

Finance and Public Administration Committee

29th Meeting 2023, (Session 6), Tuesday 14
November 2023

Scottish Fiscal Framework: Independent report and Review

Purpose

1. The Committee is invited to take evidence on the outcome of the Review of the Scottish Fiscal Framework, and the Independent Report which informed that review, from:
 - David Phillips, Associate Director, Institute for Fiscal Studies, and
 - Professor Mairi Spowage, Director, Fraser of Allander Institute.
2. Their submissions are attached in Annexe A.
3. The Scottish Government has also provided an explainer on the outcome of the Fiscal Framework Review which is attached at Annexe B.

Background

4. The Scottish Fiscal Framework, [agreed in 2016](#), sets out the funding arrangements that help determine the size of the Scottish Budget each year. It also provided for the Framework to be reviewed following the Scottish Parliament elections in 2021. That review was to be informed by an independent report with recommendations to both Governments by the end of 2021. The technical annexe to the Fiscal Framework also stated that issues to consider under the review “could include operation of the fiscal framework including the BGA [Block Grant Adjustments] and indexation methods, no detriment and spillovers, borrowing limits and, if used, operation of the dispute resolution procedures.”
5. On 28 October 2020, the Finance and Constitution Committee, the Social Security Committee and the Cabinet Secretary for Finance jointly agreed a report (“[the joint report](#)”) to the Chief Secretary to the Treasury setting out initial areas where the independent report and review should have a particular focus. A summary of the areas highlighted in the joint report is set out in Annexe C.

Fiscal Framework Review 2023

6. In November 2021, the then Cabinet Secretary for Finance and the Economy, Kate Forbes MSP wrote and confirmed that the independent report will focus on BGAs only, however “In return, CST has agreed this will inform a review that will be wider in scope. This should ensure that the current arrangements are thoroughly assessed and options for reform considered, and that input is obtained from a wide range of stakeholders as part of the overall process.”
7. On 2 August 2023, [the Deputy First Minister wrote to the Committee](#) confirming that “I have now reached agreement with the Chief Secretary to the Treasury (CST) on a package of changes to the Scottish Government’s Fiscal Framework”. The Deputy First Minister explained that she had judged it appropriate to concede to a narrower scope for the review (than the more fundamental review originally envisioned) “in the interest of securing long sought practical borrowing and reserve flexibilities, and to protect those arrangements that we already have in place which work in our favour”.
8. Alongside the letter, the Scottish Government published an [updated Fiscal Framework](#) (“Fiscal Framework 2023”) agreed between the UK and Scottish Governments. The Deputy First Minister’s letter summarises the main features of this agreement as follows:
 - The indexed-per-capita (IPC) mechanism for calculating block grant adjustments (BGAs) will be adopted on a permanent basis which, as the Cabinet Secretary explains, will mean the Scottish Budget will continue to receive a degree of protection in the event of slower population growth than would be the case under other BGA options.
 - Scotland’s resource borrowing powers for forecast error will increase by £300 million (to £600 million) from next year. Thereafter, they will be indexed in line with inflation. The total cap to the overall resource debt stock of £1,750 million (m) will be based on 2023-24 prices and will also be indexed in line with inflation from 2024-25.
 - Scotland’s capital borrowing powers will no longer be fixed at £3 billion (bn) in total and £450m per year for capital expenditure. Instead, these limits will be maintained in 2023-24 prices and will then increase in line with inflation from next year.
 - The drawdown limits of £250m a year for resource and £100m a year for capital and Financial Transactions (FTs) on Scotland’s reserve will be abolished. The overall reserve limit of £700m will also be indexed in line with inflation from next year;
 - The reduction applied to the Scottish Block Grant as part of the devolution of Crown Estate revenues – currently £6.6m – will increase over the next two years to £10m then incrementally to £40m by 2028-29, at which point it remains flat and unindexed. The profile for this annual reduction from 2024-25 is £10m / £10m / £15m / £20m / £40m.
 - The BGA for Fines, Penalties and proceeds of crime will be converted to a fixed amount, given the relative steadiness of this income stream. This will remain at 2023-24 levels which are currently £30m.

- The baseline addition to the block grant for the UK's Coastal Communities Fund will be subject to the usual operation of Barnett. This will have no immediate effect on the Scottish Government's funding position.
9. The Fiscal Framework 2023 also confirms that:
- Commencement of devolution of Air Passenger Duty will now be agreed at a suitable point by the Joint Exchequer Committee (JEC).
 - Consideration of when and how to implement VAT Assignment will be picked-up in a future meeting of the HMT/SG JEC. The Fiscal Framework no longer provides explicitly for the effectiveness of the VAT methodology to be reviewed in the final year of any transition period.
 - The Fiscal Framework 2023 no longer provides for additional borrowing to meet a Scottish specific economic shock and as a result forecasts of GDP are no longer required to inform those borrowing provisions.¹
10. In [its August 2023 blog](#) on Bank of England interest rates, the Fraser of Allander Institute (FAI) sets out how the changes would affect the Fiscal Framework limits (see table below), using the set of deflators produced by the Office for Budget Responsibility (OBR) at the Spring Budget, both in terms of annual limits and overall caps. Under the terms of Fiscal Framework 2023, the GDP deflator forecast published by HM Treasury, at the time of the Scottish Government's draft Budget (for 2024-25), will be used to set limits in 2023-24 prices.

£m	2023-24	2024-25	2025-26	2026-27	2027-28
Resource Borrowing Limit	600	609	615	623	633
Capital Borrowing Limit	450	457	461	467	475
Scotland Reserve Cap	700	711	718	726	738
Resource Borrowing Cap	1,750	1,777	1,795	1,816	1,846

¹ The Fiscal Framework 2016 provided that "for any observed or forecast shortfall in devolved or assigned tax receipts or demand-led welfare expenditure incurred where there is, or is forecast to be, a Scotland-specific economic shock" annual resource borrowing was increased from £300 m to £600m for a limited period of up to three years. This additional borrowing required to be paid back over between 3 to 5 years.

Capital Borrowing Cap	3,000	3,047	3,076	3,113	3,165
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11. Both the [FAI](#) and [the Institute for Fiscal Studies \(IFS\)](#) have published commentary on the Fiscal Framework 2023 agreement in which they explain the changes to the Fiscal Framework. The IFS blog is contained in full in the written submission from David Phillips in Annexe A, along with some additional observations.
12. In its blog, the FAI observes that the decision to use the IPC mechanism to adjust BGAs means that “the mechanisms for adjusting the block grants for Wales and Scotland will be different, given Wales’s Fiscal Framework uses the Comparable Method, albeit with additional provisions to keep a funding floor in place.” They also note that the increase in resource borrowing powers from £300m to £600m means the Scottish Government can now meet the large negative reconciliation (to reflect income tax receipts in 2021-22) of £390m which is due in 2024-25.

Independent Report

13. Alongside this updated agreement, the [Independent Report](#) commissioned to inform the review of the Fiscal Framework was also published. In order to inform this Report authors, Professor David Bell, David Phillips and David Eiser, had previously issued a call for views, to which the FPAC responded.
14. In [its response to the call for views](#), the FPAC recommended that the final agreed framework should, to the extent possible, “set out the factors and evidence considered, as well as any trade-offs made, in reaching the decision on which BGA mechanism should be used”.
15. In particular, the FPAC noted that which BGA mechanism is chosen will be clearly linked to each Government’s views of the fiscal relationship between Scotland and the rest of the UK. As such, the Committee considered it important for transparency that the Fiscal Framework arising from the Review sets out the extent to which the BGA mechanism, agreed by the UK and Scottish Governments, meets each of the Smith Commission principles, as well as any trade-offs between principles.
16. The Committee also set out a range of other areas that it considered the Independent Report should explore, including:
- How any BGA mechanisms respond to the impact of different timings of the Scottish and UK Budgets and what might be considered reasonable risks in such circumstances;
 - In considering the BGA mechanisms, the relevant data used to forecast the BGAs and to determine tax and welfare receipts should also be reviewed to ensure it is sufficiently robust and comprehensive for those purposes;

- Whether the baseline adjustment taken to date for each operational tax or welfare power represented a ‘normal’ year as compared with the multi-year approach;
- Whether some of the Smith Commission principles should have greater priority than others, in order to support the Smith Commission’s overall ambition to strengthen the financial responsibility of the Scottish Parliament;
- The risks of fully implementing the compensation principle and what, if any, approaches to interpreting the counterfactual ‘no change’ scenario could be applied
- Whether the risks arising from differences in forecast timings are reasonable and appropriate given the size of the Scottish Budget and whether the OBR and SFC forecasts could be better tied to minimise this risk
- How asymmetric shocks might be identified and the risks they could pose to the Scottish Government and UK Government

17. In their Report, the authors summarise the remit of the Independent Report as follows —

“This report evaluates the current and alternative methods for calculating BGAs. It assesses the extent to which different methods for calculating BGAs are consistent with the Smith Commission’s principles. It also considers the balance of fiscal risks and incentives faced by the Scottish Government under the different BGA approaches, and whether these differ from the balance of fiscal risks and incentives under the Barnett formula, which continues to be used to calculate the underlying Scottish block grant.”

18. Following their analysis, the report authors conclude that:

- The BGAs must be indexed to the change in equivalent revenues or spending in the rest of the UK (rUK) if the key principles identified by the Smith Commission (and set out in Annexe B) are to be met in broad terms.
- No single BGA method can simultaneously achieve all of the Smith Commission’s principles in full, especially when the ‘no detriment’ principle is interpreted dynamically, as some of the principles are mutually incompatible with each other. Fundamentally there is a tension between the taxpayer fairness principle and the no detriment principle. Both the Index Per Capita (IPC) and Comparable Model (CM) broadly achieve the economic responsibility principle although the CM achieves it more comprehensively. The IPC method is arguably more consistent with the principle that the UK Government should bear the risk of shocks affecting the whole of the UK.
- In relation to social security, when considering the BGA approaches of the IPC and Barnett Formula, the authors note that the Barnett Formula is not consistent with the ‘no detriment’ principle in its dynamic sense (post devolution). The IPC slightly better achieves the economic shock

principle, whilst the Barnett Formula slightly better achieves the economic responsibility principle.

- Given all this, the process of selecting a specific BGA to use in the Scottish Fiscal Framework will inevitably require some compromise. The authors also request that both governments should aim to set out transparently the rationale for whatever compromise solution is ultimately agreed, and the implications of that for the way in which various fiscal costs and risks are shared.

19. The Report also concludes that there may be a case in principle to incorporate some element of fiscal insurance explicitly into the BGA process but that it is very difficult to design such a mechanism that would work satisfactorily once tax divergence exists.
20. Given the narrower remit agreed for the Independent report, some of the issues the Committee raised in its consultation response and their implications for how effectively the fiscal framework (and BGAs) operate have not been fully explored.

Transparency and Accountability

21. The Scottish Fiscal Framework has been in operation since 2016 and it provided for a review after 5 years (and one that went wider than which BGA mechanism should be chosen). As Fraser of Allander noted in a blog in 2021 “The confidential nature of the discussions leading up to the 2016 agreement were not conducive to achieving a robust and sustainable agreement.” Some aspects of the framework were, they explain, “thrown together rather hastily in 2016, often based on speculative judgements about the sorts of budget management tools might be needed.” As such they considered that the opportunity to review these provisions based on actual experience to-date “is essential.”²
22. In the joint report, consideration was invited on a range of areas where greater transparency and accountability would support proper scrutiny and to secure public confidence. Those areas included that the review process should provide an opportunity for input by the public and the two parliaments.
23. The need for greater transparency over the reasons why any particular BGA approach is agreed to by the UK Government and Scottish Government was also requested³ by FPAC in its response to the Independent Report consultation. This was in order to promote greater understanding around the Fiscal Framework and support effective scrutiny. Alongside that request, the Committee also called for:

² [The 2022 review of the Scottish fiscal framework: what's been agreed so far?](#), Fraser of Allander November 2021

³ [Finance and Public Administration Committee response to the Fiscal Framework Independent Report Consultation](#), 20 September 2022

- More detailed information made available on the reasons for changes in the BGAs year to year;
 - An agreed procedure as to how any changes to BGA methods are communicated to this Committee and the Scottish Parliament; and
 - A clear communication plan alongside the Fiscal Framework, agreed following the review, setting out in plain English to the extent possible what the Framework is, what the changes are and why they have been made.
24. The authors of the Independent Report also called for greater transparency and understanding of the Fiscal Framework. They called for the Governments to highlight which Smith Commission principles have been prioritised and, if alternative principles have guided decisions, what those are. Continued publication (and improvement) of analysis of the outcomes of the Fiscal Framework was also sought. A number of areas are specifically identified, such as where any adjustments are made to account for differential population or demographic changes.
25. At the [Committee meeting on 3 October 2023](#) (and following the publication of Fiscal Framework 2023) the Deputy First Minister explained that whilst the Scottish Government wanted an expansive review, in discussion with the UK Government “it became clear that that was not on the table.” As a result, the review process became about “increasing our borrowing and reserve capacity and securing the use of the index per capita methodology”. The resulting Fiscal Framework 2023 was a pragmatic solution involving compromise from both the Scottish Government and UK Government. The Deputy First Minister added that the changes “are quite technical” and the increased borrowing powers, of up to £600 million per year, means that “we can smooth out the negative tax reconciliation [in 2024-25] over the next few years”.

Future Reviews of the Fiscal Framework

26. Built into the 2016 Fiscal Framework are arrangements for its review with a view 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”.
27. The Fiscal Framework 2023 explains that the Fiscal Framework as a whole will be reviewed “periodically” on a 50-yearly basis but not more than once in any Scottish or UK electoral cycle. It will also be open to either Government to propose changes to the Fiscal Framework as part of future reviews. It will then be for the JEC to jointly agree conclusions, recommendations and revisions of the review. The Fiscal Framework 2023 restates the general approach to any review and identifies some areas that future reviews could consider. It also reiterates that parliamentary Committees at the Scottish and UK Parliament are “actively encouraged” to give evidence to the review. It does not, however, set out how future reviews will ensure that Parliaments, and others, have an opportunity to provide their views.

28. The Fiscal Framework 2023 does not set out when the next review might take place nor whether it will be more expansive than the first review. When the Fiscal Framework 2023 was published, the BBC commented that it wasn't clear if the IPC method would be revisited but that some funding formulas can get 'stuck' because they are too difficult to change. As an example, they highlight the Barnett Formula which was proposed in 1978 as a short-term solution to resolve minor Cabinet disputes but which is still used to calculate the annual block grant for Scotland.

29. **The Committee is invited to discuss with witnesses the process for and outcome of the Fiscal Framework Review and its impact on addressing the issues raised in this paper.**

Committee Clerking Team
November 2023

Submission from David Phillips, Institute for Fiscal Studies

Fiscal Framework Review – key points

The best overall summary of my views on the Fiscal Framework Review is the IFS ‘Comment’ published on the day the outcome of the Review was announced. This is repeated below for ease of reference. Following this I include a couple of additional thoughts on the process and outcome.

IFS Comment: An immediate response to the Scottish Fiscal Framework review (2 August 2023)

The devolution of tax revenues and social security spending to the Scottish Government has required adjustments to the block grant funding it receives from HM Treasury. Exactly how these block grant adjustments (BGAs) are calculated and updated (or ‘indexed’) over time can make a big difference to the Scottish Government’s budget – to the tune of hundreds of millions and, over time, even billions of pounds a year. Rules are also needed for borrowing and reserve powers that enable the Scottish Government to deal with volatility in its budget due to the difficulty in accurately forecasting tax revenues and social security spending.

An agreement (termed a Fiscal Framework) on these issues for the first five years of devolution was reached in 2016 following months of negotiation between the Scottish and UK governments. This agreement said that after five years the Fiscal Framework would be reviewed and potentially changed. After a long delay, the two governments have concluded their review and decided to stick with the current approach to calculating the BGAs and modestly boost borrowing and reserve drawdown limits. This comment discusses the implications of these decisions. But first, some background on the tricky trade-offs between the principles supposed to guide the government’s decisions.

The Smith Commission principles

The Smith Commission which recommended the devolution of additional tax and social security powers to Scotland also set out a series of principles that the BGAs (and the wider Fiscal Framework) should meet. These are that:

- There should be no detriment (or benefit) to the Scottish or UK governments’ budgets simply as a result of the initial transfer of tax and/or spending powers – the **‘no detriment’ principle**. In defining this principle, the Commission also stated that the BGAs should be ‘indexed appropriately’, suggesting it felt that this applied not just in the very first

year of devolution, but also in subsequent years, ruling out methods of indexation that could reasonably be expected to increase or reduce the Scottish Government's budget even if it followed tax policy in the rest of the UK (rUK).

- The devolved Scottish budget should benefit in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget should bear the full costs of policy decisions that reduce revenues or increase expenditure – the **'economic responsibility' principle**.
- 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. This has often been referred to as the **'taxpayer fairness' principle**, although that terminology was not explicitly used by the Smith Commission.
- The UK Government should continue to manage the fiscal risks and shocks that affect the whole of the UK for the newly devolved tax revenues and spending responsibilities – the **'UK economic shocks' principle**.

Last year, HM Treasury and the Scottish Government commissioned me (David Phillips), alongside David Bell and David Eiser to produce an independent report on the extent to which different ways of calculating the BGAs meet these principles. This report has now been published alongside the conclusions of the two government's wider review of the Fiscal Framework.

No method satisfies all principles

We conclude that no method of calculating the BGAs fully satisfies all of the principles set out by the Smith Commission. The fundamental tension is between the 'taxpayer fairness' principle and the 'no detriment' principle. The interaction between the BGAs and the Barnett formula used to allocate funding to the Scottish Government means these two principles are incompatible.

To see this, consider what would happen if the UK government increased income tax rates in rUK and used this to increase spending on the NHS. Under the Barnett Formula, the Scottish Government would receive a population-based share of the increase in English NHS spending. To stop Scotland benefiting from a tax increase only applying in rUK, i.e. to satisfy the 'taxpayer fairness' principle, the income tax BGA (a deduction from the block grant) would also have to increase by a population-share of the increase in tax revenues in rUK. That way the increase in block grant funding via the Barnett formula and the increase in the income tax BGA would exactly offset.

But under this method of indexing the income tax BGA, even if Scottish income tax revenues per person grow at the same percentage rate as in rUK, the Scottish

Government would, over time, lose more and more from income tax devolution. This is because Scottish income revenues per person are lower than those in rUK – so if revenues per person grow at the same percentage rate, their lower absolute level means that the extra amount raised per person in Scotland would be less than the additional amount raised per person in rUK. Scottish revenues could therefore be reasonably expected to fall further and further behind the income tax BGA, reducing the Scottish Government’s funding, and violating the ‘no detriment’ principle.

Our report reviews a wide range of different options for how to calculate and index the tax and welfare BGAs over time. We find some methods better satisfy certain principles, while others better satisfy others.

We also use the forecasts of tax revenues and welfare spending in Scotland and rUK that were available when we were writing the report last Autumn to simulate how big a difference the choice of indexation method could make to the Scottish Government’s funding – and find some striking differences. For example, we find that if the so called ‘Levels Deduction’ method (which is most consistent with the ‘taxpayer fairness’ principle) had been used to index the income tax BGA from the point of devolution in 2016–17, the Scottish Government’s funding could be around £2.5 billion lower by 2026–27 than under the so called ‘Indexed per capita’ (IPC) method actually being used so far (which is more consistent with the ‘no detriment’ principle). That is no small beer – it is equivalent to over 6% of the Scottish Government’s anticipated funding for day-to-day spending in that year.

How the BGAs will be calculated going forwards

Given the large sums of money involved, it’s perhaps not surprising that the UK and Scottish governments took so long to reach an agreement. In the end they have decided to continue with the IPC method.

This method indexes the BGAs to the percentage change in revenues (or spending) per capita for the same taxes (or social security benefits) in rUK – hence its name. This approach means that if, for example, devolved income tax revenues in Scotland grow at the same percentage rate per capita as comparable revenues in rUK, the Scottish Government’s budget is neither lower or higher as a result of income tax devolution: the change in revenues is exactly offset by the change in the BGA. If Scottish income tax revenues grow at a faster percentage rate per capita, its budget is higher, while if they grow at a slower percentage rate per capita, its budget is lower.

If one thinks it’s reasonable to expect income revenues to grow at the same rate per capita (so that they neither fall further behind nor close the gap with those in rUK), this method is consistent with the ‘no detriment’ principle.

However, it isn’t consistent with the ‘taxpayer fairness’ principle. That is because when tax revenues in rUK increase – whether as a result of tax policy changes or economic growth – then Scotland would generally benefit from its population share of the increased spending funded by those revenues. If they were spent on services devolved to Scotland, the Scottish Government would receive a population share of

the increase via the Barnett Formula. And if they were spent on non-devolved items like benefits or defence, Scotland would again benefit by an amount that would average close to its population share of the spending increase. In contrast, the IPC method would increase the BGA by less than Scotland's population share of the increase in income tax revenues in rUK – because Scotland has lower revenues per capita so a given percentage increase is smaller in cash-terms. Scotland would therefore benefit, at least to some extent, from income tax revenue increases in rUK – including those funded by tax rises only applying in rUK.

The sums being transferred are significant – recall the £2.5 billion a year figure, by 2026–27, highlighted above. Whether this is a problem or not depends on how much one thinks that tax devolution should be accompanied by a reduction in redistribution and risk-sharing across the UK. If one thinks this redistribution and risk-sharing is a key feature of the UK, one should presumably be relaxed about it – indeed it could be seen as a good thing. If one views tax devolution as a fundamental change, whereby the Scottish Government should take responsibility for closing the gap in tax revenues per capita over time – and lose out financially if it does not – one may be less happy with the decision taken by the two governments.

Changes to borrowing and reserves limits

While the Fiscal Framework has decided to continue with the method to calculate the BGAs agreed back in 2016 – apart from increasing the BGA for Crown Estates revenues to avoid Scotland gaining twice over from offshore wind licenses, both in its own waters and in English and Welsh waters – modest changes are being made to borrowing and reserve powers.

Capital borrowing limits will, in future, be increased in line with inflation (as measured by the GDP deflator). The amount the Scottish Government can borrow to address devolved tax and social security forecast errors will be doubled from £300 million to £600 million, and limits on how much of its reserves it can draw down in any given year will be abolished. These resource borrowing and reserves limits will then be increased in line with inflation too.

These changes are an important step in the right direction – inflation has already eroded around 20% of the real-terms value of the existing limits since they were set – and will provide some extra flexibility to the Scottish Government to respond to forecast errors and financial shocks. Incidentally they reflect the recommendations of another report David Bell, David Eiser and I published in 2021, considering how the Fiscal Framework could be made more robust post-COVID. However, rather than link the limits to inflation, it would make more sense to link them to the amount of revenue and social security spending at risk which will typically grow faster than inflation.

David Bell, David Eiser and I also recommended granting the Scottish Government powers to be able to borrow a small amount of money to cover shocks other than tax and social security forecast errors. This could include unexpected shocks to public service spending, or falls in tax revenues or rises in social security spending that are

forecast in advance. Presently, it is only by building up and drawing down reserves that the Scottish Government can smooth out these types of issues.

Therefore, while a revised Fiscal Framework has been agreed it's unlikely to be the final say on this issue.

Additional comments

The independent report on block grant adjustment

- The terms of reference for the independent report were fairly narrowly restricted to focus on the extent to which different BGA mechanisms are consistent with the Smith Commission principles. It has been well known for several years (from my and David Bell and David Eiser's previous work) that no BGA mechanism was consistent with all of the Smith Commission's principles and which mechanisms were more consistent with which principle. The independent report was to a significant extent a restatement of what was already known and published, with some new and updated financial projections and analysis. Myself and my co-authors were careful to make sure we discussed options in relations to the risks and incentives that they involve for both the UK and Scottish Governments and raised the possibility of appraising options with reference to these issues, and broader principles (e.g. views on the appropriate degree of redistribution and risk sharing across the UK, and how this may change as more powers are devolved). However, I think it would have been beneficial to give us more latitude to assess (not just discuss) different mechanisms against a broader range of criteria.
- We had expected the independent report to be published before the Review had concluded, so it could inform discussion and debate outwith the governments at a time that could potentially influence outcomes. It was a shame this did not happen.

The outcome of the Fiscal Framework Review

- The UK Government will be relatively pleased by the outcome of the Review in that the expansion in borrowing powers for the Scottish Government were limited (albeit useful). My sense is the UK Government is especially concerned about the Scottish Government borrowing significant amounts to invest and improve services (on top of the relatively high levels of resource and capital funding it receives from the UK government) and use this in its arguments for Scottish Independence. It would have liked to change the BGA mechanism to the 'comparable model', which treats population consistently with the Barnett Formula and is the approach used in Wales, but it will not have been overly bothered by retaining the IPC model, which effectively compensates Scotland for lower population growth. In particular by granting the Scottish Government some further borrowing powers and sticking with the IPC model it will hope to have drawn the political sting from the Fiscal Framework issue, at least for the time being.

- The Scottish Government will be pleased to retain the IPC model (it would have seen the ‘comparable model’ being used in Wales as indicative of HM Treasury exerting significant pressure to use this approach in Scotland), and to have additional flexibility on borrowing for forecast errors and to drawdown reserves. It would have wanted a bigger increase in capital borrowing given it has used most of the powers already available.
- The increase the Crown Estates BGA (it was previously fixed in cash-terms) is important in the context of the windfarm license income. The fixed BGA would have meant Scotland would have benefited twice over from this income: once from its own windfarm license income, and another time from windfarm license income in the rest of the UK when it was spent (either on UK-wide things or Barnettable things). The increase in the BGA to £40 million addresses roughly half of this issue over the next 10 years: Scotland’s share of spending funded by rUK windfarm license is likely to be around £80 million. In my view ideally it should have been indexed more akin to the other BGAs, although the portfolio of Crown Estates assets in Scotland differs considerably to those in rUK (no Regent Street properties!), so indexation based on rUK excluding London may have been more appropriate if some risk sharing and redistribution across the UK was deemed appropriate. The UK government will be pleased this issue is *at least* partially addressed and I think the Scottish Government will also be pleased it is *only* partially addressed.
- As mentioned in my IFS ‘comment’, the one area where I hoped to see action was on the ability to borrow a small amount for day-to-day spending for issues other than forecast errors. As myself, David Bell and David Eiser have discussed, the fact that there is no England-only borrowing, and the above-population share of borrowing that is for or on behalf of Scotland (largely to fund the relatively high block grant) mean that it could reasonably be considered unfair to grant the Scottish Government free reign on borrowing. However, there can be unexpected pressures in public service spending and temporary declines in tax revenues or increases in social security spending that are forecast in advance (rather than arise as forecast errors), and presently the Scottish Government has relatively limited ways to respond to such options. It is true that with the Scotland Reserve it has (a bit) more formal flexibility than comparable-sized Whitehall departments. But the Scottish Government is not just another Whitehall department:
 - It is its own political operation, with a different set of political objectives and stakeholders than the UK government. In particular, whereas UK government departments can have political incentives to under-spend their budgets, and therefore maintain some leeway to address unexpected shocks, the Scottish Government has a political incentive to maximise the use of its Budget. Witness the example of Wales, where there was significant criticism from opposition parties for having to hand back unspent COVID-19 funding to the UK government (which ignored the fact that many Whitehall departments, and most notably the Department of Health, handed back funding to the Treasury).

- Whitehall departments, as part of the same government as HM Treasury have greater access to additional flexibility beyond the normal means through informal discussions. The NHS has been allowed to switch funding from capital to resource, and we might expect that departments are given informal 'heads up' about funding potentially being available in certain circumstances, enabling them to plan better and respond more nimbly to shocks. Political imperatives mean that such conversations are unlikely between two governments led by different political parties with diametrically opposing policy platforms.

For this reason, I believe there is a strong case for some limited additional borrowing flexibility, subject to caps and perhaps short repayment durations.

- Overall, the Fiscal Framework Review outcome is broadly in line with what I expected. I think both sides will be reasonably pleased given their objectives, but that the issue of resource borrowing is an issue that still needs to be fully resolved.

Submission from the Fraser of Allander Institute

The Fiscal Framework Review: Submission November 2023

The best summary of our thoughts on the fiscal framework review are contained in the comment pieces on the day and a follow up blog:

- <https://fraserofallander.org/fiscal-framework-review-finally-published-what-does-it-mean-for-scotland/>
- <https://fraserofallander.org/weekly-update-14th-time-the-charm-for-the-bank-of-england/> (where we set out the updated bands)

The review was accompanied by the long-awaited independent report, which examined the options for a Block Grant Adjustment (BGA) mechanism in detail. In summary, this concluded that –

- When considering the Smith Commission principles under which many of the current range of tax and social security powers were devolved, the principles can be conflict with each other, particularly taxpayer fairness and “no detriment”; and
- there was no way of adjusting the block grant which complied with all these principles at once.

So, this means there is not a “right” way to adjust the block grant, and it will always be the subject of a political agreement.

The indexing of all limits to inflation is a very sensible measure (although it does seem strange that this was not done in the first place). There is still a question though about whether the limits for forecast error are adequate given the risks the Scottish Government are facing. In the end, due to higher-than-expected self assessment receipts, the reconciliation for income tax for 2024-25 was not as high as the £700m that had been feared, but this could have easily been the case. It is likely still that these higher limits will be breached in some years. Given that forecast error is all that this borrowing mechanism can be used for, it would seem sensible to consider that they should be extended further.

There are wider issues which have been raised by the agreement reached by the two governments, the way it was carried out, and the issues it did not tackle. These are:

- **The role of parliamentary and public scrutiny** – the expectations of the process of the review, which had been clearly set out by both governments,

was that the independent report would be published, the terms of reference of review would be publicly agreed, and then the review would take place and report. In the end, everything was published at the same time, in the summer when parliament was in recess. Whilst recognising that this is a political agreement, the nature of the process in practice removed all opportunities for scrutiny as part of the process.

- **The nature of the BGA** – while the BGA mechanism is the SG’s preferred one now on a permanent basis, the Committee has in its work over the past two years considered differential demographic change in Scotland and how that could be impacting the tax base, particularly when we consider comparing rUK including London. However, it is worth remembering the nature of the Barnett-determined block grant when having these wider discussions (leading, as it has, to considerably higher funding for Scotland than the UK average).
- **VAT Assignment** – this issue was not dealt with in the Fiscal Framework Review, which feels like a missed opportunity.

Professor Mairi Spowage
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November 2023

Scottish Government Explainer – October 2023

Fiscal Framework Review – 2023 – Outcome

Background

- The Fiscal Framework was created in response to the recommendations of the Smith Commission, a cross-party commission set up to reach agreement on the devolution of further powers to the Scottish Parliament following the 2014 Scottish independence referendum.
- The 2016 Fiscal Framework Agreement set out the new fiscal arrangements required to enable the devolution of new tax and social security powers through the 2016 Scotland Act.
- This included the ‘Block Grant Adjustment’ arrangements that account for the devolution of tax revenues and social security expenditure.
- It was agreed at the time that the Fiscal Framework would be reviewed periodically, with the initial review to be informed by an independent report into the block grant adjustment arrangements.
- The new agreement announced on 2 August 2023 is a result of this process.
- The changes outlined below will take effect from the financial year 2024-25.
- These changes require no Scottish legislation, though subsequent Budget decisions will be subject to the usual process.

Summary of changes agreed via the review

Block Grant Adjustment Methodology

- In 2016, the Scottish and UK Governments agreed to use the Indexed Per Capita methodology for calculating Block Grant Adjustments on an interim basis.
- The original agreement was clear that a permanent Block Grant Adjustment methodology would be considered and agreed as part of a Fiscal Framework Review, to occur after a parliament’s worth of experience.
- The outcome of this review is that the Indexed Per Capita mechanism for calculating Block Grant Adjustments will now be adopted permanently.
- This ensures that the Scottish Budget is protected from the risk of slower population growth; if the BGA were calculated using the alternative Comparable Method, it is estimated by the authors of the Independent Report that “the BGA would exceed revenues by over £400 million” by 2026-27 (Ref: page 36/7, Independent Report)⁴

⁴ [Analysing the options for Scotland’s block grant adjustments: An independent report \(www.gov.scot\)](https://www.gov.scot/publications/independent-report-2023-24/pages/36-37/)

- The main impact is primarily on the Block Grant Adjustment for tax, where the Independent Report estimates that this agreement could be worth around £200 million a year after five years and ~£400 million a year after 10 years.

Borrowing & Reserve

- The Scottish Government's resource borrowing capacity to deal with forecast error will be increased by £300m (to £600m) in 2023-24 prices. As such, this limit will be indexed in line with inflation, as measured by the GDP deflator.
- Capital borrowing limits will also increase in line with inflation from next financial year. Currently, we can borrow up to £450m per year for capital expenditure.
- The drawdown limits on Scotland's reserve will be abolished. The overall reserve limit will also be indexed in line with inflation from the next financial year.
- The provision for a Scotland-specific Economic Shock has been removed; this is now improved by unconditional resource borrowing limits.

Tax

- Once completed and agreed by officials, the VAT Assignment methodology and operating arrangements will be presented for joint ministerial sign-off at a future meeting of the Joint Exchequer Committee (JEC).
- The JEC will also agree a suitable point for the commencement of VAT Assignment in a future meeting.

Other

- The reduction applied to the Scottish Block Grant as part of the devolution of Crown Estate revenues – currently £6.6m p.a. – will increase incrementally to £40m by 2028-29, profiled at £10m / £10m / £15m / £20m / £40m, at which point it will remain flat and unindexed.
- The Block Grant Adjustment for Fines, Forfeitures, and Fixed Penalties (FFFPs) will be converted to a fixed amount, given the relative steadiness of this income stream.
- Due to the removal of the indexation, this will now be a fixed adjustment to the block grant, at a level of ~ £25m per year, but final arrangements to be agreed with HMT.
- The baseline addition to the block grant for the UK's Coastal Communities Fund will be subject to the usual operation of Barnett; this will have no immediate effect on our funding position but means that if the UK Government were to reintroduce the Coastal Communities Fund, Scotland would receive a Barnett share.

Summary of Changes to the Fiscal Framework

	Original agreement – 2016/17 – 2023/24	Updated agreement – from 2024/25
BGA Mechanism	Run both Indexed per Capita (IPC) and Comparable methods (CM), but only use the IPC in practice.	IPC mechanism agreed on a permanent basis.
Resource borrowing	Up to £300m p.a. to cover forecast error.	Up to £600m p.a. to cover forecast error, indexed to inflation (GDP deflator).
Capital borrowing	Up to £450m, p.a.; £3bn cumulative cap.	Up to £450m p.a., £3bn cumulative cap, both indexed to inflation (GDP deflator).
Reserve drawdown limits	£250m resource; £100m capital.	No limits.
Overall reserve limit	£700m	£700m indexed to inflation (GDP deflator)
VAT Assignment	The two Governments agreed that VAT Assignment will be implemented in 2019-20.	How and when to implement VAT Assignment will be discussed at a future Joint Exchequer Committee.
Crown Estate	Deduction to the block grant of £6.6m (rounded) p.a.	Deduction to the block grant profiled at £10m / £10m / £15m / £20m / £40m. Fixed in nominal terms at £40m beyond.
Fines, Forfeitures, and Fixed Penalties (FFFPs)	Block Grant Adjustment to fines and penalties revenue.	Flat deduction of £25m to the block grant.
Coastal Communities Fund	A baseline addition was made equal to the UK government spending on CCF in the year immediately prior to devolution.	Absorbed into Barnett (no immediate impact on funding).
Scotland Specific Economic Shock	Forecast Error Borrowing powers temporarily increased to £600m when triggered.	Provision removed – now covered by improved unconditional resource borrowing powers.

Summary of key recommendations from the joint report of the Finance and Constitution Committee, Social Security Committee and from the Cabinet Secretary for Finance and the Economy, 28 October 2020

1. The joint report set out two structural risks that had been identified from the operation of the Fiscal Framework to date:
 - a. Demographic risks: whether the Fiscal Framework:
 - sufficiently recognises the impact of demographic divergence on income tax and social security (including the impact of immigration policy and demographic differences between Scotland and the UK);
 - 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.
 - b. Distributional Risks: whether there are potential structural risks inherent within the Fiscal Framework arising from the distribution of the tax base in Scotland relative to the UK including:
 - the incentives that tax devolution presents;
 - how the benefits of economic growth accrue across the tax base and are reflected in the Fiscal Framework operation; and
 - whether there are sufficient budget management tools for the Scottish Government to address the potential risks arising from the distribution of the tax base in Scotland relative to the rest of the UK.
2. The joint report also recommends that the review considers:
 - a. Whether the reconciliation process within the Fiscal Framework should be revised to better enable the Scottish Government to manage forecast error (in terms of the magnitude of errors and timescales for reconciliation);
 - b. The extent of the risk arising from the potential divergence in forecast error between the SFC and OBR (and the potential for any differences between forecasts to be amplified);
 - c. Whether the Scottish Government and SFC 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;
 - d. 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 and whether those limits should be protected in real terms (and retrospectively)
 - e. Re-examining the capital borrowing arrangements and merits of a prudential borrowing regime

- f. The experience of the governmental response to COVID-19 (and also at that time the agreement in the short term regarding additional flexibilities and powers to enable devolved governments to more effectively manage their budgetary response to COVID-19)
- g. Whether the implementation costs agreed as part of the Fiscal Framework are sufficient given what is known about the scope of recharges (including reasonableness of the Scottish Government meeting the costs of devolution of the social security powers within the funding envelope already agreed for implementation and administration);
- h. Re-examining how policy spill over effects are accounted for through the Fiscal Framework and flexibilities and constraints of the Fiscal Framework in responding to policy changes at Scottish or rest of the UK level
- i. The effectiveness of dispute resolution provisions and the governance arrangements (to ensure that both governments have an opportunity to respond timeously to each other's policy decisions).

Smith Commission principles - Extract from *the Independent Report*:

Analysing the options for Scotland's block grant adjustments.

The Smith Commission, which agreed the devolution of powers subsequently legislated for in the Scotland Act 2016, also set out a set of principles to guide both the calculation of the initial BGAs, and the design of the subsequent indexation method. The key principles agreed were that:

- There should be no detriment to the Scottish or UK governments' budget simply as a result of the initial transfer of tax and/or spending powers (**'no detriment from the initial decision to devolve'**). In defining this principle, the Commission also stated that the BGAs should be 'indexed appropriately'.
- The devolved Scottish budget should benefit in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget should bear the full costs of policy decisions that reduce revenues or increase expenditure (**'economic responsibility'**).
- 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 (this has often been referred to as **'taxpayer fairness'**, although that terminology was not explicitly used by the Smith Commission).
- The UK government should continue to manage the fiscal risks and shocks that affect the whole of the UK for the newly devolved revenue streams and spending responsibilities (**'UK economic shocks'**).