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The Scottish Government

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Dear Kenny

In advance of appearing before your Committee on Wednesday 13 August I wanted to provide an overview of the issues around, and progress made towards, agreeing a Block Grant Adjustment for the Devolved Taxes. This is an important matter for Scotland and the scrutiny your Committee is providing on it is both valuable and welcome.

The UK Command Paper "Strengthening Scotland's Future", published in November 2012, stated that;-

"When the smaller taxes are devolved, currently planned to be April 2015, there will be a one-off reduction which will then be deducted from the block grant for all future years."

This one-off cash adjustment mechanism set out in the Command Paper is the approach which informed the passage of the Scotland Act 2012, including the Scottish Parliament vote for the Legislative Consent Motion in March 2012.

Subsequently HMT have proposed an approach which applies an initial deduction to the block grant coupled to a reduction in all future Barnett consequentials. We do not believe that this methodology has any basis in the Command Paper. This is clearly demonstrated by the absence of any reference to such an approach in the Command Paper and the very detailed explanation of the mechanism in the Command Paper accompanying the Wales Bill published in March this year.

In our view, the proposed Barnett abatement mechanism also fails on the principle of increasing the accountability of the Scottish Parliament, which the Scotland Act 2012 is supposed to improve. Under this proposed approach a substantial factor affecting the Scottish Government's spending power in relation to the devolved taxes will be the policy choices of the UK Government on growth in public spending, over which the Scottish Parliament has no influence. For example in order to benefit (through additional spending power) from the tax choices the Scottish Parliament makes, revenue growth would need to exceed growth in public spending which would be determined by the UK Government.

In light of the differences in position of the two Governments, in April this year I proposed to index the initial adjustment to the GDP deflator. This approach is simple, easily understood, and would maintain the value of the initial one-off block grant adjustment over time.

Subsequent to offering this approach, officials here and in HMT have analysed how each mechanism might perform under a range of scenarios, including the outcomes for the Scottish Budget. This analysis has proved useful in understanding how the different mechanisms may work. The analysis has also highlighted further areas of concern.

HM Treasury have suggested that under any mechanism to adjust the block grant, constraints should be applied such that, on a set of assumptions produced by HM Treasury on future tax revenue growth and on growth in UK public spending, there should be no cumulative gain or loss to the Scottish budget over a long period extending to 2030. If Treasury's view of future receipts and spending was borne out over this period, the Scottish budget would benefit cumulatively if tax receipts grew faster than HMT's assumption, or if UK spending growth was lower than assumed. If tax growth was lower than the assumption, or if spending growth was higher, the Scottish budget would lose out. After the end of the extended period, it is in our view highly likely that the Scottish budget would continue to be lower, year after year, than if the two taxes had not been devolved and no block grant adjustment was in place.

However, we do not accept that there is a basis for implementing such a constrained approach. The Command paper made no mention of such an approach -

> *"When the smaller taxes are devolved, currently planned to be April 2015, there will be a one-off reduction which will then be deducted from the block grant for all future years."*
>
> *"In contrast to income tax, which will in future apply to a tax base shared between the Scottish and UK Parliaments, these taxes will be completely devolved to the Scottish Parliament and hence any changes to the rates or structure of a tax by one jurisdiction will not have a direct impact on the receipts of the other ….. Hence there will be no need for subsequent adjustments to the block grant to compensate for changes to these taxes after their devolution."*

It was further agreed at the first meeting of the Joint Exchequer Committee, 27 September 2011, that the block grant adjustment for the devolved taxes was clearly set out in the Command Paper -

> *"Phase 1 – in April 2015 there will be a one-off reduction to reflect the devolution of Stamp Duty Land Tax and Landfill Tax which will then be deducted from the block grant for all future years."*

I am therefore not disposed to agree to the use of a constrained approach because there was no indication of such an arrangement at the point when the Scottish Parliament voted on the LCM in March 2012 and because in our clear view the concept of achieving a zero net impact on the Scottish budget over a lengthy forecast period contains a number of fundamental flaws. I explain my reasons for saying so below, in detail. The net impact of the approach depends heavily on the forecast period chosen, and takes no account of actual trends in tax receipts. A likely gain to the Scottish budget in the short term would have to be balanced out by future losses regardless of what wider conditions may suggest. Furthermore the initial adjustment and abatement factor required to deliver the medium term reductions to the Scottish budget required by the Treasury's assumptions would lock in a permanent and increasing annual cut in Scotland's budget after the end of the forecast period and therefore for the long term.

More widely, the approach is based on assumptions around long term trends in revenue and public spending which are unrealistic in practice since they cannot capture the inevitable volatility in revenue which is a major feature of a land transaction tax subject to shocks in the housing market. There is no guarantee that the gains implied under any methodology will ever materialise as, particularly over a period as long as the 16 years to 2030, there is the potential for a market correction which results in tax receipts falling. Such long term forecasts are inevitably subject to a significant degree of uncertainty. As the Committee is aware, there is (based on recent experience) concern over the accuracy of the Office for Budget Responsibility's forecasts for the devolved taxes, particularly in respect of SDLT, and predicating any future BGA mechanism on these forecasts would in my opinion add an unacceptable level of risk to the Scottish budget.

I am very aware that my draft budget for 2015/16 requires certainty over the BGA to ensure a complete budget. To this end I had a constructive discussion with the Chief Secretary to the Treasury last week where there was a good discussion around the issues I have set out above. There was an equally good understanding of the pressing need for an agreement, and to this end we agreed a number of issues which my, and HMT officials, will follow-up on before I have a further discussion with the CST.

I have also previously discussed with you my commitment to seeking the approval of your Committee for the final choice of BGA mechanism. I remain committed to this.

I look forward to appearing before your Committee soon, and will be happy to discuss this issue further with you then.

JOHN SWINNEY