Dear Bruce

I welcomed the opportunity to briefly debate the Finance Committee’s report on the 2017-18 Draft Budget alongside Stage 1 of the Budget Bill. Given the number of recommendations focussed on the work of the Budget Process Review Group, I am sure we will have further opportunities to debate many of these issues.

Following on from the initial comments I offered in that debate, I now enclose the Scottish Government’s formal written response. I believe the Scottish Fiscal Commission will be writing to you separately to respond directly to recommendations relevant to them.

I also want to use the opportunity this letter presents to follow up on a few action points emerging from the evidence session on 16 January. At that sessions, I agreed to provide Mr Harvie with further information on the Infrastructure Investment Plan and the Equality Budget Statement (EBS) respectively.

In relation to the point raised about the work undertaken by the Low Carbon Infrastructure Task Force, I can confirm that the response offered in evidence by my officials was correct. The work of the Task Force was based on an analysis of the Scottish Government’s 2011 Infrastructure Investment Plan (IIP), which set out the Government’s long term investment programme over a period of 20-25 years, rather than analysis of a Scottish Budget. An update to the IIP was subsequently published in December 2015, which reinforced the Scottish Government’s commitments to investment in public transport, energy efficiency, renewable energy and other measures that support a low carbon economy.

Contrary to the suggestion at the evidence sessions, consideration was indeed given to the equalities impact of the spend on Concessionary Travel in the preparation of
the Equality Budget Statement. The National Concessionary Travel Scheme will continue to provide 1.3 million older and disabled people with free bus travel. The reduction in funding reflects recent decreases in patronage on buses, constrained fares growth, and efficiencies in the operation of the concessionary travel scheme. As is highlighted in the Programme for Government document, and also in the Rural Economy and Connectivity portfolio chapter of the Draft Budget there are plans to develop options in consultation with stakeholders to safeguard the scheme's long-term sustainability. However given that these options have yet to be developed it was not felt appropriate to comment on any of these scenarios in the EBS.

As I referenced at the evidence session, we plan to take forward a consultation process on longer term options for the provision of concessionary travel. We will begin by engaging with stakeholders so that we can properly understand the social, equality and other impacts of any changes. We will listen to views put to us from across Scotland, and then move into a formal written consultation on possible options. As has been previously stated by Scottish Ministers, including by Mr Yousaf on 23 January 2017, there will be no change in eligibility for existing over-60 cardholders or for the disabled. The consultation will also consider expanding the scheme to Modern Apprentices and those on Job Grants. As part of the exercise it is proposed that the views of respondents on the equality impact of the options are collected. If following the consultation it is decided to progress with any changes in eligibility, a full Equality Impact Assessment will be carried out. The exercise will highlight mitigating actions to deal with any identified negative impacts and be published on the SG website.

From Transport Scotland's own published research we know that scheme is greatly valued and works well for card holders for a number of reasons including financial savings, reducing isolation, engendering a sense of greater independence and increasing confidence in their own ability to travel. Cardholders see the scheme as having improved their mental and physical well-being.

I hope the Committee finds this information helpful.

DEREK MACKAY
The Scottish Government welcomes the Committee’s report. Responses to each of the Committee’s recommendations are presented below.

STRATEGIC CONTEXT FOR THE DRAFT BUDGET 2017-18

12. The Committee is very aware that the increased dependence of the budget on relative economic performance combined with the complexity of the Fiscal Framework means that there is now a much greater degree of volatility and uncertainty in the budget process. This uncertainty is exacerbated by the potential impact of Brexit on economic growth and the public finances.

13. The Committee emphasises therefore, that it is essential that there is complete transparency in how the Fiscal Framework operates and one of the main purposes of this report is to provide some clarity on this process.

We acknowledge that a multitude of factors will add to the complexity of determining the Scottish budget under Scotland’s new Fiscal Framework. As well as the block grant from Westminster, the size of the Scottish budget will also be determined by the revenues raised from Scottish devolved and assigned taxes. The block grant adjustments made for each tax will depend on the growth in equivalent taxes per head in the rest of the UK, as they will be indexed in line with this in future years. Similarly, the size of the Scottish budget in future years will also depend on the growth in spending on comparable social security benefits in the rest of the UK, as this will determine the size of the block grant adjustment for devolved social security. We would agree with the Committee’s observation that the potential impact of Brexit creates significant additional uncertainty.

14. The Committee recommends that information in relation to the operation of the Fiscal Framework should be provided as soon as it is available in order to provide greater opportunity for parliamentary and wider public scrutiny.

We note this recommendation and there are on-going discussions with HM Treasury about further points of operational detail of the Fiscal Framework, such as the arrangements for borrowing powers and the Scotland Reserve as referenced in paragraph 245 of the Committee’s report. We will update the Committee on any arrangements agreed with HM Treasury regarding implementation of the Fiscal Framework.

Moreover, both the UK and Scottish governments have committed to publishing annual implementation reports of Scotland Act 2016 provisions, similar to the section 33 reports published on implementation of the Scotland Act 2012 provisions. These implementation reports will be published every year in Spring so that Parliament remains sighted on the views of both Governments on the operation of the Fiscal Framework.

15. The Committee also recognises that the operation of the Fiscal Framework is a shared responsibility between the Scottish Government and the UK Government.
The Committee is, therefore, disappointed that the Chief Secretary to the Treasury declined to give evidence in relation to the operation of the Fiscal Framework. The Committee believes it is vital that we have the opportunity to hear from an HM Treasury Minister on the operation of the Fiscal Framework as part of the annual budget process. The Committee will continue to pursue this matter with HM Treasury.

We are pleased to note the Committee’s recognition of the importance of shared responsibility, which is one of the key principles of the Fiscal Framework. In this spirit, both the UK and Scottish governments have committed to publishing annual implementation reports of Scotland Act 2016 provisions, similar to the section 33 reports published on implementation of the Scotland Act 2012 provisions. These implementation reports will be published every year in spring so that Parliament remains sighted on the views of both Governments on the operation of the Fiscal Framework.

Block Grant Adjustment

34. The Committee agrees with our predecessor that full transparency is an essential element in securing public confidence in the operation of the BGA. The Committee recommends that the Scottish Government explores with HM Treasury how best to provide the respective BGA calculations for the 2017-18 budget and that in future years the BGA calculations are published alongside the draft budget.

As per our response to paragraph 14, we are committed to full transparency regarding the block grant adjustment calculations. Baseline adjustments will be separately calculated for each tax and social security power and then separately indexed each year and applied to the overall Scottish block grant. These calculations have been published alongside the 17-18 Draft Budget and will continue to be published alongside future draft budgets.

35. The Committee also notes that it is HM Treasury which has responsibility for the operation of the Barnett formula and the BGA and it is, therefore, vital, as noted above that a HM Treasury Minister is available to appear before the Committee.

We note this recommendation, which will be for HM Treasury’s consideration.

Revenue Forecasting

39. The Committee recommends that in future years the SFC provides a breakdown of any changes to its forecasts including the reasons behind them and quantification of the amounts which result from each factor. For example, any proportion that is due to policy change and any proportion that is due to methodological change.

We note this recommendation, which will be for the SFC’s consideration.

40. The Committee also recommends that the SFC publishes in-year forecasts for each of the devolved taxes in its report on the draft budget in addition to future forecasts.
We note this recommendation, which will be for the SFC’s consideration.

41. The Committee also notes that the SFC has a statutory requirement to produce forecasts for the devolved taxes twice a year and further consideration will need to be given to how this works in practice including the level of parliamentary scrutiny and the impact of the revised forecasts on the public finances.

We note and support the recommendation that these issues be included in consideration of the future working arrangements between the Scottish Government, Scottish Parliament and the SFC as the Commission moves on to its new statutory footing from 1 April.

Reconciliation

45. The Committee recommends that the Budget Process Review Group considers the scrutiny arrangements for the reconciliation process as part of its work and brings forward recommendations for amendments to the Written Agreement.

We note the recommendation here and the others for the Budget Process Review Group at paragraphs 48, 52, 60, 112-115, 120-121,125, 134 and 246. The Scottish Government strongly supports the work of the group and looks forward to working jointly with the Committee on implementing the recommendations that emerge in the final report.

Income Tax

48. The Committee recommends that the Budget Process Review Group considers the optimum timing for the publication of the recalculation of the Scottish income tax revenues and the BGA.

49. The Committee also recommends that it is essential that an analysis is provided of the outturn figures against forecast and an explanation provided for any differences. The Committee recommends that the SFC provides an analysis of the outturn figures against the forecast for Scottish income tax revenues as soon as practicable after the outturn figures become available.

[Combined 48 and 49] The Scottish Government recognises the importance of understanding what has driven the performance of outturn figures for Scottish income tax. The Scottish Government and the Scottish Fiscal Commission will set out in a Framework document the respective roles of each organisation, and this will include the issue of forecast evaluation. It should be noted that collection of Scottish income tax remains reserved to the UK Government and will be conducted by HMRC, who will be responsible for the provision of outturn data.

Fully Devolved Taxes

52. The Committee recommends that the Budget Process Review Group considers the optimum timing for the publication of the recalculation of the devolved taxes revenues and the BGA.
See response to paragraph 45.

53. The Committee also recommends that it is essential that an analysis is provided of the outturn figures against forecast and an explanation provided for any differences.

Chapter 2 of the Draft Budget 2017-18 Devolved Taxes Methodology Report published alongside the Draft Budget provides a concise analysis of the 2015-16 outturn versus forecast position for LBTT and SLfT. This report can be found here: [http://www.gov.scot/Publications/2016/12/6669/3](http://www.gov.scot/Publications/2016/12/6669/3)

In addition to this the Scottish Government submitted evidence in August 2016 for the Committee’s LBTT Inquiry which can be found here [http://www.parliament.scot/S5_Finance/Finance_Committee_-_LBTT_inquiry_-_Letter_from_Cabinet_Secretary_-_August_2016.pdf](http://www.parliament.scot/S5_Finance/Finance_Committee_-_LBTT_inquiry_-_Letter_from_Cabinet_Secretary_-_August_2016.pdf). This evidence provides a full commentary of outturn versus forecast for the first year of LBTT.

For 2016-17 onwards, we will work with the Scottish Fiscal Commission and bring forward proposals on forecast evaluation as laid out in recommendation 49.

54. While there is no reconciliation between the Scottish revenue forecasts and the outturn figures the Committee nevertheless recommends that the SFC provides an analysis of the outturn figures annually.

We note this recommendation, which will be for the SFC’s consideration.

Outlook for the Scottish Economy

59. The Committee asks the Scottish Government what consideration it as given to restructuring its approach to managing its budget given the new powers in the Scotland Act 2016.

The Scottish Government recognises the additional level of complexity and increased volatility that the Scotland Act 2016 powers bring to the budget planning and management process.

Scotland’s Economic Strategy is built around improving productivity through innovation, investing in people and infrastructure and promoting Scotland on the international stage. Draft Budget 2017-18 reflects the Government’s determination to drive inclusive economic growth, particularly through the priority attached to education and learning, supporting business, investing in and reforming our public services and empowering communities across Scotland.

Existing budget management arrangements have been assessed and extended to ensure that appropriate accurate and timely management information is available to support Ministerial decision making in managing the impact of
those new powers. The adequacy of budget management arrangements is externally assessed by Audit Scotland as part of the annual audit process.

60. Overall, the Committee welcomes the level of information provided in the Scottish Government’s methodology note on the short term and the longer term outlook for the Scottish economy. However, the Committee recommends that the Budget Process Review Group should consider the options for increasing accessibility and transparency, for example by providing more detail on the economic and fiscal outlook in the draft budget document.

See response to paragraph 45.

Productivity Growth

77. The Committee asks the Scottish Government what analysis it has undertaken of its options for addressing the “productivity puzzle” in Scotland in light of the powers available to it and what opportunities the new financial powers provide to improve productivity growth given that the recent trends are also global and many of the macro-economic levers remain at a UK level.

Scotland’s productivity growth has outperformed the UK in recent years. Output per hour worked was 9.4% higher in 2015 than its pre-recession level in 2007, indicating average growth of 1.1% per year over this period. Across the UK as a whole productivity had barely risen above its pre-recession level by the second half of 2016.

Improving productivity and competitiveness across Scotland is a central theme of Scotland’s Economic Strategy (SES). The Draft Budget sets out actions we are taking across the priority areas identified in the SES – Investment, Innovation, Inclusive Growth and Internationalisation – to support long term productivity improvements. These include:

- Substantial investments in transport infrastructure and digital connectivity;
- Working with local authorities to take long-term strategic approaches to improving regional economies, for instance through the City Deals;
- Taking forward initiatives to encourage business investment, such as the Scottish Growth Scheme;
- Supporting innovation, through investing more than £1 billion in our universities in 2017-18, and encouraging collaborations between universities, businesses and others through the Innovation Centres;
- Established a Board of Trade, and creating permanent trade representation in Berlin to add to our Innovation and Investment Hubs in Dublin, London and Brussels.
- Equipping our young people for the future by action to improve educational attainment, through the Scottish Attainment Challenge, and by continuing to expand the number of Modern Apprenticeship opportunities, as part of our planned growth to 30,000 new starts per year by 2020.
We are also progressing with the Enterprise and Skills Review, which is seeking to bring even greater integration and focus to the delivery of our enterprise and skills support, to help ensure we maximise the contribution our agencies make to improving Scotland’s economic performance.

The Draft Budget also set out tax and spending proposals that support sustainable and inclusive economic growth, through the prudent use of our new financial powers.

Relative Economic Performance

86. The Committee asks the Scottish Government whether it shares the concerns of the Fraser of Allander Institute regarding a possible sustained structural slowdown in the North Sea economy and, in the event that these concerns prove to be correct, what the likely consequences are for the Scottish budget given the way the Fiscal Framework operates.

As outlined in the Devolved Tax Methodology Report published alongside the budget, recent GDP growth has been below trend in Scotland. This has been due to two main factors. Firstly, global economic growth has been relatively subdued, affecting growth in Scottish exports. Secondly, the fall in oil prices which occurred in 2014-2015 has reduced investment in the North Sea and resulted in oil and gas operators cutting costs. This has reduced activity across the sector and has fed through to a slowdown in the wider Scottish economy. This slowdown in the oil and gas sector is expected to continue in the short term, with below trend growth forecast for 2016-17 as a whole. However, there are indications that the oil and gas sector may be approaching its nadir. A review by PwC suggests that globally, companies are increasingly reporting that the industry has reached the bottom of the cycle. In Scotland, the Aberdeen and Grampian Chambers of Commerce’s 25th Oil and Gas Survey found that around two-thirds of firms felt that the sector was nearing the bottom of the cycle, with around half of these feeling that the bottom had already been reached. The survey also found that the outlook for employment in the sector during 2017 is substantially more positive than this year, with almost 80 per cent of contractors expecting employment to remain the same or increase.

Over the longer term, up to 20 billion barrels of oil and gas remain in the North Sea. It therefore has the potential to make an important contribution to Scotland’s economy for many years to come. However, for its future to be safeguarded, further fiscal reforms are required by the UK Government to increase investment and stimulate activity and exploration.

87. The Committee notes that GDP per capita growth rates have been highly correlated historically which on the upside means that the Scottish budget is less likely to be reduced due to higher growth in per capita tax revenues in rUK than in Scotland. However, on the downside it means that the Scottish budget is less likely to increase due to higher growth in per capita tax revenues in Scotland than in rUK. The Committee asks the Scottish Government for its view on what this means for Scotland’s public finances in the medium to long term.
The Fiscal Framework agreement means that Scotland's budget is now linked to the relative growth in devolved tax receipts per person in Scotland compared to the rest of the UK. As a result, if devolved tax receipts per person in Scotland grow more rapidly than in the rest of the UK, due to either faster economic growth or a higher tax burden, then the Scottish Government budget will retain the additional tax revenue. Conversely, if devolved tax receipts in Scotland grow more slowly than in the rest of the UK, due to either government policy or economic performance, this will lead to a corresponding reduction in the Scottish Government budget.

**Brexit**

98. The Committee asks to what extent the Scottish Government has taken steps within the draft budget to address the potential disproportionate impact of inflationary pressures arising from Brexit on households on lower incomes and on public services.

The Draft Budget delivers the Scottish Government’s pledge to support a more sustainable economy, invest in public services and promote an inclusive vision for Scotland’s communities.

The Budget increases or maintains investment in key services, such as health, policing and education, recognising the range of demands these services face, including inflationary pressures. It also delivers measures that will support those on the lowest incomes, such as the continued commitment to the Scottish Living Wage, a pay policy that targets pay increases towards those in the lowest three income deciles and actions aimed at mitigating the effects of UK Government welfare reform.

A common aim of other measures, such as our commitment to no compulsory redundancy, the development of the Scottish Growth Scheme and maintaining a competitive business rates regime, is to provide households and businesses with stability at a time when there are challenges in the wider economy, including those presented by Brexit and inflation.

**Strategic Financial Planning and Budget Scrutiny**

112. The Committee recognises that the Budget Process Review Group faces a real challenge in designing a new budget process which meets the need for the publication of reliable and accurate budgetary information while also allowing sufficient time for parliamentary and wider public examination of the Scottish Government’s proposals and an opportunity to make alternative tax and spending proposals.

113. The Committee notes that while pre-budget scrutiny can be carried out in areas such as the performance of public bodies in delivering outcomes this should not be viewed as an alternative to the scrutiny of the draft budget.
114. The Committee intends to write to HM Treasury highlighting the potential challenges to the budget scrutiny timetable by changes to the timing of the UK budget announcement and asking what consultation took place with the devolved governments. The Committee will also ask HM Treasury to clarify when in the Autumn the UK budget is likely to be published.

115. The Committee recommends that the Budget Review Group considers the impact of the change on the Scottish budget process.

[Combined 112-115] See response to paragraph 45.

**Multi Year Budgeting**

120. The Committee notes that the timing issues which apply to the accuracy and scrutiny of one-year budgets are likely to be even more acute in relation to multi-year budgets. For example, it is likely that the publication of a multi-year budget in December would present further difficulties for the subject committees in carrying out effective scrutiny.

121. The Committee therefore recommends that the Budget Process Review Group considers the options for broadening financial scrutiny beyond solely the period between a draft budget being published and the Budget Bill being passed.

[Combined 120-121] See response to paragraph 45.

**Medium-Term Financial Strategy**

125. The Committee notes the increased levels of tax and borrowing powers and the increased dependence of the budget on relative economic performance. It recommends that the Budget Process Review Group explores the options for a more strategic approach to financial planning. This should include the role of the SFC in supporting such an approach.

See response to paragraph 45.

**Transparency and Accountability**

132. The Committee recognises that this is a transitional year for both how budgetary information is presented by the Scottish Government and how it is scrutinised by the Scottish Parliament. The significant complexity of the Fiscal Framework combined with the extent of the new powers and the uncertainty of Brexit means that significant work is required in developing a new budget process and wider financial scrutiny.

133. The Committee also believes that consideration needs to be given to improving the transparency of the budget document as highlighted by the Fraser of Allander Institute.

[Combined 132 and 133] As the Committee concludes, the increased complexity of the budget process introduces a steep learning curve for all
involved in the budget process and the Scottish Government welcomes feedback on ways in which the transparency of the budget process, particularly the document itself, can be improved.

134. The Committee looks forward to receiving the interim report from the Budget Process Review Group at the end of February.

See response to paragraph 45.

AFFORDABILITY

Scottish Income Tax

153. The Committee recognises that there are challenges in understanding the behavioural effects of tax changes and intends to address this issue further as part of our ongoing inquiry on a Scottish response to taxation.

The Scottish Government has previously published a paper considering the impact of a rise in the additional rate of income tax from 45p to 50p in Scotland\(^1\), which examines potential behavioural impacts around changing the additional rate of income tax. The tax forecasting methodology paper\(^2\), which accompanied Draft Budget 2017-18 document considered behavioural responses to income tax policy changes more widely. The area of behavioural responses to changes in tax policy is something which the Scottish Government will continue to examine, and welcomes any additional evidence that the Finance Committee, or others, can provide.

154. The Committee recognises that there is a wide range of views on income tax, including rates and bands, in the Scottish Parliament and beyond. The Members of the Committee were likewise unable to come to a consensus on these matters. Given the limited time available for this year's scrutiny of the draft budget, the Committee has only had a limited opportunity to take evidence on the Scottish Government's income tax proposals. The Committee notes that the Scottish Government has not consulted on its income tax policies and, therefore, asks on what basis the proposals have been put forward. The Committee also intends to consult on the income tax rates and bands which are agreed for 2017/18 prior to the publication of the Draft Budget 2018/19.

The Scottish Government recognises that there are a wide range of views held with regards to Scottish income tax policy and that consensus is unlikely to be achieved.

The Scottish Government announced its proposals for Scottish income tax in March 2016, and accompanied this announcement with the release of a policy paper\(^3\). This proposal was reconfirmed in the Scottish National Party's Scottish election manifesto, and when returned to Government after winning

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the Scottish election proceeded to implement this proposal in the Draft Budget which has since been scrutinised by the Parliament.

The Scottish Government will continue to listen to views of stakeholders and consider them in future tax policy development.

**Income Tax Revenue Forecast Methodology**

168. The Committee asks the Scottish Government to provide an estimate of the gain to the Scottish Government by raising the higher rate threshold by inflation rather than to £45,000 in 2017-18 and by inflation rather than to £50,000 by 2019-20.

169. The Committee recognises that any increase in the higher rate threshold will reduce the amount of income tax collected, but that if the threshold is higher in rUK than it is in Scotland this may reduce the Block Grant Adjustment and therefore provide an overall gain to the Scottish budget via the block grant.

170. The Committee therefore asks the Scottish Government to provide an estimate of—

- The income tax revenues that would be foregone by the Scottish Government in 2017-18, and by 2019-20, as a result of the proposed inflation-based threshold increase;
- The gain to the Scottish Government via the BGA mechanism in 2017-18, and by 2019-20, on the assumption that the tax policies of both governments are implemented;
- The total gain to the Scottish Government via tax revenues plus the BGA mechanism, if the threshold remains unchanged in 2017-18 and up to 2019-20.

The net change to the Scottish budget as a result of the devolution of Scottish income tax is dependent on any changes made to income tax policy and the size of the corresponding Block Grant Adjustment (BGA). As the Committee notes, Scottish income tax receipts could go up, yet net revenue go down because the BGA is larger than the receipts, or receipts could go down, yet net revenue go up. Therefore whilst the Scottish Government is happy to provide the forecast revenue associated with our income tax policy proposal, it is important to note that it will only reflect one element of of the net effect.

The table below sets out the net impact of the Scottish Government's income tax policy proposal of freezing the Higher Rate Threshold (HRT) at £43,000 in 2017-18 which is estimated to raise an additional £107 million in 2017-18, over and above the Block Grand Adjustment. This is £29 million higher than forecast in Draft Budget 2017-18 which was based on the proposal to freeze the threshold in real terms.

The updated forecasts below assume that the HRT is frozen in cash terms in 2017-18 and is then increased in line with September CPI inflation in each year thereafter, reflecting the minimum revenue which would accrue from the Scottish Government's stated intention to increase the HRT by a maximum of inflation in each year following 2017-18.
The table also includes a line setting out an estimate for the additional yield from our proposed policy compared to the UK Government's plans of raising the Higher Rate Threshold to £50,000 by the end of the UK Parliament. This is estimated to be £127 million in 2017-18.

A combination of faster per capita receipts growth in the rest of the UK and differences in the OBR and Scottish Government's forecasting methodologies mean that this gain is reduced by £20m through the BGA, as set out in the third line of the table. It is difficult to disentangle these effects further at this point.

It should be noted that comparisons in later years of the forecast period need to be treated with greater caution due to the methodological differences between the Scottish Government's and the OBR's forecasts. Work is ongoing between the Scottish Government, Scottish Fiscal Commission, and the OBR to better understand the impact of the different forecasting methodologies.

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<td>Net Change in SG Budget (SG Policy - BGA)</td>
<td>107</td>
<td>161</td>
<td>271</td>
<td>448</td>
<td>697</td>
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<td>of which policy divergence (SG Policy - UKG Policy)</td>
<td>127</td>
<td>165</td>
<td>206</td>
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<td>289</td>
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<td>of which differential economic performance/modelling differences</td>
<td>-20</td>
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<td>66</td>
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171. The Committee notes that Scottish income tax revenues are forecast to grow more quickly than rUK income tax revenues in each year of the forecast period despite lower forecasts for GDP growth and asks the Scottish Government for its view on the level of risk to the Scottish budget.

Scotland’s spending power is determined by growth in tax receipts per head, relative to the rest of the UK, rather than aggregate economic growth. Under the Fiscal Framework, Scotland’s Budget is effectively protected against relatively slower population growth and the impact this has on economic performance. Changes to income tax relate to the tax base, and reflect growth in the number of taxpayers, their income, and the income distribution rather than any direct measure of economic growth.

The Scottish budget will with these new financial powers be exposed to a greater amount of financial risk, and this is why the Scottish Government is developing in-year receipts monitoring tools with HMRC, and will also be able to access new revenue borrowing powers from 2017-18.
Incorporations

174. The Committee notes that the impact of the forecast increase in incorporations on the Scottish budget depends on the relative impact on rUK income tax revenues and Scottish income tax revenues. As such, if incorporations grow at the same level in Scotland and rUK we would expect that the loss in Scottish tax revenues would be offset by the reduction in the size of the adjustment to the block grant. However, a reduction in the size of the Scottish tax base would have an impact on the amount of revenue which the Scottish Parliament could raise through changes to the rates and thresholds for Scottish income tax. There is also a possibility that differential tax rates may lead to a behavioural response which could impact on the level of incorporations.

175. The Committee intends to examine this issue further as part of our ongoing inquiry on a Scottish approach to taxation.

As noted in the tax forecasting methodology paper published alongside the Draft Budget 2017-18, the Scottish Government considered the issue of behavioural impacts, including incorporations, in detail when preparing the income tax forecasts. The Scottish Fiscal Commission considered the adjustments and deemed them to be reasonable.

Behaviour impacts will continue to be an area which the Scottish Government will monitor and develop the evidence on.

Implementation of Income Tax

180. The Committee will keep the matter of the closure of HMRC offices under review.

Noted.

Land and Buildings Transaction Tax

187. Given that the Committee considers that it is too early to draw any definitive conclusions on the impact of the rates and bands from the available outturn data. The Committee has also previously recommended that the SFC should continue to monitor the data on an on-going basis.

We note this recommendation, which will be for the SFC’s consideration.

188. The Committee notes that the Scottish Government states in its response to our predecessor committee’s report on Draft Budget 2016/17 that it “intends to review the operation of LBTT after the first full year of operation and will update Parliament on the outcome of that review in the 2017-18 Draft Budget.” The Committee asks the Scottish Government whether it has conducted this review and when the update will be provided.

Our response to this recommendation will form part of our overall response on the LBTT Inquiry which we are providing to the Committee separately.
Residential Revenue Forecasts

199. The Committee notes that the response to the findings of the SFC’s outturn report on the first year of LBTT has not been published by the Scottish Government alongside the draft budget. The Committee recommends that this should be provided alongside the response to this report. As previously requested this should include an assessment of the SFC’s conclusion that the housing market in the £325k to £750k band remained subdued throughout 2015-16, excluding March 2016.

This recommendation overlaps with the recommendations of the LBTT Inquiry on which we are currently preparing our response.

The Devolved Taxes Forecast Methodology Report 2017-18 (Chart 13, page 38) contains a summary assessment of the number of £325k-750k transactions as a share of the overall market along with the following text: “As Figure 13 illustrates, outside the quarters affected by forestalling behaviour, the share of transactions in the £325k-£750k band is at similar levels in the post-LBTT period to the pre-LBTT period - there is no evidence in the data so far of a sustained underperformance of this segment of the market.”

200. The Committee asks the SFC to clarify whether the available outturn data for 2016-17 shows that the housing market in the £325k to £750k band remains subdued as explained in its outturn report for 2015-16.

We note this recommendation, which will be for the SFC’s consideration.

201. The Committee asks the Scottish Government to provide a breakdown of the changes to its LBTT forecasts including the reasons behind them and quantification of the amounts which result from each factor.

Tax receipts forecasts are kept under review and are updated in the light of economic data and trends. An explanation of the factors underlying our forecast revisions for 2017-18 are provided in Chapter 5 of the Devolved Taxes Forecast Methodology Report 2017-18 under the heading ‘Evolution of the LBTT forecasts.’ In addition, a breakdown of the impact of changes in forecast revenue for 2017-18 is contained in Table 16 of the Scottish Fiscal Commission’s Final Report on Draft Budget 2017-18 (Box B, pages 45-46). Any revisions reflect the outturn data for 2015-16 now being available, as well as updates to mean and median price and transactions growth forecasts.

Behavioural Responses

206. The Committee asks the SFC whether it intends to include behavioural factors in its forecasting methodology for residential LBTT.

We note this recommendation, which will be for the SFC’s consideration.

Additional Dwelling Supplement (ADS) Revenue Forecasts
211. The Committee notes that, as with the residential LBTT forecasts, there is insufficient information on the components of change which have influenced the forecast revisions. Again, it would be useful to receive a breakdown of the revisions to the forecasts including the reasons behind them and quantification of the amounts which result from each factor.

Tax receipts forecasts are kept under review and are updated in the light of economic data and trends. Prior to the introduction of ADS, robust data on the number of transactions falling into the relevant segment of the market was not available. The main reason for the upward revision to ADS revenue forecasts is that the number of transactions liable for ADS turned out to be higher than had been estimated on the basis of the limited data available. We will continue to closely monitor the data around ADS.

**Scottish Landfill Tax (SLfT)**

221. The Committee notes that, as with the LBTT forecasts, there is insufficient information on the components of change which have influenced the forecast revisions. Again, it would be useful to receive a breakdown of the revisions to the forecasts including the reasons behind them and quantification of the amounts which result from each factor.

Tax receipts forecasts are kept under review and are updated in the light of economic data and trends. Due to the volume of changes in methodology between the two years’ forecasts, it is not possible to produce a meaningful attribution of the revisions to the forecasts for Draft Budget 2017-18. For example this year’s forecast models the effect of incinerator waste in diverting waste from landfill; this was not incorporated explicitly in last year’s forecast.

In Chapter 6 of the Devolved Taxes Forecast Methodology Report 2017-18, under the heading ‘Evolution of the SLfT forecasts’, we set out the details of the change in the methodology and explained that “The significant factor in reconciling the two forecast series is the fundamental change to the methodology that took place for production of this year’s five year forecast.”

**Non-Domestic Rates Income (NDRI)**

228. The Committee recommends that in future the estimated costs and revenues of any policy changes to business rates and the total cost of the SBBS and total revenues from the large business supplement are included in the Draft Budget.

The Scottish Government accepts the Committee’s recommendation and will include details of the estimated financial impact of any policy changes to business rates along with estimates of the total cost of relief under the Small Business Bonus Scheme and revenues generated through the Large Business Supplement in future Draft Budget publications.
Capital Borrowing

239. The Committee notes the total drawdown of £915m capital borrowing powers for the years 2015/16, 2016/17 and 2017/18 as a result of projects being brought „on balance sheet” as a consequence of the ESA 10 ruling. The Committee notes the impact of this drawdown on other capital projects and asks the Scottish Government to provide a full and comprehensive analysis of the use of borrowing powers.

The annual limit on capital borrowing under Scotland Act 2012 powers is 10% of the ‘conventional’ CDEL total in the year in question, within an aggregate cap of £2.2 billion. In 2015-16, the 10% annual limit amounted to £312m and in 2016-17 will be £333m.

From 2017-18, under the Scotland Act 2016, the aggregate borrowing cap will increase to £3 billion with an annual limit of 15% of the overall borrowing cap (£450m).

Following the ESA 10 ruling, it was agreed with HM Treasury that the Scottish Government would use £283 million of the £312 million additional CDEL available from borrowing in 2015-16 to enable us to comply with the budgeting impact of the classification decision. However, because contracting authorities do not start paying for the projects until construction of the associated infrastructure is complete, no actual cash drawdown of borrowing was required. Consequently, no interest is payable on this notional borrowing, offering a financial efficiency relative to cash borrowing for capital works. The £283 million does count towards the 2012 Act capital borrowing limit of £2.2 billion and we expect will be nominally repaid over the lifetime of the projects.

A similar approach for 2016-17 is being discussed with HM Treasury.

Full borrowing of £450 million has been factored into the 2017-18 Draft Budget

Resource borrowing and cash management

245. The Committee notes that the Draft Budget states that detailed “arrangements for reporting and repaying borrowing and the operation of the Scotland Reserve are being agreed with the UK Government.” It is also the case that once these arrangements have been agreed with the UK Government, scrutiny arrangements will also have to be agreed with the Committee.

Noted. The Scottish Government welcomes feedback on ways in which the transparency of the budget process, particularly the document itself, can be improved and appropriate disclosure will be incorporated in future.

246. The Committee recommends that the Budget Process Review Group considers the scrutiny arrangements for the operation of the Scotland Reserve as part of its work and makes recommendations for amendments to the Written Agreement.

See response to paragraph 45.
Long-Term Investment Commitments

250. The Committee notes that the SFC remit now includes a duty to “set out the Commission’s assessment of the reasonableness of Scottish Ministers” projections as to their borrowing requirements.” The Committee recommends that this includes analysis of the Scottish Government’s long-term investment commitments which currently amount to over £1 billion annually.

We note this recommendation, which will be for the SFC’s consideration.

251. Recognising that there will be commercial sensitivities in relation to individual deals, the Committee reiterates its view that the Scottish Government explores the practicability of publishing the underlying data behind Figure 1 in Annex A of the Draft Budget. The Committee therefore asks if this can be done in a way which protects commercial sensitivities, given the aggregate nature of the figures requested.

The Scottish Government welcomes feedback on ways in which the transparency of the budget process, particularly the document itself, can be improved and we will consider what scope exists to provide this additional information, while recognising commercial sensitivities, as part of future Budgets.

PRIORITISATION

Fuel Poverty

264. The Committee invites the Scottish Government to provide an update on the expected impact of this additional funding on fuel poverty. The Committee supports the view of the EJFW Committee that “a robust and up-to-date cost analysis” of the impact of levels of spending on fuel poverty should be undertaken.

The impact of the increased funding for energy efficiency and fuel poverty will continue to contribute to our commitment to eradicate fuel poverty, by installing measures into people’s homes to make them warmer and cheaper to heat. The Scottish House Condition Survey (published 6 December) indicates that 748,000 households (31%) were in fuel poverty in 2015. Almost 100,000 fewer households than in 2014. The modelling indicates that around a third of this reduction can be attributed to improvements in the energy efficiency performance of the housing stock. We only have influence over one lever of fuel poverty, the energy efficiency of the home which is where we direct our investment. The fuel poverty rate for 2015 would have been around 8.4% (instead of 31%) if fuel prices had only risen in line with inflation between 2002 and 2015. Scotland’s Energy Efficiency Programme will deliver our commitment to make energy efficiency a national infrastructure priority. As part of the development of the SEEP programme we will be considering a robust monitoring and evaluation framework to ensure the impact and outcomes of our investment can be captured.
The Committee welcomes the Government’s commitment to considering ways of providing “longer-term stability” to “enable effective planning” of the fuel poverty programme.

Scotland’s Energy Efficiency Programme will deliver our commitment to make energy efficiency a national infrastructure priority, boosting energy efficiency investment in Scotland and decarbonising heat provision over the long term. One of the aims of SEEP is to accelerate the pace and scale of delivering energy efficiency measures and will have multiple benefits, including the opportunity to create a substantial Scottish market and supply chain for energy efficiency services and technologies. To demonstrate this commitment we have allocated over £650m since 2009 and, as set out in the PfG, we will make available half a billion pounds over the next four years to tackle fuel poverty and improve energy efficiency. This means that by the end of 2021 we will have committed over £1 billion to making our homes and buildings warmer and cheaper to heat.

Social Security

The Committee welcomes the greater clarity that has been provided by the Scottish Government with regard to how the budget for the implementation of non-tax Scotland Act 2016 powers was arrived at and the general approach with regard to allocating the budget. The Committee does, however, recommend that the Scottish Government provides indicative allocations for each of the new powers, including social security, that it intends to fund in 2017-18.

The £80m allocation in the Finance and Constitution portfolio was set aside specifically to accommodate expected spending in newly devolved areas of Scottish Government business. The arrangement allows Cabinet to respond collectively and flexibly to the needs of these evolving policy areas, including social security which will be a significant draw on this funding. Normal in year budget management arrangements will be applied to ensure that allocations and adjustments are made in year in response to specific requirements and spending is appropriately scrutinised and controlled.

Local Government

Due to the different presentation and sets of numbers relating to the local government settlement some Members were concerned about the level of financial resource available to Local Government in the settlement.

The Scottish Government welcomes feedback on ways in which the transparency of the budget process, particularly the document itself, can be improved. It is accepted that the publication of the Draft Budget and the local government finance settlement on the same day adds a further level of complexity particularly as the figures in the Draft Budget document and the Local Government Finance Circular are different due to a number of funding streams for local government being presented within other portfolios in the Draft Budget before being transferred in-year to local government. It is
necessary to include all these sums in the Finance Circular to help local authorities with their budgeting process.

This has led to a number of different interpretations of the level of funding available to local government however if we add together the local government finance settlement plus the other sources of support available through the actual and potential increases in council tax income, and the support through the Health and Social Care Integration, the overall increase in spending power to support local authority services in the Draft Budget amounted to £241 million or 2.3 per cent.

A number of commentators have compared the 2016-17 Autumn Budget Revision figures with the 2017-18 Draft Budget figures to claim that there has been a £327 million reduction in local government support in real terms but this comparison is misleading as it does not compare like with like. Each year significant sums of money are formally transferred to Local Government and approved by the Finance Committee through the Autumn and Spring Budget Revision processes. This can be seen in Table 9.12 which illustrates a difference of over £160 million between the 2016-17 Draft Budget and Budget figures and similar sums will be transferred again in 2017-18.

In addition to the funding settlement outlined above, the Scottish Government also provides local government with further funding outwith the local government finance settlement. As part of the Draft Budget scrutiny the Cabinet Secretary for Finance and the Constitution provided the Convener of the Local Government and Communities Committee with the current list of additional funding which amounted to over £320 million.

Notwithstanding the above, in response to representations on the level of funding available to Local Government a further £160m of additional funding has now been made available at Stage 2 of the Budget Bill.

276. The Committee agrees with the LGC Committee that greater transparency is required in relation to the local government draft budget.

The Scottish Government welcomes feedback on ways in which the transparency of the budget process, particularly the document itself, can be improved. Although the publication of Draft Budget 2017-18 and the local government finance settlement on the same day has added a level of complexity, the Scottish Government will undertake to provide as clear as possible the necessary transparency future in light of the recommendations of the Budget Process Review Group.

Concessionary Travel Scheme

279. The REC Committee notes the Scottish Government's assurance that the proposed budget reduction for concessionary travel will have no impact on entitlement for current scheme participants. The REC Committee called on the Scottish Government to provide further clarity on whether this cut will have any consequential impact on bus services and ticket prices for the general public.
280. The Committee agrees with the position of the REC Committee.

The Scottish Government does not expect that budget reduction will have any such consequential impact. The rate of payment is set at a level designed to ensure operators are no better or worse off from carrying passengers under the scheme. As the rate of payment is not changing and since the budget cap is set to reflect expected demand and is higher than this year's expected outturn, no impact is envisaged on bus services or on ticket prices for the general public.

VALUE FOR MONEY

Enterprise Agencies

299. The Committee asks the Scottish Government to clarify how its approach to the funding of the Enterprise Agencies meets its overall purpose within the NPF of increasing economic growth and the delivery of its Economic Strategy.

Our aim is to drive progress towards economic and productivity growth and a more competitive and inclusive economy. Our goal is to ensure Scotland thrives: to sustain higher employment, identify, plan for and seize opportunities to create better quality jobs and fairer work and withstand economic shocks. As identified in the Scottish Economic Strategy, delivering inclusive growth and improving productivity is a complex challenge and funding our Enterprise Agencies is only one element of this government’s support to the economy. Through the Enterprise and Skills review, announced last summer, we are leading work to ensure that our investment across the system is strongly aligned and delivers the best possible outcomes.

The savings previously delivered through the Strategic Forum have now been embedded in each of the Forum partners’ budgets with no negative impact on outcomes and the overall funding provided at the Draft Budget through the Economy, Jobs and Fair Work budget would rise in 2017-18, to £384.5 million, up 4.3% on 2016-17. Additional funding of £35m announced at Stage 1 consideration of the Budget Bill takes that.

The activity delivered by our enterprise bodies aligns with Scotland’s Economic Strategy supporting investment, innovation, internationalisation and inclusive growth. Over time, funding for our enterprise bodies - including through this Draft Budget - has changed to better reflect Ministerial priorities across portfolios and the level of their planned activities relative to their funding and income streams. Not all business support provided is in the form of grants and loans – the enterprise bodies provide practical support, advice and guidance to Scotland’s businesses through, for example, their Account Management process. Scottish Government funding and activities to support business has also evolved and changed over time, most notably with funding transferred from the enterprise bodies to create SDS and Business Gateway in 2008-09. Further developments to the business support landscape have also
taken place in more recent years such as the establishment of our four Enterprise Zones spread over 14 sites and the introduction of City Deals.

We have assessed SE’s Capital requirement in line with planned expenditure and income and will continue to review the potential for this income throughout the year. SE will potentially have access to additional capital income in 2017-18. In response to representations on the level of funding available to Scottish Enterprise a further £35 million of additional funding has now been made available at Stage 2 of the Budget Bill taking the portfolio budget to £419.5 million, up 13.8% on 2016-17.

Our enterprise bodies consider a full range of funding and support opportunities to ensure public funding delivers maximum returns. For example the bodies are able to supplement grant-in-aid with their own income which can be raised by realising investments, charging rents or disposing of assets etc. In 2016-17 Scottish Enterprise estimated, in its Business Plan, that it would raise £117.7m.

We will continue to fund the enterprise bodies, liaising and working with them to ensure continued support for our economic growth priorities.

CONCLUSION

346. The Committee recognises that this is an historic draft budget. This is the first time that any Scottish Parliament will set the rates and bands for income tax in Scotland. It is also the first budget that will operate within the context of the Fiscal Framework. This is complex and potentially introduces a much higher level of uncertainty and volatility to the budget process. This would have been challenging enough during a period of economic stability. But the added uncertainty arising from Brexit significantly increases the challenge faced by both the Scottish Parliament and the Scottish Government in agreeing the budget for 2017/18.

The Scottish Government welcomes the Committee’s observations and is committed to working with Parliament to address the impact of this complexity on the budget process. We remain strongly supportive of the joint budget review group, established between Government, Parliament and civil society, and look forward to considering its recommendations in due course.

347. Given this level of complexity the Committee emphasises that it is critical that there is a sufficient level of transparency to ensure public confidence in the operation of the new financial powers and the Fiscal Framework. The Committee welcomes the detailed analysis which the SFC has carried out and believes it has a crucial role in supporting parliamentary scrutiny of the draft budget. The Committee also welcomes the work which think tanks, such as the FAI and IPPR Scotland, have done in examining Scotland’s budget which is also crucial in supporting effective parliamentary scrutiny.

The Scottish Government welcomes the contribution of the SFC and will do all it can to support it in exercising its statutory functions in relation to future budget processes. The Government also welcomes the contributions that a
A wide range of stakeholders have made to recent public debate on its tax and spending plans.

348. Overall, the Committee is very aware that there is a steep learning curve for all involved in the budget process and that it is vital that we seek to improve public understanding of how it works. To do so, it is essential that both the UK Government and the Scottish Government are willing to provide timely and detailed information on how the Scottish budget is now calculated. The Committee welcomes the work which the Budget Process Review Group is doing in addressing many of the issues which we consider in this report. The Committee agrees with the Cabinet Secretary that there is a need for a transformational approach to the review. The review group is invited to consider the findings of this report that are relevant to its remit.

The Scottish Government strongly supports the establishment of the budget review group. We are also considering the presentation and accessibility of budget information as part of our commitment to the Open Government Partnership’s Pioneer Programme.