

# Scotland's Fiscal Framework: Assessing the agreement

## Executive Summary

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The Smith Commission Agreement, published on 27 November 2014, set out proposals for the devolution of new tax and welfare powers to the Scottish Parliament which will soon be enshrined in law when the Scotland Bill 2015–16 receives Royal Assent.

These new revenue and spending responsibilities mean that the block grant the Scottish Government receives from the UK government will have to be adjusted. The Smith Commission recognised this but did not set out in detail how these block grant adjustments (BGAs) should be made. It did, however, provide a number of principles that it felt the BGAs and other parts of Scotland’s new “Fiscal Framework” should satisfy.

Unfortunately, these principles turn out to be mutually incompatible: no single method of calculating the BGAs can satisfy all of the principles. Different methods can also lead to big differences in the size of the BGAs – and hence in the amount of ‘adjusted’ block grant the Scottish Government receives from the UK government – after just a few years. It is therefore perhaps unsurprising that agreeing how the BGAs will be calculated was the trickiest issue in the negotiation of the Fiscal Framework.

After many months of negotiations, the UK and Scottish governments finally published the Fiscal Framework Agreement in February 2016. This report appraises that agreement, focusing on the issue of the BGAs. This is central to understanding the potential impact of the new fiscal responsibilities on the Scottish Government’s budget and the additional fiscal incentives and risks Scotland will soon face.

## Policy background

- The Scottish Government has traditionally relied on a block grant from the UK government to finance most of its spending. The *change* in this block grant each year is determined by the Barnett Formula, which allocates to the Scottish Government a population share of changes in ‘comparable spending’ in England.
- The Scotland Act 2012 transferred stamp duty land tax, landfill tax and some powers over income tax to the Scottish Government. The recommendations of the Smith Commission, now being enshrined in law in the Scotland Bill 2015–16, go significantly further. On the tax side this includes devolving significant new powers over, and almost all the revenue from, income tax, and assigning half of VAT revenues raised in Scotland. In relation to welfare spending, it includes fully devolving a number of social security benefits, mostly related to disability. The aim is to give the Scottish Government new policy levers and more control over its budget, and greater financial incentives to boost economic and revenue growth and reduce welfare spending needs.
- The Smith Commission also committed to retaining the Barnett Formula as the mechanism for determining Scotland’s underlying block grant once these new powers are devolved. But it recognised that Scotland’s Barnett-determined block grant would need to be adjusted to reflect both the new tax-raising powers and new expenditure responsibilities.

## Block grant adjustments and ‘no detriment from the decision to devolve’

- The Commission did not define how these BGAs should be calculated and indexed over time. Instead it set out a number of principles that it felt the BGAs (and the wider new “Fiscal Framework” that Scotland requires) should satisfy.
- The first ‘no detriment’ principle states that neither government should lose out solely as a result of the ‘initial decision to devolve’ a tax or welfare power. This has obvious implications for the calculation of the initial BGAs for when a power is *first* devolved. The initial reduction in the block grant for a devolved tax should be equal to the amount of tax revenues being devolved. Similarly, the initial BGA for welfare should be equal to the amount of spending being devolved.
- The Commission did not state whether this principle should apply in subsequent years. The Scottish Government, however, believes it should. In particular, it has stated that it believes this principle means that, if Scotland’s devolved revenues and welfare spending change at the same *percentage rate per capita* as those in the rest of the UK (rUK), then Scotland’s funding should be no higher or lower than it would have been *had the powers not been devolved*.
- The Scottish Government therefore advocated updating the initial BGAs based on the percentage change in comparable revenues or welfare spending per capita in rUK, and the rate of population growth in Scotland. This Indexed Per Capita (IPC) approach would mean that if Scotland’s devolved revenues and welfare spending per capita grew at the same rate as those in rUK, Scotland’s budget (block grant *plus* devolved tax revenues *less* devolved welfare spending) would be the same as if this tax and welfare devolution had not occurred. This satisfies the Scottish Government’s interpretation of ‘no detriment’ and would insulate its budget from population-based revenue and welfare spending risk. Under such a formula, the Scottish Government would gain if its tax revenues per capita grew at a faster rate than those in rUK, and lose if they grew more slowly.

## Block grant adjustments and the ‘taxpayer fairness’ principle

- The second ‘no detriment’ principle set out by the Smith Commission was that, after the powers were devolved, neither government should lose or gain financially from policy decisions of the other government. This suggests that policy changes to taxes in rUK which are devolved to Scotland should not affect overall public spending in Scotland.
- Unfortunately, it turns out that this ‘taxpayer fairness’ principle is incompatible with the principle that there should be ‘no detriment from the decision to devolve’, and hence with the Scottish Government’s preferred IPC approach to indexing the BGAs.
- The UK Government initially proposed a method for indexing the BGAs that satisfies the ‘taxpayer fairness’ principle: the Levels Deduction (LD) approach. This method would increase the BGA each year according to Scotland’s population-based share of any changes in equivalent revenues or welfare spending in rUK.
- This is similar to the operation of the Barnett Formula, which changes Scotland’s block grant by its population share of any changes to comparable spending in rUK. Thus the LD approach means that, when increases in revenues in rUK are spent on comparable

services, the population-share based increase in the BGA exactly offsets the population-share based increase in the underlying Barnett-determined block grant. Changes in rUK tax revenues would, therefore, not feed through into changes in public spending in Scotland. The LD method thus satisfies the 'taxpayer fairness' principle.

- However, the LD approach does not satisfy the Scottish Government's interpretation of the principle that there should be 'no detriment from the decision to devolve'. Key to this is the fact that Scotland's income tax revenues per head are around 12 per cent lower than those in the UK as a whole. This means that its per capita revenues would have to grow at a faster rate to match increases in the BGA which in turn would effectively be derived from increases in revenues per capita in rUK. If its revenues instead grew at only the same rate per capita as in rUK, Scotland's budget would be lower than if taxes were not devolved.

### An attempt at compromise

- In an effort to reach an agreement, the UK government proposed a compromise: the Comparable Model (CM) approach. Under this, the change in the BGA is determined by a *tax-capacity adjusted population share of the change in rUK revenues*. In other words, it accounts for the fact that Scottish revenues per capita from the taxes to be devolved are lower than those in rUK and does not penalise Scotland for that.
- This addressed one of the Scottish Government's concerns. But the Scottish Government objects to the CM approach because it does not account for Scotland's relatively slower population growth.
- To see the issues this may cause, suppose that revenues in rUK are growing but only due to population growth (i.e. revenues per capita are constant). The CM approach would still increase Scotland's BGA. If Scotland's population and revenues were unchanged (and its revenues per capita also constant), this would lead to a fall in the Scottish Government's budget relative to what would have happened if taxes were not devolved.
- The UK Government argued that taking into account Scotland's lower population growth would be inconsistent with how block grant funding is allocated to Scotland – the Barnett formula does not take account of Scotland's lower population growth – and thus unfair to rUK. It therefore seemed that negotiations were at an impasse and there were concerns that a Fiscal Framework would not be agreed before the 2016 Holyrood elections.

### What was eventually agreed in the Fiscal Framework Agreement?

- In the end, the Fiscal Framework was agreed on the day of the deadline set by the Scottish Parliament's Devolution (Further Powers) committee.
- The Agreement, published on February 25<sup>th</sup> confirms that the initial BGAs will be set equal to the amounts of revenues and welfare spending being devolved to the Scottish Government.
- It also states that, for a transitional period until 2021–22, the governments have agreed that the BGAs would be indexed "using the 'Comparable Model' (CM), whilst achieving the outcome delivered by the Indexed Per Capita (IPC) model."

- This may sound like a compromise but it is not. Making an initial adjustment by the CM approach but then reconciling it with what would have happened under the IPC approach is ultimately no different from using the IPC approach all along. In effect the Scottish Government has got its preferred approach, at least for the first five years of devolution. This protects Scotland from revenue risks associated with its slower population growth and satisfies the Scottish Government's interpretation of the principle that there should be 'no detriment from the decision to devolve'.
- In agreeing to this, the UK government has effectively conceded its objections to the IPC approach – that it does not satisfy the 'taxpayer fairness' principle, and that it treats population growth in a way inconsistent with the Barnett formula.
- It is also worth noting that it is not only the UK government that could suffer from the resulting violations of the 'taxpayer fairness' principle. In particular, the use of the IPC approach could see the Scottish Government's budget fall if there are income tax cuts in rUK (although it could gain if there were income tax increases).
- The method for indexing the BGAs after 2021–22 will be negotiated after the 2021 Scottish Parliamentary elections. Given the difficulty of reaching an agreement this time round, and the principles at stake, these negotiations may not go smoothly.

### How might Scotland's budget evolve under the agreed Fiscal Framework?

- How much difference could tax and welfare devolution make to the level of resources available to the Scottish Government? To consider this we examine a number of indicative scenarios – drawing on historic revenue and spending outturns and future projections of revenue, spending and population growth.
- This analysis confirms that if devolved revenues and welfare spending per capita grow at the same rate in Scotland as in rUK, use of the IPC approach means that the amount available to the Scottish Government will be the same as if there were no tax and welfare devolution.
- Faster or slower growth in devolved revenues or welfare spending per person could have notable effects on the Scottish Government's budget if sustained. Illustrative scenarios – based on historic differences in income tax revenue and welfare spending growth – show impacts on the Scottish budget of over £500 million a year after five years and over £2 billion a year after 15 years.
- We also examine how different Scotland's funding will be using the IPC approach for indexing the BGAs compared to other indexation approaches. The slower population growth projected for Scotland than rUK means that Scotland's funding would have been around £300 million a year lower in real-terms after five years under the CM approach than under the IPC approach. The gap increases to over £1 billion for the LD approach.

### Budgetary risk and borrowing

- Devolution of tax and welfare also means exposing the Scottish Government's budget to additional risks. The method agreed for adjusting the block grant largely insulates Scotland from the impact of revenue or welfare spending shocks that hit the whole of the UK – such as the global financial crisis and associated recession. This is because, when rUK revenues fall, for instance, the BGA – i.e. the bit taken off the block grant – also falls.

- However, the Scottish Government will face all the risk associated with economic trends or shocks to devolved revenues or welfare spending that affect Scotland only, or affect Scotland to a greater extent than rUK. It is for this reason that Scotland needs increased borrowing powers.
- The Scottish Government got less in the way of additional borrowing power than it hoped for. Capital borrowing powers were barely increased.
- Recent experience suggests that the current borrowing limits and reserves limits agreed should be large enough to smooth devolved revenues, but some issues could still arise. First, Scotland will only be able to borrow to make up for a *forecast* shortfall in revenues – when Scottish GDP growth is below 1% and at least 1 percentage point less than UK GDP growth. This could be constraining since the correlation between devolved revenues and Scottish GDP is far from perfect and Scotland’s revenues may be temporarily relatively depressed even if these conditions do not hold. Second, the limits are currently fixed but there is a case for increasing them in line with the growth in devolved revenues and spending (i.e. the amounts of cash at risk) and for reviewing arrangements, in case the correlation between Scottish and UK economic cycles weakens in the years following devolution.

### Compensation for spillover effects

- The Smith Commission Agreement suggested compensating transfers should be paid whenever the decisions of one government affect the revenues or spending of the other.
- There could potentially be a wide range of spillover effects for any given policy change. For example, an increase in Scottish income tax rates might increase eligibility for Universal Credit (because eligibility is based on after-tax income), which is paid for by the UK government. But it might also induce behavioural effects: some Scottish taxpayers might work less, reducing the amount the UK government raises in National Insurance Contributions in Scotland; others might, if able to, convert earned income to dividend income which would continue to be taxed at a rate set by the UK government, acting to increase rUK revenues.
- The Fiscal Framework Agreement states that the ‘direct’ spillover effects – i.e. those that come about mechanically as a result of a policy change – will be subject to compensatory transfers. The impact of an increase in Scottish income tax rates on eligibility for Universal Credit would count as a direct effect and the Scottish Government would be obliged to pay a compensating transfer to the UK to account for this.
- The Fiscal Framework Agreement states that financial spillover effects resulting from behavioural change and any indirect or second round effects will not (in general) be subject to compensatory transfers. Given the difficulty in calculating the magnitude of behavioural effects, this decision appears pragmatic.
- However, the Fiscal Framework Agreement states that in exceptional circumstances behavioural effects that involve a ‘material and demonstrable’ cost or saving to the other government could be taken into account and be subject to compensatory transfers, if both governments agree to it.

- But it provides no indication about what level of financial spillover effect might be considered 'material', so this could open the door to dispute between the Scottish and UK governments. Furthermore, in many cases, those policies that may generate the biggest behavioural effects will also be those where the precise magnitude of the behavioural effect is most uncertain – and therefore subject to the most potential for disagreement.

### The Fiscal Framework in an international perspective

- Scotland's block grant will continue to be calculated by the Barnett Formula, which takes no account of spending need. This is not in itself particularly unusual: many countries, particularly those where the sub-central governments (SCGs) have substantial policy autonomy, have decided that the process of allocating grant according to spending need is too difficult politically. But what is unusual about the Barnett Formula is the way in which it allocates a largely arbitrary grant to Scotland, based on historic accident, and allocating higher grant-per-person when Scotland's population grows less quickly than England's (as it has done for many years and is expected to continue doing).
- Most decentralised countries do take into account the ability of SCGs to raise revenue from devolved taxes. SCGs that have lower tax capacity (e.g. due to lower incomes) often receive equalisation grants to top up their revenues at least to some extent, while in some cases SCGs that raise more in tax than average see part of their excess revenue equalised away to fund these grants.
- Because –at the point of devolution – Scotland's BGA will be determined by the actual revenues raised from the taxes to be devolved, there is effectively full equalisation of Scotland's lower tax capacity at the point of devolution. Indeed, this is the principle of 'no detriment from devolution' established by the Smith Commission.
- In future years however, changes in relative tax capacity for those devolved taxes are in principle fully borne by the Scottish Government. Whilst the Scottish Government will capture all of the gains of per capita tax revenue growth that are in excess of rUK revenue growth, the Scottish budget has no protection against the risk that its revenues per capita grow more slowly than those of rUK.
- This system of full revenue equalisation at the point of devolution and no equalisation thereafter is unusual.
- The proposed BGAs will protect the Scottish budget from macro-economic shocks that hit the whole of the UK equally. This is probably the key strength of Scotland's block grant adjustment and is in contrast to what happens in many countries – in many countries, SCGs tend to be more exposed to the risk of common macro-economic shocks.