

# A primer on the Scottish Parliament's new fiscal powers: what are they, how will they work, and what are the challenges?

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## Abstract

This article provides an overview of Scotland's new Fiscal Framework. The Fiscal Framework sets out how the new powers devolved to the Scottish Parliament in the Scotland Acts 2012 and 2016 will be made operational. It provides a brief overview of the history of fiscal devolution to Scotland since the establishment of the Scottish Parliament in 1999. From relying on a Block Grant from Westminster to fund virtually all its expenditure, the Scottish Parliament now has a range of revenue raising powers including substantial flexibility to vary income tax rates and thresholds; moreover the Scottish budget will in future be much more closely linked to the performance of the Scottish economy. In addition, the Scottish Parliament will gain a range of powers in relation to social security. The mechanisms and method(s) for adjusting Scotland's Block Grant – Block Grant Adjustments (BGA's) – the forecasting role of the new Scottish Fiscal Commission and Scotland's new capital borrowing, resource and cash management powers are all outlined. Finally, the implications for Scotland's budget process and what the new arrangements could mean for the Scottish Government's ability to impact on Scotland's economy and growth rate is discussed.

## I Introduction

Substantial new fiscal powers are being devolved to the Scottish Parliament, as a result of the Scotland Acts 2012 and 2016. These powers include the devolution and assignment of significant tax revenues, and devolution of new social security powers.

The devolution of these powers requires changes to be made to the way that the Scottish block grant is calculated. New arrangements for fiscal forecasting have to be put in place. And the Scottish Government requires more extensive borrowing and cash management tools to manage budget volatility and uncertainty. These arrangements are set out in Scotland's Fiscal Framework, published in 2016<sup>1</sup>.

Implementing the new powers also requires substantial technical and administrative work, much of which is ongoing. And it will require changes to the way in which Scottish budgets are presented to and scrutinised by the Scottish Parliament.

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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>

This paper outlines the Scottish Parliament's new powers, the key elements of the Fiscal Framework that enable the implementation of these new powers, and the technical and administrative issues that are still ongoing. It describes some of the budgetary opportunities that the new fiscal arrangements present, and also some of the risks to which the Scottish budget is now exposed.

## II Background to tax devolution in Scotland: how did we get to where we are?

When the Scottish Parliament was established it had substantial spending responsibilities but limited responsibility for revenue raising (i.e. taxation). On spending, the parliament has substantial responsibilities in relation to health, education, justice and policing, economic development, the environment, and culture and sport. On tax however, only two relatively small property taxes were determined in Scotland – the Council Tax (a tax on domestic property) and Non-Domestic Rates, a tax on business property.

Revenues from these two taxes amounted to around 10 per cent of the Scottish Parliament's spending budget, with the remainder of the budget provided by the block grant from the UK Government.

The Calman Commission report, published in 2009, argued that this imbalance between spending responsibility and revenue raising responsibility was problematic. It noted<sup>2</sup> *'Funding by block grant alone means that while the Scottish Parliament is completely accountable for the spending of its budget, it is not accountable for the total of that budget or how it is raised; it has no fiscal powers that can be used as policy instruments and it does not have a direct financial stake in the performance of the Scottish economy'*. .

The Calman Commission recommended that this imbalance should be addressed through the partial devolution of income tax to the Scottish Parliament, alongside devolution of stamp duty land tax (a tax on property transactions) and landfill tax (a tax on waste to landfill). These recommendations were passed into legislation through the Scotland Act 2012. Scottish Landfill Tax and the Land and Buildings Transaction Tax (LBTT, the replacement for Stamp Duty in Scotland) came into operation in April 2014. The arrangements for the partial devolution of income tax only operated for one year, 2016/17, before being superseded by subsequent legislation.

Following the 2014 Scottish Referendum, the Smith Commission was established to agree which fiscal powers to devolve to the Scottish Parliament. The Smith Commission<sup>3</sup> argued that tax decentralisation would make the Scottish Parliament 'more accountable and responsible for the

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<sup>2</sup> Commission on Scottish Devolution, 2009, para 3.87

<sup>3</sup> [http://webarchive.nationalarchives.gov.uk/20151202171017/http://www.smith-commission.scot/wp-content/uploads/2014/11/The\\_Smith\\_Commission\\_Report-1.pdf](http://webarchive.nationalarchives.gov.uk/20151202171017/http://www.smith-commission.scot/wp-content/uploads/2014/11/The_Smith_Commission_Report-1.pdf)

effects of its policy decisions and their resulting benefits or costs' and that it would 'strengthen the Scottish Parliament's ability to pursue its own vision, goals and objectives'.

The Smith Commission recommended:

- That 'Non Savings, Non-Dividend' (NSND) income tax revenues should be transferred to the Scottish Parliament. NSND income tax revenues account for around 92% of all income tax revenues raised in Scotland (and include the tax paid on income from earnings, self-employment, pension income and property income). The Commission recommended that the Scottish Parliament be able to vary income tax rates and bands in Scotland without constraint. But the UK Government will retain authority to determine the income tax base. This means that the setting of the Personal Allowance, and the way in which the pensions tax relief is defined for example, are determined by the UK Government.
- That Air Passenger Duty (APD) should be devolved in full.
- It also recommended that a share of VAT collected in Scotland should be assigned to the Scottish Parliament. Specifically, the first ten pence of Standard Rate VAT and the first 2.5 pence of reduced rate VAT to be assigned to the Scottish Parliament. Given that the Standard and Reduced rates of VAT are currently 20% and 5% respectively, this means that under current policy, half the VAT revenues raised in Scotland will be assigned to the Scottish budget.
- It also recommended the devolution of Aggregates Levy, in full.

The Smith Commission's recommendations were enacted through the Scotland Act 2016.

### III Summary of the Scottish Parliament's evolving revenue responsibilities

The Scottish Parliament's new tax powers are being implemented on a staged basis over the next few years. NSND income tax will be devolved to the Scottish Parliament from April 2017, with APD being devolved in 2018 and VAT in 2019. The staging of the introduction of the tax powers largely reflects the time taken to resolve various administration and implementation issues specific to each tax.

Table 1 summarises the extent of existing and planned tax devolution to the Scottish Parliament.

**Table 1:** Devolved, shared and assigned tax revenues in Scotland

<b>Tax</b>	<b>Date of transfer/ devolution</b>	<b>Revenues raised 2015/16 (£m)</b>	<b>Degree of control by Scottish Parliament</b>	<b>Responsibility for collection</b>
Council Tax	1999	£2,100	Fully devolved; complete autonomy.	Local government
Non-Domestic Rates	1999	£1,900	Fully devolved; complete autonomy.	Local government
Land and Business Transactions Tax (LBTT)	2015	£416	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	£147	Fully devolved; complete autonomy.	Revenue Scotland
Income tax	2017	£11,214	The Scottish Government can set the rates and bands. But the UK Government defines the tax base and sets allowances.	HMRC
Air Passenger Duty	2018	£275	Fully devolved; complete autonomy	Revenue Scotland
VAT	2019	£5,000	Assigned revenues; no autonomy	HMRC
Aggregates Levy	tbc	£53	Fully devolved; complete autonomy	Revenue Scotland

*Source: Government Expenditure and Revenue Scotland (GERS); author analysis*

A new Scottish tax agency, Revenue Scotland, has been established to collect revenues for the fully devolved Scottish taxes (LBTT, Scottish Landfill Tax, Aggregates Levy, and Air Passenger Duty, which the Scottish Government has announced will be renamed 'Air Departure Tax'). Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC.

## IV The Scottish Parliament's new social security powers

In addition to tax devolution, some devolution of social security benefits is also taking place. A number of UK-administered benefits, mainly related to ill-health, disability and care are being devolved to the Scottish Parliament. Spending on these benefits in Scotland by the UK Government in 2015/16 totalled around £3bn (Table 2).

**Table 2:** Expenditure on social security benefits being devolved to the Scottish Parliament

	<b>Expenditure, £m</b>
	<b>2015-16</b>
Disability Living Allowance	1,399
Attendance Allowance	487
Carer's Allowance	224
Winter Fuel Payment	180
Personal Independence Payment	315
Industrial Injuries Disablement Benefit	91
Severe Disablement Allowance	49
Discretionary Housing Payments	13
Cold Weather Payment	3
Funeral Payment	4
Sure Start Maternity Grant	3
<b>Total expenditure on social security benefits to be devolved</b>	<b>2,768</b>

*Source: Government Expenditure and Revenue Scotland 2015/16*

A new Social Security Bill will be introduced in the Scottish Parliament imminently. This will provide the framework for the establishment of a new social security system in Scotland. The implementation dates for any new powers will be agreed by the Joint Ministerial Group on Welfare.

Additionally, the Scottish Government has already gained the power to:

- create new benefits (except pensions) in areas not otherwise connected with reserved matters
- top up reserved benefits
- make discretionary payments or provide discretionary assistance to meet certain needs
- amend some employment support schemes

- make changes to the amount of Universal Credit (UC) for the costs of rented accommodation, and the timing and recipients of payments.

Since 1 April 2017, Discretionary Housing Payments have also been devolved.

## V Adjustments to the block grant for tax

The Scottish Government's block grant from Westminster will continue to be determined by the Barnett Formula.

However, the block grant will be adjusted (i.e. reduced) to take account of the new taxes being devolved to the Scottish Parliament.

How will this happen? For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) will be calculated. The BGA is effectively a measure of the tax revenues that the UK Government has foregone as a result of transferring the tax in question to the Scottish Parliament.

The process for calculating the BGAs is set out in detail in the Fiscal Framework<sup>4</sup>.

The BGA is calculated for each tax separately, and consists of two elements: an initial deduction and an indexation mechanism.

The initial deduction is simply equal to the tax revenues collected in Scotland in the year immediately prior to the devolution of the tax power. For example, if income tax is devolved in 2017-18, the initial deduction is equal to income tax receipts 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. Its purpose is to provide a measure of the rate at which 'comparable revenues' have grown (or declined) in the rest of the UK between 2016/17 and 2017/18 (or any subsequent year).

The basic idea is that the BGA should grow at the same rate as the growth in comparable revenues in rUK.

To calculate the BGA for income tax in 2017/18, the indexation mechanism (i.e. the growth rate of the rUK tax) is applied to the initial deduction. The BGA in 2017/18 thus provides an estimate of the level of income tax revenue that would have been raised in Scotland in 2017/18, had tax

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<sup>4</sup> <https://www.gov.uk/government/publications/the-agreement-between-the-scottish-government-and-the-united-kingdom-government-on-the-scottish-governments-fiscal-framework>

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.

How is the indexation mechanism actually calculated? During the development of the Fiscal Framework, there was some disagreement between the Scottish and UK Governments over the best way to calculate the indexation mechanism. In the end, a compromise was reached. Over the period to 2020/21, the indexation mechanism will be calculated according to the so-called 'Indexed per capita' (IPC) method. But the results from a second method, the 'Comparable Method' will also be published alongside the IPC estimates<sup>5</sup>.

Under the Comparable Method, 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 Method, if rUK income tax revenues increase by £10 billion between any two years, and if Scotland's population share is 9%, and Scotland's tax capacity for income tax is 87.7% of rUK's, then Scotland's BGA would increase by £789.3m (£10bn x 9% x 87.7%).

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>6</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 method 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>7</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 if Scotland posts a relatively slower rate of population growth than rUK.

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

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<sup>5</sup> For further details about how these methods work, see <https://www.ifs.org.uk/uploads/publications/wps/wp201605.pdf>

<sup>6</sup> The precise rate of growth of the BGA is 6.05%, calculated as  $(1.01) \times (1.05) \times 100 - 100$ .

<sup>7</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.

the IPC method would not increase Scotland's BGA at all (as there has been no increase in rUK revenues per capita, and no change in Scottish population).

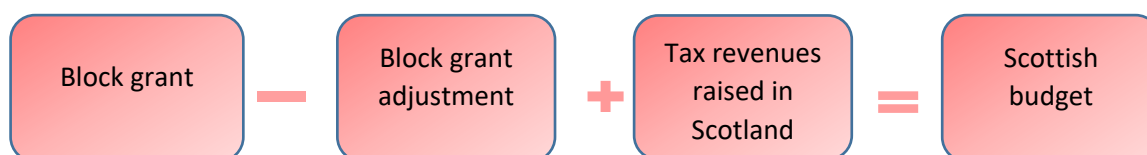
Over the period to 2020/21, the block grant adjustments will be calculated by both the CM and the IPC methods. Thus it will be possible to compare Scotland's BGAs under both indexation methods. Over the period to 2020/21 however, it is the IPC mechanism which will ultimately determine the BGA.

The method for indexing the BGAs after 2021–22 will be negotiated after the 2021 Scottish Parliamentary elections.

## VI Implications of the risk and reward structure in Scotland's Fiscal Framework

What are the implications of these BGAs?

Remember that the BGAs for each tax are deducted from the Scottish Government's block grant. What is added back into the Scottish budget are the revenues that are actually raised from each tax in Scotland.



The key implication of the BGA arrangement is that, if the sum of the revenues raised from the devolved/ assigned taxes is greater than the sum of the BGAs, then the Scottish budget will be better off than it would have been without tax devolution.

This could happen under two circumstances: if the tax base grows relatively more quickly in Scotland than in rUK; or if tax rates in Scotland increase relative to those in rUK.

Of course the reverse could happen – Scottish revenues may grow relatively more slowly than those in rUK, in which case the Scottish budget will be worse off than it would have been without tax devolution.

The principle of the new fiscal arrangements is that the Scottish budget should '*benefit in full*' from policy decisions by the Scottish Government that increase revenues, and conversely bear the costs in full of policy decisions that reduce revenues. This is fine as a principle but the reality of the arrangements is that the Scottish budget bears in full the effects of any differential growth in Scottish revenues relative to rUK revenues, regardless of the causes of any differential growth. Whilst the Scottish Government would certainly hope to be able to implement policy to grow the Scottish economy and tax base, the link between policy and growth is often weak, and many of the factors determining tax revenue growth are only dependent on policy to a limited extent.



At a time when there are structural weaknesses in the Scottish economy (arising in part from developments in the offshore oil and gas sector and its Scottish supply chain), these risks are stark.

Analysis using the Fraser of Allander's microsimulation model of the Scottish economy for example shows that, if wages in Scotland grew just a third of a percentage point more slowly than those in rUK in one year, then income tax revenues raised in Scotland would be £50 million lower than the income tax BGA. If wages in Scotland grow one percentage point more slowly than those in rUK in one year (which is certainly not outwith the realms of the historic experience), the difference between Scottish revenues and the BGA would be £150 million. And of course if these differences were to persist over time, then the revenue differential would increase exponentially.

Similar issues arise with the smaller taxes too. Imagine that Scotland's LBTT revenues per capita grow at 10% per year. This sounds great. But if the equivalent rUK Stamp Duty revenues per capita grow at 15% per year driven by a boom in London's high-end property market, the BGA for LBTT will increase more quickly than Scottish revenues. Hence, the Scottish budget would be worse off than it would have been without tax devolution.

Of course, the Scottish Government doesn't just have to sit back and hope for faster revenue growth. It can choose to implement policies – relating to the devolved taxes specifically or under any of its other devolved competences more generally – to grow the Scottish tax base (or to achieve other policy goals, such as a different distribution of income).

This additional policy flexibility provides new opportunities to the Scottish Government to pursue an alternative policy agenda. But a clear complication is that there is a large degree of uncertainty about how particular policies might influence the future growth of Scottish revenues. Some will inevitably argue that reductions in the burden of taxation will stimulate growth and increase revenues in the long term, while others will argue that the most effective way to raise tax revenue is to raise tax rates.

There are a large number of uncertainties about how individuals and businesses in Scotland might respond to particular tax policy changes. One of the impacts of the devolved tax powers is that we can expect more debates about the revenue effects of tax changes in future!

## VII Adjustments to the block grant for social security powers

As well as making deductions to the Barnett-determined block grant for the new taxes, additions will also be made to the block grant to reflect the new social security powers.

The 'block grant adjustments' for social security are intended to reflect the expenditure foregone by the UK Government as a result of transferring each social security power to the Scottish Parliament.

Similarly to the BGAs for tax, the BGA for social security 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 normally be based on the 'Barnett Formula', whereby the BGAs in such a way that the Scottish budget will be increased by a population share of the spending on 'comparable' benefits in rUK.

But for a transitional period to 2020/21, the BGAs for social security will be calculated according 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.

## VIII Forecasting revenues

As we have just seen, the determination of the Scottish budget will in future be significantly more complex than it has been in the past. In the past the resources available to the Scottish Government essentially depended on the block grant from Westminster. In future, in addition to the block grant itself, the resources available to the Scottish Government will depend on a complex interaction between the revenues from taxes transferred to the Scottish Government, and the revenues from the equivalent taxes in the rest of the UK.

In order to set its budget each year, and in order to undertake medium term financial planning, the Scottish Government will need forecasts of the Scottish revenues.

The Scottish Fiscal Commission (SFC) has been established to make the Scottish forecasts. Twice each year, the SFC will make a 5-year forecast for each of the Scottish revenues, and for spending on the social security benefits being transferred to Scotland. The SFC will also make a forecast for growth in Scottish onshore GDP.

The SFC was established as a statutory, non-Ministerial Department in April 2017 and is operationally independent of the Scottish Government. It will produce its first official forecasts later this year (2017), alongside the Scottish Budget.

It is important to note that the SFC is only mandated to produce a single forecast for each tax. This will be based only on stated Scottish Government policy. In other words, the SFC cannot produce different forecasts to reflect alternative policy scenarios.

Of course the Scottish budget is not only determined by Scottish revenues. It is also determined by the BGAs, which are themselves determined by growth in comparable rUK revenues and social security spending.

In order to set its budget each year, the Scottish Government will not only need forecasts for Scottish revenues, but also need forecasts for the BGAs. The BGA forecasts will be determined by the UK Office of Budget Responsibility's (OBR's) tax forecasts for rUK, and DWP expenditure forecasts for social security benefits.

In its budget documentation, the Scottish Government will need to set out the forecasts for the Scottish taxes alongside the forecasts for the BGAs.

## IX Reconciliation

Although income tax is being transferred to the Scottish Parliament, collection of income tax from Scottish taxpayers will continue to be undertaken by HMRC. How then will income tax revenues raised from Scottish taxpayers be transferred to the Scottish budget?

In drawing up its draft budget in any given year, the Scottish Government will rely on forecasts of the revenues raised from the Scottish taxes (to be made by the Scottish Fiscal Commission), and a forecast of the block grant adjustments for each tax (which will be based on forecasts for the growth in rUK revenues made by the OBR).

The UK Government will transfer to the Scottish Government the SFC's *forecast* for income tax revenues; these will be drawn down throughout the financial year, whilst the UK Government will deduct from the block grant the *forecast* of the income tax BGA.

Once outturn data on income tax revenues are available, the forecasts of both Scottish tax revenues and the income tax BGA will be reconciled to that outturn. These reconciliations might work in the same direction and offset each other; for example, outturn Scottish revenues that are lower than those forecast may simply be offset by lower than forecast rUK revenues, and hence a lower than forecast BGA. Of course it is possible that the reconciliation of Scottish revenues and BGA works in opposing directions, resulting in either a windfall gain or loss for the Scottish budget once reconciliation occurs.

A key point however is that outturn data for income tax is not available until 15 months after the end of a financial year. Outturn data for 2017/18 for example will not be available until June 2019. These outturn figures for 2017/18 will then not be 'reconciled' with the forecast until the Scottish Government's budget of the subsequent financial year, i.e. 2020/21.

Two points are worth making:

- First, these long (3-year) lags involved in reconciliation mean that accountability for the fiscal effects of policy decisions will often spill across parliamentary terms.
- Second, note also that the Scottish budget bears the risk of forecast errors made by the OBR for rUK income tax. For example, consider the case where the SFC's forecast for Scottish revenues corresponds exactly to outturn, but where the OBR forecast for rUK income tax revenue substantially underestimates subsequent rUK outturn figures. In this case, an upward reconciliation of the BGA would have to be made to a subsequent Scottish budget.

A similar reconciliation process will be required in the case of VAT, once this is assigned to the Scottish budget.

For the 'fully devolved' revenues that are collected by Revenue Scotland, reconciliation happens slightly differently. Because the revenues from these taxes are collected in Scotland by Revenue Scotland and made available directly to the Scottish Government, 'reconciliation' happens continuously throughout the year, rather than as a one-off event. For the BGAs, there will be reconciliations between the forecast for the BGAs and the actual BGAs (based on actual rUK outturn data). These reconciliations will happen on a monthly basis.

## X Resource borrowing and cash management

The devolution of revenue (and welfare spending) responsibility clearly exposes the Scottish budget to the risk of greater budget volatility. As we have seen, the complex process by which the Scottish budget is based on forecasts of Scottish revenues and BGAs, both of which are then reconciled to outturn, means that the Scottish Government may face a number of cash management issues.

The Scottish Government has gained additional borrowing and cash management powers to deal with this uncertainty and volatility.

Under the Fiscal Framework Agreement, the Scottish Government 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 the

collection 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 (although there is scope to increase this limit, subject to agreement between the Scottish and UK Governments). 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.

The Fiscal Framework also makes provisions for a cash reserve – the Scotland Reserve –which can be used to smooth spending and manage tax revenue volatility. The Scottish Government will 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.

## XI Capital borrowing

The Fiscal Framework also specifies that the Scottish Government will now be able to borrow up to £450m annually for capital expenditure (the previous limit was £300m), 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.

## XII Administration and set-up costs

The Scottish and UK governments are incurring costs in implementing and then managing the financial powers in the Scotland Acts. The revised fiscal framework sets out how the Scottish and UK governments will share the cost of implementing these powers.

The UK Government will make a one-off payment of £200 million to the Scottish budget as a contribution towards costs, and transfer up to £66 million each year to the Scottish budget to cover ongoing administration costs.

The Scottish Government is responsible for meeting HMRC's costs in setting up and operating the income tax powers. The lifetime estimate of these costs is now forecast to be around £20-25m, in addition to which there are likely to be annual implementation costs.

The Scottish Government is responsible for meeting all costs associated with establishing the Scottish Fiscal Commission (SFC), setting up the devolved taxes, and all administration and programme costs it incurs in creating new social security benefits or making discretionary payments.

According to Audit Scotland<sup>8</sup>, by the end of 2015/16, the Scottish Government had spent £18.5 million on programmes to implement the financial powers in the Scotland Acts. Most of this was to cover HMRC's costs in setting up and operating the Scottish rate of income tax. The Scottish Government budgeted a further £18 million for 2016/17 and £92 million for 2017/18.

The Scottish Government expects that implementation will cost more than the £200 million than the UK Government will transfer to the Scottish budget, although it has not identified how much more.

### XIII Fiscal Framework implementation issues

The transfer of revenue and social security responsibilities to the Scottish Government poses a number of technically difficult administrative challenges. Here we consider three of the main ones, relating to social security, VAT revenue estimation, and identification of Scottish income taxpayers.

Perhaps the biggest challenge will be to transfer the social security benefits in a way that ensures that no Scottish recipients lose access to benefit payments, or see their payments delayed. The fiendish complexity of untangling the Scottish elements the DWP's databases should not be underestimated. Indeed the Scottish Government has noted that<sup>9</sup>, '*transferring the devolved benefits safely presents a challenge on a scale unlike anything the Scottish Government has faced since devolution [i.e. the establishment of the parliament in 1999]*'.

Assignment of VAT to the Scottish budget will begin in 2019/20. Assigned VAT will form a significant part of the Scottish budget, so it is essential that estimates of VAT raised in Scotland are robust and reliable. But how will Scottish VAT revenues be estimated? The estimation will likely involve large scale surveys of household spending in Scotland (from which estimates of VAT revenues can be derived), combined with expenditure surveys of visitors to Scotland. As with any survey-based approach, the estimates will be subject to a degree of error. And the calculations will be complex, given the significant range of products and services that are subject to reduced rates, zero-rates and exemptions (including financial services). A VAT-assignment

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<sup>8</sup> [http://www.audit-scotland.gov.uk/uploads/docs/report/2017/nr\\_170323\\_managing\\_financial\\_powers.pdf](http://www.audit-scotland.gov.uk/uploads/docs/report/2017/nr_170323_managing_financial_powers.pdf)

<sup>9</sup> <http://www.gov.scot/Publications/2017/04/9266> (Para 89)

working group has been established to consider these issues, and is expected to release its first report later in 2017.

Working out Scottish income tax revenues requires a clear and up-to-date assessment of who is a 'Scottish' income taxpayer and who is not. HMRC has undertaken significant work to identify Scottish income taxpayers for 2017/18. But this is not a one-off task. Each year, as people relocate between Scotland and rUK (or between Scotland and overseas), records will need to be kept up to date. This in part relies on taxpayers maintaining their up-to-date address details with HMRC.

#### XIV Changes to the Scottish budget process

The Scottish budget is clearly becoming more complex and is exposed to greater risk. As we have seen, it will involve revenues and block grant adjustments, forecasts and reconciliations, borrowing and cash management, and so on.

This additional complexity will require changes to the way in which the Scottish Government presents its budgets, and the information and data it includes. It will require greater awareness of the medium term budgetary risks and opportunities facing the Scottish budget. And it will require changes to the way in which parliament scrutinises Scottish budgets and associated documentation.

Recognising this, a Budget Review Group was set up by the Cabinet Secretary for Finance Derek MacKay MSP and the Convenor of the Finance Committee Bruce Crawford MSP to consider how the Scottish budget process should evolve in light of the parliament's new fiscal powers.

The Group is due to issue its report in July 2017. The report will set out how the vast amount of budgetary data should be presented in future budgets, and is expected to recommend that the parliament adopts a more 'year round' approach to scrutinising this information.

#### XV Conclusions

Scotland's new fiscal powers bring substantial opportunities to the Scottish Parliament. These range from the possibility of radical reform – for example in the way that land and property are taxed, or in the way in which disability is assessed in the social security system – to the scope for more minor tweaks (such as the Scottish Government's decision in 2017/18 to set a somewhat lower threshold at which income taxpayers become liable for the Higher Rate of tax).

One of the big challenges that the new powers pose is the substantial uncertainty that exists around how some types of tax (or social security) changes might influence behaviours, and thus affect revenues or expenditure.

But even if the Scottish Government chooses not to vary tax policy in Scotland, the way that the Fiscal Framework is designed means that the new fiscal powers are likely to affect the size of the Scottish budget. The growth of Scottish revenues per capita must match the growth of equivalent rUK revenues per capita if the Scottish budget is to be at least as well off as it would have been without tax devolution.

This structure is intended to incentivise the Scottish Government to implement policies that will grow the Scottish economy and tax base. But the nature of this set-up comes with risks. The relative growth of Scottish revenues will be determined by many things that are outwith direct control or influence of the Scottish Government. This ranges from global developments in the offshore oil and gas sector, to a booming housing market in London and the southeast of England, to the long-term effects of policies administered by previous devolved administrations.

The new Fiscal Framework arrangements also introduce a range of complexities into the budget process. A large number of factors will determine the resources available to the Scottish Government, including not only the Scottish revenues but also the BGAs, the repayment implications of previous borrowing, the position of the Scotland reserve, and so on. And there will be a corresponding expansion in the number of organisations with some role to play in the implementation and delivery of the devolved powers, including forecasting organisations like the SFC and OBR, tax collection agency Revenue Scotland, and the new Social Security Agency.

There is still some way to go before some of the fiscal powers are ready for implementation. This is particularly the case for VAT and the social security powers. Effective inter-governmental and cross agency working will be crucial to enable a smooth implementation.

The increased level of media and public interest in the Scottish budget and Scottish fiscal policy in the past couple of years suggests that one of the supposed benefits of fiscal devolution (greater scrutiny and accountability for budgetary decisions) has already been realised. However, it is likely to be some time until we have a clearer picture about whether the Scottish Parliament's additional fiscal responsibilities have led to better policy outcomes in Scotland.

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