Written submission from David Phillips, Associate Director, Institute for Fiscal Studies

This is a response by David Phillips, an associate director at the Institute for Fiscal Studies, who leads the Institute's work on devolved and local government finance issues. However, the views and opinions expressed here are those of the authors only; the IFS has no corporate views.

What this response covers

It briefly discusses how the fiscal framework operates, and the implications of this for both the revenue risks borne by the Scottish Government, as well as the scope for the Scottish Government to announce new tax and spend measures in response to the coronavirus crisis. ***It suggests considering changes to block grant adjustments, borrowing powers, and the allocation of funding.***

The Scottish Fiscal Framework

The Scottish Government is funded by two main sources: block grant funding, provided by HM Treasury, and devolved tax revenues. In addition, it has access to capital and (in restricted circumstances) resource borrowing powers, and can maintain small reserves which it can draw down up to fixed limits.

Features of this system provide significant insurance to the Scottish Government from falls in revenue, but constrain its ability to undertake additional policy measures that entail a net cost.

Block grant funding and the block grant adjustments provide significant insurance

The fact that the Scottish Government receives a large share of its funding in the form of a block grant from HM Treasury is one feature which provides significant insurance against negative revenue shocks. This is because the amount of block grant funding received does not depend, at least in the short term, on the amount of tax collected either in Scotland or in the UK as a whole. If there is a shortfall in non-devolved revenues, it is the UK government that is responsible for covering this via borrowing.

Another mechanism that provides insurance is the system of block grant adjustments (BGAs) that sit alongside the devolved tax revenues and powers. In particular, the BGAs are indexed to what happens to comparable revenues in England and Northern Ireland. This means if revenues for these devolved taxes fall at the same rate per capita in Scotland as in England and Northern Ireland, then the Scottish budget will be insulated from the revenue effects of the coronavirus crisis. That is because the reduction in the BGAs would more or less offset the reduction in tax revenues. If Scottish revenues fall by more than those in England and Northern Ireland, the Scottish budget would be reduced (because revenues would fall more than the BGAs), while if Scottish revenues fall by less, the Scottish budget would be increased (because revenues would fall by less than the BGAs). In other words, the way the BGAs are indexed insures the Scottish Government's budget against common shocks, but exposes it to idiosyncratic shocks.

The timing of tax revenues and BGAs provides further short-term insurance for the Scottish Government when it comes to income tax revenues. The income tax "revenues" the Scottish Government will receive in 2020-21 are based on forecast for this year, made before the coronavirus crisis. The BGA for income tax is also based on forecasts for income tax revenues in England and Northern Ireland made before the coronavirus crisis.

These are not reconciled to outturns until they become available after 3 financial years. Hence, even if income tax revenues in Scottish fall more than in England and Northern Ireland, this would not hit the Scottish Budget until 2023-24 The Scottish Government has some borrowing powers to address these shortfalls, provided they are modest and short-term (see next sub-section). It has chosen to do this in the current financial year, as a result of reconciliation of outturns for income tax revenues and the associated BGA for 2017-18 leading to a net £204 million reduction in funding for the Scottish Government (revenue outturns were £941 million lower than forecast, but the BGA was only £737 lower than forecast). It can also choose to draw down reserves or absorb any shortfall in its Budget.

For landfill tax and land and buildings transactions tax, which are collected by Revenue Scotland, the process is different.[1] Revenues for these taxes are actually what is collected in-year, whereas the BGAs are initially based on forecasts for England and Northern Ireland made before the coronavirus crisis, which will be updated based on Autumn 2020 forecasts, and reconciled to outturns in 2022-23. For these taxes, therefore, the Scottish Government initially bears the full revenue risk. Much of this could be offset by reductions in BGAs when updated forecasts are produced in the autumn, and when reconciliation takes place in 2022-23, but idiosyncratic risks remain the responsibility of the Scotland. The Scottish Government has in- and cross-year borrowing powers to address the short-term shortfalls that could arise.

Short-term borrowing cannot be used to insulate the Scottish Budget from the effects of a longer-term decline in its tax base relative to that of England and Northern Ireland if, for instance the Scottish economy does not recover as well from the crisis.

One thing that could address the long-run impacts of a bigger hit to the Scottish economy would be to update the BGAs to account for changes in the relative size of the Scottish tax base. As it stands, these BGAs are set to be based on pre-coronavirus relativities indefinitely. Updating these fully or partially for future years would increase the Scottish Government's budget if its tax base is relatively smaller in future than it was when the BGAs were initially set (e.g. if the Scottish economy is hit harder on a long-term basis); but would reduce the Scottish Government's budget if its tax base is relatively larger in future (e.g. if the Scottish economy is hit less hard on a long-term basis). The current framework whereby the Scottish Government was fully insulated from differences in tax bases at the point of devolution ('no detriment') but bears in full any changes in the relative size of tax bases from that point on is unusual internationally.

Whether the Scottish economy will be hit harder or not is difficult to say. On the one hand, a larger share of the workforce work in sectors such as hospitality, which are likely to be hard hit and may take significant time to recover. And the Scottish economy is much more dependent on the oil and gas sector, where prices have fallen and may remain depressed. On the other hand, a larger share work for the

[1] Note that non-domestic rates are not covered by the fiscal framework agreement. The implicit BGA for these is initially set based on forecasts for English non-domestic rates revenues, and is adjusted to account policy measures using the Barnett formula (see final sub-section). However, I am uncertain as to whether forecasts and outturns for England are reconciled and the initial BGA eventually updated – this is something to check with HMT and/or the Scottish Government.

public sector, and may be relatively insulated from the economic effects of the coronavirus crisis.

The rules on reserves and borrowing were not designed for the current situation

The Scottish fiscal framework places limits on the amounts the Scottish Government can put into and draw down from reserves, the amount it can borrow for different purposes, and sets out rules on when these powers can be used.

Previous analysis by IFS researchers suggested that the limits looked sufficient, even in the face of economic shocks like recessions, but also that rules allowing full access of these powers only in the case of a tightly-defined "Scotland-specific economic shock" could prove constraining.[2] A forecast reduction in funding of £600 million in 2021-22 due to reconciliation of income tax revenues and BGAs for 2018-19 exceeds the maximum amount that can be borrowed and drawn down from reserves in the absence of a Scotland-specific shock by £150 million. Reform or abolition of the rules in relation to a Scotland-specific shock should be considered, and at the very least, borrowing limits should be indexed to increase in line with devolved revenues and demand-led expenditure.

Moreover, the borrowing limits and rules were not designed to deal with situations like now, when:

- There is a need to develop, cost and announce new measures very rapidly;
- There is the potential for the nations to be affected by coronavirus in very different ways.

The Scottish Government is able to hold reserves of up to £700 million in total, and draw down up to £250 million a year for day-to-day spending, plus up to £100 million for capital spending. For the current financial year, Budget forecasts suggest there could be around £107 million of unallocated reserves that could be drawn down, which might sound sizeable but is less than 0.3% of the Scottish Government's budget and less than 1% of the Scottish NHS's budget.

The Scottish Government is also able to borrow £450 million a year for capital spending, up to a total borrowing limit of £3 billion. The draft budget for 2020-21 envisioned making use of the full £450 million of this facility, meaning no scope to increase borrowing further,

The fiscal framework also provides for up to £500 million of in-year borrowing to smooth the timing of receipts and spending of £500 million. It allows for £300 million a year in cross-year borrowing if tax revenues are lower than forecast, up to a limit of £1.75 billion. This limit is increased to £600 million in the case of a forecast or actual 'Scotland-specific economic shock" which is defined as a situation when onshore Scottish GDP is below 1% in absolute terms of a rolling 4 quarter basis and 1 percentage point below UK GDP growth over the same period.

[2] D. Bell, D.Eiser and D. Phillips (2016), 'Scotland's Fiscal Framework: Assessing the Agreement', https://www.ifs.org.uk/publications/8212.

As discussed above, payments of devolved income tax from HMRC to the Scottish Government are based initially on forecasts and are not reconciled with outturns until 3 years later: 2023-24 for the current financial year. But the Scottish Government collects revenues from land and buildings transactions tax and landfill tax itself, and Scottish councils collect non-domestic rates on its behalf. In the near term then, these borrowing powers could be used to cover shortfalls in revenues from these taxes. Given approximately 40% of the business rates tax base is being exempted from business rates in the coming financial year, funded by additions to the Scottish block grant, and the BGAs are set to be updated in the Autumn for LBTT and LT, the £500 million borrowing powers would be enough to cover a shortfall in these revenue streams of perhaps 35% in the meantime. If the fall in revenues is larger than this, the Scottish Government may need to cut back spending.

Moreover, the rules preclude borrowing to cover the day-to-day costs of new policy measures – such as responses to the Coronavirus. This means that the devolved governments are very reliant on funding from the UK government in order to be able to fund additional policy measures – such as tax holidays and cash grants via the business rates system, and extra funding for the health and social care systems. If there is not good communication by the UK government in advance of its own announcements, the devolved governments could find themselves having to play catch-up once they know how much funding they will receive as a result of those announcements. This risks additional uncertainty for residents of the devolved nations and even delays to implementation of policies.

As of 30th April, the Scottish Government had received £3.5 billion in additional block grant funding as a result of measures announced in England (since then figure will have increased as a result of additional funding announcements, e.g., for social care providers). By that stage it had allocated just over £3.4 billion of that total, although, potential further allocations for health and social care were pending (and support to councils for reductions in council tax, fees and commercial income is notably absent so far).[3] If the Scottish Government decide they wish to go further than the UK government on coronavirus-related measures, they have to cut back other areas of spending to be able to do this.

It is notable that in Wales, the Welsh Government has decided to do just that. In an analysis in early April, Guto Ifan of Cardiff University estimated that of the approximately £2.4 billion of coronavirus-related measures then announced in Wales, £526 million were not covered by additions to the block grant (of just under £1.9 billion by that stage).[4] The aforementioned £105 million of unallocated funding could be used to help fund this. But funding will have to be reallocated from other budgets, including reallocating EU funding from supporting business creation and expansion to business survival. Some of the reallocated funding may be from activities no longer feasible or needed in the short term,

---

[3] N. Hudson (2020), 'What money is the Scottish Government getting for coronavirus (COVID-19) support and how is it being spent?', https://spice-spotlight.scot/2020/04/30/what-money-is-the-scottish-government-getting-for-coronavirus-covid-19-support-and-how-is-it-being-spent/.

[4] G. Ifan (2020), 'Covid-19 and the Welsh Government Budget', https://www.cardiff.ac.uk/__data/assets/pdf_file/0005/2132654/COVID19_Welsh_Budget_FINAL.pdf.

such as for international trade missions or speed limit enforcement. But it is possible that much more difficult choices over reallocation could be encountered too.

There is therefore a case for giving the devolved governments greater access to borrowing via the National Loans Fund, at least temporarily and for coronavirus related measures. Removal of the annual cap on drawdowns from reserves would also enable additional spending. This would allow devolved governments to develop, cost and announce plans more quickly than if they have to wait until UK government plans for England have been announced.

The OECD has noted that most OECD countries require sub-national governments to balance their budgets, but warns that when such rules apply over short timeframes they can be problematic.[5] It suggests relaxing or suspending these rules, alongside the provision of guarantees of debt incurred by sub-national governments as a result of the corona virus crisis. It notes that:

'During a time of crisis, it may be possible to relax such rules with a reduced risk of moral hazard problems emerging later. Relaxation may take the form of both formal escape clauses that can be triggered by prescribed circumstances and/or effective suspension of the rules in practice when it is unreasonable to expect SNGs to comply.'

It is worth noting that Spain had allowed municipalities to run deficits, and that in Germany, several states are relaxing self-imposed balanced budget rules.

Effective communication and coordination between the UK and devolved governments should also be a priority – and several OECD countries have activated or created agencies dedicated to national-regional inter-governmental crisis coordination.

Reliance on the Barnett formula risks misallocation of funding across the UK

Increments to (or decreases to) block grant funding – such as those made during the Coronavirus crisis – are calculated using the Barnett formula. In the case of Scotland, this adds to (or subtracts from) the block grant an amount equivalent to 100% of the per capita change in funding for comparable spending in England.[6] For example, if new funding of £100 per capita is announced for England for responsibilities that are devolved to Wales, the Welsh Government receives an additional £100 per capita.

This formula is simple and automatic. But there are many reasons why the share of spending needed in each nation may differ from such a population-based approach. In an observation published at the end of March,[7] I highlighted that:

- Caseloads and prevalence of Covid-19 may differ significantly, putting differing degrees of pressure on the health services of each nation. At the time of writing,

---

[5] OECD (2020), 'Covid-19 and fiscal relations across levels of government', http://www.oecd.org/coronavirus/policy-responses/covid-19-and-fiscal-relations-across-levels-of-government-ab438b9f/#section-d1e1731.

[6] In Wales, it is 105% rather than 100%. The Welsh Government negotiated a 105% share as part of the new fiscal framework introduced alongside the devolution of additional tax revenues and powers in 2018-19 and 2019-20 in recognition of long-standing concerns that Wales was under-funded via the Barnett formula.

[7] D. Phillips (2020), 'Devolved governments need more flexible funding and greater borrowing power to tackle coronavirus effectively', https://www.ifs.org.uk/publications/14766.

deaths due to Covid-19 are lower on a per capita basis in each of the nations with devolved government than in England.

- Demographic and health differences may mean the population of each nation is more susceptible to the disease. For example, the fraction of the population aged 65 or over in Wales in 114% of the level in Scotland, while it is 104% and 90% of the English level in Scotland and Northern Ireland, respectively. Rates of ill health are higher in Scotland, Wales and Northern Ireland than England.
- Differences in the composition of the labour force may affect the cost of a range of policies and the importance of different types of support. For example, a higher share of jobs are in food and accommodation services in Scotland and Wales than England.
- Differences in tax bases may affect the cost of providing support through the tax system. For example, a higher fraction of the business rates taxbase (‘rateable value’) is in the retail and hospitality sectors in Scotland than England, and a higher share of properties in Scotland have rateable values below the thresholds chosen for grant-funding – both of which would push up the cost of support in Scotland relative to England. However, the average rateable value of properties in the retail and hospitality sectors is lower in Scotland than England, reducing the cost of the business rates holiday for these sectors.

If needs differ, using the Barnett formula to allocate funding could therefore mean relatively too little or too much funding being given to the devolved governments in Scotland, Wales and Northern Ireland. When combined with limited borrowing powers, this could mean the devolved governments have insufficient funding to fund necessary expenditures and/or an inefficient allocation of scarce funding across the nations of the UK.

The UK government should therefore consider bypassing the Barnett formula, especially if it is clear that the coronavirus is having very different impacts in different parts of the UK or the cost of particular policy responses will vary significantly. Where ex-ante assessment of likely needs is infeasible it could consider funding via cost reimbursement if the devolved governments follow the same policies as the UK government in England, subject to appropriate checks on expenditure.

Any formula bypasses should probably be planned to be temporary: it is important not to rush into making new long-term fiscal arrangements in the midst of a crisis.

However, as may be the case in other areas of public policy, this crisis can be a prompt to consider the suitability of elements of the fiscal system, like the Barnett formula, that have long been subject to calls for reform. For example, the Holtham Commission, the House of Lords Economic Affairs Committee, as well as the author of this note and many other researchers, have called for the replacement of the Barnett formula with a more rational system, such as based on a spending needs assessment.