Scottish Government Response To The 'Call For Evidence' On Block Grant Adjustments For Tax And Welfare Devolution

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Scottish Government
Riaghaltas na h-Alba

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1. Summary

1.1 Considerable progress has been made since agreeing the Fiscal Framework in 2016. In taking on new tax and welfare powers, the Scottish Government (SG) has put in place new fiscal ‘architecture’ which has greatly strengthened Scotland’s capacity to undertake economic forecasting, set fiscal policy, and operate tax and social security functions. This has involved the creation of entirely new institutions in the form of the Scottish Fiscal Commission and Social Security Scotland, as well as the introduction of substantive changes to budget processes and the way in which SG, the Scottish Parliament and the Scottish Fiscal Commission work together.

1.2 The application of Block Grant Adjustment (BGAs) has been central to much of this change, and BGA arrangements remain key to the outcomes delivered by the Fiscal Framework and the devolution it supports.

1.3 SG recognises that the Fiscal Framework must balance risk, reward and fairness to taxpayers on both sides of the border, and that BGAs are pivotal to achieving this. In judging the effectiveness and appropriateness of different BGA models, the allocation of risk is fundamental. A particular focus for SG 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.

1.4 This was a fundamental issue for SG within the original Fiscal Framework negotiations, and informed SG’s preference for the Indexed Per Capita (IPC) BGA methodology. Adoption of this methodology was key to SG’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’.

1.5 The 2016 agreement was clear that the BGA arrangements should be considered as part of the review of the framework, and that the ‘two governments will jointly agree’ the future BGA method as part of the review. The Scottish Government is clear that until such agreement is reached, the IPC model remains the default and continues as the basis for calculating the BGAs.

1.6 The Scottish Government (SG) believes that further tax devolution would strengthen the relationship between the performance of the Scottish economy and funding available to the Scottish Budget. We think it is right that the operation of the Block Grant Adjustment mechanisms ensure that the SG can make alternative policy decisions on devolved taxation; benefit from growing the Scottish economy; whilst retaining a degree of protection from economic shocks that affect the Scottish and UK economies equally.

1.7 In the case of tax-base composition, there is scope to improve on current arrangements, and better insulate the Scottish Budget from short and medium term risks which the Scottish Parliament and Government can only meaningfully influence over a longer period of time. This is particularly important given the disproportionate amount of high-end taxpayers clustered within London and the South East of the UK. Analysis from the IFS noted that, due to the progressive nature of the system, 34% of total Income tax revenue across the UK in 2018-19 was paid for by the top earning 1% of taxpayers and that London alone has around a 40% share of these taxpayers in the UK with this regional clustering increasing in intensity over the last two decades.

1.8 More broadly, we also believe the BGAs could be better calibrated to manage risk associated with sustained economic divergence that is driven by circumstances outside of SG's power to meaningfully influence.

2. Response to survey questions

2.1 What do you consider to be the strengths and weaknesses of the current approach to calculating block grant adjustments for devolved taxes and social security spending for Scotland?

2.1.1 Population risk

2.1.2 There is clear evidence that Scotland's population has grown more slowly over the past half century and is forecast to continue to do so for the foreseeable future. According to the Office for National Statistics from 1971 to 2020 Scotland's population grew by around 4%, compared to 22% in the rUK. [In a recent report](), the Scottish Fiscal Commission, Scotland's independent forecaster, project that Scotland's population could decline by 16% by 2072, compared to a projected 2% decline in the UK

2.1.3 We believe that the BGA mechanism should continue to fully control for differential population growth between Scotland and the rUK, through the existing Indexed per Capita (IPC) methodology.

2.1.4 Relative population growth is a significant determinant of devolved tax revenue and social security expenditure. The Scottish Government lacks some of the key policy levers required to significantly influence this trend, such as migration policy. Without further policy powers being devolved to the SG, the IPC BGA is crucial in order to insulate the Scottish Budget from this population risk. Without it, even relatively modest periods with slower relative population growth could impose a significant cost to the Scottish Budget.

2.1.5 [Analysis]() published jointly by the Institute for Fiscal Studies and independent academics has shown that the cumulative impact of moving from a mechanism that fully protects from differential population growth like the Indexed per Capita (IPC) mechanism, towards a mechanism such as the Comparable Model (CM), which only partially protects from differential population growth, could cumulatively reduce the Scottish Budget by billions of pounds over a relatively short period of time.

2.1.6 Over longer periods of time this risk could be much worse. Assuming the latest projections are correct and that the Scottish population could fall by 16% over the next 50 years whilst the rUK' s population falls by around 2%, scenario analysis would suggest that the total net position for Tax and Social Security could be several billion pounds worse under a CM BGA mechanism relative to a IPC mechanism by the end of that 50 year period. This could cumulatively reduce the spending power of the Scottish Budget in excess of tens of billion pounds over the next half century, assuming tax per head growth and expenditure per head growth in Scotland and the rUK remains the same.

2.1.7 Without the policy levers being devolved which would allow SG to swiftly and significantly influence population growth, such as migration policy, we do not believe it is right for the Scottish Budget to be exposed to a risk of this magnitude. We believe that this would contravene the no-detriment principle set out in the Smith Commission.

2.1.8 Tax base composition risk

2.1.9 In the words of the UK Government's own Levelling Up White Paper, geographical inequality remains a "striking feature of the UK" with "economic growth and the higher productivity which drives it…over-concentrated in specific areas, particularly the South East of England".

2.1.10 The Northern Irish Fiscal Commission recently published a comprehensive review on the case for further fiscal devolution to the Northern Irish Assembly and in doing so noted that devolution should not create unreasonable future risk as a result of the structure of the tax base. They recommended that any subsequent BGA mechanism for Northern Irish Income Tax or Stamp Duty Land Tax (Land and Buildings Transaction Tax in Scotland) should control for the budgetary risk arising from the difference in the composition of the Northern Irish tax base relative to the rUK.

2.1.11 Under current arrangements Scotland carries the budgetary risk arising from differences in the composition of the Scottish and rUK tax base – including structural differences in the income distribution, with high income earners in the UK disproportionately concentrated in London and the South-East.

2.1.12 In the Scottish Government's Medium Term Financial Strategy published in January and December 2021 we published analysis demonstrating that even if average earnings, (a key driver of tax revenues) grow equally in Scotland and the rUK, and grow symmetrically at each level of income, as long as that growth is not uniform across the income distribution then differences in the composition of the different tax bases can have a significant and material impact on the Scottish Budget (either positive or negative). We again do not believe that this is consistent with the no detriment Smith Commission principle.

2.1.13 HM Treasury have acknowledged that this risk is an issue in the Welsh Fiscal Framework which creates separate BGAs for each tax band, rather than having a single BGA covering aggregate revenue. This methodology helps protect the Welsh Budget from the differences in the composition of their tax base relative to the rUK.

2.1.14 Since these differences were already evident at the point of devolution and can only be changed very gradually over prolonged periods of time, we do not believe that the Scottish Budget should significantly gain or lose because of this risk.

2.2 To what extent do you think that the various approaches to calculating the Scottish block grant adjustments, outlined in the background note, are consistent with the Smith Commission's principles? How could the calculation of the BGAs be made more consistent with the Smith Commission principles?

2.2.1 Independent academics and commentators have highlighted the difficulty in reconciling all of the principles recommended by the Smith Commission within a single BGA mechanism. The implication being that none of the BGAs are able to perfectly satisfy all of the principles simultaneously and inevitably involve trade-offs.

2.2.2 SG remains of the view that the principle of ‘no detriment’ must continue to be prioritised through the operation of the BGA. The additional devolution enabled by the Fiscal Framework originated in the ‘offer’ made to the Scottish electorate by the leaders of the parties in favour of Scotland remaining as part of the UK at the 2014 referendum.

2.2.3 Within that context it cannot be right that implementation of that offer should be accompanied by: i) the transfer of substantial fiscal risk, which SG currently lacks the levers to manage or mitigate; and ii) potentially material reductions in funding to the Scottish budget.

2.2.4 In order for SG and the Scottish Parliament to take on additional fiscal risk, there would have to be a further, meaningful transfer of fiscal and policy powers, including for example, significant additional control over tax powers, greater budgetary flexibility, and further policy responsibilities (e.g. migration policy).

2.3 To what extent do you think the various approaches to calculating the Scottish block grant adjustments shares risks between the Scottish and UK governments appropriately? To what extent do you think it is important that the allocation of risks implied by the BGA mechanism aligns with the balance of risks held under the Barnett formula?

2.3.1 Where balance of risks is concerned, SG considers that the more important issue is whether risks are matched to appropriate levers and powers.

2.3.2 The Smith Commission was clear that the Barnett Formula would continue to be used to calculate the block grant and that this was the basis for the subsequent Fiscal Framework Agreement. The Smith Commission did not require alignment between the BGA mechanism and Barnett with regard to how they allocate risks. For example, the Smith Commission did not stipulate that SG must take on population related risk in the BGA, simply because the Barnett Formula would continue to be used.

2.3.3 The role of the Barnett formula within the Fiscal Framework, and devolution more broadly, is complicated by the UKG’s decision to furnish itself with Financial Assistance powers as part of the UK Internal Markets Act, and in the face of opposition from the Scottish Government and Scottish Parliament.

2.3.4 The powers within the act afford UKG the ability to spend directly in Scotland on previously devolved activities and policy areas. This has fundamentally altered the existing devolved settlement, with the new powers giving the UKG discretion to bypass the Barnett formula, if it so chooses. The consequences of this change are still being worked through and understood, including erosion of the block grant, and implications for the balance of risks held under the Barnett formula.

2.4 Do you have any other suggestions for how the block grant adjustments should be designed beyond the transition period?

2.4.1 Fiscal insurance

2.4.2 Whilst we believe that the Scottish Government should take on a degree of risk, we do not think that risk should be unlimited given the limited fiscal levers available to the Scottish Government. Nor do we believe that the Scottish Budget should be penalised for economic shocks or trends that are outside the Scottish Government's ability to meaningfully influence.

2.4.3 For example, analysis published by the Scottish Fiscal Commission and in the latest Scottish Government Medium Term Financial Strategy, found evidence that the Scottish Budget has been negatively affected by exceptionally strong earnings growth in the South-East of England (particularly in high end taxpayer sectors such as Finance). This is exacerbated by the progressive nature of the Income Tax and LBTT system, meaning that relatively small numbers of high-income sectors, households and taxpayers can have a disproportionate impact on how aggregate Scottish and rUK tax revenues change year-on-year.

2.4.4 Such trends can be difficult for the Scottish Government to meaningfully influence in the short-to-medium term and can quite quickly cause a large gap between devolved tax revenues and the equivalent BGA. These trends can also be magnified by UK Government policy decisions – such as changes to the cap on bonuses for workers in the Finance Sector.

2.4.5 Whilst the Scottish Government accepts it should not be insulated against any long-term negative effects of its own policy decisions, it also believes that it should not bear unlimited risk for economic trends it cannot materially influence given its constrained suite of fiscal levers.

2.4.6 We believe that there is a case for some form of limited fiscal insurance that could be incorporated into the devolved taxes. For example, that could be in the form of a revision to the current BGA system, or something more akin to the Welsh Government's "funding floor."

2.4.7 We acknowledge the risk that this could dilute the relationship between economic performance and the devolved budget, and we believe that it is right that the Scottish Budget still bear some of the costs or benefits of Scottish tax revenues diverging from rUK revenue. However, we believe that a carefully designed fiscal insurance mechanism can ensure that there is a reasonable limit to such risk, without necessarily undermining or eroding the rationale for devolution and whilst remaining consistent with the Smith Commission principles.

Forecast error volatility

2.4.8 The application of BGAs within the fiscal framework introduce significant volatility into the Scottish Budget process. Some of this volatility is inevitable - driven by the necessity of using forecasts in the budget process and the resultant reconciliation process to correct for any forecast error that results from this process.

2.4.9 However, the levers available to SG to effectively manage this volatility are insufficient. We have already seen negative reconciliations in excess of the £300 million borrowing power limit currently available to deal with forecast error and this was just for Income Tax alone.

2.4.10 There have been several pieces of analysis regarding the sufficiency of the forecast error borrowing powers. The Scottish Fiscal Commission published analysis showing that Income Tax reconciliations could exceed Scottish Government borrowing powers up to four times every ten years.

2.4.11 The Scottish Government's own analysis shows that there could be between 8% to 24% chance that funding volatility, as a result of forecast error across all of the currently devolved taxes and social security benefits, would breach the £300 million annual limit of our resource borrowing powers. This was similar to analysis by Bell et al who estimated that the £300 million borrowing limit could be exceeded in between 8% and 26% of years (focusing on Income Tax and the largest Social Security benefits of DLA / PIP).

2.4.12 We believe that it is imperative that when designing how BGAs will operate beyond the transition period, that sufficient operational flexibility is also considered. Given that the scale of these forecast errors are outside of the control of the Scottish Government, there is a strong case to revise the current borrowing powers to deal with forecast error volatility, particularly on the necessity of having fixed annual borrowing limits in the first place.

2.5 Do you have any suggestions for how understanding of block grant adjustments among stakeholders can be improved?

2.5.1 Since the introduction of the Fiscal Framework, the Scottish Government has taken steps to improve understanding of the fiscal framework and its operation – including through publications such as the:

- Fiscal Framework Technical Note
- Annual Fiscal Framework Outturn Report
- Fiscal Framework Data Annex, which is regularly updated.

2.5.2 The Scottish Government also regularly provides analysis on the operation and impact of the framework and the BGAs as part of its Medium Term Financial Strategy publications.

2.5.3 The Scottish Government remains open to suggestions on how it might further improve on understanding of the framework, and the operation of the BGAs in particular.

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