Dear Bruce,

The Finance Committee has had the opportunity to briefly consider the agreement between the Scottish Government and the UK Government on the fiscal framework. The Committee took evidence from the Deputy First Minister (DFM) on 2 March and from the Chief Secretary to the Treasury (CST) on 3 March. This follows on from our report on Scotland’s Fiscal Framework which we published in June 2015.¹

The Committee welcomes the agreement between the two governments and notes the intention to provide a further annex covering operational and governance aspects. This is likely to be complex especially in relation to the interaction of the reconciliation of tax revenue forecasts and outturn figures with the indexation of the block grant adjustment. Full transparency is therefore essential in securing public confidence in the process, in particular in providing reassurance that the no detriment principle is being delivered.

The Committee will recommend in its legacy paper that our successor committee closely monitor the implementation and operation of the fiscal framework. Careful consideration will also have to be given to how the fiscal framework interacts with the budget process. In particular, there are complex issues in relation to the timing of tax decisions and the need for effective parliamentary scrutiny which may require a review of the budget process. The Committee will also address these issues in our legacy paper.

¹ http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/90923.aspx
Scottish Government’s Fiscal Flexibility

One of the key issues which the Committee considered in our report on Scotland’s Fiscal Framework is the extent to which the Scottish Government will have the flexibility to pursue separate fiscal policies while recognising the need for consistency with the overall UK fiscal framework. The Committee expressed concern that the UK Government appeared to be suggesting a much greater level of constraint on the Scottish Government’s fiscal flexibility than the Smith Commission. In particular, that “the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government across devolved and reserved areas.”

The DFM emphasised to the Committee the need for “material flexibility.” He indicated that an essential element of this flexibility is the revised level of borrowing powers and the fiscal rules which govern how they operate. He identified three key elements to be delivered in relation to borrowing:

- credible opportunities for the Scottish Government to invest for the long-term through a distinctive approach on capital borrowing that meets our requirements;
- enough flexibility to deal with the greater financial risk as a consequence of the budget being more dependent on tax receipts;
- sufficient flexibility to take forward more distinctive fiscal responsibility in Scotland.

The Committee believes that the robustness and sustainability of the fiscal framework will be largely dependent on the extent to which it provides the Scottish Government with sufficient flexibility to pursue separate fiscal policies within Scotland.

Capital borrowing

The Scotland Act 2012 provides the Scottish Government with the power to borrow up to 10% of the Capital DEL budget for capital spending for each year with a statutory limit of £2.2 billion. There is also provision to raise (but never lower) this cap. Under the provisions of the fiscal framework the statutory limit has been increased to £3bn. The annual limit is now 15% of the overall borrowing cap which is equivalent to £450m a year.

The Committee previously considered the options for capital borrowing in its inquiry on the fiscal framework. Two options were considered: a prudential capital borrowing regime and an increase in the cash borrowing limit. These are discussed in more detail below.

Prudential Capital Borrowing Regime

The Smith Commission stated that consideration should be given to the merits of undertaking capital borrowing via a prudential regime consistent with a sustainable overall UK framework. This is similar to the Prudential Code which has regulated local authority borrowing in Scotland, England and Wales since 2004. The UK
Command Paper, *Scotland in the United Kingdom: An enduring settlement*, stated that a similar regime for the Scottish Parliament would be considered as part of the fiscal framework negotiations. Both this Committee and the Devolution (Further Powers) Committee recommended the introduction of a prudential capital borrowing regime on a statutory basis. The Scottish Government stated in response to the latter that it supported the introduction of a prudential capital borrowing regime on a statutory basis. This would give “Scottish Ministers greater discretion over borrowing so that we can prioritise infrastructure investment in line with Scotland’s economic interests.” The Scottish Government also responded to this Committee that “we should be able to alter the time and quantum of our capital spending materially through capital borrowing powers.”

The DFM was asked by the Committee why prudential borrowing was not included in the fiscal framework. He responded that “it would not have given the UK Government a context within which it could operate and fulfil its commitments in relation to its own fiscal framework.” The CST stated that both Governments “were happy to go through with an increase in existing capital borrowing limit” and “both feel that this is appropriate and will work best.”

The Committee is disappointed that a prudential regime has not been included in the fiscal framework and asks whether consideration was given to a debt rule such as a percentage of cyclically adjusted GDP.

*Increase in the cash borrowing limit*

The Scottish Futures Trust (SFT) previously recommended an increase in the capital borrowing limit from £2.2 billion to £7.5 billion in order to provide flexible and meaningful support to infrastructure investment. They suggested that this increase “would credibly advance this aim and would only potentially impact public sector net debt by 0.5% over a number of years.” They also recommended removing the annual borrowing limit to further increase flexibility.

The DFM explained to the Committee, “I argued for a higher borrowing limit than £3 billion, but I accepted that the borrowing arrangement had to be consistent with the United Kingdom’s chosen fiscal framework.”

The Committee recognises that the £3bn borrowing limit has to be viewed within the context of the wider fiscal framework and the UK’s own fiscal framework. However, the Committee questions whether the increase from £2.2bn to £3bn is “sufficient to provide credible opportunities for the Scottish Government to invest for the long-term through a distinctive approach on capital borrowing.” The Committee also notes that the Scotland Act 2012

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2 http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/General%20Documents/SG_Response.pdf
3 Finance Committee, 2 March 2016, OR Col. 21
4 Finance Committee, 3 March 2016, OR Col. 6
5 Gavin Brown MSP dissented from this sentence.
6 http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Scottish_Futures_Trust.pdf
7 Gavin Brown MSP dissented from this sentence.
currently provides for the capital borrowing limit to be increased but not decreased and asks whether this will also apply to the new limit.

Resource Borrowing

The Scottish Government currently has resource borrowing powers of up to £200m annually within an overall limit of £500m. This can be used for in-year cash management and/or to deal with deviations between revenue forecasts and outturn figures. Under the fiscal framework these powers will be increased to £600m annually within an overall limit of £1.75bn. These enhanced borrowing powers will apply from 2017-18 onwards.

Forecast errors

The Scotland Act 2012 provides Scottish Ministers with the power to borrow up to £200m annually and £500m in total to deal with deviations between forecasts and actual revenues. The fiscal framework increases the annual limit to £300m within the overall limit of £1.75bn.

The Scottish Government is only able to use the resource borrowing powers under the Scotland Act 2012 if there is no cash reserve and the deviation is more than 0.5% of the total resource budget. It is not clear whether there will be any similar restrictions on the use of the new resource borrowing powers.

The Committee asks whether the limitations on the use of the Scotland Act 2012 resource borrowing powers to deal with forecast errors will still apply to the new resource borrowing powers.

Scotland-specific economic shocks

The Smith Commission proposed extending resource borrowing powers to cope with Scotland-specific economic shocks. The fiscal framework provides for a £600m annual limit on borrowing for any observed or forecast shortfall in tax receipts or demand-led welfare expenditure when there is, or forecast to be, a Scotland-specific economic shock. This 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.”

The CST was asked by the Committee why a rolling 4 quarter basis is being used when a recession is defined as two consecutive quarters of negative growth. He responded that this is consistent with the UK fiscal framework which also uses four quarters of GDP which can be both outturn and forecast. The UK Government defines an economic shock as four consecutive quarters of less than 1 per cent growth.

The Committee has previously recommended that whereas the block grant adjustment method should insulate Scotland from UK wide economic shocks there will also be a Scotland-specific cyclical risk and the Scottish Government will require substantial new borrowing powers to manage this volatility. The Committee also recommended there should be a balanced budget rule rather than a cash limit on
current borrowing. For example, the Scottish Government could be required to balance the cyclically adjusted current budget over the economic cycle. The Scottish Government responded that they agreed with the Committee’s recommendations on current borrowing.  

However, the DFM explained to the Committee that:

“One of the easier issues for us to resolve in the process was to do with resource borrowing. The Chief Secretary to the Treasury took an entirely understandable view about the risks of volatility to which the Scottish Government would be increasingly exposed. Again, the facilities that have been offered in that respect are appropriate in the circumstances.”

The Committee supports the provision of a £1.75bn cash limit for resource borrowing.

The Committee recognises the need for consistency between the definition of economic shock at both a UK and Scottish level. However, the Committee also recommends that consideration should be given to allowing resource borrowing on the same basis as an economic shock for a Scotland-specific recession of two consecutive quarters of negative growth.

Forecasting

The fiscal framework states that the SFC will prepare independent forecasts of the revenues from the fully devolved taxes and income tax, and onshore GDP in Scotland. However, the DFM informed the Committee that it was unlikely that the SFC would be ready to prepare forecasts for 2017-18.

The Committee welcomes the expanded remit for the SFC and recognises that it will inevitably take time to build up the resources to deliver the new responsibilities. The Committee considered the resources for the SFC as part of its Stage 1 scrutiny of the SFC Bill. This scrutiny will now need to be revisited given the extended remit. In particular, the resources provided in the Financial Memorandum (FM) will need to be reviewed.

The Committee has also consistently raised concerns about the availability and quality of economic and fiscal data for Scotland and this will need to be addressed as a matter of urgency. During the Committee’s inquiry on the fiscal framework Scottish Government officials advised that they are in the process of developing a macroeconomic forecasting model for Scotland which is currently being tested.

The Committee previously recommended that the SFC should identify specific areas where economic and fiscal data need updating and that these are addressed by the Scottish Government as a matter of priority. The Committee reiterates that recommendation.

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8 http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/SFF_Response_to_Stage_1_report.pdf
9 Finance Committee, 24 February 2016, OR Col.
10 With the exception of John Mason MSP
The Committee also recommends that the Scottish Government provides revised costs for the SFC.

The Committee invites the SFC to provide an update on the progress which it is making in delivering its expanded remit for consideration by the successor Committee early in the new parliamentary session.

Income tax payments

Income tax receipts can vary quite considerably from one month to the next and a proportion of income tax revenue is not received by HMRC well into the following tax year. The arrangements for SRIT are that the UK Government will make payments when they are required on the basis of the OBR’s forecast. This means that the Scottish Government will receive payments when they are needed rather than when actual tax revenues are received. It is not clear from the fiscal framework whether this arrangement will continue to apply from April 2017.

The Committee recommends that the Scottish Government should continue to receive payments based on tax revenue forecasts when they are needed rather than when the actual tax revenues are received.

Forecasting Income Tax Receipts

Under the arrangements for SRIT the forecast is prepared by the OBR. As part of this process Scottish Government officials and the SFC participate in challenge meetings before every update to the forecasts.

The OBR currently produces biannual forecasts for the devolved taxes and SRIT alongside the Autumn Statement and the UK Budget. It is these forecasts which are currently used for both the payment of SRIT receipts to the Scottish Government and the block grant adjustment for SRIT. The OBR forecast for 2016-17 is £4,900m.

It has explained that it is not possible to replicate in full the UK-wide forecast methodology for the Scottish taxes. This is because the macro-economic data they would need to produce a Scottish macro-economic forecast and economic determinants are generally not available at a Scottish level or are available only with a long lag.

The OBR’s forecast methodology for SRIT is, therefore, based on applying a Scottish share to the equivalent overall UK forecast. The Scottish share is derived from the Survey of Personal Incomes which is only available with a long lag.

However, once HMRC has identified Scottish tax payers on its PAYE and Self-Assessment systems the OBR advise that it “will be possible to determine the Scottish share of UK liabilities with much greater precision and timeliness.”

Draft Budget 2016-17 states that “the Joint Exchequer Committee gave a commitment to explore data sharing options between the Scottish and UK

Governments such that responsibility for providing forecasts of the Scottish rate may be able to be transferred to the Scottish Government from the OBR.” It has now been agreed between the two governments that the SFC will prepare the forecasts for income tax and appropriate and reciprocal information-sharing arrangements will be put in place to enable it to do so.

Given the current lack of Scottish macro-economic data it is not clear whether the SFC will be in a position, at least in the short-term, to develop a significantly different forecast methodology to the OBR for Scottish income tax. However, as noted above the DFM has informed the Committee that the SFC will not be in a position to prepare the independent forecasts for income tax for 2017-18.

The Committee recommends that the OBR prepares the revenue forecast for income tax in Scotland for 2017-18 in consultation with the SFC and that this is published alongside Draft Budget 2017-18.

The Committee also asks the Scottish Government when it is likely that sufficient Scottish macro-economic data will be available to allow the SFC to develop its own forecast methodology for income tax.

**Timing**

The Committee has previously examined the likelihood of an increase in forecast errors due to longer forecast horizons. Professor David Bell produced a paper for the Scotland Bill Committee in February 2011 which examined HM Treasury’s record in forecasting income tax revenues. He found that the mean absolute percentage error (MAPE) for year-ahead forecasts prepared for pre-budget reports between 1998 and 2010 was 3.0% which is a “reasonably good performance.” However, while these forecasts were prepared just a few months before the start of the fiscal year, Professor Bell points out that the Scottish Government “will have to rely on longer forecast horizons when making decisions about how to set income tax rates.” There is a greater level of uncertainty with such forecasts “because much of the data required for the forecast has itself to be estimated.”

The Committee notes, therefore, that there is potentially an issue regarding the timing of the preparation of forecasts used to inform the Scottish draft budget. The Scottish Government is due to publish its proposals for rates and thresholds of income tax in Scotland in September this year. The forecast revenue will also need to be published at the same time. If, as seems likely, the income tax forecast is initially based on a share of the equivalent overall UK revenue forecast then this will be dependent on the OBR forecast published in March. This means that the revenue forecast for Scottish income tax will be based on a share of a UK forecast which is prepared more than a year before the start of the financial year to which it applies.

The Committee recommends that it is important to minimise the likelihood of forecast errors due to longer forecast horizons and therefore further consideration needs to be given to the timing of the tax forecasts used to inform the draft budget.
Forecast of Income Tax Receipts

The Scottish Government will publish its proposals for the rates and thresholds of income tax in Scotland in September this year. It will also need to publish the forecast revenue for income tax which will be a significant slice of its total budget. Whether it is the OBR or the SFC which prepares the forecast it seems likely that at least initially this will be based on a share of the equivalent overall UK revenue forecast. The UK forecast will be published by the OBR alongside the UK budget in March. This would mean that the revenue forecast for income tax in Scotland will be based on a UK forecast which is prepared more than a year before the start of the financial year to which it applies.

At the same time as the forecast for income tax receipts which the Scottish Government will be able to draw down there will also need to be a forecast for income tax receipts in the rest of the UK which will be used to determine the indexation of the adjustment to the block grant. This forecast will be prepared by the OBR.

The Committee recommends that careful consideration will need to be given to how these two forecasts interact with each other and in relation to the draft budget process. For example, the impact of different methodologies being used for the respective forecasts and/or whether it is necessary that the forecasts are prepared at the same time when similar data is available. The Committee also believes that there is a strong argument that the forecasts should be prepared as near as possible to the start of the financial year to which they apply.

Reconciliation

The fiscal framework states that there will be no reconciliation of forecasts to outturn figures for either the tax revenues or the block grant adjustment for SRIT in 2016-17.

There is no mention of how the reconciliation process will work thereafter. The proposed arrangements for SRIT were that following the initial transition period, outturn receipts would be reconciled with the OBR forecast on an annual basis. The reconciliation should occur no later than 12 months after the end of the financial year when it is expected that 99.3% of income tax will normally have been collected and no further reconciliation would be made.12

The Scottish Government provided details of how the reconciliation process could work in its response to the Committee’s report on the implementation of the Scotland Act 2012 financial powers. Reconciliation will depend on the production of audited accounts by HMRC. The information to support accounts for tax receipts is generally reasonably complete about 12 months after the relevant tax year and accounts are produced and audited thereafter. This means that tax receipts for 2017-18 will be largely collected by March 2019 and accounts produced and audited by Autumn

2019. The Scottish Government has previously indicated that a reconciliation could then be carried out and reflected in the budget for the following year.

The Committee recommends that the Scottish Government provides details of how the reconciliation process will work.

Scotland Reserve

The Scotland Act 2012 provides the Scottish Government with a cash reserve capped at £125m. When outturn is above forecast the Scottish Government is able to retain this surplus in this cash reserve which can be used to offset any years in which outturn is below forecast. Any outstanding borrowing is required to be repaid from surplus outturn receipts before it can be paid into the cash reserve.

The fiscal framework replaces this cash reserve and the Budget Exchange Mechanism (BEM) with a new Scotland Reserve which will be capped in aggregate at £700m. The BEM which allows carry-over of up to 0.6% of DEL resource and 1.5% of DEL capital which amounts to around £215m in 2016-17 will no longer apply. Any unspent money can now be placed in the Scotland Reserve. The Scottish Government will be able to draw down annually up to £250m for resource and £100m for capital.

The Committee previously supported the Scottish Government’s view that it should have the flexibility to spend the surplus tax receipts as well as the option of putting them in the cash reserve. The Committee, therefore, welcomes the view of the DFM that the terms of the Scotland Reserve are “less restrictive than the terms of the cash reserve in the Scotland act 2012.” The CST told the Committee that the “reserve is a powerful mechanism to assist with budget management” and “gives the Scottish Government significant budget flexibility.”

The Committee welcomes the new Scotland Reserve. The Committee asks whether any outstanding borrowing will still have first call on surplus outturn receipts. The Committee also asks whether any shortfall in receipts will need to be met from the Scotland Reserve before resource borrowing can be used.

Baseline adjustments to the Block Grant – Income Tax

The UK Government proposed in relation to SRIT that the reduction to the block grant “would be a percentage based on the average worth of the devolved tax receipts over a number of years, not a single year.” This would include outturn receipts from SRIT during the transition period. However, the fiscal framework states that “the initial baseline adjustment for tax will be equal to the UK Government’s receipts generated from Scotland in the year immediately prior to the devolution of powers.”

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13 Finance Committee, 2 March 2016, OR Col. 33
14 Finance Committee, 3 March 2016, OR Col. 14
The DFM told the Committee that the baseline adjustment “will be driven by a year-zero calculation based on the revenue that was generated in the year before devolution.” In relation to income tax he explained that the baseline adjustment will be based on a forecast prepared by the SFC and there will be a reconciliation with actual receipts. However, as noted above the DFM does not anticipate that the SFC will be ready to prepare independent forecast for 2017-18.

The Committee questions why a single year is now being used to calculate the baseline adjustment when both governments had previously indicated the need to use an average of tax receipts over a number of years. In particular, there is a possibility that the single year used could be an outlier which may not be consistent with the no detriment principle.

The Committee recommends that the OBR should prepare the revenue forecast used to calculate the baseline adjustment for income tax and that this should be published alongside Draft Budget 2017-18.

Baseline adjustments to the Block Grant – Devolved taxes

A single year of tax receipts will also be used to calculate the baseline adjustment for the devolved taxes. Given that Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) were devolved in April 2015 then presumably the tax receipts for 2014-15 will be used. However, prior to the devolution of SLfT there are no Scotland-specific figures for landfill tax revenues available from HMRC. This is because revenue receipts are based upon reporting at a company level rather than by landfill site and many companies operate across the UK. The OBR has though provided forecasts for SLfT for 2011-12 onwards.

The Scottish Government had previously proposed using a five year average of receipts for LBTT preceding devolution to calculate the baseline adjustment to the block grant while the UK Government favoured using a combination of outturn receipts and forecasts. However, when asked by the Committee why a single year is being used the CST stated that “this is consistent with how devolution has always been done.”

The Committee questions why a single year is being used to calculate the baseline adjustment when both governments had previously indicated the need to use an average of tax receipts over a number of years.

The Committee emphasises the need for full transparency in relation to the calculation of all the baseline adjustments to the block grant.

The Committee asks how the adjustment for SLfT will be calculated given that there are not outturn figures for landfill tax in Scotland prior to it being devolved.

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16 Finance Committee, 3 March 2016, OR Col.28
17 Finance Committee, 3 March 2016, OR Col.16
The Committee recommends that the SFC should prepare independent forecasts for LBTT and SLfT for 2017-18.

Draft Budget 2016-17

Draft Budget 2016-17 states that a one year agreement has been reached for a £600m adjustment to the block grant in respect of the devolved taxes.

The DFM explained to the Committee that “the issues around 2016-17 will be subject to further discussion with the Treasury, given the fact that we agreed the block grant adjustment outwith the details of the fiscal framework negotiations.”18

The Committee recommends that the adjustment to the block grant for 2016-17 should be based on the fiscal framework agreement which means applying the agreed indexation method to the baseline adjustment.

Forestalling

The fiscal framework states that the baseline adjustment for LBTT “will take into account the forestalling that is estimated to have occurred, which will reduce the baseline adjustment by £20m.” The DFM explained to the Committee that the figure “was calculated by the OBR, and I have accepted that it is beyond dispute.”19 However, the OBR’s latest forecast for the devolved taxes was published in November 2015 and it increased its forecast for forestalling from £20m to £40m. Its forecast for forestalling for residential LBTT increased from £20m to £30m and it also forecast £10m in forestalling for non-residential LBTT. The DFM explained to the Committee during its scrutiny of Draft Budget 2016-17 that the “shortfall in residential transactions is broadly comparable at this stage with the level of forestalling that was identified or suggested by the OBR.”20

The Committee asks why £20m has been deducted from the baseline adjustment for LBTT to take into account forestalling when the latest OBR forecast for forestalling which was published in November 2015 is £40m.

The Committee previously recommended that the first ‘no detriment’ principle should include forestalling at the point of transfer.21 However, the fiscal framework states that no “further forestalling effects in relation to the implementation of new powers will be taken into account.” The DFM told the Committee that the Parliament will need to be mindful of this “when making decisions about tax issues.”22

It is not clear why the baseline adjustment for SDLT will take into account forestalling but there is to be no account taken of possible forestalling in relation to the devolution of income tax. For example, if the Scottish Parliament decides to change the rates and thresholds for income tax in 2017-18 then there may be a forestalling

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18 Finance Committee, 2 March 2016, OR Col. 27
19 Finance Committee, 2 March 2016, OR Col. 36
20 Finance Committee, 13 January 2016, OR Col. 37
22 Finance Committee, 2 March 2016, OR Col. 36
effect as a consequence of a behavioural response to income tax changes. The Scottish Government is due to announce its proposed rates and thresholds for 2017-18 in the draft budget which will be published in September 2016. If there is a proposal to increase income tax this could lead to forestalling which would increase tax receipts to HM Treasury in 2016-17 and a reduction to the Scottish Government in 2017-18.

For example, in March 2009 the UK Chancellor announced his intention to introduce a new 50p additional rate of income tax in April 2010. The new UK Chancellor announced in his Budget in March 2012 that HMRC had found evidence of considerable forestalling to avoid the 50p rate “at a cost to the taxpayer of £1 billion” and the rate would be reduced to 45p in April 2013. Figure 1 below shows the annual change in income tax for taxpayers in income brackets above £100,000. A portion of the changes i.e. the decrease in 2010-11 and the substantial increase in 2013-14 are most likely a result of forestalling and other behavioural responses, particularly from high income taxpayers with incomes over £300,000 and especially over £1m. These may include incorporating of converting a salary into dividends, converting income into capital gains, increasing pension contributions, etc.

There are, therefore, two potential risks to the Scottish budget from a change to income tax at the point of transfer of powers under the fiscal agreement. First, that there is considerable reduction in tax partly due to forestalling and other behavioural responses which would increase revenue to HM Treasury in 2016-17 and a subsequent loss of revenue to the Scottish Government in 2017-18. Second, the baseline adjustment to the block grant for income tax would be higher due to forestalling and other behavioural responses.

23 [http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN00249](http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN00249)
The Committee questions why the ‘no detriment’ principle has been applied to forestalling in relation to LBTT but will not apply to income tax if there are forestalling effects at the point of transfer.

The Committee also asks whether these and other behavioural effects in response to a change to income tax at the point of transfer would be considered under paragraph 47 of the fiscal agreement.

Indexation mechanisms

The fiscal framework states that for a transitional period covering the next Scottish Parliament, the indexation mechanism for tax will be calculated “using the Comparable Model (Scotland’s share), whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method for tax and welfare.” During this transition period the fiscal framework states that 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.” The indexation mechanism will be operated separately for each tax and applied annually.

The Committee first raised concerns about the impact of relative changes in population size in relation to the indexation of the block grant adjustment in its report on the financial powers in the Scotland Act 2012 in October 2013. The Committee asked the Scottish Government “whether the indexing of the block grant adjustment
will take into account relative changes in population size.”

The Committee again raised this issue in our report on the fiscal framework which was published in June 2015. The Committee asked whether Ministers had considered basing the indexation of the block grant adjustment on the per capita tax base rather than the overall growth in the UK tax base.

The Committee, therefore, welcomes the agreement within the fiscal framework that relative changes in population size will not impact on the size of the Scottish budget throughout the next Parliament. However, there is a need for much greater clarity in relation to how this process will work in practice. In particular, careful consideration will need to be given to how the operation of the indexation mechanism interacts with the draft budget process. There are a number of issues which will need to be addressed including:

- The timing of the operation of the indexation mechanism for each tax and the timing of the relevant forecast;
- Whether outturn figures will be used to recalculate the indexation of the block grant adjustment for each tax on an annual basis and how this will work given the lags in outturn data becoming available;
- Whether the reconciliation process to achieve the Indexed Per Capita (IPC) method will be based on forecasts and if so, will there be a subsequent reconciliation with outturn figures;
- Confirmation that the numbers will be published for both the IPC method and the Comparable method.

Value Added Tax (VAT)

The fiscal framework states that receipts from the first 10p of the standard rate of VAT and the first 2.5p of the reduced rate of VAT in Scotland will be assigned to the Scottish Government. However, details of the methodology for calculating the assignment of VAT have still to be developed and agreed by the two governments. VAT assignment will be implemented in 2019-20 and there will be a transitional period during which “VAT assignment will be forecast and calculated each year, but with no impact for the Scottish Government.”

The DFM informed the Committee that he has “agreed in principle a consumption-based approach.” He also explained that there “will be a comprehensive exercise to identify and resolve many of the detailed points that will be implicit in the methodology, which will be available for the committee to scrutinise as it is formulated.”

The Committee would welcome a more detailed explanation as to why the two governments have agreed in principle a consumption-based approach to VAT assignment.

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25 Finance Committee, 2 March 2016, OR Col. 26
26 Finance Committee, 2 March 2016, OR Col. 26
The Committee recommends that the Scottish parliament is consulted on a draft methodology for VAT assignment prior to it being agreed between the two governments.

**Forecasting**

The fiscal framework states that arrangements for the production of forecasts of VAT revenues will be agreed by the JEC.

The Committee recommends that the forecasts for VAT revenues should be prepared by the SFC in consultation with the OBR as appropriate.

**Joint Exchequer Committee (JEC)**

Lord Smith highlighted the weakness of inter-governmental relations (IGR) as a problem that needs to be fixed. The Scottish Government has also recognised that the intergovernmental machinery requires overhaul. The UK Government has stated that reformed IGR will be underpinned by much stronger and more transparent parliamentary scrutiny including the reporting of the conclusions of the JEC. The fiscal framework states that the remit of the JEC – Officials will be expanded to include detailed implementation and operation of the financial provisions of any Scotland Act 2016.

The Committee recommended in its report on Scotland’s Fiscal Framework that there needs to be a much more systematic approach to the reporting of JEC meetings with a clear expectation of the level of information to be provided including:

- Advance notification of agendas to allow the Parliament to contribute any views;
- A detailed and timeous minute to allow for effective parliamentary scrutiny.

The DFM informed the Committee that the terms of reference of the JEC will be included in the technical annex to the fiscal agreement. The CST was asked by the Committee whether there is a need for any structural changes to the JEC. He responded that he does not envisage any at the moment.

The Committee is disappointed that there doesn’t appear to be much evidence of the institutional weaknesses identified by Lord Smith being addressed in the fiscal framework.

The Committee recommends that the commitment of both governments to overhaul the intergovernmental machinery needs to be delivered and this must allow for effective parliamentary scrutiny.

**Review**

The fiscal framework states that the two governments have agreed that it will be reviewed and that the review will be informed by an independent report which will be presented to both Governments by the end of 2021. 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.”

The DFM was asked by the Committee what happens if the two governments cannot reach agreement following the transitional period. He responded that the crucial point is “nothing can be imposed on us because of the requirement for the framework to be jointly agreed.” When further asked whether the no-detriment agreement which he had secured may not last beyond the transitional period he emphasised again that nothing can be imposed upon us. He was also asked what the fallback position would be if no agreement can be reached. He responded that it “is what will be there in 2022.”

However, the CST appeared to take a different view. He was asked by the Committee what would be the status quo that we would default to if no agreement could be reached following the review. He responded that there “is no status quo” and “it is clear that there is no default indexation model.”

The Committee notes that the two governments appear to have different interpretations of what will happen if no agreement can be reached following the review of the transitional arrangements and clarification is required.

The Committee recommends that both governments consult with their respective parliaments prior to the JEC agreeing the arrangements for undertaking the review and that there is sufficient opportunity for parliamentary engagement and wider public engagement in the review.

Conclusion

The Committee invites the Devolution (Further Powers) Committee to consider the above as part of its consideration of the Scotland Bill.

Yours sincerely

Kenneth Gibson MSP,
Convener

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27 Finance Committee, 24 February 2016, OR Col. 14
28 Finance Committee, 2 March 2016, OR Col. 39
29 Finance Committee, 3 March 2016, OR Col. 10