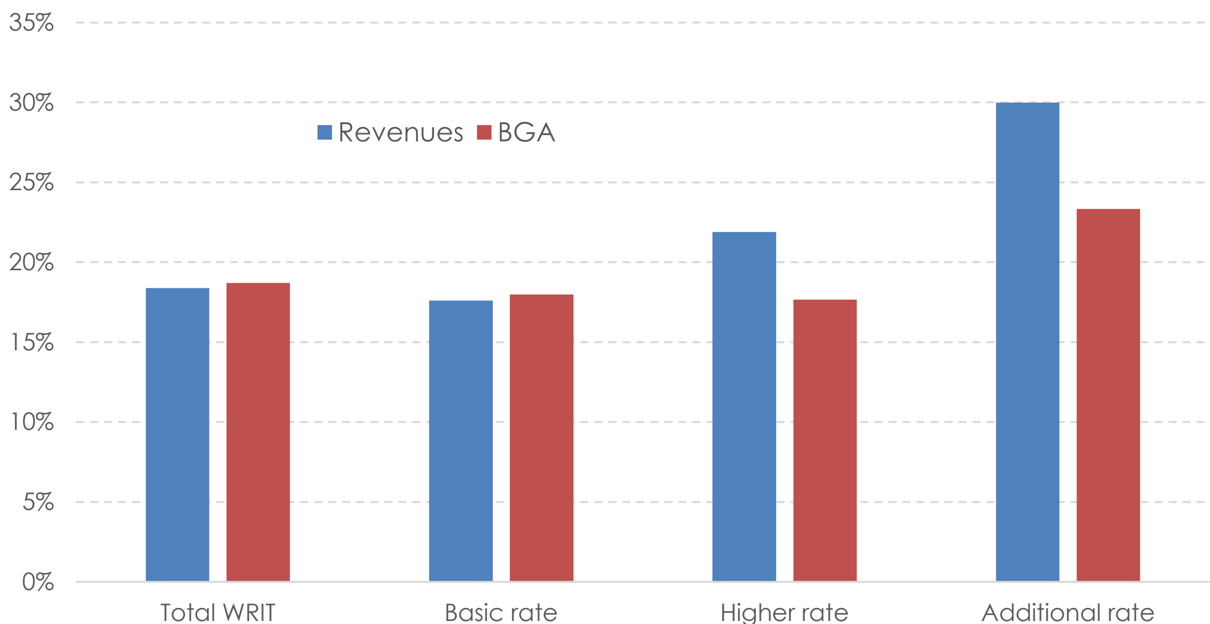
3.9 Current forecasts (produced by the OBR in March 2019) suggest tax devolution will have a small but positive effect on the Welsh budget over the five years to 2023-24. The largest effect comes from the smallest tax – LDT in the first year of devolution was significantly higher than previously collected. The separation of the BGAs for each band is projected to have a slight positive effect on the Welsh budget. Total WRIT revenues are forecast to grow at a slightly slower rate than comparable revenues in E&NI, reflecting Wales slower growing population. However, as shown in **Figure 3.2**, the Welsh income tax base at the higher and additional rates are

forecast to grow slightly faster than comparable revenues in E&NI, meaning WRIT revenues are expected to grow slightly faster than the sum of the three BGAs.

3.10 It should be noted that a similar adjustment was not made in the case of Stamp Duty Land Tax, even though there exists a similar (or an even greater) disparity in the property tax base in Wales compared with E&NI.

Figure 3.2

Forecast total change in WRIT revenues and BGAs by band (nominal terms), 2019-20 to 2023-24



Source: HMRC (2018) Survey of Personal Incomes Public Use Tapes and authors' calculations

3.11 The aim of introducing separate BGAs for each income tax band was to increase the likelihood that growth in the BGA matched the trends in Welsh revenues in a hypothetical (and unknowable) scenario where the revenues had not been devolved, in other words, the revenues foregone by the UK government. The key consideration was to protect the Welsh Government from revenue risks outside its control. Of particular concern was the recent significant increases to the personal allowance by the UK government, and separating the BGAs for each band of income tax would be a way of dealing with such decisions in an "mechanical" way, rather than through a dispute resolution process.

3.12 Since the implementation of the Scottish fiscal framework, concerns have been raised that the current methodology does not reflect differences in the structure of the Scottish economy and the tax base, which may lead to permanent divergences between Scottish tax revenues and the BGA. This may raise the prospect of introducing similar adjustments to the Scottish BGA method, for the BGA to better

reflect the likely trends in the Scottish tax base and the ability (or lack thereof) of the Scottish Government to influence them.

3.13 **Figure 3.1** shows that there are distributional differences in the Scottish tax base compared with E&NI. Scottish Finance Secretary Derek Mackay recently noted that increases to the Personal Allowance "has reduced the number of Basic Rate taxpayers in Scotland by a greater degree than across the rest of the UK", but the Scottish Government had not received compensatory funding as a result of the UK policy decision.[51] Changing the BGA method to account for distributional differences may be an 'automatic' way of compensating for such changes in UK government policy, as is the case in Wales' fiscal framework.

3.14 Perhaps a more significant difference for Scotland is the much greater importance of incomes earned in the oil and gas industry. Furthermore, although IPC method accounts for population growth risks, it does not account for structural shifts in demographics such as a population ageing more quickly than the rest of the UK. This may impact the relative growth in per person revenues though largely outside the control of a devolved government. Tax devolution and the BGA mechanism also makes the *relative* economic and fiscal impact of Brexit on the devolved countries compared with the UK as a whole an important consideration, though the likely spatial effects of Brexit are highly uncertain.

3.15 Although meaningful tax devolution will inevitably have fiscal consequences, the Scottish Government is currently exposed to fiscal risks outside its control. One of the Smith Commission principles was that the funding framework "should not require frequent ongoing negotiation". The separation of BGA for each band of income tax provides an example of the UK government agreeing to a **mechanical** way of reducing risks for the Welsh Government. Whether such an adjustment could be made to the Scottish fiscal framework to reduce Scottish Government exposure to fiscal risks should be a consideration of the review.

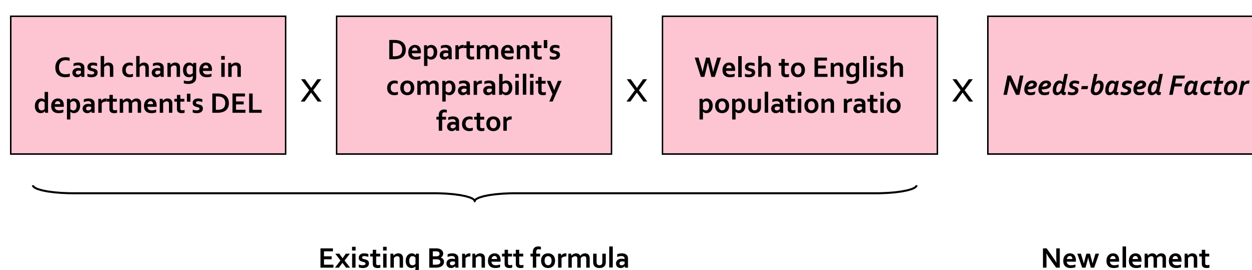
3.16 The choice of BGA method also has implications for budget management and borrowing arrangements (discussed in section 5). The closer the likelihood of the BGA 'automatically' matching the trends in devolved revenues, the lesser the need for tools to smooth asymmetric shocks to revenues. However, it should be noted that introducing more complexity to the BGA method may have an affect forecast errors.

[51] See: https://www.gov.scot/news/scottish-income-tax-revenues-grew-by-1-8-percent-in-2017-18/

4. Barnett reform – the 'needs-based factor'

4.1 The Welsh fiscal framework agreement also introduced the first major reform of the Barnett formula since its introduction in the late 1970s, which was a key reason as to why the Welsh Government accepted the deal.

4.2 The needs-based factor means that increments to the Welsh block grant triggered by the spending in England are larger than was previously the case. This was introduced to counter the so-called "Barnett squeeze", or the convergence in the level of funding per person in Wales to England's level. Changes to the Welsh Government's block grant will now be calculated as a product of the following calculation for every UK government department:



The agreement states that the **needs-based factor will be set at 115%,** based on the "range recommended by the Holtham Commission and the 'funding floor' implemented at the Spending Review 2015. However, the needs-based factor will actually **be set at 105% for a "transitional period"**. The factor will be increased to 115% only at the point at which relative Welsh funding per person converges to below 115% of the level in England. This transitional period described in the agreement could feasibly last for decades, depending on the rate of growth in comparable spending and the relative growth in population.[52]

4.3 The Welsh fiscal framework agreement set out an agreed methodology for measuring relative levels of spending. It dodged the issue of revisiting or updating the original measure of the level of 'need'. The immediate level chosen for any needs-based factor was effectively a zero-sum bargain between the Welsh and UK governments over who gets what slice of the pie.

4.4 The introduction of the needs-based factor has provided the Welsh Government with an additional £70 million for its 2019-20 draft budget. Faster growth in public spending in England will increase the Barnett *consequentials* and the value of the extra 5% to the Welsh budget.

[52] Ed Poole, Guto Ifan, and David Phillips, Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement (Cardiff: Wales Governance Centre, 2017), 14.

4.5 The reform of the Barnett formula in Wales may have some implications for the Scottish fiscal framework review. The increased spending powers of the Scottish Government following the devolution of social security and potentially EU replacement funding means the spending side of funding arrangements may also be considered by the fiscal framework review. Financially, accepting CM for the BGA method may be an option for the Scottish Government if a similar *comparability factor* on the spending side was introduced for some programmes to reflect higher initial levels of spending per person in Scotland.

5. Budget management and borrowing

Budget management tools and resource borrowing powers

5.1 Both the Scottish (2016) and Welsh (2017) Fiscal Framework agreements provided the devolved administrations with additional budget management and resource borrowing tools to cope with volatility in devolved revenues, tax forecast errors and in Scotland's case, forecast errors for certain social security benefits.

5.2 The substantial reconciliations facing the Scottish Budget in 2020-21 highlights the important role that forecasters play in the budget-setting process. The Scottish Fiscal Framework agreement stipulates that the Scottish Fiscal Commission is responsible for generating macroeconomic forecast for Scotland, including devolved tax revenues. However, tax revenue forecasts for rUK, used to calculate the block grant adjustment, are produced by the Office for Budget Responsibility (OBR).

5.3 Even if both forecasters produce their forecasts independently, in the long term, one would expect errors to be positively correlated as they rely on similar data. Positively correlated errors reduce the scope for revenue volatility; if the OBR and Scottish Fiscal Commission are both overly optimistic or overly myopic about revenue growth, lower than expected devolved revenues would be offset, at least in part, by a smaller block grant adjustment, and vice versa.

5.4 However, having two different forecasters involved in calculating the net block grant adjustment may increase the frequency of in-year negatively correlated errors. Suppose that the Scottish Fiscal Commission overestimates Scottish tax revenue and the OBR underestimates growth in rUK tax revenue. This negative correlation between forecast errors would result in lower than expected devolved tax revenues and a larger than expected block grant adjustment – a "double whammy" for the Scottish Budget. Alternatively, if the Scottish Fiscal Commission underestimates Scottish tax revenue and the OBR overestimates growth in rUK revenue, this negative correlation between forecast errors would result in higher

than expected devolved tax revenues and a smaller than expected block grant adjustment, boosting the Scottish budget.

5.5 In the long term, one would expect an equal amount of negatively correlated forecast errors in either direction. However, given the limits on borrowing and how much can be drawn down from the Scottish Reserve, the Scottish Government's suite of budget management tools may not be sufficient to wholly mitigate the effects of these negatively correlated forecast errors on the Scottish Budget, leading to increased revenue volatility.

5.6 The framework agreed with the Welsh Government stipulates that the OBR is responsible for forecasting devolved revenues as well as growth in rUK revenues. Since both forecasts are produced using similar models, this increases the likelihood of positively correlated errors and reduces the frequency and likelihood of negatively correlated forecast errors in any given year.

5.7 The Welsh fiscal framework agreement includes a provision to eventually put in place alternative independent forecasting arrangements, if the Welsh Government wishes to do so.

5.8 Figure 4.1 summarise the caps and draw-down limits for the Welsh and Scottish Reserves, as agreed in the most recent fiscal framework negotiations. The Scottish Government's limits are smaller, proportionate to devolved revenues, when compared to Wales.

Figure 4.1

Caps and limits on reserves and resource borrowing, 2018-19[53]

	Scottish Government	Welsh Government
Reserves		
Reserves Cap	**£700 m**	**£350 m**
% of devolved administration's budget	*2.1%*	*1.9%*
% of devolved revenue (excl. non-domestic rate)	*5.7%*	*14.8%*
% of devolved revenue (incl. non-domestic rate)	*4.7%*	*10.3%*
Annual draw-down limit for resource spending	**£250 m**	**£125 m**
% of devolved administration's resource budget	*0.9%*	*0.8%*
% of devolved revenue (excl. non-domestic rate)	*2.1%*	*5.3%*
% of devolved revenue (incl. non-domestic rate)	*1.7%*	*3.7%*

[53] Devolved revenue figures used in calculations exclude Council Tax. Wales' revenue figures for the 2018-19 financial year are based on projections presented in *Government Expenditure and Revenue Wales (2019)*. It is assumed that Welsh Rates of Income Tax had been devolved in 2018-19, using OBR estimates for this year. Total resource and capital financing figures sourced form Scottish Government (2018-19) *Draft Budget*, and Welsh Government (2018-19) *Second Supplementary Budget*.

Annual draw-down limit for capital spending	**£100 m**	**£50 m**
% of devolved administration's capital budget	*2.3%*	*1.8%*
Borrowing		
Annual limit for forecast errors	**£300 m**	**£200 m**
% of devolved revenue (excl. NDR)	*2.5%*	*8.5%*
% of devolved revenue (incl. NDR)	*2.0%*	*5.9%*
Annual limit for in-year cash management	**£500 m**	**N/A**
Annual limit for 'Scotland-specific economic shock'	**£600 m**	**N/A**

Source: Scottish Government (2019) Government Expenditure and Revenue Scotland; Wales Fiscal Analysis (2019) Government Expenditure and Revenue Wales and authors' calculations.

5.9 There are also differences in the resource borrowing powers of both governments. The Welsh Government's resource borrowing powers are limited to dealing with forecast errors. However, relative to the amount of revenues devolved, the £200 million limit for Wales is substantially greater than the forecast-error-related limit agreed for Scotland. It is worth noting that unlike Scotland, the Welsh fiscal framework agreement has no provision for borrowing for cash-management purposes, or in the event of a Welsh-specific economic shock. If it is forecast that devolved Welsh revenues will be subject to a temporary fall relative to revenues in England and Northern Ireland, the Welsh Government will only be able to use its reserves (and not its borrowing powers) to mitigate this. This implies that paying into the reserve is relatively more important for Wales.[54]

Capital borrowing powers

5.10 The 2016 fiscal framework agreement increased the Scottish Government's statutory limit for capital borrowing from £2.2 billion to £3.0 billion. This was a relatively modest increase, especially given that the Smith Commission had suggested a prudential system for managing capital borrowing.[55] Under this system, the Scottish Government would, in effect, set its capital borrowing limit based on the affordability of repayments.

Figure 4.2

[54] Ed Poole, Guto Ifan, and David Phillips, *Fair Funding for Taxing Times? Assessing the Fiscal Framework Agreement* (Cardiff: Wales Governance Centre, 2017), 21.
[55] David Bell, David Eiser, and David Phillips, *Scotland's Fiscal Framework: Assessing the Agreement* (London: Institute for Fiscal Studies, 2016), 42.

Annual capital borrowing limits for the Scottish and Welsh governments, 2018-19[56]

	Scottish Government	Welsh Government
Statutory limit for capital borrowing	£3,000 m	£1,000 m
Annual capital borrowing limit	£450 m	£150 m
Annual draw-down limit for capital spending	£100 m	£50 m
Total annual capital borrowing and capital draw-down limit	**£550 m**	**£200 m**
% of devolved revenue (excl. non-domestic rates)	*4.5%*	*8.5%*
% of devolved revenue (incl. non-domestic rates)	*3.7%*	*5.9%*

Source: Scottish Government (2019) Government Expenditure and Revenue Scotland; Wales Fiscal Analysis (2019) Government Expenditure and Revenue Wales and authors' calculations.

5.11 Relative to its devolved revenue, the Scottish Government's has a *lower* capital borrowing limit compared to the Welsh Government. Excluding non-domestic rates revenue, the most the Scottish Government can borrow and draw-down in a year to finance capital expenditure is £550m (4.5% of devolved revenue). This compares with 8.5% of devolved revenue for the Welsh Government (**Figure 4.2**).

5.12 The differences in capital borrowing limits relative to devolved revenues may partly reflect the timing of the fiscal framework agreements. The Scottish Fiscal Framework negotiations took place in the context of George Osborne's UK-wide strict fiscal rule, while the Welsh negotiations took place in the context of Phillip Hammond's looser 'fiscal mandate'.[57]

5.13 There is some indication to suggest that the UK government may be willing to exercise a degree of flexibility with regards to the capital borrowing limit, particularly if the additional finance is earmarked for a preferred project. The UK government has previously expressed its willingness to increase Wales' statutory limit for capital borrowing by an additional £300 million provided that the Welsh Government committed to using the funds to finance the building of an M4 relief road.[58] This proposal has since been shelved by Wales' First Minister and the statutory limit for capital borrowing remains unchanged.

[56] Devolved revenue figures used in calculations exclude Council Tax. Wales' revenue figures for the 2018-19 financial year are based on projections presented in *Government Expenditure and Revenue Wales (2019)*. It is assumed that Welsh Rates of Income Tax had been devolved in 2018-19, using OBR estimates for this year.
[57] Poole, Ifan, and Phillips, *Fair Funding for Taxing Times?*, 20.
[58] https://www.walesonline.co.uk/business/business-news/300m-m4-relief-road-use-15763020