

Fiscal Coordination

14 January 2025

## Cabinet Secretary for Finance and Local Government

### Priority and Purpose

1. **Routine** submission, seeking clearance of a response to the Scottish Affairs Committee's call for evidence for their inquiry 'The Financing of the Scottish Government'. There was a deadline for submission of **5<sup>th</sup> January 2025**, to which an extension has been agreed. Clearance of the response at Annex B as soon as possible would be appreciated.

### Recommendation

2. Recommends that you:
  - clear the response for submission to the SAC call for evidence (Annex B).

### Context and Issues

3. The Scottish Affairs Committee (SAC) has launched an inquiry examining the framework for fiscal devolution in Scotland. There is a call for evidence, with a deadline of Sunday 5th January.

4. As detailed by the SAC, "The Committee is evaluating the effectiveness of the Barnett formula and the fiscal framework in calculating the amount of money available for providing devolved services in Scotland. As part of this, the Committee is examining the interaction between UK Government fiscal events and in-year budgetary changes, and the impact they can have on the funding of Scotland's public services."

5. This is the Committee's first inquiry with the new membership and the Terms of Reference for the call for evidence reflect a range of interests from the membership.

6. The topics they are particularly interested in are the effectiveness of the Barnett Formula and the Fiscal Framework, how much fiscal certainty the current arrangements bring, and international comparisons. Further detail is set out in the specific lines of inquiry accompanying the call for evidence at Annex A.

7. Following discussions with the Committee clerks, we understand that the inquiry will be relatively short (only 3 or 4 sessions) and has not been prompted by specific concerns. The Committee are interested in taking stock of effectiveness of current arrangements and the overall stability of Scottish Government funding. UKG ministers will be invited to give evidence as part of the live sessions, and you will likely also be invited (although would be under no obligation to attend).

### **Options Considered and Advice**

8. <redacted S30(b)(i)>

9. The details of full fiscal autonomy included in the draft response were informed by Scottish Government's evidence to the Smith Commission in 2014. In summary, it is laid out that full fiscal autonomy would include: full devolution of tax powers; an assignment of reserved taxes to the Scottish budget; responsibility for key elements of domestic expenditure; a payment to UKG from Scottish tax revenues to account for UKG reserved responsibilities, eg defence, and; access to economic levers beyond the tax system, such as employment rights and access to migration.

10. <redacted S30(b)(i)>

11. <redacted S30(b)(i)>

12. Focus is given to:

- Late funding allocations from UKG and lack of engagement from UKG ahead of UKG fiscal events;
- UKG's ability to use the UK Internal Markets Act 2020 to bypass Barnett;
- UKG's inadequate consideration of (and compensation for) the impact of UK fiscal policy decisions that have an asymmetric budgetary impact on the Scottish Government;
- Greater capital borrowing powers, and;
- Technical changes to borrowing arrangements.

### **Contribution to the Government's Four Priorities**

13. Any improvements to the fiscal arrangements borne out of this inquiry will support the Government's achievement of its Four Priorities.

### **Risks to Delivery**

14. There are no risks to delivery.

#### **Verity House Agreement Implications**

15. There are no Verity House Agreement implications.

#### **New Deal for Business Implications**

16. There are no New Deal for Business Implications.

#### **Legal Considerations**

17. Significant changes to the fiscal devolution arrangements borne out of this inquiry may require legislation. However, there are no legal considerations relating to the Scottish Government's response to the call for evidence.

#### **Financial Considerations**

18. Any changes made to the fiscal arrangements between the Scottish Government and UKG may have implications for Scottish Government funding. Though, there are no direct financial considerations.

#### **Sensitivities**

19. Scottish Government's response will likely be made public during the inquiry process and could garner media attention.

#### **Quality Assurance**

20. This submission has been reviewed and cleared by Alasdair Black.

#### **Conclusion and next Steps**

21. UKG ministers will be invited to give oral evidence, you will also likely be invited.



**Officials Copy List**

<redacted S38(1)(b)>

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Davie Hutchison, Special Adviser

## **Annex A: Scottish Affairs Committee: Call for Evidence – Terms of Reference**

The Committee would like to hear your views. We welcome written submissions from anyone with answers to any or all of the questions set out in the following Terms of Reference:

1. How effective is the Barnett formula in calculating the amount of money made available to Scotland for providing essential public services?

- What was the original design intention behind the Barnett Formula, and to what extent has it fulfilled this purpose?
- What potential reforms to the Barnett formula could improve its effectiveness?
- How transparent is the UK Government's decision making regarding the application of the Barnett Formula?
- What impact could putting the Barnett formula on a statutory footing, or otherwise formalising it, have on its effectiveness?

2. Following its review in 2023, to what extent does the current Fiscal Framework effectively govern the mechanisms for Block Grant Adjustments and fiscal flexibilities of the Scottish Government?

- To what extent could changes to Scottish Government borrowing powers enable more effective fiscal management, and mitigate against the impact of inflation and economic shocks in Scotland?
- Does the current methodology for calculating Block Grant Adjustments effectively reflect the associated transfer of tax revenues or welfare spending?

3. Within the existing devolution settlement, what steps could the UK Government take to offer Scotland more financial certainty?

- Is there an appropriate level of coordination between the UK and Scottish Governments regarding in-year fiscal changes?
- To what extent can HM Treasury's decisions regarding the block grant be challenged by the Scottish Government?

4. Are there any comparative perspectives that should be considered when assessing the effectiveness of fiscal devolution in Scotland?

- What learnings can be drawn from Wales and Northern Ireland's funding settlement arrangements?
- Are there any learnings from international perspectives that should be considered?

## **Annex B: Response to SAC's Call for Evidence on The Financing of the Scottish Government**

Dear Patricia,

1. I am pleased to have the opportunity to provide evidence to the Scottish Affairs Committee's inquiry into the Financing of the Scottish Government.
2. Scotland's funding arrangements have evolved considerably since the initial devolution of power 25 years ago. In that time Scotland's budget has increased from c. £15 billion<sup>1</sup> in the first year of devolution, to £63.5 billion outlined in the 2025-26 draft Scottish Budget. This growth in part reflects changes to the devolved settlement. While council tax and business rates were devolved to Scotland at the outset, subsequent Scotland Acts have enabled substantial additional fiscal devolution - with the Scottish Government now responsible for setting and administering a range of taxes and social security benefits.
3. The Scotland Act 2012 introduced the power to set a Scottish rate of income tax, and fully devolved taxes on land transactions and waste disposal to landfill, along with arrangements for the creation of new taxes in Scotland. The Scotland Act 2016 provided for further broad and rapid devolution of fiscal powers to Scotland, including rates and bands of Income Tax, Air Passenger Duty, Aggregates Levy and 11 social security benefits. The act was supported by the 2016 Scottish Fiscal Framework agreement, which introduced new borrowing and reserve powers, as well as a 'block grant adjustment' mechanism to offset the transfer of new revenues and expenditure to Scotland. The independent Scottish Fiscal Commission was also created to enable this devolution and provide independent fiscal forecasts and scrutiny of Scotland's fiscal outlook.
4. While this devolution has equipped the Scottish Government with new policy levers with which to serve Scotland, the growth in the scale and complexity of devolved funding arrangements has also exposed the Scottish Budget to greater volatility and fiscal risk, which the Scottish Government is required to manage
5. The Scottish Government believes that independence would deliver the best deal for Scotland – providing control over all public spending decisions, as well as the suite of fiscal powers necessary to unlock Scotland's full economic potential.
6. However, until such a time as the people of Scotland can choose a different constitutional arrangement, moving to full fiscal autonomy for the Scottish Government would create a fairer system that would protect public services and allow investment in our economy.
7. The Scottish Government outlined its views on full fiscal autonomy in its evidence to the 2014 Smith Commission<sup>2</sup>, when Scotland's devolved fiscal arrangements were last subject to substantial review.
8. Full fiscal autonomy would mean that all onshore and offshore taxes would be designed and set in Scotland, including tax rates, allowances, thresholds and the tax bases. For any reserved taxes,

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<sup>1</sup> Based on historic *Public Expenditure Statistical Analyses* publications - [\[ARCHIVED CONTENT\] Public Expenditure Statistical Analyses - HM Treasury](#)

<sup>2</sup> [More Powers for the Scottish Parliament - Scottish Government Proposals](#)

revenues would be assigned to the Scottish budget. At the same time, the Scottish Parliament would also take responsibility for key elements of domestic expenditure, including currently reserved areas of welfare.

9. From the tax revenue raised in Scotland, a direct payment would be made for those responsibilities which remain reserved to the UK Government, including defence, security and foreign policy.
10. As well as a greater range of tax options, this would give the Scottish Government administrative autonomy over the tax system in Scotland. Under these circumstances the Scottish Government could ensure simplicity and transparency in tax arrangements in line with our Tax Strategy, and minimise administrative and compliance burden – for example, by creating opportunities to put in place a simplified and more efficient collection regime.
11. For full fiscal autonomy to work the Scottish Parliament would also need access to economic levers beyond the tax system, such as employment rights and aspects of migration – reflecting the role economic performance plays in driving the level of taxation that the Scottish Parliament will receive through its tax powers.
12. The Scottish Government's position reflects significant issues with current devolved fiscal arrangements, and particularly with the approach taken by the previous UK Government. Even where the new UK Government is not willing to pursue full fiscal autonomy for Scotland, it has the opportunity to agree a set of substantial improvements to devolved fiscal arrangements - including through agreement to fiscal flexibilities that are commensurate to the level of risk the Scottish Government currently manages within its responsibilities. Such powers are essential to manage and smooth the funding volatility and uncertainty which affects our current finance arrangements.
13. The remainder of this note is informed by the Scottish Government's experience managing the devolution of powers outlined above. It provides an overview of issues concerning devolved fiscal arrangements, based on lines of inquiry set out in the call for evidence, and which should be addressed as part of any consideration of how the Scottish Government is financed. I look forward to engaging with the Committee as your inquiry progresses.

### ***The Barnett Formula***

14. Within the current constitutional settlement, full fiscal autonomy would be the Scottish Government's preferred option. Where that is not available, the Scottish Government believes the Barnett Formula should remain the broad basis for calculating the block grant. This is in line with the position adopted by the cross-party Smith Commission which advised on the additional fiscal powers devolved as part of the Scotland Act 2016, and which made clear that the Barnett Formula should remain the basis for calculating the block grant that underpins the majority of the Scottish Government's funding.
15. That said, while remaining the right principle under current conditions, there are clear issues with the current operation and application of the Barnett Formula and there is considerable scope for improvement. The apparent lack of consideration of the impact of Whitehall and HM Treasury decision making on devolved finances is a real issue. Devolved Governments sit at the very tail end of UK decision-making processes – often contending with extremely late notification of substantial changes in levels of funding and of changes to UK policy that affect devolved finances, including devolved taxes.
16. This is a regular feature of managing devolved finances. In recent years the Scottish Government has experienced substantial changes to funding and tax policy at UK Autumn and Spring fiscal events – affecting the in-year funding position as well as that of the subsequent financial year. In

practice, the UK Autumn fiscal event usually only occurs a handful of weeks before the draft Scottish Budget is due to be shared with the Scottish Parliament, leaving limited time for the Scottish Government to work through and accommodate changes. The issue is compounded by the lack of meaningful engagement ahead of UK fiscal events, and the fact that the Scottish Government is usually only made aware of changes to funding and tax policy on the morning of the UK's fiscal event.

17. Devolved Governments also contend with in-year changes in funding continuing throughout the fiscal year, with final funding often only confirmed a few weeks before the end of the financial year via the UK's 'supplementary estimates' process. For example, in budget year 2023-2024, the Scottish Government was notified of additional consequentials five weeks before the end of the budget year. By this time the Scottish Government had already taken difficult in-year decisions to constrain spending plans to ensure a balanced budget could be delivered. Had funding been confirmed earlier, the in-year changes could have been avoided. Instead, given the late notification, the consequentials were carried forward into the following budget year instead of utilising the funds in the year intended. Conversely, in 2022-23 there was late notification of a reduction to the funds for Scottish Government's capital DEL. Late reduction to capital funding causes difficulties for managing contracts, for contractors and for the intended recipients of the infrastructure project. Earlier communication of changes to funding would avoid unnecessary disruption to public services.
18. While the new UKG has expressed a willingness to try and address some of this uncertainty and volatility, a more fundamental and structured response is required. The proposed move to a single fiscal event each year is welcome, but more will be required to ensure timely sharing of funding information and engagement on policy decisions that affect devolved funding.
19. Additional uncertainty stems from the introduction of the powers for UK Ministers to spend in devolved areas as part of the UK Internal Market Act 2020 (IMA). These powers allow the UK Government to make spending decisions without ensuring coherence with existing Scottish Government plans in similar areas. This approach to funding expenditure also allows the UK Government to unilaterally bypass the Barnett Formula. This violates the principle that Devolved Governments should decide devolved spending, and that where it is a devolved responsibility Devolved Governments should lead. The powers under the IMA erode the devolution settlement, blur accountability, and introduce additional uncertainty to the funding process.
20. A further issue is inadequate consideration of (and compensation for) the impact of UK fiscal policy decisions that have an asymmetric budgetary impact on the Scottish Government. This includes the recent changes to Employer's National Insurance Contributions where the level of compensation for the financial impact of the decision falls far short of what is required (with the suggestion that only around £300 million in Barnett consequentials will be provided to compensate for the direct cost impact of this UK policy, despite estimates the costs for the Scottish Government could exceed £700 million). The lack of engagement with the Scottish Government in advance of a material tax policy change to evaluate the impact, and establish the appropriate compensation, exacerbates volatility in the Scottish budget. The Scottish Budget 2025-26 has had to be set without this crucial information.
21. In summary, it is clear that devolved governments are not properly factored into Whitehall decision making as a matter of routine, which leads to considerable financial uncertainty and volatility, including late and material in-year changes to funding.

### ***The Scottish Fiscal Framework***

22. The introduction of the 2016 Scottish Fiscal Framework has reshaped the process for determining a significant share of funding for the Scottish Budget. While enabling tax and social security devolution to Scotland, the framework has also introduced additional complexity and requires the Scottish Government to manage greater fiscal risk and volatility.

23. The Scottish and UK Governments undertook a joint review of the Fiscal Framework in 2023, reflecting on a parliament's worth of experience. The Scottish Government sought a broad scope for the 2023 Fiscal Framework Review, as supported by the Scottish Finance and Constitution and Social Security committees in their joint session 5 report to inform the scope of the Fiscal Framework Review. However, the then UK Government resisted a broad-based review, and the scope for the 2023 review was therefore relatively narrow.
24. Working constructively within this constrained scope, some improvements were secured through the review. For example, the Scottish Government's preferred indexation mechanism for the Block Grant Adjustments (BGA) have been adopted on a permanent basis and borrowing and reserve limits are now indexed in line with inflation.
25. As noted in the Independent Report that accompanied the Fiscal Framework Review, the Fiscal Framework aims to balance risk, reward and fairness to taxpayers on both sides of the border, and BGAs try to achieve this. In judging the effectiveness and appropriateness of different BGA models, the allocation of risk is fundamental. A particular focus for the Scottish Government is whether the transfer of risk to the Scottish Parliament and Scottish Budget is matched by the policy and budgetary levers required to mitigate and manage such risk.
26. This was a fundamental issue for the Scottish Government within the original Fiscal Framework negotiations and informed the Scottish Government's preference for the Indexed Per Capita (IPC) BGA methodology. Adoption of this methodology was key to the Scottish Government's ability to reach agreement in 2016. In the case of population risk, the Scottish Government believes the current IPC BGA arrangements are effective in fully mitigating the impact of differential population growth, in line with the Smith Principle of 'no detriment'.
27. However, more must be done to smooth the in-year volatility facing the Scottish budget. The transfer of risk to the Scottish Parliament following fiscal devolution must be matched by the policy and budgetary levers required to mitigate and manage such risk. The Scottish Government has a significant level of demand led expenditure, which, at a UK Government level, is classified as Annually Managed Expenditure (AME). Ultimately the UK Government has many more levers with which to manage volatility in demand led expenditure, including borrowing. This is in contrast to the Scottish Government which has limited levers to manage volatility and cannot borrow for day-to-day expenditure.
28. Under current arrangements, the Scottish Government can borrow £450 million (in 2023-24 prices) for capital, less than 7% of the Scottish Capital Budget, and has no powers for resource borrowing to support any economic intervention. Instead, current resource borrowing powers are limited to offsetting forecast error, and even then are capped at £600 million (in 2023-24 prices). These resource borrowing powers may be insufficient even within that narrowly defined scope – the latest forecast for the income tax 2023-24 reconciliation is negative £701 million, significantly exceeding the Scottish Government's resource borrowing limit. Moreover, the Scottish Government is required to pay interest on borrowing to cover forecast error, penalising the Scottish Government for something entirely outside of its control.
29. While Scottish Government borrowing powers were improved as part of the Fiscal Framework Review, they remain insufficient to provide the necessary support to the Scottish Economy. With over 90% of the annual capital spending power still based on the Barnett Formula the Scottish Government's ability to fund infrastructure spending remains beholden to UK Government decisions. For this reason, it is imperative that the Scottish Government's Capital Borrowing powers are greatly enhanced, which will also ensure the Scottish Government can maintain economic stimulus even when the UK Government chooses not to do so. The Scottish Government has previously called for arrangements on capital borrowing akin to the 'prudential borrowing' regime that operates for local government across the UK. This would allow the Scottish Government to set borrowing policy based on what is affordable, rather than an arbitrary limit set by the UK Government.

30. There are further technical changes which could be made to the borrowing arrangements to cover forecast errors. There is a strong argument for this to incur no interest cost, or at the very least the tenor lengthened, to ensure that this risk mitigation facility does not become punitive to use.
31. When both Fiscal Framework and National Loans Fund restrictions are taken into account, the effective budgetary burden of resource borrowing is much higher than the interest cost alone. As an example, if the interest rate on borrowing is 4.5% the effective burden on the medium-term resource budget is a repayment rate of over 22% per annum when the profile of all repayments is factored in. It is unclear why the Scottish Budget should be penalised in this way for costs associated with covering forecast error, which is simply a facet of the operation of the Fiscal Framework, and not a result of any action by the Scottish Government.
32. Turning to tax, there is also a strong case for agreeing more permissive arrangements on creating entirely new devolved taxes in Scotland. Under current arrangements, HM Treasury has an effective veto on the creation of new taxes. Moving away from a case-by-case consideration by HM Treasury towards a broader framework setting out the circumstances and conditions within which new devolved taxes could operate would allow Devolved Governments to progress policy development and engagement with stakeholders from a more certain position.

### ***Financial Certainty***

33. The current UK timetable for fiscal events exacerbates funding volatility and uncertainty, making financial planning difficult for Devolved Governments. As noted above, in recent years we have seen substantial in-year changes to funding announced at UK Autumn Statements. Even then, final devolved funding positions are not confirmed until the end of the Supplementary Estimates process, often only weeks before the end of the financial year. The scale of late movement in expected funding can be significant.
34. Current UK processes mean that even where some indication of additional funding related to specific policy announcements can be provided, it is not possible to definitively forecast likely final position as consequential changes are driven by the net change in UK departmental funding, and may be affected by other factors.
35. This uncertainty has had a very real impact on delivery of services and investment in Scotland. In the past two years, based on the funding information available at the time, the Scottish Government has had to implement difficult in-year spending reductions so as to remain on track to deliver a balanced budget. However, in both instances the Scottish Government subsequently received substantial funding uplifts late in the financial year as part of the supplementary estimates process. The unnecessary disruption to public services resulting from this funding volatility is regrettable.
36. The issue is exacerbated by the cap on the Scotland Reserve (set at £700 million in 2023-24 prices). In the event that the Scottish Government were to experience an unexpected windfall and exceeded the reserve cap, it would face the prospect of surrendering funds that should be available to support key public services. The scale of the late in-year changes in funding experienced in recent years points to this being a real risk. This in turn disincentivises the holding of a contingency.
37. More broadly, the UK Government's inability in recent years to provide multi-year funding settlements for the Scottish Government has added to uncertainty and restricted the Scottish Government's own ability to provide multi-year planning assumptions to key public services. The lack of multi-year funding certainty is a particular hinderance to delivery of public service reform and investment in infrastructure. While the new UK Government's intention to move to a regular framework of multi-year allocations sounds positive, it remains to be seen how this will work in practice and whether it will provide the stability and certainty that is required.

38. Devolved Governments should be provided with funding certainty much earlier in the financial year. Failing that, they should be equipped with the fiscal flexibility necessary to manage and smooth in-year block grant funding volatility and funding pressures when they arise.
39. In summary, while current fiscal devolution arrangements persist, the Scottish Government views that the Barnett Formula and Fiscal Framework should broadly remain the basis for determining funding for the Scottish Budget. However, even while remaining within current arrangements there is considerable scope to improve on how UK Government decision-making impacts devolved funding, and on the fiscal flexibilities available to the Scottish Government to support financial management.