The Fiscal Framework: 2021 Review

David Eiser and Graeme Roy, Fraser of Allander Institute

I Introduction

Over the past few years, the Scottish Parliament has been taking on significant additional fiscal and economic responsibilities.

Further responsibilities are still to be transferred, principally in the form of major social security powers. Around half of VAT revenues were due to be assigned from next year (2020/21), but given concerns around the robustness of the methodology developed to estimate VAT receipts in Scotland, this appears increasingly likely to be delayed.

In around two years' time, the process for how these powers are operationalised – the Fiscal Framework – will be reviewed by the UK and Scottish Governments.

Whether the review will be as fraught as the negotiations to reach an agreement back in 2016 remains to be seen.

For a long-time, an agreement seemed unlikely with both governments refusing to budge on issues of funding, costs of administration and governance. In the end, after months of negotiations with no shortage of political rhetoric, an agreement was reached just a few weeks before the parliamentary deadline.

So what will the forthcoming review cover? Will it be a 'broad review' as the Scottish Government has indicated as its wish? Or more narrowly focussed on technical issues such as the calculation of the block grant adjustment and whether the rules over borrowing limits are flexible enough to manage the increased budget risks?

Will it open up a debate about what further tax and welfare powers might be devolved? And will politicians elsewhere in the UK seek to open up a wider debate about the funding of devolved administrations and regions of England?

Might it also be linked to a review about how EU funding is allocated in a post-Brexit world?

The stakes are likely to be high, not least given the timing of the UK's departure from the EU and the prospects for a second independence referendum.

II Background

Substantial new fiscal powers are being devolved to the Scottish Parliament. These include the devolution and assignment of some tax revenues, new economic responsibilities (including control of the Crown Estate and expanded capital borrowing powers) and the operation of various social security activities.

The devolution of these powers required changes to be made to the way that the Scottish budget is funded. As a result, there is now a complex mix of a block grant, various block grant adjustments (BGAs), forecasts and reconciliations that all impact on the amount of money that the Scottish government has to spend in a given year.

At the same time, the Scottish Government now has much greater flexibility over how it manages its budget from year-to-year, in part to cope with the added volatility that flows from being more dependent upon tax revenues.

New arrangements for analysing Scotland's economy and public finances have also been put in place, alongside a much expanded fiscal infrastructure in Scotland. This has included the establishment of an independent economic and fiscal forecaster: the Scottish Fiscal Commission.

All of these details are set out in Scotland's *Fiscal Framework* which acts as the technical framework agreed by both the Scottish and UK Governments to manage the operation of these new powers.

The 2016 Fiscal Framework took months to negotiate. In the end, an agreement was reached on most aspects, with the exception of how the new tax powers would interact with the remaining Westminster block grant under any new system. To ensure a temporary compromise, it was agreed that the framework would be reviewed "by the end of 2021".

So far, we know little about the format of the review beyond its timing. All that has been agreed is that an independent group will be established in 2021. The report will be presented to both governments at the end of 2021, who will then negotiate a revised framework during 2022.

There are however, uncertainties around what the precise scope of the review will include.

It is also unclear to what extent the review will be undertaken as a set of inter-governmental discussions, or as part of a more transparent enquiry, and at what point both parliaments may be involved in scrutinising the review.

III The future of the block grant adjustment

At the heart of the new Fiscal Framework is a set of block grant adjustments (BGAs) which adjust the Scottish block grant to take account of the fact that the Scottish Parliament has major new tax (and spending) responsibilities.

For taxes, each BGA is effectively a measure of the tax revenues that the UK Government has foregone as a result of transferring the tax in question to the Scottish Parliament. In the case of the social security powers, the BGAs are effectively a measure of the spending that the UK Government will no longer incur in Scotland as a result of certain UK benefits being switched off.

Whilst this might sound rather dry and technical, how these BGAs are calculated can have a significant impact upon how much money the Scottish Government has to spend each year.

Indeed, the Scotland Act (2016) very nearly did not happen, because the UK and Scottish Governments could not reach an agreement on the appropriate methodology for calculating these BGAs. In short, the Scottish Government favoured a method that protected the Scottish Budget from population risk (i.e. the risk that Scotland's population grew more slowly than the rest of the UK), with HM Treasury favouring an approach that more closely mirrored a Barnett-type approach.

In the end, a compromise was reached. Over the period to 2020/21, the Scottish Government's favoured approach was agreed to be used but on the condition that this was would be reviewed post-2021. The difference between the two approaches is significant. For 2019/20, the Scottish Government would have £90m less resource available to it if the BGAs were calculated according to the UK Government's preferred method relative to the Scottish Government's.

It seems unlikely that either government's position will have changed in the intervening years.

With the 2016 agreement stating that

> "the fiscal framework does not include or assume the method for adjusting the block grant beyond the transitional period. The two Governments will jointly agree that method as part of the review."

another fudge seems likely.

IV Managing risk

Scottish budgets are now exposed to two important aspects of financial risk.

The first of these – the potential for divergence between Scottish and rUK tax bases – was something that MSPs were made well aware of in 2016. And it was a risk that they were prepared to trade-off for the promise of more powers

The second risk – the potential for forecast errors to impact on Scottish budget outcomes over a number of years – was also well known. However, the likelihood of largescale forecast errors was perhaps underappreciated at the time.

Taking each risk in turn.

A principle of the Fiscal Framework is that the Scottish budget should 'benefit in full' from policy decisions by the Scottish Government that increase revenues, and conversely bear the costs in full of policy decisions that reduce revenues.

This is fine as a principle, but the practical reality is that the Scottish budget bears in full the effects of any differences in Scottish revenue growth relative to rUK revenue growth, *regardless* of the causes of any differential growth.

Whilst the Scottish Government would certainly hope to be able to implement policy to grow the Scottish tax base, the link between policy and growth is often weak – especially in the short-term - and many of the factors determining tax revenue growth are only dependent on devolved policy to a limited extent.

This issue has risen in prominence in recent times. Various data sources suggest that Scottish earnings growth has been slower than rUK earnings growth since 2014. Furthermore, the latest forecasts suggest that this gap in earnings growth will persist over the next few years, although the gap is forecast to narrow.

To see the potential impact that this may have it is useful to look at something called the 'net tax' position.

The 'net tax' position is the difference between the latest forecast for Scottish income tax revenues (i.e. the growth in Scottish devolved taxes per head) and the latest forecast for the income tax BGA (i.e. the growth in rUK taxes per head).

In principle, if Scotland had the same tax policy as the UK, and if the Scottish tax base per head had grown at the same rate as in rUK, Scottish revenues should be the same as the BGA. The Scottish budget would be no better and no worse off than it would have been without income tax devolution.

And in principle, if Scotland sets a higher tax policy than rUK, then – if the Scottish tax base per head grows at the same rate as in rUK – Scottish revenues should be higher than the BGA, with the positive 'net tax' position reflecting the revenue effect of the Scottish tax policy.

According to the latest forecasts, the BGA will be larger than Scottish revenues by around £122m in 2017/18; larger by around £179m in 2018/19, and larger (by just £5m) in 2019/20.

So in other words, based upon the latest information and expectations, rUK income tax revenues are currently on track to grow more quickly than Scottish income tax revenues even after adjusting for faster population growth in the rest of the UK.

But has the Scottish Government not chosen to set a policy that sought to raise more revenue in Scotland than UK Government policy?

Yes, this is true. In 2019/20, Scottish taxpayers are paying some £500m more in income tax than they would pay under the UK policy.

However, in effect, the revenue effects of the Scottish tax policy have been completely offset by weaker performance in the Scottish tax base.

But how accountable can and should Scottish policymakers be for such an outcome?

This is a key challenge embedded in the framework. Scotland's Budget bears the risk of any differential performance in Scottish tax receipts relative to the rest of the UK no matter its source.

So if there is a downturn in the oil and gas industry because a fall in the global price of oil, which in turn slows the Scottish economy, the Scottish Budget will take the hit.

It also takes the hit if there are particular structural challenges that have more of an impact on Scotland than the rest of the UK. For example, a Scottish population that is ageing more quickly than in the UK as a whole may cause Scotland's revenues per capita to grow less quickly than those in rUK (as individuals aged over state pension age tend to have relatively lower income tax liabilities than those of working age). Again, this long-term demographic challenge is not one that the Scottish Government can address particularly straightforwardly. Brexit is another clear structural risk, but it is difficult to say whether Scotland will be more or less adversely affected by Brexit that rUK.

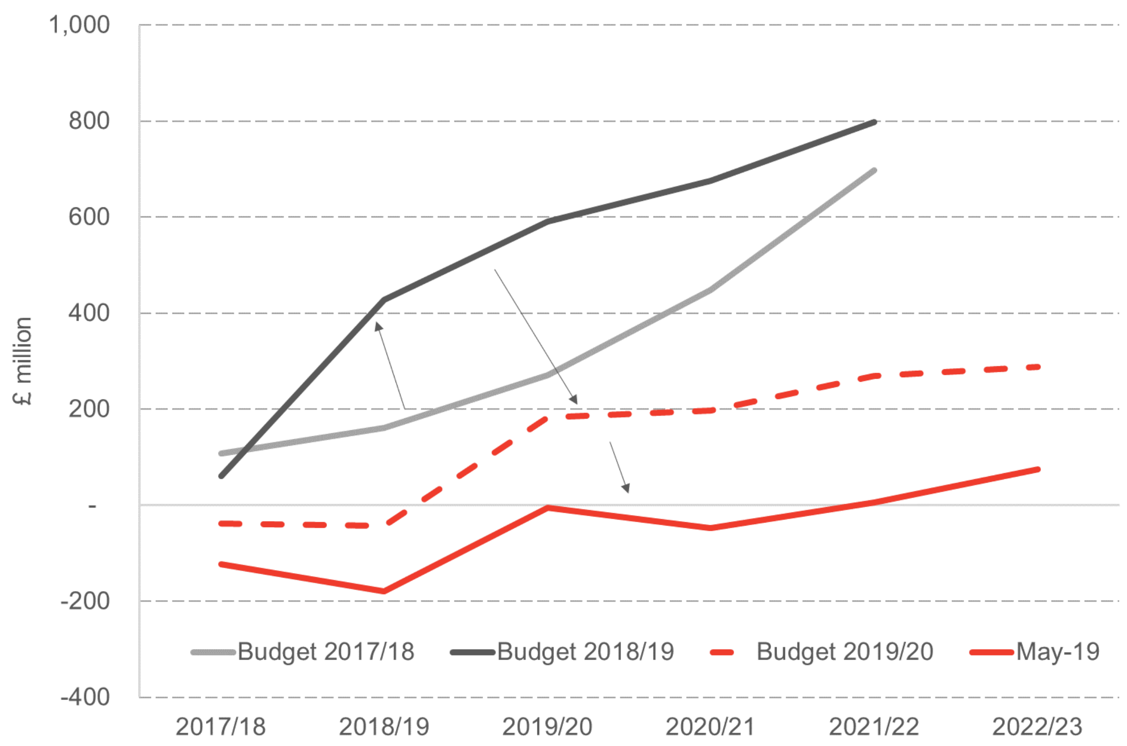
The underlying issue with all this is the question of how well the BGA really does measure the income tax revenues that the UK Government has 'forgone' as a result of transferring income tax to Scotland. Arguably, if income tax revenues had not been devolved, the UK Government would have raised less income tax from Scotland than is implied by the latest estimates of the BGA. This is because the same factors that have caused income tax revenues in Scotland to grow relatively more slowly since 2017 would have applied had income tax not been devolved.

The second area of risk relates to shorter term risks of forecast error, and the question of whether or not the Scottish Government's new risk management tools are sufficient to cope with the scale of the responsibility transferred.

The next three financial years will see the first of the income tax 'reconciliations' (the reckoning between the tax forecasts that were made when budgets were set with the reality of the outturn data). These will expose the extent to which the existing borrowing and cash management tools are adequate or require reform.

The latest forecasts suggest that the tax and BGA forecasts made at the time of the 2017/18, 2018/19 and 2019/20 budgets were too optimistic in Scotland's favour. Chart 1 shows how the 'net tax' position – the difference between the forecast for Scottish income tax revenues and the forecast of the BGA – has evolved across successive forecast events. Whilst earlier budgets forecast a 'net tax' position in Scotland's favour, the size of the net tax position has more recently been revised down and become negative in some years (i.e. Scottish revenues are forecast to be less than the BGA).

Chart 1: Income tax 'net tax' position at successive fiscal events



Source: Fraser of Allander Institute

In May 2019, the Scottish Fiscal Commission published its latest assessment of the extent of reconciliations: £229 million in 2017/18, £608 million in 2018/19 and £188m in 2019/20.

These figures are well in excess of the government's annual borrowing limit for forecast error of £350 million.

How the Scottish Government will respond to such a shortfall on monies expected remains uncertain.

The Scottish Government does not need to borrow this amount in full, it can draw down up to £250 million annually from the Scotland Reserve to meet such shortfalls, or scale-back spending in the future, but it does highlight the tight fiscal limits that the government faces.

A key aspect of the review therefore is likely to be whether or not the current borrowing limits are sufficient to manage reconciliations of such a scale. It remains too early to say whether such large reconciliations will turn out to be typical.

It should also be noted however, that extending borrowing powers only addresses the forecast error issue.

The ability to borrow does not help the Scottish Government to mitigate the risk that the Scottish tax base grows more slowly relative to rUK. This risk is the inherent 'accountability' mechanism built into the Fiscal Framework agreement as signed up to by both governments.

V The fallout from Brexit

The EU referendum in June 2016 has inevitably led to much debate around the authority of the Scottish Parliament, both in terms of the repatriation of economic powers from the EU and Scotland's constitutional future.

Whatever the final EU Withdrawal Agreement (if there is one), it is clear that Holyrood's economic and fiscal responsibilities will change once the UK leaves the EU, or at the end of any 'transition period'.

The question of how funding for aspects of agri-environment policy will be allocated for example, will demand careful thought. Similarly, the replacement of EU Structural Funds, which have boosted spending on infrastructure and social programmes across Scotland, will also need to be reviewed, implemented and assessed.

Given that the UK had not voted to leave the EU when the fiscal framework was signed in 2016, it was not envisaged that such matters would form any part of the Fiscal Framework review. However, it will be hard to disentangle any debate about new powers post-Brexit from wider discussions around devolved funding.

Scottish Government aspirations for differentiated policy in areas such as migration – particularly given its importance for the Scottish economy and future budgets – are likely to be resisted by the UK Government.

VI VAT, Air Passenger Duty and the Aggregates Levy

In principle, 2019-20 marks the first year in which a proportion of VAT revenues are being 'notionally' assigned to the Scottish budget, before they will actually 'count' in the 2020/21 budget.

The first 10p of the standard rate of VAT (20%) and the first 2.5p of the reduced rate of VAT (5%) raised in Scotland will be assigned to the Scottish budget. This means that revenues from VAT will contribute to the size of the Scottish Government budget, however the Scottish Parliament has no powers to vary VAT policy in Scotland.

The motivation behind assigning VAT was to expose an increased portion of the Scottish budget to the performance of the Scottish economy.

But it is increasingly clear that there are major challenges in assigning VAT to the Scottish Budget.

First and foremost, working out how much VAT is raised in Scotland is exceptionally difficult. The method put forward by both the UK and Scottish Government into the estimation of such revenues, has the potential to greatly increase the risks to be managed by the Scottish Budget. Indeed, the Scottish Budget could be subject to tens, if not hundreds of millions of pounds, of volatility simply as a result of statistical 'margins for error'.

Secondly, unlike income tax or the other devolved taxes, the amount of revenue assigned to Scotland in any given year will always be an estimate and never an actual outturn. This has the potential to cause confusion – for example, when legitimate but complex revisions are made to the estimation methodology – and perhaps erode confidence in the Fiscal Framework itself.

A key aim of the Smith Commission was to improve accountability and make Scotland's politicians responsible for raising the money that they spent. Unfortunately rather than helping to deliver this aim, there is a risk that the current proposals for VAT assignment risk undermining that principle.

Air Passenger Duty and the Aggregates Levy are yet to be devolved, with both having been caught up in complex legal issues. The Aggregates Levy legal issue has recently been resolved, and the Scottish Government is analysing options for a Scottish specific levy.

Whether or not the review will touch on what additional powers could be devolved – particularly if the Scottish Parliament sets out key concerns about the level of risk tied to the transfer of VAT revenues – is an open question. But it is one that deserves serious consideration, particularly in the light of the changing economic and constitutional situation since the Smith Commission made its recommendations in 2014.

VI Social security

One final policy area for the review to consider is the transfer of social security powers to the Scottish Parliament.

Recall that alongside tax devolution, around £3.5bn worth of social security responsibilities are being transferred to the Scottish Parliament, primarily focussed upon benefits tied to ill-health or disability and elements of the regulated social fund.

The fiscal responsibility will transfer to the Scottish budget in full in April 2020, even though – at that point – the majority of claimants will continue to receive the UK benefit from DWP. This means that, if expenditure on these benefits in Scotland is higher than forecast, it is the Scottish Government that bears the fiscal risk.

The introduction of Scottish-specific replacement benefits, delivered by the new Scottish Social Security Agency (SSSA), will begin in 2020, but is unlikely to be completed in full until the middle of the next decade.

Transferring the benefits from DWP to the SSSA safely presents a challenge – as well as an opportunity to do things differently – on a scale unlike anything the Scottish Government has faced since devolution.

The administration of the benefits system, including overlap between devolved and reserved areas of competence, is arguably the greatest area of risk to intergovernmental relations. It will also require the greatest scrutiny. Given the timescales involved however, it may be too early for any lessons to feed into the Fiscal Framework review.

VII Technical issues

As with any major change in governance, a number of technical issues are likely to be raised and form part of the review.

This will no doubt include that the flow of information between governments and the wider public (including parliament) could be improved.

Some specific aspects of the current framework - for example, the annual limits on what can and cannot be put in the Scotland Reserve (and what can be taken out) - seem somewhat arbitrary and unnecessary.

VIII The role of Parliament and intergovernmental relations

The new Fiscal Framework has brought about a significant step change in the nature of inter-governmental relations between the UK and Scottish Governments, but also between the Scottish Government and other institutions in Scotland such as Audit Scotland and the Scottish Fiscal Commission. A frank assessment of how these relationships have developed and been operationalised will be essential.

In looking forward to the review, if the 2016 inter-governmental negotiations are anything to go by, then it seems quite likely that negotiations will undoubtedly hit various impasses along the way.

The Scottish Parliament should be able to play a role in informing and unlocking these blockages.

At the same time, there has been a major shift in the role and capacity of the Scottish Parliament to scrutinise the budget process. Whilst not part of the review, assessing how the Parliament and its various committees have performed, and where reforms can be made, will be just as important.

The recent efforts to scrutinise the government's Medium Term Financial Strategy suggest that Parliament has a long way yet to go.

With budget pressures likely to only increase in the years ahead, Parliament will need to take a much greater role in helping to support a more strategic approach to budget scrutiny, including whether or not the budget stacks up against the wider outcomes agenda.

There is a serious set of issues here. And many of the issues should not need to become overtly politicised.

Policy-making and the Scottish budget debate will increasingly need to focus on the medium and longer term outcomes of policy, and the inevitability of uncertainty and risk. The past few months in Westminster have shown the consequences that can arise when consensus policymaking breaks down.

Twenty years ago those who established the Scottish Parliament had the hope that politics here in Scotland would take a different approach.

The need for such an approach when the Fiscal Framework is reviewed in a couple of years' time will be crucial.

Corresponding author

David Eiser
Fraser of Allander Institute
david.eiser@strath.ac.uk