Scotland’s new fiscal framework

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Elements of the new fiscal framework

• The calculation of Scotland’s block grant, taking into account:
  • Income tax
  • VAT
  • New welfare powers

• Allocating resources to Scotland for employability programmes

• Rules around implementation of ‘no detriment’ principles

• Institutional arrangements for inter-governmental coordination and negotiation

• Borrowing powers (resource and capital borrowing)

• Fiscal rules governing Scottish Government deficit and debt

• Arrangements for fiscal forecasting and fiscal scrutiny
The Smith Commission principles

- The Scottish Government’s block grant should continue to be determined by the Barnett Formula, but adjusted to reflect the new powers
- No detriment as a result of the decision to devolve power
  - Challenge is to account for revenues foregone by UK Govt in future years
- No detriment as a result of policy decisions post-devolution
  - Government budgets: Where policy decisions of one govt. affect tax receipts of the other, compensating fiscal transfer is required
  - Taxpayer fairness: tax increases in rUK do not fund increased spending in Scotland
- Scottish Govt should bear costs (and reap benefits) of its policy decisions in full; UK Govt should manage risks associated with UK-wide fiscal shocks
- Framework based on rules that are clear, transparent and do not require regular negotiation
Why index the block grant adjustment?

- First year that tax is devolved: block grant deducted by amount of income tax revenue raised in Scotland and amount of spending on devolved benefits.

- Subsequent years: BGA indexed to some measure of growth of rUK income tax revenue.

- Indexation of BGA to rUK revenues serves two purposes:
  - To represent UK revenue forgone (no detriment from decision to devolve) and
  - To protect Scotland from UK-wide fiscal shocks.
Approaches to indexing the BGA

• **Indexed Deduction (ID):** indexes BGA to % change comparable total tax revenues in rUK
  - Exposes Scotland to risk of relatively slower population growth (and reward of relatively faster growth)

• **Per Capita Indexed Deduction (PCID):** indexes BGA per capita to % change in comparable per capita revenues in rUK
  - Protects Scottish budget from risk of slower population growth

• **Levels approach:** Change in BGA is a population share of comparable rUK revenues
  - E.g. if rUK revenues increase £100m and Scotland’s population is 8% of rUK, BGA increase £8m
  - But because revenues per capita are lower in Scotland than rUK, the population share of a revenue increase is more than the equivalent % increase in the BGA
  - Implication is that Scottish revenues have to grow faster in % terms than rUK’s to maintain spending in nominal terms
### An example

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<tr>
<th>Period 1</th>
<th>rUK</th>
<th>Scotland</th>
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<tbody>
<tr>
<td>Population</td>
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<tr>
<td>Revenues per capita</td>
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<td>Total revenues</td>
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<td>£90</td>
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<tr>
<td>Total revenues</td>
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<td>£450</td>
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<table>
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<tr>
<th>Block Grant Adjustment</th>
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<th>Scotland</th>
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<tbody>
<tr>
<td>Indexed deduction</td>
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<td>45</td>
</tr>
<tr>
<td>Per capita ID</td>
<td>10%</td>
<td>45</td>
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<tr>
<td>Levels</td>
<td>11%</td>
<td>50</td>
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How would Scottish budget have fared?
Tax rate changes by the UK Govt

• Principle of taxpayer fairness: increases/decreases in rUK rates of income tax should not affect spending in Scotland

• BUT, a cut in rUK tax rates and consequent fall in rUK revenue implies less spending in Scotland – either through reduced Barnett consequential or reduced spending on reserved functions

• Taxpayer fairness principle implies Scottish taxpayers should not have to experience lower public service spending when they are making same tax effort as before

• Each of the BGA approaches ensure an adjustment to the Scottish Govt grant following a tax rate change in rUK

• But different approaches can have different effects...
An illustrative scenario....

• UK Govt increases income tax rate which raises an additional £10bn revenue

• This £10bn is used to fund increased education spend in England, resulting (via Barnett Formula) in a £1bn increase in Scottish Government’s grant, before tax adjustment

• £10bn is equivalent to a 7% increase in rUK income tax revenues, so Scotland’s BGA grows by 7%. But because Scotland’s per capita tax revenues are lower than rUK’s, 7% is equivalent to less than £1bn...

• ...so Scottish taxpayers have benefited from a balanced budget increase in English/rUK spending

• Way to avoid this is to use the levels approach... but is this a ‘fair’ way to index Scottish revenues?
Implementing ‘no detriment in respect of government budgets’

• Recognises that revenues of one govt are not independent of policy decisions of other

• Which types of policy changes will be subject to ‘no detriment’ calculations?
  • Policy changes which affect income tax revenues in rUK
  • Policy changes which affect UK Govt revenues in Scotland
  • Policy changes which affect expenditure on UK Govt benefits in Scotland

• Will there be a minimum threshold for detriment above which transfer payments are triggered?

• Calculations likely to be contentious and subject to uncertainty

• Raises institutional questions: who calculates, when, how are disputes resolved?
Funding new welfare powers

- Indexing Scotland’s block grant for the fully devolved welfare powers:
  - Indexed deduction
  - Per Capita Indexed Deduction
  - Levels approach

- Power to vary elements of UC, or top-up or create new benefits:
  - How to calculate costs of policy variation?
  - Behavioural aspects likely to prove contentious

- Work Programme and Work Choice
  - How to transfer resources to Scotland?
  - Equivalent amount per person or per LT unemployed person?
  - Or an extension of PbR approaches?
Conclusions

• Difficult/impossible to design grant system which meets all Smith principles:
  • ID/PCID best in respect of ‘no detriment from decision to devolve’
  • Levels best in respect of ‘taxpayer fairness’

• Unclear which budgetary risks/rewards Scottish budget should be exposed to

• ‘No detriment in respect of government budget’ clauses potential to create inter-governmental conflict... an issue for both BGA and other welfare powers

• Importance of mechanistic rules on block grant adjustment v. effective inter-governmental arrangements to negotiate settlement?
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