11 August 2016

Dear Convenor,

Thank you for your letter of 29 June 2016 which sought further information on the Fiscal Framework agreement and requested a response to the issues raised in the Session 4 Committee’s letter to the Convener of the Devolution (Further Powers) Committee.

My response to that letter is attached and I hope you and the Committee find it useful. As you will be aware, I also attended the Committee’s session on 29 June and provided oral evidence to the Committee on both the letter and the Session 4 Finance Committee Legacy report. I am happy to provide further evidence should the Committee find this useful.

DEREK MACKAY
Scottish Government’s Fiscal Flexibility

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.

We believe that the Fiscal Framework represents a fair financial settlement to underpin the powers set out in the Scotland Act 2016. While the Scottish Government has argued for additional powers and will continue to do so, we believe that the framework agreed between the Scottish and UK Governments in February and March will enable us to use the powers in a flexible way and so to contribute to a fair and prosperous Scotland. As the Deputy First Minister has made clear, the agreement involved some give and take on the part of both governments. We did not achieve our desired position on some elements of the framework, but the deal recognises the central importance of the Barnett formula in determining changes to the Block Grant, and of the principle of no detriment which Lord Smith’s report emphasised.

Capital borrowing

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.

The Scottish Government’s preferred option was a prudential borrowing regime, based on fiscal rules. However the UK Government did not share this view. Nevertheless we have secured an increase in aggregate and annual capital borrowing limits which will give the Scottish Government scope to increase the rate of investment in infrastructure in Scotland.

Increase in the cash borrowing limit

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 currently provides for the capital borrowing limit to be increased but not decreased and asks whether this will also apply to the new limit.

The increase agreed to the aggregate cap and the annual borrowing limits provides additional scope for capital investment, although as noted above the Scottish Government’s preference was for a prudential regime to govern borrowing. As was the case under the Scotland Act 2012, the aggregate borrowing limit can be increased but not decreased by UK Ministers via secondary legislation.
Resource Borrowing

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.

It is assumed that the limitations referred to are the requirements originally set out in the UK Government’s Command Paper “Strengthening Scotland’s Future” in November 2010 that the Scottish Government should absorb forecast errors up to a value of 0.5% of RDEL (roughly £150m) before being able to access resource borrowing powers. These requirements were removed as part of changes to the Scotland Bill announced on 13 June 2011, and this change is reflected in the Scotland Act 2012. A link to the announcement is provided below:


The purpose of the change to the Scotland Act 2012 was to give the Scottish Government more flexibility to decide how best to respond to variation in tax receipts compared to forecast. The position in the 2012 Act is carried forward into the Scotland Act 2016 resource borrowing powers.

Scotland-specific economic shocks

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.

In discussion of the criteria for triggering access to resource borrowing powers, a range of options was considered. A key consideration was the degree of funding volatility that the Scottish Government would be exposed to in the event of different economic shocks. The criteria finally agreed are designed to ensure that there is access to borrowing when significant volatility in the net funding produced by tax revenues and block grant adjustments takes place or is forecast to take place. A Scotland-specific recession of two consecutive quarters of negative growth would not of itself produce significant funding volatility, unless growth in the rest of the UK were to be materially higher than in Scotland. In that case, the economic shock criteria set out in the fiscal framework would be triggered and Scotland would have access to borrowing powers.

Forecasting

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.
The Scottish Government already publishes detailed economic statistics for Scotland and we continually look at how we can improve the scope, quality and timeliness of economic data. We will work with the Scottish Fiscal Commission to ensure it has the economic statistics which it requires to produce income tax and GDP forecasts.

**The Committee also recommends that the Scottish Government provides revised costs for the SFC.**

The Scottish Fiscal Commission is responsible for the production of cost estimates for its transition to a statutory body and for ongoing operations. We recognise that the change in forecasting functions agreed in the Fiscal Framework will have implications for the resourcing of the Commission and we remain committed to ensuring that the Commission is appropriately resourced to carry out its statutory functions. The Commission’s budget for 2017-18 will be set out in due course in the Draft Budget for that year.

**Income tax payments**

**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.**

The Technical Annex to the Fiscal Framework agreement provides that the Scottish Government will be able to access funding equal to forecast income tax revenues in Scotland during the relevant financial year. This amount will then be reconciled to outturn receipts when outturn data is available, and any necessary adjustment made to the block grant in the next future year. This will ensure that the Scottish Government is able to access revenue in the year for which it is levied.

**Forecasting Income Tax Receipts**

**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.**

As set out in the Technical Annex to the Fiscal Framework, income tax forecasts for Scotland for 2017-18 will be prepared by Scottish Government officials and scrutinised by the Scottish Fiscal Commission. The forecast, and the Scottish Fiscal Commission’s report on its reasonableness, will be published alongside the 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.**

Detailed macro-economic and income tax statistics are already published for Scotland. Work is under way now between the Scottish Government and the Scottish Fiscal Commission to ensure that the Commission is able to develop its own income tax forecasting methodology in time for Draft Budget 2018-19, and to assess what further economic information the Commission requires to support this work.
Timing

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.

The Scottish Government has developed its own bottom-up income tax forecasting model based on an anonymised sample of Scottish income tax payers and forecasts of economic determinants developed through the Scottish Government’s economic forecasting model. The revenue forecast for Scottish income tax will not, therefore, 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. It is currently being developed using the latest available knowledge of current and future economic conditions in Scotland. The forecast will inform preparation of the Draft Budget 2017-18 and will be published as part of the Draft Budget, as will the Commission’s report on the forecast.

The Scottish Government agrees with the Committee’s recommendations around the importance of the timing of tax forecasts in minimising forecast error. It is intended that the joint working group between the Parliament and the Scottish Government will consider this issue in more detail.

Forecast of Income Tax Receipts

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.

The Fiscal Framework agreement sets out that the Scottish Fiscal Commission will produce Scottish income tax forecasts with respect to financial year 2018-19 and onwards. For the transition year of 2017-18 the Scottish Government will produce the Scottish income tax forecast and the Commission will scrutinise and report on the process and the forecast as it has done in previous years for the fully devolved taxes.

For 2017-18 the Scottish Government forecast will set the amount of funding the Scottish Government will be able to draw down from HM Treasury in respect of Scottish income tax receipts for the year. From 2018-19, the Commission’s forecast will be used for this purpose.

Discussions are taking place with the UK Government and the OBR about OBR forecasts that are relevant to the calculation of Scottish funding, and the potential interactions between forecasts undertaken in Scotland and those undertaken by UK bodies.
On timing of forecasts, the Scottish Government agrees that there is a strong argument for preparing these as near as possible to the start of the financial year using the most recently available data. Scottish Government forecasts are dependent on assessments of economic determinants. These are updated regularly as new data becomes available, so the closer to that start of the financial year an income tax forecast is made, the closer forecasts and are likely to be to eventual outturn. Publishing the Draft Budget 2017-18 at any point prior to the 2016 Autumn Statement would mean using Scottish forecasts of tax receipts (and, in due course, social security spending) produced shortly before publication, but relying on OBR forecasts of growth in rest of UK tax receipts prepared before the March 2016 UK Budget to calculate the block grant adjustments.

Reconciliation

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

The process for adjusting the Scottish block grant in respect of the newly devolved tax and other powers will follow an annual cycle. A separate adjustment will be calculated in respect of each relevant tax and spending power.

The Fiscal Framework sets out that the BGA will be based on forecasts of relevant UK Government receipts and expenditure in the rest of the UK, and the latest available mid-year population estimates. These adjustments will be applied to the Scottish block grant for the next financial year.

The Fiscal Framework sets out that the BGAs for the following financial year will be calculated at the “Autumn Statement provided this occurs at least three months in advance of the start of the financial year”. Consequently the Scottish Government will not be in a position to provide definite figures for the BGA until after the publication of the Autumn Statement.

The BGA will be recalculated once actual data is available. For the majority of the fully devolved taxes this will be in the summer following the end of the relevant financial year. However, with regard to income tax, the data required to undertake the reconciliation will not be available until approximately fifteen months after the end of the relevant financial year. Any necessary adjustments flowing from the reconciliations will be applied to the Scottish block grant in the next following year, provided this can be done at least 3 months before the start of the financial year.

Scotland Reserve

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.

The Scotland Reserve, which will be implemented from 2017-18, will replace the existing cash reserve and the Budget Exchange Mechanism. It will enable the Scottish Government to smooth all types of spending and manage tax volatility by adjusting the timing of expenditure. The Scottish Reserve will be capped in
aggregate at £700m with annual drawdowns from the cash reserve limited to £250m for resource and £100m for capital.

Operational arrangements for the Scotland reserve are still being discussed with HMT. However, it would be prudent financial management to repay borrowing as soon as reasonably possible from surplus receipts and to exhaust funds in the Scotland Reserve before deciding to borrow, to reduce and avoid the additional cost of borrowing.

Baseline adjustments to the Block Grant – Income Tax & Devolved Taxes

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.

For tax, there will be a deduction to the block grant equal to the UK Government’s receipts generated from Scotland in the year immediately prior to devolution (year 0). For social security, there will be an addition to the block grant equal to the UK Government’s spending on these areas in Scotland in the year immediately prior to devolution (year 0). Indexation will then be applied to the year 0 baseline to determine the block grant adjustment for each tax or benefit in the first year of devolution (year 1). The exception to this is the Cold Weather Payment, where the initial baseline addition will be an average of the UK government’s spending in Scotland on this benefit from 2008-09 to the year prior to devolution. This reflects the substantial volatility of these payments.

These baseline adjustments will be separately calculated for each tax and welfare power and then separately indexed each year, with the result applied to the overall Scottish block grant. Both governments have committed to publishing these calculations and ensuring that the process is transparent.

The indexation mechanism agreed through the Fiscal Framework also reduces the risk of an artificially high or low initial deduction being ‘locked in’ for subsequent years. This is because the volatility of tax receipts and spending in the rest of the UK broadly mirrors that in Scotland. Any cyclical decline in devolved tax receipts would therefore be expected to be broadly matched by a fall in rUK receipts and in turn the BGA, and vice versa.

This would not have been the case if the Governments had agreed a different indexation mechanism, for example if the BGA had been linked to movements in economic indicators generally, or in public spending which tend to be less volatile than receipts.
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.

The Fiscal Framework states that an average of the GERS and HMRC methodology for apportioning UK Landfill Tax revenues to Scotland will be applied to UK receipts in 2014-15 to calculate the initial baseline adjustment for SLfT.

The Committee recommends that the SFC should prepare independent forecasts for LBTT and SLfT for 2017-18.

The Scottish Fiscal Commission will assume responsibility for the production of devolved tax forecasts when it becomes a statutory body on 1 April 2017.

For the short period while the Commission is preparing to assume responsibility for independent forecasting, the Scottish Government will produce forecasts and the Commission will provide independent scrutiny and assurance of the reasonableness of those forecasts. This applies to the 2017-18 Scottish Budget only. This will allow the Commission time to develop capacity and capability to support the production of robust forecasts.

Draft Budget 2016-17
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.

A provisional one-year block grant adjustment was agreed between the two Governments for both fully devolved taxes in 2016-17 of £600 million. It was also agreed that this figure would be reviewed following agreement of a permanent BGA mechanism as part of the Fiscal Framework, and that any change to the adjustment would be applied after the end of 2016-17.

Now that agreement has been reached, revised BGAs for the two fully devolved taxes in 2016-17 will be calculated, and the agreed annual indexation method will be applied to these to obtain the BGAs for 2017-18. As noted, the revised BGAs will not be applied to the block grant in 2016-17. Instead, any difference between the provisional, combined BGA of £600 million and the 2016-17 BGA figures calculated using agreed methodologies and outturn data will be dealt with through the annual reconciliation process and the block grant adjustment with respect to the next future year will be adjusted.

Forestalling
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 Fiscal Framework agreed to include a £20m adjustment to the baseline for Stamp Duty Land Tax to take account of the forestalling that is estimated to have
occurred. This represents the gain to the UK Government from increased SDLT receipts in 2014-15 (the year relevant for setting the baseline) rather than the loss to the Scottish Government from lower LBTT receipts in 2015-16, due to forestalling.

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 decision to recognise and compensate for forestalling in relation to LBTT in the Fiscal Framework reflects the fact there had been previous written agreement between the Scottish and UK Government to investigate this issue.

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.

There will be no other forestalling effects taken into account. This is in recognition of the difficulty in estimating and agreeing the impacts of forestalling effects. Furthermore, the risks with not including these effects are symmetrical for both Governments.

Indexation mechanisms
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.

For the period up to and including 2021-22, each year the block grant adjustments for all relevant taxes and new spending powers will be concurrently calculated on the basis of both the Comparable and Barnett Models and the IPC model.

The first step will be to calculate the adjustments on the basis of the Comparable and Barnett models. The second, concurrent step will be to calculate the BGA adjustment to achieve the outcome delivered by the IPC model each and every year. At a later date, this indexation mechanism based on forecasts will be reconciled to actuals to ensure IPC is met on outturn data.
This means that the BGA will effectively be indexed to per capita growth in comparable receipts and spending in the rest of the UK over the transition period. This will ensure that the Scottish Government’s overall level of funding will be no different to that under pre-Smith arrangements if relevant tax receipts per head in Scotland grows at the same rate as in rUK and if tax policies remain the same in both countries. If Scotland’s population grows differently from the rest of the UK, that will make no difference to funding. This means there will be no detriment to devolved funding to Scotland over this period.

The Scottish Government intends to publish the results of these calculations and reconciliations with the Draft Budget so Parliament has the opportunity to fully scrutinise the outcomes.

**Value Added Tax (VAT)**

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.

VAT is a tax levied on the sale of goods or services at the point of consumption. As such it is not possible to estimate VAT on a production basis. For example, goods which are produced in Scotland but then exported internationally are not subject to UK VAT. Similarly, a large amount of VAT receipts paid in Scotland will be associated with the consumption of imported goods, which are not produced in Scotland.

The consumption-based method to estimate Scotland’s VAT liabilities is consistent with the approach used by HMRC and the OBR to forecast VAT for the UK. Estimating Scotland’s VAT based on and goods and services consumed in the country provides a measure which is suitable for policy purposes but also imposes minimal burden on businesses. Alternative approaches would either require companies to split their accounts between Scotland and the rest of the UK, or require further statistical estimation techniques which have been investigated but found to be problematic.

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.

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

The methodology to assign VAT receipts to Scotland is under development. There are a number of areas which will be covered including household expenditure, irrecoverable VAT on business expenditure (e.g. expenditure by financial services firms who do not charge VAT on their products and services), government expenditure and housing expenditure.

The development of the methodology will require enhancements to existing surveys and may require new survey data, in particular to ensure that we can accurately
estimate expenditure by Scottish households. There are also a number of other issues to be explored, for example VAT paid on expenditure by tourists in Scotland.

Forecasting arrangements for VAT will be dependent on the methodology agreed. The Scottish Government will consult the Scottish Parliament on the draft methodology for VAT assignment.

**Joint Exchequer Committee (JEC)**

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.

The future governance of Fiscal Framework was considered as part of negotiations and the technical annex to the Fiscal Framework sets out revised Terms of Reference for JEC.

Clearly the framework will need time to bed in and so we will want to ensure appropriate review points and mechanisms to take stock of issues and ensure the framework is operating effectively. This is also in line with the Smith recommendation that the Fiscal Framework that arrangements “should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective” [Paragraph 95 (6)]

The first review will take place after an independent report on the block grant adjustment arrangements is presented to both governments, which must happen by the end of 2021. The Governments will agree jointly how that review will be carried out and the Scottish Government intends to ensure the Scottish Parliament has an appropriate scrutiny role as part of these arrangements.

Both governments have also committed to publishing annual implementation reports, similar to the section 33 reports published on implementation of the Scotland Act 2012 provisions.

The Devolution (Further Powers) Committee report, ‘Changing Relationships: Parliamentary Scrutiny of Intergovernmental Relations’ recommended that information provided by governments must enable parliamentary scrutiny of formal, inter-ministerial meetings before and after such meetings. I recognise the key role of the Scottish Parliament in scrutinising the activity of the Scottish Government within formal inter-governmental structures.

A Written Agreement, drafted jointly with Parliament and SG officials, setting out proposals for more formal sharing “subject to the need to both respect the views of other Governments involved and maintain confidentiality around discussions as and when appropriate” was agreed by the then Cabinet Secretary for Finance on 9 March 2016 and published by the Committee on 10 March 2016.
Review

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 Fiscal Framework sets out that the block grant adjustment methodology will be reviewed in 2021-22, in the light of a Parliament's worth of experience. The review will be informed by an independent report presented to both governments by the end of 2021.

The fiscal framework is clear that there is no default position in the event that the governments cannot reach agreement on the method for adjusting the block grant.

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.

The Fiscal Framework is clear that future arrangements have to be agreed jointly. The terms of reference for the review will be agreed by both Governments. The Scottish Government would expect to reach such an agreement in consultation with interested parties, including the Scottish Parliament.