Scotland’s Fiscal Framework: Block Grant Adjustments

Briefing paper from the Scottish Government

7 December 2021

What are Block Grant Adjustments (BGAs)?

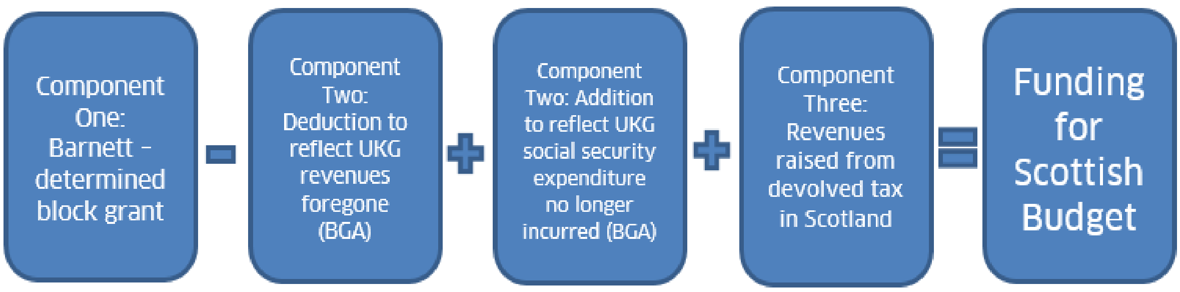
1. The Scotland Act 2012 and the Scotland Act 2016 devolved a number of significant new tax and social security powers to Scotland. This required major changes to the process of calculating Scotland’s annual Block Grant, described in a new Fiscal Framework, agreed by the Scottish and UK governments in February 2016, underpinned by the Smith Commission principles.

2. While the Barnett formula continues to determine the initial size of Scotland’s Block Grant, the Fiscal Framework describes how the Block Grant should be adjusted to take account of tax and social security devolution. These funding changes are called Block Grant Adjustments (BGAs).

3. Tax BGAs **remove funding** from the Block Grant as the Scottish Government is now retaining tax revenues that would have flowed to the UK Government. Social security BGAs **add funding** because the Scottish Government has become responsible for making social security payments that were previously made by the UK Government.

4. The Scottish Government has greater funding available where its devolved tax revenues exceed the corresponding Block Grant Adjustment (or where its social security expenditure is less than the corresponding Block Grant Adjustment).

5. Together, the Barnett-determined block grant, the deduction of the tax BGAs, the addition of the social security BGAs and revenues raised from devolved taxes, compose the funding for the Scottish budget[1].



[1] Non-Domestic Rates also form part of the funding arrangements, together with other revenue raising powers (including fees, charges and sales of goods, services and assets), and borrowing.

How are BGAs calculated?

6. Each BGA involves two steps: (i) an initial baseline value is established based on revenues/spending in Scotland in the year prior to devolution, and (ii) this value is then subject to annual indexation reflecting the growth in the corresponding UK tax revenue/spending.

7. Both governments agreed that the initial baseline value for the BGAs would be the level of tax revenues or social security spending in Scotland in the year prior to devolution (the "baseline" year), calculated separately for each tax or benefit. For example, in 2016-17, the baseline year for devolved Non-Saving Non-Dividend Income Tax, Scotland raised £10.7 billion. Consequently, that is the baseline revenue figure against which the 2017-18 Income Tax BGA (and future Income Tax BGAs) is indexed.

8. The baseline BGA is then updated annually using an indexation mechanism. The Governments agreed to apply two indexation mechanisms to track the growth in UK Government tax receipts – **the Comparable Model (CM)** and the **Indexed Per Capita (IPC) method.**

9. The current Fiscal Framework states that the indexation mechanism will be based on the Comparable Model (CM), but then reconciled to the Indexed Per Capita (IPC) method. In practice, it is therefore the IPC method which determines the BGAs until the Fiscal Framework is reviewed.

10. The implications of using the different indexation methods are considered in detail later in the paper. Using IPC, the Scottish Government's preferred method, means that if corresponding UK Government tax revenues per head grow at the same rate as Scotland's, the Scottish Budget will be no better or worse off than before devolution.

11. Both the revenue being added to the Scottish Government's Budget and the figures being deducted through the BGA are based on forecasts at the time the Budget is set. Since 2018-19, the Scottish Government has used the Scottish Fiscal Commission's forecasts for tax revenues and social security spending. To calculate the BGAs, HM Treasury uses the forecasts of the Office for Budget Responsibility (OBR).

12. As revenue and BGAs are based on forecasts, these figures need to be 'reconciled' once outturn data for tax revenues and spending on devolved social security benefits are available. Further details on the reconciliation processes can be found in the Fiscal Framework Technical Note.[2]

Issues to be considered in the Fiscal Framework Review

13. The Smith Commission's report recommended that, once agreed, the Fiscal Framework should be reviewed periodically to ensure arrangements "continue to be seen as fair, transparent, and effective."

[2] Fiscal framework technical note: September 2021 - gov.scot (www.gov.scot)

14. Both governments agreed that a review would take place after a Parliament's worth of experience, and that the Smith Commission principles should inform the Review. In particular, the method for adjusting the Block Grant must be agreed in that review, and no default method will be assumed.

15. Some of the key Smith principles[3] relevant to a review of the BGA arrangements are summarised below:

- The Scottish Government should have ***economic responsibility*** for its policy decisions. This means that the Scottish Budget should benefit in full from the policy decisions of the Scottish Government that increase revenues or decrease expenditure and bear the full cost of policy decisions which lower revenues or increase expenditure.

- There should be ***no detriment*** to the Scottish Budget simply from the initial decision to devolve further powers. Specifically, the Scottish or UK budgets should be no larger or smaller simply as a result of the initial transfer of the tax or social security power before deciding how these are used. The initial deduction/addition to the block grant should also be "*indexed appropriately*" according to the Smith report. However, it did not provide detailed recommendations on the mechanics of this indexation. This principle is sometimes referred to as the ***first no detriment principle***.

- Changes to tax rates in Scotland should only affect public spending in Scotland. Changes in tax rates (that have been devolved) in the rUK should only affect public spending the in the rUK. This is the *principle of* ***taxpayer fairness*** and sometimes referred to as the ***second no detriment principle***.

- The underlying Scottish Block Grant should continue to be adjusted via the ***Barnett Formula*****.**

- The resulting framework should be implementable and ***sustainable.***

16. During the original Fiscal Framework negotiations, both governments agreed on the method for setting the initial level ("the baseline value") of each BGA. However, there were significant differences in opinion with regards to how the BGAs should be adjusted over time ("indexed appropriately") taking into consideration the various Smith principles.

17. While several different methods were considered, the debate ultimately centred on whether to use the IPC or CM mechanisms. Under the IPC mechanism, the Scottish Budget is protected from slower overall population growth in Scotland relative to the rUK – although not from changes in the composition of the population (for example, a reduction in the proportion of the population at working age would still be likely to reduce growth in tax revenues relative to the UK).

[3] Fiscal framework: agreement between the Scottish and UK Governments - gov.scot (www.gov.scot)

18. The Scottish Government's view was that this mechanism better met the first no detriment principle. Specifically, the Scottish Government argued that it does not have the policy levers to manage the historically lower population growth rate in Scotland, as many key levers, including migration policy, remain reserved to the UK Government. Therefore, the IPC BGA should be used as this fully protects the Scottish Budget from that risk.

19. Conversely, the CM mechanism does not fully offset that population growth risk, meaning that, even if tax per head and expenditure per head were to grow at the same rate in Scotland as in rUK, a slower growing population in Scotland relative to the rUK would lead to a negative impact on the Scottish Budget over a relatively short period of time, contravening the first no detriment principle.

20. To give an example, using official outturn data and population data, in 2019-20, the Scottish Budget would have been around £80 million worse off using the CM mechanism for Income Tax compared to IPC. This difference reflects the fact that Scottish Population growth was slower than in the rUK across this time period and, were that to continue, the gap between the CM and IPC BGAs would continue to grow.

21. The UK Government's argument in favour of CM (and against IPC) was that it better met the "taxpayer fairness" or second no detriment principle. The argument against the IPC mechanism is that it contravenes the 'taxpayer fairness' principle, as it does not operate symmetrically with the Barnett formula (which determines the block grant). This means that there is a risk of tax increases in rUK feeding through to the Scottish Budget via the Barnett Formula from increased spending in rUK and contravening the second no detriment principle.

22. However, academics and stakeholders such as the Institute for Fiscal Studies (IFS) have highlighted that the Smith Principles are mutually exclusive: *" no single method of calculating the BGAs can satisfy all of the (Smith) principles"* [4]

23. As noted, the Fiscal Framework makes no assumption about which BGA indexation method would be used beyond this transitional period but instead details that the arrangements would be evaluated after a Parliament's worth of experience; that the two governments must agree the prospective BGA mechanism as part of the review process and any mechanism must deliver results consistent with the Smith Commission Principles.

24. Both governments will therefore need to revisit the discussion of how to interpret the Smith Commission principles in order to agree an appropriate BGA mechanism for future years, drawing on the experience of operating the BGA arrangements to date.

25. Aside from reviewing the arguments already covered above, the Scottish Government has also set out some further issues that should be considered as part of the BGA arrangements, including the treatment of demographic risks, economic risks and tax base distributional risks. These issues are covered in the joint report

[4] wp201605.pdf (ifs.org.uk), p.5

with the Scottish Parliament's Finance and Constitution and Social Security Committees[5] and the Scottish Government's Medium-Term Financial Strategy published in January 2021.[6]

Further reading:

- Fiscal framework technical note: September 2021 - gov.scot (www.gov.scot)

- Essentials_of_the_Fiscal_Framework_David_Eiser.pdf (parliament.scot) – with a useful description of the IPC versus CM methods.

- The Fiscal Framework (nrscotland.gov.uk) – Spice briefing note on the framework overall, with useful material on the BGAs

- Adjusting Scotland's block grant – the options on the table - Institute For Fiscal Studies - IFS – This provides a useful overview as to how the options developed over time, including the initial proposition of the Levels Deduction method.

- Scotland's fiscal framework: assessing the agreement - Institute For Fiscal Studies - IFS – A Detailed analysis of the final agreement, with a useful chart – Figure 4.1 comparing Levels deduction, Comparable method and IPC methods.

[5] Report(2).pdf (parliament.scot)
[6] Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy - gov.scot (www.gov.scot)