FINANCE COMMITTEE

AGENDA

2nd Meeting, 2016 (Session 4)

Wednesday 13 January 2016

The Committee will meet at 9.30 am in the Sir Alexander Fleming Room (CR3).

1. UK Spending Review: The Committee will take evidence from—

   Paul Johnson, Director, Institute for Fiscal Studies.

2. Draft Budget 2016-17 (Revenue): The Committee will take evidence from—

   John Swinney, Cabinet Secretary for Finance, Constitution and Economy, Sean Neill, Acting Deputy Director of Finance, and Graham Owenson, Head of Local Government Finance and Local Taxation Unit, Scottish Government.

James Johnston
Clerk to the Finance Committee
Room T3.60
The Scottish Parliament
Edinburgh
Tel: 0131 348 5215
Email: james.johnston@scottish.parliament.uk
The papers for this meeting are as follows—

**Agenda Item 1**

Note by the Clerk  
FI/S4/16/2/1

**Agenda Item 2**

Note by the Clerk  
FI/S4/16/2/2
Purpose

1. The purpose of this paper is to provide the Committee with information for its oral evidence session with Paul Johnson, Director of the Institute for Fiscal Studies (IFS). The session will focus on the UK Spending Review and Autumn Statement which was published on 25 November 2015.

2. This is the second of two evidence session on the Spending Review following the appearance of Robert Chote, Chair of the Office for Budget Responsibility (OBR) on 6 January 2016.

3. The IFS published a briefing note in advance of the Spending Review. The day after the Spending Review’s publication IFS researchers presented their analysis of the consequences for government departments, the size of spending cuts required and an analysis of any new tax and benefit changes. Hard copies of the briefing note and Paul Johnson’s opening remarks from the presentation are attached.

Conclusion

4. The Committee is invited to consider the above in its evidence session with the Director of the IFS.

Alan Hunter
Assistant Clerk to the Committee
The outlook for the 2015 Spending Review

Rowena Crawford, Carl Emmerson and Gemma Tetlow

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Executive summary

• The plans set out by the Chancellor in the July 2015 Budget imply that departmental spending is to be cut by £11.3 billion (3.2%) in real terms between 2015–16 and 2019–20. Within that, capital (investment) spending is planned to increase by £4.9 billion (11.5%) while resource (non-investment) spending is planned to be cut by £16.2 billion (5.1%).

• In the absence of further changes to the government’s planned level of total spending or forecasts for non-departmental spending, it will be cuts of this order that the upcoming Spending Review will allocate between departments.

• The government has already pledged to increase real-terms resource spending on the National Health Service, the Ministry of Defence and official development assistance and essentially to freeze real-terms resource spending on schools. Taken together, these pledges amount to around £7.6 billion by 2019–20. This means that other ‘unprotected’ departmental resource spending would need to be cut by £23.7 billion (18.8%) between 2015–16 and 2019–20. These departments also experienced significant cuts in recent years: the cut between 2010–11 and 2019–20 would be £64.9 billion (38.8%).

• After taking account of resources that will be devolved through block grants to Scotland, Wales and Northern Ireland through the possible operation of the Barnett formula, this would leave other Whitehall departments facing an average cut to their resource budgets of around 27% between 2015–16 and 2019–20. Over the period from 2010–11 to 2019–20, the total real cut to this resource spending would reach around 50%.

• In practice, some departments would be expected to fare better than this and others worse, depending on the government’s priorities. In response to a request from HM Treasury, departments have provided an assessment of the implications of cuts to their resource budgets of 25% and 40% between 2015–16 and 2019–20.

1. Introduction

On 25 November 2015, HM Treasury will publish the results of its latest Spending Review, allocating budgets to Whitehall departments for the four financial years 2016–17 to 2019–20. This short briefing note sets the scene, clarifying what we already know about the government’s plans for spending over this period and therefore what might be expected in November in terms of the scale of cuts and the allocation across departments.

We do not produce any predictions about the outcome of the Spending Review. However, we do provide an illustrative example of the cuts that would be required across ‘unprotected’ departments if all departments saw their resource (non-investment) budgets cut by the same proportion. This enables us to give a sense of the scale of the
implications for these departments of the protection the government has already announced for some areas of spending.

This briefing note is accompanied by an online tool that allows you to make your own changes to departments’ resource budgets and see how these stack up against the plans set out by the Chancellor in the July 2015 Budget. This is available at


Irrespective of how spending is allocated between departments, the next parliament will be a challenging one for public services as a whole. Total public spending is forecast to be cut from 39.6% of national income in 2015–16 to 36.3% by 2019–20, the lowest share of national income spent since 2000–01. Excluding spending on social security and debt interest, other ‘public service’ spending is forecast to fall from 26.1% to 23.8% of national income. This would also be the lowest level of this spending since 2000–01 (with the four-year period from 1997–98 to 2000–01 being the only years since the Second World War in which this measure of spending has been below 24% of national income).

2. The total departmental spending envelope

In the July 2015 Budget, the Chancellor planned that total public spending (‘total managed expenditure’, TME) would increase from £742.3 billion in 2015–16 to £804.4 billion in 2019–20. Taking into account forecast inflation from the Office for Budget Responsibility (OBR), this would imply real spending of £746.9 billion in 2019–20 (in 2015–16 prices) – a real-terms increase of 0.6%. The Office for Budget Responsibility forecasts that by 2019–20 the government will have ‘eliminated the deficit’ and will achieve a budget surplus of 0.4% of national income. In 2020–21, the government’s planning assumption is that public spending will grow in line with national income, which implies a real-terms increase of 2.4%.

For planning purposes, total public spending is divided into two broad components: departmental expenditure limits (DEL) and annually managed expenditure (AME). DEL, which is now just under half of total public spending, is allocated to government departments to spend on administration and delivery of public services – typically done in Spending Reviews. AME, which is currently just over half of total public spending, is spending that is deemed harder to control as it is demand-led, such as welfare spending and debt interest payments. The latest OBR forecast suggests that AME will grow by 4.1% in real terms between 2015–16 and 2019–20. This means that DEL will need to be cut by 3.2% over this period to keep to the government’s total spending plans (see Table 1). This implies an average real cut to DEL of 0.8% per year – which is smaller than the average annual cut of 2.1% implemented between 2010–11 and 2015–16. Taking the period since 2010–11 as a whole, the July 2015 Budget plans imply a cut to DEL of 12.7% between 2010–11 and 2019–20.

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1 This would be the fourth-lowest share of national income devoted to total public spending since the Second World War (after 1957–58 at 35.8%, 1999–2000 at 36.0% and 2000–01 at 36.2%).

2 If inflation were to turn out differently, then by default this would mean that real-terms changes in spending would turn out differently (for example, higher-than-expected inflation would imply a smaller real-terms increase or larger real-terms cut than currently expected). However, the government could respond to the change in forecast inflation by changing cash spending plans (as in effect happened over the last parliament).

Table 1. Latest forecasts for total departmental spending

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<tbody>
<tr>
<td>Total public spending (TME)</td>
<td>742.3</td>
<td>741.7</td>
<td>741.8</td>
<td>743.4</td>
<td>746.8</td>
<td>764.9</td>
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<td>of which:</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Annually managed expenditure (AME)</td>
<td>384.9</td>
<td>386.0</td>
<td>393.3</td>
<td>396.6</td>
<td>400.7</td>
<td>402.4</td>
</tr>
<tr>
<td>Departmental expenditure limits (DEL)</td>
<td>357.5</td>
<td>355.7</td>
<td>348.4</td>
<td>346.8</td>
<td>346.2</td>
<td>362.4</td>
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<tr>
<td>DEL % change on previous year</td>
<td></td>
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<tr>
<td>DEL % change since 2015–16</td>
<td>-0.5%</td>
<td>-2.0%</td>
<td>-0.4%</td>
<td>-0.2%</td>
<td>4.7%</td>
<td></td>
</tr>
<tr>
<td>DEL % change since 2010–11</td>
<td>-9.9%</td>
<td>-10.3%</td>
<td>-12.2%</td>
<td>-12.6%</td>
<td>-12.7%</td>
<td>-8.6%</td>
</tr>
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Note: To provide a consistent comparison over time, figures for AME and DEL in 2010–11 are adjusted for the subsequent movement of the Network Rail grant, council tax benefit and localised business rates.


In the rest of this document, we assume that the DEL spending envelope for the Spending Review – that is, the total amount of money available to be allocated between departments – will be as shown in Table 1 (i.e. the figures suggested by the July 2015 Budget based on current AME forecasts). Under this assumption, the 2015 Spending Review would be looking to allocate around £11 billion of real-terms cuts to departments’ annual budgets by 2019–20.

In practice, the government has not explicitly set the spending envelope. The HM Treasury document announcing the Spending Review stated that ‘all areas of public expenditure will be in scope including departmental budgets and Annually Managed Expenditure’.

In other words, the government may be looking to reduce AME in order to loosen the cuts required to DEL. However, in practice, it seems reasonable to assume that the DEL forecasts laid out in the July 2015 Budget (shown in Table 1) will form the basis of the settlement allocated between departments, and that is the assumption we maintain in the rest of this briefing note.

**Resource and capital budgets**

Each department has two separate DEL budgets: a resource budget for day-to-day spending and a capital budget for investment spending. The July 2015 Budget plans are for total departmental capital spending to increase in real terms between 2015–16 and 2019–20 by £4.9 billion (11.5%). In contrast, resource spending will be cut by £16.2 billion (5.1%) – see Table 2. This implies an average cut to resource DEL of 1.3% per year – somewhat lower than the average annual cut of 1.9% implemented between 2010–11 and 2015–16.

The planned cuts to resource DEL are not smooth. The July 2015 Budget plans imply only around £1.3 billion need by found in 2016–17, but an additional £7.2 billion in 2017–18, a further £5.7 billion in 2018–19 and an additional £1.9 billion in 2019–20. However, the pressure on departments in 2016–17 may be greater than these figures imply, since from 2016–17 the public sector faces higher employer National Insurance contributions due to the ending of contracting out into defined benefit pension schemes. HM Treasury has

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estimated that this will cost public sector employers £3.3 billion in 2016–17.\(^5\) Hence the effective cut in 2016–17 could be more like 1.5% rather than the 0.4% shown in Table 2. The largest forecast cut to resource DEL in a single year is 2.3% in 2017–18, which is smaller than the cuts achieved in 2011–12 and 2012–13 (3.2% and 3.1% respectively). The profile for the change in capital DEL is also far from smooth, but investment spending is inherently lumpy.

Table 2. Latest forecasts for resource and capital departmental spending

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<tbody>
<tr>
<td>Total departmental spending</td>
<td>396.7</td>
<td>357.5</td>
<td>355.7</td>
<td>348.4</td>
<td>346.8</td>
<td>346.2</td>
</tr>
<tr>
<td>Of which:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Resource DEL</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>% change on previous year</td>
<td>–0.4%</td>
<td>–2.3%</td>
<td>–1.9%</td>
<td>–0.6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% change since 2015–16</td>
<td>–0.4%</td>
<td>–2.7%</td>
<td>–4.5%</td>
<td>–5.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% change since 2010–11</td>
<td>–9.1%</td>
<td>–9.4%</td>
<td>–11.5%</td>
<td>–13.2%</td>
<td>–13.7%</td>
<td></td>
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<tr>
<td>Capital DEL</td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>% change on previous year</td>
<td>–1.2%</td>
<td>–0.2%</td>
<td>9.9%</td>
<td>2.8%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% change since 2015–16</td>
<td>–1.2%</td>
<td>–1.4%</td>
<td>8.4%</td>
<td>11.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>% change since 2010–11</td>
<td>–15.5%</td>
<td>–16.5%</td>
<td>–16.7%</td>
<td>–8.4%</td>
<td>–5.9%</td>
<td></td>
</tr>
</tbody>
</table>

Note and source: As Table 1.

The planning of capital and resource spending is being undertaken somewhat separately in the 2015 Spending Review. The government has asked departments to set out plans for how they would reduce their resource budgets (specifically, asking departments to model the implications of cuts of 25% and 40%), but the government has stated that capital spending will be considered separately and across departments ‘to identify the areas of spending that will achieve the best economic returns’.\(^6\)

3. Allocations between departments

The full allocation of DEL between government departments will not be known until the Spending Review is published in November, but the government has already made a number of announcements about the allocation of spending to some areas. In this section we describe these commitments and illustrate what they could imply for other areas of spending.

In doing so, we take as our reference point departments’ actual budgets in 2015–16 (as published by HM Treasury in July 2015). This is likely to be different from the approach taken by HM Treasury for the figures published in the Spending Review, which will probably be calculated using departments’ ‘baseline’ budgets in 2015–16, excluding temporary or one-off items of expenditure. It is also important to note that simple comparisons of budgets over time will not capture changes in responsibilities between departments over time.

\(^5\) Table 2.1 of HM Treasury, *Budget 2013*, HC1033, 2013.

Pre-announced settlements\(^7\)

Health
The government has announced that it will increase NHS funding in England by £10 billion in real terms between 2014–15 and 2020–21. The profile of this spending increase is unknown, other than that £2 billion of the increase is planned to occur in the current year (2015–16).\(^8\) In the calculations that follow, we assume that the increase happens linearly after this year – i.e. that the Department of Health (DH) receives a £1.6 billion increase in its budget each year between 2016–17 and 2020–21. This implies a £6.4 billion (or 5.7%) real increase in the DH resource budget between 2015–16 and 2019–20 (and an £8 billion real increase between 2015–16 and 2020–21).

Schools
The government has also committed to protecting per-pupil non-investment spending on schools in nominal terms. Based on current forecasts for inflation and student numbers this commitment would imply a maximum cut in schools’ resource spending of £0.3 billion (or 0.6%) in real terms between 2015–16 and 2019–20.

Defence
The government has pledged to raise the Ministry of Defence (MoD) budget by 0.5% per year in real terms up to 2020–21. We assume that this pledge applies to non-investment spending by the MoD (given the focus of the HM Treasury Spending Review document on resource spending); this could require an increase in the MoD resource budget of £0.6 billion (2.0%) in real terms between 2015–16 and 2019–20.\(^9\)

Spending on official development assistance
The government has legislated a commitment to spend 0.7% of national income on official development assistance (ODA). This is forecast to require a real-terms increase in ODA spending of around £1.2 billion (9.8%) between 2015–16 and 2019–20.\(^10\) The Department for International Development (DfID) is responsible for the majority of ODA (86% in 2014) and so can expect to see its budget grow over the next parliament. Under the assumptions that around 26% of ODA spending is capital (this is the proportion of the DfID budget that is capital in 2015–16) and that capital spending on ODA grows in line with total capital DEL over the period 2015–16 to 2019–20, resource spending on ODA would need to increase by around £0.9 billion (9.3%) in real terms.

Other commitments
The government has made a number of other commitments to a variety of smaller areas of spending – for example, ‘making available an additional £1.5 billion a year towards the end of the Parliament to increase spending on the military and intelligence agencies’ and the additional £0.3 billion a year that has been pledged to improve HM Revenue and

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\(^7\) The commitments below are made in HM Treasury, ‘A country that lives within its means: Spending Review 2015’, Cm 9112, 2015.

\(^8\) Paragraph 1.77 of HM Treasury, Summer Budget 2015, HC 264, 2015.

\(^9\) This is calculated using the MoD resource DEL budget of £28.1 billion in 2015–16. However, this budget includes the ‘likely initial drawdown of funding from the Special Reserve for the net additional cost of military operations’. If the government commitment applies to increasing only the MoD defence capability budget, then the increase in real spending required will be slightly smaller.

\(^10\) This is calculated by assuming that ODA spending in 2013–14 is equal to 0.75×ODA spending in 2013 + 0.25×ODA spending in 2014, that ODA spending between 2013–14 and 2015–16 grows in line with GDP, and that ODA spending between 2015–16 and 2019–20 grows in line with GDP.
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Customs (HMRC)’s tackling of non-compliance and tax evasion. We do not explicitly take account of these, since it is always the case that within departments’ budgets there will be some areas of spending that are relatively protected and others less so. It is less clear what effect these commitments would have on any department’s total resource budget allocation.

Implications for other departmental spending

The main areas of protected resource spending set out above are summarised in Table 3. Together we estimate that these protections amount to around £7.6 billion (in 2015–16 prices) by 2019–20. This implies that other areas of departmental resource spending will need to be cut by £23.7 billion (18.8%) in real terms between 2015–16 and 2019–20. This would bring the cuts to these other areas of departmental resource spending since 2010–11 to £64.9 billion (38.8%).

Table 3. Summary of main spending commitments pre-announced

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<tr>
<td></td>
<td></td>
<td>£bn (2015–16 prices)</td>
<td>%</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>111.9</td>
<td>+6.4</td>
<td>+5.7%</td>
</tr>
<tr>
<td>Schools</td>
<td>39.5</td>
<td>–0.3</td>
<td>–0.6%</td>
</tr>
<tr>
<td>Defence</td>
<td>28.1</td>
<td>+0.6</td>
<td>+2.0%</td>
</tr>
<tr>
<td>ODA</td>
<td>9.2</td>
<td>+0.9</td>
<td>+9.3%</td>
</tr>
<tr>
<td>Implied other RDEL</td>
<td>126.3</td>
<td>–23.7</td>
<td>–18.8%</td>
</tr>
</tbody>
</table>

Note: ‘Health’ is the Department of Health budget, ‘Schools’ is spending on ages 5–16 schooling, ‘Defence’ is the Ministry of Defence budget (including estimated outlay on operations) and ‘ODA’ is estimated spending on official development assistance.

Source: Authors’ calculations based on HM Treasury, Public Expenditure Statistical Analyses 2015 (for total resource DEL, health and defence), Conservative Campaign Headquarters (for schools), Department for International Development, Statistics on International Development 2014 (for ODA) and OBR, Public Finances Databank (for deflators).

However, it is important to note that this ‘other’ resource DEL includes the block grants paid to the devolved administrations of Scotland, Wales and Northern Ireland to fund the provision of public services in their jurisdictions. The changes in these grants are traditionally calculated according to the Barnett formula, based on the change in the budgets allocated to the Whitehall departments responsible for delivering public services in England. HM Treasury has indicated that this will be largely the case again in this Spending Review. Since spending on health and schools in England has been protected, part of the block grant to the devolved administrations will be protected too. Exactly how much the grant allocated to Scotland, Wales and Northern Ireland will change depends on

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13 For the majority of spending, the Barnett formula will apply in the normal way at the Spending Review, and devolved administration allocations will be calculated by the Treasury on the basis of the settlements reached with UK government departments (page 19 of HM Treasury, ‘A country that lives within its means’, Cm 9112, 2015).
The outlook for the 2015 Spending Review

how much is allocated to each department, since not all the functions of the various Whitehall departments are devolved and the functions that are devolved vary by nation.

We estimate that, if all unprotected departments were to see the same percentage cut to their resource budgets and if the block grants for Scotland, Wales and Northern Ireland were calculated using an approximation to how the Barnett formula may operate, then the resource budgets of Scotland, Wales and Northern Ireland would be cut by an average of 5.2% between 2015–16 and 2019–20. That would imply that other unprotected Whitehall departments would see their resource budgets cut by 27.2% (£21.3 billion).

Over the period from 2010–11 to 2019–20, this would bring the total real cut to unprotected resource spending, outside of that done by the devolved assemblies, to 50.3% (£57.7 billion). Figure 1 shows the implications for departments' total DEL budgets if we assume that all departments see the same percentage change in their capital DEL budgets (an increase of 12.3%) and that all unprotected departments see the same percentage change to their resource DEL budgets (a cut of 27.2%). The change in total DEL differs across departments because departments differ in their capital intensity – i.e. the proportion of their total budget that is accounted for by capital. For example, the Department for Transport is relatively capital intensive (capital DEL accounted for 72% of its total DEL in 2015–16) and so would actually experience a small increase (1.1%) in

Figure 1. Illustrative example of one possible spending allocation

Note: Scenario assumes that all departments (except Scotland, Wales and Northern Ireland) receive a 12.3% increase in their capital budgets and that all unprotected departments (except Scotland, Wales and Northern Ireland) receive a 27.2% cut to their resource budgets. The budgets of Scotland, Wales and Northern Ireland are determined according to the Barnett formula, which given the scenario above implies an average increase in capital DEL of 5.8% and an average cut to resource DEL of 5.2%. ODA is official development assistance.

* ‘Local government’ is the central government grant to local authorities. Note that local authorities also receive revenue from council tax and business rates.

14 The Barnett formula used by HM Treasury in the upcoming Spending Review will likely differ to that employed in these calculations for two reasons. First, the factors we use for the proportion of each department’s budget that is devolved for each nation are based on the 2010 Spending Review factors with an adjustment for the impact of the business rates retention policy. We expect HM Treasury will calculate new factors for each department based on the current programmes being funded by each department. Second, in February 2015, the coalition government announced that it would introduce a ‘funding floor’ for Wales (https://www.gov.uk/government/news/landmark-funding-announcement-and-new-powers-for-wales-in-ct-davids-day-agreement). The details of how this will operate have yet to be published, but it is likely to affect the calculation of the block grant for Wales in the 2015 Spending Review.
its total DEL budget under this illustrative scenario, while the Home Office is much less capital intensive (only 4% of its 2015–16 budget was capital) and so would experience a relatively large cut (of 25.7%) to its total budget.

It should be noted that the DEL grant to local government is just one source of revenue for English local authorities – they also raise revenue from council tax and business rates, and these sources of revenue are forecast by the OBR to rise in real terms over the parliament. Taking into account this revenue, the spending power of local authorities under the scenario presented above would be cut by substantially less than the 27.2% cut to Local government DEL presented in Figure 1.

Figure 2 shows the implications of this illustrative spending settlement for the change in departments’ budgets since 2010–11. For example, under this scenario the total budget cut from 2010–11 to 2019–20 faced by the Ministry of Justice would be 50.7%.

Figure 2. Impact of illustrative spending allocation on change in departments’ budgets since 2010–11

Note: Scenario as in Figure 1. Adjustments for classification changes set out in footnote 15.
* As for Figure 1.

4. Conclusions

This briefing note has set out the implications of the government’s July 2015 Budget plans for departmental spending over the period 2015–16 to 2019–20. We have provided one simple illustration of a possible allocation of cuts across departments taking into account the possible operation of the Barnett formula – this scenario assumes that all departments see the same percentage change in their capital budgets and that all unprotected departments see the same percentage change in their resource budgets. This scenario implies cuts to unprotected departments’ resource budgets of 27.2% and cuts to total budgets that vary depending on the capital intensity of the department. An

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15 In doing these calculations, we have made some adjustments for classification changes that affect the consistency of departments’ budgets over time – in particular: we adjust the transport budget to remove the Network Rail grant prior to 2015–16; we adjust the local government budget to remove the equivalent of retained business rates prior to 2013–14; and we adjust the local government, Scotland and Wales budgets to include council tax benefit prior to its localisation in 2013–14.
accompanying online calculator allows you to explore alternative ways of sharing the cuts to spending between departments (www.ifs.org.uk/tools_and_resources/spending-review-2015-guide).

A key question remains about whether or not spending cuts of this magnitude, on top of those delivered over the last parliament, are achievable. On the one hand, the coalition government demonstrated the ability to hold down spending, with many departments actually underspending their allocated budgets over the last parliament. On the other hand, further spending cuts (particularly with many of the same departments potentially seeing the biggest cuts again) will get harder as presumably easy efficiency savings have been identified and delivered, while demand and wage pressures continue to increase.
Paul Johnson’s opening remarks

26 November 2015

July’s fiscal arithmetic implied average cuts of 27% to the resource spending of “unprotected” departmental spending – that is to day-to-day spending other than that on health, schools, ODA and defence which was explicitly protected. The comparable figure after yesterday’s announcements is “just” 18%, one third less than implied in July. Yet the planned surplus for 2019-20 is largely unchanged.

The first thing to say is that this is not the end of “austerity”. This spending review is still one of the tightest in post war history. Total managed expenditure is due to fall from 40.9% of national income in 2014-15 to 36.5% in 2019-20. A swathe of departments will see real terms cuts. The 3% cumulative increase in health spending over the next five years is not far off the average annual increase in spending in the last 50 years.

On the other hand there is no question that the cuts will be less severe than implied in July. The gap with what one might have expected based on the Conservative manifesto is substantially greater.

How has Mr Osborne done that whilst keeping to his surplus target in 2019-20? He has banked some changes in forecasts for lower debt interest payments and higher tax revenues. That was lucky. By adding some tax increases he has made some of his own luck.

He’s going to need his luck to hold out. He has set himself a completely inflexible fiscal target – to have a surplus in 2019-20. This is not like the friendly, flexible fiscal target of the last parliament which allowed him to accept a bigger deficit when growth and tax revenues disappointed. This is fixed four years out. The forecasts will change again, and by a lot more than they have over the past few months. If he is unlucky – and that’s almost a 50-50 shot – he will have either to revisit these spending decisions, raise taxes, or abandon the target.

Abandon it is just what the Chancellor has done with his self imposed welfare cap. He won’t keep to it in any of the next three years. In the long run, though, the tax credit change has little effect on the public finances because the cuts to Universal Credit announced in July are unaffected.

Beyond the spending numbers and the welfare changes, though, we also saw yesterday glimpses of George Osborne the reforming Chancellor. He really is cutting spending on non pension benefits to its lowest level relative to national income for about 30 years. The changes to local government financing and devolution are genuinely radical and could transform both the role of local government and the UK’s fiscal architecture. The same is true of additional devolution to Wales and Northern Ireland. The commitment to consult on reforming school funding is long
overdue – and would have been much more easily done when there was more money to go around.

**The spending (and tax) numbers**

There are still some very significant cuts ahead. Unprotected resource DELs (for these purposes all RDEL other than defence, aid, health, schools and devolved nations) are falling 18% by 2019-20.

That these cuts are now so materially different to what was expected is down to a “gearing” effect. Only about £90 billion of resource DEL spending is unprotected. By comparison with July’s implied numbers this spending will be cut by £5 billion less. That’s a very small number in the scheme of government spending, but accounts for nearly 6% of all unprotected spending. That’s why small changes to the forecast and relatively small tax increases can have such a big effect on the percentage cuts to be suffered by these departments.

So one story is that the police and the foreign office, for example, were spared expected cuts because there were modest changes to forecasts. Perhaps it is foolish to speculate about what might have been. But suppose the forecasting changes had moved in the other direction. Would it really in those circumstances have made sense to impose swingeing cuts on the police? It is odd that small corrections to forecasts are presented as driving big changes in policy.

Don’t forget though that this was also a tax raising budget. A £3 billion tax on the payrolls of companies with paybills over £3 million is substantial as is an increase in stamp duty land tax of nearly £1 billion on second homes and buy to let properties. The latter especially is also ill designed, not least because it reintroduces, albeit on a small scale, a cliff edge into the Stamp Duty schedule a mere year after the Chancellor made much of abolishing cliff edges in the Stamp Duty schedule. Allowing an extra 2% a year on council tax bills to help pay for social care will also raise revenues by £1.7 billion a year by 2019-20. The tax share of the overall consolidation since 2010 rose modestly as a result of yesterday’s announcements, but only from 14% to 17% of the total. Spending will still bear the brunt.

One spending cut that might have escaped your attention in the announcements about housing is in capital grants to Housing Associations. These will be cut by 40% in 2017-18 for example. As the OBR points out in paragraph B.38 despite these cuts “grants are higher over our forecast period as a whole, but this is mainly due to the increase in 2020-21 (which is beyond the current spending review period).” (My emphasis).

**Welfare**

The OBR has significantly reduced its forecast of savings from disability benefit reforms – in particular the move from disability living allowance to personal independence payment. This is familiar. Year after year expected savings from this reform go down. In fact this change in forecast would have ensured that the welfare cap in 2020-21 would have been breached. Only a
reclassification (which the government argues is a policy change affecting behaviour) of a minor item of spending on temporary accommodation has allowed the cap to be met.

Of course the biggest welfare announcement was that tax credit cuts proposed for April 2016 will no longer happen. They have been abandoned entirely. The long term cost? Nil. Why? Because the equivalent cuts to Universal Credit, now legislated, were left untouched. The expected cost of the U turn is £3.4 billion in 2016-17 but less than £0.5 billion by 2020-21. If you thought the announced saving in 2016-17 was £4.4 billion not £3.4 billion you’d be right. The £4.4 billion number was just wrong. As the OBR puts it in Box 4.3 of the EFO this reflected:

"the challenge of estimating interactions between HMRC tax credits and DWP benefits in the run up to a fiscal event, where the Treasury's policy costings process does not permit us to call on the expertise of officials across both departments on all measures that might be subject to interactions" (my emphasis again).

The policy change ensures that no family will take an immediate cash hit. And people will be protected in cash terms even as they roll off tax credits and on to Universal Credit. But the long term generosity of the welfare system will be cut just as much as was ever intended as new claimants will receive significantly lower benefits than they would have done before the July changes. Overall the shift from tax credits and other benefits to Universal Credit is complex. We estimate that in steady state UC will now involve 2.6 million working families being an average of £1,600 a year worse off than they would have been under the current system while 1.9 million will be £1,400 a year better off. UC was always designed to be less generous than the current system to non working families. We estimate that spending on 1.8 million non working families will be reduced by £2.2 billion relative to the current system.

There was also one small, but in the long run potentially important change made to Housing Benefit for social tenants. For new tenants only (a desire not to impose cash losses may be apparent here) housing benefit will be restricted to the equivalent private sector rate. That won’t bite much initially, saving £225 million by 2020. Had it been imposed on all tenants immediately it would have saved more than £1 billion. The long run effect is likely to be larger than that. Private sector benefit rates only rise with inflation. Rents tend to rise faster than that. If that happens in the social sector (after the current policy of cutting rents expires) then the long run effect could be substantial.

**Education, Local government and devolution**

The chancellor has talked of a “devolution revolution”. Looking across local government and the constituent countries of the UK there is some reason to accept that a revolution is underway. This is not just political hype.

Additional powers are of course being devolved to Scotland. Wales is also to get some powers over income tax without the need for a referendum. Northern Ireland will get corporation tax
devolved and looks like it will cut the main rate to 12.5% to match that in the Republic. A flaw in the Barnett formula (pointed out by my colleague David Phillips in research published last year) is being fixed. As we showed in a paper published last week there is an increasingly urgent need though to work out the appropriate fiscal framework for this newly devolved United Kingdom. We still don't know how devolution to Scotland will work in practice and what (necessary) compromises to the mutually incompatible principles laid down by the Smith commission will be made.

We are also in the middle of a revolution in the funding of English local government. In part this reflects a big cut in central government support – cuts of over 50% in this spending review period, come on top of big cuts in the last parliament. These cuts in grants have had big distributional effects – those authorities more dependent on central government funding have seen their spending power reduced much more than others.

Following changes in April 2013, councils’ spending power already depends, in part, on how much business rates are raised in their area. They get to keep up to 50% of the growth in their rates revenue that’s due to new development. The Chancellor confirmed plans to go further. These changes have big effects on economic incentives, financial risk and funding patterns across the country. How much councils have to spend in future will depend much more on the performance of their tax base than it did in the past. This is a big change.

What isn’t such a change are the ‘new powers’ for councils to cut or reduce these rates. Councils already have many of these powers, and they have been little used.

Finally, another change in prospect, is a long overdue reform to the way in which schools are funded. For more than a decade grants to local authorities to pay for schools have been based on little more than historic allocations, themselves based on complex funding formulae. Different local authorities have themselves taken very different views as to how to distribute money to their own schools. This has resulted in differential funding for schools which is hard to understand let alone justify.

Previous governments have signally failed to sort this out when there has been plenty of money around. It will be harder to make changes when money is tight. It is to be hoped that this government will be more successful than its predecessors in effecting rational reform.
Finance Committee
2nd Meeting, 2016 (Session 4), Wednesday 13 January 2016
Draft Budget 2016-17 (Revenue)

Introduction
1. The purpose of this paper is to provide information for the Committee’s evidence session with the Cabinet Secretary for Finance, Constitution and Economy on the revenue side of draft budget 2016-17. The paper focuses on Scottish Rate of Income Tax (SRIT), the Land and Buildings Transaction Tax (LBTT) and the Scottish Landfill Tax (SLfT).

2. In previous years, the Committee’s scrutiny of the Draft Budget has tended to focus on the expenditure side of the budget and all elements of the Draft Budget have been covered in a single evidence session with the Cabinet Secretary. However, 2016-17 will be the first year in which the Scottish Government will have responsibility for setting the rate of SRIT in addition to having full responsibility for setting and collecting the LBTT and SLfT.

3. The Committee and the Scottish Government therefore agreed that going forward, scrutiny of the Draft Budget would take place over two separate oral evidence sessions, with one considering the revenue side and the other expenditure.

4. The Committee will take evidence on the expenditure side of the Draft Budget at its external meeting in Pitlochry on Monday 18 January.

5. In addition to this paper, a SPICE briefing note is attached--

- Financial Scrutiny Unit Briefing: Draft Budget 2016-17

Scottish Rate of Income Tax (SRIT)

6. The Scotland Act 2012 introduces a SRIT which will apply to the non-savings non-dividend (NSND) income of Scottish taxpayers from 6 April 2016. The UK Government will deduct 10p in the pound from the basic, higher and additional rates of income tax and the Scottish Parliament will then have the power to levy a Scottish rate that will apply equally across each tax band. The SRIT will be collected by HMRC on behalf of the Scottish Government.

7. The Scotland Bill 2015-16’s tax provisions are expected to supersede SRIT by granting the Scottish Parliament unrestricted powers to set the rates and bands of income tax payable on the NSND income of Scottish taxpayers. However, SRIT will not be a fully devolved tax and the command paper Scotland in the United Kingdom: An Enduring Settlement states that “all other aspects of Income Tax will remain reserved to the UK Parliament.”

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Rate

8. Draft budget 2016-17 states that the Scottish Government proposes to apply a 10p rate of SRIT meaning that Scottish taxpayers will continue to pay the same rate of income tax as those in the rest of the UK. The Scottish Government therefore expects the impact of the SRIT to be revenue neutral in 2015-16. The Draft Budget also suggests that “there are advantages” to allowing the work HMRC has been doing in relation to the identification of Scottish taxpayers “to bed in against a background of no change” to income tax rates.

9. The OBR has produced forecasts for SRIT revenues (assuming a 10p rate) for 2013-14 to 2020-21 as set out in the following table.2

<table>
<thead>
<tr>
<th></th>
<th>£ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish income tax liabilities (pre-mea</td>
<td>4288</td>
</tr>
<tr>
<td>New measures</td>
<td>0</td>
</tr>
<tr>
<td>Scottish income tax liabilities (post-mea</td>
<td>4288</td>
</tr>
</tbody>
</table>

10. HMRC has produced estimates of the impact of a 1p change to SRIT (positive or negative) on revenues over the next 3 years as set out in the following table3—

<table>
<thead>
<tr>
<th></th>
<th>£ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>2016-17</td>
<td>345</td>
</tr>
<tr>
<td>2017-18</td>
<td>390</td>
</tr>
<tr>
<td>2018-19</td>
<td>400</td>
</tr>
</tbody>
</table>

11. The Committee received 24 responses to its call for evidence on SRIT. The Committee’s budget adviser has produced a briefing paper summarising these responses.

12. A number of individual respondents favoured a reduction in the rate on the basis that this would act as a stimulus to the wider economy and boost jobs and growth. NHS Health Scotland advocated an increased rate on the basis that higher taxation revenues could be used to reduce health inequalities—

“We know that the Scottish Government is working hard to mitigate some of the so-called welfare reforms that have come from Westminster. There is a strong case to do something soon and urgently to increase the Scottish rate of income tax, while using the revenue to ensure that people on lower incomes are not penalised.”

2 http://budgetresponsibility.org.uk/wordpress/docs/Devolved-taxes-forecast.pdf
13. The majority of responses from organisations, however, supported the maintenance of the 10p rate for 2016-17 citing factors such as complexity for employers, mobility of labour, the economy’s ongoing but incomplete recovery from recession and the “blunt” nature of the power. Professional bodies including ICAS, the CIOT and the LITRG expressed no view on the appropriate rate for SRIT but raised issues they felt should be considered in setting the rate. These included the administrative costs for employers and HMRC of having a different rate from the UK one and the impact of potential behavioural responses from taxpayers.

14. Both Lucy Hunter-Blackburn and Ben Thomson highlighted the interaction of SRIT with local taxation and perceived issues relating to the council tax freeze although they proposed different solutions. Ms Hunter-Blackburn suggested that a higher rate of SRIT could be used to provide additional funding for local services which are relied upon by the most vulnerable and to improve the student grant for poorer students. In her view the council tax freeze disproportionately benefits those with higher incomes and an increased rate of SRIT would go some way to redressing the balance. It would also restore the tax income lost since the implementation of the freeze in 2008.

15. Conversely, Ben Thomson proposed that increased revenues from a reformed council tax which placed a higher tax burden on owners of more expensive properties would help to empower local government and could be offset against a reduction in the rate of the SRIT.

16. In oral evidence Ms Hunter-Blackburn acknowledged the attraction of waiting until the implementation of the expected Smith Commission powers stating “The argument that we should wait has validity, and if we were not living in these times I would consider the argument to be very sensible from a public administration point of view.” However, given the current budgetary situation she was of the view that time was of the essence; “this is a question of urgency; I see the political debate about austerity and public service cuts as an urgent issue.”

17. However, the STUC’s view was that “having been through an historically unprecedented collapse in real wages over the past five years, 2016-17 is not the moment in which to increase taxes on the lower paid.” The STUC also suggested, however, that “the Scottish Government should accompany any decision to leave SRIT at 10p in 2016-17 with a comprehensive statement on tax policy in the future.”

18. Price Waterhouse Coopers (PwC) also urged caution, stating that—

“Keeping the status quo would probably be better while you are trying to embed a new tax regime in Scotland. Yes—you should see how you go in the first year while you let the new regime embed. What you do with future powers post Smith will obviously need careful modelling, but you could perhaps do something differently then.”

19. Both the STUC and NHS Health Scotland commented on the “bluntness” of the SRIT powers with the STUC stating “I wish that we were discussing the Smith commission powers now. If that were the case, our submission and
recommendations for next year would look very different from the ones that we have expressed in our written submission.” However, NHS Health Scotland differed from the STUC in terms of using the SRIT powers now—

“Clearly, it would be much more interesting if we could describe a sharper tool that would allow us to vary the bands and be much more progressive. However, there is urgency on the issue.”

Progressive Taxation

20. The Scottish Government has stated its intention to apply a progressive taxation policy in line with Adam Smith’s four principles of taxation. This means that the average rate of tax should increase as a taxpayer’s income increases. However, the Committee heard conflicting evidence regarding the progressivity of SRIT. Ben Thomson, for example stated that—

“it would be much more progressive if we were allowed to vary the bands. That will potentially happen later, once the effects of the Smith Commission come in. However, at this stage, the 10p rate is across all bands, so it is quite an inflexible tax. If we look at it as a percentage of how much tax increases, it will hit the people on lower taxes more as a percentage of the total tax that they pay than people on higher rates, although those on higher rates will pay more in absolute terms.

“In absolute terms, the people who pay more tax will pay a greater amount, but people at the lower end will pay a greater percentage.”

21. Lucy Hunter-Blackburn, however, disputed this position stating—

“It is absolutely right to say that, under the Scottish rate, as a percentage of the current tax, the extra penny will be more for those on lower incomes. However, that argument does not pick up the point that, at lower incomes, people pay much less of their income as tax full stop. It [the SRIT] increases the proportion of income that people pay as tax. If you put a penny on everyone’s income tax above roughly £10,000, people will pay a larger share of their income as tax, because they will pay more of their income as tax, generally. That is progressive.”

22. NHS Health Scotland stated—

“We need to be careful because, if we take money from across society with a blunt income tax tool such as the SRIT, there are risks that some groups will be disadvantaged, but we also need to discuss what that additional revenue would be used for. It could be used to mitigate loss of income to some lower-income groups.

23. Striking a similar tone, the STUC highlighted the view that outcomes were more important than a strict interpretation of “progressivity” stating—
“I do not think that the SRIT is progressive in and of itself, but that is not to say that the funds that could be raised through increasing it could not be used in progressive ways. Lucy Hunter Blackburn makes a reasonable case, but I cannot agree with her on the fundamental point of whether the SRIT is in and of itself progressive. It is clearly a regressive tax.”

**Behavioural Response**

24. The Committee heard from a number of witnesses that a key consideration when determining the rate of SRIT or any tax should be the likely behavioural response of taxpayers to any changes in the tax rate. As Professor David Bell stated in oral evidence—

> “Multiplying the average additional tax liability by the number of Scottish taxpayers gives an arithmetic estimate of the extra revenue but the outcome may be quite different, because that simple calculation does not take account of how taxpayers’ behaviour may change if tax rates change.”

25. This behavioural response is described by economists as the “elasticity of labour supply” and according to Professor Bell, could include people reducing their working hours, withdrawing from the labour market entirely, switching the way in which their income is accounted for (for example by taking income as profit rather than earnings) or migrating to take advantage of more favourable tax rates in another jurisdiction. Witnesses agreed that the impact of any behavioural response could be expected to be most apparent in relation to high earners.

26. On that basis, Professor Bell explained that the Government “faces considerable revenue risk if that group alters its behaviour.” He therefore suggested that the Scottish Government should “proceed cautiously—ca cannie—when considering significant changes to the structure of income tax in Scotland.”

27. The Committee’s budget adviser produced a paper which reviewed some of the evidence for tax driven migration in other countries where sub-national governments have power to set income tax rates. Whilst he was clear that many factors aside from tax influence migration, examples from the US, Switzerland and Canada gave “good reason to expect that relative changes in rates of income tax between Scotland and the rest of the UK, provided the differences are expected to persist, will have an effect on the migration decisions of high-income individuals.”

28. Professor Bell also submitted a paper on behavioural responses to changes in income tax rates which noted that worldwide evidence tended to agree that higher income tax rates will lead to behaviours that have a negative effect on tax revenues such as reducing labour supply, tax avoidance and migration. Whilst Professor Bell considered that the applicability of the evidence to Scotland was “difficult to judge,” he highlighted the responses of high income earners who generate a disproportionate share of tax revenues as being “particularly important.”

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5 [http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/David_Bell_briefing.pdf](http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/David_Bell_briefing.pdf)
29. According to Professor Bell, the richest 10 per cent of taxpayers pay more than 50 per cent of income tax revenues whilst the top 1 per cent contribute around 20%. He also estimated there to be around 11,000 additional rate taxpayers in Scotland. As such a large proportion of tax revenues is dependent on a relatively small number of taxpayers, Professor Bell noted that “how this group reacts to changes in tax rates will be very important for the health of the Scottish economy.”

30. PWC agreed with this view explaining that “individuals who are more mobile can move if the rate fluctuates, and that drives investment and the economy in Scotland to a certain extent. We are therefore saying that you should be mindful in what you do.” PWC went on to confirm that “it is clear from the clients with whom we engage—the higher-rate and additional-rate taxpayers—and from history that there is mobility in that section of the taxpaying population, so it is likely that some of them would move, depending on what you do with the rate.”

31. Similarly HMRC stated—

“Our experience with the wider tax system has been that those individuals who change their behaviour for tax reasons tend to be those who have most to gain, and they are the better off, so it is the levels of tax that apply to the wealthy that are most likely to result in a behavioural effect.

If I had to conjecture, I would say that, for the overwhelming majority of the population, the sort of differential in tax rates that is likely to come about—as suggested by past experience—will have an almost negligible effect. However, to the extent that there are significant differentials for the better off, that is where we would expect to see a change in behaviour, and we would probably be looking to ask compliance questions about that.”

32. Whilst the CIOT stated that, in its view- if the status quo is not maintained, taxpayer behaviour will need to be considered. Taxpayers might accelerate or defer income if they are in a position to do so, and they might base themselves either north or south of the border—whichever suits them—for the determination of whether they are Scottish taxpayers in the first instance. Those are the more complex cases in which it is not particularly straightforward to work out whether the person in question is a Scottish taxpayer, and such people are likely to be the most mobile in our employment sector.

33. However, the STUC disputed the extent to which changes to the SRIT might impact on labour mobility stating—

“Even under the SRIT, it is very difficult to envisage circumstances in which increases will materially affect labour mobility—I just do not really see it. There will be much more of a discussion on that when we assume full control over rates and thresholds. I would argue that we need a significantly higher top rate of tax and a lower threshold, and there should be a discussion about what that might mean for labour mobility. However, I think that it is a false issue in relation to the SRIT. If we stuck 2p on the SRIT, I do not think that we would suddenly see a flow of executives from Scotland to the rest of the UK.”
Implementation Costs

34. The Scottish Government will meet costs of implementing SRIT and the Committee has monitored preparations for its implementation since its announcement. To this end, the Committee took evidence from HMRC on 28 October. At the meeting, HMRC confirmed it was “on track to implement the Scottish rate on time and within—indeed, a little bit below—the original budget...the estimate of the costs of implementation remains a set-up cost of £30 million to £35 million against an original estimate of £40 million to £45 million.” Audit Scotland confirmed this in a report published on 10 December 2015 which found that—

“The Scottish Government and HMRC are working well together in preparing for the introduction of the Scottish rate of income tax in April 2016. The estimated cost range of setting up the Scottish rate of income tax has decreased by £10 million, to between £30 million and £35 million.”

35. The Deputy First Minister wrote to the Committee on 10 December to inform it that the Scottish Government had also agreed to meet one-off costs estimated at £1.8 million for the updating of DWP systems so they can recognise and process information relating to Scottish taxpayers.

Identification of Scottish Taxpayers

36. One area in which the Committee has taken a particular interest is the identification of Scottish taxpayers. In oral evidence, HMRC outlined its plans to ensure its starting database is as accurate as possible before stating that “about 98% of the taxpayers for whom HMRC holds Scottish addresses are correctly identified as likely to be Scottish taxpayers.” HMRC further explained that it was in the process of checking its data against other sources but accepted that “With very large data sets—we are talking about 2.5 million people—we are never going to be 100 per cent accurate. That is just the reality.”

37. As noted above HMRC went on to set out its intention to write to all identified Scottish taxpayers to inform them of their status. This would give taxpayers who felt they had been wrongly identified as such (eg people with a property in Scotland but who spent most of their time at an address in the rest of the UK) to contact HMRC to correct their status.

38. HMRC confirmed that taxpayers are not obliged to inform it of a change of address but explained that the PAYE system would pick up employees moving to Scotland from a different part of the UK in the same way that it currently does for employees who have moved to the UK from abroad. However, PwC stated in oral evidence that “There needs to be a sea change in taxpayer mentality with regard to whether people want to tell HMRC that they are Scottish taxpayers or that they have changed their address.”

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Awareness of SRIT

39. Another topic on which a number of witnesses expressed concerns relates to publicity around SRIT. HMRC’s intention was to write to all identified Scottish taxpayers to inform them of the new S tax code that reflected their status but this was delayed as a result of the late publication of the draft budget. However, the letters have now been issued.

40. When giving oral evidence in September, PwC stated that “the area is complex, and awareness across the population is relatively low. We engage with a number of employers from a range of industry sectors, and we find that awareness is very low.”

41. In the same evidence session, the CIOT stated “We are starting from a very low base on publicity. We have not undertaken any surveys, but comments that we have received from members suggest that there is very low awareness of the introduction of the Scottish rate of income tax from next April.” ICAS, similarly suggested that “the SRIT seems to have got completely lost in all the noise about Smith.”

42. ICAS further stated that “Lots of our members seem to be getting a bit twitchy that they ought to know about the Scottish rate of income tax but, once they know about it, they will realise that not much needs to be known…Employers will not have to do a lot but, if they do not know that, they will all be slightly twitchy, for want of a better way to put it….When they get there, they will see that they will not have to do that, because HMRC will issue the S codes.” As noted above, these letters were issued in early December.

Tax Reliefs

43. A further issue on which questions were raised in evidence related to reliefs for taxpayers who make donations under the gift aid scheme or who make pension contributions. ICAS explained that—

“Relief is to be given at the Scottish rate of income tax, but the systems that are in place at the moment, and which will be in place from next April, only give relief at the 20 per cent tax rate, so a taxpayer’s liability will have to be adjusted to give the correct relief overall. We do not know how smoothly that will go.”

44. Whilst PwC stated its understanding that HMRC—

“is looking at updating systems so that it can give the correct relief, but that might take two years. HMRC might accelerate that or give further consideration to it if the Scottish rate of income tax diverges significantly from the UK rate.”

Compliance

45. The Revenue Scotland and Tax Powers Act 2014 introduced a General Anti Avoidance Rule (GAAR) in respect of the devolved taxes. The GAAR is broader in scope than the UK General Anti Abuse Rule as its focus is on tax avoidance rather than abuse. However, as the SRIT will not be a fully devolved tax the Scottish GAAR will not apply to it.
46. When invited to expand on the compliance work it would undertake for those suspected of giving a wrong address, HMRC stated—

“It is quite easy to change one’s address, just as it is quite easy to fill in a tax return and put false figures on it. However, that is not a good thing to do, because our compliance work is quite effective. We resource according to risk. We are not that worried about people giving false information, because the better-off are aware of the consequences. The concern is about ensuring that we have in our net everybody who ought to be there. People are more likely to be tripped up by a lack of awareness than a deliberate misstatement of their position.”

Block Grant Adjustment - SRIT

47. An issue that is of paramount importance in respect of the SRIT and the future devolution of further tax raising powers is that of the block grant adjustment, a subject that the Committee has scrutinised in detail over recent years. For SRIT, the deduction from April 2016 in each year of transition will be calculated annually and will be based on an OBR annual forecast of Scottish income tax receipts. These will not be reconciled during transition and the UK Government will bear the risk of any deviation of outturn from forecast. Following the transition period, there will be a one-off deduction to the block grant. The intention is that the transition period will have provided real outturn data for Scottish tax receipts.

48. It was previously agreed between the Scottish and UK Governments that the Holtham indexation method would be used to adjust the block grant for SRIT in future years following the transition period. This means recalculating the block grant adjustment year-by-year by indexing it to movements in the NSND income tax base in the rest of the UK.

49. The Committee has considered this approach on a number of occasions and has consistently raised concerns about the impact of changes in the size of the population on the indexation of the block grant. The main concern is that the Scottish tax base may grow more slowly than that of the UK as a whole due to the relatively lower number of higher rate tax payers in Scotland compared to the rest of the UK and relative population growth. The relatively lower number of higher rate tax payers in Scotland compared to the rest of the UK largely explains why Scotland’s tax contribution to the UK is 7.3% which is less than its population share of 8.3%.

50. During the Committee’s inquiry on the fiscal framework the Deputy First Minister was asked by the Committee whether the Holtham method should be applied to the Smith proposals for income tax devolution. He responded that we “think that is the most robust mechanism.” He was further questioned about the likely impact of relative population changes. He responded that “if we are growing our population and benefits are arising from that, we should see the fruits of that” and that “if we take on those risks, we have to have mechanisms in place that enable us to manage and deal with them as different outcomes materialise.”
51. However, in a response to a Parliamentary question on 9 December 2015 he stated—

“there have been a number of very substantial contributions to the debate from the Scottish Trades Union Congress, Professor Anton Muscatelli, Professor David Bell and the Institute for Fiscal Studies. I think that they have provided very good, dispassionate commentary on the issues that are at stake and on what I consider to be the crucial issue, which is the block grant adjustment for income tax. Mr Chisholm asked me whether I agreed with him that indexed deduction per capita is the best way to proceed with that, and I am very happy to confirm to Parliament that I do.”

Land and Buildings Transaction Tax (LBTT)

52. The Scottish Government proposes to maintain the rate and bands for LBTT at their current levels which are set out in Table 1 below.

Table 1

<table>
<thead>
<tr>
<th>Residential Transactions</th>
<th>Rate</th>
<th>Non-Residential Transactions</th>
<th>Rate</th>
<th>Non-Residential Leases</th>
<th>Rate</th>
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<td></td>
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</tr>
</tbody>
</table>

53. The Scottish Government also proposes levying an LBTT supplement on purchases of additional residential properties, such as buy-to-let properties and second homes. The supplement will be 3% of the total price of the property for all relevant transactions above £40,000.

Residential Transactions

54. The Draft Budget 2016-17 states that by maintaining the rates and bands for residential transactions this will:

- Take over 10,000 additional house purchases out of tax compared to SDLT;
- Reduce the tax charge relative to SDLT for over 36,000 house purchases at or below £330,000; and
- Ensure that over 93% of house buyers are no worse off than under SDLT.7

55. The Committee published a call for evidence in July 2015 asking for views on the operation of LBTT and whether there should be changes to the rates and bands

in the forthcoming draft budget. 13 responses were received and the Committee’s Adviser provided a summary of the written evidence.⁸

56. The Committee heard from some witnesses that the introduction of LBTT has had a negative effect on the higher end of the property market. Homes for Scotland stated in their written submission that—

“early indications are that the revised rates are having an adverse effect on the sale of properties in the middle to higher end of the residential new build market, where activity has diminished. This may particularly be the case for properties with a value above £500,000.”

57. They are not calling for an immediate change but suggest that the bands and rates should be kept under close review.

58. The Scottish Property Federation (SPF) state in their written submission that there has been a significant reduction in transactions above £400,000 and, in particular, transactions above £750,000 have reduced markedly. They told the Committee that there has been a 22.5% decline in sales of properties over £400,000 between May and September 2015 compared with the same period in 2014 and a 54% reduction in the sale of £1m plus properties.⁹ They propose increasing the 5% rate threshold to £500,000 and abolishing the 12% rate which “we believe is making little positive contribution to LBTT revenues.”

59. The Committee’s budget adviser states that the market data shows a significant reaction to the introduction of LBTT. In particular, the Your Move/Acadata house price index for August 2015 demonstrates a considerable impact at the very top of the market. This shows that between January and March 2015 there were 112 sales of homes worth £1m or more whereas in the following three months only ten such houses were sold.¹⁰ Christine Campbell, Your Move’s managing director in Scotland, stated that LBTT “has slowed high value property sales considerably.”¹¹

60. However, the more recent price index for October which was published by Your Move/Acadata in December shows that there were 30 sales of homes worth more than £1m between August and October compared with 14 in the previous 3 month period. Christine Campbell states that after “the introduction of the new levy in April, home sales in this price bracket ground to a halt, but they are now picking up again.”¹² Table 2 below provides details of the number of monthly sales of £1m plus houses between January and October 2015.

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⁸http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Adviser_briefing_on_LBTT_Written_Evidence.pdf
⁹Finance Committee, 25 November 2015, OR Col. 5
¹⁰http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Adviser_briefing_on_LBTT_Written_Evidence.pdf
Table 2

<table>
<thead>
<tr>
<th>Month (2015)</th>
<th>£1m plus sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>8</td>
</tr>
<tr>
<td>February</td>
<td>14</td>
</tr>
<tr>
<td>March</td>
<td>90</td>
</tr>
<tr>
<td>April</td>
<td>0</td>
</tr>
<tr>
<td>May</td>
<td>2</td>
</tr>
<tr>
<td>June</td>
<td>8</td>
</tr>
<tr>
<td>July</td>
<td>4</td>
</tr>
<tr>
<td>August</td>
<td>13</td>
</tr>
<tr>
<td>September</td>
<td>11</td>
</tr>
<tr>
<td>October</td>
<td>6</td>
</tr>
</tbody>
</table>

61. The Your Move/Acadata report states that: “It would thus appear that the market is slowly edging back to include the same number of high value transactions as that experienced prior to the introduction of the LBTT.”

62. While LBTT may have slowed sales at the higher end of the market, Your Move/Acadata suggest that it has had a much more positive impact on the middle and lower tiers. In October, Christine Campbell stated that this end of the market “have got a new lease of life under the new tax regime” and more recently in December that “property sales in Scotland for first-time buyers and home movers are increasing three times faster than the rest of the UK.”

Residential Revenue Forecasts

63. The Scottish Government has, for the first time, produced five year forecasts for the devolved taxes. The forecasts for residential LBTT are set out in Table 3 below.

Table 3

<table>
<thead>
<tr>
<th></th>
<th>2015-16 (£m)</th>
<th>2016-17 (£m)</th>
<th>2017-18 (£m)</th>
<th>2018-19 (£m)</th>
<th>2019-20 (£m)</th>
<th>2020-21 (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential</td>
<td>245</td>
<td>295</td>
<td>355</td>
<td>415</td>
<td>480</td>
<td>545</td>
</tr>
</tbody>
</table>

64. The figure for 2015-16 is a revised forecast and is £10m higher than the forecast in last year’s draft budget. The SFC also point out that £188m out of the £300m increase between 2015-16 and 2020-21 is due to fiscal drag whereby rising house prices will push some transactions into higher bands. This assumes that the bands are not adjusted in line with house price inflation.

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65. There have been no significant changes to the forecasting methodology used by the Scottish Government for residential LBTT since last year's draft budget. The Scottish Government’s methodology paper states that the residential LBTT forecasts have “been calculated in the same manner as the forecasts underpinning the 2015-16 Scottish Budget.”

66. The SFC states that the overall progress “in developing the forecasting methodologies has been slower than the Commission has hoped” and that “in some instances the Commission has yet to be convinced that all possible avenues have been fully explored.”

67. For example, the SFC reiterates the concerns it raised in its report on Draft Budget 2015-16 that the Scottish Government’s forecasting methods for residential LBTT contain some deficiencies. In particular, there is a need to widen the economic determinants incorporated into the modelling of the housing market that underpins the forecast. The SFC states that it continues to encourage the Scottish Government to explore a multi-variate modelling approach.

68. The SFC also advise that the available outturn data for 2015-16 does not feed into the forecast. It is not clear why this is the case and the Scottish Government’s methodology paper does not address this issue. The OBR substantially revised down its forecast for residential LBTT in November 2015 on the basis of outturn receipts for the first 6 months of the new tax.

69. The SFC has also consistently raised concerns in relation to the lack of any analysis of the behavioural response to LBTT and this issue is explored in detail below.

**Behavioural Response**

70. One of the key issues which the Committee has considered is the extent to which behavioural factors in response to the introduction of LBTT are temporary or longer term. The temporary response is known as forestalling whereby homeowners shifted the timing of property transactions when the tax was introduced. A longer term response would include homeowners deciding to upgrade existing homes rather than moving home.

*Forestalling*

71. The Scottish Government estimate the loss of revenues for 2015-16 due to forestalling to be in the range of £12m to £37m “with the expectation that they would lie towards the bottom of this range.” The SFC advise that this “comes from examining the response observed in Scottish data to the stamp duty holiday analysed by Best and Kleven (2015).” Professor Leith explained to the Committee on 25 November 2015 that “we encouraged the Scottish Government to look into that paper” and that the range of £12m to £37m “captures the range of estimates as

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17 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf) page 37
18 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf) paragraph 3.11
to the magnitude of the behavioural effect and how long it lasts."\textsuperscript{19} These estimates do not include any permanent behavioural effects but relate only to forestalling which is a temporary effect.

72. The OBR’s latest forecast for the devolved taxes which was published in November 2015 increased its forecast for forestalling from £20m to £30m.

73. The SFC state that the available outturn data provides an opportunity to begin to evaluate to what extent forestalling has materialised. Table 4 provides the most up to date outturn figures relative to the forecast.

<table>
<thead>
<tr>
<th></th>
<th>Expected Tax Revenues (%)</th>
<th>Expected Tax Revenues (£m)</th>
<th>Actual Liabilities (Accruals) (£m)</th>
<th>Difference (£m)</th>
<th>Cumulative Difference (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>April</td>
<td>7.5</td>
<td>17.6</td>
<td>7</td>
<td>-10.6</td>
<td>-10.6</td>
</tr>
<tr>
<td>May</td>
<td>8.1</td>
<td>19.1</td>
<td>11.4</td>
<td>-7.7</td>
<td>-18.3</td>
</tr>
<tr>
<td>June</td>
<td>9.3</td>
<td>21.9</td>
<td>18.5</td>
<td>-3.4</td>
<td>-21.7</td>
</tr>
<tr>
<td>July</td>
<td>10.3</td>
<td>24.1</td>
<td>19.4</td>
<td>-4.7</td>
<td>-26.4</td>
</tr>
<tr>
<td>August</td>
<td>9.2</td>
<td>21.5</td>
<td>21.4</td>
<td>-0.1</td>
<td>-26.6</td>
</tr>
<tr>
<td>September</td>
<td>9.1</td>
<td>22.5</td>
<td>18.7</td>
<td>-3.8</td>
<td>-30.3</td>
</tr>
<tr>
<td>October</td>
<td>8.4</td>
<td>21.3</td>
<td>20.0</td>
<td>-1.3</td>
<td>-31.6</td>
</tr>
<tr>
<td>November</td>
<td>9.8</td>
<td>19.8</td>
<td>20.9</td>
<td>1.1</td>
<td>-30.5</td>
</tr>
</tbody>
</table>

74. The SFC looked at the outturn figures for the period up to the end of October and concluded that either the:

- forestalling effects are larger and possibly more prolonged than anticipated;
- underlying forecast is over-predicting revenues received for the year to date;
- process of seasonal adjustment in attempting to allocate an annual forecast across individual months is not accurately capturing the monthly variable in revenues observed this year.\textsuperscript{20}

75. Professor Leith told the Committee that the—

"outturn data is significantly below what one would expect, given the normal seasonality. That may be because of a temporary forestalling effect, or it may be that the change in the tax regime has permanently subdued parts of the market, so the trend will continue indefinitely."\textsuperscript{21}

76. He went on to say that from the data, "the best guess is that there is a combination of a little bit of forestalling and perhaps a little bit of a longer-term effect."\textsuperscript{22} He also stated that "it seems that there was substantial forestalling in those

\textsuperscript{19} Finance Committee, 25 November 2015, OR Col. 37
\textsuperscript{20} http://www.fiscal.scot/media/media_437935_en.pdf
\textsuperscript{21} Finance Committee, 25 November 2015, OR Col. 31
\textsuperscript{22} Finance Committee, 25 November 2015, OR Col. 32
early months.” The SPF stated that “there will be an element of forestalling, but not to the extent of over £30 million”

** Longer term **

77. Both Homes for Scotland and the SPF raised concerns that the impact of the introduction of LBTT may be longer term. The former stated that on “the basis of the evidence that we have, I think that we will see the lower volume of activity at the middle and upper end of the market continue” and that “that there will be lower levels of activity in those parts of the market for the foreseeable future.” The SPF agreed stating that the “trend is not a blip and it reflects not an adjustment but a behavioural change as a result of the cost of moving.”

78. The SFC state that “there may be longer-term behavioural responses to the new tax which the current forecasting approach does not allow for.” The SFC’s view is that this could mean the forecast is too optimistic. Professor Leith told the Committee that in “our initial report, there are several instances in which we suggest that it would be best if the behavioural effects of policy could somehow be incorporated into the method of producing the forecast.”

79. The SFC recommended in its report on Draft Budget 2015-16 that behavioural factors should be included in the forecasting methodology as soon as practicable. They pointed out that there may be other environmental or behavioural factors which could have a bigger impact on outcomes than forestalling particularly in the medium term and these need to be considered as well.

80. However, despite these concerns the methodology still doesn’t account for any behavioural response. In their report on this year’s draft budget the SFC state that “we are increasingly concerned about the residential LBTT forecasts which still assume no behavioural responses.”

81. The Scottish Government states in its methodology paper that it “will continue to monitor the appropriateness of the methodology used for modelling LBTT revenues, including the potential to incorporate behavioural analysis into the forecasting approach.” This appears to be at odds with the view of the SFC that behavioural factors should be included in the forecasting methodology as soon as practicable.

82. The DFM was asked at the Committee’s meeting on 2 December whether he intends to change the forecast methodology to include behavioural factors. He responded—

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23 Finance Committee, 25 November 2015, Or Col. 35  
24 Finance Committee, 25 November 2015, OR Col. 23  
26 Finance Committee, 25 November 2015, OR Col. 12  
27 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)  
28 Finance Committee, 25 November 2015, OR Col. 67  
29 [http://www.fiscal.scot/media/media_397838_en.pdf](http://www.fiscal.scot/media/media_397838_en.pdf)  
30 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)  
“That remains a work in progress. There will be developments in the model that are designed to reflect that, but our understanding of behavioural factors will, in itself, be a developing part of our thinking.”

Non-Residential Transactions

83. The Draft Budget states that maintaining the rates and bands for non-residential transactions “will ensure that Scotland remains a competitive and attractive location for business.”

84. The SPF pointed out that the increase from 4% to 4.5% for non-residential transactions is absorbed by the seller as the tax is deducted from the value of the asset. Their view is that this change has not “been material enough to lead to a wholesale change in activity” but that there is a need to guard against the fragility of the market. For example, transactional levels in Glasgow and Edinburgh are much lower than they would expect.

85. While the 4.5% rate seems to be working the SPF “would like there to be more transactional activity and more confidence in the market.” Their view is that “the rates in the intensely competitive commercial sector should either remain the same or be re-aligned to be the same as the UK SDLT top rate for the sector.”

Non-Residential Revenue Forecasts

86. The methodology for forecasting non-residential revenues “has followed the approach which underpinned the 2015-16 forecast and uses the latest OBR growth rates from a base year based on a 3-year average to 2014-15.”

87. The forecasts for non-residential revenue for 2015-16 to 2020-21 are set out in Table 5 below.

Table 5

<table>
<thead>
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</thead>
<tbody>
<tr>
<td>Non-residential</td>
<td>£210m</td>
<td>£220m</td>
<td>£230m</td>
<td>£240m</td>
<td>£250m</td>
<td>£260m</td>
</tr>
</tbody>
</table>

88. The figure for 2015-16 is a revised forecast and is £64m higher than the forecast in last year’s draft budget. It is not clear why the forecast has changed by this amount. In contrast the OBR provides a breakdown of the basis for any changes when it publishes its bi-annual forecasts for the devolved taxes.

[32] Finance Committee, 2 December 2015, OR Col. 19
[34] Finance Committee, 25 November 2015, OR Col. 6
89. As with the residential forecasts the available outturn data for 2015-16 does not feed into the forecast. Again it is not clear why this is the case and the Scottish Government’s methodology paper does not address this issue. As with the residential forecasts the OBR substantially changed its forecast for non-residential LBTT in November 2015 on the basis of outturn receipts for the first 6 months of the new tax.

90. The SFC recommended that—

“there is a case for using the information contained in the part-year outturn data on non-residential LBTT revenues to improve the base from which non-residential LBTT revenues are projected forwards, particularly when outturn data for the majority of the year are released before the forecast is made.”

Lack of Data

91. The SFC stated in its report on Draft Budget 2015-16 in relation to non-residential LBTT that “because there is currently a lack of data to forecast this component of the Scottish economy directly, the primary recommendation is to develop new data sources as a high priority.” Since then HMRC has begun to publish data on commercial property transaction data for Scotland.

92. The methodology paper suggests that the initial HMRC data published in October 2015 shows a reasonably strong relationship between the UK and Scottish data and, therefore, “there is no evidence to suggest that the use of UK level transactions determinants would introduce a systematic bias into Scottish forecasts.”

93. The SFC suggests that “this provides some comfort that the use of projections of UK transactions data is not inappropriate in forecasting” non-residential LBTT revenues. However, “the existence of this data set may also facilitate direct modelling of this variable for Scotland in the future.” The SFC reiterates its view that a new model for forecasting non-residential LBTT revenues “with some explanation of the economic drivers of the revenue variations, and better data, are needed in the longer term.”

Scottish Landfill Tax (SLfT)

94. The proposed rates for SLfT are £84.40 per tonne for the standard rate and £2.65 per tonne for the lower rate which ensure that the tax burden increases in line with inflation. As with the rates for 2015-16 these are the same rates as the planned UK landfill tax rates for 2016-17. This approach is intended to address the possibility of waste tourism.

95. The credit rate for the Scottish Communities Land Fund will remain at 5.6% compared to the UK credit rate which is 4.2%.

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38 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf) page 21
40 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)
41 [http://www.fiscal.scot/media/media_437935_en.pdf](http://www.fiscal.scot/media/media_437935_en.pdf)
Revenue Forecast

96. The forecasts for SLfT are set out in Table 6 below.

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>£ million</td>
<td>117</td>
<td>133</td>
<td>123</td>
<td>114</td>
<td>104</td>
<td>94</td>
</tr>
</tbody>
</table>

97. These forecasts assume that the Scottish Government meets its target of reducing total waste reduction by 85% of its 2011 level by 2025 and that total disposals to landfill fall by 5% of total waste by 2025. The SFC state that it “has obviously been concerned that a target does not automatically imply a forecast and has therefore sought reassurance that this projection is a reasonable one.” They further state that “they have sought a quantitative evaluation of the impact of various environmental policies to assess whether or not these are capable of delivering the implied reduction in landfill volumes” and that they are “broadly satisfied that there are potential policies which could feasibly deliver the target which underpins the forecast.”

98. In contrast to the forecasting methodology for the LBTT forecasts the methodology for the SLfT forecasts has been revised on the basis of the first 6 months of outturn data. The SFC point out that unlike “the other forecasts where the part-year outturn data do not directly affect the forecast, in the case of the SLfT the outturn data are being used to refine the forecast in various ways.” It is unclear why the outturn data for 2015-16 has been used to refine the forecast for SLfT but not for LBTT.

Block Grant Adjustment – Devolved Taxes

99. The UK and Scottish Governments have yet to agree a permanent block grant adjustment mechanism for the fully devolved taxes. A one year adjustment of £494m was agreed for 2015-16. This was based on the mid-point of the Scottish Government and the OBR forecasts for the devolved taxes.

100. Draft Budget 2016-17 states that discussions on a permanent adjustment mechanism are on-going as part of the negotiations on the fiscal framework. In the meantime a further one year agreement has been reached for 2016-17 of £600m. The Scottish Government forecasts tax revenues of £671m for LBTT and SLfT for 2016-17 while the OBR forecast is £627m. The mid-point of these two forecasts is £644m. It is, therefore, unclear how the adjustment of £600m has been arrived at.

101. The Committee has previously raised concerns about the lack of transparency regarding adjustments to the block grant arising from the devolution of further powers. The Scottish Government consequently agreed the following changes to the Written Agreement:

“The Scottish Government will ensure that the Finance Committee is kept informed of progress on any agreement, or change to existing agreement, with the UK Government on adjustments to the block grant arising from the devolution of further powers. Wherever possible, the Scottish Government will consult with the Finance Committee prior to final agreement being reached,
and where for any reason consultation is not possible, the Scottish Government will as soon as possible write to the Committee providing reasons for not consulting and setting out how the adjustments and any changes to them were calculated. The Scottish Government will aim to provide this information prior to the publication of the Draft Budget, to support budget scrutiny.\(^42\)

**Conclusion**

102. The Committee is invited to consider the above in taking evidence on the revenue side of the draft budget with the Deputy First Minister.

Committee Clerks
January 2016

\(^{42}\) http://www.scottish.parliament.uk/S4_FinanceCommittee/General%20Documents/Written_Agreement_-_Revised_April_2015.pdf
Financial Scrutiny Unit Briefing
Draft Budget 2016-17

05 January 2016

Financial Scrutiny Unit

This briefing summarises the tax and spending plans contained within the Scottish Government’s Draft Budget 2016-17.

More detailed presentation of the budget figures can be found in the Draft Budget 2016-17 spreadsheets. The Draft Budget 2016-17 level 1 and 2 spreadsheet covers higher level figures. Level 3 is the most detailed breakdown contained in the Government’s spending plans and can be found in the Draft Budget 2016-17 level 3 spreadsheet. The FSU has also published the most detailed available level 4 figures.

A high level overview of the budget can be found in the Draft Budget 2016-17 infographic and an overview of of the taxation plans in the Scottish Rate of Income Tax and Devolved taxes infographic.
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EXECUTIVE SUMMARY

Draft Budget 2016-17 sets out Scottish Government spending plans for financial year 2016-17. The plans include the setting of the Scottish Rate of Income tax for the first time, and rates and revenue forecasts for the devolved taxes.

The discretionary element of the Scottish Government Budget is the Departmental Expenditure Limit, which is planned to fall in 2016-17 by 2% in real terms. Resource spending will fall by 2.2% in real terms with Capital spending overall (including borrowing and financial transactions) broadly standing still in real terms at -0.1%. Health, Wellbeing and Sport is by far the largest portfolio (42.5% of DEL) and receives the largest absolute increase (£662m).

The Scottish Rate of Income tax is set for the first time at 10%, meaning Scottish taxpayers will pay no more than taxpayers in the rest of the UK. The Office for Budget Responsibility (OBR) estimates that this will generate £4.9bn. Devolved taxes (Land and Buildings Transaction Tax and Scottish Landfill Tax) are expected to generate £671m, £71m more than the £600m corresponding reduction in the block grant (via the block grant adjustment mechanism).

Five years of forecasts for devolved taxes have been provided for the first time and show Scottish Government total forecasts, by and large, to be higher than OBR forecasts. The Scottish Fiscal Commission assesses the Scottish Government forecasts for devolved taxes as “reasonable” but is concerned at the lack of further modelling on the behavioural responses of taxpayers in relation to residential Land and Buildings Transaction Tax.

The Scottish Government plans to supplement the 2016-17 capital budget with non-profit distributing investment to the value of £909m. However, due to changes in accounting rules, £398m of the value of this investment is reflected in the capital DEL budget.

Over the period 2012-13 to 2019-20, on the basis of current plans, a total of £1.8bn will be allocated to financial transactions, relating to equity/loan schemes beyond the public sector. These amounts need to repaid to HM Treasury in future years – no payments have been made to date. In 2016-17, £251m in Financial Transaction monies has been allocated to housing related schemes, including Help to Buy.

Local Government will receive £10,152.3m in 2016-17. This includes a real terms fall of 5.2% in its revenue settlement. The Scottish Government plans to freeze Council tax in 2016-17 for the 9th successive year at a cumulative cost of £3,150m.

The Draft Budget was accompanied by documents covering performance, carbon impacts and equalities. The Scottish Government also published a one year pay policy which includes a 1% cap on pay for staff earning over £22,000.
INTRODUCTION

Draft Budget 2016-17 was published on 16 December 2015 and sets out the Scottish Government’s draft tax and spending plans for 2016-17. A Scottish Rate of Income Tax (SRIT) is set for the first time under the powers devolved by Scotland Act 2012. Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) are also set for the second year since they were devolved. Publication of the Draft Budget commences parliamentary scrutiny of the Government’s tax and spending plans, a scrutiny process which is truncated due to the UK Spending Review not being published until 25 November 2015.

Alongside the main budget document, the Scottish Government published documents on Infrastructure Investment, Performance, Carbon Assessment, Equalities and a forecasting methodology for the devolved taxes. The Scottish Fiscal Committee also published its assessment of the five-years of devolved tax forecasts and economic determinants underpinning the projected non-domestic rate income.

Table 1.01 in the introduction to the Draft Budget document presents the Scottish Departmental Expenditure Limit (DEL) as received from the Treasury. This presents the Scottish allocations from HM Treasury for the remainder of the Spending Review period (through to 2019-20) – the document itself only allocates these monies for one year, 2016-17.

Table 1.01 shows that the Scottish DEL will increase by 0.5% in cash terms and decrease by 1.2% in real terms in 2016-17. However, the DEL presented in the actual portfolio chapters and presented in the annex in p160 shows DEL falling in cash terms by 0.3% and by 2.0% in real terms. It is not clear how this difference arises. This briefing presents the actual spending plans as set out in the portfolio chapters and annex tables of the Draft Budget publication.

The level 2 and 3 figures in the document reflect any changes that were formally made in the passage of the Budget Bill in February 2015. Most of the changes announced by the Deputy First Minister at Stage 3 of the Budget Bill did not formally amend the Bill. Instead these were shown in the accounts at the mid-year Autumn Budget Revision stage. As such some budget lines for 2015-16 do not reflect what is actually being spent. An example of this is the Fuel Poverty/Energy Efficiency line of £89m on p86, which does not include the £20m announced by the Deputy First Minister at Stage 3 of the Budget Bill and formally approved by Parliament at the Autumn Budget Revision. This has the effect of making the 2015-16 baseline look lower than it is in reality and presents the Fuel Poverty/Energy Efficiency budget line as increasing in 2016-17, when it is actually falling if compared with the final 2015-16 budget.

The Scotland Act 2012 allows Scottish Ministers to borrow up to 10% of the DEL Capital budget (including financial transactions). The Draft Budget indicates that the Scottish Government intends to use the full borrowing limit in 2016-17 of £316m. Last year’s Draft Budget also committed to the full capital borrowing limit but that is still to be drawn down.

Many of the numbers in this briefing are adjusted for inflation (presented in “real terms” or 2015-16 prices) and the deflator used is the HM Treasury GDP deflator, as used in the Draft Budget, which is 1.7% for 2016-17.

ALLOCATIONS

Total Managed Expenditure (TME) comprises DEL and Annually Managed Expenditure (AME). TME in 2016-17 is £37,133.5m. Figure 1 shows how this is allocated between DEL and AME. DEL is the element of the budget over which the Scottish Government has discretion and is
divided into Capital and Resource. AME is expenditure which is difficult to predict precisely, but where there is a commitment to spend or pay a charge, for example, pensions. Pensions in AME are fully funded by HM Treasury, so do not impact on the Scottish Government’s spending power. Non-domestic rates (covered below) are also classed as an AME item in the budget and form part of Local Government spending.

**Figure 1: Allocation of TME, 2016-17, cash TERMS**

![Figure 1: Allocation of TME, 2016-17, cash TERMS](image)

**Figure 2: Absolute change, DEL Resource and DEL Capital real terms, 2015-16 to 2016-17**

![Figure 2: Absolute change, DEL Resource and DEL Capital real terms, 2015-16 to 2016-17](image)

Figure 2 shows the real terms changes in DEL Resource and DEL Capital between 2015-16 and 2016-17. DEL Capital is boosted in 2016-17 by £316m of Capital borrowing under the terms of the Scotland Act 2012.
Figure 3: DELs by portfolio, 2016-17

Figure 3 shows the DEL portfolio budgets and their cash and real change in 2016-17. Key points to note are as follows:

- Health, Wellbeing and Sport is the largest portfolio, comprising 42.5% of total DEL in 2016-17. This is an increase on the 2015-16 share of total DEL which was 40.2%.
- The next largest portfolio is the Social Justice, Communities and Pensioners’ Rights portfolio which comprises 27.2% of total DEL in 2016-17. The equivalent figure for 2015-16 is 28.9%. This is largely due to the fall in Local Government which accounts for the majority of this portfolio budget, and is discussed in more detail below.
RESOURCES AND CAPITAL EXPENDITURE

Figure 4 shows the split between DEL Resource and DEL Capital by portfolio in 2016-17 and shows that, as might be expected, the Infrastructure, Investment and Cities portfolio has the highest concentration of DEL Capital Spend within it (53% of portfolio DEL). The next largest is Finance, Employment and Sustainable Growth (40% of portfolio DEL).

Figure 5 shows the Real terms percentage change in 2016-17 in DEL Resource and DEL Capital by portfolio.

**Figure 4: Resource and Capital DEL budget split by portfolio**

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Resource</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
<td>47%</td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>Social Justice</td>
<td>84%</td>
<td></td>
</tr>
<tr>
<td>Culture</td>
<td>87%</td>
<td></td>
</tr>
<tr>
<td>Rural Administration</td>
<td>93%</td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>96%</td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>96%</td>
<td></td>
</tr>
<tr>
<td>Crown Office</td>
<td>97%</td>
<td></td>
</tr>
<tr>
<td>Justice</td>
<td>97%</td>
<td></td>
</tr>
<tr>
<td>Parliament</td>
<td>98%</td>
<td></td>
</tr>
<tr>
<td>Fair Work</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>
Only two portfolios show an increased resource budget (in real terms): health, wellbeing and sport (up 1.6% in real terms) and Scottish Parliament and Audit (up 7.4% in real terms). The health, wellbeing and sport increase represents the largest cash increase of any portfolio (+£396.3m).

For all other portfolios, resource budgets are falling in real terms, with the biggest reductions in administration (-6.7%), social justice, which includes local government (-6.0%) and education (-5.8%).

The health, wellbeing and sport capital budget more than doubles in real terms, partly as a result of the need to provide £215m upfront capital cover for three capital projects that are being delivered using NPD financing (see below for further details). If this effect is stripped out, the real terms increase in the health capital budget is 35%.

The administration capital budget increases by 59% in real terms, but this represents a relatively small cash increase of £5m.

The justice capital budget shows a 33.7% real terms reduction, reflecting reprioritising and review of capital investment proposals for the Scottish Prison Service, the Scottish Police Authority and the Scottish Fire and Rescue Service.
The Parliament and Audit capital budget is reduced by 56% in real terms, but this represents a relatively small cash reduction of £2.1m

CAPITAL AND INFRASTRUCTURE

The 2016-17 DEL capital budget from HM Treasury is £2,832m, a 3.5% increase in real terms compared with 2015-16. The Scottish Government is also able to borrow up to 10% of its capital budget (DEL capital + Financial Transactions). If the maximum capital borrowing powers are used, this will be equivalent to £316m in 2016-17. In addition, the Scottish Government has £326m allocated for financial transactions in 2016-17 and will receive further funds in year from HM Treasury in relation to the Glasgow City Deal (£10m currently allocated). Taken together, these four elements give a total allocated capital budget of £3,484m. The Scottish Government plans to supplement the 2016-17 capital budget with non-profit distributing (NPD) investment with a net additional capital value of £511m in 2016-17.\(^1\)

NON-PROFIT DISTRIBUTING (NPD) PROGRAMME

In 2016-17, the Scottish Government plans to progress a range of projects using NPD financing. Planned investment through NPD financing in 2016-17 is £909m. This includes projects such as the M8/M73/M74 motorway improvements, the Aberdeen Western Peripheral Route as well as a range of school, college and health projects. NPD investment is a form of revenue funding which means that the Scottish Government does not pay the upfront construction costs, but is committed to making annual repayments to the contractor, typically over the course of 25-30 years.

ESA 10

New European accounting guidance (European System of Accounts 2010 – ESA10) came into effect in September 2014. These rules have implications for the accounting treatment of public-private partnership projects (PPPs), including NPD. The new guidance means that some projects that were formerly classified as private sector will now be classified as public sector. This affects any projects reaching financial close since September 2014.

Projects that are deemed to be public sector projects require upfront budget cover to be provided from the capital DEL 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. The change in treatment means that affected NPD projects impact on the capital DEL budget.

The Scottish Government has been able to adjust the design of smaller NPD hub projects so that they can continue to be treated as private sector assets and financed through the revenue budget as before. This means that 2 community health and 10 school hub projects that had been put on hold are now able to progress.

However, uncertainty remains over a number of larger “stand-alone” NPD projects. The UK Office for National Statistics (ONS) has determined that the £745m Aberdeen Western Peripheral Route (AWPR) project which is currently under construction should be treated as a

\(^{1}\) Due to the ESA 10 changes described below, £398m of the £909m capital value of planned NPD investment has required upfront capital budget allocation.
public sector project, with resulting implications for the capital DEL budget. Decisions have yet
to be reached in relation to four further NPD projects:

- the Dumfries & Galloway Royal Infirmary (£275.5m, currently in construction)
- the Royal Hospital for Sick Children/Department for Clinical Neurosciences (£230.1m,
currently in construction)
- the Scottish Blood Transfusion Service (£38.1m, currently in construction)
- the Balfour Hospital in Orkney (£67.5m, currently in procurement).

The projects that are under construction are continuing to the same timetable, but amounts
have been included in the capital DEL budgets to allow for the capital costs incurred in 2016-17:

- £215m in the health capital DEL project for the three health projects listed above that are
  under construction
- £183m in the motorways and trunk roads capital DEL budget for the AWPR.

**REVENUE FINANCING AND THE 5% CAP**

Annual repayments resulting from revenue financed projects, such as NPD projects, come from
the Scottish Government’s revenue budget. The Scottish Government has committed to
spending no more than 5% of its total DEL budget on repayments resulting from revenue
financing (which includes NPD, previous PPP contracts, regulatory asset base (RAB) rail
investment) and any repayments resulting from borrowing. Based on current plans, the Scottish
Government will spend around 3.75% of its total DEL budget on such payments in 2016-17,
rising to a peak of just over 4.2% in 2020-21. On the basis of the 2016-17 total DEL\(^2\), this would
suggest current repayment commitments of just over £1.1bn.

**FINANCIAL TRANSACTIONS**

The Draft Budget includes £326m in 2016-17 for “financial transactions”. This relates to Barnett
consequentials resulting from a range of UK Government housing-related equity/loan finance
schemes. Over the period 2012-13 to 2019-20, on the basis of current plans, financial
transactions allocations will total £1.8bn. The Scottish Government has to use these funds to
support equity/loan schemes beyond the public sector, but has some discretion in the exact
parameters of those schemes and the areas in which they will be offered. This means that the
Scottish Government is not obliged to restrict these schemes to housing-related measures and
is able to provide a different mix of equity/loan finance.

In 2016-17, a total of £251m has been allocated to housing-related schemes, including Help to
Buy (Scotland). The Scottish Government is also providing equity/loan finance support in areas
other than housing. Individual tables in the budget document show the following profile for
financial transactions.

---

\(^2\) Excluding Financial Transactions.
Table 1: Financial transactions, £m

<table>
<thead>
<tr>
<th>Portfolio area</th>
<th>2015-16</th>
<th>2016-17</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health, wellbeing and sport</td>
<td>2.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Finance, constitution and economy</td>
<td>8.5</td>
<td>35.5</td>
</tr>
<tr>
<td>Education &amp; lifelong learning</td>
<td>7.2</td>
<td>14.0</td>
</tr>
<tr>
<td>Rural affairs, food and the environment</td>
<td>7.5</td>
<td>5.0</td>
</tr>
<tr>
<td>Culture, Europe and external affairs</td>
<td>8.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Infrastructure, investment and cities</td>
<td>5.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Social justice, communities and pensioners' rights</td>
<td>340.0</td>
<td>251.2</td>
</tr>
<tr>
<td>Total of above</td>
<td>378.2</td>
<td>322.7</td>
</tr>
</tbody>
</table>

Note: the total of amounts shown for individual portfolios differs from the total shown in Table 1.01 of the Draft Budget (£386m in 2015-16 and £326m in 2016-17). The Scottish Government has indicated that this reflects a carry-forward of £30.6m of the allocation for financial transactions from earlier years.

The Scottish Government will be required to make repayments to HM Treasury in respect of these financial transactions. The repayments will be spread over 30 years, reflecting the fact that the majority of FT allocations relate to long term lending to support house purchases and the construction sector. The repayment schedule is based on the anticipated profile of Scottish Government receipts. It is agreed with HM Treasury and reviewed on an annual basis. No repayments have been made to date and none are planned for 2015-16.

**REAL TERMS INCREASES AND DECREASES**

Figure 6 presents the largest real terms level 2 budget line increases and decreases in 2016-17 on the previous financial year. Only increases and decreases above £5m have been included. Points to note are as follows:

- Health receives by far the largest increase, with Local Government receiving by far the largest decrease
- Motorways and Trunk Roads receive the 2nd largest increase, however Rail Services in Scotland receive a reduction in funding
Figure 6: Largest real terms changes, 2015-16 to 2016-17, £m

<table>
<thead>
<tr>
<th>Category</th>
<th>Change (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>471.8</td>
</tr>
<tr>
<td>Motorways and Trunk Roads</td>
<td>111.8</td>
</tr>
<tr>
<td>Digital Strategy</td>
<td>63.2</td>
</tr>
<tr>
<td>Other Transport Policy, Projects and Agency</td>
<td>49.8</td>
</tr>
<tr>
<td>Ferry Services in Scotland</td>
<td>8.2</td>
</tr>
<tr>
<td>Learning</td>
<td>6.8</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>6.4</td>
</tr>
<tr>
<td>Children &amp; Families</td>
<td>-5.2</td>
</tr>
<tr>
<td>Police and Fire Pensions</td>
<td>-5.9</td>
</tr>
<tr>
<td>Administration</td>
<td>-7.9</td>
</tr>
<tr>
<td>Research, Analysis &amp; Other Services</td>
<td>-7.9</td>
</tr>
<tr>
<td>Scottish Police Authority (SPA)</td>
<td>-12.2</td>
</tr>
<tr>
<td>Legal Aid</td>
<td>-12.2</td>
</tr>
<tr>
<td>Parliamentary Business &amp; Government Strategy</td>
<td>-13.2</td>
</tr>
<tr>
<td>Fair Work, Skills &amp; Training</td>
<td>-13.3</td>
</tr>
<tr>
<td>Culture</td>
<td>-18.7</td>
</tr>
<tr>
<td>Police Central Government</td>
<td>-19</td>
</tr>
<tr>
<td>Scottish Fire and Rescue Service</td>
<td>-19.4</td>
</tr>
<tr>
<td>Scottish Further &amp; Higher Education Funding Council</td>
<td>-22.7</td>
</tr>
<tr>
<td>Sport</td>
<td>-26.8</td>
</tr>
<tr>
<td>Safer and Stronger Communities</td>
<td>-33.3</td>
</tr>
<tr>
<td>Scottish Prison Service</td>
<td>-45</td>
</tr>
<tr>
<td>Enterprise, Energy &amp; Tourism</td>
<td>-47.5</td>
</tr>
<tr>
<td>Rail Services in Scotland</td>
<td>-69.6</td>
</tr>
<tr>
<td>Scottish Water</td>
<td>-78.4</td>
</tr>
<tr>
<td>Higher Education Student Support</td>
<td>-108.6</td>
</tr>
<tr>
<td>Scottish Public Pensions Agency (SPPA)</td>
<td>-156.1</td>
</tr>
</tbody>
</table>

LOCAL GOVERNMENT

TOTAL LOCAL GOVERNMENT BUDGET

The presentation of local government in the 2016-17 Draft Budget has changed. Rather than its own portfolio chapter, local government is now included within the “Social Justice, Communities and Pensioners’ Rights portfolio. This section of the briefing discusses the local government settlement in brief. A further, detailed, dedicated briefing on the local government settlement and the allocations to individual local authorities will be published in due course.

The total allocation to local government in 2016-17 will be £10,152.3m. This is a substantial reduction on the 2015-16 allocation of £10,756.7m – more than 7% in real terms. Table 2 below sets out the level 3 breakdown of the local government settlement, in cash and real terms.
Table 2: Local Government – level 3 breakdown

<table>
<thead>
<tr>
<th>Level 3</th>
<th>2015-16</th>
<th>2016-17 (cash)</th>
<th>2016-17 (real)</th>
<th>Real change</th>
<th>Real change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Revenue Grant</td>
<td>7,004.0</td>
<td>6,685.9</td>
<td>6,574.1</td>
<td>-429.9</td>
<td>-6.1%</td>
</tr>
<tr>
<td>Non-Domestic Rates</td>
<td>2,799.5</td>
<td>2,768.5</td>
<td>2,722.2</td>
<td>-77.3</td>
<td>-2.8%</td>
</tr>
<tr>
<td>Support for Capital</td>
<td>716.2</td>
<td>480.6</td>
<td>472.6</td>
<td>-243.6</td>
<td>-34.0%</td>
</tr>
<tr>
<td>Specific Resource Grants</td>
<td>91.9</td>
<td>91.0</td>
<td>89.5</td>
<td>-2.4</td>
<td>-2.6%</td>
</tr>
<tr>
<td>Specific Capital Grants</td>
<td>145.1</td>
<td>126.3</td>
<td>124.2</td>
<td>-20.9</td>
<td>-14.4%</td>
</tr>
<tr>
<td>Total Local Government</td>
<td>10,756.7</td>
<td>10,152.3</td>
<td>9,982.6</td>
<td>-774.1</td>
<td>-7.2%</td>
</tr>
<tr>
<td>of which: RDEL</td>
<td>7,095.9</td>
<td>6,776.9</td>
<td>6,663.6</td>
<td>-432.3</td>
<td>-6.1%</td>
</tr>
<tr>
<td>CDEL</td>
<td>861.3</td>
<td>606.9</td>
<td>596.8</td>
<td>-264.5</td>
<td>-30.7%</td>
</tr>
<tr>
<td>AME</td>
<td>2,799.5</td>
<td>2,768.0</td>
<td>2,721.7</td>
<td>-77.8</td>
<td>-2.8%</td>
</tr>
<tr>
<td>GRG+NDRI</td>
<td>9,803.50</td>
<td>9,454.40</td>
<td>9,296.34</td>
<td>-507.16</td>
<td>-5.2%</td>
</tr>
</tbody>
</table>

The Scottish Government guarantees the combined general resource grant (GRG) and distributable non-domestic rate income (NDRI) figure, approved by Parliament, to each local authority. A drop in NDRI is compensated for by an increase in general revenue grant and vice versa. Therefore, to calculate Local Government’s revenue settlement, the combined GRG + NDRI figure is used. The table above shows that combined GRG+NDRI falls by 5.2% in real terms in 2016-17.

The capital allocation also appears to be falling substantially – more than 30% in 2016-17. However, this includes a number of reprofiling and other changes in both 2015-16 and 2016-17 (see footnotes 3 and 4 to table 9.12 in the Draft Budget). Table 3 below adjusts the capital allocation for these changes to provide a like for like comparison, meaning that on a like for like basis the local government capital allocation increases by 7.4% in real terms.

Table 3: Local Government capital - adjusted

<table>
<thead>
<tr>
<th>£m</th>
<th>2015-16</th>
<th>2016-17 (cash)</th>
<th>2016-17 (real)</th>
<th>Real change</th>
<th>Real change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEL Capital</td>
<td>861.3</td>
<td>606.9</td>
<td>596.8</td>
<td>-264.5</td>
<td>-30.7%</td>
</tr>
<tr>
<td>Reprofiling</td>
<td>-168.2</td>
<td>150.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjusted</td>
<td>693.1</td>
<td>756.9</td>
<td>744.2</td>
<td>51.1</td>
<td>7.4%</td>
</tr>
</tbody>
</table>

Non-Domestic Rates income is forecast to fall by 2.8% in real terms in 2016-17. This is a very different picture to the previous spending review period, when each year saw a year on year above-real terms increase. The Draft Budget explains that this is due to lower than forecast growth in the tax base and low inflation resulting in low growth in poundage. The Government is also proposing a number of changes to the large business supplement and some reliefs.

In terms of local government’s share of the Scottish budget, to ensure comparability, this is calculated on the basis of the total local government settlement as a percentage of Scottish
Government DEL+NDRI. Table 4 shows that, on this basis, and using the allocations in the Draft Budget, Local Government’s share of the Scottish budget is falling by 1.7%.

Table 4: Local Government – share of the Scottish Budget

<table>
<thead>
<tr>
<th></th>
<th>2015-16</th>
<th>2016-17 (cash)</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>LG total</td>
<td>10,756.7</td>
<td>10,152.3</td>
<td></td>
</tr>
<tr>
<td>SG DEL+ DNRI</td>
<td>33,336.5</td>
<td>33,212.6</td>
<td></td>
</tr>
<tr>
<td>LG as a % of SG DEL+NDRI</td>
<td>32.3%</td>
<td>30.6%</td>
<td>-1.7%</td>
</tr>
</tbody>
</table>

COUNCIL TAX

The Government confirmed that it is currently considering its response to the recently published report of the Commission on Local Tax Reform, “and will bring forward detailed proposals in the new year to reform the current system, drawing on the evidence considered by the Commission.” The Draft Budget further confirms that the settlement contains an additional £70m to freeze the council tax for another year. This brings the total cost of the freeze in 2015-16 to £630m, and the total cumulative cost from 2008-09 to 2016-17 to £3,150m.

SCOTTISH RATE OF INCOME TAX

SRIT will be introduced in Scotland from 6 April 2016 through the Scotland Act 2012. UK income tax rates will be reduced by 10p in the pound. The Draft Budget proposes to set SRIT at 10p for 2016-17 on the basis that “any increase above a 10% rate would have a disproportionate effect on the amount of tax paid by people on very low taxable incomes against their current tax bill, and any decrease would disproportionately benefit those people with high incomes.” This means that income tax for Scottish taxpayers in 2016-17 will be the same as in the rest of the UK.

The OBR has forecast that SRIT revenues for 2016-17 will be £4,900m. The Scottish Government has not produced an alternative forecast.

2016-17 is the first, transitional year of implementation of SRIT. Thus the OBR’s forecast for SRIT revenues will be notionally taken off the block grant but will be automatically added on to the Scottish budget. The net effect on the Scottish budget is 0.

DEVOLVED TAXES

LBTT and SLfT have been devolved since April 2015. The Draft Budget proposes to keep the same rates and bands for LBTT for 2016-17 as for 2015-16 as shown in Table 5.
Table 5: LBTT bands and rates

<table>
<thead>
<tr>
<th>Residential transactions</th>
<th>Non-domestic transactions</th>
<th>Non-residential leases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Band</td>
<td>Rate</td>
<td>Band</td>
</tr>
<tr>
<td>Up to £145,000</td>
<td>Nil</td>
<td>Up to £150,000</td>
</tr>
<tr>
<td>£145,001 to £250,000</td>
<td>2%</td>
<td>£150,001 to £350,000</td>
</tr>
<tr>
<td>£250,001 to £325,000</td>
<td>5%</td>
<td>Over £350,000</td>
</tr>
<tr>
<td>£325,001 to £750,000</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Over £750,000</td>
<td>12%</td>
<td></td>
</tr>
</tbody>
</table>

The Draft Budget proposes to introduce from 1 April 2016 a new LBTT supplement on additional homes, such as buy-to-let properties and second homes. This supplement will be 3 percentage points of the total price of the property for all relevant transactions above £40,000 and will be levied in addition to current LBTT rates. Thus LBTT on a second home valued over £750,000 will be 12 + 3 = 15%. The Draft Budget states this supplement “imposes a greater tax burden on those purchasing residential property as an additional purchase, for investment or recreational purposes compared to those seeking to purchase the property as a main residence. Our proposal complements our commitment to supporting home ownership in a balanced and sustainable way.”

The Scottish Government estimates the LBTT supplement in 2016-17 will raise between £17m and £29m.

Table 6 shows proposed SLfT rates that will apply from 1 April 2016 compared to 2015-16 rates.

Table 6: SLfT rates

<table>
<thead>
<tr>
<th></th>
<th>2015-16</th>
<th>2016-17</th>
<th>% increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard rate</td>
<td>£82.60</td>
<td>£84.40</td>
<td>2.2%</td>
</tr>
<tr>
<td>Lower rate</td>
<td>£2.60</td>
<td>£2.65</td>
<td>1.9%</td>
</tr>
</tbody>
</table>

These rates are the same as the planned UK Landfill Tax rates for 2016-17. The Draft Budget states this “addresses concerns over potential ‘waste tourism’ were there to be a material differential between the rates of tax charged in Scotland and the rest of the United Kingdom.”

For the first time, the Scottish Government has produced five-year forecasts for the devolved taxes. Figure 7 shows the Scottish Government’s forecast for LBTT and SLfT revenues compared to the OBR’s forecast.
The residential LBTT supplement was announced in the Draft Budget and revenue has thus not been forecast by the OBR. A comparison between the Scottish Government and OBR forecasts must exclude this supplement. OBR forecasts for the devolved taxes are between £7m and £31m lower than Scottish Government forecasts each year, except in 2020-21 when the OBR estimate revenues of £10m more than the Scottish Government. This is a change from previous forecasts from the OBR which tended to be higher than those produced by the Scottish Government.

The Scottish Fiscal Commission (SFC) carried out an independent assessment of the Scottish Government’s forecasts and published its Report on Draft Budget 2016-17 the same day the 2016-17 Draft Budget was published. The SFC stated that the forecasts of devolved tax revenues for the Draft Budget are reasonable but highlighted a number of points of concern (the lack of further modelling of the behavioural responses of taxpayers in relation to LBTT for instance) and made a series of recommendations to the Scottish Government for future modelling.

On LBTT, the SFC specifically noted that the forecasting method used by the Scottish Government “will tend to produce reasonable short-term forecasts when there is no major change in the economic environment. However, such approaches are known to miss major turning points such as housing market booms or busts” (Scottish Fiscal Commission 2015). It highlighted the following points in particular:

- On residential LBTT: “we are increasingly concerned about the residential LBTT forecasts which still assume no behavioural responses.”
- On non-residential LBTT: “we urge the forecasters to analyse what micro-data are available for non-residential LBTT as a way to interrogate any effects of fiscal drag.”
- On the LBTT supplement: “we emphasise the uncertainties behind our assessment of reasonableness in terms of data available for the second homes and buy-to-let market and the challenge of estimating the size of the tax base.”

<table>
<thead>
<tr>
<th>Year</th>
<th>SG</th>
<th>OBR</th>
<th>SLfT</th>
<th>Non-residential</th>
<th>Residential</th>
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<tr>
<td>2016-17</td>
<td>133</td>
<td>131</td>
<td>123</td>
<td>120</td>
<td>114</td>
</tr>
<tr>
<td>2017-18</td>
<td>220</td>
<td>243</td>
<td>230</td>
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<td>2018-19</td>
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<td>268</td>
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<td>2020-21</td>
<td>94</td>
<td>260</td>
<td>282</td>
<td>418</td>
<td>545</td>
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</tbody>
</table>

Legend:
- SG: Scottish Government
- OBR: Office for Budget Responsibility
- SLfT: Scottish Landfill Tax
- Non-residential LBTT
- Residential LBTT

Figure 7: Scottish Government and OBR LBTT and SLfT forecasts, 2016-17 to 2020-21
Concerning SLfT, the SFC stated: “Overall, given the current data availability, this approach to forecasting revenues from the SLfT is not unreasonable, although the Commission would hope to continue monitoring closely the validity of the assumptions underpinning the forecast as further Scotland-specific data on landfill waste and tax receipts become available.”

**BLOCK GRANT ADJUSTMENT**

The Scottish and UK Governments have agreed a provisional one-year block grant adjustment for LBTT and Landfill Tax in 2016-17 of £600m. This is £71m lower than the forecast figures for these two taxes.

**PERFORMANCE**

Since 2007 the Scottish Government has been operating an outcomes based National Performance Framework. The [Scotland Performs website](https://www.scotlandperforms.gov.scot) “measures and reports on progress of government in Scotland in creating a more successful country, with opportunities for all to flourish through increasing sustainable economic growth”. The outcomes and indicators were refreshed in 2011, and a review of the current suite of indicators is now under way.

To support the 2016-17 Draft Budget the government has provided an [Update](https://www.scotlandperforms.gov.scot) to Scotland Performs. This includes a Performance Scorecard tailored to several committees, providing an update on relevant indicators. The report also includes for the first time two (one page) narratives for each of the 16 National Outcomes. The idea is to identify examples of policies and programmes and show the link between the budget and the outcomes in each case.

Figure 8 below provides an overview of the status of indicators linked to each of the 16 National Outcomes at time of the publication of the Draft Budget.
The Scottish Government published a public sector pay policy for 2016-17 alongside the draft budget. This pay policy directly affects the pay of Scottish Government staff, and the staff of around 50 public bodies, which together account for around 7% of the Scottish public sector (around 30,000 staff). Other parts of the public sector, such as local government and the NHS are not directly covered by the Scottish Government’s pay policy and determine pay separately.

The main features of the pay policy are:

- A 1% cap on the cost of the increase in basic pay for staff earning above £22,000
- A minimum basic pay increase of £400 for those earning less than £22,000, before progression payments (to be awarded on a pro-rata basis for part-time staff); the costs of this are not included in the 1% cap
- A continued commitment to paying a Scottish living wage (currently at £8.25 per hour)
- A continued suspension of non-consolidated performance related pay (bonuses)
- Discretion for individual employers to reach agreements relating to pay progression, whereby employees progress through set pay bands on an annual basis, regardless of the basic pay settlement
A continued commitment to no compulsory redundancies, to be negotiated by individual employers in exchange for agreements on workforce flexibilities and efficiencies where appropriate

EQUALITY BUDGET STATEMENT

The Government has published its seventh Equality Statement on the budget, an assessment which it describes as “ever more important”. Assessing the impact of the Draft Budget on equalities is an inherently difficult task and the statement aims to be more concise and readable than in previous years. It again includes an overview by equality characteristic as well as a more detailed focus by spending portfolio.

The Overview chapter identifies approximately 50 budget measures as having an impact on age, disability, ethnicity, LGBTI communities, religion and belief as well as on socio-economic inequality. The vast majority of the budget measures identified are seen as making a positive contribution to tackling inequality. Examples include “investment to deliver the increased entitlement of 1,140 hours a year early learning and childcare by the end of the next Parliament”, support for the National concessionary Travel Scheme, and maintaining the cash value of the Equalities budget. Two examples of negative impacts are “a net reduction in funding for alcohol and drug treatment services in 2016-17” and deferral of 2016-17 funding to support the Bus Investment Fund “which could impact on further improvements to the accessibility of Scottish bus services”.

As indicated above the Scottish Government has provided an update of Scotland Performs. This includes tailored analysis for the indicators relevant to each committee. The summary of what is happening with the indicators seen to be relevant to the Equal Opportunities Committee is set out below.
The Climate Change (Scotland) Act 2009 requires the Scottish Government to publish an assessment of the impact of its budgetary expenditure on Scottish emissions of greenhouse gases. The carbon assessment accompanying the Budget (Scottish Government 2015) gives an estimate that total emissions resulting from the 2016-17 Draft Budget will be 8.8 million tonnes CO2-equivalent (MtCO2e).

The assessment measures the “first round” effects but not the subsequent impact of the use of these public services. For example, the beneficial impacts of spend on energy efficiency measures, or the potential effects of road building on traffic levels, are not captured in these calculations. The assessment includes indirect and imported emissions that are generated in producing the goods and services that the Scottish Government purchases.

More than one third (35.8%) of the Scottish Government’s carbon footprint is caused by the use of energy, water and waste services. This is followed by manufactured goods (21.7%) and transport and communication services (14.7%).

The carbon assessment accompanying the 2015-16 Draft Budget showed emissions at 8.8 Mt. However, the 2016-17 carbon assessment is based on new HM Treasury deflators and ratios of greenhouse gas emissions per unit of industry output (ONS Environmental Accounts, July 2015).
Applying the more recent emissions data to last year’s Draft Budget (2015-16) suggests emissions would have been around 9.0 MtCO2 in 2015-16. The change between the two comparable carbon assessments suggests emissions fell by 2.2% (from 9.0 to 8.8 MtCO2).

The carbon assessment was based on Total Managed Expenditure (TME) which decreased in real terms by 2.2% between 2015-16 and 2016-17 (highlighted earlier in this briefing).

It is reasonable to suggest the volume of goods and services purchased will fall between the 2015-16 and 2016-17 Draft Budgets. A projected comparable fall in emissions is therefore reasonable and suggests little overall change in efficiency.

Caution must be taken in interpreting the changes between the Draft Budgets. Both assessments rely on measures of emissions per unit spending for the whole of the UK applied to the pattern of spending outlined in the Draft Budgets. This means that efficiency of Scottish activities relative to the rest of the UK is not fully captured. For example, the direct emissions per unit of spending on health services, education or electricity in Scotland are assumed to be the same as the UK.

The latest data from Scotland’s National Performance Framework shows the carbon footprint (emissions associated with Scotland’s consumption of goods and services) in 2012 was 76.8 million tonnes CO2 equivalent.

WELFARE REFORM

Within the ‘Social Security’ section of the Social Justice, Communities and Pensioners’ Rights budget the Scottish Government has set out spending plans aimed at mitigating “the negative impacts of welfare changes and cuts” arising from UK-wide welfare reforms. Total funding for these measures amounts to £74.3 million for 2016-17 (approximately 0.3% of the total Scottish Government DEL Resource budget). This includes:

- £38.4 million for the Scottish Welfare Fund (SWF). The SWF provides a safety net in an emergency or a disaster when there is an immediate threat to health and safety. It is also a source of help for people on low incomes to access household goods to set up home or remain in their community.
- £35 million for discretionary housing payments, which, according to the Scottish Government, allows local authorities to “fully mitigate the effects of the bedroom tax”.

Both budget lines are being maintained in cash terms between 2015-16 and 2016-17. The remaining £1m of the ‘Social Security’ budget is for “building the foundations of the system required to implement new social security powers” in anticipation of new powers being devolved under the Scotland Bill.

In addition to the budget lines highlighted above, the Cabinet Secretary announced up to £343m for the Council Tax Reduction Scheme (CTRS) within the context of “mitigating against UK Government cuts”. Council Tax Reduction (CTR) was introduced in April 2013 to replace Council Tax Benefit (CTB), which had been abolished by the UK Government as part of its welfare reform programme. Much of this £343m funding comes direct from the UK Government, with the Scottish Government making up £23m from its own resources and local government £17m of the total.
## ANNEX

### Table A1: Scottish Government and OBR LBTT and SLfT forecasts, 2016-17 to 2020-21

<table>
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<tr>
<th></th>
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<th>2019-20</th>
<th>2020-21</th>
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<td>OBR</td>
<td>SG</td>
<td>OBR</td>
<td>SG</td>
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<td>253</td>
<td>355</td>
<td>302</td>
<td>415</td>
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<tr>
<td>Non-residential LBTT</td>
<td>220</td>
<td>243</td>
<td>230</td>
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<tr>
<td>LBTT total</td>
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<td>496</td>
<td>585</td>
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<td>655</td>
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<tr>
<td>SLfT</td>
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<td>123</td>
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<td>Grand total</td>
<td>670</td>
<td>750</td>
<td>815</td>
<td>884</td>
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</table>
SOURCES


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