



The Scottish Parliament  
Pàrlamaid na h-Alba

**FINANCE AND CONSTITUTION COMMITTEE**

**AGENDA**

**21st Meeting, 2019 (Session 5)**

**Wednesday 2 October 2019**

The Committee will meet at 10.00 am in the David Livingstone Room (CR6).

1. **Decision on taking business in private:** The Committee will decide whether to take item 3 in private.
2. **Fiscal Framework Outturn Report:** The Committee will take evidence from—  
  
Derek Mackay, Cabinet Secretary for Finance, Economy and Fair Work,  
Lucy O'Carroll, Director of Tax, and Daniel Hinze, Deputy Director Fiscal  
Responsibility, Scottish Government.
3. **EU Structural Funds Report:** The Committee will consider a draft report.

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The papers for this meeting are as follows—

**Agenda item 2**

Cover note

FCC/S5/19/21/1

**Agenda item 3**

PRIVATE PAPER

FCC/S5/19/21/2 (P)

**Finance and Constitution Committee**  
**21<sup>st</sup> Meeting, 2019 (Session 5), Wednesday 2 October 2019**

**Pre-budget 2020/21 scrutiny**

**Purpose**

1. The purpose of this paper is to set out background information for the Committee's pre-budget scrutiny evidence session with the Cabinet Secretary for Finance, Economy and Fair Work.

**2020/21 Pre-budget scrutiny approach**

2. At its meeting on 5 June 2019, the Committee agreed its approach to pre-budget scrutiny of the 2020/21 budget which aims to build on its work last year on the operation of the Fiscal Framework and will adopt the new full year approach to budget scrutiny.

*MTFS and forecasts*

3. On 12 June 2019, the Committee took evidence from the Cabinet Secretary on the Scottish Government's Medium Term Financial Strategy (MTFS) which was published on the 30 May 2019<sup>1</sup>. This was the second MTFS published by the Scottish Government following the recommendations of the Budget Process Review Group.

4. The MTFS was informed by the Scottish Fiscal Commission's (SFC's) May economic and fiscal forecasts<sup>2</sup> which were also published on the 30 May. The Committee took evidence from the SFC on these forecasts at its meeting on 5 June. The transcript from these meetings can be found on the website<sup>3</sup>.

5. The Committee discussed with the Cabinet Secretary the implications for the Scottish Government's future spending and tax policies of forthcoming income tax reconciliations. The impact on the fiscal framework and reconciliation of differences between the UK and Scotland in the distribution of income tax earners (particularly higher rate earners), population growth, relative forecast accuracy and the range of factors which affect Scotland's economic performance were also explored.

6. During evidence, the Cabinet Secretary discussed the Scottish Government's plans to undertake a Spending Review and the extent to which this was dependent upon the UK Government also undertaking a spending review. He explained that "I intend to focus on our spending commitments and priorities, and on issues such as cross-departmental expenditure, outcomes and wellbeing. We might also be able to set out multiyear spending on capital. Although it is my intention to do a spending review, I am sure that all members understand that it is easier to do that if the UK

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<sup>1</sup> <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/>

<sup>2</sup> <http://www.fiscalcommission.scot/publications/scotlands-economic-and-fiscal-forecasts/scotlands-economic-and-fiscal-forecasts-may-2019/>

<sup>3</sup><https://www.parliament.scot/parliamentarybusiness/CurrentCommittees/101355.aspx>

Government is conducting the equivalent spending review, because it influences so many of our numbers.”

7. Commenting on concerns regarding the extent to which the MTFS set out spending priorities and plans as envisaged by the Budget Process Review Group, the Cabinet Secretary explained that this detail would be set out in the spending review.

#### *Outturn data*

8. On 26 September 2019, the Cabinet Secretary wrote to the Committee regarding the publication of the Fiscal Framework Outturn Report (FFOR)<sup>4</sup>. This report, the second FFOR to be published, forms part of the revised budget process as recommended by the Budget Process Review Group and follows on from the publication in May of the MTFS. The letter is attached in the Annexe to this paper.

9. The FFOR focuses on the operation of the Fiscal Framework and is designed to support Scottish Parliamentary scrutiny. It provides information on the reconciliation process for Income Tax, Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) as well as the operation of the Scotland Reserve and borrowing levels. It also covers the expected impacts of LBTT and SLfT Block Grant Adjustment reconciliations on the 2020-21 Scottish Budget.

10. In July 2019, HMRC published outturn data for 2017-18 Scottish income tax revenues. These income tax revenues were forecast as part of the Budget Bill process in December 2016 and the adjustment to the block grant (BGA) was forecast at the Autumn Statement in November 2016. The outturn figures for revenues and the BGA were compared with forecast and reconciliations calculated by HM Treasury, with any differences being applied in the 2020-21 financial year. Chapter 3 of the FFOR highlights that this reconciliation translates into a £204 million negative reconciliation requirement that will be applied to the 2020-21 Budget.

11. In September 2019<sup>5</sup>, the Committee heard from the SFC on their Forecast Evaluation Report<sup>6</sup> which contained detailed evaluations of the economy, income tax, NonDomestic Rates (NDR), Land and Buildings Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT) forecasts and, for the first time, included an evaluation of its social security forecasts.

12. The SFC provided a graphic showing the 2017-18 income tax reconciliation which is reproduced below —

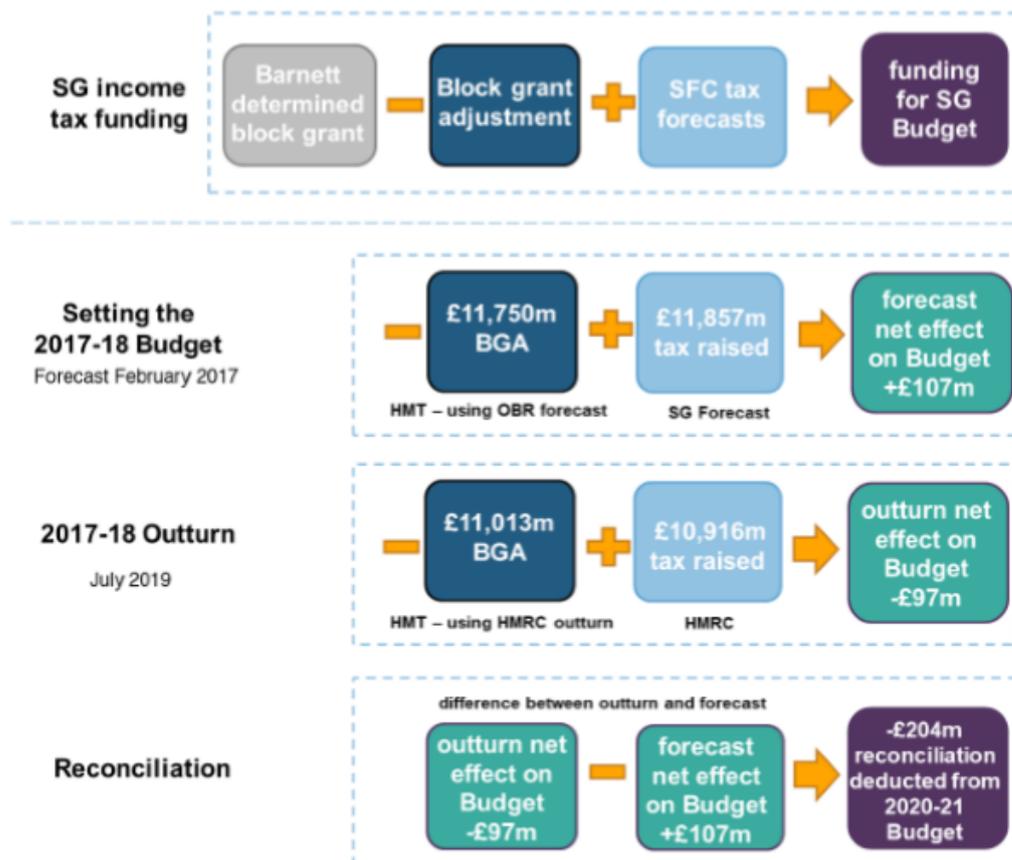
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<sup>4</sup> <https://www.gov.scot/binaries/content/documents/govscot/publications/publication/2019/09/fiscal-framework-outturn-report-september-2019/documents/fiscal-framework-outturn-report/fiscal-framework-outturn-report/govscot%3Adocument/fiscal-framework-outturn-report.pdf>

<sup>5</sup> <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12244&mode=pdf>

<sup>6</sup> <http://www.fiscalcommission.scot/publications/forecast-evaluation-reports/forecast-evaluation-report-september-2019/>

Figure 2.2: 2017-18 income tax reconciliation



Source: Scottish Fiscal Commission

Note: The Scottish Government provided the forecast for income tax in February 2017, which we assessed as reasonable. Future years will use SFC rather than SG forecasts.

13. The SFC told the Committee that the reconciliation arises from “the combination of the error in forecasting growth in Scottish income tax and the error in forecasting growth in the block grant adjustment, using OBR forecasts”. It said that the block grant adjustment was underestimated by around £83 million and growth in the Scottish income tax revenues was overestimated by £121 million, both of which led to the £204 million negative reconciliation.

14. The SFC highlighted a range of factors as contributing to the forecasting error with the 2016-17 baseline error accounting for most of it and, to a much lesser extent, errors in economic forecasts. The SFC explained that HMRC outturn data was not available until last year and that now the SFC can make use of that new data source so forecasts will improve. They added that “With any devolved tax or benefit, over the years, as we get more outturn data, we will have a sounder base on which to prepare future forecasts.”

15. In that regard the SFC highlighted the impact of the changing labour market and the need for better data on Scottish income and earnings on its forecasts. In relation to the challenges of forecasting the new Scottish Social Security benefits the

Committee discussed with the SFC the key factors influencing its forecasts including the scale of take up of new benefits and understanding of eligibility criteria.

## Full year approach

16. In addition, by adopting the new full year approach to scrutiny the Committee's pre-budget scrutiny covers a range of budget scrutiny work already undertaken which the Cabinet Secretary could provide an update on. This work covered the following areas —

- Earnings in Scotland
- Additional Dwelling Supplement
- Air Departure Tax
- VAT assignment
- Policy spillover provisions within the Fiscal Framework

### *Earnings in Scotland*

17. The Committee held two evidence sessions on earnings in Scotland, a roundtable discussion in April 2019<sup>7</sup> and evidence from the Cabinet Secretary in May 2019<sup>8</sup>. The Committee was interested in how earnings in Scotland compared to the rest of the UK and how public sector pay compared with private sector pay.

18. The Committee heard that in 2017 and 2018, average wages grew less quickly in Scotland than they did in other areas of the United Kingdom. Given the direct impact income tax receipts now have on the size of the Scottish Budget, the Committee explored wage growth levels across Scotland and the reasons behind the recent stagnation. The Committee heard that slow wage growth was related to weak productivity growth and this low productivity growth was in part due to the UK's historically low levels of investment, a trend which has been accentuated since the recession, possibly combined with weak management practices and weak levels of innovation.

19. The Committee heard that achieving higher income tax revenues requires pay growth across the distribution, but that pay growth at the top of the distribution (i.e. for high earners) has a relatively larger impact on tax revenues given the higher tax rates applied. However, pay growth at the top of the earnings distribution, which is important for tax revenue growth, should not be at the expense of pay growth across the earnings distribution. It was argued that it is much more sustainable to try to boost lower-paid and medium paid workers' career progression to achieve sustainable growth.

20. The Cabinet Secretary said that oil and gas downturn and had been a significant factor in the slowdown in wage growth. He highlighted that the Scottish Government, through its Economic Action Plan, is making a range of interventions to tackle economic growth such on areas such as productivity, innovation and investment and that further work will be done on retraining and upskilling.

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<sup>7</sup> <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12061>

<sup>8</sup> <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12087>

### *Additional Dwelling Supplement*

21. The Committee held two evidence sessions on the Additional Dwelling Supplement (ADS), a roundtable discussion in May 2019<sup>9</sup> and evidence from the Minister for Public Finance and Digital Economy in June 2019<sup>10</sup>. The Committee was interested in how ADS had been operating in practice and what unintended consequences have arisen with the introduction of ADS. The Committee was also interested in the impact of ADS on Scotland's housing market.

22. Following the evidence session, the Committee wrote<sup>11</sup> to the Minister asking the Scottish Government to work with Revenue Scotland to gather data regarding the number of people affected by each of these anomalies and, once collated, provide this information to the Committee. In addition, the Committee requested that the analysis of consultation responses to the Scottish Government's consultation on the future of devolved taxes is sent to the Committee.

23. In her response<sup>12</sup>, the Minister confirmed that she would provide the Committee with the analysis of responses to the Scottish Government's consultation on the future of devolved taxes when it is published.

### *Air Departure Tax (ADT)*

24. The Committee has been kept updated on the expected introduction of ADT and in its pre-budget report published in November 2018, commented that "The Committee appreciates the difficulties surrounding the introduction of ADT in Scotland and understands why the UK and Scottish Governments have agreed to defer its introduction. However, the Committee believes it is imperative that both Governments continue to work together more closely to develop options for devolving ADT and delivering an exemption for Highlands and Islands passengers at the earliest opportunity".

25. The Minister for Public Finance and the Digital Economy wrote to the Committee in March<sup>13</sup> and April<sup>14</sup> with an update on the ongoing work with the UK Government and the ADT Highlands and Islands (H&I) Working Group on the H&I exemption. She told the Committee despite this work, the Scottish and UK Governments have been unable to find a solution to the issue of the H&I exemption. As a solution has not yet been found that would be ready for introduction at the beginning of the next financial year, "this, taken together with the continued uncertainty around Brexit, means that that we have to defer the introduction ADT beyond April 2020."

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<sup>9</sup> <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12131>

<sup>10</sup> <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12186>

<sup>11</sup> [https://www.parliament.scot/S5\\_Finance/General%20Documents/2019.6.27\\_Kate\\_Forbes\\_ADS.pdf](https://www.parliament.scot/S5_Finance/General%20Documents/2019.6.27_Kate_Forbes_ADS.pdf)

<sup>12</sup>

[https://www.parliament.scot/S5\\_Public\\_Audit/General%20Documents/Correspondence\\_from\\_the\\_Minister\\_for\\_Public\\_Finance\\_and\\_Digital\\_Economy\\_-\\_15-07-19\\_-\\_BC.pdf](https://www.parliament.scot/S5_Public_Audit/General%20Documents/Correspondence_from_the_Minister_for_Public_Finance_and_Digital_Economy_-_15-07-19_-_BC.pdf)

<sup>13</sup> [https://www.parliament.scot/S5\\_Finance/Inquiries/2019\\_3\\_6\(1\).pdf](https://www.parliament.scot/S5_Finance/Inquiries/2019_3_6(1).pdf)

<sup>14</sup> [https://www.parliament.scot/S5\\_Finance/General%20Documents/2019\\_4\\_23.pdf](https://www.parliament.scot/S5_Finance/General%20Documents/2019_4_23.pdf)

*VAT assignment*

26. Last year, during the Committee's Budget and pre-Budget scrutiny, the Committee considered the methodology for VAT assignment for Scotland and noted that basing VAT assignments for Scotland on estimated figures could introduce further volatility into Scotland's public finances. Given the impact that VAT assignment will have on the Scottish Budget, the Committee explored the issue further with stakeholders in a roundtable discussion in March 2019 and following this session, wrote to the Cabinet Secretary on issues raised during the session

27. The Committee asked the Cabinet Secretary to respond to points made that the main challenge in assigning VAT was how to calculate a robust estimate and the questions which also arose around the data sources being used in the model. Responding in April 2019 the Cabinet Secretary welcomed the Committee's interest in this issue and said he would respond to the points at the forthcoming oral evidence session<sup>15</sup>.

28. The Cabinet Secretary subsequently gave evidence to the Committee on 8 May 2019 and explained his concerns centred on the fact that VAT assignment is based on survey data and estimates "We will never have outturn data; we will always be comparing one set of estimates with another set of estimates. Unlike what happens with income tax, there will be no reconciliation.". In addition, he said that the potential impact of Brexit could affect the economy, consumption and VAT receipts and the Scottish Government did not know whether the impact of this on Scotland would be disproportionate. He explained that this uncertainty and lack of data carries a disproportionate risk.

29. On 15 May the Cabinet Secretary wrote to the Chief Secretary to the Treasury<sup>16</sup> setting out his concerns about the proposed approach to assigning VAT confirming that "As a result, the only appropriate course of action at present is to seriously consider the case for a delay to the implementation of VAT assignment and review the case at the time of the Fiscal Framework review."

*Policy spillover*

30. At its meeting on 8 May 2019, the Committee considered the UK and Scottish Governments reports on the implementation of the Scotland Act 2016 and the Seventh Annual Report on the Implementation and Operation of Part 3 (Financial Provisions) of the Scotland Act 2012. The Committee noted the Scottish Government's request that a "policy spillover" be considered in relation to the increase of the Personal Allowance for 2018-19 and 2019-20 and so the Committee wrote<sup>17</sup> to the Chief Secretary to the Treasury (CST) asking her view as to whether the policy spillover

<sup>15</sup> [https://www.parliament.scot/S5\\_Finance/General%20Documents/2019.4.17\\_-\\_Derek\\_Mackay\\_to\\_Convener\\_on\\_VAT\\_assignment\\_in\\_Scotland.pdf](https://www.parliament.scot/S5_Finance/General%20Documents/2019.4.17_-_Derek_Mackay_to_Convener_on_VAT_assignment_in_Scotland.pdf)

<sup>16</sup> [https://www.parliament.scot/S5\\_HealthandSportCommittee/General%20Documents/20190515\\_-\\_Derek\\_Mackay\\_to\\_CST\\_-\\_VAT.pdf](https://www.parliament.scot/S5_HealthandSportCommittee/General%20Documents/20190515_-_Derek_Mackay_to_CST_-_VAT.pdf)

<sup>17</sup>[https://www.parliament.scot/S5\\_Finance/General%20Documents/20190508\\_-\\_Convener\\_to\\_CST.pdf](https://www.parliament.scot/S5_Finance/General%20Documents/20190508_-_Convener_to_CST.pdf)

provisions within the Fiscal Framework had indeed been triggered by the decision of the UK Government to increase the Personal Allowance for 2018-19 and 2019-20.

31. In her response<sup>18</sup>, the CST said that the UK Government's position is that the CPI linked increases to the Personal Allowance in April 2018 did not constitute a change in UK Government policy however the UK Government accepts that the above inflation increases to the Personal Allowance in April 2019 and the freeze to Personal Allowance in 2020 does constitute a change in policy. HM Treasury officials are currently considering the Scottish Government's analysis of this issue. If the Scottish Government and HM treasury agree on the methodological approach, then "we will consider if any transfer of funding (in either direction) is due for these years."

### **Next steps**

32. The Committee will consider its draft pre-budget report at a future meeting.

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<sup>18</sup>[https://www.parliament.scot/S5\\_Finance/General%20Documents/Personal Allowance Policy Spillovers.pdf](https://www.parliament.scot/S5_Finance/General%20Documents/Personal_Allowance_Policy_Spillovers.pdf)

**Letter from the Cabinet Secretary to the Convener – 26 September 2019**

I am pleased to be able to share with you the second annual Fiscal Framework Outturn Report which can be accessed using the following link;  
<http://www.gov.scot/ISBN/978183960781>

This document will enable Parliament to scrutinise Scotland's public finances, in keeping with the recommendations of the Budget Process Review Group.

Like last year's, this Outturn Report contains information on Income Tax, Land and Buildings Transaction Tax, and Scottish Landfill Tax, borrowing levels and the operation of the Scotland Reserve.

This year, it also contains information on the impact of Fines, Fees, and Fixed Penalties, Proceeds of Crime, Carer's Allowance, Best Start Grants, and Discretionary Housing Payments.

As the Scottish Government takes on additional tax and social security powers, information on the impact of these new powers on the Scottish Budget will be added to subsequent Outturn Reports as part of our commitment to full transparency in the operation of the Fiscal Framework.

I welcome the opportunity to discuss the contents of this Report with the Committee on 2 October.