SPICe
The Information Centre

Financial Scrutiny Unit Briefing
The Fiscal Framework

07 November 2016

16/88

Anouk Berthier

This briefing explains the agreement between the Scottish Government and the United Kingdom Government on the Scottish government's fiscal framework. This includes how the block grant will be calculated, what new borrowing powers will be available to the Scottish Government and the arrangements for independent fiscal scrutiny. The briefing also discusses the block grant adjustment for 2016-17 set out in the Draft Budget 2016-17.

The Scottish Parliament
Pàrlamaid na h-Alba

CONTENTS

EXECUTIVE SUMMARY

On 23 February 2016 the Scottish and UK governments agreed an "updated" funding and fiscal framework for the Scottish Government. This is the non-legislative document that accompanies the Scotland Act 2016 and sets out the Scottish Government's funding arrangements and fiscal rules such as borrowing limits. Prior to the fiscal framework, Scotland's fiscal arrangements were contained in a number of different documents including the Scotland Act 1998, the Scotland Act 2012, the Public Finance and Accountability (Scotland) Act 2000 and various non-statutory documents.

The fiscal framework covers how the block grant will be funded as the provisions of the Scotland Act 2016 are implemented, what borrowing powers Scotland will have and the fiscal rules governing Scottish Government deficit and debt. It also discusses the Scottish Fiscal Commission's role, and intergovernmental mechanisms between the two governments in terms of information sharing, dispute resolution, etc.

The briefing covers:

- How Scotland's funding arrangements are changing.
- The start date of the financial provisions of the Scotland Act 2016 and the fiscal framework.
- How the block grant will be calculated including block grant adjustments.
- Governance rules including the role of the Joint Exchequer Committee and dispute resolution.

It also discusses the adjustment to the block grant for 2016-17 that is set out in the Scottish Draft Budget 2016-17. This is in relation to the Scottish Rate of Income Tax and the fully devolved taxes (Land and Buildings Transaction Tax and Landfill Tax).

BACKGROUND

THE SCOTLAND ACT 2016

The Scotland Act 2016 is the third major piece of UK Parliament legislation dealing with the powers of the Scottish Parliament after the Scotland Act 1998 and the Scotland Act 2012.

It is based on the recommendations for further devolution made by the Smith Commission (2014). However, the Scottish Parliament Devolution (Further Powers) Committee noted:

> "There are still some areas where we feel that the [then] Scotland Bill continues to fall short of the spirit and substance of Smith" (Scottish Parliament 2016a).

It provides for the devolution of the following tax and social security powers:

- Income Tax on Non Savings Non Dividend Income (this is an extension of the Scottish Rate of Income Tax introduced in the Scotland Act 2012)
- Fully devolved taxes:
    - Air Passenger Duty.
    - Aggregates Levy.
- Some social security powers including the devolution of the following benefits:
    - Attendance Allowance.
    - Carer's Allowance.
    - Disability Living Allowance.
    - Personal Independence Payment.
    - Industrial Injuries Disablement Allowance.
    - Severe Disablement Allowance.
    - Cold Weather Payment.
    - Funeral Payment.
    - Sure Start Maternity Grant.
    - Winter Fuel Payment.
    - Discretionary Housing Payments.

It also assigns some of Scottish VAT receipts:

- First 10p of the standard rate.
- First 2.5p of the reduced rate.

If the UK Government sets the standard rate of VAT at 19% or 21%, the Scottish Government would continue to receive the revenue from the first 10p of the standard rate VAT and there would be no impact on the amount assigned to the Scottish Government (Scottish Parliament 2016b). The way in which Scottish VAT revenue will be estimated has not been agreed yet.

A "REVISED" FISCAL AND FUNDING FRAMEWORK FOR SCOTLAND

Further tax devolution means a greater share of the Scottish budget will in future be funded directly by Scottish tax revenue and the budget will be more closely linked to the Scottish economy than before.

The Smith Commission recommended that the devolution of further powers be accompanied by an "updated fiscal framework" for Scotland.

A fiscal framework consists of the rules, regulations and procedures that influence how budgetary policy is planned, approved, carried out and monitored (European Commission 2016).

Scotland's fiscal arrangements are distinct but related to the UK Government's fiscal framework. This is set out in the Budget Responsibility and National Audit Act 2011 and requires that the UK Government lay a Charter of Budget Responsibility before the UK Parliament setting out its approach to fiscal policy and the management of public debt.

Negotiations on the fiscal framework started in the Joint Exchequer Committee (JEC) in July 2016. Its publication was initially planned for autumn 2015. This would have allowed the UK and Scottish Parliaments to look at the Scotland Bill 2015 and the fiscal framework together. The House of Lords Select Committee on Economic Affairs stated:

> "The implications of the Scotland Bill 2015 cannot be understood without reference to the fiscal framework and vice versa." (UK Parliament 2015)

However a deal was not reached until March 2016 and the House of Commons passed the Bill without the fiscal framework. The House of Lords Select Committee on Economic Affairs noted:

> "The lack of an agreed fiscal framework leaves a significant gap in the information before Parliament. It is to be regretted that the Bill passed through the House of Commons without MPs having the opportunity to scrutinise the fiscal framework." (UK Parliament 2015)

The major stumbling block reported in the final stages of the fiscal framework negotiations was how the block grant would be adjusted to account for further devolution.

The fiscal framework was published in March 2016 leaving the Scottish Parliament little time to consider the implications of the fiscal framework and the Scotland Bill 2015 together before pre-election dissolution (on 24 March 2016). The Scottish Parliament Devolution (Further Powers) Committee highlighted the detrimental impact that this had on its scrutiny of the framework but nevertheless recommended that the Scottish Parliament give its consent to the Scotland Bill 2015 (Scottish Parliament 2016a). The Scottish Parliament passed Legislative Consent Motion S4M-15941 on 16 March 2016 and the Scotland Bill 2015 completed its passage in the UK Parliament, receiving Royal Assent on 23 March 2016.

The fiscal framework will be reviewed after the UK and Scottish Parliament elections (in 2020 and 2021 respectively). The review will be informed by an independent report with recommendations presented to both Governments by the end of 2021.

Asked what would happen if the two governments could not agree on the way to calculate the block grant adjustment after the transitional period, the Chief Secretary to the Treasury said:

> "There is no preconceived plan. It is clear that there is no default indexation model. The review will be entirely unprejudiced and will have no preconceived view. It will be an

independent review set up by the agreement of the two Governments, and both Governments will have to agree its terms." (Scottish Parliament 2016c)

To support the implementation of the new powers, the fiscal framework states that the UK Government will provide £200m to the Scottish Government in addition to the block grant on a one-off basis. There will also be a baseline transfer of £66m to cover the ongoing administration costs. This this will be indexed through the Barnett formula. According to the First Minister this is a fair resolution (Scottish Parliament 2016d).

FISCAL GOVERNANCE IN SCOTLAND BEFORE AND AFTER THE FISCAL FRAMEWORK

Prior to the fiscal framework, Scotland's fiscal arrangements were contained in a number of different documents including the Scotland Act 1998, the Scotland Act 2012, the Public Finance and Accountability (Scotland) Act 2000 and various non-statutory documents.

Table 1 summarises the main differences between Scotland's fiscal arrangements before and after the fiscal framework.

Table 1 Scotland's fiscal arrangements before and after the Scotland Act 2016 and accompanying fiscal framework

<table>
<tr><th></th><th>Pre-fiscal framework</th><th>Post-fiscal framework</th></tr>
<tr><td rowspan="2">UK funding arrangements</td><td colspan="2">Set out in the Statement of Funding Policy (SFP), last updated in November 2015 (UK Government 2015).</td></tr>
<tr><td>The SFP sets out:
• The Barnett formula.
• The Budget Exchange Mechanism (BEM) which allows the Scottish Government to carry over unspent resources up to 0.6% of DEL Resource and 1.5% of DEL Capital.</td><td>• The SFP will continue to set out the detailed arrangements for the operation of the Barnett Formula, which will continue to be used to calculate the (unadjusted) block grant.
• The BEM will no longer apply after expanded borrowing powers are in place from April 2017.</td></tr>
<tr><td>Balanced budget rule</td><td colspan="2">Set out in the Public Finance and Accountability (Scotland) Act 2000 according to which spending by the Scottish Administration cannot exceed the amounts authorised by the Budget Act.</td></tr>
<tr><td rowspan="2">Scottish Fiscal Commission (SFC)</td><td colspan="2">Established mid-2014 and put on a statutory footing from April 2017 through the Scottish Fiscal Commission Act 2016.</td></tr>
<tr><td>The SFC's remit was initially to assess the reasonableness of the Scottish Government's devolved tax forecasts and some of the variables used by the Scottish Government to do the business rates forecast.</td><td>The SFC will be responsible for forecasting (likely in 2018-19):
• Scottish welfare spending.
• Revenues from the fully devolved taxes, business rates and Income Tax on Non Savings Non Dividend Income.
• Scottish GDP.

For 2017-18 the Scottish Government will produce forecasts that the SFC will scrutinise.
It will be up to the OBR to decide how to incorporate taxes devolved to the Scottish Parliament in its UK-wide forecasts (Scottish Parliament 2016e).</td></tr>
<tr><td>Scottish Government Borrowing</td><td>Set out in Scotland Act 1998 as amended by the Scotland Act 2012.</td><td>Expanded from April 2017 onwards (see Table 2).</td></tr>
<tr><td>5% Revenue Financed projects Cap</td><td colspan="2">Infrastructure Investment Plan, last updated in 2015 (Scottish Government 2011, 2015).</td></tr>
<tr><td>Local Authority Borrowing</td><td colspan="2">Set out in The Prudential Code for Capital Finance in Local Authorities which allows local authorities to borrow from the Public Works Loans Board for capital investment purposes as long as their capital spending plans are prudent, affordable and sustainable.</td></tr>
</table>

Table 2 describes Scotland's borrowing powers and cash reserve. The Smith Commission Agreement recommended that a prudential regime for capital borrowing be considered but this was not subsequently adopted.

Table 2 Scottish Government resource and capital borrowing powers over time

	Scotland Act 1998 and 2012	From 2017-18 onwards
Resource	Up to £200m annually and £500m overall (this means at any given point in time) for forecast errors	Up to £600m each year and £1.75bn overall. There are different limits for different purposes: • £500m a year for in-year cash management. • £300m a year for forecast error in relation to devolved/assigned taxes and welfare. • £600m a year for any shortfall in devolved/assigned taxes or welfare where there is, or is forecast to be, a Scotland specific economic shock.
Capital	Up to 10% of the Capital DEL budget annually and £2.2bn in total.	• Up to 15% of overall borrowing cap (equivalent to £450m a year) and £3bn in total.
Reserve	• Referred to as a "cash reserve". • Surplus could be saved if revenues higher than forecast, funds can be drawn if revenues lower than forecast. • Overall limit £125m.	• BEM no longer applicable. • A "Scotland Reserve" will replace the cash reserve, capped at £700m. • Annual drawdowns up to £250m for resource and £100m for capital. • No annual limits for payments.

The fiscal framework agreement states:

> "A Scotland-specific economic shock is triggered when onshore Scottish GDP is below 1% in absolute terms on a rolling 4 quarter basis, and 1 percentage point below UK GDP growth over the same period." (UK Government 2016)

There is a word missing: "Scottish GDP" should say "Scottish GDP growth" as highlighted in the Scottish Parliament Finance Committee (Scottish Parliament 2016c).

Asked about the meaning of "absolute terms", the Chief Secretary to the Treasury explained in a letter to the Scottish Parliament Finance Committee:

> "I can confirm that access to borrowing to cushion a Scotland-specific economic shock is triggered when onshore annual Scottish GDP growth in real terms is or is forecast to be below 1% on a rolling 4 quarter basis (i.e. actual or forecast real terms GDP growth is to be measured over a full year, starting in any quarter) and is at least 1 percentage point below actual or forecast UK GDP growth in real terms over the same period." (Scottish Parliament 2016b)

START DATES FOR THE POWERS

The fiscal framework lays out the start dates for the financial provisions of the Scotland Act 2016 as well as additional borrowing powers. These are shown in Table 3.

Table 3 Starting dates for the Scotland Act 2016 and fiscal framework provisions

Power	Start date
Devolution of Income Tax on Non Savings Non Dividend Income	April 2017
Retention of revenues from courts and tribunals	April 2017
Devolution of Air Passenger Duty	April 2018
Assignment of Scottish VAT	2019-20
Devolution of Aggregates Levy	Will be agreed in the JEC once current state aid and other outstanding legal issues have been resolved.
Devolution of social security powers	• Under the Scotland Act 2016 (Commencement No.1) Regulations 2016, new social security powers were transferred to the Scottish Parliament on 5 September 2016. The Scottish Parliament can now: o Create new benefits in devolved areas o Top up reserved benefits o Make discretionary payments and assistance o Change employment support o Make changes to Universal Credit for the costs of rented accommodation, and on the timing of payments and recipients. o From 1 April 2017, it will have power over discretionary housing payments. • No date has been set for the devolution of Attendance Allowance, Carer's Allowance, Disability Living Allowance, Personal Independence Payment, Industrial Injuries Benefit, Severe Disablement Allowance, Funeral Payment, Sure Start Maternity Grant, Winter Fuel Payment or Cold Weather Payment.
Transfer of Scottish Crown Estate assets and devolution of Coastal Communities Fund	The Crown Estate Scotland (Interim Management) Order 2017 establishes an interim body to manage those Crown Estate assets in Scotland which will be transferred to the body as part of a Scheme made by the Treasury. The Scheme will specify a transfer date on which the transfer will occur. The transfer scheme has not yet been made by Treasury but will require agreement from Scottish Ministers as well as the approval of the UK Parliament.
Introduction of new borrowing powers	April 2017
Implementation of the cash reserve	April 2017

The BGA for revenues from courts and tribunals will reflect the amounts of fines, forfeitures, and fixed penalties imposed by courts and tribunals in Scotland during the financial year 2016-17.

Table 4 shows the revenue from courts and tribunals in 2013-14 and 2014-15.

Table 4 Fines, forfeitures, fixed penalties and proceeds of crime receipts, 2013-14 and 2014-15

	2013-14	2014-15
Scottish Court Service Fines	31,296,835.4	30,545,141.6
Scottish Solicitors Discipline Tribunal Fines	-	87,243.3
Total	31,296,835.4	30,632,384.9
Proceeds of Crime Receipts	3,887,565.9	4,908,436.0

Source: Scottish Parliament 2016b

BLOCK GRANT AND ADJUSTMENTS

WHAT IS A BLOCK GRANT ADJUSTMENT?

The block grant

The Barnett formula will continue to be used to calculate the block grant. The block grant is made up of the previous year's block grant plus/minus "consequential". The Barnett formula calculates the consequentials based on Scotland's population share of changes to UK Government spending in areas that are devolved in Scotland.

A BGA will be calculated for each devolved/assigned tax and benefit. BGAs linked to the devolved/assigned taxes will be deducted from the block grant to reflect the fact that revenue from these taxes will flow to the Scottish Government. BGAs linked to the devolved benefits will be added to the block grant to reflect additional social security spending by the Scottish Government.

Block grant adjustment: baseline adjustment

The baseline adjustment for BGA calculations is tax revenue in Scotland the year prior to devolution, or benefit spend the year prior to devolution (except for Cold Weather payments which will be based on a multi-year average prior to devolution). This figure will initially be based on a forecast. Once outturn data is available, the baseline figure may be amended.

Table 5 summarises how it will be calculated for each devolved/assigned tax and benefit.

Table 5 Initial baseline adjustment for tax and social security

Tax/benefit	Methodology
Income Tax on Non Savings Non Dividend Income	Non-Saving Non-Dividend income tax revenue from Scottish taxpayers in 2016-17. This will be reconciled with outturn data which will be available around 15 months after the end of the financial year. However, there will be no reconciliation of forecasts to outturn (either for Scottish revenue or the BGA) for the Scottish Rate of Income Tax in 2016-17 (UK Government 2016).
Air passenger duty (APD)	Average of the Scottish Government (as laid out in the annual report on Government Expenditure and Revenue Scotland or GERS) and HMRC's methodologies for apportioning UK APD revenues to Scotland applied to a forecast of UK-wide receipts in 2017-18.
Aggregates levy (AL)	Average of the GERS and HMRC methodologies for apportioning UK AL revenues to Scotland applied to a forecast of UK-wide receipts in the year immediately preceding devolution. This will be reconciled to outturn based on UK receipts and on the share estimated by the HMRC and GERS methodologies for Scotland.
Landfill tax	Average of GERS and HMRC methodologies for apportioning UK Landfill Tax revenues to Scotland applied to UK receipts in 2014-15. This is without prejudice to the one-off block grant adjustment agreed in respect of Landfill Tax for 2015-16.
Stamp Duty Land Tax	Receipts in Scotland in 2014-15 will be used as published in HMRC statistics with a reduction to account for the £20m forestalling effects associated with residential tax receipts in 2014-15. This is without prejudice to the one-off BGA agreed in respect of Stamp Duty Land Tax for 2015-16.
Assigned VAT	Methodology to estimate receipts in the year immediately prior to assignment to be agreed by JEC.
Revenues from courts and tribunals	Revenues collected by the Scottish Government in 2016-17 will be used as the baseline deduction. This will initially use outturn data from the Scottish Consolidated Fund for the latest year available and be updated to use the year prior to devolution once available.
Benefits (except Cold Weather Payment)	UK Government expenditure in each benefit in Scotland in the year immediately prior to the devolution of powers - initially be based on an Office for Budget Responsibility forecast and reconciled to outturn using DWP's statistics.
Cold Weather Payments	Given the substantial volatility in these payments, the baseline will be the average of the spending on the Cold Weather Payment in Scotland from 2008-09 to the year prior to devolution, reconciled to outturn, and based on DWP statistics.

Block grant adjustment: Indexation method for BGAs

Each year BGAs will be linked, or "indexed" to the previous year's BGAs. The indexation of each BGA will be based on the annual growth in comparable revenue or expenditure in the rest of the UK (rUK).

For instance the BGA for income tax in 2018-19 will based on:

- The BGA for income tax in 2017-18.

- The change in income tax in Non Savings Non Dividend income in the rest of the UK from 2016-17 to 2017-18.

The major stumbling block reported in the final stage of negotiations between the two governments was how the initial baseline figure would be "indexed." They each favoured a different indexation method based on their interpretation of the concept of "no detriment" which was set out by the Smith Commission (see Scottish Parliament 2016d). "No detriment" includes:

- "no detriment 1": neither government should be better or worse off simply as a result of devolution;
- "no detriment 2" or the principle of "taxpayer fairness": when either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government should either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving (Smith Commission 2014).

The two governments agreed that during the transitional period covering this Session of the Scottish Parliament (up to and including 2021-22) two calculations will be made each BGA. These are:

- The Indexed Per Capita (IPC) method (or Per Capita Indexed Deduction Method) will be used for both taxes and benefits.
- The "Comparable Model (Scotland's share)" for tax and the Barnett formula for benefits. The arithmetic formula for these two is the same.

The technical annex provides more detail on these two methods.

If the two calculations yield different results, the result of the IPC method will be used. The fiscal framework states:

> "This will ensure that the Scottish Government's overall level of funding will be unaffected if Scotland's population grows differently from the rest of the UK." (UK Government 2016)

The indexation and therefore the BGAs for that year will provisionally be based on a forecast (as with the baseline adjustment) of relevant UK government receipts and expenditure in rUK and the latest available mid-year population estimates.

BGAs will be calculated by:

- At the Autumn Statement by the UK Government if this occurs at least three months in advance of the start of the financial year.
- If the Scottish Draft Budget is published before the UK Autumn Statement, the UK government will additionally provide a provisional estimate of the adjustments for budgeting purposes based on the previous UK Budget forecasts which will be revised at the Autumn Statement.
- If the Autumn Statement has not occurred at least three months in advance of the start of the financial year, then the provisional estimate of the adjustments calculated for budgeting purposes in the Scottish Government's Draft Budget will be applied to the block grant for the next financial year.

RECONCILIATION BETWEEN FORECAST AND OUTTURN

The Scottish budget will depend on two sets of forecasts, both of which will be reconciled to outturn data. These are:

- Forecasts of Scottish tax revenues/benefit spending which will be done by the SFC.
- Forecasts of comparable tax revenues/benefit spending in rUK which will be done by the **OBR.**

Baseline reconciliation
Reconciliation for the baseline year for both taxes and benefits spending will be made at the same time as the reconciliation for Year 1 receipts.

Once outturn data is available, a final reconciliation (there may be some before) will occur and any difference in Scottish tax receipts or the BGA compared to the original calculations will be incorporated into the equivalent funding for the following financial year or the second following year. The Scottish Government may determine whether any adjustment that is due will be made in-year to the block grant or whether this will be incorporated at the final reconciliation when outturn data is available.

Scottish tax revenue

The forecast of income tax revenues in Scotland will be available for the Scottish Government to draw down in the upcoming financial year. The Scottish Government will be able to access the block grant and forecast of HMRC-collected tax revenues (income tax and VAT). There will be no in-year updates to either the Scottish income tax and VAT forecasts or the associated BGAs.

For the fully devolved taxes, the BGAs will be updated during the year to reflect latest forecasts of corresponding tax receipts in the rest of the UK and in-year updates to the block grant adjustments will be made at the Autumn Statement.

Changes to the forecast due to UK Government policy changes will not automatically result in an adjustment. Nevertheless, the effect of the tax policy change on tax receipts in rUK will be included in forecasts used to calculate the block grant adjustment for subsequent years.

Following the financial year to which the BGAs relate, once outturn data becomes available and once mid-year population estimates are out, the adjustments to the block grant will be recalculated and the results will be reconciled. There are two possible scenarios:

- If the information is available at least two months in advance of the Scottish Draft Budget, any difference compared to the original calculation will be applied to the block grant for the following financial year;

- If the information is not available at least two months in advance of the Scottish Draft Budget, the Scottish Government may determine whether the adjustment will apply in the following financial year or the second following financial year.

Indexation for benefit spending

In relation to benefits, adjustments to the block grant will be calculated on the basis of forecasts at each fiscal event (Budget or Autumn Statement) at which a forecast for UK government benefit spending is produced.

Where UK government in-year spending diverges from forecast the BGAs will be updated during the year. These updates will take place at the in-year Autumn Statement. In-year updates will not automatically apply to any policy changes introduced by the UK government after the Scottish Government's Budget. The Scottish Government may determine whether the adjustment will be made in-year to the block grant or whether this will be incorporated within the end-year reconciliation (and the policy change will also be included within forecasts for subsequent years).

Block grant Adjustments for 2016-17
The Draft Budget 2016-17 include the BGA for 2016-17. This includes:

- £4900m for the Scottish Rate of Income Tax. This figure will not be revised – it is fixed for 2016-17.

- £600m for the fully devolved taxes. This is provisional but there will be no in-year adjustment to this figure. It could be adjusted in the Draft Budget 2017-18 as forecasts for the devolved taxes are updated and/or outturn data starts becoming available.

The Draft Budget 2017-18 will include the value of the BGA 2016-17 for the fully devolved taxes. The results of both models will be presented: the Comparable Model (Scotland's share) and the IPC model. At this point the BGA 2016-17 will still be relying on forecasts as actual returns from HMRC for Stamp Duty Land Tax in rUK for 2016-17 will only be available around September 2017 (6 months after end of tax year). There may be reconciliation between the initial forecast and the updated forecast in the Draft Budget 2017-18 but this will not be final.

There will be a final reconciliation for the 2016-17 BGA in the first Draft Budget after final outturn data for the devolved taxes is available (September 2017). The final reconciliation will therefore not occur before the 2018-19 Draft Budget. It could also be in the 2019-20 Budget.

In order to calculate BGA 2016-17 for the devolved taxes, BGA 2015-16 will be calculated but not applied to 2015-16 (because the fiscal framework says there will be no prejudice to the 2015-16 BGA) – it will only be used to calculate BGA 2016-17.

BLOCK GRANT ADJUSTMENT FOR THE CROWN ESTATE

The Scotland Act 2016 devolved the function of managing the Crown Estate's Scottish assets, the revenue arising from these assets and competence to legislate about those functions. The fiscal framework states:

- The managers of these assets will be exempt from corporation tax, income tax, capital gains tax and other HMT finance rules;
- Responsibility for the Coastal Communities Fund will be devolved to the Scottish Government (UK Government 2016).

There are two aspects to the initial calculation of the BGA in relation to the Crown Estate:

- Baseline deduction to the block grant equal to the net revenues generated by the Crown Estate assets in Scotland in the year immediately prior to the transfer, net the costs of managing these assets;
- Baseline addition for the funding of the Coastal Communities Fund equal to UK Government spending in the year immediately prior to devolution.

These BGAs will all be incorporated into the block grant and will not be revised.

SPILLOVER EFFECTS

No detriment 2 states that when either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government should either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.

The financial effects of policy decisions are "spillover effects". The ones covered in the fiscal framework are:

- Direct effects: these will directly and mechanically exist as a result of the policy change (before any associated change in behaviours). All of these effects will be accounted for.

- Behavioural effects: these result from people changing behaviour following a policy change. They will be taken into account if they are "material", "demonstrable" and "exceptional". This will be assessed on the basis of a shared understanding of evidence.

Other potential indirect or second-round effects are not included in "no detriment".

REPORTING AND BUDGETING INFORMATION

The fiscal framework states that both governments will report to the UK and Scottish Parliaments on the finance, functions and duties being devolved under the Scotland Act 2016.

The fiscal framework states that the two governments will need to update their budgeting arrangements. The Scottish Government will have to provide information to the UK Government, the OBR and the ONS, including:

- Planned capital borrowing for the Spending Review period, updated in advance of each financial year;
- Planned drawdown of funds from the Scotland reserve in advance of each financial year;
- Monthly in-year funding/spending data;
- Five-year forecasts for tax revenues and demand-driven benefit spending (UK Government 2016).

GOVERNANCE

The implementation, operation and review of the fiscal framework as a whole will be governed by the Joint Exchequer Committee (JEC). The JEC will:

- Consist of the relevant Ministers from the UK and Scottish Governments.
- Be Supported by an Officials Group – the JEC (O).
- Meet at least twice a year.
- After each meeting, a public statement will be agreed by both Ministers. The discussions at each meeting, the agenda, the minutes and any papers are to be confidential to the UK and Scottish Governments, unless the JEC specifically decides otherwise. The fiscal framework notes that each Government will respect this confidentiality.

The Joint Ministerial Working Group on Welfare will have responsibility for the policy and legislative aspects of devolution of this function.

DISPUTE RESOLUTION

WHAT DOES IT COVER?

The fiscal framework sets up a dispute resolution mechanism for:

- Disputes arising from issues around “spillover” effects (these occur where either the UK or the Scottish Government makes a policy decision that affects the tax receipts or expenditure of the other).
- Inter-administration disputes on the fiscal framework including BGA calculations.

The Memorandum of Understanding Procedure will continue to apply for any other inter-governmental issues.

HOW DOES IT PROCEED?

If there is an issue it should be resolved at the working level.

If this fails it becomes a “disagreement” and is referred to senior officials including the JEC (O).

If this fails, it becomes a “formal dispute” and is referred to Ministers and discussed at a JEC meeting.

If this also fails, there is an automatic pause placed on the disputed finances i.e. no decisions or actions can be taken by either government in relation to the disputed amount until the dispute is resolved. Both governments make a statement of fact on the dispute which the other government considers.

If no agreement can be reached then the dispute falls and there is no fiscal transfer between the Governments.

If either Government pursues the dispute further it can be referred to the Protocol on the Resolution and Avoidance of Disputes attached to the Memorandum of Understanding between the UK government and the devolved administrations.

TECHNICAL ANNEX

COMPARING THE MODELS

The comparable model (Scotland’s share) and the IPC method both partly shield Scotland from UK-wide economic shocks. Broadly speaking, if tax revenue dropped in the whole of the UK, Scottish revenue will decrease but so would the BGAs for devolved and assigned taxes. This means the block grant would be bigger for that year.

COMPARABLE MODEL (SCOTLAND’S SHARE)

The formula for Comparable Model (Scotland’s share) is:

$$Tax\ Consequential = (X_{t+1}^{UKG} - X_t^{UKG})\frac{P_{t+1}^{S}}{P_{t+1}^{UKG}} \times Comparability\ Factor$$

Where t denotes the year, P denotes population and X denotes tax receipts, S denotes Scotland and UKG denotes UK Government and P^{UKG} refers to the population of the rest of the UK. The comparability factor for each tax is Scotland's revenue per head as a share of the average revenues per head in the rest of the UK (UK Government 2016).

For example, income tax will be devolved in 2017-18. The block grant adjustment for 2017-18 based on the Comparable model (Scotland's share) is:

$$BGA_{2017-18} = \left[(Income\ tax^{UKG}_{2017-18} - Income\ tax^{UKG}_{2016-17})\frac{P^{S}_{2017-18}}{P^{UKG}_{2017-18}} \times Comparability\ Factor\right] + Income\ Tax^{S}_{2016-17}$$

On comparability factors, the fiscal framework states that:

> "The comparability factors used in the model will be revised to reflect outturn figures in the year immediately prior to devolution, and will subsequently be revised following any devolution of corresponding tax revenues to another administration within the UK, for example the devolution of SDLT and landfill tax to the Welsh Assembly." (UK Government 2016)

This formula is "symmetric" with the spending side of the Barnett Formula, which according to Bell et al.:

> "…is useful when it comes to changes in rUK tax rates. Changes in UK tax rates for taxes that are devolved are likely to lead to a change in spending by the UK Government. To the extent that this spending is likely to benefit Scottish taxpayers in some way (either because it leads to an increase in the Scottish block grant via the Barnett formula, or because it leads to an increase in 'reserved' spending in Scotland), the block grant to Scotland would need to be adjusted to ensure that increases in taxes in rUK tax do not fund higher spending in Scotland, without a corresponding increase in Scotland's tax effort. This is the 'taxpayer fairness' element of the Smith Commission's 'no detriment' principles." (Bell et al. 2015)

However, it has been said that the Comparable model does not seem to satisfy the spirit of no detriment 1. (Gallagher 2016) highlighted that this was because devolved Scottish tax revenues start out lower per head than the rUK's (though if Scottish tax income rises in future the opposite could be the case) a given rate of growth in Scottish revenues (e.g. 5%) translates into *less* than a population-based share of the equivalent growth in rUK revenues. Thus Scottish revenues would have to grow at a faster rate both per person and in aggregate than in rUK (Bell et al. 2015) in order to deliver the same cash increase in spending per head. Gallagher concludes:

> "…it might be expected that a levels approach could create pressure to drive tax rates up, but the same effect has always been present for council tax and nondomestic rates – in total about 1/3 of income tax in size, and which yield less than their rUK equivalents by as much as income tax – and no such result has been seen there, either in taxes or spending. To be sure of avoiding such an effect it would be necessary to allow Scotland access to some of the revenues from devolved taxes in rUK, which might seem to contradict tax devolution and is arguable unfair to rUK taxpayers" (Gallagher 2016)

BARNETT FORMULA

The Barnett formula which will be used to adjust the block grant in relation to the devolution of benefits is:

$$Barnett\ Consequential = (Y_{t+1}^{UKG} - Y_t^{UKG})\frac{P_{t+1}^{S}}{P_{t+1}^{UKG}} \times\ Comparability\ Factor$$

Where Y denotes expenditure on the devolved benefit by the UK Government outside of Scotland. The comparability factor for each devolved benefit is 100%.

INDEXED PER CAPITA METHOD

With the IPC method, the baseline would be indexed annually to comparable tax (or benefit) per head annual growth in rUK multiplied by Scottish population growth. The Scottish budget would be the same as it would have been prior to the devolution of these powers if tax revenue per head grows at the same rate in Scotland and rUK. The Scottish budget would be bigger than it otherwise would be if tax per head grows faster in Scotland than in rUK (Gallagher 2016).

This method partly protects Scotland from the risk of relatively slower population growth than rUK. The flipside of this is that Scotland would not benefit from relatively faster population growth compared to rUK.

The formula for the IPC method is:

$$BGA_{t+1} = \frac{X_{t+1}^{UKG}}{X_t^{UKG}} \times \frac{\frac{P_{t+1}^{S}}{P_t^{S}}}{\frac{P_{t+1}^{UKG}}{P_t^{UKG}}} \times BGA_t$$

Where BGA denotes the block grant adjustment, t denotes the year, P denotes the population and X denotes either tax receipts or benefit expenditure, S denotes Scotland and UKG denotes UK government.

SOURCES

Bell D., Eiser D. and Phillips D. (2015) *Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options, Institute for Fiscal Studies*. Available at - http://www.ifs.org.uk/uploads/publications/mimeos/Scotland_Block_Grant.pdf [accessed 04/11/2016]

European Commission (2016) *Fiscal governance in the EU Member States*. Available at - http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm [accessed 04/11/2016]

Gallagher, J. D. (2016) Algebra and the Constitution: The Fiscal Framework of the Scotland Bill. Available at - https://www.nuffield.ox.ac.uk/Research/Politics%20Group/Working%20papers/Documents/Gallagher%20WP%20-%20Algebra%20and%20the%20Constitution.pdf [accessed 04/11/2016]

Smith Commission (2014) *The Smith Commission Report.* Available at - https://www.smith-commission.scot/smith-commission-report/ [accessed 04/11/2016]

Scottish Government (2011a) *Infrastructure Investment Plan 2011*. Available at - http://www.gov.scot/Resource/Doc/364225/0123778.pdf [accessed 04/11/2016]

Scottish Government (2015) *Infrastructure Investment Plan 2015*. Available at - http://www.gov.scot/Resource/0049/00491180.pdf [accessed 04/11/2016]

Scottish Parliament (2016a) *Devolution (Further Powers) Committee, 3rd Report, 2016 (Session 4): New Powers for Scotland: Final Report on the Scotland Bill*. Available at - http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/97413.aspx [accessed 04/11/2016]

Scottish Parliament (2016b) *Finance Committee, Letter from Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy to Kenneth Gibson (Convener) dated 9 March 2016*. Available at - http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/LetterFromDFM20160903.pdf [accessed 04/11/2016]

Scottish Parliament (2016c) *Finance Committee, Official Report, Thursday 3 March 2016*. Available at - http://www.scottish.parliament.uk/parliamentarybusiness/report.aspx?r=10407&mode=pdf [accessed 04/11/2016]

Scottish Parliament (2016d) *Official Report, Meeting of the Parliament, Tuesday 23 February 2016*. Available at - http://www.parliament.scot/parliamentarybusiness/report.aspx?r=10380&mode=pdf [accessed 04/11/2016]

Scottish Parliament (2016e) *Finance Committee, Letter from Greg Hands, Chief Secretary of HM Treasury to Kenneth Gibson MSP (Convener) dated 4 March 2016*. Available at - http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Letter_from_Chief_Secretary_4.03.2016.pdf [accessed 04/11/2016]

UK Government (2015) *HM Treasury, Statement of funding policy: funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly*. Available at - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479717/statement_of_funding_2015_print.pdf [accessed 04/11/2016]

UK Government (2016) *UK Government and Scottish Government, The agreement between the Scottish government and the United Kingdom government on the Scottish government's fiscal framework*. Available at - https://www.gov.uk/government/publications/the-agreement-between-the-scottish-government-and-the-united-kingdom-government-on-the-scottish-governments-fiscal-framework [accessed 04/11/2016]

UK Parliament (2015a) *House of Lords Select Committee on Economic Affairs 1st Report of Session 2015–16, A Fracturing Union? The Implications of Financial Devolution to Scotland*. Available at - http://www.publications.parliament.uk/pa/ld201516/ldselect/ldeconaf/55/55.pdf [accessed 04/11/2016]

THIS PAGE IS INTENTIONALLY BLANK.

SPICe
The Information Centre

RELATED BRIEFINGS

SB 16-52 Scotland Act 2016: Carer's Allowance

SB 16-51 Scotland Act 2016 – Universal Credit

SB 16-50 Scotland Act 2016: Discretionary Payments and New Benefits

SB 16-45 New Social Security Powers

SB 15-83 Scotland's Fiscal Framework

SB 14-11 Scotland Act 2012: Financial provisions

Published by the Scottish Parliament Information Centre (SPICe), The Scottish Parliament, Edinburgh, EH99 1SP

www.parliament.scot