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Finance and Constitution Committee

To consider and report on the following (and any additional matter added under Rule 6.1.5A)—
(a) any report or other document laid before the Parliament by members of the Scottish Government containing proposals for, or budgets of, public revenue or expenditure or proposals for the making of a Scottish rate resolution, taking into account any report or recommendations concerning such documents made to them by any other committee with power to consider such documents or any part of them;
(b) any report made by a committee setting out proposals concerning public revenue or expenditure;
(c) Budget Bills; and
(d) any other matter relating to or affecting the revenue or expenditure of the Scottish Administration or other monies payable into or expenditure payable out of the Scottish Consolidated Fund.
(e) constitutional matters falling within the responsibility of the Cabinet Secretary for Finance and the Constitution

finance.constitution@parliament.scot
0131 348 5215
### Committee Membership

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<tr>
<th>Convener</th>
<th>Deputy Convener</th>
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<tr>
<td>Bruce Crawford</td>
<td>Adam Tomkins</td>
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<td>Scottish Conservative and Unionist Party</td>
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<td>Scottish National Party</td>
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</table>
INTRODUCTION

1. Draft Budget 2018-19 (“the draft budget”) was published by the Scottish Government on 14 December 2017. This report sets out the views of the Finance and Constitution Committee (“the Committee) on the draft budget and is informed by the helpful submissions we received from other parliamentary committees. Links to the other committees’ reports can be found at Annexe A. The Cabinet Secretary for Finance and the Constitution also wrote to the Committee in responses to issues raised at our meeting on 15 January 2018. The letter provided further information in relation to the Fairer Scotland, Equalities and Third Sector budgets, Financial Transactions, and the Infrastructure Investment programme and is attached at Annexe B.

2. The Committee recognised in our report on Draft Budget 2017-18 that the new powers in the Scotland Act 2012 and the Scotland Act 2016 fundamentally change the budget process. The Committee and the Cabinet Secretary for Finance and the Constitution (“the Cabinet Secretary”) established a tri-partite working group to review the process. The Budget Process Review Group published its final report on 30 June 2017.¹

3. The Committee welcomes the recommendations of the Review Group and is committed to implementing these in full. The Committee also welcomes the Scottish Government’s commitment to deliver the Review Group’s recommendations including the early implementation of some of the Group’s recommendations in relation to the transparency of the budget document. It is anticipated that the bulk of the recommendations will be implemented through a revised Written Agreement² between the Committee and the Scottish Government and any necessary changes to the Standing Orders.

4. The Committee will consider a revised Written Agreement following the completion of this year’s budget process and will publish revised guidance for the subject committees on the new process once the revised Written Agreement has been agreed by the Parliament.

5. The Committee recommends that the SPCB should consider what additional support needs to be given to Members to ensure the effectiveness of the new budget process.

² [http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Written_Agreement_-_Revised_April_2015.pdf](http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Written_Agreement_-_Revised_April_2015.pdf)
6. The Committee issued guidance on the scrutiny of Draft Budget 2018/19 to the subject committees in June 2017. This confirmed that this year’s budget process would be carried out on the basis of existing procedures including the emphasis on the Chartered Institute of Public Finance’s four principles of financial scrutiny—

- **Affordability** – the wider picture of revenue and expenditure and whether they are appropriately balanced;

- **Prioritisation** – a coherent and justifiable division between sectors and programmes;

- **Value for Money** – the extent to which public bodies are spending their allocations well and achieving outcomes; and

- **Budget Processes** – integration between public service planning and performance and financial management.

7. The Committee invited the subject committees to examine prioritisation and value for money as part of their budget scrutiny and financial scrutiny more widely. This should include the extent to which public bodies are adopting a priority-based budgeting approach and whether they are spending their allocations well and achieving outcomes.

8. The Committee welcomes the extensive scrutiny carried out by the subject committees and other committees with an interest in budget scrutiny and notes that some have already begun to adopt the full year approach recommended by the Budget Process Review Group. In particular, the Committee highlights the approach of the Health and Sport Committee in publishing a pre-budget report in November 2017 with the aim of influencing the content of future budgets. The Scottish Government subsequently responded prior to the publication of the draft budget. The Committee cites this approach as an excellent example of how the new budget process should work especially in terms of a more outcomes-based and longer-term model of financial scrutiny.

**STRATEGIC CONTEXT FOR DRAFT BUDGET 2018-19**

9. The Committee noted in our report on Draft Budget 2017-18 that there is now a much greater degree of volatility and uncertainty in relation to the size of the Scottish Budget. Where previously the size of the budget was almost wholly determined by the UK Government on the basis of the Barnett formula, around 40% of the Budget now comes from taxation raised in Scotland with an equivalent

---

reduction in the size of the block grant. The process for calculating the size of the annual Scottish Budget is set out in the Fiscal Framework agreed between the UK Government and the Scottish Government. iv

Fiscal Framework

10. The operation of the Fiscal Framework in calculating the size of the Scottish Budget is complex. Each time a tax is devolved there is a reduction in the size of the block grant to reflect the revenues foregone to HM Treasury. This initial baseline reduction then requires to be updated annually through an indexation mechanism. Otherwise, the size of the baseline reduction, in real terms, would erode over time. The size of the Scottish Budget is, therefore, calculated as follows –

![Diagram showing the calculation of the Scottish Budget]

11. The process is further complicated by the need to base the initial calculations on revenue forecasts which are then reconciled with actual outturn receipts. HM Treasury is responsible for calculating the adjustments to the block grant which are initially based on relevant Office for Budget Responsibility (OBR) forecasts for rUK tax receipts. The Scottish Fiscal Commission (SFC) has a statutory responsibility for forecasting revenues for the devolved taxes.v

Block Grant

12. HM Treasury has introduced a new annual publication designed to increase the transparency of the block grant calculation process.vi The document provides a table setting out the Scottish Government’s block grant between 2016-17 and 2019-20 and this is reproduced below as Table 1.

---


Table 1: Total Scottish Government Block Grant

<table>
<thead>
<tr>
<th>(£m)</th>
<th>2016-17</th>
<th>2017-18</th>
<th>2018-19</th>
<th>2019-20</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block Grant</td>
<td>29,342</td>
<td>30,380</td>
<td>30,742</td>
<td>31,141</td>
</tr>
<tr>
<td>Block Grant Adjustment</td>
<td>-5,500</td>
<td>-12,539</td>
<td>-12,472</td>
<td>-12,793</td>
</tr>
<tr>
<td>Total</td>
<td>23,842</td>
<td>17,841</td>
<td>18,270</td>
<td>18,348</td>
</tr>
</tbody>
</table>

Block Grant Adjustments

13. The block grant adjustments consist of two elements: an initial baseline adjustment and an indexation mechanism. The initial baseline adjustments are set out in Table 2.

Table 2: Initial Baseline Adjustments

<table>
<thead>
<tr>
<th>(£m)</th>
<th>Initial Baseline Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Savings Non-Dividend Income Tax (NSND)</td>
<td>11,214</td>
</tr>
<tr>
<td>LBTT</td>
<td>468</td>
</tr>
<tr>
<td>SLfT</td>
<td>149</td>
</tr>
</tbody>
</table>

14. The initial baseline adjustments are equal to the UK Government’s tax receipts generated in Scotland in the year immediately prior to the devolution of the powers. The deduction for Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) are based on outturn figures for 2014-15.

15. The baseline adjustment for NSND income tax is initially based on a forecast for revenues raised in Scotland in 2016/17 as outturn data will not be available until Summer 2018. The baseline adjustment which was used to inform Draft Budget 2017-18 was based on an OBR forecast. This was £11,525m and once the indexation mechanism was applied to this the income tax Block Grant Adjustment (BGA) for 2017/18 was forecast to be £11,750m. In principle, in calculating the BGA for 2018/19 HM Treasury should have applied the indexation mechanism to the BGA for 2017/18.

16. However, the 2018/19 forecasts for Scottish income tax were made by the SFC for the first time. In forecasting Scottish income tax revenues in 2018/19, the SFC has been working with the most recent set of outturn data for individual taxpayers. This data pertains to 2014/15. Therefore to forecast Scottish revenues in 2018/19, the
SFC must implicitly forecast revenues for each intervening year between 2014/15 and 2018/19.

17. In applying its own methodology to a more recent set of tax data than had been available to the OBR this time last year, the SFC has forecast that Scottish income tax revenues will be lower in 2016/17 than the OBR forecast last year. Specifically, the SFC forecasts that income tax revenues will be £11,214m in 2016/17.

18. If the Initial Deduction were not changed to reflect the lower SFC forecast for 2016/17, then even if Scottish income tax revenues per capita were subsequently forecast to grow at the same rate as rUK revenues per capita, there would be a gap between the forecast of Scottish revenues and the forecast of the BGA. This gap would simply be due to a difference in forecast of the Initial Deduction. The BGA would thus not be ‘fiscally neutral’ and not be compliant with the Smith Commission principle that the Scottish and UK budgets be no larger or smaller simply as a result of the initial transfer of tax spending powers.

19. To avoid this anomaly, HM Treasury and the Scottish Government agreed on a one-off basis to use the SFC’s 2016/17 forecast rather than last year’s OBR 2016/17 forecast as the basis for the calculation of the BGA in 2018/19. (The calculation of the 2017/18 BGA is unaffected, as both the BGA and Scottish income tax forecast were made on the basis of the same forecast for 2016/17 Scottish revenues).

20. Once outturn data for tax revenues in 2018/19 is available, the forecast of the BGA and Scottish revenues will be reconciled with the audited outturn data. For the fully devolved taxes the outturn data will be available in the September following the end of each financial year. However, for income tax the outturn data will not be available until 15 months after the end of the financial year. This means that if any adjustments to the budget are required following the reconciliation process for 2018-19 this will be addressed in the Budget for 2022-23.

21. This means that the initial baseline adjustment for NSND income tax is £11,214m rather than £11,520m which it would have been if the latest OBR forecast had continued to have been used.

Indexation Mechanisms

22. The purpose of the indexation mechanism is to provide a measure of the rate at which comparable revenues have grown in rUK between any two years. In calculating the adjustment to the block grant for each of the devolved taxes for 2018/19 the indexation mechanism is a measure of the growth rate of comparable revenues in rUK between 2017/18 and 2018/19.

23. During the negotiations on the Fiscal Framework there was disagreement between the two governments regarding the model for the indexation mechanism. The UK Government prefers the comparable model while the Scottish
Government prefers the Indexed Per Capita (IPC) model. The two governments have agreed that during a transition period until 2021/22 it will be necessary to concurrently calculate the block grant adjustment using both models.

24. The IPC model, in broad terms, calculates adjustments to the block grant as follows—

| Percentage change in the equivalent UK Government tax receipts per head | Scottish population growth |

25. The comparable model calculates, in broad terms, adjustments to the block grant as follows—

| Changes in UK Government revenues from tax devolved to the Scottish Parliament | Scotland’s population share | Comparability factor |

26. These calculations will be made separately for each tax each year and then applied to the block grant. If there is a difference between the calculations using the two models there will be a “reconciling adjustment” to the comparable model to “ensure the mechanism delivers the IPC outcome.”

27. HM Treasury has published the calculations for the adjustments to the block grant using both models in a spreadsheet alongside its block grant transparency document in December 2017. The most recent calculations for 2018-19 using both models are reproduced in tables 3 and 4 below.

Table 3: Block Grant Adjustment Calculations (IPC Model) 2018-19.

<table>
<thead>
<tr>
<th>Relative Scottish Population Growth</th>
<th>% change in UKG Receipts</th>
<th>Block Grant Adjustment (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax</td>
<td>99.7%</td>
<td>102.2%</td>
</tr>
<tr>
<td>LBTT</td>
<td>99.7%</td>
<td>101.8%</td>
</tr>
<tr>
<td>SLfT</td>
<td>99.7%</td>
<td>91.2%</td>
</tr>
</tbody>
</table>

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Table 4: Block Grant Adjustment Calculations (Comparable Model) 2018-19

<table>
<thead>
<tr>
<th></th>
<th>Comparability</th>
<th>Population</th>
<th>Change in UKG receipts (£m)</th>
<th>Block Grant Adjustment (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Tax</strong></td>
<td>83.2%</td>
<td>8.9%</td>
<td>3,444.5</td>
<td>11,807.2</td>
</tr>
<tr>
<td><strong>LBTT</strong></td>
<td>48.9%</td>
<td>9.4%</td>
<td>229.8</td>
<td>606</td>
</tr>
<tr>
<td><strong>SLfT</strong></td>
<td>164.1%</td>
<td>9.4%</td>
<td>-59.1</td>
<td>95.8</td>
</tr>
</tbody>
</table>

28. The Committee has consistently been concerned about the lack of transparency in relation to the calculation of the adjustments to the block grant and therefore welcomes the publication of HM Treasury’s block grant transparency spreadsheet. The Committee has also consistently emphasised the need for a HM Treasury Minister to appear before us on the operation of the fiscal framework.

29. This approach is consistent with the practice in the previous Parliament when the Chief Secretary to the Treasury (CST) gave evidence to our predecessor Committee on a number of occasions. It is also consistent with previous HM Treasury policy as set out in the Statement of Funding Policy 2010 which states that “UK Ministers may, if invited, attend the Scottish Parliament and Wales and Northern Ireland Assemblies to explain the budget allocation.”ix Indeed, the current CST’s predecessor also agreed to appear before the Committee in his letter dated 28 February 2017. He told the Committee that he would be happy to discuss the contents of the UK Government’s annual implementation report on the Scotland Act 2016 and the Fiscal Framework.

30. The Committee is, therefore, deeply concerned about the refusal of the current CST to appear before the Committee as outlined in her letter dated 7 December 2017. She states that the “UK Government is accountable to the UK Parliament for its role in operating the fiscal framework; and the Scottish Government is accountable to the Scottish Parliament.” However, as is clear from the Statement of Funding Policy which is a HM Treasury document, it is the UK Government which has responsibility for the allocation of the block grant including any adjustments in accordance with the Fiscal Framework.


31. The Committee has repeatedly stated that full transparency is an essential element in securing public confidence in the operation of the Fiscal Framework. It is, therefore, not acceptable that the CST or any other UK Minister is unwilling to appear before the Committee to discuss the block grant.

Revenue Forecasting

32. As noted above, the resources which are available to the Scottish Government in the draft budget depend on the block grant as adjusted to reflect tax devolution plus the forecast revenues from the devolved taxes. The Fiscal Framework specifies that the SFC will have responsibility for preparing the forecasts for the devolved taxes from 2018-19 onwards.

33. The SFC published its first independent and official forecasts of Scottish GDP, devolved tax receipts and devolved social security expenditure on the same day as Draft Budget 2018-19. Table 5 provides details of the SFC forecast for the devolved taxes for 2018-19 alongside the forecasts for the adjustments to the block grant and the net impact on Draft Budget 2018-19.

<table>
<thead>
<tr>
<th>Forecast Tax Receipts (£m)</th>
<th>Forecast Block Grant Adjustment (£m)</th>
<th>Net Resource Budget Adjustment (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSND Income Tax</td>
<td>12,115</td>
<td>11,749</td>
</tr>
<tr>
<td>LBTT</td>
<td>588</td>
<td>600</td>
</tr>
<tr>
<td>SLfT</td>
<td>106</td>
<td>94</td>
</tr>
<tr>
<td>Total</td>
<td>12,809</td>
<td>12,443</td>
</tr>
</tbody>
</table>

34. This means that devolved revenues are forecast to raise £366m more than the adjustments to the block grant for revenues foregone to HM Treasury. The Committee’s Budget Adviser (“Adviser”) states that the £366m appears to be largely due to policy differences between the UK Government and the Scottish Government—

- The SFC forecasts that the tax policy announcements in the 2018/19 Budget will raise about 164m after behavioural effects are accounted for;
- The SFC explained in correspondence to the Committee that the Scottish Government’s policy on public sector pay is forecast to raise an additional £55m;
35. The implication of this is that, in the absence of tax policy differentiation, income tax revenues per capita are forecast to grow at the same rate in Scotland as in the UK. This is discussed in more detail below.

36. While the Committee welcomes the level of detail provided by the SFC in providing an understanding of its forecasts for economic growth and devolved tax revenues this only provides a partial explanation of the impact of these revenues on the size of the budget. These forecasts need to be understood in relation to the equivalent forecasts for the adjustment to the block grant which is the responsibility of HM Treasury.

37. While the Committee welcomes HM Treasury’s publication of the BGA calculations there is no accompanying narrative explaining the year on year changes to the adjustments to the block grant. Yet the changes to the size of the adjustments to the block grant are equally as important in influencing the size of the budget as the revenue forecasts provided by the SFC.

38. The calculations for working out how the net impact of the block grant adjustments and the revenue forecasts will impact the annual Budget will become increasingly complex as outturn figures become available for income tax. While the SFC can be expected to provide a comprehensive analysis of the complexity of this process in relation to their revenue forecasts there is no equivalent independent analysis currently provided for the block grant adjustments.

39. The Committee, therefore, recommends that the OBR should have responsibility for publishing an independent analysis of the year on year changes to the adjustments to the block grant as part of its devolved taxes forecast. This should include an evaluation of the forecasts which inform the BGA against the outturn figures.

---

The SFC costs the HR freeze policy at £61m in 2018/19. But this costing reflects the additional revenues raised in Scotland by freezing the HR threshold in 2017/18 rather than allowing it to increase in line with inflation (i.e. the difference between the HRT at £44,273 rather than £45,250 in 2018/19). However, in considering the total difference between Scottish income tax revenues and the income tax BGA, it is necessary to take account of the difference between the HR threshold in Scotland and the HR threshold in rUK (as it is this difference that determines the difference between revenues and the BGA). The revenue effect of the Scottish Government setting the HRT at £44,273 compared to £46,350 in 2018/19 has been estimated by the Fraser of Allander Institute at around £150m.
40. **The Committee notes that while there is some merit in comparing the OBR forecasts for the devolved taxes with the SFC forecasts the more significant issue for the size of the Scottish budget is comparing the SFC forecasts with the OBR forecasts for growth in the equivalent taxes in the rest of the UK. The Committee, therefore, recommends that the SFC should provide this comparative data in future forecast reports.**

**Reconciliation**

41. Both the forecasts which are used to inform the BGA for each of the devolved taxes and the forecast for the revenues from Scottish income tax will be reconciled with outturn figures once these are available. The technical annexxxii to the Fiscal Framework provides some details of how this process will work which varies between each tax. However, there is no agreed process for how this information is published or scrutinised. The Committee, therefore, asked the Budget Process Review Group in its report on Draft Budget 2017/18 to consider scrutiny arrangements for the reconciliation process.

42. The Review Group recommended the introduction of a Fiscal Framework Outturn Report to be published annually in September by the Scottish Government. In relation to the reconciliation process the Group recommended that this report should include—

- Outturn data for Scottish tax revenues (Including comparison of outturn with forecast);
- Calculation of outturn adjustments to the block grant (and comparison with forecast);
- Net budgetary position (revenue minus adjustment to the block grant) for each tax relative to forecast;
- Implications of reconciliation for subsequent financial year;
- Commentary on latest available interim outturn data on income tax.

43. Final audited outturn data on LBTT and SLfT is now available in relation to both the BGA and the revenue forecasts (Table 6). HMRC have also confirmed that they will carry out the final reconciliation for income tax about 15 months after the end of the tax year which as discussed above will impact on the 2022-23 Budget.

Table 6: Reconciliation of LBTT and SLfT 2016/17 forecasts to outturn.

<table>
<thead>
<tr>
<th></th>
<th>LBTT (£m)</th>
<th>Landfill Tax (£m)</th>
<th>Combined (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Forecast</td>
<td>538</td>
<td>133</td>
<td>671</td>
</tr>
<tr>
<td>Draft Budget 2016/17</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue Outturn</td>
<td>483</td>
<td>148</td>
<td>631</td>
</tr>
<tr>
<td>Net difference</td>
<td>-55</td>
<td>15</td>
<td>-40</td>
</tr>
<tr>
<td>BGA Forecast</td>
<td>N/A</td>
<td>N/A</td>
<td>£600</td>
</tr>
<tr>
<td>BGA Outturn</td>
<td>534</td>
<td>£131</td>
<td>665</td>
</tr>
<tr>
<td>Net difference</td>
<td></td>
<td></td>
<td>65</td>
</tr>
</tbody>
</table>

44. As illustrated the outturn figures for LBTT and SLfT are £40m lower than forecast while the outturn figures for the BGA are £65m higher. This means that the Scottish Government had £40m less receipts to draw down in 2016/17 than set out in Draft Budget 2016/17. It also means that the Block Grant for 2016/17 is £65m lower than set out in Draft Budget 2016/17. This is because the growth in the equivalent tax revenues in rUK was higher than the forecast meaning the adjustment to the block grant was higher. The net impact of this higher than forecast rUK tax revenues and lower than forecast Scottish tax revenues is that the 2016/17 Budget is £105m lower than when the Budget Bill was agreed in February 2016. Draft Budget 2018/19 states that the £65m arising from the BGA forecast error for 2016-17 will require in-year revisions to the 2017-18 Budget.

45. The Cabinet Secretary noted that the Fiscal Framework “is a pretty complex way to determine a budget” and if “we design a system based on forecasts, it will carry risks.” His officials explained to the Committee that while the tax forecasts will be reconciled with the outturn figures “what is really important for our budget is the difference between that error and the error that the OBR is likely to make in forecasting” the BGA. The Cabinet Secretary pointed out that the Fiscal Framework includes provision of additional borrowing powers to address the impact of any forecast errors on the size of the budget.
46. The Committee asks the Scottish Government to provide a breakdown for each devolved tax of the difference between the BGA and tax revenues for 2016-17 following the reconciliation process.

47. The Committee asks the Scottish Government to provide details of how it addressed the £40m shortfall arising from forecast error for the revenue receipts for the devolved taxes in the 2016-17 Budget. The Committee also asks the Scottish Government how it intends to address the shortfall of £65m arising from forecast error in relation to the BGA for 2016/17.

48. The Committee notes that the budget will become increasingly complex once the reconciliation process for the devolved taxes becomes fully operational and that transparency is essential. The Committee, therefore, welcomes the Budget Process Review Group recommendation to introduce a Fiscal Framework outturn report. The Committee’s view is that this must include outturn adjustments to the block grant which presumably will need to be provided by HM Treasury. The Committee recommends that the Cabinet Secretary pursues this matter with HM Treasury Ministers.

49. The Committee believes that it is essential that we have the opportunity to consider the impact of the reconciliation process on the public finances prior to the publication of the budget and therefore welcomes the Budget Process Review Group’s recommendation that the outturn report is published annually in September.

Outlook for the Scottish Economy

50. The SFC has a statutory responsibility to produce independent economic and fiscal forecasts of—

- Revenue from the fully devolved taxes;
- NSND income tax receipts;
- Devolved social security expenditure;
- Onshore GDP growth in Scotland.

51. The SFC has published economic growth forecasts for the Scottish economy. (Table 7).

Table 7: SFC GDP Growth Forecasts

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (%)</td>
<td>0.4</td>
<td>0.7</td>
<td>0.7</td>
<td>0.9</td>
<td>0.6</td>
<td>0.9</td>
</tr>
</tbody>
</table>
52. The SFC states that an outlook of slow growth is its core view and that this is based on “analysis of historic trends and broad assumptions that these trends continue in the near future.” SPICe point out that the SFC forecasts are significantly more cautious than other economic forecasts for the Scottish economy and slower than the OBR forecasts for the UK economy (Table 8).

### Table 8: Comparative Growth Forecasts

<table>
<thead>
<tr>
<th>GDP (%)</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraser of Allander</td>
<td>1.2</td>
<td>1.2</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>EY Item Club</td>
<td>0.8</td>
<td>1.4</td>
<td>1.6</td>
<td>1.7</td>
</tr>
<tr>
<td>PWC</td>
<td>1.3</td>
<td>1.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OBR (UK Economy)</td>
<td>1.5</td>
<td>1.4</td>
<td>1.3</td>
<td>1.3</td>
</tr>
</tbody>
</table>

53. A key factor in explaining the difference between the SFC and OBR economic growth forecasts is relative population growth. The SFC forecasts lower population growth for Scotland than the OBR forecasts for the UK. Robert Chote told the Committee that this is the main explanation for the difference between the two GDP growth forecasts.\(^{xiii}\)

54. Notwithstanding this, the SFC also forecasts that GDP per capita will grow markedly slower in Scotland than in rUK. The SFC forecasts per capita growth of 0.8% in Scotland compared to the OBR’s forecast of 1.4% for the UK (although the gap narrows over the period to 2022.) The SFC’s main reasons for this are as follows—

- Slower forecast growth in productivity;
- A faster relative decline in working age population in Scotland;
- A view that the Scottish economy is currently operating ‘above capacity’ (see paragraph 58).

55. The SFC forecasts slower productivity growth in Scotland of 0.5% in 2018/19, increasing to 1% by 2022/23. In contrast the OBR forecasts productivity growth in the UK rising from 0.9% to 1.2% over the same period. Our Adviser points out that since 1999, growth in Scottish GDP per capita has largely tracked the UK (Chart 1). For the last two and a half years however, Scottish growth has been particularly weak.

\(^{xiii}\) Finance and Constitution Committee, 10 January 2018, OR Col. 15
56. Both the OBR’s forecasts for the UK and the SFC’s forecasts for Scotland assume that recent trends will be reflected in growth over the next few years. Thus the gap between Scottish and UK GDP per capita is increasing over the period to 2022 (Chart 1).

Chart 1: GDP per capita in Scotland and UK, Q1 1999 = 100

57. The Adviser points out that the combination of weak output growth with a strong labour market implies weak productivity growth and that by the end of 2016 productivity in Scotland was no higher than three years previously. He also highlights the impact of weak productivity growth on earnings growth since the financial crash in 2008 and that median earnings actually declined slightly in real terms between 2016 and 2017 in both Scotland and the UK. This has clear implications for tax revenues and this is discussed in more detail below.

58. The SFC’s view is that the Scottish economy is “on trend but operating slightly above capacity” which means that actual output is judged to be above potential output in 2017/18. The Committee’s Adviser points out that this implies that the recent weaker performance of the Scottish economy is structural rather than cyclical and limits the scope for ‘bounce-back’ in economic growth. In his view this is not dissimilar to the OBR’s assessment of the UK economy “but the fact that weak Scottish economic growth recently represents above capacity growth will surprise some.” The FAI’s view is that the “economic outlook for Scotland and the
UK as a whole remains fragile, with continuing uncertainty around the terms of Brexit an ongoing concern.\textsuperscript{xiv}

59. The Fiscal Framework provides the Scottish Government with resource borrowing powers of up to £600m annually and within an overall limit of £1.75bn in the event of a Scotland-specific economic shock. The Fiscal Framework defines such a shock as being—

“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 shock may be triggered from outturn data or forecasts. In the event that forecast data shows an economic shock but outturn data does not, no retrospective revisions will be applied to borrowing powers.”

60. The SFC is required to assess whether a Scotland-specific economic shock is expected to occur. It states that while it forecasts growth in Scotland to be below 1% this is less than 1% below the OBR’s forecast for the UK economy on a rolling four quarter basis. The SFC’s view, therefore, is that a Scotland-specific shock is not expected to occur.

61. The FAI’s view is that given current economic indicators there is the possibility that the Scottish Government could use the borrowing powers provided by the Fiscal Framework if a Scotland-specific economic shock occurs.

62. The Cabinet Secretary was asked how the Scottish Government has changed its approach to the draft budget given the increased dependence of the public finances on the relative performance of the Scottish economy. He responded that “there has been an even stronger focus on economic spending, economic and industrial interventions and a tax environment that takes a balanced approach to grow the economy stably.”\textsuperscript{xv} He also highlighted the working age population and migration as arguably even more substantial factors.

63. The Committee notes that while per capita GDP growth in Scotland has largely tracked the UK since 1999 a gap has begun to appear over the past two and a half years. Our Adviser points out that the SFC implies that the recent weaker performance of the Scottish economy is structural rather than cyclical. While it is not clear what the impact will be on income tax revenues there is nevertheless some risk to the public finances which will require close monitoring by both the Scottish Government and the SFC.

\textsuperscript{xiv} https://www.sbs.strath.ac.uk/economics/fraser/20170926/Scotlands-Budget-2017.pdf page 1
\textsuperscript{xv} Finance and Constitution Committee, 10 January 2018, OR Col. 24
BREXIT

64. The impact of the process of the UK leaving the European Union (EU) has been the subject of a wide range of economic reports and commentary since June 2016. Given the potential impact of this process upon the UK and Scottish economy and consequently on public finances the Committee took evidence on the impact of Brexit upon the Scottish budgetxvi.

Forecasts

65. The potential implications of Brexit have influenced the approach taken by both the SFC and OBR in producing growth forecasts. Both forecasters recognise that, given negotiations between the UK Government and the EU are currently underway, assessing what the end-point of that process will be is complex. Accordingly, given the economic and fiscal implications of a range of possible outcomes from the negotiations both organisations adopted the same “broad-brush assumptions”xvii with regard to this process. These were that—

- The UK leaves the EU in March 2019;

- New trading arrangements with the EU and others slows the pace of import and export growth; and

- The UK adopts a tighter immigration regime than currently in place.

66. In broad terms, the SFC notes that it expects the "uncertainty created by the UK-EU negotiation, and the final settlement, to impact negatively on the Scottish economy over the next five years"xviii. With regard to the SFC 2017 forecasts, the impact of Brexit has resulted in the SFC adopting a lower EU migration population projection, termed the ‘50 per cent EU migration population variant’, as opposed to the ‘ONS principal projection’ used by the OBR. The effect of this change in the variant used is to reduce the SFC growth variant from 0.9% to 0.7%. David Wilson from the SFC commented on the impact of this change as being—

“In Scotland we have gone from having net out-migration 20-or-so years ago to having fairly significant net in-migration more recently, and the expert view in advising on forecasts is that in-migration more recently is around 15,000 a year – it has been a bit higher over the past couple of years, but that is the benchmark. The implication of the assumption that we used is the difference between 15,000 and 12,000, which does not make a significant difference in terms of the overall numbers, but we are moving in that direction, given the

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xvi Details of the evidence, both oral and written, the Committee has taken on the impact of Brexit and the budget can be accessed at—


xviii Ibid. p.10.
circumstances that we are in, and we are very committed to monitoring the situation”.

67. The SFC also considered the impact of Brexit on productivity and trade. In terms of productivity, the Commission considered that the changing relationship between the UK and the EU would result in lower levels of trade and migration which would impact upon productivity. As a consequence the SFC considered that “productivity in Scotland will grow at a slower rate than may otherwise have been the case over the next five years”. In terms of international trade, the SFC outlined a more nuanced scenario for Scottish international trade in the following terms—

“Changing trade agreements, possibly leading to the UK and Scotland being more closed to trade, will have a negative impact on both gross exports and gross imports, reducing the volume of trade, but with an ambiguous impact on net trade. In addition, an on-going lower Sterling level is likely to support exports and limit import growth, while weakness in household spending power will limit import growth. In aggregate, Scotland’s net international trade is expected to fall slightly in 2017 and 2018 before flattening at this lower level for the next 5 years, neither contributing or detracting from GDP growth from 2019 onwards”.

**Economic Impacts**

68. Beyond the 2018-19 budget process, the Committee also considered evidence on the wider economic impact of the Brexit in the medium-term. The evidence the Committee received was consistent in predicting negative consequences for the Scottish and UK economies and therefore for the public finances. Paul Johnson, Director of the Institute for Fiscal Studies, suggested that the loss to the UK public finances would be in the region of £20 billion by the early 2020s. He summarised the rationale for this negative outcome in the following terms—

“It is clear that leaving the single market will reduce living standards relative to a world in which we stay in the single market. In a sense, that is a simple proposition. The European Union is by far our biggest, closest and richest trading partner. We do about half our trade with it and, if we make that trade more expensive, that will on average make us worse off”.

69. In terms of the Scottish economy, modelling by the Fraser of Allander Institute (FAI) indicated that over a 10 year period Scottish GDP would be between 2% to 5% lower as a consequence of Brexit. In written evidence to the Committee,
CIPFA Scotland estimated that Scottish GDP could be reduced by up to £11.2 billion by 2030. Accordingly CIPFA Scotland suggested that—

“There could be a reduction in Scottish tax revenues between £1.7 billion and £3.7 billion annually. As an indicator of scale, this is equivalent to a reduction to the Scottish Government budget of between 6% and 11%.”

70. The Scottish Government published an analysis of the impact of Brexit on the Scottish economy in January 2018. The Committee has not had the opportunity to consider this as part of the budget scrutiny process but will consider this analysis in the on-going scrutiny the Committee intends to undertake on this issue.

71. The accuracy of economic forecasts as predictors of future economic trends has been widely contested since the financial crash of 2008 and particularly since the referendum on UK membership of the EU. Professor David Bell commented on the degree of trust which should be placed on economic forecasts of the impact of Brexit that—

“I think that they are useful indications and they make the basic point about trade that we are currently in a single market, in which we have extremely advantageous trading relationships, and we are moving to a situation in which there is great uncertainty and there are all kinds of issues that trade economists would say would make life more difficult. I think that those are the general lessons that are worth placing some weight on.”

72. As discussed above, in relation to growth forecasts informing the Scottish budget, the importance of migration to recent economic growth in Scotland was also emphasised in evidence submitted to the Committee. The importance of migration to particular sectors of the Scottish economy such as agriculture, fishing, hospitality and the food industry was a recurring theme in the evidence received. However, public sector organisations, notably with regard to higher education, were also cited. This issue was a recurring theme in workshops which the Committee held in Aberdeen with key stakeholders in North East Scotland regarding the impact of Brexit upon the economy of the region. The Environment, Climate Change and Land Reform Committee (ECCLR) stated in relation to the impact of Brexit upon recruitment by environmental bodies that—

“Marine Scotland, the agencies and all the SEFARI and Centres of Excellence noted that they currently recruit staff including researchers / scientists from EU countries. The Committee recognises the need to be able

xxiv CIPFA Scotland, Written Submission, p.1.
xxvii For example, the written submissions from COSLA, CIPFA and the Royal Society of Edinburgh.
xxviii An overview of the content of discussions during the workshops held in Aberdeen can be accessed at: http://www.parliament.scot/parliamentarybusiness/report.aspx?r=11304
to recruit and retain the highest calibre staff worldwide including from the EU and EEA, specifically in research / science. The Committee heard the impact of a restriction on this was a significant concern with some organisations already experiencing staff losses and recruitment issues“xxxix.

73. The Committee also heard that Brexit was most likely to impact upon not only recruitment of highly skilled professionals but also upon locations with high concentrations of such occupations. Accordingly a further central theme to the evidence received was that the impact of Brexit was likely to be most pronounced in urban areas. Professor David Bell observed that locations with high concentrations of private sector service workers were likely to be most affected particularly given that most trade agreements do not include services. Accordingly, Professor Bell observed—

“The higher-paid private sector workers are the most likely to be affected. In Edinburgh, for example, if it becomes more difficult for life sciences to penetrate markets or for high-tech computing firms to break into new markets, those are the effects that are most likely to impact on the overall GVA in that city”xxx.

74. Similarly, the LSE’s Centre for Cities found that cities with large shares of employment in private sector knowledge intensive services were most likely to be most negatively impacted by Brexit. Their analysis“xxxi of the impact of both a ‘hard’ and ‘soft’ Brexit upon all cities in the UK found that under both scenarios, Aberdeen would be the worst affected and Edinburgh the sixth worst affected cities in the UK. In the case of a ‘soft Brexit’, the Centre for Cities predicted a reduction in Gross Value Added, over a 10 year period following implementation of new trade arrangements with the EU, of 2.1% in Aberdeen and 1.4% in Edinburgh. In the case of a ‘hard Brexit’, a reduction of 3.7% in Aberdeen and 2.7% in Edinburgh was forecast. Central to this finding was that financial and business services were likely to be particularly impacted by Brexit. Naomi Clayton observed in evidence to the Committee that—

“If those impacts play out in loss of employment and earnings, of course that will impact on tax take. That is particularly significant, given that per capita levels of tax take in Edinburgh and Aberdeen are among the highest, so that might well have an impact on Scottish finances overall”xxi.

75. Nevertheless, given the highly skilled and productive workforces present within such locations, the Centre for Cities also suggested that such cities may be better placed to adapt to Brexit in the medium term. Instead Naomi Clayton noted that—

xxi LSE Centre for Cities, Written Submission for 29 November meeting.
“Although the initial shocks may be smaller in less-affluent parts of the country, we know that unemployment rates tend to be much higher and wages tend to be much lower in those areas, so the initial shocks might have longer-term impacts on those economies.”

76. A range of responses the Scottish Government could take to mitigate the impact of Brexit were outlined in evidence to the Committee. Investment in education, skills and training were frequently cited. Investment in regional/urban policy was also a recurring suggestion whether through existing vehicles such as City Deals or through funds to replace EU mechanisms such as the EU Structural Funds. Some respondents suggested potential opportunities that may result from Brexit. For example, Dr Jim Campbell of Glasgow Caledonian University highlighted that ending EU procurement policy could have beneficial effects. Naomi Clayton, from the LSE Centre for Cities, suggested that replacing the European Structural Funds offered an opportunity to improve reduce bureaucracy and improve outcomes. In relation to agriculture, Jonathan Hall of NFU Scotland stated—

“There is a clear opportunity right now to recast how we support rural areas and agricultural businesses to deliver more of what we want in terms of quality food production, protection of the environment and sustaining rural communities.”

77. In terms of the 2018-19 budget, the Royal Society of Edinburgh (RSE) considered that the Scottish Government would not have to change the formulation of the budget. However, the RSE commented that—

“we strongly urge that the Scottish Government use scenario planning to help predict the effects of Brexit rather than relying on point forecasts. Scotland’s Economic Strategy outlines the key growth sectors of the Scottish Economy including: Food and Drink, Creative Industries, Sustainable Tourism, Energy, Financial Services and Life Sciences. These are likely to be affected in different ways by Brexit. Scenario planning might help Government, and others, to better understand the risks and challenges that the various sectors may face.”

78. The FAI undertook an analysis of the potential impact of Brexit on the sectors of the Scottish economy. It found that just over 60% of Scottish trade with the EU derived from the manufacturing sector. Within manufacturing, FAI found that refined petroleum and chemicals, and food and drink were the most significant sectors in terms of trade with the EU.
EU Funding

79. Scotland receives monies from a range of EU funds with the Common Agricultural Policy (CAP) and the Structural Funds being the principal sources of monies. During the 2014-2020 EU budget period, Scotland will receive €4.6bn to implement CAP and €941m in Structural Fund support\(^{xxxvii}\). The UK Government has agreed to match CAP payments until 2020 while the agreement between the EU and the UK Government at Stage One of the Brexit negotiations provides for the “continued participation”\(^{xxxviii}\) in current EU funding streams to the end of the 2020 budgetary period. In a post-Brexit environment, the extent to which the UK would continue to participate in EU funding streams or what would replace such funding streams remains to be agreed. The ECCLR Committee stated that it was “gravely concerned about the loss of EU funding” for environmental agencies and organisations. Accordingly, the ECCLR Committee recommended that—

“The Scottish Government work closely with agencies and partners and the UK Government to identify possible replacement funding streams, as a matter of extreme urgency”.

80. At present, the implementation of areas of EU funding has tended to differ between Scotland and the rest of the UK. For example, Professor Bell highlighted this issue in relation to the Structural Funds and commented that—

“We have to think through the size of the structural funds as well as all the rules around when support can and cannot be given. It appears that the EU was content for Scotland to have a slightly different set of rules than was applied in England. Therefore, when those rules come up for discussion, it will be interesting to see whether the UK Government is willing to negotiate a continuation of that kind of difference between different parts of the UK”\(^{xxxix}\).

81. In addition, it is not clear how funding attached to any competences which are returned to the Scottish Parliament will be treated. Professor Heald observed on this issue that—

“Obviously, the UK Government could keep everything and just run it all from the Treasury. Alternatively, the existing Scottish spend on presently EU-financed functions could be transferred into the Scottish block, with future changes going through the Barnett formula”\(^{xl}\).

\(^{xxxvii}\) Scottish Government website – EU funding. Accessible at—
http://www.gov.scot/Topics/International/Europe/Benefits-EU-Membership/Funding


\(^{xxxix}\) Official Report, 27 September 2017, Col. 37.

82. The Committee stated in its Interim Report on the European Union (Withdrawal) Bill that—

“further consideration is required in relation to the funding of devolved competences which are currently funded at an EU level. The UK’s net contribution to the EU will revert to the UK Government. There are a number of options available as to how this funding will then be distributed across the UK and the Committee intends to consider this further including how the funding of obligations and commitments arising from common frameworks should be agreed. Again, the Committee intends to return to this issue.”

83. The Committee reiterates its intention to undertake further work on funding of competences currently provided for by the EU. The Committee also notes the concerns expressed by the ECCLR Committee and agrees that the Scottish and UK Government should begin work on agreeing replacement funding streams for all current EU funding sources as a matter of urgency.

AFFORDABILITY

84. This aspect of financial scrutiny relates to the need for a balanced budget which means expenditure should be no greater than the revenue source. As discussed above, the revenue source of the Scottish Government’s budget has substantially changed and it now raises around 40% of the money which it spends.

85. Table 9 below sets out the estimated receipts from these taxes for 2018-19.

Table 9: Forecast Revenue (£m)

<table>
<thead>
<tr>
<th>Tax</th>
<th>Forecast Revenue (2018-19) (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSND Income Tax</td>
<td>12,115</td>
</tr>
<tr>
<td>Land and Buildings Transaction Tax (LBTT)</td>
<td>588</td>
</tr>
<tr>
<td>Scottish Landfill Tax (SLfT)</td>
<td>106</td>
</tr>
<tr>
<td>Non-Domestic Rates Income (NDRI)</td>
<td>2,812</td>
</tr>
<tr>
<td>Council Tax</td>
<td>2,073</td>
</tr>
<tr>
<td>Total</td>
<td>17,694</td>
</tr>
</tbody>
</table>

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Scottish Income Tax

86. The Scottish Government’s proposals for Scottish income tax rates and bands are set out in Table 10.

Table 10: Scottish Income Tax Rates and Bands

<table>
<thead>
<tr>
<th>Scottish Bands</th>
<th>Band name</th>
<th>Scottish Rates (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over £11,850 - £13,850</td>
<td>Starter</td>
<td>19</td>
</tr>
<tr>
<td>Over £13,850 - £24,000</td>
<td>Basic</td>
<td>20</td>
</tr>
<tr>
<td>Over £24,000 - £44,273</td>
<td>Intermediate</td>
<td>21</td>
</tr>
<tr>
<td>Over £44,273 - £150,000</td>
<td>Higher</td>
<td>41</td>
</tr>
<tr>
<td>Above £150,000</td>
<td>Top</td>
<td>46</td>
</tr>
</tbody>
</table>

87. The Cabinet Secretary stated when announcing the Draft Budget –

“That new starter rate, combined with the increase in the personal allowance, will ensure that no one earning less than £33,000, which is 70 per cent of all taxpayers, will pay any more in tax than they do now for given incomes; on the contrary, anyone earning less than £33,000 will pay slightly less in tax in the coming year than they do this year. The introduction of the new starter rate will also mean that those earning up to £26,000, which is 55 per cent of taxpayers in Scotland, will pay marginally less tax than they would if they lived elsewhere in the UK.”

88. He also stated that the proposal for the top rate of tax of 46% is—

“at a level that will generate the most income with the least risk of losing revenues next year and damaging the economy. Our modelling indicates that, had we gone further, once behavioural effects and forestalling are considered, a higher rate could reduce income tax revenues next year. That is not a decision that any sensible Government would take.”

89. The Committee heard evidence from three organisations on the Draft Budget. The Scottish Chambers of Commerce (SCC) told us that their “biggest concern is about perception” and that “over the piece, we are creating a perception that it is more difficult and more expensive to do business in Scotland.” When asked by the Committee whether there is any evidence of such a perception the SCC

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xliv Finance and Constitution Committee, 20 December 2017, OR Col.25
xlv Finance and Constitution Committee, 20 December 2017, OR Col.38
responded that some EU citizens are already leaving or not coming to Scotland "not necessarily because of Brexit but because of the effect of the exchange rate."\(^{xlvii}\)

90. In contrast the STUC stated that their priority is investment in public services and they "do not believe that the tax proposals are ambitious enough in either quantum or structure to meet that public service investment."\(^{xlviii}\) Their view is that a large part of the additional revenue from the income tax proposals "will disappear straight away as a result of cuts in business rates."\(^{xlvii}\)

91. IPPR Scotland told the Committee that the "income tax rises are necessary and therefore welcome" but that the income tax cuts are "not well targeted at the poorest households."\(^{xlix}\) They also explained that more women are low earners and therefore may benefit more as individuals from the tax cut element of the changes. This point was also made by the Scottish Women’s Budget Group who state in written evidence that the taxation proposals "rightly focus on protecting people on low incomes" and that women, “particularly women of colour, older, and disabled women tend to be amongst people on the lowest incomes."\(^{l}\)

92. SPICe highlight that while those earning less than £33,000 will pay less income tax it is not the case that all those earning above that will pay more. Those earning over £43,525 and up to £58,500 will pay less than in 2017-18. This is a consequence of the increase to the personal allowance by the UK Government and the Scottish Government’s proposal to increase the higher rate threshold in line with inflation.

93. The Cabinet Secretary explained to the Committee that this “creates what I have admitted is an anomalous situation, but resetting the tax structure in the way we have done creates that anomaly.” In response to questioning from the Committee about whether this is an anomaly or a choice about whether to increase the higher rate threshold he stated that “where we set the thresholds is a choice for the Parliament. It is just normal that thresholds increase in line with inflation, but there is choice.”\(^{li}\)

94. Scottish Government officials also explained to the Committee that there have been discussions with HMRC about the entitlement of basic rate tax payers who are married to tax relief up to a maximum of £260 per couple. Scottish Government officials explained that the “question is whether we stick to the letter and have the marriage allowance only for basic rate payers, which means that

\(^{xlvii}\) Ibid.
\(^{xlviii}\) Finance and Constitution Committee, 20 December 2017, OR Col. 28
\(^{xlix}\) Finance and Constitution Committee, 20 December 2017, OR Col. 30
\(^{li}\) Finance and Constitution Committee, 10 January 2018, OR Col. 40

(P.66)
people on the intermediate rate lose that entitlement, or take a pragmatic approach that avoids that eventuality.iii

95. The Cabinet Secretary was also asked by the Committee about the impact of the new bands on other tax reliefs such as pension contributions. He responded that “where there are relief anomalies, it is for HMRC to address those, knowing what our tax policy is and what our intended policy outcomes are.”

96. HMRC explained to the Committee prior to publication of Draft Budget 2018/19:

“if new bands were to be added at the bottom—for example, if the basic rate band was split—we would have to think through some policy and administrative changes to cope with that, because various reliefs are given at source at the basic rate, and some things that currently happen automatically might require intervention to make them work in the future.”iii

97. The Cabinet Secretary subsequently wrote to the Committee on 12 Januaryliv confirming that UK Ministers have agreed that Scottish income taxpayers who fall into the proposed new tax bands will continue to be eligible for marriage allowance.

98. The Committee welcomes the confirmation that the proposed new bands will not result in unintended consequences to eligibility for marriage allowance for Scottish income taxpayers. The Committee asks whether other amendments to UK legislation may be required for other reliefs.

99. The Committee notes that the proposed changes to income tax illustrate the extent to which the tax is a shared competence with the UK Government which will inevitably increase the complexity of the tax in Scotland. The Committee therefore recommends that it is essential that the potential impact of any proposed changes to rates and bands on income tax policy areas which are reserved is fully explained at the earliest possible date.

Income Tax Revenue Forecasts

100. The SFC’s income tax forecast is much lower than the Scottish Government forecasts in Draft Budget 2017-18 (Table 11).

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iii Finance and Constitution Committee, 10 January 2018, OR Col. 34
iii Finance and Constitution Committee, 29 November 2017, OR
livhttp://www.parliament.scot/S5_Finance/General%20Documents/Letter_to_Convener_from_Cabinet_Secretary_for_Finance_and_Constitution_Marriage_Allowance_12_January_2018.pdf
101. Over the period 2018/19 to 2021/22 cumulative revenues are now forecast to be £2bn lower. The SFC explain this on the basis that the “outlook for income tax is driven by the outlook for earnings and employment” and that slow growth in the economy “means slow growth in income tax revenues.”

102. However, the downward revision to the income tax forecast has not resulted in a worsening outlook for the Scottish resource budget compared to the 2017/18 Budget. This is because the forecast for the income tax BGA has also been revised down compared to last year due to both –

- The decision by both the UK and Scottish Governments to use the SFC forecast for the baseline adjustment which is much lower than the previous forecast;
- Lower OBR forecasts for the growth of UK income tax revenues.

103. The net impact of the forecast revenues for income tax and the forecast for the income tax BGA using the IPC model are set out in Table 12.

<table>
<thead>
<tr>
<th></th>
<th>2017-18 (£m)</th>
<th>2018-19 (£m)</th>
<th>2019-20 (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast Receipts</td>
<td>11,584</td>
<td>12,115</td>
<td>12,582</td>
</tr>
<tr>
<td>BGA (IPC)</td>
<td>11,522</td>
<td>11,749</td>
<td>12,056</td>
</tr>
<tr>
<td>Net Impact</td>
<td>62</td>
<td>366</td>
<td>526</td>
</tr>
</tbody>
</table>

104. The SFC is effectively forecasting that in the absence of any tax policy differentiation, income tax revenues per capita will grow at the same rate in Scotland as in the UK. Our Adviser has suggested that “it might seem puzzling as to why Scottish revenues should be higher than the BGA when the forecast for Scottish economic growth is noticeably weaker.” He points out that although the
SFC forecasts lower economic growth than the OBR forecasts for the UK, they forecast that earnings in Scotland will grow at the same rate as in rUK.

105. The implicit assumption is therefore that the link between Scottish economic performance and wage growth is relatively weak. The Adviser suggests that there are a number of potential explanations but that the SFC has “not in its report sought to articulate the extent to which its judgements about earnings growth are not influenced by its growth and productivity assumptions”. Robert Chote explained to the Committee that “weaker productivity growth implies weaker growth in real earnings than we would otherwise anticipate.”

106. The Adviser suggests that the link between GDP per capita and income tax revenues is slightly ambiguous. The standard assumption is that growth in GDP per capita is driven by higher employment rates and improvements in productivity which underpin wage growth; with employment and earnings being the two key drivers of income tax revenues.

107. But particularly over the short-term, our Adviser suggests GDP per capita growth might be only partially related to employment and earnings. Scottish wages may be determined as much by UK-level wage settlements and productivity trends as by Scottish specific productivity trends; and some components of taxable income, such as pension income, are only marginally related to GDP per capita growth.

108. The relationship between GDP and earnings growth is complicated by a range of other factors, such as the fact that the geographical scales on which the two indicators are measured differs, and that the way in which GDP growth is distributed across the economy also matters.

109. In the lead up to the financial crash and its aftermath, the employment rate in Scotland trended similarly to the employment rate in the UK (Chart 2). During 2015 and 2016 however, the Scottish employment rate fell relative to the employment rate in the UK, although there are signs of a recovery more recently (Chart 2 shows the 16+ employment rate which is arguably the more relevant in relation to income tax, but the 16-64 employment rate in Scotland has already closed the gap to the equivalent UK rate).

110. Between 2004 and 2015, average annual earnings grew more quickly in Scotland compared to the UK (Chart 3). But in 2015 and 2016, average earnings have grown relatively more slowly. Earnings at the 90th percentile (i.e. the earnings of the individual who earns more than 90% of all other wage earners), which are arguably more important in determining income tax revenues have tended to grow less quickly in Scotland than in the UK. And in the last two years, earnings at the 90th percentile have fallen by 0.5% in Scotland whilst growing by 1.6% in the UK.


Finance and Constitution Committee, 10 January 2018, OR Col.8
Chart 2: Scotland and UK employment rate (16+, seasonally adjusted)

![Employment rate chart]

(Source: Budget Adviser)

Chart 3: Scottish earnings as percentage of UK

![Earnings chart]

(Source: Budget Adviser)
111. On the basis of the evidence here therefore, there does appear to be some evidence that slower growth in GDP per capita in Scotland compared to the UK in 2015 and 2016 has coincided with relatively slower growth in earnings and the employment rate.

112. The SFC has forecast however that, whilst average annual earnings growth in Scotland will somewhat underperform the UK in 2017/18 (1.8% v. 2.3%), in subsequent years earnings growth in Scotland will match that of the UK. And while it forecasts that total employment will grow more slowly than the OBR forecasts for the UK, this reflects slower population growth, but the employment rate will implicitly grow at a similar rate.

113. In written evidence to the Committee, the SFC told us that, as a result of the recently announced Scottish public sector pay policy, the SFC estimates that average earnings from employment in the public sector will rise by 3.2% in 2018-19 and by 2.9% from 2019-20 onwards; in the absence of the Government’s policy announcement, the SFC had been assuming that average earnings from employment in the public sector would increase by 1.9% in all years. However, it is not clear what difference the assumption about public sector wage growth makes to the SFC’s forecast for average earnings (which are forecast to increase 2.3% in 2018/19 and 2.4% in 2019/20).

114. What does all this mean for income tax revenues? The SFC’s forecasts for income tax revenues are driven mainly by its assumptions for earnings growth and employment. Because these are forecast to grow broadly in line with rUK, the implication is that income tax revenues per capita would grow at broadly the same rate in Scotland as rUK if fiscal policy changes were the same in Scotland and rUK. Once policy change is factored in per capita, revenues are forecast to grow even more strongly in Scotland compared to the UK (Table 13).

<table>
<thead>
<tr>
<th></th>
<th>2017-18</th>
<th>2018-19</th>
<th>2019-20</th>
<th>2020-21</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scotland</td>
<td>2.8%</td>
<td>4.2%</td>
<td>3.5%</td>
<td>3.7%</td>
</tr>
<tr>
<td>rUK</td>
<td>2.2%</td>
<td>1.4%</td>
<td>2.0%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

115. In their 2017 report on Scotland’s Budget the FAI ask whether it is likely that Scottish income tax revenues will grow faster or slower than the BGA in 2017/18 and beyond. To do so they consider the major determinants of the tax base: wages and employment. They suggest that in recent years while the employment rate in Scotland has declined relative to the UK, wages have not declined quite as much as in rUK. Their view is that whether Scotland “continues to match UK

growth in per capita income tax revenues will depend on how these determinants evolve.\(^{lviii}\) They point out that employment and wages in Scotland declined in 2016/17 relative to those in the UK and it is not yet clear whether this is a one-off or the start of a trend.

116. The Cabinet Secretary told the Committee –

“It is interesting that the Fiscal Commission’s current forecast suggests that income tax will continue to rise in Scotland. Even if GDP does not have the same rise, wage growth will match that in the UK and income tax receipts in Scotland should be in a stronger position.”\(^{lix}\)

117. Robert Chote explained to the Committee that weaker GDP growth means “weaker growth in all the major tax bases, so that has implications for the public finances.”\(^{lx}\) The Committee asks the SFC to explain, therefore, why despite lower economic growth forecasts per capita relative to rUK, they forecast that income tax revenues per capita will grow at the same rate in Scotland as in rUK. In particular, why its judgements about earnings growth do not appear to be influenced by its growth and productivity assumptions.

118. The Committee notes that the downward revision to the income tax revenue forecast has not resulted in a worsening outlook for the public finances as the forecast for the BGA has also been revised down. While this is welcome, due to the risks to the public finances from forecast error, there needs to be parliamentary scrutiny and wider public consideration of estimated outturn figures for income tax prior to consideration of the audited figures which are published around 15 months following the end of the financial year. The Committee, therefore, welcomes the recommendation of the Budget Process Review Group that estimated income tax outturn figures are published each September for the previous financial year.

**Behavioural Response**

119. One of the key considerations for the Scottish Government and the Scottish Parliament in setting income tax rates is an understanding of the likely behavioural responses to any changes. The Committee sought to examine this issue generally as part of our work on a Scottish taxation system.

120. The Scottish Government published a paper at the same time as the Draft Budget which provides analysis of the “potential revenues that could be raised from an

\(^{lviii}\) https://www.sbs.strath.ac.uk/economics/fraser/20170926/Scotlands-Budget-2017.pdf page 54  
\(^{lix}\) Finance and Constitution Committee, 10 January 2018, Col. 39  
\(^{lx}\) Finance and Constitution Committee, 10 January 2018, OR Col. 2
increase in the Additional Rate (AR) of Income Tax in Scotland from 45p to 50p for incomes above £150,000 and gives an overview of the impacts of potential revenue risks and mitigating actions associated with these.\textsuperscript{xi}

121. The paper explains that in order to gauge the responsiveness of taxpayers to tax changes, the academic literature provides taxable income elasticities (TIEs). These cover a range of behaviours, such as migration, income shifting and changes in the hours worked. However, the paper points out that many of these studies consider national tax reforms and that the “Scottish context is more complex as differential tax policy in Scotland and the rest of the UK creates new opportunities for behaviour change.” For example, some additional rate tax payers in Scotland may have more than one UK address or may choose to incorporate.

122. The paper states that “a review of the existing evidence base suggests that TIEs for AR taxpayers in Scotland are likely to fall into the range of 0.35 to 0.75 in the short run” but that “TIEs are also likely to vary within the AR taxpayer group.”\textsuperscript{xi} If the behavioural response was around the midpoint of this range, it would suggest that the revenue raised by a 5p increase in the AR would be in the low single millions. The paper concludes that therefore there is “likely to be a revenue and policy risk associated with increases to the AR that result in a substantial divergence with the equivalent rate in the rest of the UK.”\textsuperscript{xii} At the same time, changes “below this level will result in a proportionately lower behavioural response” and these “risks could therefore be alleviated if the AR is increased by less than 5 pence.”\textsuperscript{xiii}

123. The Draft Budget states that having carefully considered this analysis the Scottish Government decided that the Top Rate of income tax which will replace the Additional Rate should be increased from 45p to 46p. The Scottish Government believes that “such a reform strikes the correct balance between making our tax system more progressive, raising tax revenues and ensuring that our tax changes do not damage our economic competitiveness.”\textsuperscript{xiv}

SFC Forecast

124. The SFC forecasts additional revenues to be generated from the policy changes (both prior to and subsequent to any behavioural response) are set out in Table 14 below.
### Table 14. SFC Forecasts of additional revenues to be generated by policy changes (before and after any behavioural responses)

<table>
<thead>
<tr>
<th>£m</th>
<th>2018-19</th>
<th>2019-20</th>
<th>2020-21</th>
<th>2021-22</th>
<th>2022-23</th>
</tr>
</thead>
<tbody>
<tr>
<td>SFC Dec 2017 pre-measures</td>
<td>11,951</td>
<td>12,413</td>
<td>12,906</td>
<td>13,474</td>
<td>14,097</td>
</tr>
<tr>
<td>Dec 17 Policy Measures (static - assuming no behavioural responses)</td>
<td>215</td>
<td>224</td>
<td>235</td>
<td>249</td>
<td>264</td>
</tr>
<tr>
<td>SFC Dec 2017 post-measures (static - assuming no behavioural responses)</td>
<td>12,166</td>
<td>12,637</td>
<td>13,141</td>
<td>13,723</td>
<td>14,361</td>
</tr>
<tr>
<td>Behavioural responses</td>
<td>-51</td>
<td>-55</td>
<td>-57</td>
<td>-61</td>
<td>-65</td>
</tr>
<tr>
<td>SFC Dec 2017 post-measures (including behavioural responses)</td>
<td>12,115</td>
<td>12,582</td>
<td>13,084</td>
<td>13,662</td>
<td>14,296</td>
</tr>
</tbody>
</table>

125. The SFC used TIEs to forecast the behavioural response. They were asked by the Committee why they use a higher elasticity rate in forecasting the behavioural response to income tax changes than the central estimate of 0.48 which is used by HMRC. They responded –

“Broadly speaking, elasticity would be negligible to low at the very low end of tax. For starter-rate and basic-rate taxpayers, we would expect elasticity of around zero. We used a figure just above that. For £150,000 to £300,000 we used 0.35, for £300,000 to £500,000 we used 0.55, and for above £500,000 we used 0.75. I know that, in the Scottish Government’s latest estimates—its medium-responsive estimates—it uses 0.48 throughout. It does not use the variability that we use.”

126. The SFC’s report states that –

“Our TIEs are somewhat higher at the top end of the income distribution than HMRC’s central estimates for the UK. We see there being a particular risk that very high income individuals in Scotland might be able to relocate to

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lxvi Finance Committee, 20 December 2017, OR
other parts of the UK in response to any changes in the additional rate of income tax.\textsuperscript{lxvii}

127. Following oral evidence the SFC clarified further their use of TIEs compared to HMRC in a letter to the Committee. In their view “a more disaggregated set of TIEs is more appropriate for additional rate taxpayers in Scotland.” These are set out in Table 15 below.

Table 15: SFC TIEs

<table>
<thead>
<tr>
<th>Taxable Income (£)</th>
<th>Intensive Elasticity</th>
</tr>
</thead>
<tbody>
<tr>
<td>150,001 – 300,000</td>
<td>0.350</td>
</tr>
<tr>
<td>300,001 – 500,000</td>
<td>0.550</td>
</tr>
<tr>
<td>500,001 – high</td>
<td>0.750</td>
</tr>
</tbody>
</table>

128. The SFC’s evidence base for these TIEs “primarily comes from looking at the impact of historic changes in income tax in the UK and other economies.” They “expect a greater behavioural response of Scottish additional rate taxpayers to a change in the additional rate of tax than HMRC assumes for additional rate taxpayers in the UK.”

129. The SFC explained to the Committee that their forecasts of a behavioural response to the proposed income tax changes on the basis that “if the change happens only in Scotland, the opportunity for people to rearrange their affairs between Scotland and the rest of the UK is much stronger.”\textsuperscript{lxviii}

130. Robert Chote noted that the SFC’s approach to the use of TIEs is consistent with the OBR’s approach but “assuming that there is a greater responsiveness for higher incomes.” His view is that the SFC “reasonably points to the greater possibility of cross-border issues between Scotland and the rest of the UK.”\textsuperscript{lxix}

131. The SFC were asked how they weighted the various evidence which they examined in making a judgement on the behavioural response. They explained that they drew, in particular, on evidence in the HMRC model and that in relation to Scotland “there is reason to suppose that upper-rate taxpayers might be relatively mobile between Scotland and the rest of the United Kingdom.”\textsuperscript{lxx}

\textsuperscript{lxvii} \url{http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf} paragraph 3.52

\textsuperscript{lxviii} Finance and Constitution Committee, 20 December 2017, OR

\textsuperscript{lxix} Finance and Constitution Committee, 10 January 2018, OR Col. 4

\textsuperscript{lxx} Finance Committee, 20 December 2017, OR
132. The Committee asks the SFC what evidence it examined of behavioural responses to relatively small changes to marginal tax rates including a 1p change and how this informed its forecast.

133. The Committee asks the Scottish Government whether its own analysis of a behavioural response to proposed income tax policy changes is consistent with the SFC analysis and whether it has had any discussions with HMRC about how to address this response.

Forestalling

134. The SFC also considered whether the proposed income tax policy changes may lead to forestalling whereby tax payers have a one-off opportunity to shift the timing of income to avoid paying the higher rate of tax once it is introduced. The SFC’s view is that the “greater the difference between tax rates in one year and another, the greater the incentive for taxpayers to forestall” and for small differences “the taxpayer behavioural change will be limited.” Therefore, the proposed changes are “unlikely to lead to a significant amount of forestalling behaviour.”

135. The Committee asks the SFC why it views small differences in tax rates as having little impact on forestalling behaviour yet a relatively high impact on other behavioural responses. The Committee also asks the Scottish Government whether its own analysis of the impact of forestalling behaviour is consistent with the SFC’s analysis.

Tax Motivated Incorporations

136. The SFC states that throughout the UK “there has been a steady rise in the proportion of people working for themselves, rather than as an employee.” Those who work for themselves may choose to be self-employed or have the option to incorporate and manage their business as directors of a limited company. This means that three people doing very similar work “can face differing tax treatment depending on their employment classification.”

137. The Committee took evidence on the issue of tax motivated incorporations as part of its work on a Scottish approach to taxation. Sandra Eden from the University of

http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf paragraph 3.59
http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf paragraph 3.54
Ibid.
Edinburgh explained in written evidence to the Committee that “a shift in status from employee or self-employed to being an owner-managed company (OMC) is, from the perspective of the Scottish Government likely to be equivalent to a shift in tax residence.” This is because the income from the OMC is likely to be subject to corporation tax and income tax on dividends which are not devolved.

138. The Chartered Institute of Taxation told the Committee that if there is an income tax differential between Scotland and rUK then incorporation would be the most likely route to reduce the tax burden. Professor Murphy suggested that “incorporation is easy” but did not think that changes in Scottish income tax would really increase its attractiveness as the trend is already there. Sandra Eden’s view in written evidence to the Committee while “it might be unlikely that a small variation in income tax rates will increase (or slow) the trend, a dramatic differential may well do.”

139. ICAS took a different view and told the Committee that “people cannot automatically flip out of employment into a company” and that the “process is not as simple as that.” They also suggested that there is a need not to overemphasise the issue given that 85% of income tax papers are employees. PWC’s view is that there are a huge numbers of factors involved in deciding whether to incorporate and that the Committee “should not lose sight of the fact that there are some very good reasons to incorporate, such as having the ability to roll up profits and to decide when to distribute and when to bring stakeholders in or take them out.”

140. The SFC forecasts a substantial increase in the loss of NSND income tax revenues due to tax motivated incorporations compared to the Scottish Government forecast in February 2017 (Table 16).

Table 16: Tax Motivated Incorporations (£m)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Draft Budget</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2017-18</td>
<td>-41</td>
<td>-68</td>
<td>-102</td>
<td>-136</td>
<td>-164</td>
<td>-212</td>
</tr>
<tr>
<td>Draft Budget</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Difference</td>
<td>-95</td>
<td>-110</td>
<td>-137</td>
<td>-161</td>
<td>-190</td>
<td>-228</td>
</tr>
</tbody>
</table>

Finance and Constitution Committee, 19 April 2017, OR Col. 7
Finance and Constitution Committee, 19 April 2017, OR Col. 9
Finance and Constitution Committee, 3 May 2017, OR
141. The SFC’s forecast of tax-motivated incorporation is largely based on HMRC estimates and effectively assumes that the rate of growth will be the same in Scotland as rUK. The SFC points out that this trend and especially incorporation places a downward pressure on the NSND income tax forecast. Individuals who choose to incorporate may pay corporation taxes on profits or income taxes on dividends taken out of the company. However, as these taxes are not devolved these revenues would flow to HM Treasury.

142. 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. The impact should be neutral if the incorporations grow at the same level in rUK and in Scotland as the reduction in Scottish income tax receipts would be offset by a reduction in the size of the adjustment to the block grant.

143. The SFC were asked to what extent their forecast of a behavioural response to the proposed income tax changes is due to the forecast of increased incorporations. The SFC responded that there are two separate estimates and that “tax-motivated incorporation will impact on all groups and will apply irrespective of any change in tax.” The behavioural response forecast of £51m is not broken down into different factors and is a single overall estimate.

144. The Committee asks the SFC to explain whether it believes that the number of incorporations in Scotland is likely to increase relative to the rest of the UK as a consequence of the proposed income tax policy changes.

Implementation of Income Tax

145. NSND Income tax is now a shared policy between the Scottish and UK Government. While the Scottish Government has responsibility for setting the rates and bands of the tax the UK income tax continues to have responsibility for other areas of income tax policy including the personal allowance and tax reliefs. The savings and dividends elements of income tax and related taxes including national insurance are also reserved to Westminster. In addition, responsibility for the collection and administration of devolved income tax is the responsibility of HMRC.

146. The Cabinet Secretary indicated in a Written Answer (S5W-12712) that a “more significant divergence between the rates and bands that apply in Scotland when compared to the rest of the UK may lead to an increase in costs of up to £5m.” HMRC explained these estimated costs in oral evidence to the Committee that –

“First, while rates and thresholds do not diverge very much, we expect very low levels of contact from Scottish taxpayers about Scottish income tax

lxx Finance Committee, 20 December 2017
issues and their Scottish taxpayer status, but if there is more divergence we can expect, first, more contact from people who have queries, and secondly, to have to consider what compliance work we need to do to manage the risks that arise from divergence. That is where the estimate of £5 million comes from.\textsuperscript{xxxix}

147. HMRC were also asked by the Committee about the provision of outturn data for Scottish income tax liabilities. They responded that they “now have an arrangement with the Scottish Government to provide the monthly data for Scottish taxpayers” and that these “figures are being looked at by HMRC and the Scottish Government each month as they come through.” HMRC also explained that they “hope to publish that series in the future, but we want to get a bit of experience of the figures and make sure that we understand them before we make them a public document.”\textsuperscript{xl}

148. The Committee asks the Scottish Government to confirm the additional implementation costs arising from the proposed changes to income tax policy and whether it agrees that monthly outturn data for Scottish income tax is made publicly available as soon as practicable to do so.

Land and Buildings Transaction Tax

149. The Scottish Government proposes to maintain the rates and bands for LBTT at their current levels which are set out in Table 17 below.

Table 17: LBTT Rates and Bands

<table>
<thead>
<tr>
<th>Band</th>
<th>Rate</th>
<th>Band</th>
<th>Rate</th>
<th>Band</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td></td>
<td>Non-Residential</td>
<td></td>
<td>Non-Residential Leases</td>
<td></td>
</tr>
<tr>
<td>Transactions</td>
<td></td>
<td>Transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Up to £145,000</td>
<td>Nil</td>
<td>Up to £150,000</td>
<td>Nil</td>
<td>Up to £150,000</td>
<td>Nil</td>
</tr>
<tr>
<td>£145,001 to £250,000</td>
<td>2%</td>
<td>£150,001 to £350,000</td>
<td>3%</td>
<td>Over £150,000</td>
<td>1%</td>
</tr>
<tr>
<td>£250,001 to £325,000</td>
<td>5%</td>
<td>Over £350,000</td>
<td>4.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>£325,001 to £750,000</td>
<td>10%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over £750,000</td>
<td>12%</td>
<td></td>
<td></td>
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</tbody>
</table>

\textsuperscript{xxxv} Finance and Constitution Committee, 29 November 2017, OR Col.
\textsuperscript{xxxvi} Finance and Constitution Committee, 29 November 2017
150. The Scottish Government also proposes maintaining the Additional Dwelling Supplement (ADS) at 3% of the total price for all relevant transactions above £40,000.

Residential Transactions

151. The Draft Budget states that the Scottish Government’s “policy priority for residential LBTT remains to help first-time buyers enter the property market, and to assist people as they progress through the property market.” The Scottish Government proposes introducing a new LBTT relief for first-time buyers of properties up to £175,000. This relief raises the zero tax threshold for first-time buyers from £145,000 to £175,000.

152. The SFC’s forecasts for residential LBTT (excluding ADS) are set out in Table 18 below.

Table 18: Residential LBTT forecasts (excluding ADS) (£m)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Draft Budget 2016-17</td>
<td>282</td>
<td>347</td>
<td>406</td>
<td>469</td>
<td>533</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Draft Budget 2017-18</td>
<td>211</td>
<td>235</td>
<td>251</td>
<td>265</td>
<td>280</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Draft Budget 2018-19 (outturn)</td>
<td>214</td>
<td>271</td>
<td>305</td>
<td>336</td>
<td>366</td>
<td>395</td>
<td>426</td>
</tr>
</tbody>
</table>

153. The SFC states overall “the forecasts are a significant upward revision to the Scottish Government forecasts produced in December 2016.” The main reason for this is higher average house prices. These were forecast to increase by 1.8% in 2017-18 but averaged 4.3% in the first half of the year and the SFC expects that growth to continue in the second half.

154. The SFC explained in its evaluation report for the devolved taxes forecasts that the main reason for the forecast error for residential LBTT for 2016-17 was too
high a projection for the rate of growth in house prices. Average house price growth was forecast to be 5.6% in both 2015-16 and 2016-17 but actually fell by 1.1% in 2015-16 and only rose by 0.2% in 2016-17.\textsuperscript{100}

155. The SFC also highlighted the impact of the Aberdeen housing market on LBTT revenues in its evaluation report. The report showed that an additional £15m would have been raised had Aberdeen and Aberdeenshire prices grown at the same rate as the Scottish average. There is no mention of the impact of the Aberdeen housing market in the SFC’s most recent forecast report.

156. The Committee notes that there has been significant volatility in the year on year forecasts for residential LBTT which would appear to be related to fluctuations in house price growth. The Committee asks the Scottish Government whether there is any risk to the public finances arising from this volatility.

157. The Committee asks the SFC whether it considered the impact of the Aberdeen housing market on its LBTT revenue forecasts in its most recent report.

**Behavioural Responses**

158. One of the key issues which the Committee has previously considered is the extent to which the behavioural factors in response to the introduction of LBTT are temporary or longer term. In its forecast evaluation report the SFC stated that it would be considering these behavioural effects “carefully in preparation for future forecasts.”\textsuperscript{100}\textsuperscript{vi}

159. In relation to its residential LBTT forecast published in December 2017 the SFC stated that it adjusted the forecast to account for the behavioural response to fiscal drag. Fiscal drag occurs when the tax liability increases as a result of growth in prices. The SFC states that the impact on the forecast is modest but the effect will be greater when the average prices are rising at a faster rate.\textsuperscript{100}\textsuperscript{vii}

160. The Committee asks the SFC whether it considered the possibility of longer term behavioural responses to residential LBTT other than in relation to fiscal drag.


\textsuperscript{100}\textsuperscript{vii} [http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf](http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf)
Additional Dwelling Supplement (ADS) Revenue Forecasts

161. The Scottish Government’s stated policy objectives in introducing ADS were to “ensure that the opportunities for first time buyers to enter the housing market in Scotland remain as strong as they possibly can” and to ameliorate the likely distortions from the introduction of a similar UK supplement.

162. The ADS was introduced on 1 April 2016 and applies to additional residential property purchases worth £40,000 or more. The rate is 3% on the full value of the purchase. The SFC reports that since its introduction around 22% of all residential transactions have been liable for ADS.

163. The SFC’s forecasts in comparison with previous Scottish Government forecasts are set out in Table 19.

Table 19: ADS Revenue Forecasts (£m)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Draft Budget 2016-17</td>
<td>36</td>
<td>51</td>
<td>56</td>
<td>62</td>
<td>66</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Draft Budget 2017-18</td>
<td></td>
<td>72</td>
<td>75</td>
<td>78</td>
<td>80</td>
<td>82</td>
<td></td>
</tr>
<tr>
<td>Draft Budget 2018-19 (Outturn)</td>
<td>93</td>
<td>93</td>
<td>93</td>
<td>98</td>
<td>102</td>
<td>106</td>
<td>110</td>
</tr>
</tbody>
</table>

164. The SFC explains that the "main upward revision to the forecasts come from the higher forecasts of prices and transactions for the residential market as a whole." It is not clear, therefore, why the forecasts for 2017-18 and 2018-19 are the same as the outturn figures for 2016-17.

165. The Committee notes that the 2016-17 outturn figures for ADS are nearly three times higher than the initial Scottish Government forecast. The Committee, therefore, asks the Scottish Government whether it has reviewed whether the supplement at its current rate is delivering the policy objectives as stated when it was introduced.

166. The Committee asks the SFC why its forecasts for ADS for 2017-18 and 2018-19 are the same as the outturn figure for 2018-19 when it is forecasting higher average house prices and a higher number of transactions.

Non-Residential Revenue Forecasts

167. The Scottish Government states in the draft budget that our “approach to non-residential transactions ensures that smaller businesses pay the lowest or zero rates of LBTT” while the “non-residential tax rates ensure that Scotland is a competitive and attractive place for business.”

168. The SFC’s forecasts for non-residential LBTT revenues compared to previous Scottish Government forecasts are set out in Table 20.

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Draft Budget</td>
<td>220</td>
<td>230</td>
<td>240</td>
<td>250</td>
<td>260</td>
<td></td>
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<tr>
<td>2016-17</td>
<td></td>
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<tr>
<td>Draft Budget</td>
<td>224</td>
<td>233</td>
<td>242</td>
<td>252</td>
<td>262</td>
<td></td>
<td></td>
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<tr>
<td>2017-18</td>
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<tr>
<td>Draft Budget</td>
<td>177</td>
<td>193</td>
<td>190</td>
<td>194</td>
<td>200</td>
<td>206</td>
<td>212</td>
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<tr>
<td>2018-19 (Outturn)</td>
<td></td>
<td></td>
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169. The SFC states that the main change in the forecast is due to a change in the base year forecast. They explain that a “base year forecast is constructed based on a weighted average of the in-year forecast and the previous two years of revenues.”

Scottish Landfill Tax (SLfT)

170. SLfT is a tax on the disposal of waste to landfill and is charged by weight on the basis of two rates, a Standard Rate and a Lower Rate for less polluting materials. The Scottish Government describes SLfT rates as “continuing to provide financial incentives to support a more circular economy and the delivery of our ambitious targets to reduce waste, increase recycling and cut waste going to landfill.”

171. A small proportion of the tax revenues received is used to fund environmental projects in the vicinity of landfill sites which qualify for funding under the Scottish Landfill Communities Fund (SLCF).

172. The Scottish Government proposes to increase the Standard rate of SLfT from £86.10 per tonne to £88.95 per tonne in line with RPI inflation. It also proposes to increase the lower rate from £2.70 per tonne to £2.80 per tonne, again in line with RPI inflation. As in previous years these rates are identical to the planned UK landfill tax rates for 2018-19. This approach is intended to address the possibility of waste tourism and to assist in providing “a stable tax environment for industry to invest in alternative waste treatment options”.

173. The credit rate for the SCLF will remain at a maximum of 5.6% of an operator’s tax liability. In its 2017 Spring budget, the UK Government increased the equivalent cap across the rest of the UK from 4.2% to 5.3% of an operator’s tax liability.

Revenue Forecasts

174. The SFC’s forecasts for SLfT are set out in Table 21 below alongside the Scottish Government forecasts published in Draft Budgets 2015-16, 2016-17 and 2017-18. The outturn figures for 2015-16 and 2017-18 (the only years for which such data is currently available) are also included in the table.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>2015-16</td>
<td>117</td>
<td></td>
<td>133</td>
<td>123</td>
<td>149</td>
<td>106</td>
</tr>
<tr>
<td>2016-17</td>
<td></td>
<td>Outturn: 147</td>
<td>114</td>
<td>104</td>
<td>118</td>
<td>88</td>
</tr>
<tr>
<td>2017-18</td>
<td></td>
<td></td>
<td>109</td>
<td>112</td>
<td>109</td>
<td>90</td>
</tr>
<tr>
<td>2018-19</td>
<td></td>
<td></td>
<td></td>
<td>82</td>
<td>82</td>
<td></td>
</tr>
</tbody>
</table>

Draft Budget P26.
http://www.fiscalcommission.scot/media/1167/forecast-evaluation-report-september-2017.pdf: Table 4.1
175. The SFC notes that “since 2005 landfill volumes have fallen consistently, although recently there is evidence that this reduction has begun to stall in Scotland”\(^{xcv}\) However, despite this apparent stalling, the SFC is forecasting “significant reductions” in the amount of waste landfilled over the next five years as a result of planned increases in the capacity of incineration facilities and preparatory actions taken in anticipation of the statutory ban on the landfilling of biodegradable municipal waste from 2021.

176. Whilst noting that “progress towards implementing the ban on biodegradable municipal waste landfilled from 2021 represents a major source of uncertainty in our forecast,” the SFC states that sensitivity analysis “suggests SLfT revenue could fall as low as £20m per annum by the end of the forecast as a result of the ban.”\(^{xcvi}\)

177. The Adviser noted that whilst the SLfT forecast had been revised down by £12m since the same point last year, “revenues are still forecast to outperform the block grant adjustment slightly in each year of the forecast period.” He further notes that faster than expected progress towards targets to reduce waste to landfill could result in revenues underperforming relative to forecast, whilst slower than expected progress (for example as a result of delays in incinerator capacity coming on stream) could result in revenues overperforming relative to forecast.”

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

178. The Draft Budget states that the Government responded to the Barclay Review of NDR in September 2017 and confirmed that the following new policies would be introduced in 2018-19—

- A Business Growth Accelerator, which will ensure that any rates bill rises due to improvements to or the expansion of existing properties will not take effect until 12 months after those changes are made to the property;

- A new relief for day nurseries to support the increased provision of increased childcare;

- An expansion of Fresh Start Relief to include all property types, not limited to only listed property types as recommended by Barclay; halving the period the property has to be empty to qualify from 12 months to six; and doubling the level of relief from 50 per cent to 100 per cent for the first year of new occupation; and

- A move to three-yearly revaluations from 2022 with valuations based on market conditions on a date one year prior.


179. In addition to the Barclay reforms, the Draft Budget further states that the Government will—

- Use the September 2017 rate for CPI (3 per cent) rather than for RPI (3.9 per cent), to calculate the annual inflationary uplift in the Business Rates poundage for 2018-19;

- Continue the transitional cap for Aberdeen City and Shire offices and all but the very largest hospitality properties. This means that 2018-19 bills will rise by no more than 12.5 per cent in real terms (15 per cent in cash terms) for eligible properties;

- Introduce a new 60 per cent relief for hydro generation properties; and

- Delay the entry of new build properties onto the valuation roll, ensuring that no rates are paid until they are occupied. Thereafter the tenant will qualify for the Growth Accelerator for 12 months.

180. The Draft Budget proposes a poundage NDR rate in 2018-19 of 48p and a large business supplement rate of 2.6p. Comparable rates in 2017-18 were 46.6p and 2.6p. The Adviser notes that “RPI is a largely discredited measure of inflation which tends to be higher than CPI. Moving from RPI to CPI indexation thus implies lower bill increases for business, and commensurately lower revenues for government.” However, the Adviser further notes that the UK Government’s decision to move to CPI indexation in the Autumn Statement generated Barnett consequentials for the Scottish budget, “effectively offsetting the policy cost.”

181. The SFC’s forecasts for NDRI revenues over the next five years are set out in Table 22 below—

<table>
<thead>
<tr>
<th>Table 22 – SFC NDRI Revenue Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>£m</strong></td>
</tr>
<tr>
<td>NDRI</td>
</tr>
</tbody>
</table>

182. The SFC forecasts the revenue foregone arising from the policy changes introduced in the draft budget as being £96m for 2018-19. This is set out in Table 3.18 of the SFC’s forecast report which appears to be slightly different from Table 2.10 in the draft budget document. In particular, the pre-measures forecast and the revenue foregone from the business growth accelerator are slightly different in each table.

xcvii David Eiser Briefing on Draft Budget
NDRI Account Deficit

183. The FSU notes an NDR account deficit in 2016-17 of £8m bringing the cumulative deficit balance of the pool to £297m by the end of that year. As a result of measures taken during 2017-18, the cumulative deficit is anticipated to reduce to £68m by the end of the financial year.

184. In December 2017 The Auditor General for Scotland recommended that the Scottish Government—

- Develop a strategic plan of how it plans to manage the NDR account balance in the future;
- Improve the information it publishes to make it easier to see how NDR are budgeted for and reflected in annual accounts;
- Publish detail of how the distributable amount is calculated and set; and
- Publish details of future distributions and how it expects the NDR account balance to change over time.\textsuperscript{xcviii}

185. The Local Government and Communities (LGC) Committee endorsed these recommendations and recommends that the Government implement them.

186. The Draft Budget contains a plan to bring the NDR account back into balance by the end of 2019-20 by distributing fewer revenues than received as set out in Table 23 below.

Table 23: NDR Account

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributable Amount (£m)</td>
<td>2,810</td>
<td>2,812</td>
<td>2,867</td>
<td>2,939</td>
<td>3,117</td>
</tr>
<tr>
<td>Distributable Amount (£m)</td>
<td>2,666</td>
<td>2,636</td>
<td>2,867</td>
<td>2,939</td>
<td>3,117</td>
</tr>
<tr>
<td>Prior Year Adjustments (£m)</td>
<td>-23</td>
<td>-34</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yearly Balance (£m)</td>
<td>155</td>
<td>142</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cumulative Balance (£m)</td>
<td>-142</td>
<td>0</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

187. The Committee notes the recommendation of the LGC Committee that in relation to the Small Business Bonus Scheme and the new Growth Accelerator, we seek \textsuperscript{xcviii} http://www.audit-scotland.gov.uk/report/the-201617-audit-of-the-scottish-governments-non-domestic-rating-account
clarification from the Scottish Government of whether it will evaluate the effectiveness, economic impact, and value for money of these schemes and if so, what measures it will use to determine this. The Committee asks to be copied into the response from the Scottish Government to the LGC Committee on this issue.

**Borrowing**

188. The Written Agreement between the Committee and the Scottish Government states that the Scottish Government—

> “will provide details of any planned borrowing under the Scotland Act powers as part of the Draft Budget publication. Details should include the amounts to be borrowed, and a commentary explaining the use of the powers.”

189. The SFC is responsible for assessing the reasonableness of the Scottish Government’s borrowing projections and stated—

> “The Commission judges that the Government’s projections of capital borrowing are reasonable, as they comply with the terms set out in the Fiscal Framework.”

**Capital Borrowing**

190. Table 24 below shows the Scottish Government’s historical and current capital borrowing plans, along with repayment schedules and cumulative stock of debt.

Table 24: Scottish Government capital borrowing

<table>
<thead>
<tr>
<th>£ m</th>
<th>2015-16 Outturn</th>
<th>2016-17 Outturn</th>
<th>2017-18 Plans</th>
<th>2018-19 Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowing</td>
<td>283</td>
<td>333</td>
<td>450</td>
<td>450</td>
</tr>
<tr>
<td>Repayment on 2015-16 borrowing</td>
<td>9</td>
<td>9</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Repayment on 2016-17 borrowing</td>
<td></td>
<td>11</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>Repayment on 2017-18 borrowing</td>
<td></td>
<td></td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Total Repayment</td>
<td>0</td>
<td>9</td>
<td>21</td>
<td>39</td>
</tr>
<tr>
<td>Debt Stock</td>
<td>283</td>
<td>607</td>
<td>1,036</td>
<td>1,448</td>
</tr>
</tbody>
</table>

xcix [http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Written_Agreement_Revised_April_2015.pdf](http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Written_Agreement_Revised_April_2015.pdf)


ci [http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf](http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf) (Table 5.2)
191. The Fiscal Framework increased the capital borrowing powers within the Scotland Act 2012 from an overall limit of £2.2 billion to £3 billion and an annualised limit of just over £300m to £450m which is 15% of the overall borrowing cap. The Draft Budget states that\textsuperscript{cii} —

“In order to maximise our commitment to investing in infrastructure, we will make use of the full £450 million available in 2018-19

192. The SFC is responsible for assessing the reasonableness of the Scottish Government’s borrowing projections and stated\textsuperscript{ciii}—

“The Commission judges that the Government’s projections of capital borrowing are reasonable, as they comply with the terms set out in the Fiscal Framework.

**European System of National and Regional Accounts (ESA 10)**

193. As a result of new European accounting guidance (European System of Accounts 2010 – ESA10), the budgeting treatment of NPD projects has changed. NPD projects are now deemed to be public sector projects and require upfront budget cover to be provided from the capital budget over the construction period of the asset. This compares with the budget treatment for private sector projects, where the costs are treated as revenue costs and are spread over the period (usually 25-30 years) over which the asset is used and maintained.

194. SPICe note that the Scottish Government has been able to adjust the design of smaller revenue-hub projects so that they can continue to be treated as private sector assets and financed through the revenue budget as before.\textsuperscript{civ}

195. The scoring of NPD schemes against the government’s borrowing limit does not mean that the Scottish Government borrowed in that year (and thus there will be no interest rate charges); but the full value of the capital project will score on the balance sheet, and count as part of the Scottish Government’s borrowing limit.

196. In total, as set out in evidence provided to the Public Audit Committee\textsuperscript{cv}, a combined capital spend of around £860 million to be delivered over the period to April 2018 is likely to be reclassified. The implication is that around £134 million of the £860 million remains to be ‘covered’ by capital borrowing in 2017/18 (representing £860m minus the £328m freed up from capital budgets in 2014/15 and 2015/16, minus the £398m scored against the Scottish Government’s borrowing limit in 2016/17).

\textsuperscript{cii} \url{http://www.gov.scot/Resource/0052/00529171.pdf} page 35
\textsuperscript{ciii} \url{http://www.fiscalcommission.scot/media/1196/scotlands-economic-fiscal-forecasts-publication.pdf} page 187
\textsuperscript{cv} \url{www.parliament.scot/S5_Public_Audit/2016_10_06_SG-PAPLS_MCP_Progress_Report_Sept_16.pdf}
197. The Economy, Jobs and Fair Work (EJFW) Committee points out that the “change in treatment means that affected NPD projects impact on the capital budget, thereby limiting the capital funds available for other projects.” The Cabinet Secretary for the Economy, Jobs and Fair Work explained to the EJFW Committee that this meant “more pressure on public sector borrowing” but the Scottish Government was “seeking to compensate for that by borrowing to the maximum”.\textsuperscript{cvi} Asked whether £234 million of the £450 million ceiling for borrowing was already on the balance sheet, Scottish Government officials told the EJFW Committee that they would clarify in writing.

198. The Cabinet Secretary for the Economy, Jobs and Fair Work added “it does not affect the infrastructure…it simply means that the projects will be paid for in a different way”.\textsuperscript{cvii} He also explained that —

“More worrying in relation to the Aberdeen western peripheral route and the M8 bundle…is the fact that both projects were heavily invested in by the European Investment Bank, which has now said that it will do no more business in the UK in advance of Brexit.”\textsuperscript{cviii}

199. The EFJW Committee concluded that —

“There is a degree of imprecision with the spending plans for infrastructure, given factors such as the impact of the European Investment Bank’s decision on UK projects, and the change in treatment of NPD-budgeted work. The Committee wishes to be updated as and when the picture becomes more defined.”

200. The Committee asks the Scottish Government to provide an update on the status of the reclassification of NPD schemes and the implications for the government’s borrowing capacity in 2017/18 and 2018/19.

Scotland Reserve

201. Under the rules of the Fiscal Framework, the Scottish Government can build up funds in the Scotland Reserve which can be drawn down as required. The government is able to build up reserves of £700m in aggregate. However the Reserve is separated between resource and capital. Payments into the resource reserve can be made from the resource budget (including tax receipts), and drawn down at a rate of up to £250m per year to fund resource or capital spending\textsuperscript{cix}. Payments into the capital reserve can be made from the capital budget and can be drawn down at a rate of up to £100m per year for capital spending only.

\textsuperscript{cvi} OR, 19 Dec, Col 30
\textsuperscript{cvii} OR, 19 Dec, Col 30
\textsuperscript{cviii} OR, 19 Dec, Col 30
\textsuperscript{cix} See paragraphs 71 to 78 of the Fiscal Framework
202. In our report on Draft Budget 2017-18 the Committee highlighted the need for greater transparency around the operation of the Scotland Reserve. Appropriate management of the Reserve will form a critical part of managing the forecast errors and general volatility associated with the new tax and social security powers.

203. Table 1 in Annex 1 of the 2018/19 Budget contains some information on the Scotland Reserve. It shows for example that the 2017/18 Budget was underpinned by anticipated underspend of £203m carried forward from the previous year, whilst the 2018/19 Budget is underpinned by anticipated underspend of £158m from the prior year.

204. The Budget Process Review Group recommended that additional information on the operation of the Scotland Reserve is provided both in the proposed Fiscal Framework outturn report and in the Budget document.

205. The Committee asks the Scottish Government to provide the following information in relation to Table 1 in Annex 1 of the Draft Budget document – a breakdown in terms of capital and resource and the current balance of the Scotland Reserve.

206. The Committee reiterates its view that there is a need for greater transparency around the balance of the Scotland Reserve. The Committee therefore welcomes the recommendations of the Budget Process Review that detailed information in relation to the operation of the Scotland Reserve should be provided in the annual Fiscal Framework Outturn report.

Long-Term Investment Commitments

207. Annual repayments resulting from revenue financed projects, such as NPD and hub (revenue) projects, come from the Scottish Government’s revenue budget. The Scottish Government has committed to spending no more than 5% of its total budget on repayments resulting from revenue financing (which includes NPD/hub, previous PPP contracts, RAB rail investment) and any repayments resulting from borrowing. Based on current plans, the Scottish Government estimates that it will spend around 3.9% of its total budget on such payments in 2018-19, rising to a peak of just under 4.3% in 2020-21. The Draft Budget does not contain details of the anticipated revenue financing costs of infrastructure projects in 2018-19.

208. The Committee’s report on the Draft Budget 2017-18 recommended that “Recognising that there will be commercial sensitivities in relation to individual deals, the Committee reiterates its view that the Scottish Government

http://www.scottish.parliament.uk/S5_Finance/Reports/FCCS052017R01.pdf
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.”

209. The Scottish Government responded that it 
“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.

210. The Committee notes that the Draft Budget does not contain details of the anticipated revenue financing costs of infrastructure projects in 2018-19.

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

PRIORITISATION

212. Prioritisation is defined as a coherent and justifiable division between sectors and programmes. The Committee recognises the need to scrutinise whether the Scottish Government’s spending decisions reflect the priorities and commitments it has set out in, for example, the programme for government.

213. The FAI in their 2017 report on Scotland’s Budget emphasise the need to consider changes “in the balance of and scale of public spending” and “how public services are delivered and prioritised.” They suggest that this “is not a challenge just for the Scottish Government but for all political parties in Scotland” and that “an open and transparent debate about the sustainability of the public finances – and the options for reform – is now essential.”

214. The FAI points out that a number of areas of expenditure such as health and policing are ‘protected’ which means that ‘non-protected’ areas “will shoulder a greater share of the burden.” However, they also point out that demographic

change and other cost pressures mean that in future the health resource budget will need to increase in real terms just to stand still. The FAI’s view is therefore that a “strategic look at the future long-term financial sustainability of Scotland’s public finances is therefore required.”

215. The Budget Process Review Group also emphasised the need for longer-term scrutiny of the public finances. The Group’s view is that the scope of the existing budget process is too narrow and there is little consideration of long-term trends. The Group, therefore, recommends that “scrutiny should have a long term outlook and focus more on prioritisation, addressing fiscal constraints and the impact of increasing demand for public services.” (page 4). To support effective long-term scrutiny the Group recommends the introduction of a Medium-Term Financial Strategy (MTFS) which will “provide a means of focusing on the longer-term sustainability of Scotland’s public finances.” (page 31).

216. The Committee recommended in its guidance to subject committees that they focus on prioritisation including—

- The extent to which public bodies have moved towards a priority-based budgeting approach;
- Whether spending priorities support outcomes;
- Whether current performance informs the choices about where to allocate resource; and
- The extent to which the NPF influences the budget-setting process of public bodies.

Public sector pay

217. The Scottish Government published its Public Sector Pay Policy for 2018-19 alongside the Draft Budget. The Scottish Government 2018-19 pay policy lifts the 1% pay cap that has been in place since 2013-14 (which itself followed a pay freeze in 2011-12 and 2012-13).

218. The main features of the 2018-19 pay policy are:

- a minimum 3 per cent increase for public sector workers who earn £30,000 or less
- a limit of 2 per cent on the increase in baseline paybill for those earning above £30,000 and below £80,000
- a limit of £1,600 on the pay increase for those earning £80,000 or more
- a continuation of the requirement for employers to pay staff the real Living Wage (currently £8.75 per hour)
- flexibility for employers to use up to 1 per cent of paybill savings on baseline salaries for limited non-consolidated payments to certain employees or to address equality issues.

219. The pay policy retains the features of previous pay policies in relation to:

- discretion for employers in relation to pay progression
- the suspension of non-consolidated performance related pay (bonuses)
- the commitment to no compulsory redundancies
- the expectation that there will be a 10% reduction in remuneration packages for new Chief Executive appointments.

220. The pay policy does not apply directly to all public sector staff. It only directly affects the pay of Scottish Government staff, and the staff of 44 public bodies, which together account for around 9% of the Scottish public sector (around 37,000 staff). Large parts of the public sector, such as local government and the NHS are not directly covered by the Scottish Government’s pay policy and pay is determined separately for these groups, although often in line with the Scottish Government’s pay policy and - in some cases - with some Ministerial control. The pay policy notes that:

“This policy also acts as a benchmark for all major public sector workforce groups across Scotland including NHS Scotland, fire-fighters and police officers, teachers and further education workers. For local government employees, pay and other employment matters are delegated to local authorities.”

221. The estimated costs of implementing the 2018-19 pay policy, compared with the cost of a 1% cap, is £20m for those groups directly affected by the Scottish Government's pay policy. Estimated costs for other groups are shown in Table 25. The Scottish Government has varying degrees of influence on the pay settlement and negotiations of NHS staff, police, firefighters, teachers and further education staff. For these groups, additional costs associated with the new pay policy are estimated to total £120m. The Scottish Government has no involvement in the pay negotiations of non-teacher local authority staff. For this group, the additional costs of implementing the same pay policy are estimated at £60m. If the pay policy was implemented across the whole Scottish public sector, then the additional costs over and above the cost of a 1% pay increase are estimated at £200m.
Table 25: Estimated additional costs of implementing the Scottish Government pay policy, 2018-19

<table>
<thead>
<tr>
<th>Influence of Scottish Government pay policy</th>
<th>Estimated total costs (£m)</th>
<th>Estimated additional costs compared to 1% increase (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core Scottish Government, NDPBs, Public Corporations, Departments and Agencies</td>
<td>Pay policy applies directly</td>
<td>40</td>
</tr>
<tr>
<td>NHS (Agenda for Change, Medical and Dental Staff and Senior Managers)</td>
<td>Pay award is aligned with public sector pay policy</td>
<td>170</td>
</tr>
<tr>
<td>Police Officers, Firefighters, Teachers and Further Education workers</td>
<td>Different levels of Ministerial control on matters relating to pay</td>
<td>90</td>
</tr>
<tr>
<td>Local government employees (except teachers)</td>
<td>Pay and other employment matters are delegated to local authorities</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total for all groups</strong></td>
<td></td>
<td><strong>400</strong></td>
</tr>
</tbody>
</table>

Source: SPiCe

222. These estimates relate to the cost of the pay policy alone and do not take account of any additional costs that might result from progression payments (whereby staff progress through set pay bands irrespective of the pay settlement). In addition, the estimates assume no change in the mix of staff and do not reflect any adjustments that employers might make in order to maintain pay differentials between staff.

223. The LGC Committee's view is that "the outcome of the Scottish Government's Public Sector Pay Policy creates an expectation as to what local government workers might achieve." The Scottish Government's pay policy states that it is to act as “a benchmark for all major public sector groups across Scotland.” The LGC Committee has asked the Scottish Government to provide details of how its public sector pay policy aspirations are taken into account in its decision on the local government revenue budget.
224. The Cabinet Secretary was asked by the Committee whether he had “set out a pay policy but not funded it?” He responded that he had “set out a pay policy for the Scottish Government that becomes the benchmark for the NHS.” He also explained that pay policy for local government is a matter for them to negotiate with the trade unions although the Scottish Government is involved in the negotiations for teachers pay.

Social Security

225. The Social Security Committee raised concerns with the Minister for Social Security about a 7% real terms cut to the Scottish Welfare Fund since 2013-14 and that the amount of funding allocated to local authorities may not meet demand in some geographical areas especially once Universal Credit is rolled out. They also raised concerns that the amount allocated to local authorities for Discretionary Housing Payments may be inadequate in areas with high rents, due to the benefit cap. The Minister responded that the amounts cannot be increased as they are set by the overall formula for local authority funding but that she is open to discuss the issue with COSLA.

Fuel Poverty

226. In the Committee’s report on Draft Budget 2017-18 we supported 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 Scottish Government responded that as part of the development of Scotland’s Energy Efficiency Programme they “would be considering a robust monitoring and evaluation framework to ensure the impact and outcomes of our investment can be captured.”

227. The EJFW state in their submission on Draft Budget 2018/19 that a recurring finding in their budget scrutiny has been the need to fully assess the scale of fuel poverty and that they have previously recommended a robust and up-to-date cost analysis. They recommend, therefore, that the Scottish Government include in the financial memorandum for the forthcoming Warm Homes Bill a fully costed assessment of what it will take to end fuel poverty. The Committee notes this recommendation and asks to be kept informed.

Local Government

228. During scrutiny of Draft Budget 2017-18, the LGC Committee noted the “different presentation and sets of numbers relating to the local government settlement.” We agreed with the LGC Committee “that greater transparency is required in relation to the local government draft budget”.

229. For Draft Budget 2018-19, the Scottish Government has made a number of changes to the way in which the local government information is presented in the budget documents and the local government finance circular. The Committee
welcome these improvements, which have assisted the clarity of the local government settlement.

230. The LGC Committee report notes that much of the debate on the local government settlement this year centred on whether Scottish Government funding commitments had been fully funded within the overall local government settlement. The LGC Committee is of the view that “where the Scottish Government requires local government to deliver new services or an additional level of an existing service then we consider those requirements should be identified and fully funded.”

231. On providing further transparency to the local government budget, the LGC Committee stated that the total General Revenue Grant budget line should separately identify funding commitments entered into by Government and Local Government from those resources which councils can spend at their discretion.

232. The Committee notes the recommendation of the Rural Economy and Connectivity Committee calling on the Scottish Government to “satisfactorily resolve” the issue of the fair funding principle for internal ferries in Orkney and Shetland “by the conclusion of the current consideration of the draft budget.”

233. The Committee welcomes the presentational changes made to the local government budget by the Scottish Government. These changes make the different local government figures much easier to follow.

Low Carbon Economy

234. The Committee asked the Cabinet Secretary whether the proposals for capital expenditure increase the spending on low-carbon infrastructure. He responded that he wants “further analysis to be done on low carbon” and that the budget “represents a transition to a low-carbon economy in respect of transport.” He also indicated that he is content to provide further information on the proportion of the capital spend that goes to low carbon. cxiv

235. The Committee welcomes the commitment of the Cabinet Secretary to provide further information on the proportion of capital spend that goes to low carbon.

cxiv Finance and Constitution Committee, 5 January 2018, OR Col. 47
VALUE FOR MONEY

236. Value for money is defined as the extent to which public bodies are spending their allocations well and achieving outcomes. Since 2007 the Scottish Government has adopted an outcomes-based approach to its objectives. A new emphasis was also placed on partnership working with public bodies which were now expected to work towards the shared objectives of government.

237. The whole of the public sector was invited to align their own objectives with the delivery of the Scottish Government’s Purpose and National Outcomes as set out in the NPF. The Scottish Government’s Purpose is to “focus government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth.” Sixteen national outcomes describe more fully what the Government wants to achieve over the next ten years. 55 national indicators allow progress to be tracked on the Scotland Performs website.

238. The Budget Process Review Group recommended that budget scrutiny should be more output and outcome focused and that it should be “evaluative with an emphasis on what budgets have achieved and aim to achieve over the long term, including scrutiny of equalities outcomes.” The Group’s view is that an “outcomes-based scrutiny approach provides a means for evaluating the economic and social outcomes being achieved by public spending.”

239. The Scottish Government published performance scorecards which are drawn from the Scotland Performs website to assist the scrutiny of Draft Budget 2018/19. Score cards are provided for each of the committees involved in scrutiny of the draft budget. The Budget Process Review Group makes a number of recommendations in relation to how the NPF can be developed and used more effectively to inform budget scrutiny.

240. The Group concluded that while the performance scorecards provide a basis for performance reporting and public and parliamentary scrutiny, they require further development. The Group recommend that the committees should work with the Scottish Government to develop this approach as a basis of strengthening parliamentary scrutiny of outcomes.

241. The Committee recommended to the subject committees in its guidance on the scrutiny of Draft Budget 2017/18 that in addition to prioritisation they also focus on value for money including—

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\(^{cxvi}\) http://www.parliament.scot/S5_Finance/General%20Documents/Convener_to_Convener_guidance_2016.30.06.pdf
• The extent to which public bodies are spending their allocations well and achieving outcomes;

• The extent to which an open and rigorous performance culture has been embedded within the public services;

• The extent to which the public services are using performance data to ensure value for money;

• The progress of public bodies in moving towards a more outcomes-based approach to public service management;

• The contribution which public bodies are making towards the NPF.

242. The ECCLR Committee “supports this shift in focus from annual changes to financial inputs, to focus on the difference spending makes.” They note, however, when using the NPF “as a baseline for assessing outcomes, it is not always clear how the performance of organisations is directly linked to the national outcomes they are associated with, particularly in complex, cross-cutting policy areas.” The ECCLR Committee was also concerned to hear that the Cabinet Secretary for Environment, Climate Change and Land Reform “did not think there is a direct relationship between the Budget and the performance indicators.” The ECCLR Committee’s view is that there “should be a strong link and would like to see a more quantifiable link” between the NPF “and the work of public bodies.”

243. The Health and Sport Committee have also raised concerns about the extent to which the new health and social care integration authorities (IAs) are succeeding in aligning budgets to outcomes despite a statutory duty to do so. The IAs are required to report annually on how their activities have contributed towards meeting nine statutory national health and wellbeing outcomes. The nine outcomes were introduced by the Public Bodies (Joint Working) (Scotland) Act 2014 and are also intended to underpin the delivery of the national outcomes in the NPF.

244. In November 2016 the Health and Sport Committee found that only one IA made any attempt to link their budgets to outcomes. In its pre-budget report published in November 2017 they found that IAs continue to struggle with aligning budgets to outcomes and that some IAs believe there is a need for direction from the Scottish Government to support delivery of this approach. They also noted that the Scottish Government is working with the Integration Authority Chief Finance Officer Network to develop a plan to link outcomes and budgets.

245. The view of the Health and Sport Committee is that while there are challenges in measuring the link between budgets and performance these are not insurmountable and that the Scottish Government needs to have confidence that its priorities are being met. As such, the Health and Sport Committee note that being unable to evaluate the performance of IAs in relation to the government’s priorities “cannot be desirable” and “must be resolved as a matter of priority.”
246. The Scottish Government stated in its response to the Health and Sport Committee that CIPFA has been commissioned to identify options for a methodology to facilitate outcomes budgeting reporting. The Scottish Government recognises that this is expected to be a challenge to existing financial reporting processes for Health Boards, Local Authorities and IAs.

247. The Equalities and Human Rights (EHR) Committee recommend a closer link to equality outcomes within the NPF. They, therefore, welcome the recommendation of the Budget Process Review Group that it should be clear how public spending on a particular policy or activity will contribute towards improving the national outcomes in the NPF including equalities outcomes.

248. The Scottish Women’s Budget Group “welcomes the significant commitments to embed analysis in the revised budget process” and notes that “it is imperative that parliamentary committees actively engage in equality analysis of outcomes.”

249. The Budget Process Review Group noted that public bodies and local authorities have an important role in delivering Scottish Government policy and contributing towards improved outcomes. The Group found that the performance material currently provided by public bodies requires further development to more effectively support public and parliamentary scrutiny. The Group recommended that effective annual performance reporting by public bodies should include –

- a balanced and objective account of performance;
- clearer reporting of spending against activities and services, rather than departments or organisations;
- information about trends and changes in spending over time (covering multiple years); and
- a narrative about what spending is achieving and how it is contributing to outcomes, supported by output measures and indicators.

250. The Cabinet Secretary was asked by the Committee whether he recognised that “a lot more progress needs to be made in terms of gender analysis in the construction of budgets” to which he responded that “he was happy to concede that point.”

251. The Cabinet Secretary was also asked whether more work needs to be done in linking the NPF to the Budget. He responded that the NPF “identifies where more work is required through a traffic light system, which Ministers and officials look at in coming to decisions.” He went on to say that “there is not necessarily a true relationship between performance figures and spending figures, because there is also the question of political choice” and the NPF “does not automatically lead to

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cxvii Finance and Constitution Committee, 15 January 2018, OR Col. 30
particular spending decisions.\textsuperscript{cxviii} The Cabinet Secretary also pointed out that the NPF is being reviewed on a cross-party basis.

252. The Committee notes the concerns of the ECCLR Committee that the Cabinet Secretary for Environment, Climate Change and Land Reform “did not think there is a direct relationship between the Budget and the performance indicators.” We welcome therefore that the Scottish Government has commissioned CIPFA to identify options for a methodology to facilitate outcomes budgeting reporting.

253. The Committee asks the Cabinet Secretary to provide further details on how outcomes inform the budget setting process including some specific examples.

254. The Committee recognises that delivering a more outcomes-based budget process will be challenging and require a cultural shift both within the Parliament and Government as well as Scotland’s public bodies and local authorities. The Committee, therefore, recommends that the Scottish Government works with Audit Scotland and other public bodies to identify how to improve performance reporting, including equality outcomes, which will support more effective parliamentary and public scrutiny and ultimately result in delivering better value for money.

255. The Committee welcomes the Cabinet Secretary’s recognition that more needs to be done in terms of gender analysis in the budget setting process and believes that the recommendations of the Budget Process Review Group in relation to equalities provide a useful way forward.

BUDGET PROCESSES

256. This scrutiny test is concerned with examining the integration between public service planning and performance and financial management. The previous Committee focused on the Scottish Government’s commitment to the transformation of the public services which is built on four pillars–

- Decisive shift towards prevention;
- Greater focus on ‘place’ to drive better partnership, collaboration and local delivery;
- Investing in people who deliver services;

\textsuperscript{cxviii} Finance and Constitution Committee, 15 January 2018, OR Col.40
• A more transparent public service culture which improves standards of performance.

A Decisive Shift to Prevention

257. The Written Agreement between the Scottish Government and the Finance Committee which was last revised in April 2015 states that—

“Both the Scottish Government and the Finance Committee recognise the need to move towards a greater emphasis on a preventative approach to public spending. The Finance Committee aims to ensure that the scrutiny of preventative spending is integral to the budget process and the Scottish Government agrees to include an overall assessment in the Draft Budget of the progress that is being made towards a more preventative approach.”

258. The Committee’s guidance to the subject committees recommended that they continue to scrutinise the extent to which public bodies have adopted a more preventative approach including—

• Evidence of disinvestment;

• The impact of the Change Funds

• Cultural change;

• Measurement and evaluation including interim targets and benchmarking;

• Joint-working and public sector collaboration;

• Engagement with the Third Sector;

• Innovation and the role of digital technology;

• The role of community planning.

259. The Health and Sport Committee’s strategic plan includes scrutinising policy issues in relation to their preventative focus. In their pre-budget report they state that “more needs to be done to quantify the financial and practical benefits of long-term investment in preventative healthcare.” They recommend that more details on “what level of funding is being allocated to preventative policies, and how this is being evaluated and its cost effectiveness assessed” should be provided in future budget documents. The ECCLR Committee recommend that the Scottish Government considers how the impact of cross-cutting expenditure can be

http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/Written_Agreement - Revised_April_2015.pdf

The three change funds were: the early years change fund; the reshaping care for older people change fund; and the reducing reoffending change fund.

http://www.scottish.parliament.uk/S5_Finance/General%20Documents/Convener_to_Convener_guidance_2016.30.06.pdf
assessed “particularly in considering preventative spend on outcomes that cross portfolios.

260. The Scottish Government provide a summary, in Annexe E of the draft budget, of some examples “of the ways in which our work embodies reform principles, in particular through preventative approaches.” However, little evidence is provided of the disinvestment, cultural change or joint-working and collaboration which Ministers have previously emphasised as being essential to delivering the decisive shift to prevention. It is also not clear what impact the change funds have had on delivering a more preventative approach.

261. The Committee asks the Scottish Government to provide an update on its view of the progress which has taken place in delivering the decisive shift to prevention across Scotland’s public bodies. The Committee also asks what evaluation has been carried out of the £500m change funds which it introduced to support the shift to prevention.

Climate Change

262. The Committee notes the view of the ECCLR Committee that the current budget process does not easily lend itself to the scrutiny of climate change expenditure and that the Scottish Government and the Scottish parliament need to take account of these concerns in the new Budget process.

263. The Budget Process Review Group noted that following the publication of the Climate Change Plan in early 2018, the Scottish Government will start to report on the Climate Change Plan monitoring and evaluation framework later that year. The Group stated that it “is not clear at this stage whether the annual reporting against the framework could form a useful additional element to the pre-legislative phase of the budget scrutiny process, but the Group believes that this should be considered by the Scottish Government as it develops its climate change reporting approach.”

264. The Committee may return to this issue.

SCOTTISH PARLIAMENTARY CORPORATE BODY

265. The Committee is required to consider the budget proposal from the Scottish Parliamentary Corporate Body (SPCB). The SPCB has a prior call on the Consolidated Fund, meaning that its budget is allocated before the Scottish

Government makes any other allocations. The SPCB budget provides for the costs of the Parliament and also the costs of the Ombudsman and Commissioners (termed ‘Officeholders’) which fall within the definition of SPCB supported bodies.

266. The SPCB budget\textsuperscript{cxxiii} was submitted to the Committee on 29 November 2017 and the Committee took oral evidence on it at its meeting on 7 December 2016\textsuperscript{cxxiv}. Following, the evidence session, the Chief Executive, Sir Paul Grice, provided a detailed breakdown\textsuperscript{cxxv} to the Committee of how an additional £1m in funding has been allocated within Scottish Public Service Ombudsman (SPSO) budgets in 2017-18 and 2018-19. These monies relate to new statutory functions taken on by the SPSO in relation to the Scottish Welfare Fund and social work complaints.

267. The SPCB identified a total budget requirement, including capital charges and non-cash items, of £102.3m for 2018-19. This represents an increase in cash terms of £4.7m, or 4.8%, compared to the budget of £97.6m for 2017-18. Excluding capital charges and non-cash items the SPCB 2018-19 budget submission for revenue and capital expenditure is £89.8m. This represents a £4.6m (5.4%) increase, in cash terms, than the approved 2017-18 budget and £2.5m (2.9%) higher than the indicative forecast for the 2018-19 SPCB budget provided to the Committee last year. The Presiding Officer, in a letter to the Committee\textsuperscript{cxxvi}, attributed this increase in the budget submission from last year’s indicative forecast as being the result of three factors. These were:

- One-off relocation costs of £1.75m arising from a co-location project for the SPSO and Commissioners;
- An increase in contingency funding of £0.5m to support the implementation of recommendations from the Commission for Parliamentary Reform; and
- Additional resource funding of £0.25m to support scrutiny demands arising from constitutional change and Brexit.

**Officeholders: Ombudsman and Commissioners**

268. The 2018-19 budget for Officeholders is proposed to increase from £9.6m in 2017-18 to £11.6m. This represents an increase, in cash terms, of £2m or 20.4%. As noted above, this proposed increase is largely accounted for by a one-off increase in contingency funding to support a co-location project for Officeholders. Jackson Carlaw MSP, from the Scottish Parliamentary Corporate Body, commented on the rationale for the project as follows—

\textsuperscript{cxxiii} http://www.parliament.scot/S5_Finance/Meeting%20Papers/Public_.pdf
\textsuperscript{cxxiv} Finance and Constitution Committee, 6 December 2017, OR http://www.parliament.scot/parliamentarybusiness/report.aspx?r=11246
\textsuperscript{cxxv} Correspondence from the Clerk / Chief Executive, SPCB Budget Submission for 2018-19
\textsuperscript{cxxvi} Correspondence from the Presiding Officer, SPCB Budget Submission 2018-19, p.2: Available at: http://www.parliament.scot/S5_Finance/Meeting%20Papers/Public_.pdf
“The SPSO has to move, so there would have been a cost associated with that, even if we had not looked to co-locate the office with other commissioners.

The commissioners are in accommodation with contracts of variable lengths, but there is an opportunity to see whether we can bring together three of them on to a single stand-alone site….

It is difficult to be precise about the saving that we will realise over the years ahead – we are looking at a number of premises, so the savings vary, and we are still negotiating – but, to be cautiously optimistic, we could save about half a million pounds in accommodation costs on an on-going basis over the next decade\textsuperscript{cxxvii}.

269. The Committee sought further information on the potential location of the new joint office. Michelle Hegarty, assistant chief executive, indicated that for “reasons of continuity of staffing, it would be desirable to look in Edinburgh in the first instance\textsuperscript{cxxviii}.

\begin{boxednote}
270. The Committee recognises that the SPCB has to balance obtaining property that is both value for money and fit for purpose and that locations outwith Edinburgh may incur additional expense due to staff turnover as a result of relocation. However, the Committee considers that locations outwith Edinburgh which are within commuting distance should also be considered.
\end{boxednote}

271. In addition, the Committee sought to ascertain the extent to which the trade union recognised by Officeholders, the Public and Commercial Services Union (PCS), had been consulted with regard to the co-location project and the equality considerations which may arise as a consequence of the project. The Chief Executive noted that engagement should take place between the employers and the relevant trade union. As the relevant employer, in this instance, was the Officeholders and not the SPCB it would be for the Officeholders to engage directly with PCS. He went on to observe that—

“The corporate body will have to judge the effectiveness of the proposals, and we will consider the extent to which the commissioners have engaged with their staff and unions. I am keen not to cross the line into telling the employers how to engage with their staff; that is a matter for them. However, I think there will be a positive process\textsuperscript{cxxix}.

\begin{thebibliography}{9}
\bibitem{cxxvii} Finance and Constitution Committee, 6 December 2017, Official Report, Col. 5.
\bibitem{cxxviii} Ibid, Col. 6.
\bibitem{cxxix} Ibid, Col. 9.
\end{thebibliography}
272. The Committee, in its report on the 2017-18 Draft Budget, suggested that the SPCB “may wish to consider undertaking a review of SPCB supported officeholders”\textsuperscript{cxxx}. In evidence to the Committee, Jackson Carlaw MSP noted that the SPCB had not undertaken such a review but that if the Committee “was again to suggest to us that it felt that that was something we should do, we would certainly consider doing it”\textsuperscript{cxxxi}.

273. The Committee reiterates that the SPCB should carry out a review of SPCB Officeholders.

Scottish Parliament

274. The SPCB budget proposal contains two further areas accounting for the proposed increase in the budget proposal which are directly linked to the workload of the Scottish Parliament. These are, as noted above, the implementation of recommendations from the Commission on Parliamentary Reform and increased demand arising from constitutional change and Brexit. In relation to the proposed allocation of £0.5m in contingency funding to support parliamentary reform, Jackson Carlaw MSP commented—

“Against the backdrop of additional work for the Parliament, there is also broad cross-party support for reform, and the corporate body is set to consider the resources that are required to implement recommendations in that regard. Many have no cost implication at all, but some do, and we are proposing an additional £500,000 for contingency at this stage to enable the flexibility to progress that work”\textsuperscript{cxxxii}.

275. In relation to increased demand arising from constitutional change and Brexit, the SPCB Budget proposal would provide for the creation of 13 new ‘operational posts’ to meet scrutiny demands in this area. The Chief Executive stressed that the SPCB was keen to take a flexible approach to meet increased scrutiny demands. He commented that—

“We do not exactly know what the scrutiny load will be, particularly around constitutional change, as well as the new powers that are coming on line, which must not be forgotten, such as social security. When we see how it pans out, we may flex that, but that breakdown is our starting point. If we need to flex it through the year – because, for example, we need more researchers or fewer lawyers – we will do that. However, that is our starting assumption with those 13 posts”\textsuperscript{cxxxiii}.

\textsuperscript{cxxxi} Ibid, Col. 4.
\textsuperscript{cxxxii} Ibid, Col. 12.
\textsuperscript{cxxxiii} Ibid, Col.13.
276. The budget proposal also provides for the establishment of six public engagement posts and a further seven posts to meet increased demand being experienced for parliamentary support and services more generally.

277. The Equality and Human Rights Committee would be interested to learn how the SPCB’s budget including the request for additional staffing gave due regard to the Public Sector Equality Duty, and the 'three needs' which are associated with the Duty.

278. The Committee notes that the powers of the Scottish Parliament have substantially increased and will further increase following Brexit. The Committee further notes that the operation of many of these powers is increasingly complex, for example, the way in which the Fiscal Framework works. The Committee, therefore, recommends that the main priority for any additional posts should be to ensure that the Scottish Parliament can fulfil its scrutiny role in relation to constitutional change and Brexit and welcomes the approach the SPCB is taking in keeping demand in these areas under review.

279. The Committee recommends that the SPCB respond, initially in writing, to the Equality and Human Rights Committee regarding “the three needs” under the Public Sector Equality Duty.

AUDIT SCOTLAND

280. Audit Scotland is required to prepare, for each financial year, proposals for its use of resources and expenditure. It is the responsibility of the Scottish Commission for Public Audit (SCPA) to examine these proposals and report on them to Parliament.

281. Audit Scotland submitted its budget proposal for 2018-19 and its associated fee strategy on 12 December 2017\(^{\text{cxxxiv}}\). The SCPA took evidence from Audit Scotland on 20 December 2016\(^{\text{cxxxv}}\).

282. Audit Scotland’s budget proposal for 2018-19 is based on a total expenditure requirement of £24,356K for 2018-19. This represents an increase of £837K (3.6%) in cash terms from the approved 2017-18 budget of £23,519K albeit lower than the 2016-17 budget of £24,579K. The budget proposal seeks parliamentary approval for funding of £7,148K. This represents an increase of £617K (9.4%) in cash terms from the 2017-18 budget. Audit Scotland summarised the rationale for this proposed increase, in the following terms—


“The new financial powers demands and the biennial National Fraud Initiative exercise are principal factors in the Total Resource Requirement for 2018-19 increasing by £617K from the approved requirement in 2017-18”\(^{cxxxvi}\).

283. The Audit Scotland budget proposal is underpinned by three main assumptions. These are:

- The creation of eight new posts to deal with audit work arising from the devolution of new financial powers and constitutional change;
- An increase in the Audit Scotland pay bill of 2% (1% on pay scales and 1% pay progression); and
- An increase in pension scheme employer contributions of 0.5%.

284. The SCPA considered that the devolution of further powers will necessarily result in an additional workload for Audit Scotland and concluded that—

“...The Commission considers that the additional resources sought in the 2018-19 Budget Proposal are commensurate with the scale of that additional workload”\(^{cxxxvii}\).

285. Overall, the SCPA recommended that Audit Scotland’s budget proposal for 2018-19 be approved.

286. The Committee notes the report from the Scottish Commission for Public Audit.

\(^{cxxxvi}\) Audit Scotland, Budget Proposal 2018-19, p.2.
CONCLUSION

287. The Committee noted in our report on Draft Budget 2017-18 that there is now likely to be a much greater degree of volatility and uncertainty in relation to Scotland’s public finances. The Scottish budget is also more directly dependent on the performance of the Scottish economy relative to the performance of the UK economy. The Committee notes that while per capita GDP growth in Scotland has largely tracked the UK since 1999 a gap has begun to appear over the past two and a half years which shows lower growth in Scotland. Compared to the OBR’s forecast for the UK, the SFC’s forecast implies that Scottish GDP per capita will continue to grow slightly more slowly in Scotland in coming years. Despite this, the SFC’s forecasts imply that growth in Scottish income tax revenues will exceed the growth of the block grant adjustment for income tax. The net impact on the Scottish Government’s Budget arising from differential per capita economic growth is therefore forecast to be minimal.

288. However, these are only forecasts and there is a risk to the public finances if there is significant forecast error. In particular, if income tax revenues per capita do not grow as strongly in Scotland as in the rest of the UK. On the other hand there may also be some benefit to the public finances if the SFC forecasts prove to be overly pessimistic. The Committee emphasises that it is therefore essential that tax revenues are monitored closely by the Scottish Government and, as recommended by the Budget Process Review Group, that HMRC publishes monthly outturn data for Scottish Income tax as soon as practicable to do so.

289. This information will be vital in providing a sufficient level of transparency to ensure public confidence in the operation of the new financial powers and the Fiscal Framework. The Committee also welcomes the recommendations of the Budget Process Review Group which provide a platform for more effective scrutiny of an increasingly complex Budget. In particular, the information provided in the proposed Fiscal Framework Outturn report will be essential in providing a better understanding of changes to the Budget arising from the complex interaction of adjustments to the block grant and actual tax revenues in Scotland.
Annexe A: Reports from other Committees and the Scottish Commission for Public Audit

- Culture, Tourism, Europe and External Relations Committee
- Economy, Jobs and Fair Work Committee
- Education and Skills Committee
- Environment, Climate Change and Land Reform Committee
- Equalities and Human Rights Committee
- Equalities and Human Rights Committee follow up letter
- Health and Sport Committee
- Justice Committee
- Local Government and Communities Committee
- Rural Economy and Connectivity Committee
- Scottish Commission for Public Audit
- Social Security Committee
Annexe B: Letter from Cabinet Secretary for Finance and the Constitution dated 15 January 2018

Bruce Crawford MSP Convener
Finance and Constitution Committee
The Scottish Parliament
Edinburgh
EH99 1SP

19 January 2018

Dear Bruce

At the Finance and Constitution Committee evidence session on the Draft Budget on 15 January, I agreed to write to the Committee to clarify the following matters raised by Adam Tomkins MSP, Alexander Burnett MSP and Patrick Harvie MSP.

Mr Tomkins asked about the £75 million allocated to the Fairer Scotland, Equalities and Third Sector budgets. These increased budgets demonstrate the value Ministers place on creating a fairer Scotland by tackling prejudice and discrimination and supporting a more equal and inclusive society where human rights are central. The increase of around £24 million in 2018-19 enhances our work on tackling inequality including £13.8 million to provide access to sanitary products; £2.5 million towards tackling child poverty; £0.5 million for a range of advice and advocacy services; £0.5 million towards the problem of food poverty; £0.6 million to support the implementation of the British Sign Language (Scotland) Act 2015; and £0.5 million to establish a Social Isolation and Loneliness Strategy and Fund. The balance of the increase is made up of a range of smaller budget allocations to support other key policy commitments.

As with all Scottish budgets we will ensure that our public funding investment is strongly aligned and delivers the best possible outcomes.

Mr Burnett asked for additional information on the repayment associated with Financial Transactions. As discussed at the meeting, the profile for repaying Financial Transaction capital to the Scottish Government differs depending on the individual programme being supported. This only emerges over the course of the financial year as arrangements for each agreement are finalised. A schedule is then collated covering all the arrangements and the profile for repayment from Scottish Government to HM Treasury is agreed. There is scope within the HM Treasury arrangements for some recycling of Financial Transaction capital within Scottish Government. I attach the schedule detailing the latest repayment profile (up to 2016-17) agreed with HM Treasury (at Annex A) in July 2017. This will be updated with the final profile for 2017-18 over the summer.
Finally, Mr Harvie asked for further information on the Infrastructure Investment programme and specifically about the proportion of that investment that is spent on low carbon.

The Scottish Government currently publishes four periodic reports (one annual report and three 6 monthly reports) setting out progress with the range of projects and programmes set out in the 2015 Infrastructure Investment Plan (IIP). The three six-monthly IIP updates also form the basis of the information contained within the Major Capital Projects Progress Update Report to the Public Audit and Post-legislative Scrutiny Committee twice a year. The report also includes a link to the annual IIP – Progress Report, further information about hub investment projects and any other additional information as is relevant.

Annex B to this letter sets out additional information on the carbon impact of the Infrastructure Programme.

I hope this assists the Committee.

DEREK MACKAY
Annex A - Financial Transactions – Annual Scottish Government return to HM Treasury

July 2017

Purpose

The Statement of funding policy section 5.11 sets out the annual return requirements to HM Treasury relating to Financial Transaction (FT) allocations. This report sets out the Scottish Government’s return for the year ended 31 March 2017.

Details of FT schemes to the end of 2016-17

FTs received by the Scottish Government in UK Budgets and Autumn Statements covering 2012-13 to 2016-17 total £1.364 billion (Annex A).

The Scottish Government has disbursed a total of £1.316 billion in FTs, including £606.4 million in the year to 31 March 2017 (Annex B). Repayments received total £253 million (Annex C), of which £251 million were received in the year 2016-17. The majority of these repayments are being recycled.

With the exception of repayments that have been consolidated in baselines, no repayments have been made to HM Treasury, in line with the repayment profile previously submitted on 14 July 2014. The FT budget exchange carry over is therefore £52.7 million per our provisional outturn submission of 22 June 2017.

Forward allocation profile

The Scottish Government received £289 million in FTs for 2017-18 and these have been included in allocations in our Draft Budget 2017-18 (Annex D).

The budget exchange carry over mentioned above will be allocated during the year as determined by the Scottish Ministers.

Forecast repayment profile

Our repayment profile, as agreed, incorporates the condition of 60% repayment by 2019-20 that was attached to the first tranche of FTs. £51 million is expected to be repaid by March 2020. For the financial year 2020-21 onwards we anticipate a fairly even re-payment pattern based on at least an 80% repayment rate which reflects known and anticipated repayments.

As set out in previous returns, the majority of FTs to date have been allocated mainly to support housing and regeneration schemes over the medium to long-term. There have also been short-term allocations to support Farmers which, in general, are repaid the following financial year and made available for re-cycling. In terms of ultimate repayment to HM Treasury, we have modelled the expected level and timing of repayments to ensure the overall repayment to HM Treasury can be made, as previously agreed.
In many instances, however, timing of future repayments and the amount and timing of recovery are out-with our control and cannot be guaranteed.

This is because significant sums are bound up in shared equity schemes for individual households, such as Help to Buy, where the scheme in Scotland differs from that in England, and for which a reliable prediction of future repayments cannot therefore be determined at this stage.

**Flexibility**

The repayment profile (Annex E) remains indicative and, as previously agreed, will continue to be refined and updated.

We continue to monitor and update our repayment profile in line with the broad principles that repayments should be based on the forecast receipts, and on the basis that the devolved Scottish Budget should not be adjusted on an annual basis in a way that reduces the total level of resource that is subject to the approval of Scottish Ministers and the Scottish Parliament.

Scottish Government Finance
31 July 2017
Annex A

Consequential received

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</tr>
<tr>
<td>Budget 2012</td>
<td>9.3</td>
<td>5.7</td>
<td>-1.5</td>
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<tr>
<td>Autumn Statement 2012</td>
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<td></td>
<td></td>
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<tr>
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<tr>
<td>UK Spending review 2016</td>
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<td></td>
<td></td>
<td>326.6</td>
<td>286.7</td>
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<tr>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td>2.0</td>
</tr>
<tr>
<td>Total consequential</td>
<td>35.3</td>
<td>174.7</td>
<td>187.2</td>
<td>385.0</td>
<td>328.6</td>
<td>288.8</td>
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<tr>
<td>Cumulative Total</td>
<td>35.3</td>
<td>174.7</td>
<td>361.9</td>
<td>746.8</td>
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<td>1,364.2</td>
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Annex B

Disbursed

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<tr>
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<th>2012/13</th>
<th>2013/14</th>
<th>2014/15</th>
<th>2015-16</th>
<th>2016-17</th>
<th>TOTAL</th>
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<tr>
<td>Help to Buy</td>
<td>32.9</td>
<td>144.1</td>
<td>136.7</td>
<td>64.1</td>
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<td>45.7</td>
<td>42.5</td>
<td>59.8</td>
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<td>2.0</td>
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<td>32.3</td>
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<tr>
<td>Other Housing and Regeneration</td>
<td>3.8</td>
<td>18.0</td>
<td>7.1</td>
<td>12.8</td>
<td>49.8</td>
<td>91.5</td>
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<td>Enterprise Investment</td>
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<td>54.8</td>
<td>-</td>
<td>-</td>
<td>56.3</td>
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<tr>
<td>Carbon reduction and energy efficiency schemes</td>
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<td>2.2</td>
<td>3.4</td>
<td>6.1</td>
<td>11.0</td>
<td>24.8</td>
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<tr>
<td>Hub Investments</td>
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<td>5.4</td>
<td>2.3</td>
<td>11.7</td>
<td></td>
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<tr>
<td>Rural loans</td>
<td>53.6</td>
<td>370.2</td>
<td>423.8</td>
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<tr>
<td>Culture loans</td>
<td>6.0</td>
<td>4.0</td>
<td>10.0</td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td>35.3</td>
<td>108.8</td>
<td>204.6</td>
<td>360.9</td>
<td>606.4</td>
<td>1,316.0</td>
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</table>

Annex C

Repayments

<table>
<thead>
<tr>
<th></th>
<th>2016-17</th>
<th>Total to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Help to Buy</td>
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<td>8</td>
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<tr>
<td>Shared Equity</td>
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<tr>
<td>Housing Infrastructure</td>
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<tr>
<td>TOTAL HRW</td>
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<td>14</td>
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<td>Other Portfolios:</td>
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<tr>
<td>Rural</td>
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<td>239</td>
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<tr>
<td>Culture</td>
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<td>0</td>
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<tr>
<td>Total</td>
<td>251</td>
<td>254</td>
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Annex D

<table>
<thead>
<tr>
<th></th>
<th>2016-17</th>
<th>2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
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<tr>
<td>Education and Learning</td>
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<td>14.0</td>
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<tr>
<td>Economy, Jobs and Fair Work</td>
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<td>14.0</td>
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<td>Communities, Social Security and Equalities</td>
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<td>259.5</td>
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<tr>
<td>Culture, Tourism and External Affairs</td>
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<tr>
<td>Rural Economy and Connectivity</td>
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<tr>
<td>Total - Draft Budget</td>
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Annex D

### Repayment Profile at 31 March 2017

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<th>£m</th>
<th>%</th>
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<td>48</td>
<td>6%</td>
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<tr>
<td>2025-26</td>
<td>88</td>
<td>11%</td>
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<tr>
<td>2026-27</td>
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<td>13%</td>
</tr>
<tr>
<td>2027-28</td>
<td>71</td>
<td>9%</td>
</tr>
<tr>
<td>2028-29</td>
<td>56</td>
<td>7%</td>
</tr>
<tr>
<td>2029-30</td>
<td>24</td>
<td>3%</td>
</tr>
<tr>
<td>2030-31</td>
<td>28</td>
<td>4%</td>
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<td>2031-32</td>
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<td>2038-39</td>
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<td>3%</td>
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<tr>
<td>2044-45</td>
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<td>0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>812</td>
<td>100%</td>
</tr>
</tbody>
</table>
Annex B - Carbon Assessment - Infrastructure

The Case for Low Carbon Infrastructure in Scotland concluded that the Scottish Government is already achieving on increasing low carbon activities but should aim to increase its low carbon infrastructure focus as a proportion of total infrastructure spend by at least 20% to over 70%. The estimate provided in the report was that ~ 52% of total capital spending in Scotland is on low carbon focused projects. The Scottish Government welcomed the report but acknowledges that the simple analysis carried out for the report is uncertain beyond the short term, and that it is dependent on overall funding, borrowing powers and the balance between capital and revenue budgets.

The 52% related to an analysis of the 2011 Infrastructure Investment Plan (which covers a 20 year period and includes other investment beyond that which the Scottish Government makes – e.g. the £6 billion of grid upgrades for electricity transmission by the private sector) and therefore it is not a comparable approach to compare this with the Scottish Government’s planned investment for a single year.

It should also be recognised that the Infrastructure Investment plan sets out a point in time picture of planned investment over the next 20 years, and is not dynamic and evolving as time moves forward. As an example, we have this year committed to additional expenditure on low emission zones and electric vehicles as part of the PfG that are not covered by either the 2011 or 2015 IIP.

The Scottish Government has undertaken some initial analysis to look at planned spend on infrastructure in individual years using broadly the same categorisation as the Taskforce’s report to see whether our level/percentage of investment in low carbon has been increasing year on year. This approach allows us to take account of new commitments or developments in our overall assessment and would suggest looking at our level of low carbon investment on an annual basis to ascertain whether or not it has increased.

In undertaking this assessment we have categorised all the planned infrastructure investment in 2017-18 and current capital spend plans for 2018-19 against the Taskforce categories, and then removed local government capital spending from the figures as we cannot say how exactly that is spent at local level.

<table>
<thead>
<tr>
<th>% of SG Infrastructure Spend that is:</th>
<th>Low Carbon</th>
<th>Carbon Neutral</th>
<th>High Carbon</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017-18</td>
<td>21</td>
<td>56</td>
<td>23</td>
</tr>
<tr>
<td>2018-19</td>
<td>29</td>
<td>59</td>
<td>12</td>
</tr>
</tbody>
</table>

- This initial high level analysis shows that on the basis of current planned capital spend there is a broadly positive expectation that our level of spend on low carbon will be higher in 2018-19 than it is in 2017-18.

- The percentage of low carbon expenditure increases from 21% to 29% and when you take a combination of low carbon and carbon neutral spend (based on current figures), we see that between 77% and 88% of our infrastructure spend will either have a neutral or positive carbon impact in 2017-18 and 2018-19.
Annex C - What level of detailed information is publicly available on the capital pipeline as it stands?

**Infrastructure Investment Plan Reporting**

The Scottish Government has a commitment to publishing the following four periodic reports on the progress of projects and programmes relating to the Infrastructure Investment Plan (IIP) which was published in December 2015.


**IIP – Progress Report**

An annual report which outlines the sector by sector key achievements over the course of the previous year and which looks forward to developments in the next and beyond.


**IIP – Major Capital Projects Progress Update**

A six-monthly report which provides a narrative on the progress of projects with a capital value of £20 million or more which are at the Outline Business Case approved stage or beyond. It also includes school projects in construction with a capital value of £20 million or more which are being delivered by Scotland’s Schools for the Future Programme as well as those health projects in construction with a capital value of £20 million or more which are being delivered by the Scotland-wide ‘hub’ initiative and which form part of the Scottish Government's current revenue funded NPD/hub investment programme. The report also includes information on the contribution that each project is making towards local economic development.


**IIP – Project Pipeline Update**

A six-monthly report which provides delivery information relating to projects with a capital value of £20 million or more where Scottish Government has a lead role in procurement or funding. It also includes school projects which are being delivered through the Scotland’s Schools for the Future Programme and those health projects being taken forward through the Scotland-wide ‘hub’ initiative which form part of the Scottish Government's revenue funded NPD/hub investment programme.
