UNIVERSITY of STIRLING Management School

Institute for Fiscal Studies

CENTRE ON CONSTITUTIONAL CHANGE

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

Barnett-derived block grant – Revenues from devolved tax + Spending on devolved welfare powers = Adjusted block grant

Revenues from devolved tax + Spending on devolved welfare powers: Block Grant Adjustment (BGA)

- 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

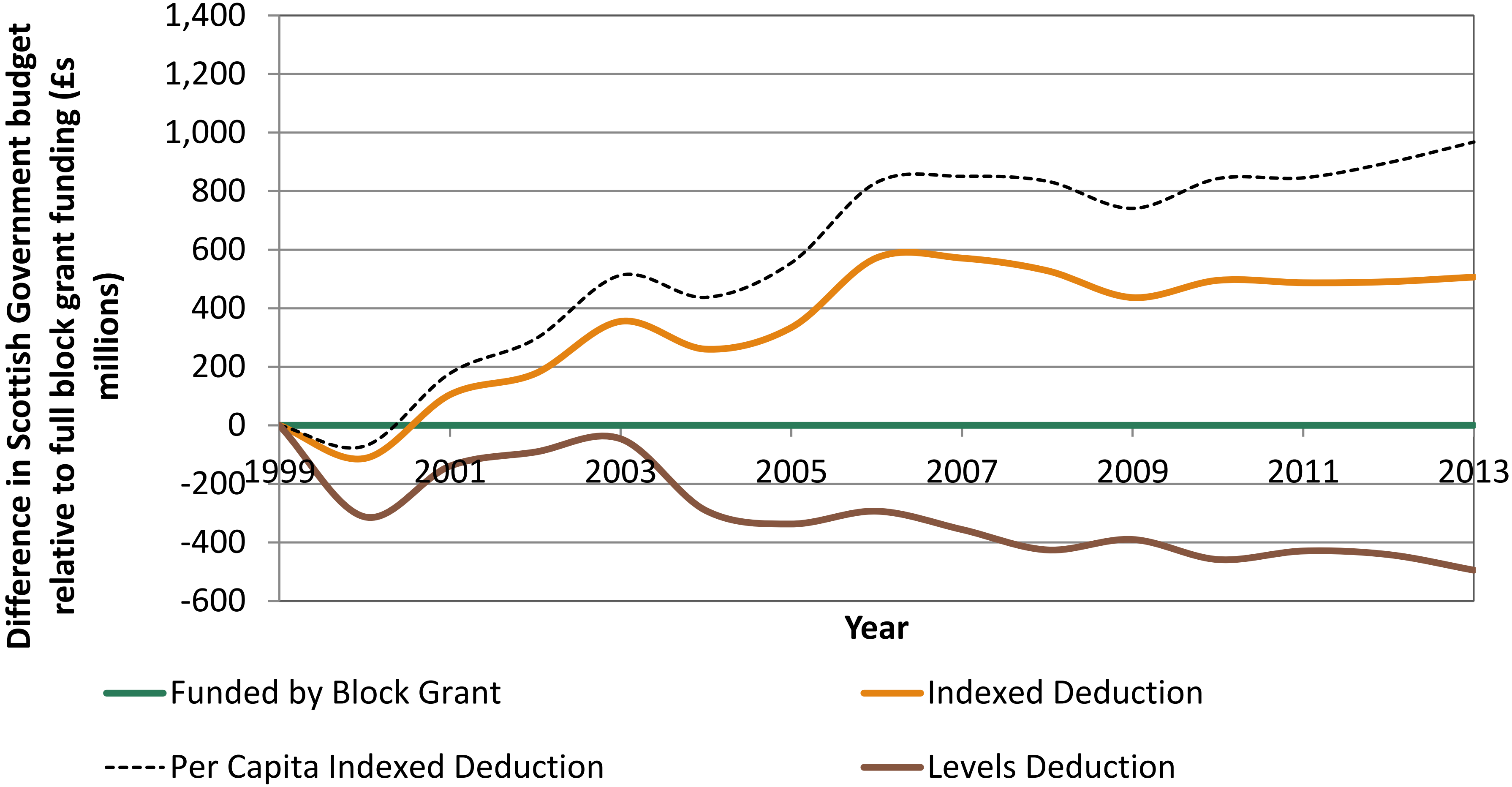
An example

Period 1	rUK	Scotland
Population	50	5
Revenues per capita	£100	£90
Total revenues	£5000	£450

Period 2	**rUK**	**Scotland**
Population	50	5
Revenues per capita	£110	£90
Total revenues	£5500	£450

Block Grant Adjustment	**rUK**	**Scotland**
Indexed deduction	10%	45
Per capita ID	10%	45
Levels	11%	50

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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