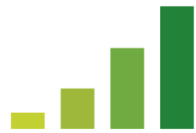

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CENTRE ON CONSTITUTIONAL CHANGE

Scotland’s Fiscal Framework: assessing the agreement

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Background

- Agreement of new Fiscal Framework is a key part of devolving tax and welfare powers to Scotland
- Our project, funded by Nuffield Foundation and ESRC aimed to inform its development, and assess its implications
  - Focus specifically on how Scotland's block grant will be adjusted to reflect new tax and spending responsibilities
- Today's report is third under the project
  - Presentation draws primarily on it, but on our earlier work too

Outline of presentation

- The new powers and the need for block grant adjustments (BGAs)
- The agreed method for calculating the BGAs
  - How does it compare to what each governments wanted?
  - To what extent does it meet Smith Commission's principles?
  - What are its implications?
- Scenarios for the Scottish Government's budget
- Policy change, spillovers and 'compensation payments'
- Uncertainty and risk: forecasting and borrowing
- International perspective on the Fiscal Framework

Scotland’s traditional funding regime

- Scottish Government traditionally funded largely via block grant from Westminster
- Block grant updated each year using Barnett formula
  - Previous year’s block grant
  - Plus population-share of change in comparable spending in England
- Protects Scottish budget from revenue risk
- But means no financial incentive to grow revenues
  - And therefore weak fiscal accountability for decisions
- And limited scope to vary policy and revenues/level of spending

Devolution of fiscal powers

- Some tax powers and revenues devolved under Scotland Act 2012
  - Stamp Duty Land Tax
  - Landfill Tax
  - Part of Income Tax
- Smith Commission and Scotland Bill 2015-16 go much further
  - With an aim of giving more control
  - And more financial incentives and accountability

Taxes and welfare revenues to be devolved

Tax	Revenue (£m, 2013-14)	When?
Income tax (non-savings; non-dividend)	10,900	2017-18
Assignment of half VAT receipts	5,000	2019-20
Air Passenger Duty	250	2018-19
Aggregates Levy	50	TBC

- Around £2.5 billion of welfare benefits
  - Mostly related to disability (e.g. DLA/PIP, Carers Allowance)
  - Also winter fuel & cold weather payments
  - And a few others

Need for a new Fiscal Framework

- Smith Commission recognised these new powers meant a need for a new "Fiscal Framework"
  - Borrowing powers to reflect increased exposure to revenue volatility and forecast error
  - Arrangements for independent scrutiny of fiscal forecasts
  - New inter-governmental relationships and dispute resolution mechanisms
- Barnett Formula to continue to determine Scotland's block grant
- But recognised that block grant adjustments (BGAs) needed, to account for newly devolved revenues and welfare responsibilities
  - Did not say how these should be calculated
  - But did lay out a set of principles

Fiscal Framework Agreement

- Fiscal Framework Agreement finally published on 25th February
  - After many months of negotiations
  - The day of deadline set by Scottish Parliament Devolution Committee
- BGAs were perhaps the most difficult issue to get an agreement on

The initial BGAs

- Relatively easy to agree initial BGA for when a tax or welfare benefit first devolved
- For a tax, BGA subtracted from block grant is equal to amount of revenues being devolved
- For welfare, BGA added to block grant is equal to amount of spending being devolved
- Needed to be this way to satisfy Smith Commission's "no detriment" principle
  - Neither government should be better or worse off simply as a result of the 'decision to devolve'

Indexing the BGAs in subsequent years

- Much more difficult to agree how to index these initial BGAs in subsequent years
- Cannot be the amount raised or spent in Scotland each subsequent year as that would undermine whole case for devolution

Revenues up £500m | **Block grant cut £500m** | **= no net change**

- Instead index the initial BGAs according to what happens to comparable revenues and spending in rest of the UK (rUK)
  - But there is more than one way of doing this
  - UK and Scottish governments wanted to do it differently, based on different prioritisation of Smith Commission principles

No Detriment and BGA indexation (I)

- Scottish Govt put most weight on principle that there should be “no detriment from the decision to devolve”
- Argued that if Scotland’s devolved revenues and welfare spending per capita grow at same % rate as rUK, Scotland should be no better or worse off than without devolution
  - Gain or lose if revenues per capita grow more or less quickly
- It suggested **‘Indexed Per Capita” (IPC)** approach to achieve this
  - BGAs to be updated each year according to
    - % change in revenue/spending per capita in rUK
    - % change in Scottish population

No Detriment and BGA indexation (II)

- Example:
  - rUK revenues per capita up 5%
  - Scotland's population up 0.3%
  - BGA would therefore increase by 5.3%, whatever happened to rUK population and aggregate rUK revenues
- Approach therefore insulate Scotland from population-based risk to revenues and welfare spending

Taxpayer Fairness and BGA indexation (I)

- But this IPC approach violates another of the Smith Commission's principles: the 'taxpayer fairness' principle
- This principle states that changes to 'devolved' taxes in rUK should not affect overall level of public spending in Scotland
- The UK Government initially proposed a method that would achieve this – **Levels Deduction (LD)** method.
- Update BGA each year according to Scotland's population-based share of changes in equivalent revenues or welfare spending in rUK
- This is symmetric with Barnett formula which adds a population-based share of changes in 'comparable spending' to block grant

Taxpayer Fairness and BGA indexation (II)

- Example:
  - rUK revenues increase £10bn, rUK public spending up £10bn
  - Suppose Scotland's population-share is 9%
  - BGA increases by £900m (£10bn x 9%)
  - But Barnett increases underlying block grant by £900m
  - Exactly offset leaving actual block grant unchanged
- But Scotland has lower revenues per capita than rUK
  - These have to go up at a faster % rate than in rUK to keep up with BGAs that would take no account of this
  - If, instead, revenues grew at same % rate per capita, Scotland's budget would be lower than without devolution
  - Violating Scottish Govt's interpretation of "no detriment"

An attempt at compromise… (I)

- UK Government offered to modify its LD method to take account of Scotland's lower revenues per capita
  - It called this the **"Comparable Model"**
- Example
  - rUK revenues increase £10bn, rUK public spending up £10bn
  - Suppose Scotland's population-share is 9%
  - It's initial revenues per capita are 90% of those in rUK
  - BGA increases by £810m (£10bn x 9% x 90%)
- Means Scotland not lose out from its lower revenues per capita
  - But the 'taxpayer fairness' principle not satisfied
  - Barnett increases underlying block grant by £900m
  - So actual block grant up £90m (£900m - £810m)

An attempt at compromise… (II)

- This is not reason Scottish Govt objected to Comparable Model
  - Its IPC approach also violates this principle
- Objected because the model does not take account of Scotland's lower population growth than rUK
  - e.g. The BGA goes up even if rUK revenues increasing only due to population growth and Scotland's population unchanged
- UK Govt said accounting for differences in population growth would be unfair/inconsistent as the Barnett Formula does not do it
- Looked like negotiations were at an impasse
  - But they did eventually reach an Agreement…

The Agreement on BGA indexation

- Agreement says that for a transition period lasting 5 years that the indexation should be…

  "effected by…the Comparable Model…, whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method"

- At first glance this looks like a compromise:
  - Both the Scottish Govt's preferred and UK Govt's latest proposals are mentioned

- But using Comparable Model and then modifying the result to match the IPC method is ultimately the same as using the IPC method all along
  - Scottish Govt has got it's way – for the first 5 years

Why the convoluted language of Agreement?

- No clear economic or practical rationale
- Politics?
  - To highlight the differences in funding under different approaches?
  - To help keep “Comparable Model” on the table?
- Remember: Agreement only covers period to 2021-22 and then negotiations have to start all over again…

Implications of agreed IPC approach

- Scottish Govt's budget will be unaffected by devolution if revenues and welfare spending per capita grow at same rate as in rUK
  - Satisfying Scottish Govt's interpretation of 'no detriment' principle
- But 'taxpayer fairness' principle not satisfied
  - And some rUK revenues will continue to be redistributed to Scotland

Scenarios for Scotland’s budget

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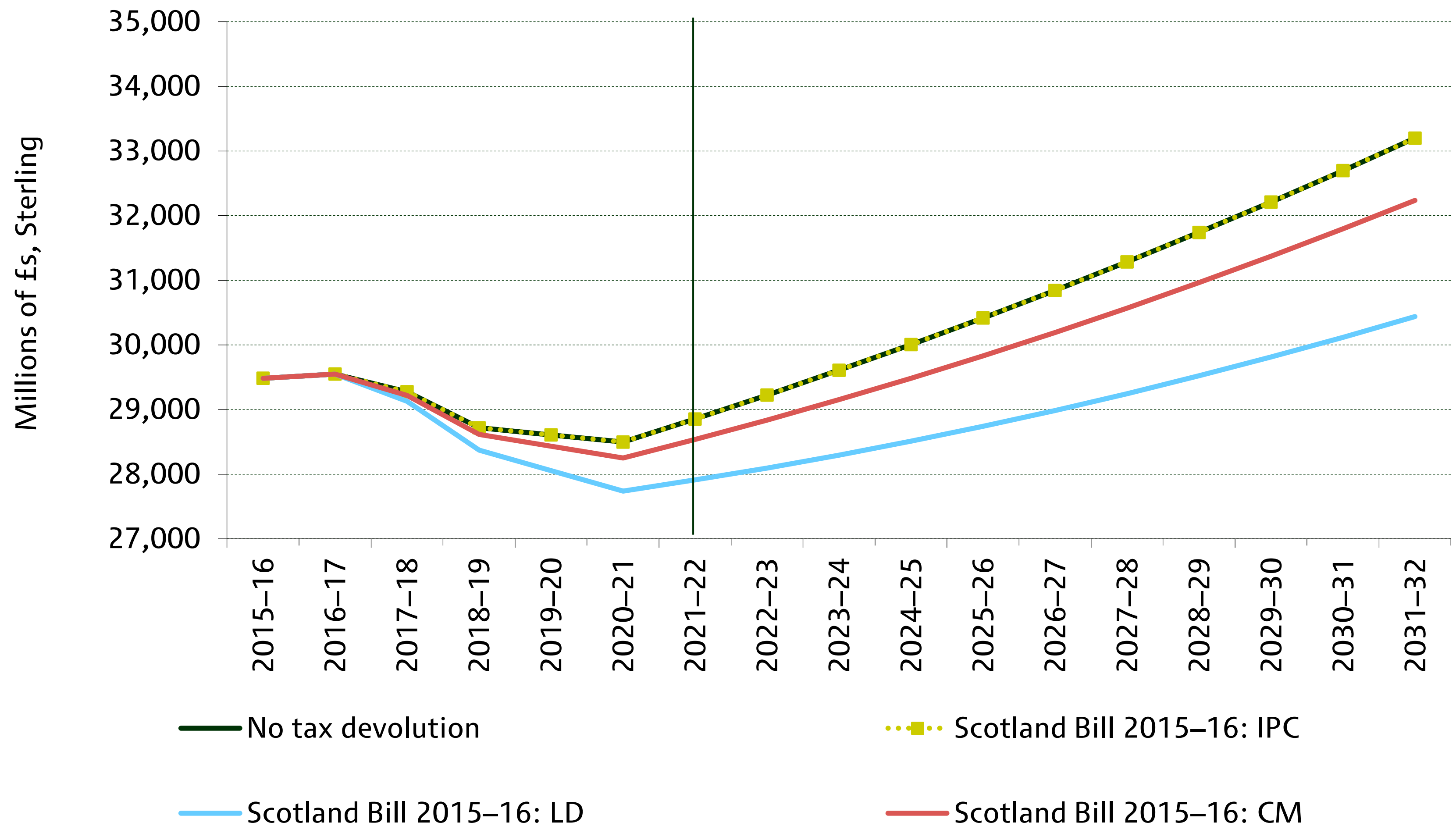
Scenarios for Scotland's block grant and devolved tax funding

- How might Scotland's budget evolve given its new powers and the BGA indexation approach agreed?
- Scenarios, not forecasts!
- Assumptions, based on forecasts from UK Govt and DWP, OBR and ONS, imply over period til 2021:
  - Income tax: +2% per year
  - Stamp Duty Land Tax and Landfill Tax: +4.1% per year
  - Air Passenger Duty: +2.3% per year
  - VAT: +1.6% per year
  - Aggregates Levy: +4.1% per year
  - Devolved welfare: -0.7% per year
- Population: +0.6% per year (rUK); +0.3% per year (Scotland)
- Beyond 2021, revenues and spend grow 1.9% per year

Equal per capita revenue and spending growth in Scotland and rUK



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The effect of faster or slower revenue and spending growth in Scotland - assumptions

Optimistic scenario

Per capita growth of income tax revenues

- rUK: 1.9%; Scotland: 2.8%

Per capita growth of welfare spending:

- rUK 1.1%; Scotland 0.8%

Pessimistic scenario

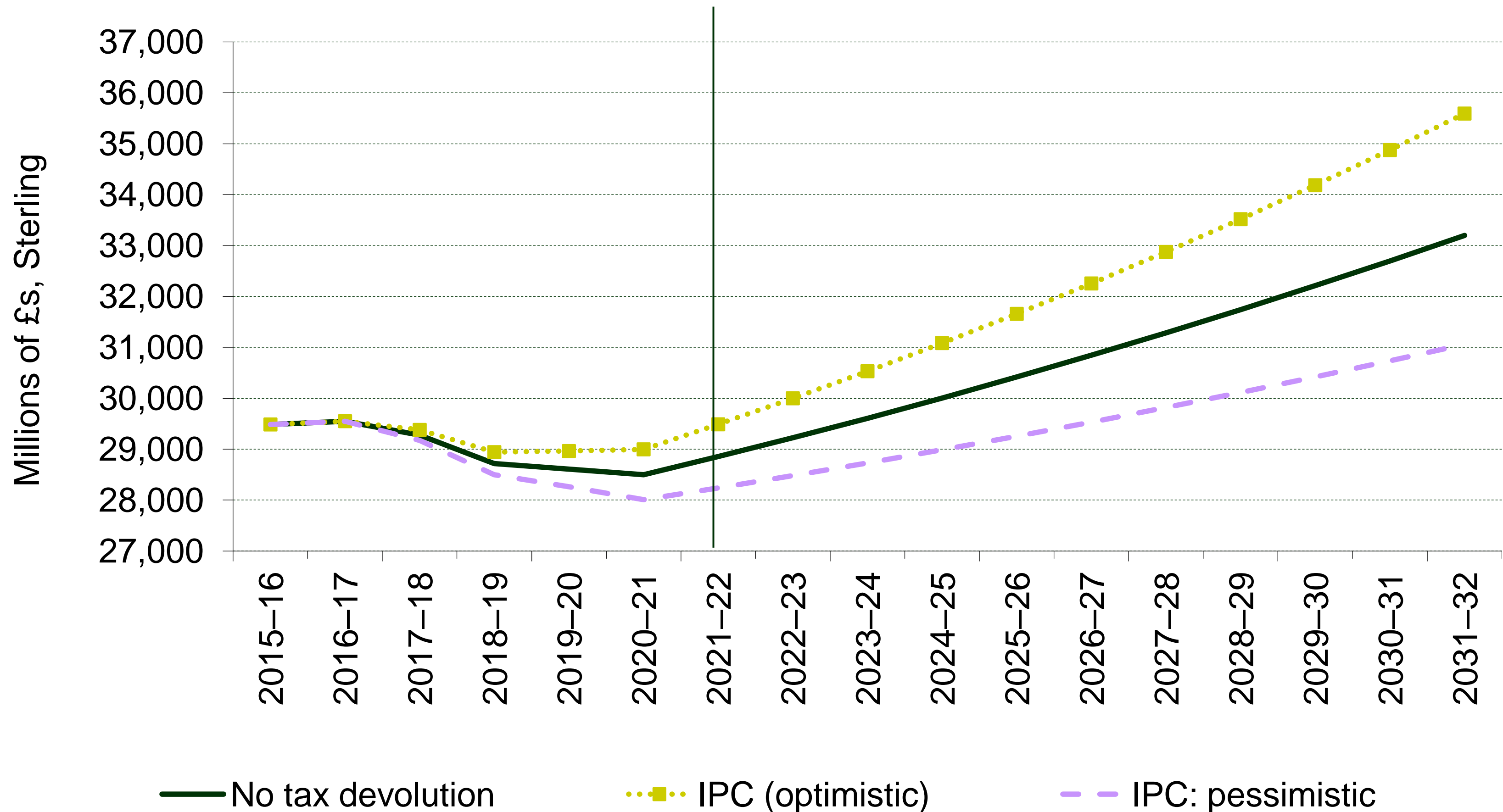
Per capita growth of income tax revenues

- rUK: 1.9%; Scotland: 1.1%

Per capita growth of welfare spending:

- rUK 1.1%; Scotland 1.4%

The effect of faster or slower revenue and spending growth in Scotland



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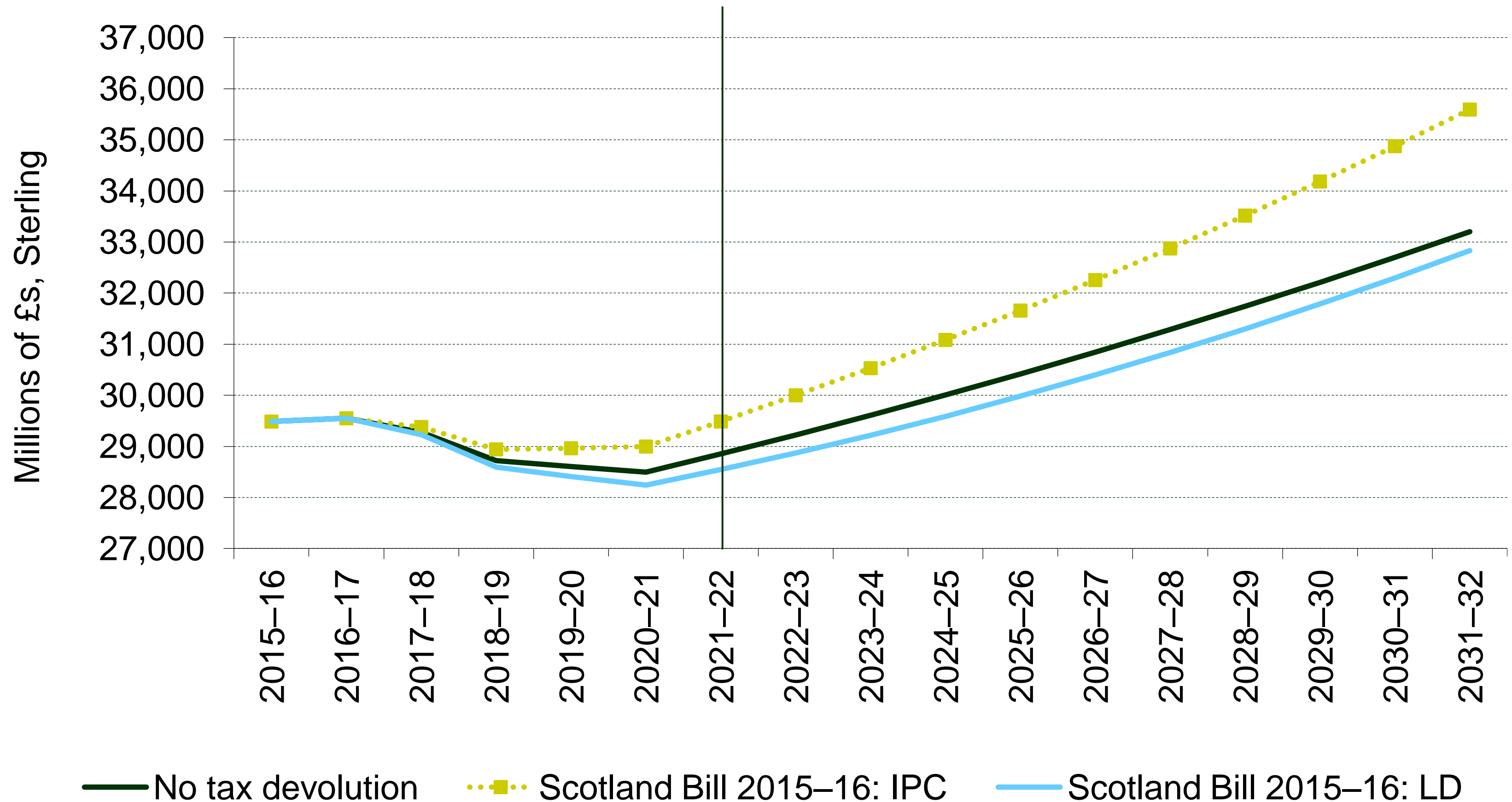
There are still implicit transfers to Scotland, even when its revenues grow more quickly



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Scenarios: key points

- Projected slower population growth in Scotland means IPC likely to be most generous to Scotland
- Difference between IPC and CM: £300m per year by 2020 under core scenario
- Difference between IPC and LD even greater: £900m per year
- Faster or slower growth in devolved revenues or spending will have significant budgetary effects if sustained
- Process of agreeing BGA method is a zero-sum game

Policy change, spillovers, and compensation

Tax rate changes and no detriment

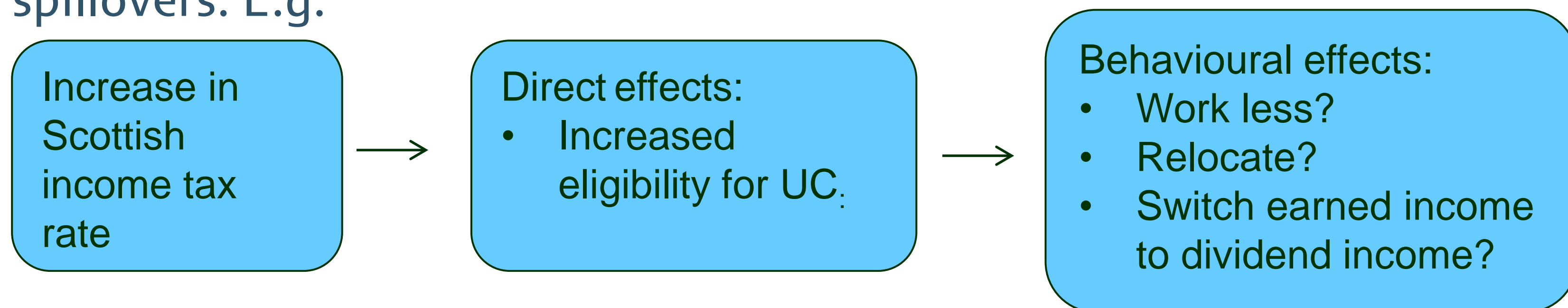
- No detriment as a result of UK Government or Scottish Government policy decisions post-devolution:
  - **Taxpayer fairness principle**:
  - **Compensation principle**: Where either the UK or Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.

Taxpayer fairness principle: not met!

- Only 'Levels Deduction' achieves the taxpayer fairness principle, because it is symmetric with Barnett:
  - Barnett increases Scotland's block grant by a population share of rUK spending increases
  - LD method increases Scotland's BGA (i.e. the bit taken away from the block grant) by a population share of rUK tax revenue increases
- Neither Comparable Model nor IPC achieve taxpayer fairness, as both account for Scotland's lower revenues per capita:
  - Barnett gives Scotland a population share increase in rUK spending; but BGA deducts a less than population share increase in rUK revenues
- In theory the 'unfairness' can work both ways

Compensation for policy spillovers

- Any policy change, by either government, can potentially generate spillovers. E.g.



- What was agreed in the Fiscal Framework?
  - Direct spillover effects of policy change subject to compensatory transfers
  - Behavioural (and 'second-round') effects will not be…
  - …unless they involve a 'material and demonstrable' cost or saving
- But how will 'shared understanding' of spillover policy effects be arrived at? Causal effect of policy very difficult to estimate.

Uncertainty and Risk: Borrowing and Forecasting

Importance of forecasting and borrowing

- - Devolution of taxes and welfare spending will necessarily mean more budgetary uncertainty - more budgetary risk
- - Forecasting arrangements become more important
- - Tools needed to manage the fiscal risk - borrowing and reserves powers

The Fiscal Framework Agreement: Forecasting

- Forecasting role for the Scottish Fiscal Commission
  - will make forecasts, not endorse them
  - UK Government win?
- The "reciprocal statutory duty of cooperation between the Scottish Fiscal Commission and the OBR"
  - How will this work? How will differences be resolved?
- What will be the pattern of forecast errors and how will this influence short-term borrowing requirements?

Insurance cover on Scotland's finances

- UK-wide economic shocks
  - Through the BGA
- Borrowing cover for Scotland-specific shocks
  - Through the "Scotland-specific shock" borrowing provision
- Welfare spending
  - Through the BGA
- Fiscal framework being reviewed in 2021 – opportunity to revisit borrowing powers as well as BGA

Borrowing powers in the fiscal framework agreement

- Fixed in cash terms – not set by fiscal rules
- Borrowing from the UK National Loans Board
- Or the markets (within the specified limits)
- Scottish Government not given the option to extend borrowing as much as it might wish?

Borrowing powers in the fiscal framework agreement

- **Resource borrowing** to cover
  - Forecast errors
  - Cash management
  - Scotland-specific shocks
  - [Scotland Act 2012 only allowed borrowing for forecast errors]
- Scotland Act 2012
  - total borrowing - £500 million
  - annual limit of £200 million.
- Scotland Bill 2015-16
  - total borrowing - £1.75 billion
  - annual limit of £600 million.

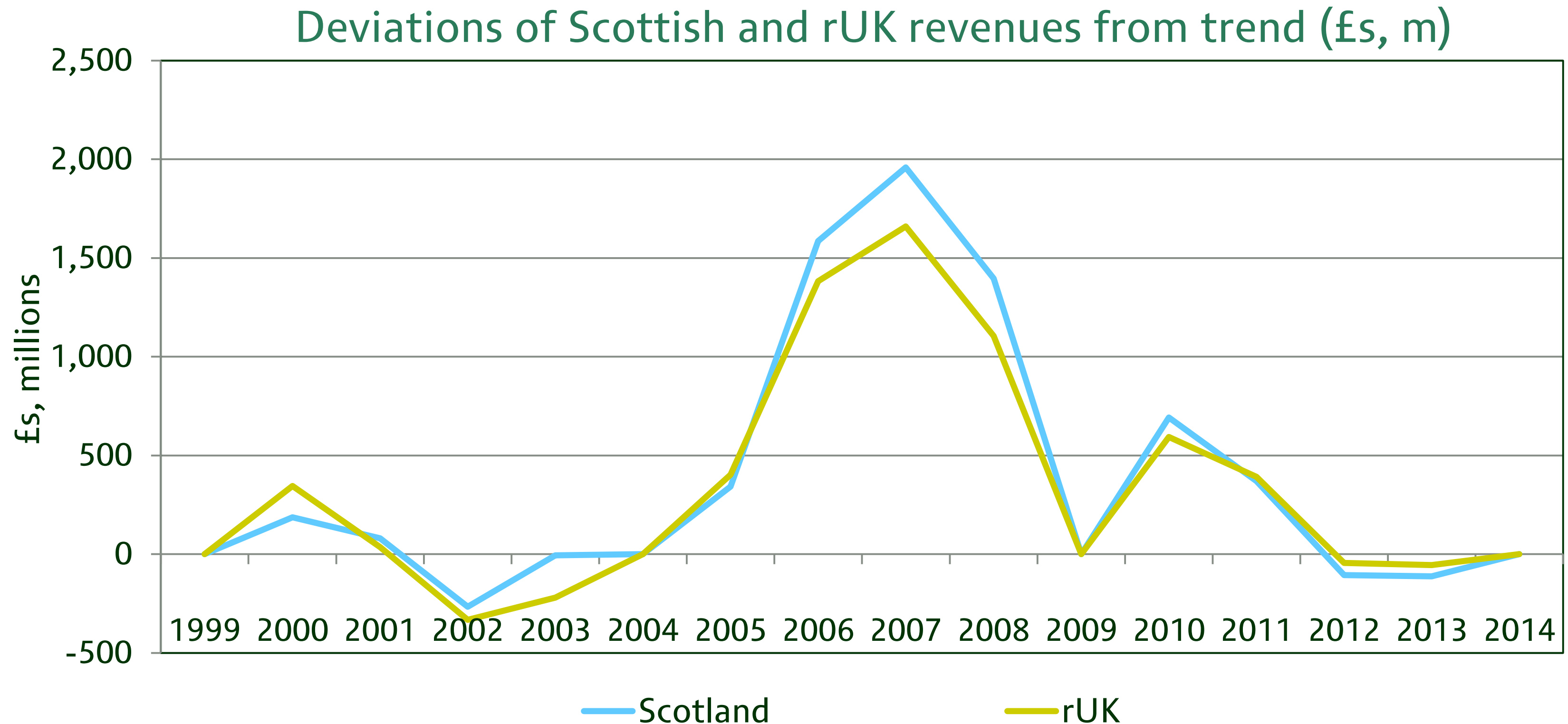
Tax revenue growth – implications for growth

- The Scottish Government's borrowing and reserves powers will be most useful in managing shocks that affect Scotland's devolved revenues and welfare spending *differently* than equivalent revenues and spending in rUK.

- If the past is anything to go by, the scale of these borrowing powers looks appropriate to the fiscal risks the Scottish Government will face.

Tax revenue growth – implications for borrowing

- more positively correlated Scottish and rUK revenues (and welfare spending), means less need for additional borrowing powers



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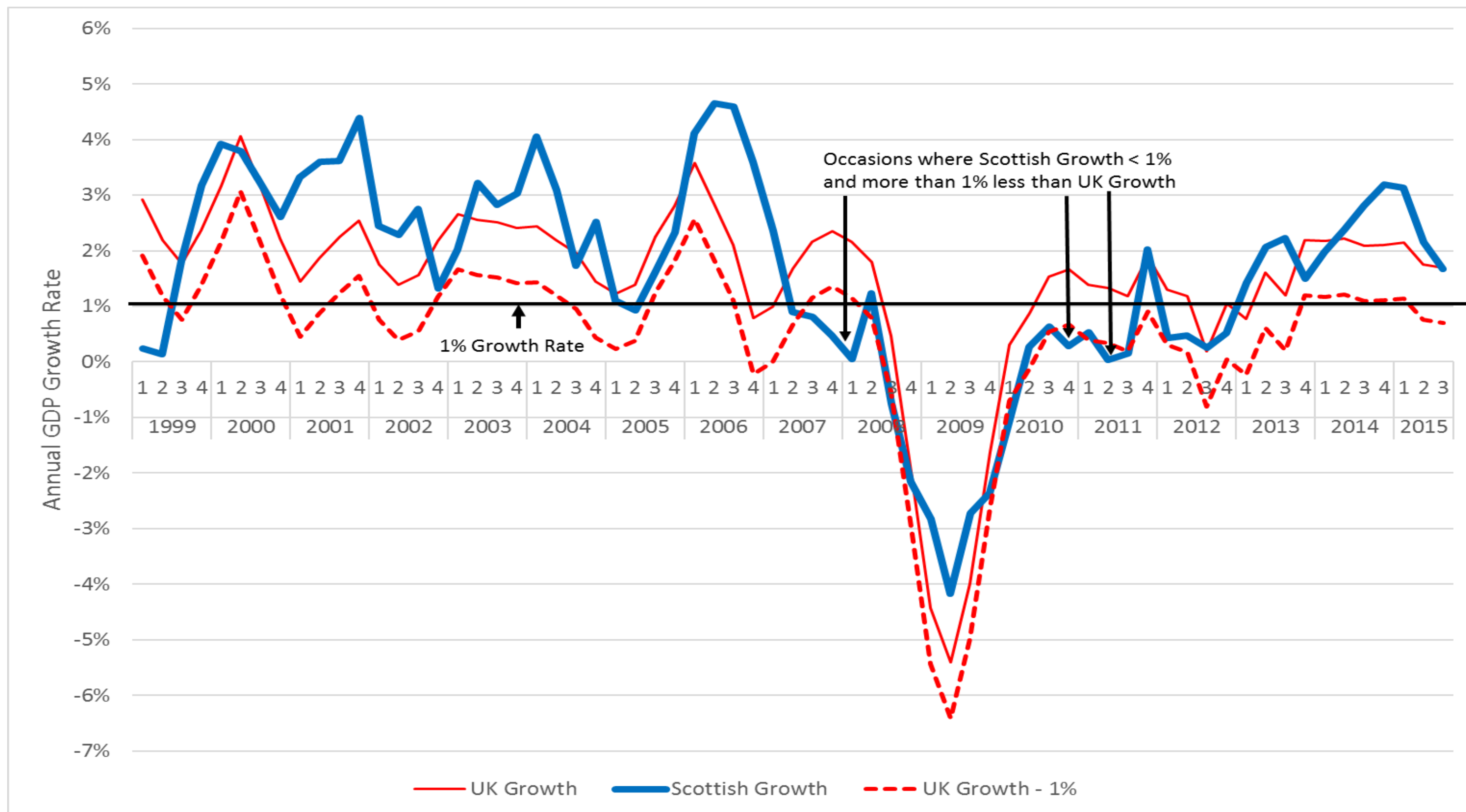
What are Scottish specific shocks?

- Growth in onshore Scottish GDP is below 1% and at least one percentage point below UK GDP growth



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Borrowing powers in the fiscal framework agreement

Capital borrowing

- Limit increased from £2.2 billion to £3 billion
- Annual borrowing limit increased to £450 million
- Smaller increase than for resource borrowing – why?
- UK-wide fiscal rule that there should be an overall budget surplus in "normal times" (defined as growth of 1% or more)
- Implies need to contain borrowing for capital
- Also rules out "prudential" regime?

International Perspective

Fiscal equalisation and insurance

- Fiscal equalisation is the ‘transfer of financial resources to a SCG to enable it to provide citizens with a similar level of public services at similar levels of taxation’
- Equalise may be used to reduce/remove disparities in *tax capacity* or in *spending needs*.
- Or - equalisation can be used to insure a SCG against macro-economic shocks. This function could include stabilisation against common and/or idiosyncratic shocks.

Tax capacity equalisation

- In most decentralised countries, grant to sub-central government (SCG) does take into account the ability of SCGs to raise revenue from devolved taxes
- Scotland's fiscal framework unusual:
  - Full equalisation of Scotland's lower tax capacity at the point of devolution
  - But risk associated with future changes in relative tax capacity are fully borne by the Scottish Government
- So no insurance against risk that Scottish revenues grow more slowly…
- …but protection against UK-wide revenue shocks

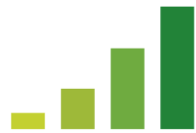
Spending needs equalisation

- Spending needs equalisation less common than tax capacity equalisation
- Because spending needs can only be assessed relative to some standard policy. May be difficult to agree this policy.
- Might be seen as counter to the spirit of devolution.
- This form of equalization often discussed in relation to UK
- Barnett Formula unique: allocates fairly arbitrary grant to Scotland based on historic accident and perverse treatment of population growth
- But opportunity to introduce needs-based funding formula in UK may have gone?

Summing up

Concluding points

- Protracted negotiation on how to adjust Scotland's block grant the result of differing interpretations of Smith principles
- SG got the deal it wants – for the next five years
- This meets the SG's interpretation of 'no detriment'
- But Fiscal Framework provides less borrowing capacity than perhaps SG wanted
- And does not meet 'taxpayer fairness' principle
- Agreement continues UK's ad hoc approach to devolution
- Governments' interpretations of Smith principles can be contrasted with their stances in Scottish referendum debate



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