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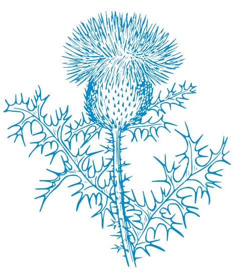

How and why has the Scottish Government's funding changed in recent years?

Scottish Election Analysis Briefing Note 1

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Executive summary

The last ten or so years have seen big changes to the level and composition of the Scottish Government's budget. Broadly speaking, the period between 2010–11 and 2017–18 was one of austerity, with real-terms funding for day-to-day (or resource) spending falling by 6% over the seven years. Since then though, funding has been increasing. It had almost returned to 2010–11 levels by 2019–20 and, excluding the additional temporary funding being provided by the UK government to address the COVID-19 pandemic, plans suggest 'core' funding will be around 3% higher in 2021–22. However, after accounting for population growth, it will still be around 2% lower per person. These trends largely reflect changes in funding from the UK government, although the use of devolved tax, borrowing and reserve powers has also had a growing impact on the Scottish Government's overall funding.

Key findings

1 Although fiscal devolution has seen the Scottish Government set and keep more of its own taxes, block grant funding from the UK government is still set to contribute two-thirds of its resource (i.e. non-investment) budget in the year just ending, 2020–21. Scottish income tax will contribute 27% of its funding and other Scottish taxes 5.5%, with borrowing contributing the remaining 0.5%.

2 The Scottish Government's resource funding fell by 6% between 2010–11 and 2017–18, driven by cuts to block grant funding from the UK government. Funding has since increased, largely driven by increases in the block grant, with 'core' resource funding set to be 3% higher in the coming financial year, 2021–22, than in 2010–11. However, this still represents a reduction of 2% per person over this 11-year period.

3 The Scottish Government has received around £9.5 billion in additional COVID-19 related funding from the UK government in 2020–21. This is equivalent to £1,370 per person in Scotland. It has been allowed to carry forward £874 million of this on top of its usual powers to hold and use reserves, which is a greater degree of flexibility than provided to UK government departments serving

England. When combined with a special 'funding guarantee', this means that the Scottish Government will almost certainly receive more funding per person to address COVID-19 over these two years than is spent in England.

4 After accounting for these financial flexibilities, funding to address the COVID-19 pandemic in Scotland will be £8.6 billion in 2020–21 (£9.5 billion minus £874 million) and £4.2 billion in 2021–22 (£3.3 billion of block grant funding plus £874 million). It is worth noting that not all of the extra funding in 2021–22 will be used to address the direct effects of the COVID-19 pandemic – some is being used to extend free school meals and free bus travel, for example. Paying for such policies may be more difficult in 2022–23 and beyond, when this temporary funding is currently planned to cease, and the money must be found from within core budgets.

5 That core funding is likely to be tight. In particular, the overall spending envelope pencilled in by the UK government in its March Budget imply spending £14 billion less on unprotected budgets in 2022-23 than was planned before the COVID-19 crisis. Fairly hefty increases in NHS and schools spending in England mean that the Barnett formula should still deliver a small increase in core funding in 2022-23 for the Scottish Government. But if the Scottish Government channels this money to the NHS and schools too, without additional funding from the UK government in its upcoming Spending Review or increases in Scottish taxes, spending on some services will likely need to be reduced in real-terms.

6 Scottish Government tax revenues have had a modest, but growing impact on its resource budget over time. For example, Scotland's more progressive and more complicated five-band income tax system and lower threshold for higher (41%) rate income tax are estimated to raise around £456 million more in 2020–21 than if policy had remained the same as in the rest of the UK. However, forecasts suggest the Scottish Government will ultimately receive only £117 million more in funding as a result of devolved income tax powers. This is because weaker underlying growth in the income tax base – mostly due to slower earnings growth in the late 2010s – offsets most of the extra revenues from its income tax policy reforms.

7 The majority of funding for Scottish Government capital investment spending comes from the UK government. This block grant funding

was reduced by 22% between 2010–11 and 2015–16 as investment spending in England was cut, but has been increasing since, and is set to be at least 7% above 2010–11 levels in the current financial year. The Scottish Government is also able to borrow up to £450 million a year and smooth spending by using reserves, and in recent years, net borrowing has averaged almost 10% of block grant funding for capital investment. Accounting for net borrowing, overall investment spending this year is set to be at least 16% higher than in 2010–11.

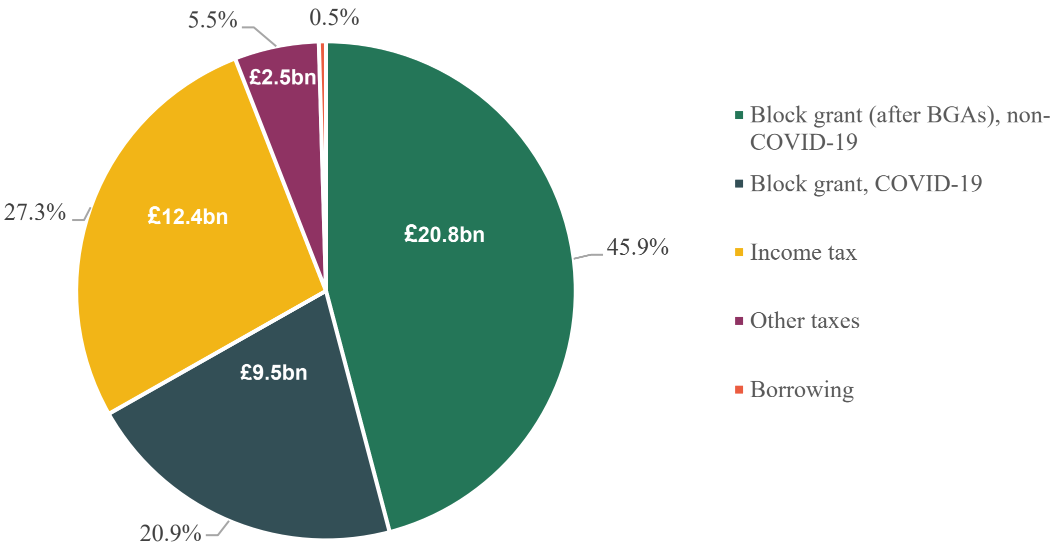
8 Total 'core' Scottish Government funding (resource plus capital) per person in 2020–21 is approximately 131% of what is being provided to UK government departments for spending in England. Higher funding levels are driven almost entirely by higher block grant funding from the UK government. In turn, this reflects two factors. First, that the Barnett formula used to allocate funding to the Scottish Government does not account for Scotland's lower population growth. Second, that the formula had a flaw up until 2015–16 that meant Scotland was insulated from the cuts it would have faced as a result of cuts to local government funding in England under a corrected formula.

1. How is Scottish Government resource spending funded?

When it was set up in 1999, the Scottish Government received almost all its funding in the form of a block grant from the UK government. This reflected the fact that nearly all the taxes paid by people and businesses in Scotland went to the UK government, which used them to help pay for the block grant and its own spending in or on behalf of Scotland (such as on UK-wide working-age social security, state pensions and defence).

However, in recent years, *fiscal devolution* has resulted in the Scottish Government setting and keeping more of its own taxes – including land and buildings transactions tax (paid on the purchase of real estate), Scottish landfill tax, and most of income tax. Figure 1.1 shows that together with business rates, which have been devolved since 1999, these taxes are forecast to contribute around 33% of the Scottish Government's funding for day-to-day (or resource) spending in 2020–21, with the vast majority of this (27 percentage points) coming from income tax.

Figure 1.1. Sources of Scottish Government resource funding, 2020–21



Note: Block grant funding includes the main block grant and BGAs, as well as reconciliation payments for previous forecast errors, and other funding for day-to-day spending from the UK government. 'Other taxes' are business rates, land and buildings transactions tax and Scottish landfill tax. Figures are gross of transfers into or out of reserves.

Source: Author's calculations using Scottish Fiscal Commission (2021a).

It remains the case that the majority of funding comes in the form of a block grant from the UK government though: 67% including the extra temporary funding provided to address the COVID-19 pandemic, and 57% excluding it.[1] The level of this grant is determined as follows, and as shown in Figure 1.2.

- First, the amount of block funding that would be due in the absence of fiscal devolution is calculated. This is equal to the block grant from the previous year plus an amount equal to Scotland's population share of any change in funding for devolved services in England.
- Second, an adjustment is made for the taxes that are devolved to the Scottish Government. When these taxes were first devolved, an amount equal to the revenues being devolved was deducted as a block grant adjustment (or BGA).

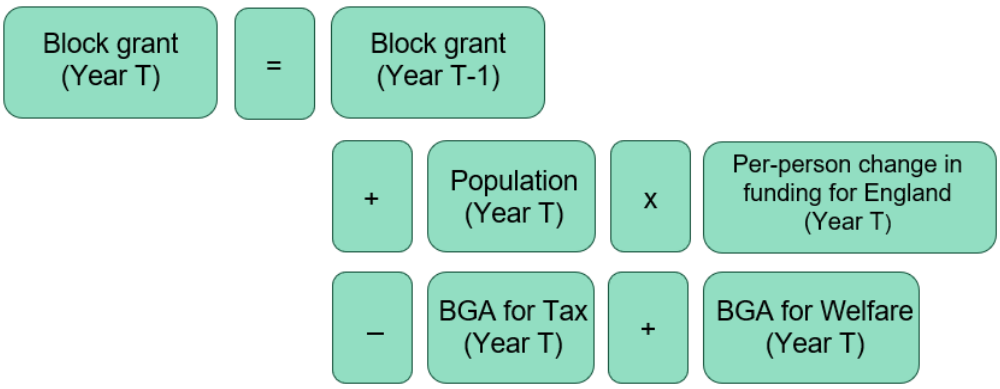
[1] It is not the 46% shown in Figure 1.1, because if the COVID-19 related funding were not being provided, total funding would also be lower, so non-COVID-19 block grant funding would represent a bigger share. Without the extra COVID-19 block grant funding, income tax would contribute 34% and other taxes 9% of total funding, respectively.

Subsequently, these BGAs have been updated each year according to the change in Scotland's population and the change in revenues per person in the rest of the UK. Together, this means that the Scottish Government receives more revenue that it would in the absence of tax devolution if revenues per person grow faster than in the rest of the UK, and vice versa – whether these differences are the result of policy changes, or underlying economic performance. The aim of this is two-fold:

1. to give the Scottish Government a stronger financial incentive to boost economic performance – it retains the additional revenue generated from devolved taxes resulting from better economic performance, and bears the losses resulting from poorer economic performance;
2. to insulate the Scottish Government's funding from the ups and downs of economic cycles affecting the whole of the UK – the resulting ups and downs in Scottish revenues are offset by changes in the BGAs.

- Third, an adjustment is made for the new welfare spending responsibilities that have been devolved alongside the new tax powers. The BGAs were initially set equal to the amount of welfare spending being devolved, and as with the tax BGAs, have subsequently been updated in line with changes in the Scottish population and changes in spending per person in the rest of the UK.

Figure 1.2. The calculation of Scottish Government block grant funding



Source: Author's summary of block grant calculation.

Even though this 'fiscal framework' offers protection from economic cycles and shocks affecting the whole of the UK (such as the COVID-19 crisis), the Scottish

Government is still exposed to more funding risk than before fiscal devolution.[2] To help it address these risks, the Scottish Government is able to pay money into, and draw down from, its reserves. It is also able to borrow if revenues turn out to be lower, or welfare spending higher, than forecast, and if the associated BGAs also turn out to differ from forecasts (e.g. because tax revenues grow more strongly than expected in the rest of the UK, meaning a higher-than-expected BGA).

Drawdowns from reserves are usually limited to a maximum of £250 million a year for day-to-day spending, which is less than 1% of overall funding. The total amount that can be held in reserve is also usually capped at £700 million. However, the UK government is allowing additional reserves to be carried forward to address the COVID-19 crisis, and the Scottish Government plans to pay £887 million into reserves for use in the coming financial year instead.

Borrowing is also subject to strict limits. The Scottish Government currently plans to make use of £207 million of borrowing for day-to-day spending in 2020–21 (less than the £300 million maximum allowed), which is equivalent to around 0.5% of funding.

2. Has funding for resource spending changed in recent years?

All told, this means the Scottish Government is forecast to have access to £45.3 billion of funding to cover resource spending in 2020–21 (around £8,300 per person). Of this, approximately £9.5 billion is one-off funding to help address the COVID-19 pandemic, which is discussed in more detail in Box 2.1. There is therefore £35.9 billion for 'core' (non-COVID-19) resource spending.

Box 2.1. Funding for and spending on the COVID-19 pandemic

Much of the spending in response to the COVID-19 pandemic is carried out by the UK government across the country as a whole. This includes paying for the Coronavirus Job

[2] For a full discussion of Scotland's fiscal framework, see Bell, Eiser and Phillips (2016). IFS researchers are currently conducting a review of the fiscal frameworks of Scotland, Wales and Northern Ireland in light of the COVID-19 pandemic alongside researchers at Strathclyde and Stirling Universities, with a first report planned for mid-April.

Retention Scheme ('furlough') and the Self-Employment Income Support Scheme (SEISS), which are expected to cost almost £80 billion across the UK as a whole – with around £6–£7 billion of this flowing to Scotland.

However, much of the spending is being undertaken by the devolved governments, including extra funding for the NHS and councils (although vaccines are being procured by the UK government) and grants and business rates relief for businesses affected by COVID-19 public health restrictions. To fund this extra spending, the UK government has provided additional block grant funding. Initially this was calculated by applying the Barnett formula to what was being spent on equivalent measures in England. However, starting in July, the UK government has provided the devolved governments with upfront guarantees of at least a certain amount of funding, irrespective of what is being spent in England. In Scotland's case, the guaranteed level was at first £6.5 billion, and to make sure the guarantee is at least as high as what is being spent per person in England, it has since been increased to £9.5 billion.

The latest increase of £874 million was only announced on 15 February 2021, around six weeks before the end of the financial year. Because it would be difficult to spend such a large amount effectively in only a few weeks, the UK government is allowing the devolved governments to carry this latest tranche into 2021–22 if they wish – which the Scottish Government plans to do. This is more generous than the rules facing UK government departments serving England: a department with the same level of funding as the Scottish Government can carry forward up to around £340 million (0.75% of their funding) via a system called 'budget exchange'.

When combined with a special 'funding guarantee' provided to the Scottish Government, these differences in flexibilities mean that the Scottish Government will very likely receive more funding per person to address COVID-19 over these two years than is spent in England. This is because if departments serving England are on course to underspend their budgets in 2020–21, they cannot carry as much forward as the Scottish Government can – the funding simply returns to HM Treasury. Yet if this means bigger top-ups are needed to UK government departments in 2021–22, the Scottish Government will still receive its population share of the increase via the Barnett formula.

Bearing this in mind, accounting for the carry-forward of this £874 million to 2021–22 means around £8.6 billion is being used by the Scottish Government to fund its response to the COVID-19 pandemic in 2020–21. Table 2.1 shows how this breaks down by spending portfolio, with the largest allocations to health, business support (mostly via the communities and local government and economy, fair work and culture portfolios), local government, and public transport subsidies (via the transport, infrastructure and connectivity portfolio).

Differences in how additional spending is categorised and reported hinder comparisons with other parts of the UK. However, analysis of COVID-19 pandemic-related expenditure suggests that the Scottish Government has allocated spending in broadly similar ways to the UK government in England, but allocated a higher share to health and a lower share to business support than in Wales.[a]

Table 2.1. Scottish Government COVID-19 pandemic-related spending, £s millions

Spending area	2020–21
Health and sport	2,957
Communities and local government[a]	2,524
Economy, fair work and culture	1,318
Transport, infrastructure and connectivity	727
Education and skills	453
Justice[b]	282
Rural economy and tourism	157
Social security and older people	74
Other	108
Total	**8,601**

Note: (a) Includes support for business provided via local government, including business rates reliefs and grants related to rateable value. (b) Includes COPFS (the prosecution service) and SCTS (the courts service).
Source: Hudson (2021).

The Scottish Government set out initial plans for its COVID-19 spending allocations in the coming financial year, 2021–22, in its Budget proposal, published at the end of January.[b] At that stage just under half (£883 million in real terms) of the planned funding (£1.9 billion) was due to go to health services, with local government (£406 million of which £188 million was to pay for a three-month extension to 100% business rates reliefs for the retail, hospitality and leisure sectors) and transport (£234 million, largely for increased subsidies to public transport operators) also receiving significant amounts.

Since then, the late Barnett consequentials being carried over from 2020-21 and additional funding provided in the UK Budget, and have taken the total amount of temporary COVID-19 related resource funding available to the Scottish Government in the coming financial year to £4.2 billion. Full details on how this additional temporary funding will be allocated have not been published – and it is likely not all of it has yet been allocated. But some allocations have been announced. Around one-quarter (£540 million) will pay for the continuation of business rates relief for the full duration of 2021–22.[c] And in its deals with the Scottish Greens and Liberal Democrats to pass the Budget,[d] the Scottish Government states that a range of more *permanent* and non-COVID-19 policies will be largely funded in the short term by this *temporary* COVID-19 funding. This includes free school meals for all primary school aged children, increased funding for mental health services, free bus travel for those aged up to 21 and a commitment to make permanent the funding for Scottish councils to cover this year's council tax freeze. Such policies will likely have to be funded by the Scottish Government's 'core' non-COVID-19 funding from April 2022 – an issue we discuss below.

The plan is for increases in non-NHS public sector pay to be paid for from within 'core' Budgets, but the Scottish Fiscal Commission notes that depending on the precise deals reached for different groups of workers, COVID-19 funding may be used to help fund this expenditure too. How the recently announced 4% increases in NHS pay are being funded is less clear. However, a note by Unison suggests that prior to the UK government's March Budget, the Scottish Government had allocated funding for pay rises of at most 2% for those earning more than £49,000, and was waiting to see what additional funding it received in the Budget before working out if it could allocate more.[e] Given that nearly all of the additional funding received as a result of the Budget was COVID-19 funding, it may be the case that some of the permanent NHS pay rises this year are being paid for by temporary funding.

a. For England, see Honeysett and Brien (2020) for information on allocations made at Main Estimates in May 2020, and Honeysett et al. (2021) for information on allocations made at Supplementary Estimates in February 2021. For Wales, Ifan and Siôn (2020) provide an analysis of COVID-19 allocations up to December 2020, with Welsh Government (2021) providing information on subsequent allocations in the third supplementary budget in February 2021.

b. Scottish Government (2021a).

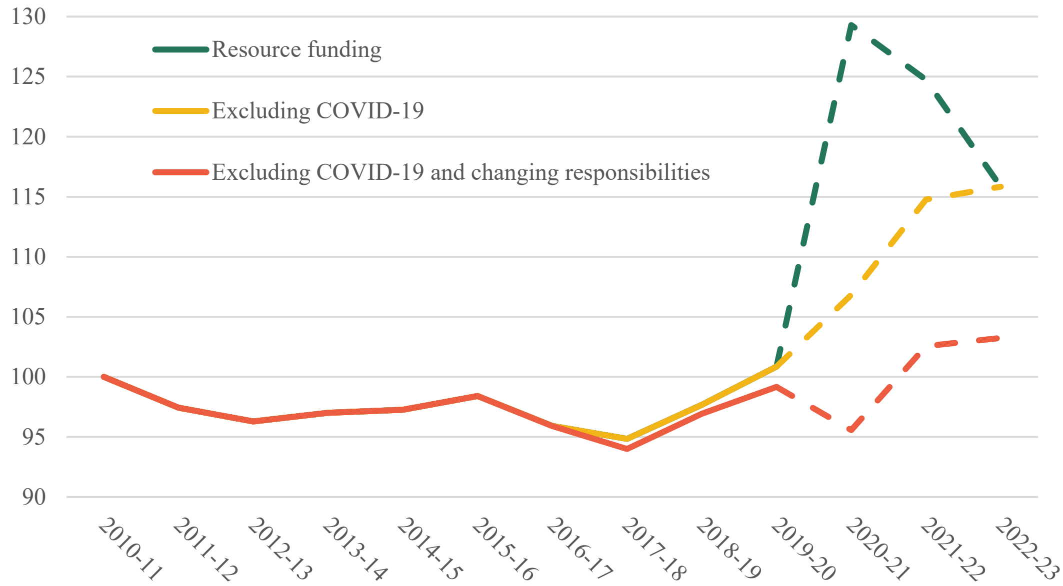
c. Scottish Fiscal Commission (2021b).

d. Burnside (2021).

e. Unison (2021).

Figure 2.1 shows how Scottish Government resource funding compares with previous years: both overall; excluding the extra COVID-19 related funding being provided this year and next; and finally, after also excluding newly devolved responsibilities (such as certain benefits and post-Brexit agricultural payments). Amounts are normalised to 100 in 2010–11 and adjusted for inflation so that it is easier to see the real-terms changes that have taken place over the last decade. The figure also shows budgeted plans for 2021–22 and a projection for 2022–23, to look at what the future may hold.

Figure 2.1. Scottish Government resource funding, 2010–11 to 2021–22, adjusted for estimated inflation (2010–11 = 100)



Note: Funding adjusted for inflation using the GDP deflator measure of inflation. Reductions in measured public-sector output (e.g. as a result of cancelled operations and school closures) during 2020–21 have temporarily raised this measure of inflation, driving the real-terms fall in 'core' resource funding (excluding COVID-19 and changing responsibilities). These effects unwind during 2021–22 and 2022–23, as measured public-sector output is forecast to return to normal.

Source: Author's calculations using HM Treasury (2015a, 2018, 2020a, 2021), Scottish Fiscal Commission (2021a, 2021b) and Scottish Government (2018, 2019, 2020a, 2020b).

The figure illustrates how:

- Between 2010–11 and 2017–18, Scottish Government funding for day-to-day spending fell by 5.2% in real terms, or 6.0% after adjusting for changes in responsibilities. The cuts took place in two distinct periods: 2010–11 to 2012–13, and 2015–16 to 2017–18, with very modest real-terms growth in funding in the intervening years.

- Between 2017–18 and 2019–20, funding grew by approximately 5% in real terms. This means that on the eve of the COVID-19 crisis, funding had almost reached its 2010–11 levels: just 0.8% lower in real terms. However, because the population had grown by 3.8% during the same period, funding per person in 2019–20 was still 4.5% lower than in 2010–11.

The picture in 2020–21 is affected by three key factors: (1) funding to address the COVID-19 pandemic; (2) the devolution of responsibility for around £3.2 billion of welfare spending and around £0.5 billion of post-Brexit agricultural funding; and (3) the effect of the pandemic on inflation – the closure of schools and cancellation of many non-urgent operations has reduced measured public-sector output, which has meant that the cost of producing each unit of measured output is higher, reducing the resulting estimated real-terms value of public spending.

As a result of all these factors, total Scottish Government resource funding has increased by an estimated 28% in 2020–21 compared with 2019–20. Excluding the additional funding to address the COVID-19 pandemic, the increase is 6%. Also excluding the funding for newly devolved responsibilities, 'core' resource funding has actually fallen by an estimated 4.4%. However, this fall reflects the aforementioned increase in measured inflation as a result of the pandemic: based on pre-COVID-19 forecasts for inflation, 'core' non-COVID-19 funding would have increased in 2020–21.

Looking to the future, plans for 2021–22 imply that total funding will fall by 3.5% compared with 2020–21, as the amount provided specifically to address the COVID-19 pandemic is currently planned to be sharply reduced. After excluding funding to address the COVID-19 pandemic and pay for newly devolved responsibilities, 'core' funding is set to increase by an estimated 7.3% compared with the current financial year – although part of this large increase represents the flip side of the effect of the pandemic on measured inflation (i.e. the fall in measured inflation as public-sector productivity rebounds once schools are fully open and non-COVID-19 hospital activity recovers). As a result of this increase, 'core' resource funding is planned to be around 3% higher than in 2010–11, although it is still expected to be around 2% lower per person.

Plans for 2022–23 have not yet been set out. However, based on the overall spending envelope set out by the UK government and allocations to the NHS and schools, together with Scottish Fiscal Commission and Office for Budget

Responsibility forecasts for tax revenues, it is possible to project funding for that year. These projections show a further fall in total resource funding as the extra temporary funding provided to address the COVID-19 pandemic comes to an end. However, there is a further small real-terms increase in 'core' resource funding of 0.7%.

This means 'core' resource funding in 2022–23 will be around 3% higher than in 2010–11, although this still represents a small fall (1%) on a per-person basis. Moreover, an increase overall of 0.7% in real terms between 2021–22 and 2022–23 would likely mean cuts to a range of service areas in order to facilitate larger increases in spending for others, such as healthcare. As noted in Box 2.1, some of the temporary extra COVID-19 funding in 2021–22 is actually being used to pay for policies that will have longer-term cost implications. Paying for these policies may be more difficult in 2022–23 and beyond, when this temporary funding is currently planned to cease, especially given the tighter overall funding outlook.

3. What explains these changes in funding?

What explains these changes in funding?

By far the biggest driver is changes in UK government spending that have fed through to the Scottish block grant via the Barnett formula. However, during the early to mid-2010s increasing revenues from business rates offset some of reductions in block grant funding; and since 2016–17, discretionary increases in income tax on those on higher incomes compared with the rest of the UK have raised modest amounts of additional funding for Scottish public services. The Scottish Government has also made use of its powers to borrow to smooth the impact of tax revenue forecast errors and to use reserves to adjust when spending takes place.

These factors are illustrated in Table 3.1, which splits the Scottish Government's funding into block grant (and other UK government) funding, and net tax revenues (i.e. after subtracting the BGAs) and net borrowing (including payments into, and drawdowns from, reserves).

Between 2010–11 and 2017–18, for example, a real-terms reduction in 'core' block grant funding of £2.1 billion (–6.5%) was partially offset by above-inflation growth in business rates revenues of £0.3 billion (+13.0%) and a net £0.1 billion from newly devolved tax powers. However, in 2017–18, the Scottish Government also had to make a reconciliation payment to account for past forecast errors for the BGAs for newly devolved taxes, and it chose to put almost £0.4 billion into reserves. This meant total 'core' resource funding declined by £2.1 billion (6.0%).

Table 3.1. Breakdown of Scottish Government funding, selected years, £s billions (2020–21 prices)

	2010–11	2017–18	2019–20	2020–21	2021–22
Block grant (total)	31.7	29.9	31.1	43.3	39.1
Of which COVID-19	*0.0*	*0.0*	*0.0*	*9.5*	*3.3*
Of which, new resp.	*0.0*	*0.3*	*0.6*	*3.9*	*4.2*
Of which 'core'	*31.7*	*29.6*	*30.6*	*29.9*	*31.6*
Business rates	2.7	3.0	3.1	1.9	2.1
Net income and other taxes	0.0	0.1	0.3	0.2	0.5
Fiscal reconciliations	0.0	–0.1	0.0	–0.2	–0.3
Net borrowing and drawdowns	0.0	–0.4	0.2	–0.7	1.4
Total resource funding	**34.4**	**32.5**	**34.7**	**44.4**	**42.9**
Core resource funding	**34.4**	**32.3**	**34.2**	**32.9**	**35.3**

Note: 'Net income and other taxes' is revenue from income tax, land and building transaction tax and Scottish landfill tax, net of the BGAs for these taxes. 'Core resource funding' excludes funding specifically for addressing the COVID-19 crisis and for new responsibilities. It also incorporates a measure of business rates revenues *before* the special COVID-19 reliefs (which have been funded using COVID-19 block grant funding).

Source: As Figure 2.1.

In more recent years, changes in block grant funding have also dominated changes in overall spending – not least because of the large quantities of additional block grant funding provided to help address the COVID-19 crisis. Part of this has been used to waive business rates for the retail, leisure and hospitality sector, and to freeze them for businesses in other sectors in 2020–21 and 2021–22, which explains most of the lower level of business rates revenues in these years relative to 2019–20.

But other elements of Scotland's funding system have also become more important. For example, the aforementioned special dispensation to carry forward the final tranche of COVID-19 funding from 2020–21 into 2021–22 means net borrowing and drawdowns are projected to be –£0.7 billion and +£1.4 billion, respectively, in each of these years.

Net revenues from income tax, land and buildings transactions tax (LBTT) and Scottish landfill tax (SLfT) have also started to make their mark on the Scottish Government's resource funding, reflecting both changes in tax policy and differences in underlying revenue performance.

The biggest changes are for income tax, where the Scottish Government has introduced a new five-band system and increased the higher-rate tax threshold (where Scotland's 41% rate kicks in) by less than the comparable (40% rate) threshold in the rest of the UK. These make the income tax system a bit more progressive, but also more complicated, and raise more revenue. The most recent estimates from the Scottish Government are that this system will raise £456 million more in 2020–21 than if the Scottish Government had followed UK government income tax policy.[3]

However, the income tax revenues being paid to the Scottish Government in 2020–21 are just £46 million more than the BGA for income tax being applied this year. This suggests that if income tax policy had remained the same as in the rest of the UK, the income tax revenues the Scottish Government would receive in 2020–21 would be around £410 million less than the BGA. Recall that the BGA is set equal to the revenues the Scottish Government would receive from income tax if its tax revenues had grown at the same rate per person since devolution in 2016–17. This means that the forecasts used when setting the amount of income tax to be transferred to the Scottish Government and the BGA assume that the underlying

[3] See Scottish Government (2020c). This estimates the pre-behavioural-response yield to be £591 million, but changes in taxpayers' behaviour as a result of the income tax increases to offset £135 million of this yield.

income tax base has grown less quickly in Scotland than in the rest of the UK over the last five years.

This reflects two things. First, total earnings grew by just 6.1% in Scotland compared to 8.8% across the UK as a whole between 2016–17 and 2018–19, depressing growth in income tax revenues over these two years.[4] Second, the operation of Scotland's fiscal framework means that the amount of income tax paid over to the Scottish Government and the BGA for income tax in 2020–21 is based on February 2020 forecasts, with reconciliation to outturn figures not due until 2023–24. These forecasts were made after the slower growth in earnings in 2016–17 and 2018–19 was known, but before it became clear that there was some catch-up in earnings growth in 2019–20,[5] likely boosting revenues. This means the tax revenue and BGA forecasts used when setting the 2020–21 budget likely overstate the fall in underlying income tax revenues in Scotland.

Nevertheless, final outturns and the most recent forecasts do suggest that underlying income tax revenues have grown slightly less quickly in Scotland than in the rest of the UK since devolution took effect in 2016–17: revenues are currently forecast to be £117 million higher than the BGA this year, which is lower than the estimated £456 million revenue generated by the higher tax rates in Scotland. In other words, slower growth in the income tax base is offsetting almost three-quarters of the revenue that is raised from the Scottish Government's income tax reforms.

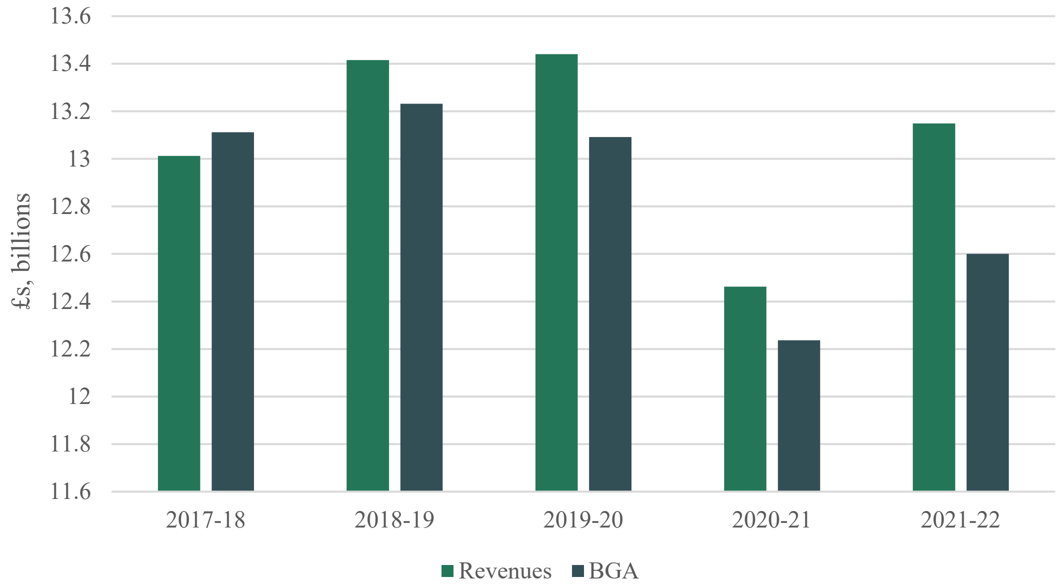
Figure 3.1 shows that also including revenues from LBTT and SLfT, devolved tax revenues are forecast to exceed the BGAs by £0.23 billion this year. This follows on from additional net revenues of £0.35 billion in 2019–20 and £0.18 billion in 2018–19, but a net shortfall of £0.10 billion in 2017–18.

The figure also illustrates how Scotland's fiscal framework insulates the Scottish Government from the revenue effects of UK-wide economic shocks, such as the COVID-19 pandemic. While the Scottish Government's tax revenues are estimated to have fallen in real terms, similar falls in revenues in the rest of the UK mean that the BGAs have also fallen.

4 Scottish Fiscal Commission (2020a).
5 Scottish Fiscal Commission (2021a).

Looking to 2021–22, current forecasts imply that the Scottish Government's tax revenues will grow more quickly in 2021–22 than comparable revenues in the rest of the UK, and hence the BGAs. As a result, Scottish revenues are forecast to exceed the BGAs by around £0.55 billion, twice the amount in 2021–22. Most of this effect is driven by income tax, for which revenues are forecast to exceed the BGA by £494 million, up from £117 million in 2020–21.

Figure 3.1. Devolved tax revenues and BGAs, final outturns (2017–18 to 2018–19) and forecasts (2019–20 to 2021–22)



Note: Outturns for 2017–18, 2018–19, and for LBTT and SLfT, 2019–20, and forecasts from January 2021 for other years. BGA forecasts are calculated using 2018-based population projections, adjusted for differences between projections and estimates in 2019.

Source: Author's calculations using HM Treasury (2020a), ONS (2019, 2020), Scottish Fiscal Commission (2019, 2020b, 2021a) and Scottish Government (2019, 2020a).

We might think this means that a stronger recovery from the COVID-19 crisis is expected for Scotland than the rest of the UK. However, this does not appear to be the case. Indeed, the Scottish Fiscal Commission, which forecasts the Scottish Government's tax revenues, expects growth to be lower in 2021 (1.8%) than the Office for Budget Responsibility (4.0%),[6] whose forecasts determine the BGAs.

[6] Office for Budget Responsibility (2021).

Instead it appears to be driven by differences in judgements about how overall growth in the economy will relate to changes in employment, earnings and tax revenues. The Scottish Fiscal Commission has said that it does not expect this relationship to be different in Scotland than in the rest of the UK, and hence neither does it expect Scottish income tax revenues to outperform those in the rest of the UK. Instead, its judgement is that, across the UK, income tax revenues will perform better than the Office for Budget Responsibility expects – and this affects its forecasts specifically for Scotland.[7]

If, in the end, Scottish income tax revenues do not grow more strongly than those in the rest of the UK, then the ultimate difference between tax revenues and the BGA will be smaller than implied by current forecasts. As a result, the extra funding provided by these forecasts would be temporary, and the Scottish Government would have to pay a reconciliation payment in 2024–25, to 'pay back' the extra net tax revenues that never actually arise.

4. How has funding for capital investment changed?

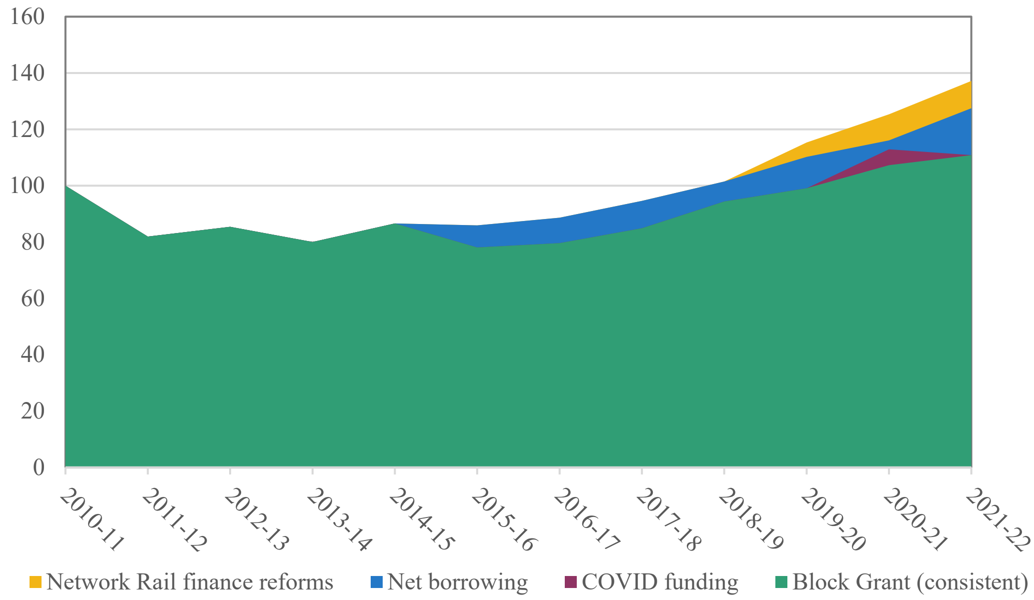
So far, we have focused on day-to-day spending. But the Scottish Government also spends significant amounts of money investing in new roads, schools and hospitals.[8] How has funding for such capital investments changed over time?

Figure 4.1 shows how capital funding has evolved over time, separately showing block grant funding from the UK government ('core' and COVID-19 related), and the use of borrowing and reserves powers.

7 See paragraphs 80 to 90 of Scottish Parliament Finance and Constitition Committee (2021).

8 In recent years, the Scottish Government has also received funding to pay for lending money households and the private sector, such as via the Help to Buy scheme and the Scottish National Investment Bank. The figures cited in this report exclude that funding which is ring-fenced and cannot be used for other more traditional types of capital investment. This 'financial transactions' capital funding is set to amount to £537 million in 2020-21 and £450 millin in 2021-22, after accounting for payment into and out of reserves.

Figure 4.1. Scottish Government capital funding, 2010–11 to 2021–22, adjusted for estimated inflation (2010–11 = 100)



Note: Excludes 'financial transactions' capital funding, which funds repayable loans to the private sector, for example via the Help to Buy scheme and the Scottish National Investment Bank.

Source: Author's calculations using HM Treasury (2015a, 2015b, 2018, 2020a), Scottish Fiscal Commission (2021a, 2021b) and Scottish Government (2018, 2019, 2020a).

As with funding for day-to-day spending, this shows that it is changes in block grant funding from the UK government that has driven the changes seen over the last decade. Large cuts to capital spending by UK government departments meant block grant capital funding was reduced by 22% in real terms between 2010–11 and 2015–16. However, as the UK government has ramped up its investment spending again over the last few years, these cuts have been more-than-undone.

It is important to note that changes to accounting rules mean that since 2019–20, all of Network Rail's capital investment is funded via up-front block grant funding whereas historically only part of it was. This means that in order to make meaningful like-for-like comparisons of capital funding over the last decade, it is important to try to adjust for this. We do this by subtracting from capital funding 2019-20 and beyond, the uplift allocated in 2019-20, largely to address this change in accounting rules. However, part of this uplift is likely to have represented a genuine increase in investment spending too – but how much is impossible to estimate using published data.

This means our adjusted figure for the Scottish Government's capital block grant funding is likely to slightly under-estimate true like-for-like funding from 2019-20 onwards. Bearing this in mind, the adjusted figures suggest that capital block grant funding in 2020–21 will be at least 13% higher in real terms than in 2010–11, or at least 7% higher after excluding funding provided specifically to fund investments to tackle the COVID-19 pandemic.

In addition, the Scottish Government has also made significant use of its new borrowing powers (allowing it to borrow up to £450 million per year to boost capital spending since 2015–16.[9] In recent years, net borrowing (i.e. also accounting for payments into and drawdowns from reserves) has provided additional funding for investment that is equivalent to be between 3% and 15% (and 10% on average) of (adjusted) block grant capital funding. And accounting for net borrowing, overall real-terms capital funding is set to be at least 16% higher this year than in 2010–11 and at least 46% higher than in 2015–16, after accounting for changes in how Network Rail investment is funded. Capital funding is set to increase further in 2021–22 – to at least 27% above 2010–11 levels and at least 48% above 2015–16 levels, again after accounting for how Network Rail investment is funded – partly reflecting a decision by the Scottish Government to defer £237 million of capital funding received this year into next, via its temporarily enhanced COVID-19 reserve powers.[10]

It is worth noting that Scotland's total capital borrowing is capped at £3.0 billion. Borrowing plans imply that the debt stock will be around £2.2 billion by the end of 2021–22. If the Scottish Government were to borrow the maximum allowed, after accounting for repayment of existing borrowing, the debt stock would reach £2.9 billion in 2023–24 and borrowing would be restrained by the cap in 2024–25. This would reduce the Scottish Government's ability to borrow to be equal to the amount of debt being repaid during the year from resource funding. If, for example, the Scottish Government pays for both the principal and debt interest from its resource funding, this might enable around £150 million of new borrowing each year, given current repayment periods of around 20 years. Shorter repayment periods would enable more new borrowing each year, but would mean more resource funding

9 In 2015–16 and 2016–17, the limit was 10% of the capital block grant. The £450 million cash limit was introduced in 2017–18.

10 The increase in 2021-22 including new up-front payments for Network Rail investment spending is 37% relative to 2010–11 and 60% relative to 2015–16.

would be needed to cover the cost of repayments. Thus, without an increase in borrowing limits, capital funding will be more dependent on UK government block grant funding than it has been in recent years.

5. How does funding compare with England?

A comparison of funding levels between Scotland and England is complicated by the fact that the UK government departments with responsibility for public service spending in England are also often responsible for some spending in Scotland and the other devolved nations. For example, the Department of Business, Energy and Industrial Strategy is responsible both for research funding specifically for English universities (via 'Research England') and for research funding across the UK as a whole (via 'UK Research and Innovation', among other bodies). Usefully, the UK government publishes estimates of what fraction of each department's spending is specifically for England for certain specific years in its Statement of Funding Policy, published alongside major Spending Reviews. We can use this information to estimate funding for comparable areas of responsibility in England, focusing on funding for non-COVID-19 and non-welfare spending.

Figure 5.1 shows that in 2020–21, per-person funding for the Scottish Government is estimated to be 131% of per-person funding for equivalent responsibilities in England.[11] Only a small part of this (less than 2 percentage points) is explained by devolved tax revenues and borrowing: block grant funding from the UK government explains the vast majority (29 percentage points) of the difference.

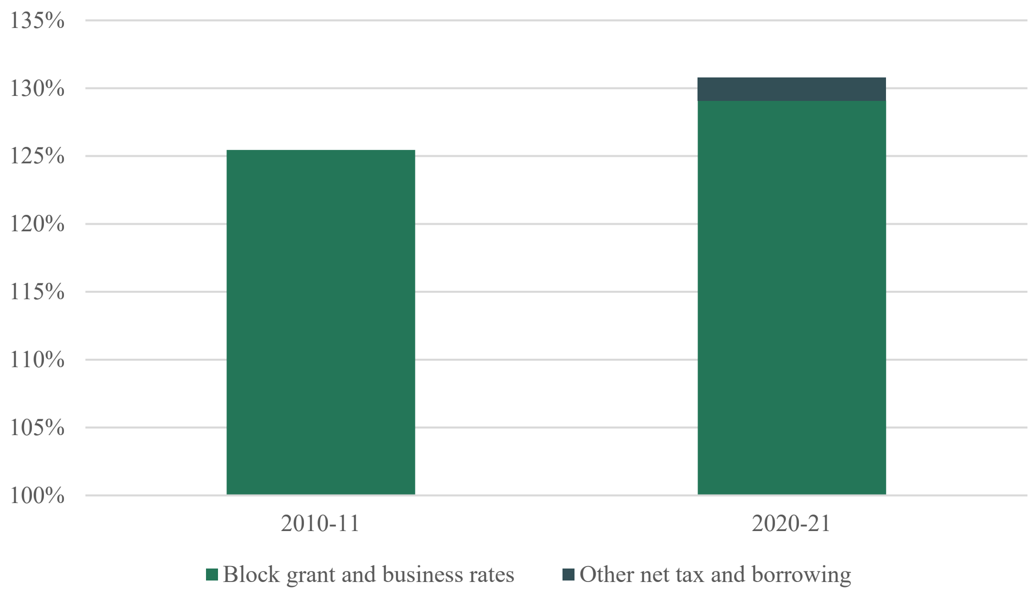
Comparing this gap over time is difficult given changes in responsibilities and in accounting rules. Doing the same calculations for 2010-11, for example, suggests that funding per person in Scotland was 125% of English levels – based on the responsibilities and accounting rules then in place. What might it look like given the responsibilities and accounting rules *now* in place? Because one of the biggest changes that has happened in the intervening decade is to capture all Network Rail investment up front, and the share of this that goes to Scotland is lower than the

[11] Excluding devolved welfare expenditure which is funded by a block grant adjustment rather than via the block grant itself.

share of other spending going to Scotland, it is likely that the gap 2010-11 would been smaller than 25% if calculated based on today's responsibilities and rules. It is therefore clear that the gap has grown over time, with the Scottish Government facing smaller cuts in funding per person over the last decade than in England.

But wat explains this large gap in the first place, given that the Barnett formula, which determines year-on-year changes in the block grant, allocates the Scottish Government a population share of changes in spending in England? A number of factors play a role.

Figure 5.1. Scottish Government funding per person, percentage of comparable funding for England



Note: Figures for 2020–21 exclude COVID-19 funding, for which information on comparable funding in England is unavailable.

Source: Author's calculations using HM Treasury (2010, 2015a, 2015b, 2018, 2020a, 2020b).

1. The Barnett formula only applies to *changes* in the block grant and not the level of the block grant. So, all else equal, if funding starts off higher than for England and spending in England is increasing, the Barnett formula, which allocates the Scottish Government its population share of that increase, would only slowly narrow that gap over time, in a process termed the 'Barnett squeeze'. And when funding is being cut – such as during the early 2010s – the funding gap would actually *grow* in relative terms, because Scotland's

population share of the funding cut would represent a smaller share of its higher initial funding level.

2. The Scottish population has historically grown less quickly than the English population: by 5% as opposed to 21% over the period since 1979, when the Barnett formula was introduced. This matters because as the Barnett formula applies only to changes in the block grant and not the level of the block grant, it does not account for this slower population growth. This means less of the extra funding the Scottish Government has historically received has been taken up by increases in the population, and more has translated into increases in funding per person, increasing its relative levels of funding per person.
3. In the years prior to devolution, Scottish Secretaries of State were able to negotiate additional funding via bypasses to the Barnett formula, especially to finance public-sector pay increases.[12]
4. As previously highlighted by IFS researchers,[13] up until 2015–16, the Barnett formula contained a flaw in the way it treated business rates revenues. This meant that during the early to mid-2010s the Scottish Government avoided at least £600 million of cuts that it would have faced as a result of cuts in UK government funding for English councils under a formula without this flaw. The flaw was fixed from 2016–17 onwards, but the £600 million cut the Scottish Government should have faced over the preceding five years has never been applied.

Factors (1), (3) and (4) also explain the growth in the funding gap over the last decade. However, with funding increasing again, and the flaw in the Barnett formula fixed going forwards at least, the growth in the funding gap is likely to be much slower, and may go into reverse in the coming years.

6. Concluding remarks

The last decade has seen major changes in the Scottish Government's funding sources and levels. In 2020–21, almost one-third of its resource funding is set to come from devolved taxes – and over 40% if we focus on its 'core' non-COVID-19 funding – up from less than 7% in 2010–11, when its only tax revenues came from

[12] House of Lords Select Committee on the Barnett Formula (2009).
[13] Phillips (2014).

business rates. The Scottish Government has used its new tax powers to raise modest amounts of additional revenues, and its capital borrowing powers to boost investment spending by almost 10%, on average, in recent years. But it remains the case that changes in block grant funding from the UK government – driven by changes in spending in England by the Barnett formula – drive the big trends in Scottish Government funding. These changes have seen funding fall and then rise over the last decade. Both the initial cuts and subsequent increases were especially big for capital funding, which is set to be at least 16% higher this year than in 2010–11. However, 'core' non-COVID-19 resource funding is set to be just 3% higher in real terms in the coming financial year, 2021–22, than in 2010–11: a cut of 2% after accounting for population growth.

The picture for resource funding in 2022–23 and beyond looks to continue to be challenging. Neither the UK government nor the Scottish Government has set out detailed plans, but the overall spending envelope pencilled in by the UK government – which is between £14 billion and £17 billion lower than was planned pre-COVID-19 from 2022–23 onwards – imply a tight Spending Review later this year. If the Scottish Government is unable or unwilling to draw down reserves further in 2022–23 and beyond, its 'core' resource funding would likely increase by less than 1% in real terms that year. This would likely necessitate cuts to a range of services in order to provide bigger increases to areas such as health and schools, or further increases in Scottish taxes. Similar stark choices face the UK government, where planned increases for the NHS and schools in England and other protected departments imply funding for other departments would fall by 3% in real terms in 2022–23, given the overall spending envelope currently set out.[14] It seems doubtful that there is the appetite for such cuts – especially given the proclaimed end of austerity – suggesting that UK government spending in England is likely to be topped up in the Spending Review, generating additional funding for Scotland via the Barnett formula. Whether this would be enough to meet all increases in costs and demands, especially in the wake of the COVID-19 crisis, is unclear though. And here the Scottish Government may face a bigger challenge than the UK government: a number of policies with longer-term cost implications that the Scottish Government committed to as part of its Budget deals with the Scottish Greens and Liberal Democrats – for example, on mental health services, free school meals, council tax and public transport – are being funded in the current year by

[14] Zaranko (2021).

temporary COVID-19 funding. These will likely have to be funded out of the Scottish Government's core funding from 2022–23 and beyond.

It is important not to forget though that the Scottish Government receives substantially more funding than is spent on comparable services in England – and in Wales, for that matter, which has a poorer and older population.[15] And this gap has grown since 2010–11, in part reflecting a flaw in the Barnett formula that was fixed going forwards but not retrospectively in 2015–16.

In our subsequent Scottish Election Briefing Notes, we will look in more detail at which services the Scottish Government targets most of this additional funding, and how its priorities have changed over time and compare to the rest of the UK. We will also look in more detail at the Scottish Government's devolved tax and welfare policies: who the winners and losers are; any common themes in the choices made; and the broader issues arising from these choices – and those choices ducked.

[15] HM Government and Welsh Government (2016).

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