

# Essentials of the Fiscal Framework

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## Introduction

The Fiscal Framework Agreement was published in February 2016<sup>1</sup>. The Fiscal Framework sets out the new fiscal arrangements required to go alongside the devolution of new tax and welfare powers.

Key elements of the Fiscal Framework include:

- How the Scottish block grant will be adjusted to reflect the transfer of fiscal responsibilities;
- Forecasting arrangements and responsibilities;
- Arrangements for revenue borrowing and cash management to smooth revenue volatility and differences between revenue forecasts and outturn;
- Capital borrowing;
- And a range of other issues including administration costs, data sharing arrangements, dispute resolution, and implementation and review.

This paper provides a basic overview of the key components of the Fiscal Framework.

## The Block Grant Adjustments for taxes

### The purpose of the BGAs

The Scottish Government's block grant will continue to be determined by the Barnett Formula. The Barnett-Formula allocates to the Scottish Government a population share of changes in 'comparable spending' in England. This change is added to the block grant in the previous year.

But the Barnett Formula-determined block grant has to be adjusted to reflect the transfer of revenue responsibility from the UK Government to the Scottish Government. For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) will be calculated. The BGA can be interpreted as a counterfactual estimate of the revenues that the UK Government is likely to have foregone as a result of transferring the tax to the Scottish Government. If actual Scottish revenues from the devolved taxes are higher than the BGAs, then the Scottish budget is better off than it would have been without tax devolution, and vice versa.

### How are the BGAs calculated?

How are the BGAs calculated? For each tax, the BGA consists of two elements: an 'initial deduction' and an 'indexation mechanism'.

The initial deduction is the revenue raised from the tax to be devolved in the year prior to devolution. For example, if income tax is to be devolved to the Scottish Government in 2017/18, the initial deduction is the revenue raised from income tax in Scotland in 2016/17.

But what should the BGA be in 2017/18 and any year thereafter? This is where the indexation mechanism comes in. The purpose of the indexation mechanism is to provide a measure of the rate at which 'comparable revenues' have grown in rUK between any two years.

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<sup>1</sup> <https://www.gov.uk/government/publications/the-agreement-between-the-scottish-government-and-the-united-kingdom-government-on-the-scottish-governments-fiscal-framework>

To calculate the BGA for income tax in 2017/18, the indexation mechanism is applied to the initial deduction. The indexation mechanism is a measure of the growth rate of comparable revenues in rUK between 2016/17 and 2017/18. By applying it to the initial deduction, it thus provides a counterfactual estimate of the level of income tax revenue that would have been raised in Scotland in 2017/18, had tax policy been the same in Scotland as in rUK, and had income tax revenues grown at the same rate in Scotland as in rUK between 2016/17 and 2017/18.

The BGA for income tax in 2018/19 will be calculated by applying the indexation mechanism (i.e. the measure of the growth in income tax receipts in rUK between 2017/18 and 2018/19) to the BGA for 2017/18.

## Two ways of calculating the indexation mechanism

Disagreement between the Scottish and UK governments about how the indexation mechanism should be calculated was the reason why the Fiscal Framework took so long to agree. The Smith Commission Agreement identified a number of high-level principles that Scotland's new fiscal framework should adhere to. But no one method for calculating the indexation mechanism was capable of meeting all of the Smith Commission principles simultaneously<sup>2</sup>.

So what was finally agreed?

The Fiscal Framework states that, over the period to 2020/21, the indexation mechanism for the devolved taxes will be based on the 'Comparable Method' (CM), but then reconciled to the Indexed Per Capita (IPC) method.

Under the Comparable Model, the change in Scotland's BGA is determined by a *tax-capacity adjusted population share of the change in rUK revenues*. The *population share* is Scotland's share of the UK population. *Tax capacity* is the amount of tax raised per person by a given system of tax rates and thresholds. Scotland's tax capacity for income tax (set out in the Fiscal Framework) is 87.5% of rUK's.

So under the Comparable Model, if rUK income tax revenues increase by £10 billion between any two years, if Scotland's population share is 9%, and Scotland's tax capacity for income tax is 87.5% of rUK's, Scotland's BGA would increase by £787.5m (£10bn x 9% x 87.5%).

The IPC method indexes the BGA to the growth in tax revenues per capita in rUK and the rate of population growth in Scotland. For example, if rUK revenues per capita grow by 5% and the Scottish population grows by 1%, the BGA grows by approximately 6%<sup>3</sup>.

## What is the difference between IPC and CM?

The principle difference between the CM and IPC indexation mechanisms is the way that they treat differences in relative population growth between Scotland and rUK.

The IPC mechanism has the feature that, if tax revenues per capita grow at the same rate in Scotland and in rUK, then the Scottish budget will be identical to what it would have been without tax devolution<sup>4</sup>, even if the Scottish population grows more slowly than the rUK population. In contrast, the implication of the Comparable Method is that the Scottish budget loses out from relatively slower population growth.

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<sup>2</sup> For further information, see: <http://www.ifs.org.uk/publications/8212>

<sup>3</sup> The precise rate of growth of the BGA is 6.05%, calculated as  $(1.01) \times (1.05) \times 100 - 100$ .

<sup>4</sup> This is because, with equal growth rates of per capita revenues, the amount of tax raised in Scotland is equal to the BGA, so the two effects cancel out.

To see this, suppose that revenues in rUK are growing only due to population growth – revenues per capita are constant – and Scotland’s population and revenues are constant. The Comparable Method increases Scotland’s BGA by a population share of the rUK tax revenue increase. But the IPC method would not increase Scotland’s BGA at all (there has been no increase in rUK revenues per capita, and no change in Scottish population).

### Reconciliation between CM and IPC

Over the period to 2020/21, the CM will be used as the indexation mechanism in the first instance. But the BGA will subsequently be reconciled to the IPC method. Thus it will be possible to compare Scotland’s BGAs under both indexation methods, although it is the IPC mechanism which will ultimately determine the BGA.

The method for indexing the BGAs after 2021–22 will be negotiated after the 2021 Scottish Parliamentary elections. Given the difficulty of reaching an agreement this time round, and the principles at stake, these negotiations may not go smoothly.

### The Block Grant Adjustment for welfare

The BGA for welfare involves a transfer of revenue from the UK Government to the Scottish government, to reflect the transfer of responsibility.

Similarly to the BGAs for tax, the BGA for welfare powers involves a ‘baseline addition’ to the Scottish budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism.

The indexation will initially be based on the ‘Barnett Formula’ – the Scottish Government will receive a population share of the spending on ‘comparable’ benefits in rUK. But for a transitional period to 2020/21, this will be reconciled to the IPC indexation mechanism. This will calculate the change in Scotland’s grant for devolved welfare based on the percentage change in per capita spending on the ‘comparable’ benefits in rUK, and the change in Scotland’s population.

### Revenue forecasting

From now on, the resources available to the Scottish Government essentially depend on the block grant that it receives from Westminster, (including the adjustment to that block grant), and the actual revenues received from the taxes devolved.

The BGAs described above are in effect counter-factual estimates of the revenues that would have been raised from the taxes devolved to Scotland had tax policy been the same in Scotland as in rUK, and if Scottish revenue growth had been equivalent to that in rUK.

But actual revenues raised in Scotland from each of the devolved taxes may differ quite substantially from the BGAs for each tax. This is particularly the case if tax policy differs in Scotland compared to rUK.

Thus as well as knowing what the BGAs for each tax will be, it is also essential that the Scottish Government has reliable forecasts of revenues from the devolved taxes, taking into account Scottish growth and Scottish tax policy.

The Fiscal Framework specifies that the Scottish Fiscal Commission (SFC) will be responsible for preparing independent forecasts of Scottish Government tax receipts and benefit expenditure, and Scottish onshore GDP.

The Fiscal Framework recognises however that it will take some time for the newly established SFC to develop appropriate forecasting tools and expertise. Thus the SFC will assume its forecasting role in full for financial year 2018/19, which means producing forecasts from summer 2017. For 2017/18, forecasts will be prepared by the Scottish Government and scrutinised by the SFC.

## Resource borrowing and cash management

The transfer of revenue responsibility to the Scottish Government clearly implies greater uncertainty around what the Scottish Government's budget might be in any given year. The BGAs will initially be based on forecasts of the growth rate of rUK revenues for comparable taxes, and will subsequently be reconciled to outturn. Similarly, forecasts of Scottish income tax revenues in any given year will be reconciled to outturn.

The devolution of revenue responsibility may also imply some additional volatility in the Scottish budget. Welfare spending and tax receipts can vary from one year to the next. The BGA mechanisms effectively shelter Scotland from any volatility in revenues that is UK-wide (because a fall in UK revenues implies a fall in the BGA). But there may still be some Scotland-specific volatility in revenues from one year to the next. Borrowing powers can help smooth such volatility.

The Fiscal Framework provides the Scottish Government with borrowing powers to deal with this uncertainty and volatility.

Under the Fiscal Framework Agreement, the Scottish Budget will have the ability to borrow up to £600m each year within a statutory overall limit for resource borrowing of £1.75 billion. A fairly complex set of rules govern how these powers can be used in these different circumstances:

- There is an annual limit of £500 million on borrowing for in-year cash management (such borrowing allows the Scottish Government to deal with the fact that the timing of its devolved revenues and its spending commitments within a year may differ);
- There is an annual limit of £300 million on borrowing to account for errors in forecasts of devolved taxes or welfare spending, and error in the forecasting of the BGAs;
- There is an annual limit of £600 million on borrowing to address any observed or forecast shortfall in revenues or welfare expenditure where there is, or is forecast to be, a Scotland-specific economic shock. The Fiscal Framework defines such a shock as periods when (on a rolling 4-quarter basis), Scotland's GDP grows (or is forecast to grow) by less than 1% and is also more than 1 percentage point less than growth in UK GDP growth.

In addition to borrowing powers which the Scottish Government can use when revenues are below forecast, the Fiscal Framework also makes provisions for a cash reserve – the Scotland Reserve – which can be built up when revenues are higher than forecast. The 'Scotland Reserve' can be used to smooth spending and manage tax revenue volatility. The Scottish Government will also be able to pay into reserves up to a total of £700 million and draw these down at a rate of up to £250 million a year for resource spending, and £100 million a year for capital spending.

## Capital borrowing

The Fiscal Framework specifies that the Scottish Government will be able to borrow for capital expenditure up to £450m annually, within an overall statutory cap of £3bn.

The Scottish Government may borrow through the UK Government from the National Loans Fund, by way of commercial loan, or through the issue of bonds.

## No detriment due to policy spillover effects

The Smith Commission Agreement stated that there should be *'no detriment [to either government] as a result of UK Government or Scottish Government policy decisions post-devolution'*.

For any given policy change made by either the UK or Scottish Government, there could potentially be a wide number of spillover effects on the budget of the other government. For example:

- An increase in Scottish income tax rates might increase eligibility for Universal Credit, a reserved benefit, given that eligibility is based on after-tax income.
- But it might also induce behavioural effects: some Scottish taxpayers might work less, reducing rates of National Insurance Contributions paid to HMRC; others might relocate to rUK, or convert earned income to dividend income, either of which would benefit the UK Government budget. Identifying the size of such effects could be problematic, given that no counterfactual scenario can ever be observed.

The Fiscal Framework Agreement states that the **'direct'** spillover effects of policy change will be subject to compensatory transfers. Direct effects are those which come about directly and mechanically as a result of policy change. In the example given above, the impact of the increase of Scottish income tax rates on eligibility for Universal Credit would count as a direct effect – the Scottish Government would be obliged to pay a compensating transfer to the UK to account for this.

The Fiscal Framework Agreement states that financial spillover effects resulting from **behavioural change, or any indirect or second round effects**, will not in general be subject to compensatory transfers. However, in exceptional circumstances, behavioural effects that involve a 'material and demonstrable' welfare cost or saving will be taken into account, and subject to compensatory transfers. Any decision as to whether it is appropriate to take into account a behavioural spillover must be made jointly by the two governments.

The Agreement provides no indication as to what level of financial spillover effect might be considered 'material', so this will be entirely a matter for each Government to decide on a case-by-case basis.

## Other issues

The Fiscal Framework also covers a number of other issues, including:

- **Administration and implementation costs.** The arrangements set out in the Fiscal Framework include a one-off transfer from the UK Government to the Scottish Government of £200m to support the implementation of the new powers, plus an ongoing transfer of £66m to reflect the transfer of some administration costs from UKG to the Scottish Government. The Fiscal Framework specifies that the Scottish Government will reimburse the UK Government for costs associated with income tax changes (which will be implemented by HMRC).
- **Memorandums of Understanding.** The Fiscal Framework sets out provisions for MoU between a multiplicity of agencies (e.g. OBR, SFC, DWP, HMRC, etc.) to support the effective operation of the Framework.
- **Data sharing.** The Fiscal Framework outlines the type of data and information that will require to be shared between the two governments and relevant agencies.
- **Governance.** The Joint Exchequer Committee (JEC) will govern the implementation, operation, and review of the Fiscal Framework. Annex D of the Fiscal Framework sets out

the JEC Terms of Reference. The Fiscal Framework also sets out arrangements for dispute resolution.

### **Unresolved issues**

There remain a number of unresolved issues in the Fiscal Framework. These relate to issues around the timing of reconciliations between different indexation mechanisms, the timing and methodologies underpinning Scottish tax forecasts, and the timing of the calculation of some aspects of the BGAs. These issues, and others, were set out in a letter from the Convener of the Finance Committee in Session 5 to the Convener of the Devolution (Further Powers) Committee<sup>5</sup>.

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[http://www.parliament.scot/S4\\_FinanceCommittee/General%20Documents/20160307\\_Letter\\_to\\_Devolution\\_Committee.pdf](http://www.parliament.scot/S4_FinanceCommittee/General%20Documents/20160307_Letter_to_Devolution_Committee.pdf)