Finance and Public Administration Committee

1st meeting 2022 (Session 6), Tuesday 11 January 2022

Scottish Fiscal Framework: Independent Report

Purpose

1. This paper provides background information to inform the evidence session on Block Grant Adjustments (BGAs) which are the focus of the Fiscal Framework Independent Report. This evidence session is to further inform the Committee on some of issues that may be explored in the Independent Report.

2. The Committee will take evidence from two panels of witnesses:

   Panel 1:
   - David Eiser, Fraser of Allander Institute
   - David Phillips, Institute for Fiscal Studies
   - Professor David Bell, University of Stirling

   Panel 2:
   - Dr Ed Poole, University of Cardiff
   - Guto Ifan, University of Cardiff

3. On 21 December 2021, David Eiser, David Phillips and Professor David Bell published a paper titled Options for reforming the devolved fiscal frameworks post-pandemic. An extract from that paper on *Reforming how the BGAs are calculated* is attached in Annexe A.

4. Dr Ed Poole and Guto Ifan have provided a written submission which provides a brief overview of how divergent elements of the Welsh framework would work in the Scottish context. This submission is also attached in Annexe A.

Background to the Report and the Review

5. On 2 November, the Cabinet Secretary for Finance and the Economy and the Chief Secretary to the Treasury each wrote to the Committee confirming that there has been agreement in principle to commission an Independent Report on the existing BGA arrangements. That includes:

   a. the baseline adjustments and
   b. subsequent application of the Indexed Per Capita and Comparable methods and

   c. any alternative arrangements for calculating BGAs in relation to tax, welfare and non-tax revenues (such as from Fines, Forfeitures and Fixed Penalties, or from the Proceeds of Crime Act).

6. The letters also advise that the Independent Report:

   a. will not make recommendations but will involve a call for evidence from stakeholders;
   b. will aim to be presented to both Governments by the end of 2021 (or as soon as possible thereafter);
   c. will have a terms of reference but this and its authorship is currently being considered by government officials.

7. In relation to the subsequent review by the UK Government and Scottish Government, the letters set out that:
   a. preparations for the review (including its scope) are to take place in parallel with the Independent Report; with a view to beginning as close as possible to the start of 2022 (after the report has been published);
   b. it will be wider in scope and will include input obtained from stakeholders as part of the overall process;
   c. the Scottish Government will undertake a programme of analysis to inform its views and build on the Independent Report, and other key publications and evidence, including the Session 5 Joint Committee and Scottish Government report on the fiscal framework review.

8. In a letter to the Committee on 21 December the Cabinet Secretary for Finance and the Economy confirmed that "progress has been made on the Terms of Reference for the report, as well as identifying potential authors with the necessary expertise." The letter also confirms, however, that the original timescale in the Fiscal Framework agreement of reporting by the end of 2021 will not be met.

Approach to developing Block Grant Adjustments

Smith Commission report

9. When the Smith Commission reported it set out three key pillars in relation to the devolution of further powers to the Scottish Parliament – the third of which was "strengthening the financial responsibility of the Scottish Parliament". The report then set out the powers the Commission considered should be devolved including that "The devolution of further responsibility for taxation and public spending, including elements of the welfare system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework."

10. In setting out what the fiscal and funding framework should consider, the Smith Commission report identified the aspects or principles which should be incorporated into the framework – these are set out in Annexe B.

11. The UK Government and the Scottish Government both recognised that the Scottish Block Grant would need to be adjusted in the first year that a newly devolved tax or welfare power was used to reflect that transfer of powers. A more challenging issue, however, was how the Block Grant should then be subsequently indexed to account for issues such as inflation and economic performance over time.

12. In their paper from November 2015 David Phillips, David Eiser and Professor Bell assessed the three most widely discussed approaches to indexation at that time - indexed deduction, Per Capita Indexed deduction and Levels Deduction (an explanation of each is attached in Annexe C). They suggested that in the first year that new powers are devolved the baseline block grant adjustment should, in principle, be relatively straightforward.[1]

13. As the report notes, however, depending upon a number of factors such as changes in UK tax rates for taxes that are devolved, underlying growth in the economy and the tax base, the initial starting levels of revenues per person, revenue growth per person, and population growth, the approaches above can have markedly different effects on the Scottish Government's budget. As such, having considered the impact of these three approaches on the Smith Commission principles:

    "It is impossible to design a block grant adjustment system that satisfies the spirit of the 'no detriment from the decision to devolve' principle at the same time as fully achieving the 'taxpayer fairness' principle: at least while the Barnett Formula remains in place."

14. They considered that without a more fundamental debate about the types of fiscal risks and incentives Scotland should face, "it is difficult to recommend a particular form of BGA as these are intimately linked to the type of fiscal risks and incentives a Scottish Government will face."

15. The report also highlights challenges in fully implementing the 'compensation principle' set out by the Smith Commission because the way that individuals change their behaviour in response to tax rate changes means that the counterfactual "no change" scenario cannot be observed or easily modelled. They observe that these issues are particularly relevant for welfare devolution "where there are complicated interactions between different parts of the benefit system, and significant scope for behavioural response to changes to benefit structure and rules".

16. This poses some key issues such as:

    a. Which Smith Commission principles should be satisfied by any BGA mechanism?

[1] Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options, Bell, Easier and Phillips, Institute for Fiscal Studies, November 2015

b. to what extent can any BGA approach be considered by the Independent Report without also assessing the types of fiscal risks and incentives that are reasonable for the Scottish Budget to be exposed to; and
c. how will decisions be taken on which alternative approaches to explore in the report (including, as below, variations of the two current approaches in the Fiscal Framework) and will this be set out in the report.

The Scottish Fiscal Framework

17. In February 2016 the UK Government and Scottish Government jointly published The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework. How the framework works in practice and the parts which inform the BGA is set out in the diagram below:

Source: Audit Scotland

18. The Fiscal Framework confirms that the initial (baseline) BGA will be based on either the level of tax receipts foregone in the case of taxes or the level of spending on devolved welfare payments in the year immediately prior to the powers being devolved. An Annexe to the Fiscal Framework sets out the detailed arrangements for how the baseline for each tax and welfare spending is established.

19. The Framework then identifies two different indexation approaches but that:

> "For a transitional period covering the next Scottish Parliament, the Governments have agreed that the block grant adjustment for tax should be effected by using the Comparable Model (Scotland's share), whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method for tax and welfare. This will ensure that the Scottish Government's overall level of funding will be unaffected if Scotland's population grows differently from the rest of the UK."

20. As explained by David Eiser, the predecessor Committee's advisor, under the Index Per Capita (IPC) approach for tax the BGA is indexed to the growth in tax revenues per capita in rUK and the rate of population growth in Scotland. For example, if revenues per capita in rUK grow by 5% and the Scottish population grows by 1%, the BGA grows by approximately 6%. Using Scottish rather than rUK population growth in these calculations means that Scotland is insulated from differences in revenue growth compared to rUK that are the result of differences in population growth.

21. Under the comparable model (CM), the change in Scotland's BGA is determined by a tax-capacity adjusted population share of the change in rUK revenues. The population share is Scotland's share of the UK population. Tax capacity is the amount of tax raised per person by a given system of tax rates and thresholds. Scotland's tax capacity for income tax is 87.5% of rUK's.

22. Similar to the BGAs for tax, the BGA for welfare powers involves a 'baseline addition' to the Scottish budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism. The indexation will initially be based on the Barnett Formula – the Scottish Government will receive a population share of the spending on 'comparable' benefits in rUK. But for a transitional period (to 2020/21), this will be reconciled to the IPC indexation mechanism. This will calculate the change in Scotland's grant for devolved welfare based on the percentage change in per capita spending on the 'comparable' benefits in rUK, and the change in Scotland's population.

23. The principle difference between the CM and IPC indexation mechanisms is the way that they treat differences in relative population growth between Scotland and rUK. The IPC mechanism has the feature that, if tax revenues per capita grow at the same rate in Scotland and in rUK, then the Scottish budget will be identical to what it would have been without tax devolution, even if the Scottish population grows more slowly than the rUK population. In contrast, the implication of the Comparable Method is that the Scottish budget loses out from relatively slower population growth.[2]

24. David Phillips, David Eiser and Professor David Bell also undertook analysis of the Fiscal Framework following its agreement between the UK Government and Scottish Government, publishing their paper: Scotland's Fiscal Framework: Assessing the Agreement in March 2016.

Parliamentary Committee scrutiny

25. The Session 5 Finance and Constitution Committee had a focus on scrutinising the operation of the Fiscal Framework. It highlighted a number of risks associated with BGAs – a summary of which is set out below.

Baseline adjustments

26. The Fiscal Framework identifies that baseline adjustments would be made on the basis of the Scottish share of tax receipts or welfare spend in the year before the power is devolved. Initially a forecast of either the tax receipts or welfare spend in Scotland would be made for the first year of operation and this would then be reconciled to actual data once available, and the baseline adjusted if necessary.

[2] Essentials of the Fiscal Framework, David Eiser, Budget Advisor to the Finance and Constitution Committee.

27. Whilst in general it has been accepted that this calculation of the baseline adjustments would be fairly straightforward there are some potential risks with the decision to use only one year's receipts or spend.

28. Audit Scotland highlighted that the point in the relative economic cycles of Scotland and the rest of the UK at which baselines for BGAs were established is a key aspect of economic performance risk. They also highlight that the extent of any changes to social security entitlements and benefit levels in areas prior to devolution, could impact on baseline BGAs and, at that time, noted that a similar risk applies in relation to the taxes that have yet to be devolved.[3]

29. Understanding whether the year before baseline adjustments represented a 'normal' year (as compared with a multiyear approach) could be therefore be important.

Transparency and accountability

30. A consistent theme across the Session 5 Committee's budget related reports was the transparency of the calculations made to determine the BGAs. Whilst some steps have been taken to address this through HM Treasury's publication of the BGA calculations, the Session 5 Committee noted that there is no accompanying narrative explaining the year on year changes to the adjustments to the block grant.[4]

31. Changes in BGAs could be a consequence of a number of interrelated factors such as UK tax policy changes, changes to the baseline for income tax, the performance of the UK economy and the performance of UK tax receipts. In its Report on the Draft Budget 2019-20 the Committee noted that the BGA had been significantly revised downward as the "the OBR has revised up its forecasts for the performance of the key determinants of UK income tax revenues (the employment rate and average earnings) since last year." However, without an explanation of what factors led to this revision, the Committee noted that "we don't know with any certainty how these various different factors play off against each other. The Committee's view was that it is essential that this information is published to enable wider understanding of and for confidence in the operation of the Fiscal Framework."[5]

32. Others also expressed concern about the transparency of BGA calculations and its wider impact on transparency, scrutiny and public confidence. In its submission to the joint SP/SG Fiscal Framework Review Group ('the joint working group'), ICAS highlighted the example a lack of clarity around the role of BGAs in relation to the Land and Buildings Transaction Tax Additional Dwelling Supplement (ADS). They note that some had suggested 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

[3] Written submission to the joint Scottish Parliament/Scotland Government Fiscal Framework Review working group.
[4] Report of the Draft Budget 2018-19, Finance and Constitution Committee, 28 January 2018
[5] Report on Draft Budget 2019-20, Finance Committee, 25 January 2019.

block grant. ICAS comment that this "demonstrates that either the BGA is wrong in principle or that there is great confusion over it".[6]

33. ICAS went on to highlight that "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."

34. In his paper on the Scottish Budget 2019-20, the Session 5 Committee's then Budget advisor, David Eiser, highlighted questions about how changes to the BGA calculation methodology are communicated to Parliament. As an example, he noted that the "UK and Scottish Government have agreed a small change to the BGA calculation methodology in 2020/21 to reflect the fact that income tax will be partially devolved to Wales in 2019/20". He queried whether this had been communicated to the Committee or Parliament.

35. The appropriate level of transparency and accountability over how BGAs are calculated and the detail that should be made public about the factors that have contributed to the BGA each year are key areas that the Independent Report could explore. Other areas for consideration could include the role the Scottish Parliament should have in providing accountability and scrutiny of the BGA mechanism and the extent to which the Independent Report will address ambitions such as delivering simplification and public understanding of any approach to BGAs.

Working Age Population

36. In its 2019-20 Pre-budget scrutiny report the previous Committee noted that the annual adjustment to the block grant using the IPC method is based on overall population growth in Scotland and the rest of the UK. It does not, therefore, account for the relative growth in the working age population or the 'old-age dependency' ratio.

37. SPICe define this ratio 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')." The Committee reported that "Based on the ONS historical and projected old age dependency ratios in Scotland and the rest of the UK, Scotland is forecast to have a higher dependency ratio than the rest of the UK for around the next 25 years. This is potentially significant for the size of the Scottish Government's Budget given that the annual adjustment to the block grant is adjusted on the basis of general population growth rather than on working age population growth."[7]

38. When asked whether it had sufficient levers to address this risk, the Scottish Government responded that "the UK Government's immigration policy does not

[6] Written submissions to the joint Scottish Parliament/Scotland Government Fiscal Framework Review working group
[7] Pre-budget scrutiny report 2019-20, Finance and Constitution Committee, 7 September 2018

address our economic, demographic and social needs. Devolved powers on immigration would be an essential lever in addressing these challenges given that all of our population increase will come from migration over the next 25 years".

39. In contrast the Chief Secretary to the Treasury stated that "the Fiscal Framework ensures that the Scottish Budget "is shielded from the effects on its tax revenues of any UK-wide economic slowdown, from slower relative population growth and from forecast risk, including through increased borrowing powers and the use of the Scotland Reserve."

40. Professor Jim Gallagher of Nuffield College, Oxford highlighted in written evidence[8] that arguing for the use of weighted population "implies a needs calculation, and therefore is relevant not only to the increment [BGA] to the Scottish Budget but the Scottish budget as a whole." As such, if the "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."

41. Members may therefore wish to consider the risks and benefits of the different indexation approaches, informed by what is now known about the Scottish economy.

Forecasting rest of the UK revenues and spending

42. As noted above a key component of calculating the adjustment to the block grant for each of the devolved taxes for any single year is the indexation mechanism. That mechanism includes a measure of the forecast growth rate of comparable revenues per capita in rUK in the current year. For example, in calculating the adjustment to the block grant for each of the devolved taxes for 2019/20 the indexation mechanism is a measure of the forecast growth rate of comparable revenues per capita in rUK between 2018/19 and 2019/20.

43. Understanding the drivers of income tax revenues is therefore important in ensuring that income tax forecasts are as accurate as possible. As more data about Scotland becomes available over time, this has impacted on forecasting. In its Report on Budget 2019/20, the predecessor Committee noted the Scottish Fiscal Commission (SFC) suggestion that there is some evidence that the slower earnings growth in Scotland is "due to the disproportionate level of higher taxpayers in the rest of the UK relative to Scotland." The SFC subsequently explained as part of the Committee's prebudget 2020/21 scrutiny that the likeliest single explanation for this was that the UK has a higher concentration of higher-rate taxpayers and the recent growth in UK income tax revenue has been concentrated among them. The SFC explained that neither they or the OBR were aware that the recent growth in income tax revenues "would be so strongly affected by distributional issues" and that had they been aware "Scotland would

[8] 8 Written submissions to the joint Scottish Parliament/Scotland Government Fiscal Framework Review working group

have had a smaller budget two years ago and we would not need a reconciliation now."[9]

44. As with tax devolution the BGAs for newly devolved welfare powers are initially based on OBR forecasts. For social security benefits, forecasts are for spending rather than revenues and BGAs are additions rather than deductions. The OBR explains that forecasting disability benefits "involves the consideration of many factors, both in the context of wider trends in the population – such as perceptions of disability and diagnoses – as well as in the administration of the benefits system." This means that they "need to make numerous assumptions and judgements, so our estimates are inevitably subject to a range of risks and uncertainties."

45. In its Report on [Budget scrutiny 2020-21] the predecessor Committee highlighted that, given Scotland's population is forecast to age faster than that of the rest of the UK, there is a risk that social security spending will be higher in Scotland even if there is no policy change. The then Budget Adviser questioned whether "this outcome would be 'fair' and whether or not it was an intended feature of the funding mechanism could be debated."

46. The pandemic has also exposed other potential issues with forecasting. As was noted in the Pre-budget scrutiny report 2021-22, while not having a direct impact on the size of the Scottish Budget, the OBR's devolved taxes forecasts at that time "provide some insight into the risk of the pandemic having a differential impact to the Scottish economy and income tax revenues relative to rUK". The then Committee's Budget Adviser pointed out that the OBR forecasts did not build in any differential economic impact of COVID-19 but instead assumed that the fiscal and economic impact would be similar across the UK. In those circumstances the question arises of what would happen with the BGA forecasts should there be a differential economic impact on Scotland.

47. In evidence to the Committee, the OBR explained that they undertake their forecasts differently to the SFC "We take a top-down approach when we estimate the tax basis for things such as Scottish income tax. We estimate what we think is the Scottish share of the tax base and applying the policy rates on top of that." The SFC consider that the data is good for the majority of devolved taxes. That said in relation to the self assessment population (about 10 % of the labour force) the time lag means the OBR (and SFC) misses this data. "Given the way that we produce forecasts, if there are differential trends in self-employment or other parts of the non-saving, non-dividend, non-PAYE tax base, we will not pick them up."[10]

48. The role of the OBR in the BGA process including the impact of and robustness of its forecasting and the adequacy of data are areas which the Independent Report could comment on.

[9] Pre-Budget Scrutiny 2020/21 Report, Finance and Constitution Committee, 12 November 2019
[10] Official Report, Finance and Public Administration Committee, 7 December 2021

BGA timings

49. The Scottish Budget process anticipates that normally the UK Budget along with the corresponding OBR forecasts will be published in Autumn each year in advance of the Scottish Budget. Where this has not happened (such as with Budget 2020-21), the Scottish Government can publish its budget first but has to be provided with indicative BGAs by the UK Government. The Fiscal Framework states that provisional BGAs will be applied when the UK Budget takes place less than three months before the start of the next financial year.

50. In 2019 when this circumstance arose the Scottish Government agreed with HM Treasury that it could choose whether to update BGAs according to the latest forecasts from the UK Budget or alternatively use the provisional BGAs. Either approach is not without its issues.

51. In 2019 the Scottish Government decided to use the provisional BGAs "to protect the Scottish Budget in the short-term, allowing further time to consider the impact of the Covid-19 crisis on forecasts and the 2020-21 Budget position. However, using the provisional BGAs does not eliminate all risk to the Scottish Budget 2020-21, as the fully devolved taxes and social security BGAs are subject to an in-year reconciliation under the Fiscal Framework."[11]

52. A further potentially complicating factor in relation to forecasting is the timing of the forecasts during a period of considerable uncertainty. For example, in its Pre-budget report 2021-22 the Committee's view was that in relation to the pandemic "the current levels of uncertainty and volatility could exacerbate the risks from forecast error. In particular, the rapidly evolving situation is likely to have an impact on the OBR and SFC forecasts given they are 2 months apart."

53. The Committee may wish to explore whether the Independent Report should also consider the opportunities that exist to provide greater certainty on when final BGAs are available including the timing of and triggers for producing forecasts.

Welsh Fiscal Framework

54. In its submission to the Scottish Parliament/Scottish Government Fiscal Framework Review working group, Dr Ed Gareth Poole, Guto Ifan and Cian Siôn, set out some of the differences between the Scottish Fiscal Framework and the Welsh Fiscal Framework.[12]

55. The Welsh Fiscal Framework uses the comparable model for determining the BGAs in the years following the devolution of each tax or welfare power. The Welsh agreement also 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 with England and Northern Ireland.

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[11] Cabinet Secretary letter to the Convener of the Finance and Constitution Committee, April 2020.
[12] Written submissions to the joint Scottish Parliament/Scotland Government Fiscal Framework Review working group

56. Other differences include that:

    a. the Welsh Government can vary each rate of income tax separately and by any amount;
    b. forecasts of the rest of the UK and Welsh tax revenues and welfare spend are both provided by the OBR;
    c. a new, needs-based factor was added to the Barnett formula meaning that from 2018-19, increments passed onto the Welsh budget from the Barnett Formula are 5% greater than they would have been under the original formula.

57. As the authors note in this submission because the Welsh agreement was reached subsequent to the Scottish agreement, elements of the Welsh Fiscal Framework may be used as a precedent for the Scottish review of the Fiscal Framework.

Next Steps

58. The Committee is invited to explore Block Grants Adjustments with witnesses at its meeting on 11 January.

Extract from the paper titled “Options for reforming the devolved Fiscal Frameworks post-pandemic”, by Professor David Bell, David Eiser and David Phillips, pages 53-56.

Reforming how the BGAs are calculated

Replacing the Barnett formula with a needs-based funding system would address long-term asymmetric shocks and trends on the spending side of the devolved governments’ budgets. But what about long-term shocks or trends that affect devolved government revenues proportionately more (or less) than they affect the equivalent revenues in rUK?

The degree of insurance provided in such circumstances is determined by the block grant adjustments (BGAs) made to account for the devolved tax revenues the Scottish and Welsh governments now retain and control. The way these BGAs were initially calculated and have subsequently been indexed differs slightly between Scotland and Wales but in both cases reflects several of the Smith Commission principles we introduced in Chapter 2:

- The ‘no detriment’ principle informs the calculation of the initial BGA. In particular, when a tax is first devolved, the BGA is set equal to the amount of revenue devolved, so that the devolved government neither loses nor gains if its revenues per person are initially higher or lower than those of the rest of the UK.

- The ‘economic responsibility’, ‘no detriment’ and ‘risk-sharing union’ principles inform the indexation approach, which uprates the BGAs each year in line with the equivalent revenues or tax bases in the rest of the UK. This ensures that the devolved government bears the cost or reaps the rewards of its tax policy changes (and, albeit less perfectly, the UK government bears the cost or reaps the rewards of its policies). It also insulates the devolved government from any revenue shocks that affect the whole of the UK (because the BGAs will change in ways that offset the changes in devolved tax revenues). But, in addition, it means that the devolved governments bear in full the risk that their revenues grow more or less quickly than those in the rest of the UK, including for reasons outside of their control – such as a major shock with asymmetric impacts.

This combination of full equalisation and insurance at the point of devolution and, at least for the proportion of tax revenues that are devolved, no equalisation or insurance at the margin following devolution is unusual internationally.

Table 4.2. Impact on devolved government funding from a 2.5% fall in income tax or all devolved tax revenues relative to rUK revenues

	2.5% fall in income tax		2.5 % fall in all devolved taxes	
	Cash terms	**As a % of resource budget**	**Cash terms**	**As a % of resource budget**
Scotland	£296m	0.8%	£382m	1.0%
Wales	£51m	0.3%	£85m	0.5%

Note: Estimates based on out-turn revenues and resource budgets in 2019–20, the last year of out-turn data available, and largely prior to the COVID-19 crisis.

Source: Authors' calculations using Scottish Government (2020), Welsh Government (2020) and HM Revenue and Customs (2021a, 2021b).

The scale of the risks that the devolved governments of Scotland and Wales are exposed to as a result of bearing the full marginal risk of divergences in devolved revenues varies substantially. For example, consider a shock that reduces income tax revenues relative to England and Northern Ireland by 2.5% on an ongoing basis. Table 4.2 shows the impacts on Scottish and Welsh government funding, both in per-capita and percentage terms, using data from 2019–20. It shows that the impact on Scottish government revenues would be much higher than for Wales, both in cash terms (£296 million versus £51 million) and measured as a percentage of the resource budget (0.8% versus 0.3%). This reflects the fact that substantially more income tax is raised (in aggregate and per person) in Scotland than in Wales, and a larger share of it is devolved. The table also shows the impact of a 2.5% fall in revenues from all devolved taxes, indicating that what happens to income tax matters most, especially for Scotland. In addition, it confirms that the Scottish Government is more exposed, overall, to shocks to tax revenues than the Welsh Government.

In principle, reforming the way the BGAs are indexed so that marginal changes in revenue-raising capacity are partially equalised for would provide greater risk-sharing for long-term shocks (borrowing, discussed earlier, is not a suitable response to long-term shocks). For example, if BGAs were updated to insure against 75% of the risk of any fall in tax revenue capacity below 99% of its level at the point of devolution, the Scottish Government's exposure to revenue losses would have been reduced to £96 million, or less than 0.3% of its resource budget (given trends prior to 2019–20 meant that Scottish tax capacity had already fallen below 99% of its initial level).

Providing such insurance in practice is challenging though. So that the devolved and UK governments still bear the revenue effects of their own tax policies, one would have to strip out the effects of any policy changes. This could be done by defining a benchmark tax system with which to assess each devolved government's tax revenue capacity, in turn basing updates to BGAs on these assessments. This is the approach traditionally used within each nation to assess each council's revenue-raising capacity (using a reference level of council tax) and also in many other countries (such as Australia and Canada).

Doing this becomes more difficult the more that tax systems diverge in structure – for example, if the definition of tax bases differs, there may not be the administrative data to calculate revenue capacity under a common benchmark tax system. At this stage though, that is probably a minor concern for the UK, where devolved taxes have yet to diverge significantly from their UK equivalents (and in the case of income tax, the definition of the tax base is not currently devolved).

Potentially more of an issue is the treatment of behavioural effects of tax policy decisions. In particular, if tax policies differ between different parts of the UK, to what extent is it those differences that are driving differences in revenue capacity versus other underlying factors? This matters because ideally (and under the 'economic responsibility' principle), we would want the government in question to bear the behavioural impact of its tax policies on revenues, not just the direct mechanical effects of any changes in tax rates, thresholds, etc. For example, if the Scottish or Welsh Government were to increase the tax rate paid on incomes above £150,000 (a highly responsive group of taxpayers), we would want it not only to gain revenues as a result of the higher tax rate, but also to lose as a result of behavioural responses undertaken by taxpayers to reduce their tax liability (such as reducing their work effort, engaging in greater tax avoidance or evasion, or migrating). If the devolved governments do not bear these costs, their incentives are skewed towards setting higher tax rates.

However, even after a policy is implemented, one cannot know for sure what the behavioural response to it is – one can only estimate it statistically, and such estimates are subject to both measurement error and methodological difficulties. For a tax such as income tax, even relatively small differences in estimates of the scale of behavioural response can mean differences of tens of millions of pounds in revenue. Agreeing the size of the behavioural adjustments to make to estimates of the tax revenue capacities of the devolved governments would therefore likely be politically difficult.

Any decision on whether to reform how BGAs are calculated to provide more insurance against shocks should take into account the effect this may have on the incentives the devolved governments have to change tax policies. It should also be informed by debate and discussion about the nature of the UK's fiscal union – in particular, how much equalisation and risk-sharing should there be across the UK? The answers to this question may differ between different parts of the UK, with the current Welsh Government potentially favouring more risk-sharing (and hence equalisation at the margin) than the current Scottish Government, which advocates Scottish independence (and hence no risk-sharing).

In summary, reform of the BGAs is the main way to provide greater insurance against long-term fiscal shocks and trends differentially affecting the revenues of different nations of the UK. However, providing such insurance in a way that is consistent with the Smith Commission's principle of 'economic responsibility' – the idea that the devolved governments should bear the risk and reap the rewards for their tax policies – would be challenging, not least

due to the difficulty of agreeing the nature and scale of behavioural responses to tax policy. In addition, whether such insurance is desirable or not depends on one's conception of the role of the Union. We therefore recommend that decisions over whether BGA indexation should be reformed to provide greater insurance are considered as part of political reviews of the devolved fiscal frameworks, rather than considered a 'technical' issue.

Written Submission from Dr Ed Poole and Guto Ifan, Cardiff University

Preface

Declaration of funding

Wales Fiscal Analysis is hosted by the Wales Governance Centre and the School of Law and Politics at Cardiff University, and funded through a partnership between Cardiff University, the Welsh Government, the Welsh Local Government Association and Solace Wales. The programme continues the work of Wales Public Services 2025 hosted by Cardiff Business School, up to August 2018.

About us

Wales Fiscal Analysis (WFA) is a research body within Cardiff University's Wales Governance Centre that undertakes authoritative and independent research into the public finances, taxation and public expenditures of Wales.

The WFA programme adds public value by commenting on the implications of fiscal events such as UK and Welsh budgets, monitoring and reporting on government expenditure and tax revenues in Wales, and publishing academic research and policy papers that investigate matters of importance to Welsh public finance, including the impact of Brexit on the Welsh budget and local services, options for tax policy, and the economics and future sustainability of health and social care services in Wales.

Working with partners in Scotland, Northern Ireland, the UK and other European countries, we also contribute to the wider UK and international debate on the fiscal dimension of devolution and decentralisation of government.

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. Although a number of similar taxes have been devolved to both Scotland and Wales, there are 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 terms of reference for the Independent Report on the Scottish Fiscal Framework have not yet been agreed. Given their magnitude in terms of the Scottish budget, alternative methods of adjusting the Scottish Block Grant will almost certainly be investigated.

1.3 The Scottish Fiscal Framework Agreement of February 2016 provided context and precedent for the Welsh fiscal framework negotiations later that year, though the eventual agreements diverged considerably in terms of block grant funding arrangements. Likewise, elements of the Welsh settlement may well be used as a precedent for the re-negotiation of the Scottish fiscal framework.

1.4 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. This written submission attempts to provide a brief overview of how divergent elements of the Welsh framework would work in the Scottish context.

1.5 To date, and contrasting with the Scottish experience, tax devolution (as operationalised by the Welsh Fiscal Framework) has resulted in a net benefit for the Welsh budget. The relative performance of Wales' devolved taxes, particularly Land Transaction Tax and forecast receipts of Welsh Rates of Income Tax, have outpaced deductions to the block grant.

1.6 Two negotiated elements of the Welsh fiscal framework have also been particularly important in explaining Wales' overall net benefit from tax devolution. First, three separate block grant adjustments for income tax, one each for the Basic, Higher and Additional rate, recognise Wales' weaker tax base relative to rUK and protect the Welsh government from factors which disproportionately affect one part of the income distribution. Second, a 'Needs-based factor' was added to the Barnett formula to recognise historic concerns about the operation of the formula in Wales. This factor boosts Barnett consequentials that are triggered by English spending by a 5 percent multiplier. These positive aspects of the Welsh Fiscal Framework can be viewed, in part, in the context of the Welsh Government's willingness to accept a less favourable model for calculating Block Grant Adjustments than the one agreed with the Scottish Government. While the 'Indexed Per Capita' method currently applies in Scotland, the formula known as the 'Comparable Model' calculates BGAs in Wales.

2. Background: tax devolution in Scotland and Wales

2.1 The Committee will be familiar with the historical development of the fiscal devolution settlement in Scotland, so this section provides a very brief overview of the parallel but distinct journey in Wales, and how the current Welsh settlement compares with Scotland's.

2.2 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 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 establishment of 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**. Based on assertions that Scotland's two-question 1997 referendum had established a precedent, the 2014 Act initially required a referendum before substantial tax powers could be devolved to Wales. However, based on a consensus that had emerged from cross-party discussions, the UK government committed to dropping the referendum requirement in November 2015. This change was codified by the **Wales Act 2017**, paving the way for the devolution of 10p of each band of income tax from April 2019.

2.3 The tax devolution measures implemented in Wales over recent years therefore include provisions from the 2014 and 2017 Westminster Acts:

- Full devolution of **non-domestic (business) rates** from April 2015
- The devolved **Land Transaction Tax** replaced Stamp Duty Land Tax from April 2018
- The devolved **Landfill Disposals Tax** replaced Landfill Tax, also from April 2018
- The **Welsh Rates of Income Tax (WRIT)** replaced 10p in each band of the UK government's income tax from April 2019

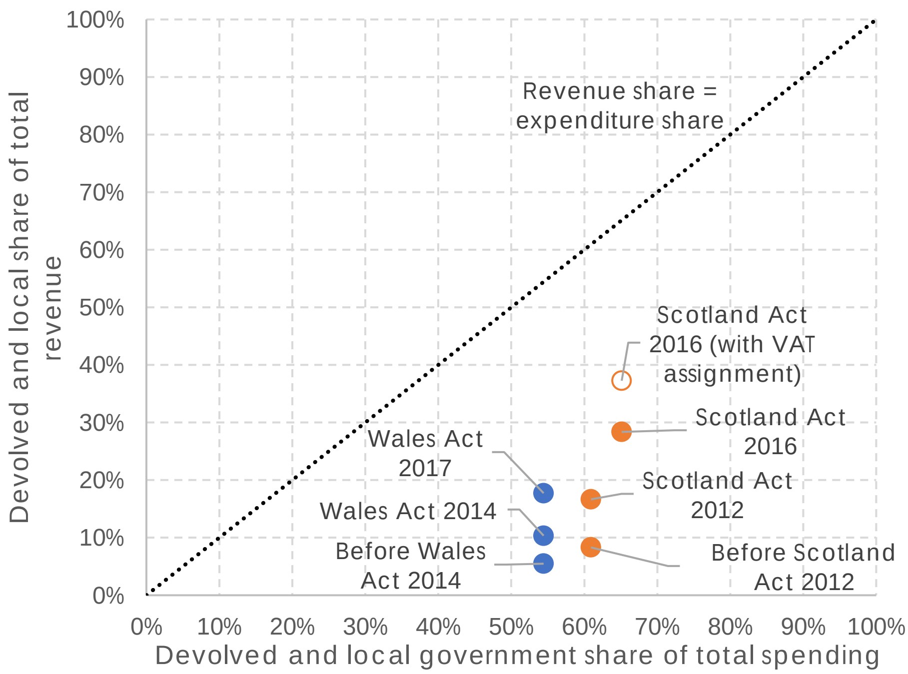
One important difference from the earlier Scottish Rates of Income Tax (SRIT) powers devolved by the Scotland Act 2012 is the absence of the so-called 'lock-step' – the Welsh Government is able to change each rate of income tax separately by any amount.

2.4 As the Committee will be aware, the Smith Commission recommendations and the resulting Scotland Act 2016 devolved substantially greater taxation powers to the Scottish Government, most importantly the full devolution of the earned (NSND) income tax base to Scotland. These broader income tax powers are not yet held by the Welsh Government and Senedd. Ironically, the longest-lasting legacy of the Calman Commission proposals (and the resulting Scotland Act 2012) is the partially devolved income tax system currently operating in Wales.

2.5 **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.

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 the Scottish and Welsh Governments

Comparable method v Indexed Per Capita

3.1 For both Scotland and Wales, 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 in important ways.**

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 England and Northern Ireland.* This is the formula that HM Treasury termed the ***Comparable Method (CM)***, and is 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 England and Northern Ireland.

3.3 This contrasts with the ***Indexed Per Capita (IPC)*** method, 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 is the case in Scotland, the Welsh population has also been growing (and is projected to grow) at a slower rate than the UK population as a whole. The Scottish Government (2019) therefore notes that BGAs determined by CM would grow substantially more quickly than BGAs determined by the IPC approach.

3.4 When the 2016 Scottish Fiscal Framework was negotiated, 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 In contrast, **the Welsh fiscal framework agreement stated that the Comparable Method 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 revenue side. The 'bonus' from slower population growth on the expenditure side is dependent on the rate of growth in comparable expenditure in England.

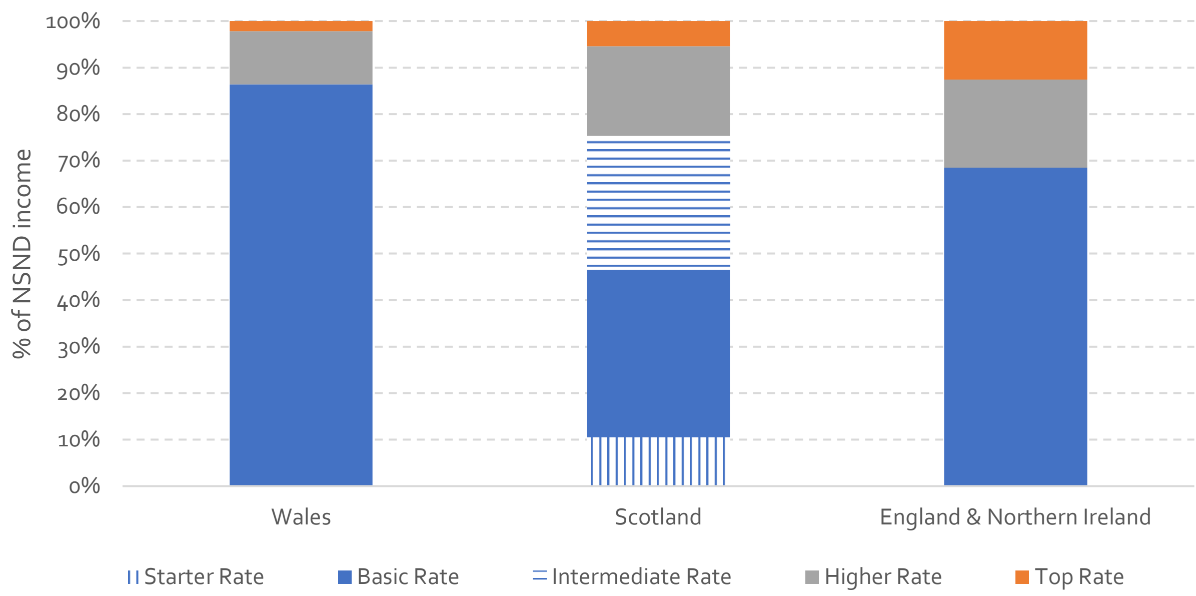
3.6 We argue that there are three reasons why the Welsh Government decided to accept the population-based risk, whereas the Scottish Government refused. First, the more limited extent of tax devolution left the Welsh Government relatively less exposed to population-based risk than Scotland in absolute terms. Second, the Welsh fiscal framework agreement recognised Wales' weaker income tax base by treating each tax band separately for the purposes of block grant adjustment (discussed immediately below). Third, the agreement also fulfilled a long-standing demand for reform of the Barnett formula in Wales (discussed in section 4).

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 far greater share of Welsh income tax is raised at the Basic Rate compared with England and Northern Ireland, and a far lower share is raised at the Additional Rate. Since bands, thresholds and rates have been changed in Scotland, direct comparisons of the tax base are less straightforward. However, **Figure 3.1** also shows clear (although slightly lower) differences in Scotland's tax base compared with the rUK tax base that determines its block grant adjustments.

Figure 3.1

Non-saving non-dividend income earned by tax rate



Source: HMRC (2021) Welsh Income Tax Outturn Statistics: 2019 to 2020; HMRC (2021) Scottish Income Tax Outturn Statistics; and authors' calculations

3.8 **The three separate BGAs for income tax are a critical element of the Welsh Fiscal Framework, because they insulate the Welsh Government from UK-wide factors which disproportionately affect one part of the income distribution, allowing a fair system to operate in Wales despite its markedly weaker tax base.** For example, the rapid increases in the personal allowance in the last decade significantly reduced taxable income at the basic rate, resulting in a much more pronounced negative 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.

3.9 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.

Comparing the projected net effect of tax devolution in Wales and Scotland

3.10 The net effect of tax devolution on the devolved budget is shown by the difference between devolved revenues and the corresponding block grant adjustments. In this regard, there is a significant difference in the projected net effect of tax devolution in Wales and Scotland in the coming years.

3.11 As shown in **Figure 3.2, current forecasts produced by the OBR in December 2021 show a significant positive projected effect of tax devolution on the Welsh budget**, with forecast revenues growing faster than projected BGAs. The main driver of this effect in the short term is the relatively faster recovery in Land Transaction Tax (LTT) revenue in Wales, faster growth in property prices, and policy changes. In later years of the forecast period, revenues from the Welsh Rates of Income Tax (WRIT) are also projected to grow more rapidly than the corresponding BGAs. The budgetary surplus from WRIT is estimated at £89 million by 2024-25, growing to £136 million by 2026-27. When all devolved taxes are accounted for, **the overall impact of tax devolution on the Welsh budget is forecast to be a surplus of £252 million a year by 2026-27.**

3.12 By contrast, the latest forecasts by the OBR and Scottish Fiscal Commission suggest that tax devolution will have a broadly negative effect on the Scottish Government budget in the coming years (as shown in **Figure 3.3**). As is the case for Wales, Land and Buildings Transaction Tax (LBTT) revenues are set outpace the corresponding BGAs over the forecast period. However, devolved income tax is set to have a negative effect on the budget – approximately £190 million in 2022-23. Income tax policy increases are set to be offset by slower forecast growth in employment and earnings in Scotland. **This negative projected effect of tax devolution is estimated to reach £355 million a year by 2026-27.**

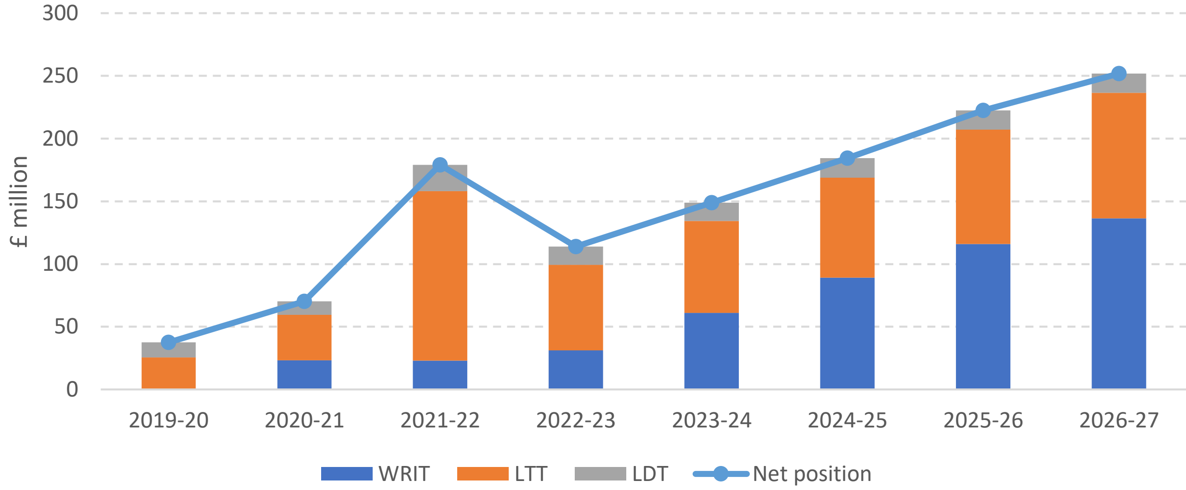
3.13 It should be noted that there is significant uncertainty surrounding the forecasts underlying these projections, and the net effects are likely to differ significantly once outturns are available. The differences may also reflect the varying assumptions being made by the two forecasting bodies.

3.14 Given the negative projected effect on the Scottish budget, 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. The Cabinet Secretary for Finance and the Economy Kate Forbes recently argued some of the divergence was a result of “strong earnings growth in London and the South East, particularly among the highest earners”, noting this issue is “accounted for in the Welsh Fiscal Framework”.[13]

[13] https://www.gov.scot/publications/budget-statement-2022-23/

Figure 3.2

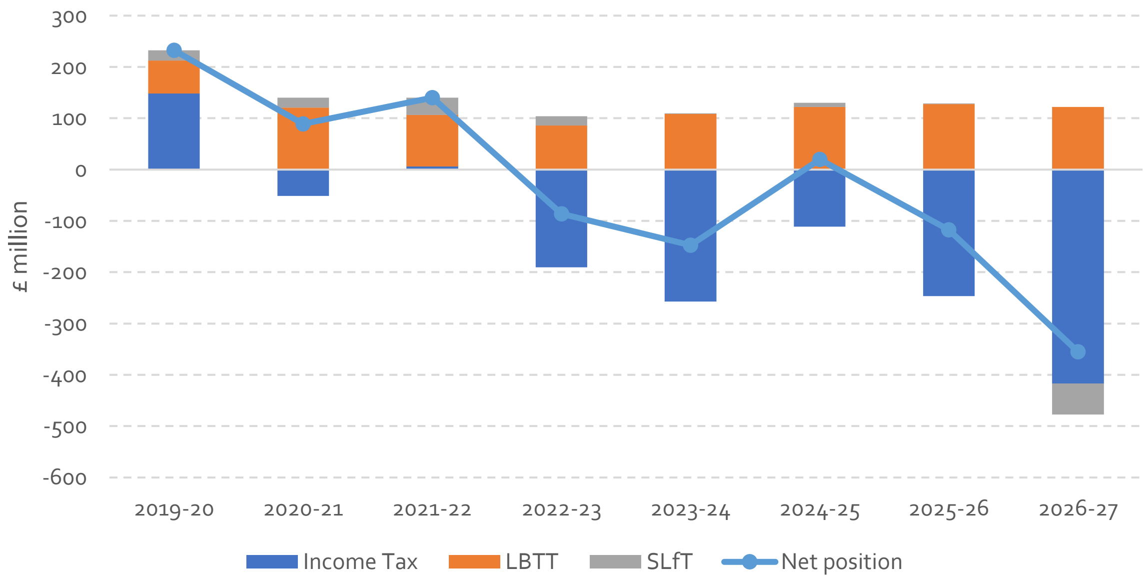
Projected net effect of tax devolution on the Welsh Government budget, 2019-20 to 2026-27 (nominal terms)



Source: Office for Budget Responsibility (2021) Welsh Taxes Outlook – December 2021; HM Treasury (2021) Block Grant Transparency – December 2021; and authors' calculations. Note: The net effect shown is the difference between devolved revenues and corresponding Block Grant Adjustments. The effect is shown uses the latest forecasts available for each year – it does not show therefore the effect of forecast errors and the resultant reconciliations in later years.

Figure 3.3

Projected net effect of tax devolution on the Scottish Government budget, 2019-20 to 2026-27 (nominal terms)



Source: Scottish Fiscal Commission (2021) Scotland's Economic & Fiscal Forecasts.

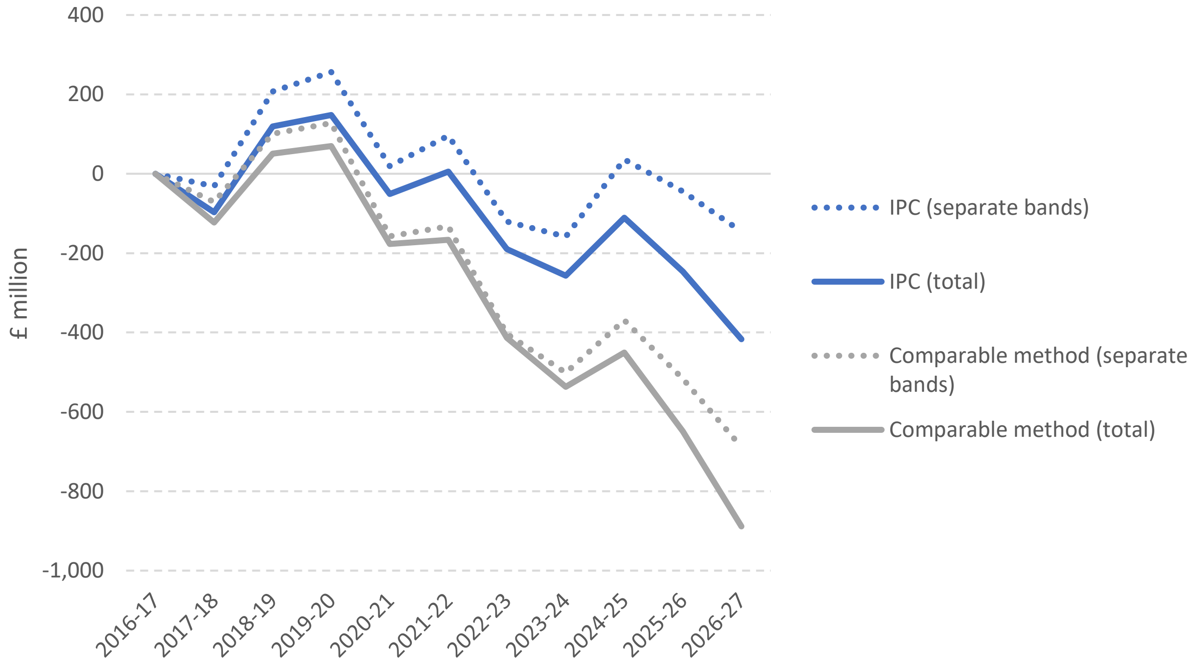
3.15 The Welsh experience of three separate BGAs for income tax may raise the prospect of introducing similar adjustments to the Scottish block grant, for the BGA to better reflect the likely trends in the Scottish tax base and the ability (or lack thereof) of the Scottish Government to influence them.

Modelling alternative ways of calculating Block Grant Adjustments

3.16 This section calculates the net effect of tax devolution on the Scottish budget had alternative methods for calculating BGAs been used since the devolution of all NSND income tax in 2017-18, using outturn data to 2019-20 and forecasts thereafter. The solid red line in **Figure 3.4** shows the difference between revenues and BGAs under the Indexed Per Capita method used since the implementation of the Scottish Fiscal Framework Agreement. The solid green line shows the net effect of devolution had the Comparable Method been used to calculate BGAs. Since the Comparable Method does not account for Scotland's slower growing population, the large difference between the two lines shows the benefit to the Scottish Government of not bearing population-based risks. The difference amounts to £341 million in 2024-25, growing to a projected £472 million by 2026-27. [14]

Figure 3.4

Projected net effect of tax devolution on the Scottish Government budget under different methods for calculating BGAs



Source: Scottish Fiscal Commission (2021) Scotland's Economic & Fiscal Forecasts; Office for Budget Responsibility (2021) Devolved Tax Forecasts October 2021; HM Treasury (2021) Block

[14] We follow the HM Treasury (2021) *Block Grant Transparency December 2021* methodology of assuming the differential growth rate in population after the last estimates (2020) is maintained throughout the forecast period.

Grant Transparency December 2021; and authors' calculations

3.17 **Figure 3.4** also shows the effect of separating the BGA for income tax into three BGAs – one for each band of rUK income tax. The BGAs in the first year are based on Scottish revenues by band in 2016-17 and are then grown in line with the changes in each band for the rest of the UK (excluding Wales after 2019-20).

3.18 There is some evidence that the stronger growth in revenues in the rest of the UK has been partly driven by stronger growth in the incomes of higher earners. From 2016-17 to 2019-20 (the year of the latest outturn data), income tax paid at the Additional Rate in the rest of the UK grew by 21% (in nominal terms), compared with a 9% increase for the Basic Rate and a fall of 1% at the Higher Rate. **Because a smaller share of the tax base is earned at the Additional Rate in Scotland, separating the BGAs by band would have resulted in a lower overall BGA for income tax, protecting the Scottish Government from the effect of incomes and tax base growth at the top end.** Similarly, growth in the later years of the forecast period in England and Northern Ireland is expected to be stronger for the Higher and Additional Rates than for the Basic Rate.

3.19 The effect of using separate BGAs for each income tax band is shown by the dotted lines in **Figure 3.4**. Under both the Comparative Method and IPC method, separate BGAs reduce the projected negative effect of tax devolution on the Scottish Budget significantly during the forecast period. **The difference in the size of the overall BGA using separate bands amounts to £146 million in 2024-25 under the IPC method, growing to £271 million in 2026-27.**

3.20 From the analysis above, **it remains likely that population-based risk continues to be a significant risk for the Scottish Government were it to move to the Comparable Method of calculating BGAs.** Separating BGAs for each tax band could mitigate some of the risks currently borne by the Scottish Government. It should also be noted even under IPC with separate BGAs for each tax band, the projected net effect of income tax devolution on the Scottish budget would still be mostly negative in future years. In contrast to Wales, perhaps a more significant difference for Scotland is the much greater importance of incomes earned in the oil and gas industry and the effect this has had on high-paid jobs over recent years.

3.21 Although meaningful tax devolution will inevitably have fiscal consequences, the Scottish Government is currently arguably 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.

4. Barnett reform in Wales – 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. This reform, known as the 'needs-based factor', responded to historic concerns about the fairness of the Barnett formula's application in Wales compared with Scotland and Northern Ireland (and non-formula-based spending in England). Along with the three BGAs for income tax, this was a key reason for the Welsh Government to agree to accepting the less-favourable Comparable Model in the Welsh Fiscal Framework negotiations.

4.2 The needs-based factor added to the Barnett formula means that increments to the Welsh block grant triggered by spending in England are now larger than they were previously. This new element 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 over time. Changes to the Welsh Government's block grant are now calculated as a product of the following calculation for every UK government department:

Cash change in department's DEL	x	**Department's comparability factor**	x	**Welsh to English population ratio**	x	***Needs-based Factor***
		Existing Barnett formula				***New element***

4.3 Although the name 'needs-based' implies a method of calculating needs, the 2016 agreement sets a specific amount by which Barnett consequentials should be enhanced. On the face of it, 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. This would imply that every Barnett consequential triggered by spending in England would be further enhanced by 15%. However, this is not the case, because the needs-based factor is set at 105% for a "transitional period". **Barnett consequentials for Wales are currently therefore increased relative to the original formula by 5%.**

4.4 The 'needs-based' multiplier increases from 105% to 115% only at the point at which relative Welsh funding per person converges to below 115% of the level in England. But 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. Relative funding per head for Wales during the Spending Review 2021 period (2022-23 to 2024-25) is estimated to be 120% of England's level.[15]

4.5 The Welsh fiscal framework sets 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 and the values were specified in the Fiscal Framework agreement.

[15] See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040846/BGT_Explanatory_note__HMT_template_.pdf

4.6 Since its implementation from 2018-19, the needs-based factor has provided substantial additional funding for the Welsh Government, due to the significant increase in UK government spending plans over recent years. **The needs-based factor has resulted in roughly £389 million of additional Covid-19 funding in 2020-21 and 2021-22. It also resulted in £404 million of consequentials above the Spending Review 2021 baseline from 2022-23 to 2024-25.**

4.7 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 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.

Extract of the Smith Commission principles

(1) Barnett Formula: the block grant from the UK Government to Scotland will continue to be determined via the operation of the Barnett Formula.

(2) **Economic Responsibility**: the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure.

(3) **No detriment as a result of the decision to devolve further power**: the Scottish and UK Governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

> (a) This means that the initial devolution and assignment of tax receipts should
> be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately.
> (b) Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK Government, including 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.
> (c) The future growth in the addition to the block grant should be indexed appropriately.

(4) **No detriment as a result of UK Government or Scottish Government policy decisions post-devolution**

> (a) Where either the UK or the Scottish Governments makes policy decisions that affect 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. There should be a shared understanding of the evidence to support any adjustments.
> (b) Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.

(5) **Borrowing Powers**: to reflect the additional economic risks, including volatility of tax revenues, that the Scottish Government will have to manage when further financial responsibilities are devolved, Scotland's fiscal framework should

provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework.

(a) The Scottish Government's borrowing powers should be agreed by the Scottish
and UK Governments, and their operation should be kept under review in conjunction with agreement on the mechanism to adjust the block grant to accommodate the transfer of taxation and spending powers.
The Smith Commission Heads of Agreement: Pillar 3 27
(b) Borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.

(6) **Implementable and Sustainable**: once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

(7) **Independent Fiscal Scrutiny**: the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process.

(8) **UK Economic Shocks**: the UK Government should continue to manage risks and economic shocks that affect the whole of the UK. The fiscal framework should therefore ensure that the UK Government retains the levers to do that, and that the automatic stabilisers continue to work across the UK. The UK Parliament would continue to have a reserved power to levy an additional UK-wide tax if it felt it was in the UK national interest.

(9) **Implementation:** the Scottish and UK Governments should jointly work via the Joint Exchequer Committee to agree a revised fiscal and funding framework for Scotland based on the above principles. The two governments should provide updates to the Scottish and UK Parliaments, including through the laying of annual update reports, setting out the changes agreed to Scotland's fiscal framework.

Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options – Professor David Bell, David Eiser and David Phillips, November 2015

Indexed Deduction (ID). This indexes the change in the BGA to the percentage change in total comparable tax revenues in the rest of the UK (rUK). For example, if comparable revenues in rUK grow by 5%, the BGA also grows by 5%. Under the ID adjustment method, growth in either the number of people or revenue per person in rUK would lead to an increase in Scotland's BGA. This approach therefore exposes Scotland to the risk of relatively slower population growth than in rUK. On the other hand, this mechanism would allow Scotland to capture the reward of relatively faster population growth. Scotland would therefore gain from attracting and retaining more income tax payers, for instance.

Per Capita Indexed Deduction (PCID). This indexes the BGA per capita to the percentage change in comparable rUK revenues per person. This option clearly protects the Scottish budget from the risk that its population grows relatively slower than the rUK's. But equally the Scottish budget would not benefit from revenue increases that resulted from population growth. The Scottish Government would therefore lack incentives to boost growth through attracting more people to Scotland.

Levels Deduction (LD). This calculates the change in the BGA as a population share of the change in comparable revenues in rUK. For example, if income tax revenues increased by £10 billion in rUK, then if Scotland's population was 9% of rUK, Scotland's BGA would increase by £900m. The rationale for the LD approach is that, by being based on a population share of a cash terms change in revenue, it is symmetric with the spending side of the Barnett Formula (which calculates the change to Scotland's block grant as a population share of the cash terms change in English spending).