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Fraser of Allander Institute

Scotland's Budget Report 2017

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The Fraser of Allander Institute is Scotland's leading economic research institute with over 40 years experience of researching, analysing and commentating on the Scottish economy. It is widely regarded as Scotland's expert authority on economic policy issues.

The 'Fraser' undertakes a unique blend of cutting-edge academic research, alongside applied commissioned economic consultancy in partnership with business, local and national government and the third sector.

For over 40 years, *The Fraser of Allander Institute Economic Commentary* has been the leading publication on the Scottish economy providing authoritative and independent analysis.

The Fraser of Allander Institute is a research institute of the Department of Economics at Strathclyde Business School, UK Business School of the Year 2016.

For regular analysis on the Scottish economy and public finances please see our blog

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MORTON FRASER
LAWYERS

Welcome to this second annual briefing on the Fraser of Allander Institute's Report on Scotland's Budget.

The First Minister has said that it is now time to open a discussion as to how "responsible and progressive" use of the Scottish Parliament's tax raising powers could "help build the kind of country we want to be".

Given their unrivalled knowledge and understanding of the Scottish economy, the Fraser of Allander Institute's 2017 Report on Scotland's Budget will serve as a key contribution to this discussion and we are delighted to be supporting the Fraser of Allander Institute and Mackay Hannah in facilitating such an important debate.

At Morton Fraser our focus is on supporting those working, investing or doing business in Scotland and we share with our clients the desire to be part of a more prosperous Scotland.

I have no doubt that this Report will be a key reference point for all us with a stake in Scotland's future growth and prosperity.

Chris Hart
Chief Executive

Foreword

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This publication – and the Scotland's Budget 2017 seminar which it underpins – articulates the critical questions that the Scottish Government must address in the coming months prior to its Budget at the end of the year.

The broader economic context.

Any fiscal analysis can not of course be detached from the broader economic context in which it is set.

Unsurprisingly, the BREXIT negotiations have dominated the economic discourse over the past year. A vast array of commentators and business people have spoken of the uncertainty that this has injected into investors and households alike, and indeed policy-makers.

Perhaps surprisingly, however, current economic indicators suggest that uncertainty has not generated paralysis and stagnation. Employment growth is robust and unemployment low. But recent data does show a cooling UK economy with business investment weak, consumer confidence falling and growth slowing. In Scotland, the picture is if anything arguably more fragile. This is concerning for the immediate future but more worrying for the medium term in which BREXIT may well intensify the degree of uncertainty or lead to an adverse long-term trading environment.

Welcome and perhaps unexpected though this degree of short-term resilience is at the UK level, the likelihood of serious economic deceleration and dislocation in the event of a departure, or anticipated departure, from the European Union Single Market and Customs Union remain extremely high. The timing may be unknown but the nature of the impact, at least over the medium term, seems less so.

Alongside this is the critical question of the future mobility of people, and especially those fundamental to the operation of the productive economy, including both the highly skilled and also the less skilled but essential individuals; to the underlying research and innovation base of the country; and to our educational standing in the world.

Within this complex context, the Institute's fiscal analysis is therefore necessarily challenging. At this stage of the EU negotiations, the implications for the fiscal aggregates are unknown. Nonetheless, it is essential to explore the possible scenarios and understand the key questions that must be addressed.

Addressing multiple objectives.

Current debate is not of course without its potential policy tensions. One such tension is that between the growth objectives of policymakers and their wish to also pursue policies of greater equity of opportunity – often founded on some form of inclusive growth strategy. At one level, this is a familiar tension, but the newly established fiscal powers provide both a greater opportunity and a greater challenge to securing these multiple objectives.

Interestingly, the crucial role of the new Fiscal Framework in this context has received little attention. The new Framework puts an explicit burden on the Scottish Government to secure growth rates that are at least equal to those prevailing in the rest of the UK.

How might explicit policy decisions that tend to favour greater equity or a more sustainable environment impact on absolute growth rates at least in the short-term? The answer is that we do not yet know. But politicians will be loathe to expose themselves to accusations that they are presiding over inferior aggregate fiscal revenues and therefore cautious about policy choices that are not directly supportive of accelerated growth. We all need to gain a more sophisticated understanding of how the new framework operates and the manner in which it might impact on policy behaviours.

The crucial longer term structural questions.

More broadly, there remains a subdued debate around what should arguably be the critical central piece of our thinking today: namely, the long-term economic opportunities and challenges facing the Scottish economy and the mechanisms by which the dynamism of economic activity might be secured.

One area of considerable importance is the external economic strategy: how to boost Scottish trade, not least in non-EU markets which will take on a far greater significance in the coming years. Establishing stronger global networks of trade missions has a place, not least in the crucial gathering of trade and local intelligence in key markets, but, this needs to be complemented by the identification of those elements that have historically constrained external performance in Scotland and by a major focus on supporting more global mindsets and ambitions amongst Scottish companies. Of this, there remains little sign.

The key point here is that Scotland's strategic economic focus should be upon the key outcomes that define the vision for Scotland and upon the crucial policy instruments that can secure these outcomes. Organisational structures are important but the emphasis in this area in recent times has been to the detriment of a cross-public sector outcome approach.

Our future work.

In the coming year, we will continue our regular analysis on the Scottish and UK Budgets and the Scottish economy. In addition, we shall extend the range of services that we offer across Scotland, with regular Economic and Fiscal Workshops dedicated to critical questions of immediate interest to businesses, policy-makers, academics, commentators and others.

Over the past eighteen months, I believe that the 'new' Fraser of Allander Institute has made a significant contribution to the economic and fiscal debate in Scotland. The outputs of the Institute are now widely sought and referenced. The independence of the Institute – whilst challenging to governments and all political parties – is well respected and acknowledged.

Particulary pleasing is the growing number of new and young researchers choosing to study, take internships and work in the Institute. If Scotland is to meet the fiscal and economic challenges that we face in the coming years, then having a skilled set of economists, statisticians and researchers to advise and guide policymakers will be crucial.

Working with the Fraser of Allander Institute.

Finally, I want to acknowledge the great support of many different people and organisations without whom the Institute would not be able to play the role that it does.

For our budget analysis in particular, the Institute continues to benefit immensely from the support of the University of Strathclyde, the Scottish Funding Council and Dr Jim Walker from Asianomics.

The publication of this report and accompanying event has been made possible by the support of ICAS, Morton Fraser and Mackay Hannah.

We are indebted to these supporters for their financial support but we also seek to work with them as partners and contributors in the analysis that we undertake. For this reason, we are keen to continue extending our range of collaborators and would warmly welcome exploring such partnerships with other bodies. All investment made in the Institute goes directly toward developing new talent and research. Our new membership scheme is an ideal way for your organisation to help support independent analysis of the fiscal and economic challenges and opportunities set out so clearly in this report.

Professor Andrew Goudie
Chair, Fraser of Allander Institute Advisory Board
University of Strathclyde

September 26, 2017

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Executive Summary

- Scotland faces considerable public spending restraint in the years to come.
- Through a combination of ongoing fiscal consolidation at the UK level, a relatively fragile economic environment and major policy commitments to be paid for, the resources available to fund many public services will continue to be squeezed.
- Such pressures are not just restricted to the near-term. With an ageing population and rising health costs, more money will need to be found to support the health service even to stand still.
- Changes in the balance of and scale of public spending; how public services are delivered and prioritised; and the way in which devolved revenues are raised, are all likely to be required. Continuing as before is not an option if Scotland's devolved budget is to be sustainable in the long term.
- This is not a challenge just for the Scottish Government but for all political parties in Scotland. An open and transparent debate about the sustainability of the public finances – and the options for reform – is now essential.

Outlook for the Scottish Economy

- The economic outlook for Scotland and the UK as a whole remains fragile, with continuing uncertainty around the terms of Brexit an ongoing concern.
- Despite showing initial signs of resilience in the aftermath of the EU referendum, UK economic growth has slowed markedly. In Scotland, whilst the most recent GDP data – for Q1 2017 – are positive, growth has been much weaker than for the UK economy for most of the last two years. Annual Scottish growth is currently just 0.4% compared to 1.9% for the UK.
- In contrast, recent Scottish employment growth has been strong and outpaced the UK as a whole. But earnings and productivity remain weak and we are yet to fully understand how much of the recent growth in employment – particularly from non-standard work patterns – is sustainable.
- Under the new Fiscal Framework, whilst the overall fiscal envelope that the Scottish Government will face continues to be largely set by the UK Government, at the margin, what is now of crucial importance is how Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.

- Given recent data, we believe that the Scottish Fiscal Commission (SFC), in forecasting Scottish GDP and tax revenues for the first time, is likely to be relatively cautious in their forecasts for growth and Scottish taxation over the next few years.

Tax devolution: a view from ICAS

- Scotland's new tax powers – whilst giving the Scottish Parliament significant new autonomy – are intricately interwoven with UK taxes. The Scottish Parliament has only a limited number of pieces of the jigsaw.

- Behavioural responses by taxpayers may limit some options; however, behavioural repercussions may not limit the Scottish Government's choices if the policies are considered attractive. It will also be necessary for the electorate to trust that policy objectives are achievable – and that a better economy, desired redistribution, or better public services will result from additional taxation.

- Care needs to be taken in setting a tax competitive policy such as low Scottish rates or reliefs as it may simply lead to further intra-UK competition, 'a race to the bottom', and ultimately falling revenues for everyone.

- A key element of tax policy should be, where possible, to enhance and support the economy: at the very least, measures should not add to the complexity of doing business which would put Scottish business at a disadvantage.

- Trends so far with devolved taxes have been to align with UK taxes, evident in both directions with, for example, the new LBTT progressive structure being adopted by the UK SDLT, and then the UK 3% surcharge being introduced into LBTT. In the longer term, tax policies which are more distinctive from those in the rest of the UK may be needed to meet spending commitments.

- The Budget Process Review Group has examined the budget processes but the tax process itself needs further consideration and should be given an equal weighting to the spend side of the budget.

- A five-year roadmap setting out objectives of Scottish tax policy would be helpful: this should set out policy objectives and provide clarity of purpose. Transparency of data and the link between Scottish tax receipts and the operation of the Fiscal Framework will be crucial if the public are to have faith in the Parliament's new fiscal powers.

Outlook for the Scottish Budget

- After a relatively good year in 2017-18 (where the Scottish resource block grant increased by 0.5% in real terms), based upon current UK Government plans, the next few financial years looks like being challenging for the Scottish budget.

- We set out a range of possible scenarios for the Scottish budgetary outlook. We conclude that the balance of probability points towards further real terms reductions in the discretionary day-to-day (resource) spending power of the Scottish budget.

- Whilst the exact outcome will no doubt differ from our scenarios – and the exact profile in each year will undoubtedly fluctuate – they provide a useful illustration of the overall financial envelope the Scottish Government should prepare for.

- Under our central scenario, the total Scottish resource budget (grant and tax revenues) is forecast to fall by 2.3% in real terms between 2016/17 and 2020/21.

- Under alternative but arguably, equally realistic scenarios (an 'upside budget risk' and a 'downside budget risk'), the Scottish resource budget could decline by 1.2% or by up to 3.8% by 2020/21.

- Given current indicators of economic performance, there is the possibility that the Scottish Government could trigger the emergency borrowing powers embedded within the Fiscal Framework. This would boost the budget by up to £600 million in any given year, but this would of course have to be repaid at a future date.

- There is more flexibility on the capital budget, with the block grant from Westminster set to increase 5% per year up to 2019/20. By the end of the parliament in 2021, it will be close to its peak in 2010/11.

Spending commitments and constraints

- Through various manifesto and Programme for Government commitments, the Scottish Government has set out a number of budget priorities for the next few years.

- This includes a commitment to increase health spending by £500 million more than inflation by the end of this parliament, to maintain real terms spending on policing, to double free childcare provision and to invest an additional £750 million in a school attainment fund.

- Taking these commitments just on their own means that over half the Scottish budget can be viewed as 'protected'.

- In a time of fiscal restraint, delivering on such commitments necessarily requires tough settlements for some public services.

- When certain areas of expenditure are protected, 'non-protected' areas will shoulder a greater share of the burden. As an illustration, delivering on just four budgetary priorities – health, policing, childcare and educational attainment – could mean that 'non-protected' areas face real terms cuts of between 9% to 14% over the parliamentary term (2016/17 to 2020/21).

- On top of this can be added other commitments and priorities like free higher education tuition, college places, free personal and nursing care and funding for school education. The 2017 Programme for Government confirmed that the government will lift the 1% pay cap. A 3% increase in pay – in line with inflation – could cost around £350 to £400 million even accounting for the higher tax revenues the government could receive back.

- All of this leaves the non-education elements of local government as the largest part of the budget which could be categorised as "non-protected" – re-igniting the debate about the future of local government finance.

- In the medium term, Scotland's new social security powers carry significant opportunities to design better policies and to take advantage of synergies with existing devolved levers.

- But they also provide budgetary risks, notably around set-up and administration costs but also delivering on any policy commitments. Of course, over the medium term better linking of existing devolved services with the new social security powers could not only deliver better outcomes but also save money.

Long-terms fiscal challenges

- The size and distribution of the Scottish budget has changed markedly in recent years.

- There have been reductions in the real terms value of public spending across the UK. With a growing population, these reductions have been even more significant on a per capita basis. The Scottish Government's resource spending (including income from NDRI) is likely to be 10% lower in real terms by 2020/21 compared to 2010/11.

- Within this period, health has been a priority with real terms health resource spending forecast to increase by 10% between 2010/11 and 2020/21. As a result, non-health resource spending has seen substantial declines. On a per capita basis, resource spending in areas other than health is, on current projections, expected to be – on average – almost 20% lower in 2020/21 in real terms than a decade earlier.

- Demographic change and other cost pressures mean that in future the health resource budget will need to increase in real terms just to stand still. With tight fiscal settlements likely for the foreseeable future, if the prioritisation of the health resource budget is

continued, further spending reductions will be required elsewhere or new sources of revenue found.

- A strategic look at the long-term financial sustainability of Scotland's public finances is therefore required.

- On spending, options include reforms to the way in which public services are delivered, with a view to a more preventative approach; a more targeted approach to the allocation of scarce public sector resources; and a reappraisal of the services provided by the state.

- On revenue, a number of options are possible – particularly around income tax – but there are also significant constraints.

- Substantial changes are already happening to the balance of and scale of public spending, and the way in which devolved revenues are raised. An open and transparent debate about the long-term sustainability of the public finances is now essential.

Chapter 1: Scotland's fiscal framework and economic outlook

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly with major new powers over taxation and welfare. Around 40% of devolved expenditure is now funded by tax revenues generated in Scotland – a figure that will rise to 50% once VAT revenues are assigned. The block grant will continue to fund remaining expenditure.
- As a result, Scotland's economic performance – or more accurately, Scotland's economic performance *relative* to the UK – now has a much greater bearing on the revenues available for the Scottish budget than ever before.
- This autumn, for the first time, the Scottish Fiscal Commission (SFC) will provide detailed forecasts for Scottish devolved taxes, income tax, devolved social security and GDP. The Office for Budget Responsibility (OBR) will be preparing forecasts for the equivalent UK taxes which will determine the Block Grant Adjustments.
- Both of these will be shaped by their assessments of the outlook for the Scottish and UK economies respectively.
- Despite showing initial signs of resilience in the aftermath of the EU referendum, UK economic growth has slowed markedly. Consumption has tailed off, business investment is weak and the fall in Sterling has yet to boost trade as much as had been hoped.
- Whilst the most recent GDP data – for Q1 2017 – was positive, growth in Scotland has been much weaker than for the UK economy for most of the last two years. Annual Scottish growth is currently just 0.4% compared to 1.9% for the UK.
- In contrast, Scottish employment growth has been strong and outpaced the UK as a whole. But earnings and productivity remain weak and we are yet to fully understand how much of the recent growth in employment – particularly from non-standard work patterns – is sustainable.
- Over time, what matters most for the Scottish Budget – relative to Barnett – is how Scottish tax revenues grow (*per head*) relative to the equivalent taxes in the rest of the UK.
- But in looking ahead to this year's Scottish Budget, what will be crucial will be the actual forecasts made by both the SFC and OBR. It is the combination of these two forecasts that will determine, at the margin, how much more or less money the Cabinet Secretary for Finance will actually have to spend next year.
- Given recent data, we believe that the SFC is likely to be relatively cautious in their forecasts for growth and Scottish taxation over the next few years.

The new fiscal framework means that Scotland's economic performance is more important than ever before. 2015 and 2016 were challenging years for the Scottish economy with growth lagging behind the UK. There are signs of recovery however, with strong employment data and some confidence returning to the North Sea. But with growth fragile and ongoing Brexit uncertainty, the new powers could not have come at a more challenging time.

1.1 Introduction

The Scottish budget is in the process of significant reform.

As a result of the Scotland Acts 2012 and 2016, substantial new fiscal powers are being transferred to Holyrood, including the devolution and assignment of tax revenues and the devolution of some social security powers.

The Scottish Parliament will soon oversee annual public spending of over £40 billion and has significant devolved tax responsibilities, including £11 billion worth of income tax[1].

The outlook for Scotland's budget now depends upon three key elements –

- What remains of the Westminster block grant – as determined by the Barnett Formula – which will account for around 50% of the overall spending power;
- Future tax policy choices of the Scottish Government/Parliament; and,
- The performance of Scottish devolved tax revenues relative to the rest of UK (rUK) counterparts.

UK economic performance and spending decisions taken at Westminster will continue to set the overall envelope for Scottish public spending through the Barnett formula.

But with Scotland's block grant now being adjusted (i.e. reduced) to take account of the new devolved tax revenues, how Scottish tax revenues perform relative to rUK will have a much greater bearing on the outlook for the Scottish budget than ever before.

In time, it is this relative economic performance that will determine whether or not the Scottish Budget is better or worse off relative to what it would have been prior to tax devolution.

[1] In 2017/18, the Scottish Parliament gained the power to set the rates of income tax and the band thresholds on the non-savings and non-dividend (NSND) income of Scottish taxpayers (i.e. income from employment, self-employment, pensions and rental income). Responsibility for determining the tax base is reserved.

But for the immediate outlook of next year's Budget and the trajectory to the end of the Parliament, it will be the forecasts made for Scottish tax revenues and the equivalent taxes in the rest of the UK by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) that will be crucial.

This chapter is structured as follows.

Section 1.2 summarises the key elements of this new fiscal framework and explains how Scotland's relative economic performance will now feed through to budget outcomes.

Section 1.3 summarises the recent performance of the Scottish and UK economies.

Section 1.4 discusses the outlook.

Section 1.5 highlights some of the key issues facing the Scottish Fiscal Commission in compiling economic and tax forecasts for Scotland.

Section 1.6 concludes.

1.2 Scotland's fiscal framework

The new powers

The Scottish Parliament's new tax and welfare powers are being phased in gradually over the next few years. With these new powers have come fundamental changes to the way that the Scottish budget is calculated and administered.

New arrangements for fiscal forecasting have been put in place with the Scottish Fiscal Commission achieving statutory status in April this year.

The Scottish Government has secured more extensive borrowing and cash management tools to manage budget volatility and uncertainty.

At the same time, implementing the new powers is requiring substantial technical and administrative work, much of which is ongoing. The way in which Scottish budgets are presented to and scrutinised by the Scottish Parliament is also changing.

Table 1.1 provides a summary of the new responsibilities for taxation – including the taxes devolved as part of the 2012 Scotland Act.

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 will be replaced with an 'Air Departure Tax').

Table 1.1: Devolved, shared and assigned tax revenues in Scotland, 2016/17

Tax	Date of transfer/ devolution	Revenues raised 2016/17 (£m)	Degree of control by Scottish Parliament	Responsibility for collection
LBTT[2]	2015	£466	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	£149	Fully devolved; complete autonomy.	Revenue Scotland
Income tax	2017	£11,313	Can set the rates and bands but not the tax base or allowances.	HMRC
Air Passenger Duty	2018	£264	Fully devolved; complete autonomy	Revenue Scotland
VAT	2019	£5,097	Assigned revenues; no autonomy	HMRC
Aggregates Levy	tbc	£59	Fully devolved; complete autonomy	Revenue Scotland

Source: Government Expenditure and Revenue Scotland (GERS), 2016/17

Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC.

Alongside taxation, some devolution of social security benefits is also taking place.

Table 1.2: Devolved Social Security under Scotland Act 2016 – 2016/17 estimates

Benefit	£ million
Disability Living Allowance	1,208
Attendance Allowance	487
Carer's Allowance	234
Winter Fuel Payment	180
Personal Independence Payment	547
Industrial Injuries Disablement Benefit	87
Severe Disablement Allowance	26
Discretionary Housing Payments	15
Cold Weather Payment	1
Funeral Payment	3
Sure Start Maternity Grant	2
Total expenditure on benefits to be devolved	*2,790*

Source: GERS 2016/17

[2] LBTT refers to Land and Buildings Transaction Tax.

In particular, a number of UK-administered benefits, mainly related to ill-health, disability and carers are being devolved. The benefits associated with the regulated social fund – such as winter fuel payments – are also being devolved.

Spending on these benefits in Scotland by the UK Government is expected to total almost £3 billion in 2017/18 – see Table 1.2.

The Scottish Government is working to establish a new social security system in Scotland. Implementation dates are subject to agreement by the Joint Ministerial Group on Welfare. In May 2017, the Scottish Government announced its intention for an increased Carer's Allowance to be paid from the summer of 2018 with two new benefits the 'Best Start Grant' and 'Funeral Expenses Assistance Grant' from summer 2019.

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 (DHPs) have been devolved although the Scottish Government has effectively been adding to DHPs since 2014/15 to mitigate the effects of the 'bedroom tax'.

The calculation of the Scottish budget

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

Therefore, decisions on public spending by the UK Government will still set the overall envelope for Scottish public spending through the decisions that they take on comparable funding for Whitehall departments where spending is devolved to Scotland.

However, the block grant will be adjusted (i.e. reduced) to take account of the fact that some taxes are now devolved to the Scottish Parliament.

How does this happen?

For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) is 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.

Box 1.1 explains the operation of the BGAs in more detail.

Box 1.1: The Block Grant Adjustments

The Block Grant Adjustments (BGA) are a key component of the new framework for the Scottish Budget – as it is the combination of Scottish tax revenues *and* the BGAs that will ultimately determine whether or not the Scottish budget is better or worse off relative to pre-tax devolution.

Under the new approach, a BGA will be calculated for each tax and will consist of two elements: an *initial deduction* and an *indexation mechanism*.

The initial deduction is equal to the tax revenues collected in Scotland in the year prior to devolution of the new power. For example, income tax was devolved for 2017/18. So the initial deduction was equal to income tax receipts in Scotland in 2016/17. The net effect was that the Scottish Budget was no better or worse off.

But what is the BGA for 2017/18 and 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 (rUK) 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.

So how is the indexation mechanism actually calculated?

Until 2020/21[3], the BGA for Scotland will effectively grow in line with the growth in per capita tax receipts for the equivalent devolved taxes in rUK. For income tax for example, the BGA will increase in line with the growth in NSND income tax growth per head in the rest of the UK.

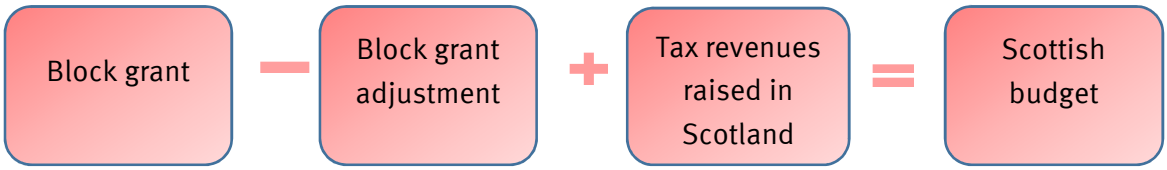
A similar mechanism has been established for the new welfare powers. But instead, the BGA for social security powers involves a 'baseline addition' to the budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism.

The final indexation mechanism is still to be agreed but could ultimately be based on the 'Barnett Formula', so that the BGAs will be increased by a population share of 'comparable' benefits in rUK. But for the transitional period to 2021, they will grow in line with the percentage change in per capita spending on these 'comparable' benefits in rUK (and the change in Scotland's population).

[3] During the development of the Fiscal Framework, there was disagreement between the Scottish and UK Governments over the indexation mechanism. In the end, a temporary mechanism was agreed for review in 2021.

So each year the BGAs for each tax will take money out of the Scottish Government's block grant. What is added back in are the revenues that are raised from each tax in Scotland.

Diagram 1.1: The new Fiscal Framework



The key implication of how all this works is quite straightforward (even if the process underpinning it is not). In short, 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[4].

It is this mechanism that builds in 'risk and reward' to the Scottish budget process, with how the economy performs now crucial to the future outlook for public spending.

Scotland's Budget could be better off under the new system if –

- the tax base grows relatively more quickly in Scotland than in rUK; or
- tax policies in Scotland seek to raise revenues 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.

Table 1.3: Devolved revenue per head: Scotland and UK, 2012-13 to 2016-17, (£)

	Scotland					Rest of UK				
	2012/13	2013/14	2014/15	2015/16	2016/17	2012/13	2013/14	2014/15	2015/16	2016/17
Income tax	1,973	2,040	2,055	2,074	2,093	2,302	2,366	2,373	2,418	2,454
VAT	783	851	871	909	943	790	827	858	891	924
APD	40	42	45	46	49	45	47	50	47	49
LBTT	53	74	92	80	88	113	152	175	174	189
Landfill tax	27	29	28	27	28	17	17	16	15	14
Aggregates levy	8	8	10	10	11	4	4	5	5	5

Source: GERS, 2016/17

[4] Similarly, for social security, if Scottish spending increases faster than in the rest of the UK, then this will have to come at the expense of lower spending in other parts of the budget or increased taxation.

In recent years, Scottish devolved and assigned tax revenues have tended to broadly track equivalent taxes in the rest of the UK – although there have been variations between taxes and years. See Table 1.3.

Since 2012/13 income tax revenues per head have grown 6.1% in Scotland compared to 6.6% in the rest of the UK. The gap is largely explained by the fact that in the last two years, income tax revenues per head have grown quite a bit faster in the rest of the UK than in Scotland – driven in part, by the stronger UK economic performance.

In contrast, VAT revenues – albeit it should be noted that there is much greater uncertainty about such estimates – have grown 20.4% in Scotland versus 16.9% in the rest of the UK.

Finally, it is important to note that under this new framework, the Scottish budget takes on the risk in full of the effects of any differential growth in Scottish revenues relative to rUK revenues, even if the causes of any differential growth are beyond the control of the Scottish Government.

Operational issues with the implementation of the new powers

As highlighted above, the determination of the Scottish budget is now significantly more complex than in the past. It is no surprise therefore that the institutional framework that underpins this new arrangement has been reformed significantly.

Box 1.2 summarises some of the major new changes.

Box 1.2: The Fiscal Framework

The fiscal framework is the term used to cover the new budget arrangements for the Scottish Parliament's tax and welfare powers.

In addition to setting out the mechanism for how the block grant adjustment (BGA) will operate – see Box 1.1 – there are a number of other important features of the new framework:

- The Scottish Government's capital borrowing powers have increased. The overall limit on borrowing has risen to £3 billion, with an annual limit of 15% of the overall borrowing cap.
- The Scottish Government now has increased revenue borrowing powers of up to £600 million per annum, subject to a combined overall limit of £1.75 billion, for in-year cash management, forecast error and Scottish-specific economic shocks.
- The Scottish Fiscal Commission has been established with responsibility for forecasting economic growth and devolved tax revenues and social security payments.
- The processes for managing cash flow and variations in tax revenues between years have changed significantly. Gone is the old Budget Exchange Mechanism for transferring

'underspends' from one year to the next, with a new Scotland Reserve established in its place. In this Reserve, the Scottish Government is able to deposit up to £700 million and draw down monies – subject to annual limits of £250 million for resource and £100 million for capital – should they need to.

- Following the recommendations of the Budget Review Group, new procedures are likely as to how the budget is presented to and scrutinised by Parliament. A greater focus on 'year round' scrutiny is likely.

- Finally, the inter-governmental relations between the Scottish and UK Governments have been reformed with new dispute resolution mechanisms, and new arrangements for information sharing. These have already been tested in the light of the deal by the new UK Government to secure parliamentary support from the Democratic Unionist Party.

One of the biggest institutional changes has been the establishment of the Scottish Fiscal Commission.

From now on, 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. They will also make a forecast for growth in Scottish onshore GDP.

The SFC will produce its first official forecast this year alongside the Scottish Budget. But in order to set its budget, the Scottish Government will not only need forecasts for Scottish revenues but forecasts for the BGAs. The BGA forecasts will be determined by the Office of Budget Responsibility's (OBR's) equivalent forecast for UK taxes and social security benefits.

The UK Government will transfer to the Scottish Government the SFC's forecast for income tax revenues whilst deducting from the block grant the forecast of the income tax BGA made by the OBR.

Therefore in looking ahead to this year's Scottish Budget, the outlook that the SFC and OBR have for the Scottish and UK economies (and tax revenues) will be crucial for determining the exact amount of money the Scottish Government will have at its disposal for the coming financial year[5].

[5] Once outturn data on the taxes are available, the forecasts of both Scottish tax revenues and the income tax BGA will be reconciled to that outturn. For the fully devolved taxes these will happen on a monthly basis. But for income tax, outturn data will not be known until 15 months after the end of the financial year – so outturn data for 2017/18 for example will not be available until June 2019.

1.3 Recent Scottish and UK economic performance

Economic Growth

All of this above discussion makes the outlook for the economy vitally important. A detailed discussion of the latest trends and developments in the Scottish (and UK) economies is provided in our latest Fraser of Allander Economic Commentary[6].

In recent times, the Scottish economy has been in a fragile position. Over 2015 and 2016, the Scottish economy grew by just 1.1%.

The downturn in the oil and gas industry has been a major factor, with the oil price around half its 2014 value. Manufacturing sectors tied to the North Sea have been particularly badly hit, with overall manufacturing output in Scotland 5.4% lower than at the end of 2014.

But wider indicators of economic performance – not just those tied to the oil and gas industry – have been relatively weak and the economy has arguably yet to fully bounce back from the financial crisis in any meaningful way. Average annual economic growth in Scotland was 2.2% in the years leading up to the financial crisis. Since then, average annual growth has been just 0.7%.

Over the last 12 months, the Scottish economy grew by 0.4% (on a 4Q-on-4Q basis). This is below the equivalent growth rate for the UK as a whole (which grew by 1.9%).

Table 1.4: Scottish growth (%) by sector Q1 2016 to Q1 2017 (annual 4Q-on-4Q growth)

	GDP	Agriculture	Production	Construction	Services	*GDP per head*
Scotland	+0.4	+0.3	-4.1	-4.7	+2.0	*+0.2*
UK	*+1.9*	*-3.0*	*+1.8*	*+2.6*	*+2.8*	*+1.2*

Source: Scottish Government, Q1 2017 GDP

It is also below the forecast made by the Scottish Government for growth of 1.0% in 2016-17 published alongside December's Draft Budget[7]. It is also sufficiently weak to trigger the £600 million emergency revenue borrowing powers in the fiscal framework to cope with asymmetric shocks. This is defined as when Scottish growth is less than 1% and more than 1 percentage point lower than the UK as a whole.

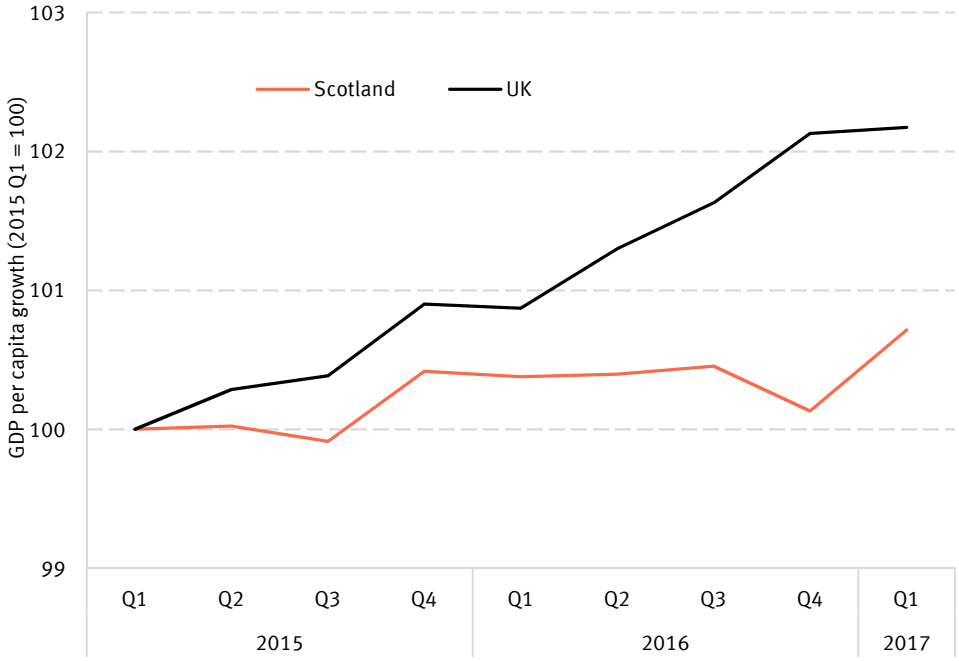
When measured in terms of output per head – arguably the more relevant indicator given the focus of the new framework on tax receipts per capita – a similar story emerges.

[6] See www.strath.ac.uk/business/economics/fraserofallanderinstitute/economic_commentary/

[7] See https://beta.gov.scot/publications/scottish-budget-draft-budget-2017-18-devolved-taxes-methodology-report/pages/4/

Scotland grew strongly in 2014 but since then the UK has grown more quickly (Chart 1.1) – with growth in GDP per capita in Scotland of just 0.2% compared to the UK's 1.2% over the past year.

Chart 1.1: Scottish & UK GDP per head: Q1 2015 to Q1 2017



Source: Scottish Government, Q1 2017 GDP

Of course, as last year was the first year of the devolution of the income tax power, what matters most is the outlook in the months ahead[8].

The Scottish economy recorded strong growth during the first three months of 2017. Whilst welcome, as discussed in our latest Economic Commentary, some caution needs to be exercised when interpreting these figures.

- Firstly, the growth of +0.7% in Q1 2017 comes on the back of a fall in output of 0.2% in the final three months of 2016 with the latest figures now showing that the Scottish economy actually contracted during 2016 as a whole – falling by 0.1%.

- Secondly, much of the growth during Q1 2017 was driven by a 'bounce-back' in sectors which have been going through a challenging period in recent years. Even with the strong growth in Q1, these sectors are still well below where they were just two years ago. At the same time, domestic demand was flat this quarter, with all the net growth coming from rUK and international exports.

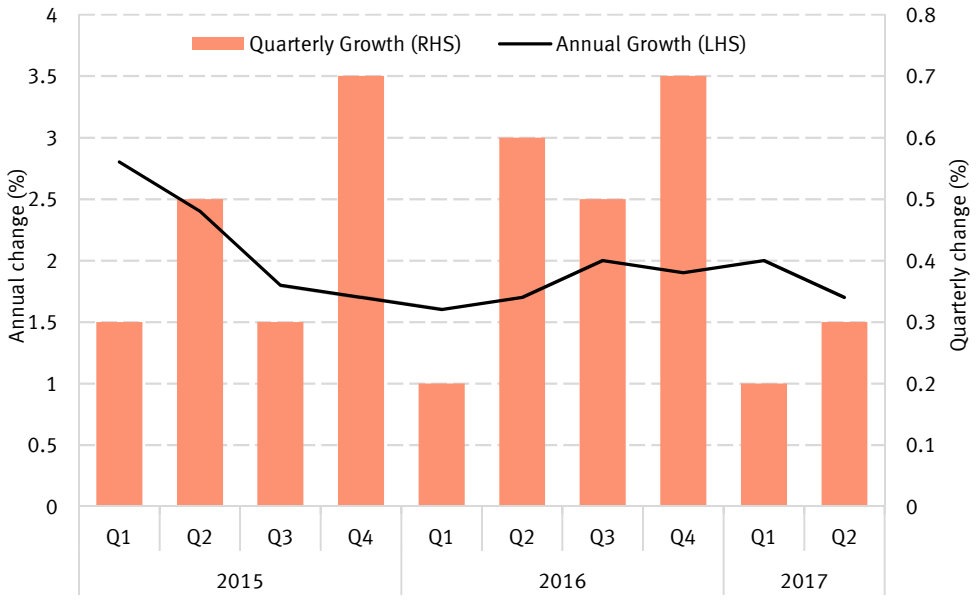
[8] A quirk in the devolution process itself is that, as 2016-17 is taken as the baseline for introducing income tax revenues, the weaker the Scottish performance in that year the less is taken out from the block grant to ensure no-detriment. If this is temporary, then it would lead to a small 'windfall' relative to a year when revenues are stronger.

So the potential gains in terms of tax revenues might be relatively limited. Indeed, as highlighted in Table 1.3 income tax receipts per head grew 0.9% in Scotland between 2015-16 and 2016-17 compared to 1.5% in the rest of the UK.

All things considered, it is our expectation that the Scottish Fiscal Commission will view the recent GDP data with some caution. Much will depend upon the figures for Q2 to be published in October 2017.

The UK economy initially appeared to hold up much better than expected in the immediate aftermath of the EU referendum. In fact, growth picked up through the second half of the year. But conditions have weakened.

Chart 1.2: UK Quarterly GDP growth since 2015: slowdown during first six months of 2017



Source: ONS, Q2 2017 2nd estimate of GDP

As expected, household consumption – which had been the principal driver of growth in recent times – has slowed to just 0.1% in the three months up to June. But discretionary spending in particular is being scaled back as inflation continues to bite[9].

Business investment remains subdued with little growth over the last two years. Some indicators from the Bank of England suggest that investment intentions may have *"strengthened a little further"* in recent months, but they also find that heightened uncertainty is playing a part in some firms' unwillingness to invest[10].

The UK's net trade position is broadly similar to that back in 2015 (at a deficit of around £8 to £9 billion) even despite the sharp depreciation in Sterling.

[9] CPI inflation is currently 2.9% as at August 2017.

[10] See www.bankofengland.co.uk/publications/Documents/agentssummary/2017/q2.pdf

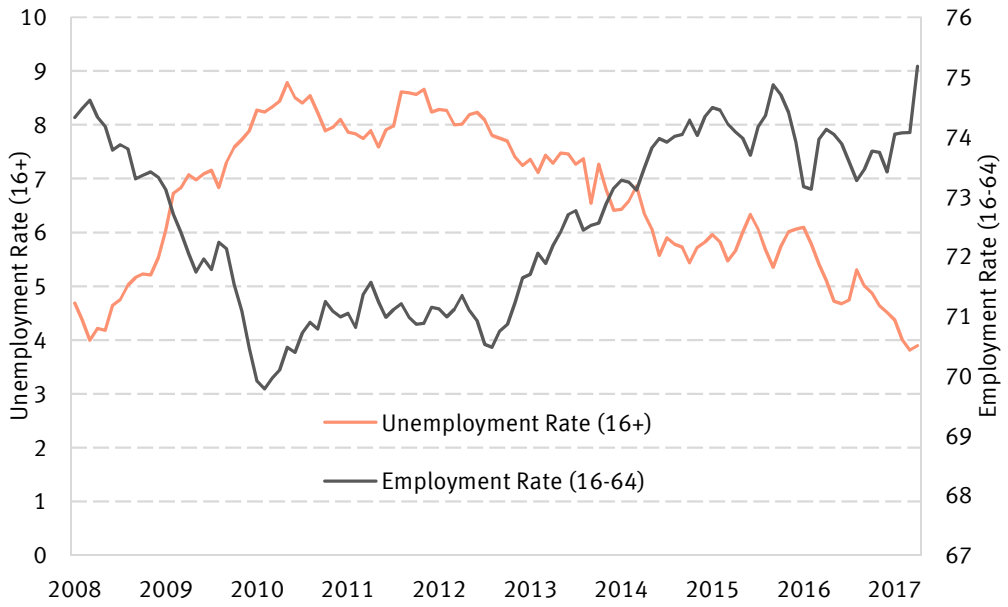
Labour market

In contrast to the wider economy, Scotland's labour market continues – at least in terms of the headline figures – to hold up remarkably well.

This is important given the focus of the new fiscal framework on income tax and VAT where employment and earnings will be key determinants of future revenue growth.

The employment rate in Scotland now stands at 75.8% (up 1.8 percentage points) – and a rise of 44,000 in 16+ employment – on a year ago. Meanwhile the unemployment rate has fallen to 3.8% down 0.9 percentage point since last year – and a fall of 24,000 in 16+ unemployment.

Chart 1.3: Scottish employment rate and unemployment rate – 2008 to 2017



Source: ONS, Labour Force Survey, September 2017

Table 1.5: Scottish and UK labour market outcomes: May-July 2017

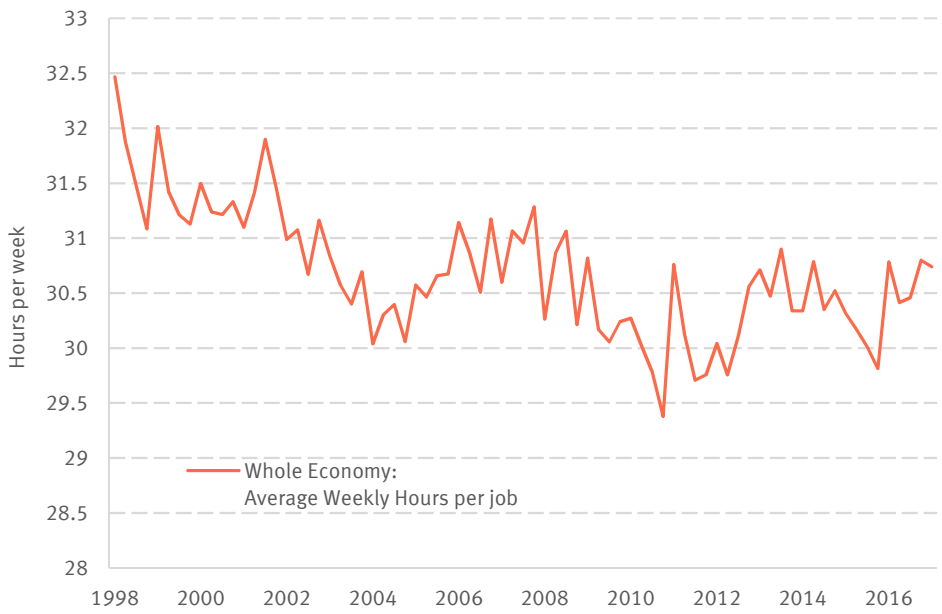
	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.8%	3.8%	21.2%
Annual Change	+1.8	-0.9	-1.0
UK	*75.3%*	*4.3%*	*21.2%*
Annual Change	*+0.8*	*-0.5*	*-0.3*

Source: ONS, Labour Force Survey, September 2017

Compared to the UK, Scotland now has a marginally higher employment rate and a lower unemployment rate.

Of course, some care has to be taken when interpreting these headline labour market indicators and attempting to look for any divergences between Scotland and the UK in terms of relative performance given the degree of uncertainty that surrounds these estimates. That being said, the general trend in overall levels of employment is clearly positive for Scotland[11].

Chart 1.4: Average weekly hours per job since 1998: more people in work but working fewer hours



Source: Scottish Government, Productivity Statistics Q1 2017

However as we have discussed in our Scottish Labour Market Trends reports, the headline figures hide some challenges.

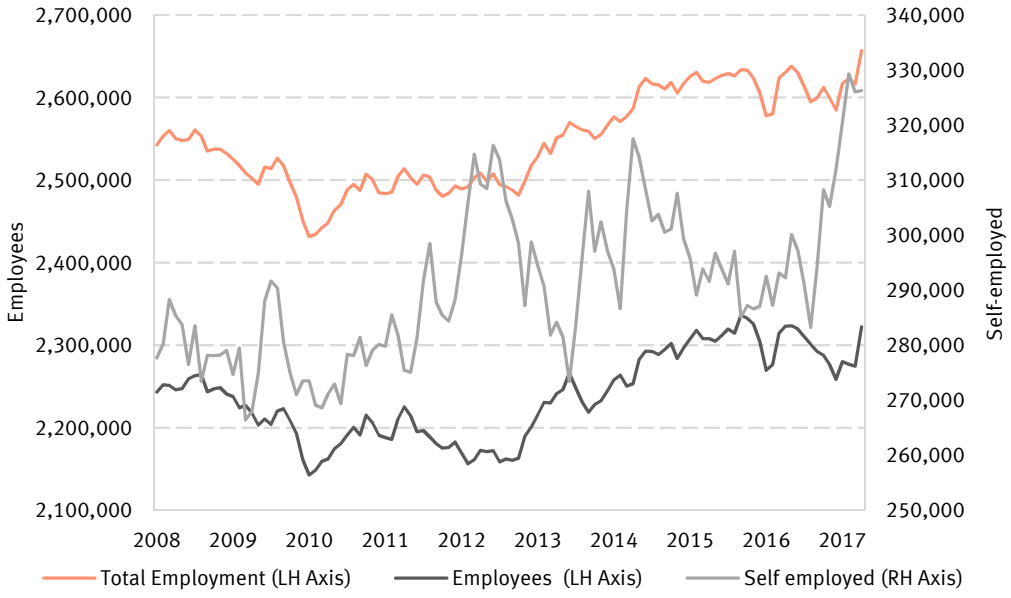
Firstly, there is an ongoing concern about the nature and type of work being created. For example since the financial crisis, there has been a rise in part-time employment (up around 10% over the past 10 years). This is one reason why that, although employment levels have increased, the average hours worked per job continues to remain relatively weak. (See Chart 1.4)

Secondly, while employment has grown over the past year, this has almost all been driven by increases in self-employment.

We wait to see what the long-term economic consequences of both effects are on tax revenues (and the position of Scotland vis-à-vis the UK)[12].

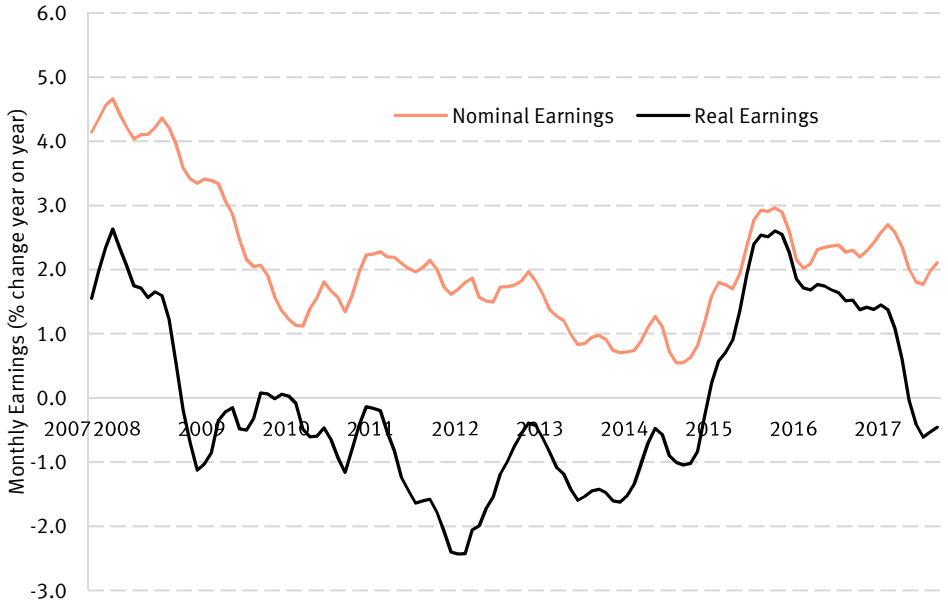
[11] For example, the sampling variability – at a 95% confidence level – for employment in Scotland is ±53,000. At the same time, the confidence interval for Scotland's unemployment rate is ±0.8 percentage points.
[12] On the one hand, by paying less in National Insurance contributions, a self-employed person who earns more than the personal allowance will pay more in income tax than a traditional employee. But against that, those in self-employment have arguably greater scope to alter their tax affairs such as taking more in un-earned income (e.g. dividends) from their 'company' than do employees.

Chart 1.5: Sharp rise in self-employment in Scotland over last year continuing a decade-long trend



Source: ONS, Labour Force Statistics, September 2017

Chart 1.6: Falling UK regular average weekly earnings growth: 3-month on a year ago



Source: Thomson Reuters Datastream, ONS

Thirdly, real earnings remain under real pressure. Chart 1.6 highlights the sharp fall once again in UK real earnings growth.

Unfortunately, the most recent robust data on earnings in Scotland – from the Annual Survey of Hourly Earnings (ASHE) – only covers to the end of March 2016.

Over that year, wage growth was slower in Scotland than in the UK. One explanation is the downturn in the offshore economy. Median wages declined by 5% in Aberdeen and 4% in Aberdeenshire between 2015 and 2016.

Table 1.6: Median Gross Weekly Earnings, Scotland to March 2016

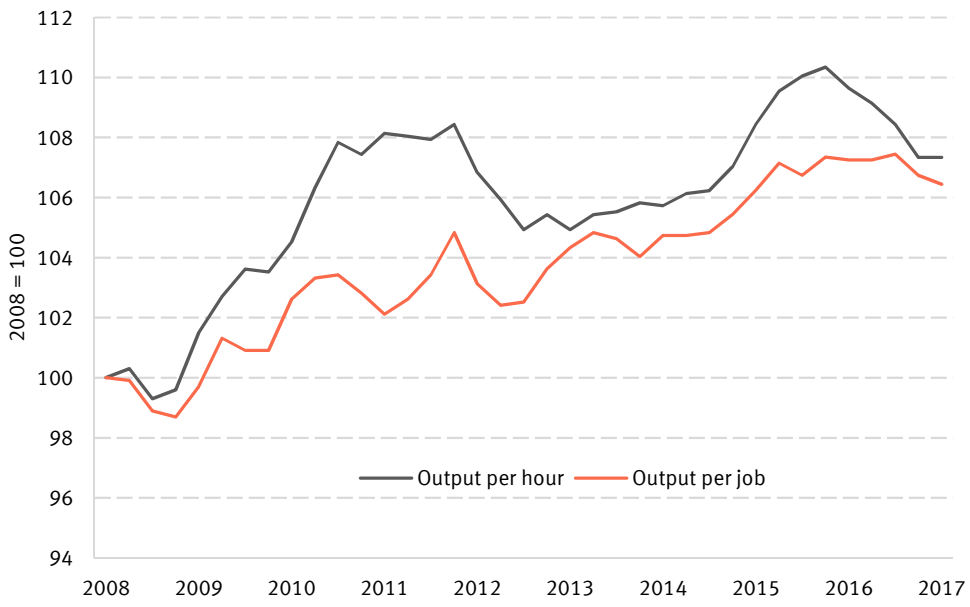
	Median Earnings	% change	FT Median Earnings	% change	CPI
2014	£414.70	1.5%	£519.60	2.1%	1.8
2015	£422.60	1.9%	£527.00	1.4%	-0.1
2016	£432.00	2.2%	£535.00	1.5%	0.3

Source: ASHE

Data from other sources also paint a mixed picture. Data from the Labour Force Survey shows Scottish earnings growth slightly behind the UK in recent months, but this series is especially volatile and only provides a partial assessment of earnings from certain groups in the labour force. The measure of compensation of employees used in the National Accounts shows growth of 3.4% for Scotland over the past year, compared to growth of 4.3% in the UK – with the gap wider over two years[13].

The next set of ASHE data will be published in October.

Chart 1.7: Productivity performance in Scotland since 2008



Source: Scottish Government productivity statistics, Q1 2017[14]

[13] Of course, this refers to total compensation of employees and not per head (which is an important caveat given that the terms of reference are per capita growth).

[14] www.gov.scot/Topics/Statistics/Browse/Economy/PROD16Q4

Productivity

The strong performance in the labour market belies weak productivity growth. In the UK, productivity growth averaged 2% per year until the mid-2000s, but has slowed significantly since.

Scotland has seen a similar slow trend – Chart 1.7 – although Scotland has fared better than the UK as a whole with the Scottish and UK gap narrowing in recent years.

As we discuss below, the view of the Scottish Fiscal Commission on the outlook for productivity growth in Scotland compared to the UK as a whole will have a significant bearing on their forecasts for Scottish tax revenues.

1.4 The economic outlook

The economic outlook for both Scotland and the UK is highly uncertain.

Most forecasters predict that the UK economy will grow by 1.5% to 2.0% this year, before falling back slightly in 2018.

Table 1.7: Latest growth forecasts for the UK economy

	2017	2018	2019
Bank of England	1.7	1.6	1.8
OBR	2.0	1.6	1.7
NIESR	1.7	1.9	2.0
European Commission	1.8	1.3	n/a
IMF	1.7	1.5	1.6
ITEM Club	1.5	1.3	n/a

Source: HM Treasury

The UK outlook will have three key implications for the Scottish Budget.

- Firstly, we await details of how the UK Government will respond to the short-term economic challenges from Brexit. Any changes – e.g. to support a greater than planned pay increase for public sector workers – could have some Barnett consequentials.

- Secondly, with around £11bn worth of exports destined for the rest of the UK every three months, the UK economy's performance will have an important bearing on the outlook for Scottish growth.

- Thirdly, as highlighted above, what is also now important at the margin is how Scottish tax revenues perform *relative* to equivalent taxes in the rest of the UK.

Box 1.3: The UK fiscal position

Delivering his Budget in March 2016, then Chancellor George Osborne set out plans to deliver a fiscal surplus – revenues higher than spending – by 2019/20. With the public finances in surplus, this would pave the way for reductions in the size of the UK government's debt (currently around 90% of GDP).

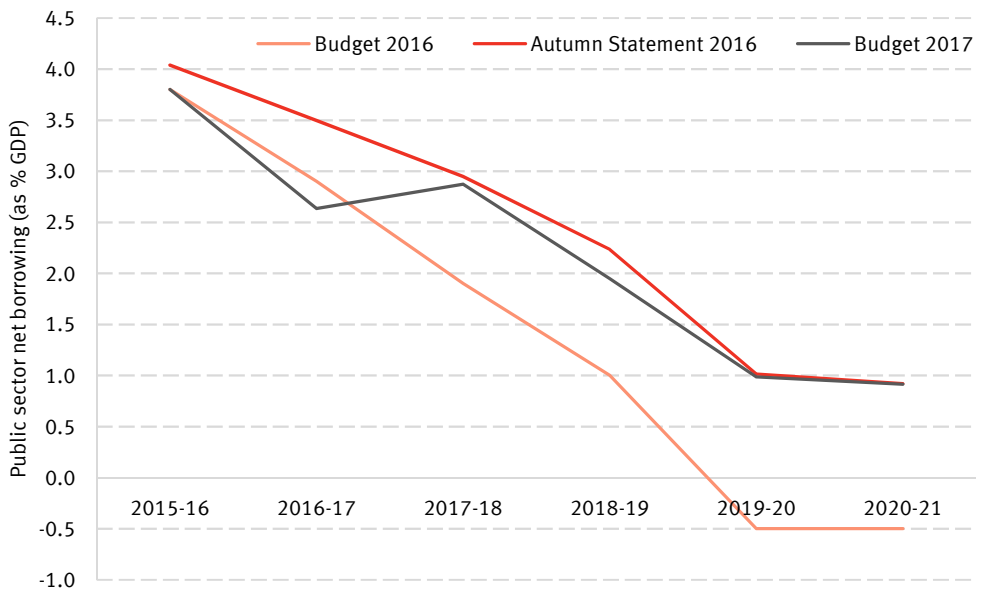
But by the time of the Autumn Statement in November 2016, the forecast for public sector net borrowing over the period to 2020/21 parliament had been revised up by £100bn, largely (but not entirely) due to the anticipated impacts of Brexit on the economy and public finances. Any hope of a budget surplus by 2019/20 had long been extinguished.

New Chancellor Phillip Hammond 'reset' fiscal policy by adopting a new target. Rather than targeting a surplus by 2019/20, Hammond announced he would aim to reduce cyclically adjusted Public Sector Net Borrowing (PSNB) to no more than 2% of GDP by 2020/21, while aiming for surplus at some point beyond that.

In response to the worsened economic and fiscal outlook, Mr. Hammond effectively pushed back the target for achieving surplus, letting borrowing (rather than spending) take the immediate strain, but with fiscal consolidation extended significantly beyond 2020.

The debate continues however as to how quickly the Chancellor should aim to reduce the debt to GDP ratio, and the extent to which he should allow himself to borrow more now in order to improve longer-term economic prospects.

Chart 1.8: Revisions to forecast for Public Sector Net Borrowing – 2015/16 to 2020/21



Source: Office for Budget Responsibility

But in relation to the Chancellor's own target, PSNB is forecast to be around 1% of GDP by 2019/20. In theory this does provide him some scope to loosen fiscal policy (through some combination of increased spending or reduced taxation).

On the other hand, these forecasts are predicated on an improvement in productivity growth to 1.6% in 2017 and beyond – some way above the trends of the recent past. If the economy does not perform so well, any existing fiscal headroom will disappear.

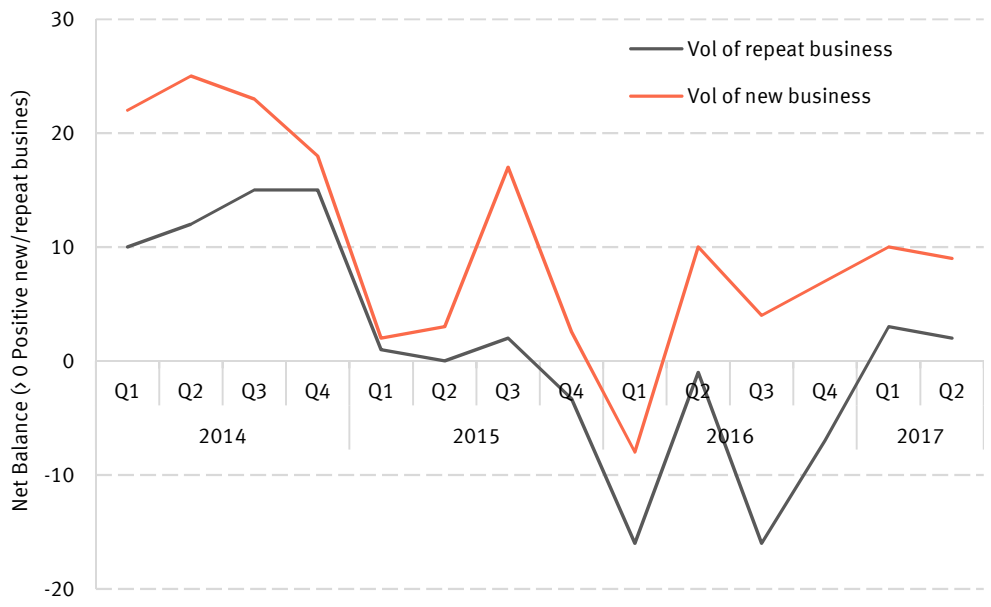
The exact implications of this for UK public spending are uncertain. On the one hand, the less stringent fiscal rules mean that the Chancellor has greater flexibility to increase public spending and still remain within the fiscal target boundaries.

But on the other hand, if the government's intention is still to reduce levels of public indebtedness over the medium term, then this greatly increases the likelihood of real-terms cuts being continued well into the next decade

All of this takes us to the outlook for Scotland. As highlighted above, the latest figures for Scotland showed strong growth in the first three months of 2017 on the back of much weaker growth over the last two years.

More up to date indicators suggest that the economy continues to recover, albeit at a relatively fragile pace. For example, the FAI-RBS Business Monitor for Q2 2017 shows that the total volume of business activity in Scotland increased with both the volume of repeat and new business positive for the 2nd quarter in a row. That being said, the rate of growth remains relatively weak.

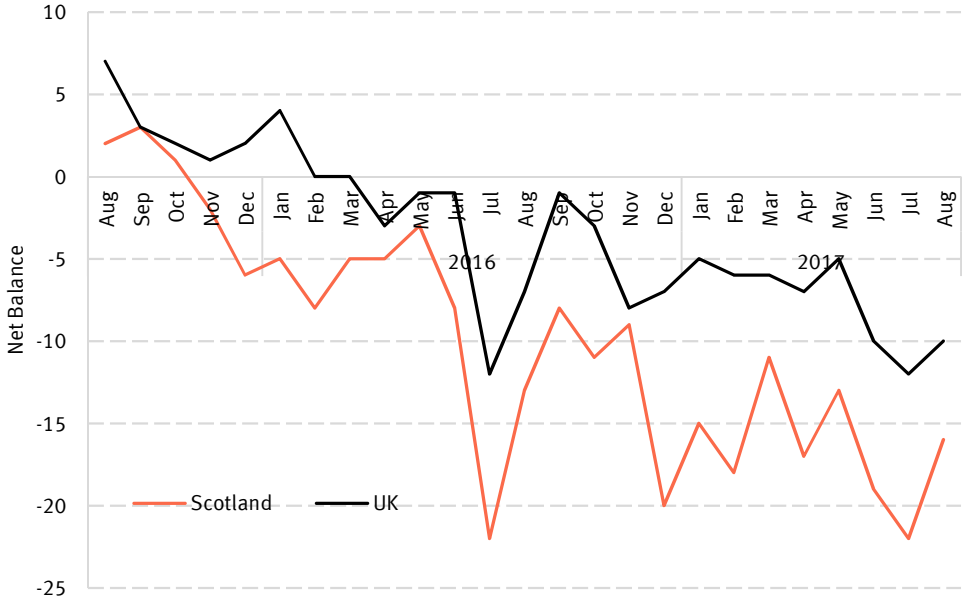
Chart 1.9: FAI-RBS Business Monitor for Q2 2017



Source: Fraser of Allander Institute-Royal Bank of Scotland

The latest Lloyds Banking Group PMI for Scotland is also relatively encouraging and is close to a three year high – albeit that Scotland is still tracking behind the UK average.

Chart 1.10: Consumer confidence remains negative in Scotland and gap with UK remains



Source: GfK

In contrast to the slightly more positive sentiment within the business community, levels of consumer confidence have remained weak. The GfK indicator shows much weaker confidence in Scotland than the UK as a whole[15].

To provide an up to date assessment of economic activity in Scotland, the FAI produces monthly 'nowcasts' of Scottish growth – www.fraserofallander.org. The advantage of a 'nowcast' is that it provides an indication of economic performance far in advance of official data. Our latest nowcast figures, including data up to the start of September 2017, predict growth of between 0.3% to 0.4% in Q2 and Q3 of 2017.

Table 1.9: FAI forecast Scottish economic growth (%) by sector: 2017-2019

	2017	2018	2019
GVA	**1.2**	**1.4**	**1.7**
Production	1.3	1.6	1.9
Construction	0.7	0.9	1.1
Services	1.2	1.4	1.7

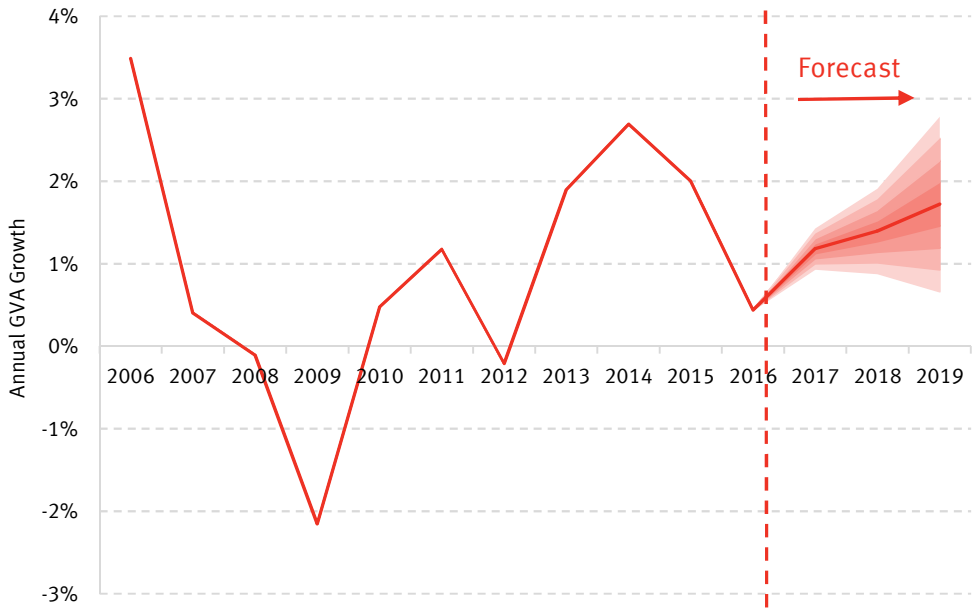
Source: Fraser of Allander Institute, September 2017

[15] The Scottish Government's own measure of consumer confidence has been negative during the first quarter of 2017 https://beta.gov.scot/publications/state-of-the-economy-june-2017/

The Institute's latest forecast for Scotland is for growth of around 1.2% in 2017 – fragile growth but clearly better than the outturn for 2016 – picking up to 1.4% in 2018 and then 1.7% in 2019.

These forecasts suggest that whilst growth will be faster than last year, it is likely to remain below trend. Quarterly growth is also likely to remain volatile. We continue to recommend that the focus of attention is centred upon the medium to long-term trend as opposed to sharp movements in one quarter or another.

Chart 1.11: FAI forecasts for Scottish economic growth: 2017-2019*



** Actual data up to Q1 2017, central forecast with forecast error for 2017 – 2019*

Source: Fraser of Allander Institute, September 2017

Whilst the position has undoubtedly improved – in relative terms – in recent months, whether or not Scotland matches the UK in terms of economic performance is very much in the balance. We think that Scotland will do well to match the UK. A number of factors will determine whether this is the case or not –

1. Much will depend upon the outlook for the North Sea and the recent pick-up in confidence. The outlook is more positive than 12 months ago but remains fragile.

2. The Brexit process will add its own unique dynamics to the pattern of Scottish and UK growth over the coming months. We continue to hold the view that Brexit will act as a headwind over the next few months - whether Scotland will fare better or worse is however, uncertain.

3. There is no doubt that Scotland has been stuck in a relatively weak growth cycle for over two years now. Economies go through cycles, sometimes operating above potential and other times below potential. To the extent that at least some of the recent weak performance in

the Scottish economy is cyclical, we could see faster growth in Scotland over the short-term as the economy catches up with trend.

We therefore continue to recommend that just as much focus is given to the range of our forecasts as to the central estimate.

Box 1.4: Brexit uncertainty for the economy and budget

The implications of the decision to leave the EU are still largely unknown, creating uncertainties for the Scottish economy and budget.

As we have recently said in our Economic Commentary, regardless of your views on the decision to leave the EU, the immediate outlook for the economy will depend critically on how the negotiations go between London and Brussels. This includes:

- The terms of exit.
- The transition to any new arrangement.
- The long-term economic, political and social relationship between the UK and the EU.

The lack of progress on all three is a concern.

On the budget side, again there is uncertainty around if and how existing EU funding programmes are continued post-Brexit.

Prior to the Brexit vote Scotland expected to receive €5.6 billion over the seven year programme period (2014-20), the largest portion of this being payments to farmers through the CAP Pillar 1 programme (€4,096m). €941 million was also allocated towards support for economic development in Scotland through the structural funds, whilst €478m was allocated towards CAP Pillar 2 (rural development) and €108m to the EMFF (fisheries) fund.[16]

EU funding is proportionately more significant to Scotland than the rest of the UK. Scotland was set to receive 14% of the UK's funding between 2014 and 2020, compared to its population share of 8.2%.

The UK Government has made guarantees that enable the continuation of funding in Scotland whilst the UK remains a member of the EU, and in the case of CAP Pillar 1 funding, guarantees that run until the end of 2020[17].

How the UK Government might chose to allocate previous EU funding to the devolved parliaments post-Brexit is unclear.

[16] www.parliament.scot/ResearchBriefingsAndFactsheets/S5/SB_16-89_European_Union_Funding_in_Scotland_2014-2020.pdf

[17] www.gov.uk/government/uploads/system/uploads/attachment_data/file/545767/CST_letter_to_SoS_for_DExEU_August_2016.PDF

One option, given the precedent set by the devolution of social security powers to the Scottish Parliament following the Smith Commission, is that EU funding received by each devolved administration will be incorporated into the block grant, and then adjusted in subsequent years according to the change in comparable English spending.

1.5 The forecasting choices facing the Scottish Fiscal Commission

So the outlook for the Scottish and UK economies remains fragile and there is a high degree of uncertainty about the outlook.

As we set out in Section 1.2, under the new Fiscal Framework, what ultimately matters over time will be how devolved Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.

But in looking ahead to this year's Scottish Budget we will clearly not have actual data on tax revenues to base decisions upon.

So what the SFC forecast for devolved taxes – and how they compare to the forecasts made by the OBR for the equivalent UK taxes – will be what determines the relative size of the Scottish Budget at the margin. And as we saw in last year's Budget negotiations, the margins are often the most important part.

In making these forecasts, the SFC face a number of important judgement calls.

The size of the output gap in Scotland

One of the most important decisions the SFC will need to take a view on, is the underlying economic potential of the Scottish economy.

In the short-run, growth is largely determined by the level of demand in the economy, such as the growth in exports or government consumption.

But in order to assess how the Scottish economy – and by implication devolved taxes – may evolve over the forecast horizon, a much more subjective view of Scotland's potential level of output is required. Ultimately, it is the outlook for the determinants of potential output – the growth in Scotland's population, labour market participation and hours worked, and the rate of productivity growth – that are most important.

Ultimately these are significant judgement calls. We highlight three key issues.

Firstly, one area for consideration will be the outlook for Scotland's population. In 2016, the government's forecasts were based upon a projection following the ONS's principal population projection for Scotland. Should the SFC take a different view – perhaps in the light of recent trends

in EU migration – then the forecasts for Scottish tax revenues may look quite different (and potentially be materially weaker than for the rest of the UK) than they did before.

Secondly, Scotland's participation rate is at a record high. How might this evolve over the next few months and years? What potential is there for further growth?

Thirdly, perhaps the most important area will be their view of productivity growth (i.e. potential output per hour worked). The OBR has been persistently overly optimistic when forecasting UK productivity growth. The SFC is not bound by such assumptions. Should the SFC take a different view, then the outlook for Scottish revenues could be smaller than the equivalent BGAs from the OBR simply because of a different take on the outlook for productivity.

Modelling tax forecasts

The SFC will be considering carefully how their new models and methods will stack-up vis-à-vis other forecasters.

A somewhat peculiar feature of the fiscal framework is that the SFC will produce devolved tax forecasts, whilst the OBR will produce equivalent forecasts for rUK taxes (and thereby the BGAs).

That means that the two numbers could diverge because the two institutions base their forecasts on different modelling, policy and economic assumptions, rather than reflecting an expectation that economic performance will diverge between Scotland and rUK.

Forecasting future tax revenues is, by its very nature, subject to margins of error. Assumptions that are built into forecasts often prove to be too optimistic or pessimistic as economic events unfold.

None of this will be straightforward. The SFC will be doing this for the first time and with data that lags the UK as a whole, has fewer observations and is more susceptible to revision.

Note also that the Scottish budget bears the risk of forecast errors made by the OBR for rUK income tax[18]. So in pinning down its final budget numbers – and those all-important margins – the Scottish Government will have something of a moving target.

Determinants of individual tax revenues

Finally, whilst the overall pattern of growth in an economy is strongly correlated with tax revenue growth in the long-run, from one year to the next it can fluctuate.

For example, it is possible for GDP growth to be relatively tax rich or tax poor. Public sector wages for example, may not be strongly correlated with GDP in the short run. Property prices and transactions are strongly pro-cyclical, meaning that they often grow more strongly than GDP during

[18] 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, the BGA will be smaller than it otherwise should have been so a future Scottish budget will be cut to reconcile actual rUK receipts with forecast.

upswings, but fall more quickly than GDP during downswings. And GDP growth in any year may be accounted for in part by higher profits repatriated overseas, which have no bearing on Scottish income tax revenues.

Therefore, the Fiscal Commission will – alongside taking a view about the overall health of the Scottish economy – be monitoring key individual determinants of each devolved tax.

For NSND income tax for example, what matters is not so much real growth in the economy but nominal growth. Their focus will be centred upon the outlook for employment, earnings growth and the relative distribution of wage growth by decile. As we will discuss in the next chapter, they will also have to consider potential behavioural responses if tax policies were to change in Scotland vis-à-vis the rest of the UK.

Property prices in Scotland will clearly be a key factor for Land and Buildings Transaction tax, with factors such as the number of transactions and tax band of sales important.

1.6 Conclusions

The new fiscal framework for Scotland will mean that developments in the Scottish economy will now have a much greater impact on budgets than ever before.

The potential paths for the economies of both Scotland and the UK – and the implications for fiscal policy – are highly uncertain.

Growth in the UK economy has weakened in recent months. On balance, the immediate outlook for the Scottish economy appears to be just as – if not more – challenging.

Of course, we will not know how Scotland has fared until tax revenues are collected and this will not happen – in the case of income tax – for a good few months after the financial year in question. Therefore in assessing the outlook for the Scottish Budget for next year and the remainder of the Parliament, what will be crucial will be the forecasts that the Scottish Fiscal Commission and the Office for Budget Responsibility make for Scottish devolved taxes and rUK taxes respectively.

On balance, given recent data we believe that the Scottish Fiscal Commission are likely to be relatively cautious in their forecasts for Scottish growth and tax revenues.

Chapter 2: Tax devolution: a view from ICAS

- 'Scottish taxes' encompass different types of devolved powers and responsibilities. In terms of accountability, there is still a lack of awareness of the Scottish tax powers and scope for confusion.
- Scottish income tax cannot be considered in isolation because the powers are only partly devolved. The tax is intricately interwoven with UK taxes, and the Scottish Parliament has only a limited number of pieces of the jigsaw.
- Behavioural responses by taxpayers may limit some options; however, behavioural repercussions may not limit the Scottish Government's choices if the policies are considered attractive by the electorate. It will also be necessary for the electorate to trust that policy objectives will be achieved – that a better economy, desired redistribution, or better public services will result from additional taxation.
- At the same time, care needs to be taken in setting a tax competitive policy such as low Scottish rates or reliefs as it may simply lead to further intra-UK competition, 'a race to the bottom', and ultimately falling revenues for everyone.
- A key element of tax policy should be, where possible, to enhance and support the economy: at the very least, administrative measures should not add to the complexity of doing business in Scotland and not put Scottish business at a competitive disadvantage.
- Trends so far with devolved taxes have been to align with UK taxes, evident in both directions with, for example, the new Land and Buildings Transaction Tax (LBTT) progressive structure being adopted by the UK Stamp Duty Land Tax (SDLT); then the UK 3% surcharge being introduced into LBTT. In the longer term, tax policies which are more distinctive from those in the rest of the UK may be needed to meet spending commitments.
- The Budget Process Review Group has examined the budget processes but the tax processes need further consideration and should be given an equal weighting to the spend side of the budget.
- A five-year roadmap to set out the objectives of Scottish tax policy would be helpful: this should set out policy objectives and provide clarity of purpose. Transparency of data and the link between Scottish tax receipts and the operation of the Fiscal Framework will be crucial to retaining public confidence.

The most important source of Scottish tax revenues in 2018/19 is the Scottish income tax. However, due to the nature of the partly devolved powers and the interaction with other UK taxes, there are constraints. At the same time, LBTT and ADT, which collect relatively little revenue, are prominent in Scottish tax messaging because they are fully within the control of the Scottish Parliament. The First Minister and her Government seek to start '…a debate about how to best use our tax powers - responsibly - to protect public services and strengthen the social contract …[19]'

2.1 Introduction

Scottish taxes have been introduced on a phased basis over the last few years with the objective being to demonstrate accountability for the Scottish Parliament and the devolution settlement. So, what will the Cabinet Secretary for Finance and the Constitution have at his disposal when setting his next budget?

Before the Scotland Act 2012 and the Scotland Act 2016 took effect, 'Scottish' taxes were limited to council tax and business rates, and a power in the 1998 Scotland Act that was never exercised to increase or decrease income tax by a Scottish Variable Rate. Since then, structural changes have taken place and continue to do so. Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) were introduced in 2015/16. These were followed by implementation of the Scottish Rate of Income Tax (SRIT) in 2016/17 and the more visible implementation in 2017/18 of Scottish Income Tax (SIT).

And that is not all. From April 2018, Air Passenger Duty in Scotland will be replaced by the new devolved tax – Air Departure Tax (ADT); the legislation is in place but the rates still need to be set. From 2019, a proportion of the estimated VAT raised in Scotland is to be assigned to the Scottish budget.

By 2020, an estimated £22 billion of annual tax revenue will be raised in Scotland, representing around 50% of the devolved budget. Whilst this appears as though there is significant control of Scottish revenue raising, the practical realities may be limited – and more so than anticipated at first sight.

There are the political considerations over the tensions between needing to raise funds, and to be mindful of taxpayers' wishes not to pay more than necessary or more than their neighbours, whether the neighbours live next door or further afield in the rest of the UK.

[19] A Nation With Ambition, The Government's Program for Scotland 2017-2018

There are questions such as whether lower tax rates for ADT are attractive, and will they actually boost the economy by the scale that is hoped for? Does the same rationale also apply to LBTT? Do lower rates introduce tax competition and, if so, is this a good thing? A question that may appear more bureaucratic, but is equally important, is the impact and costs on the 'unpaid' collectors of taxes; usually businesses. And a further consideration is the potential for behavioural response if taxpayers react to the policies or rates.

Devolution has introduced new opportunities, but also new complexities, with associated practical and administrative issues that should be evaluated and addressed when setting the 2018/19 Budget. What businesses will press for is a clear articulation of the Scottish Government's approach to tax and a plan which sets a clear path over, say, a five year term.

This chapter focuses on the taxes devolved in the Scotland Acts of 2012 and 2016, which are a number of transactional taxes and the income tax rates and bands.

Box 2.1 The Scottish Budget 2018/19 – which taxes are relevant?

Land and Buildings Transaction Tax – maintain or change the rates? (2016/17 £466 million)

Scottish Landfill Tax – maintain or change the rates? (2016/17 £149 million)

From 1 April 2018 - Air Departure Tax – set the rates (2016/17 UK equivalent APD £264 million)

Scottish Income Tax on non-savings, non-dividend income – rates and bands need to be set for 2018/19 (2016/17 £11,313 million)

Source: GERS www.gov.scot/Topics/Statistics/Browse/Economy/GERS

Section 2.2 outlines the current structure of Scottish taxes. Section 2.3 discusses the most important of these, the Scottish income tax. Section 2.4 looks at the other devolved taxes. Section 2.5 looks at policy changes whilst 2.6 discusses issues in relation to the assignation of VAT. Section 2.7 discusses the options for raising 'new' taxes whilst Section 2.8 concludes.

2.2 Scottish taxes: the overall picture

- *Fully devolved taxes:* are the outright responsibility of the Scottish Parliament and the administrative duties rest with Revenue Scotland. The nature of the taxes, the legislation, and the associated collection and management duties are fully devolved. These taxes have their locus tied to transactions in Scotland but they are relatively limited in revenue raising terms. Being the only taxes fully within the Scottish Parliament's power, they have a higher profile than the corresponding taxes in a UK context (SDLT and APD being two of the smallest sources of UK revenue). Both LBTT and ADT policy, and rates, attract more attention than they might

otherwise do, with this being treated as a broader commentary on Scottish taxes, tax policy, and the Scottish Government's approach to supporting the economy.

- *Partially devolved tax:* which includes Scottish income tax rates and bands from April 2017, involves joint responsibilities. Political responsibility is split between the UK and Scottish parliaments. The UK Parliament remains responsible for the tax base, i.e. what is considered to be income, and how it is measured. It is also responsible for the personal allowance and for reliefs, and the underlying legislation for these is in the UK taxes acts. The Scottish Parliament is responsible for setting the rates and the bands, in other words, the tax is partly devolved or in more colloquial terms Scotland has 'half the lego set'.

  Administrative responsibility remains with HMRC but the Scottish Government pays HMRC for the costs of collection. However, it needs to be remembered that much of the collection of income tax, through PAYE, is done by employers – and a key reason for the above structure of a partly devolved tax is to minimise collection costs.

  The Scottish income tax rates are applied to earned income, pensions and rental income, but not to savings income and dividend income (this was to ease administrative pressures where income tax was withheld at source, although this is no longer applicable). Scottish income tax is a significant part of overall revenues.

- *Assignment of 'Scottish' VAT receipts:* VAT at present remains the responsibility of the EU in terms of defining the tax base, and the UK Parliament in setting the tax rates, with administration and collection by HMRC. It was agreed by the Smith Commission, and enacted in the Scotland Act 2016, that a proportion of VAT attributed to Scottish transactions is to be assigned to Scotland, and this will apply from April 2019. However, the methodology for doing so has, at the time of writing still to be agreed[20]. The assignment of VAT does not require any direct decisions to be made in the Scottish Budget. There is arguably a lack of transparency as to what level of VAT receipts will be assigned to Scotland and the relative inability of the Scottish Government to have much influence over the level of assigned receipts.

2.3 Scottish income tax

The Scotland Act 2016 replaced the single Scottish Rate of Income Tax (SRIT) with the new Scottish Income Tax (SIT).

This allows the Scottish Parliament to set whatever rate or rates of income tax it may wish to levy on the non-savings, non-dividend income of Scottish taxpayers and, if more than one rate, the income bands at which these are to be charged.

[20] A decision has to be made on whether the assigned value will be based on an output model or a consumption model but it is not clear whether accurate data exists for an output model to function efficiently

SIT was implemented on 6 April 2017. Arguably, it has assumed a higher profile among the electorate because the government is explicitly forced to set a policy each year. This has been added to by the decision for income tax to differ north and south of the border. The UK higher rate threshold was increased to £45,000 in 2017/18, but the Scottish higher rate threshold was left unchanged at £43,000. Thus, Scots with earnings, property income, and pensions of £45,000 or more in 2017/18 are paying £400 a year more tax than their counterparts south of the border.

The 2017 Programme for Government notes that the government will publish a discussion paper on income tax and possible options for using the tax powers ahead of setting the budget for 2018/19. There are a number of practical and administrative matters to consider in the discussion.

Box 2.2 UK Legislation implementing Scottish income tax

Key legislation is found in:

- The Scotland Act 1998, as amended by the Scotland Acts 2012 and 2016 – defines who is 'Scottish' for income tax purposes
- The Income Taxes Act 2007 – state the rules for tax bands and separates out non-savings, non-dividend income

A health warning however: for those who wish to refer to the legislation, this is difficult. Measures around Scottish income tax are in both the Income Taxes Act 2007 and the Scotland Act 1998 (as amended by the Scotland Acts 2012 and 2016): it is not accessible, nor is it easy to read, and requires reference to different legislation for completeness. ICAS recommends that a 'tax law re-write' version should be produced so that there is clarity in these taxing provisions.

Setting the income tax rates and bands for the tax year 2018/19

2018/19 will be the second year of the 'Scottish income tax' being in place. With the Scottish higher rate band being different from the rest of the UK in 2017/18, potential tax issues emerge. First, there is greater complexity so the overall tax charge can be more difficult to understand. See the example in Box 2.3.

Second, wherever there are differentials there is scope for tax planning.

Whether it is worthwhile to the taxpayer concerned is more difficult to predict but, of course, the wider the differentials the more attractive tax planning may become. So, what are taxpayers' possible options to mitigate any increased charges in income tax and to what extent might they be used? And to what extent does the Cabinet Secretary need to be mindful of these possible strategies and to what extent might this restrict his options?

Box 2.3 Calculating a Scottish taxpayer's tax bill in 2017/18

For a Scottish taxpayer entitled to a personal allowance, higher rate SIT will be payable on non-savings, non-dividend income in excess of £43,000 (£11,500 of personal allowance; and £31,500 at basic rate of 20%).

SIT only applies to non-savings, non-dividend income so the UK rates and bands must still be used for the purposes of working out the level of the personal savings allowance ('PSA' of £1,000 for basic rate payers; £500 for higher rate payers), the rates of tax on savings and dividends, and the rates of capital gains tax.

This means that when dealing with a Scottish taxpayer's computation, parallel income tax computations may be required, applying the SIT bands first to non-savings, non-dividend income and then reassessing the available bands and rates when dealing with savings and dividend income.

Example

Janet is a Scottish taxpayer. She earns £43,400 in 2017/18 and receives taxable interest of £2,400

	Non-savings, non dividend income £	SIT payable £
Earnings	43,400	
Less personal allowance	(11,500)	
	31,900	
Taxes within SIT basic rate band at 20%	31,500	6,300
Taxed within SIT higher rate band at 40%	400	160
Total tax on Scottish earnings		6,460

By contrast, Janet's income tax liability on interest must be calculated by reference to UK rates and thresholds as follows:

	Savings, dividend income £	UK IT payable £
Taxable interest	2,400	
UK basic rate band	33,500	
BR band already set against earnings (above)	31,900	
Balance of UK BR band	1,600	
Covered by personal savings allowance	(500)	0
Taxed within the UK basic rate band at 20%	1,100	220
Taxed within the UK higher rate band at 40%	800	320
Total tax on interest		540

Janet's total income tax liability for 2017/18 is therefore £6,460 and £540 = £7,000.

Scottish taxpayers fall into the following categories of marginal rate of tax in 2017/18[21] :

- 36,000 'savers' rate
- 2,150,000 basic rate
- 365,000 higher rate
- 21,000 additional rate

One option is that a taxpayer may move to a new house outside Scotland. Ceasing to be classified as a Scottish taxpayer may be a more feasible alternative for those with greater wealth and higher incomes – and the avoidance behaviour by these individuals will have a disproportionate effect on the amount of Scottish income tax that is raised.

Scottish income and its interaction with UK income tax legislation

For those who are, and remain, Scottish taxpayers, and with a partly devolved tax, consideration needs to be given by the Cabinet Secretary to 'Scottish income' (broadly, earnings from employment, self-employment, pensions and rentals) and its interaction with other income (savings and dividends). The impact of any changes in the rates of income tax in Scotland also needs to be set in context against UK taxes and trends.

There are two areas of tax planning with UK taxes that may be pertinent.

One is that a business owner may choose to operate as a sole trader (unincorporated and liable to income tax) or via a company (incorporated and liable to corporation tax). This taxpayer choice can determine some of the tax outcomes so that the main taxes cannot be considered in isolation, nor in this debate can income tax be viewed separately from other policies or matters such as National Insurance Contributions. For example, aspects of the taxation of the self-employed and small companies can lead to tax planning and influence behaviors because of:

- the differential in tax rates, combined with the different timings of payment, between income tax for the unincorporated business and corporation tax for the incorporated business,

- the decision to extract profits from a company by way of salary, pension contributions, or dividends, and

- the different tax consequences arising from receipts of income and receipts of capital.

Any taxpayer who views a tax bill as an unwanted cost will seek to minimise this. So divergent rates across income tax, corporation tax and capital gains tax lend themselves to tax planning behaviours such as incorporation by an individual who wishes to be paid in dividends rather than a salary.

[21] The Survey of Personal Incomes
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/616438/Table_2.2.pdf

When some elements are devolved, this opens the way to greater complexity, wider differentials and therefore potential planning if tax costs are increased. For instance, if Scottish income tax becomes significantly more expensive (and it is not clear where this behavioural tipping-point might be), taxpayers may seek to convert sources liable to income tax into something else that is liable to, say, corporation tax or capital gains tax. Both corporation tax and capital gains tax are reserved taxes so any increase in receipts will flow to Westminster, with a corresponding decrease in Scottish income tax.

A second aspect of this area of tax planning that needs to be considered is the 'gig economy' and its drivers, which are the interaction of both employment law and 'employment taxes'. To date, in the UK debate this has covered both income tax and NIC. The key issue is the differential in income tax and NIC costs for employees compared with the self-employed or company owners (where remuneration may be by way of salaries or dividends (the dividends being NIC free)). It should be noted, however, that there are various UK measures designed to block this type of planning.

- New IR 35 regulations are directed at those working on a consultancy basis for the public sector and they negate the attraction of using a one-man company to reduce tax costs. A significant proportion of higher rate tax payers in Scotland work in the public sector.
- For owner-managed businesses, the owners need to consider the post-tax costs after extracting funds from the company - so there is a choice of the salary route which is expensive when NIC is considered, or dividends. Recent changes to the taxation of dividends make this route less attractive than in the past.
- If owners want to convert their income into gains they need to wind up the company, which has a commercial impact, and there is also tax anti-avoidance legislation to be navigated.

These are UK policy issues and outwith the control of the Scottish Government but there is an added dimension if Scottish income tax rates diverge from those in the UK.

It remains to be seen what, if any, impact divergent income tax rates might have. The change to the higher rate threshold for 2017/18 is likely to have had little behavioural impact but there will always be behavioural challenges to the tax base if there are significant differences in tax costs. This is driven by cost management – why pay more than you have to? The Finance & Constitution Committee recently commissioned evidence on this as part of their inquiry 'Scottish Approach to Taxation' and it will be helpful to have the Committee's thoughts on this topic.

National insurance

As well as a lack of clarity about what is 'Scottish tax', across the UK there is a further opaqueness in the presentation of 'tax' to the taxpaying population. For taxpayers, and particularly for those on PAYE, NIC seems to be largely invisible. This has not gone unnoticed by recent UK Governments – NIC has increased considerably over the last couple of decades whilst income tax has reduced.

For example, in the 2016 Autumn Statement, the income tax higher rate threshold increase from £43,000 to £45,000 for the rest of the UK was widely publicised: it offered a saving of up to £400 to each affected taxpayer. At the same time, the NIC threshold for Class 1 employee contributions was also increased to £45,000 but this has the opposite effect and negates over half the income tax saving. This was not publicised.

Some commentators noticed that changing the thresholds in 2017/18 for income tax in Scotland has wider cost implications which, in comparative terms, are held to be unfair. Not only is higher rate tax payable over £43,000 at 40%, but so is Class I NIC at 12% up to income of £45,000, ie an overall rate at 52%. The NIC and IT thresholds in Scotland are now out of alignment; tax is devolved but NIC is reserved.

Table 2.1 Scottish taxpayer employment income – marginal rates of income tax and national insurance

2017/18	Below NIC primary earnings threshold £8,164	Between NIC and Personal Allowance Threshold of £11,500	Between personal allowance and basic rate threshold £43,000	Between Scottish and UK higher rate thresholds £43, 000 and £44,999	Between HR threshold £45,000 and AR threshold £149,999	Over the additional rate threshold of £150,000
Income Tax	0%	0%	20%	40%	40%	45%
NICs	0%	12%	12%	12%	2%	2%
Total Marginal Tax Rate	0%	12%	32%	52%	42%	47%

Source: ICAS

It may be that with different jurisdictions having different responsibilities the presentational elements will change, as either government seeks to distance itself from the costs of a 'tax' it is not responsible for. A different Scottish presentation of what income tax is for, and what NIC is for, would introduce a greater element of hypothecation with NIC going towards state pensions and other reserved benefits, whilst Scottish income tax aligns with Scottish Government spending responsibilities. Clarity is required about income tax being devolved, whilst national insurance remains reserved and, therefore, different parliaments making the decisions in relation to each.

Are Scottish taxpayers aware of the amounts of SIT they pay?

For employees and pensioners, Scottish income tax is collected through PAYE, and they simply receive the net sum. PAYE is designed to collect tax in as efficient a way as possible so income tax is not as visible as other taxes where an amount has to be paid over based on annual income and tax self-assessment. PAYE 'plucks the goose with as little hissing as possible[22]'. It is not designed to be transparent and, therefore, is unlikely to be viewed as part of a Scottish tax system.

[22] Louis XIV's finance minister Jean-Baptiste Colbert declared famously that "the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing"

There is often a lack of understanding around PAYE codes and, with responsibility for income tax rates and thresholds in Scotland having diverged from those elsewhere in the UK from April 2017 onwards, it means that clear explanations and guidance, and headline reminders in the Scottish budget announcements, would be helpful to inform taxpayers about Scottish tax raising.

2.4 Scottish devolved taxes: LBTT, SLfT, ADT

Three fully devolved taxes will provide sources of funding for the Scottish Government in 2018/19. These are Land and Buildings Transaction Tax, Scottish Landfill Tax and Aid Departure Tax. The first two have been in place since April 2015 whereas the Air Departure Tax is due to come on stream from April 2018. Each has its locus in Scotland, is based on tax law enacted by the Scottish Parliament, and is collected and administered by Revenue Scotland.

In setting the rates of ADT, it would be helpful if a relatively long term view could be taken with a minimum number of changes to the thresholds and rates over time to provide certainty and stability. This will help taxpayers, both individuals and businesses, to plan ahead with confidence.

Importance of messaging as well as the sums raised

Because these taxes are levied on transactions – on land transactions, landfill deposits, or passenger flights – they can be easily avoided by not undertaking the transaction, or not undertaking it in Scotland. As a result, the amounts that can be raised from them will always be limited but due to these taxes being new and fully within Scottish control, they have a prominence that they might not have in a Westminster budget. As a result, they are important in messaging about the broader tax policy being put forward by the Scottish Government. There needs to be clear articulation of why particular policies and rates are being proposed.

How Scottish are these taxes?

Each devolved tax has been designed using the equivalent UK legislation as a starting point. In the case of LBTT this tax was refashioned on a 'progressive' basis rather than its equivalent SDLT 'slab' basis and this was warmly welcomed. So much so, UK SDLT has also been amended to become a 'progressive' charge.

In November 2015, when the UK Government proposed a 3% supplement to SDLT on second homes, the Scottish Government did likewise with the Additional Dwelling Supplement. This leads to a number of questions, including how much can, or should, each tax be different from its counterpart in the rest of the UK? It may be that taxes on both sides of the border gravitate to a common position but, if so, the reasons for this need to be clearly articulated. On the other hand, if they do differ, this may lead to tax competition or to claims of administrative complexity where LBTT and SDLT rules differ. Again, the reasons for this need clear articulation.

Box 2.4 Devolved tax legislation passed by the Scottish Parliament

There are four acts of the Scottish Parliament in relation to devolved taxes. These are:

- The Land and Buildings Transaction Tax Act 2013 (LBTT(S)A 2013)
- The Landfill Tax (Scotland) Act 2014 (LfT(S)A 2014), and
- The Revenue Scotland and Tax Powers Act 2014 (RSTPA 2014)
- Air Departure Tax (Scotland) Act 2017 (ADT(S)A 2017)

RSTPA 2014 and the specific tax Acts operate together.

There is also a significant number of statutory instruments supporting these acts.

Setting the rates of ADT

The setting of tax rates and policies can be driven by different factors – to raise funds, to encourage or discourage certain behaviours, or to grow the economy. Seeking to influence behavioural responses may limit some options; equally behavioural responses may not be limiting if the policies are considered attractive. This could be by offering an attractive tax rate, such as reduced Air Departure Tax, thereby potentially encouraging more travellers through Scottish airports.

In order to garner support for the ADT rates, the policy objectives need to be clearly articulated. More passengers may use Scottish airports if ADT is reduced relative to the UK's APD, and this may lead to more economic activity, but will this increase the Scottish tax take? Economic growth may lead to more employees (paying Scottish income tax) and /or more businesses (paying UK corporation tax to Westminster), while increasing Scottish VAT receipts (half of which will be assigned to Scotland).

Care is needed when offering a competitive tax regime, particularly if it is an aggressive competition policy, because it may give a broader message to neighbouring jurisdictions of England, Wales and Northern Ireland that may be unattractive. It may also simply lead to further competition, 'a race to the bottom', and ultimately to falling revenues for everyone.

The other feature of competitive tax policies is that where there are differentials - with different jurisdictions taxing different amounts, or charging tax at different rates, from another – this also lends itself to tax avoidance. It may be asked how this fits in with the general tone that was being set by the Scottish Parliament when the Revenue Scotland and Tax Powers Act 2014 was being enacted, with the inclusion of a Scottish General Anti- Avoidance Rule (SGAAR), and much discussion about the evils of tax avoidance.

Setting the rates of SLfT

When setting the Scottish landfill tax rates there is little scope to diverge from rates in the rest of the UK if consideration needs to be given to the possibility of 'waste tourism' which could result in

trucks simply crossing the border in whichever direction is favourable. It may also be difficult to align policy objectives of raising revenue and waste reduction.

Setting the rates of LBTT

Setting of the rates of LBTT has been questioned – are the higher rates too expensive? In considering this, the principle of 'ability to pay' is generally viewed as a proportionate rise in tax rates as income increases, but this can be less clear cut in transaction-based taxes such as LBTT. Further, the operation of this principle can be undermined by behavioural changes such as fewer purchases of property; the principle itself may undermine other objectives such as stimulating the economy. This needs to be recognised, and balanced, in the matrix of policy objectives when setting the rates.

2.5 Policy changes in current tax law

In the devolved taxes, notably with LBTT, there are some areas that would benefit from being revisited. There are differences in the law and its interpretation when compared with the corresponding UK tax, SDLT.

For example, there are questions concerning the LBTT rules for group relief in certain instances – where a transfer of property which gives rise to a taxable transaction takes place between two separate companies that are both in the same commercial group – and group relief from the LBTT charge is denied. This means that there is a tax bill in the commercial group, although there has been no change in overall ownership of a property – it is simply been moved amongst group companies. This may be intended by the Scottish Parliament but nevertheless it may also be helpful for policy makers to reconsider whether this is still the desired outcome.

Such examples may not affect many transactions but it can give rise to an impression of Scotland being a less attractive environment for businesses. Commentary so far has invariably led to comparing any tax measure in Scotland with that in the rest of the UK, and usually with a focus on the elements that are 'more expensive' and, by implication, less taxpayer friendly. Arguably, this may be seen as negative and particularly so if the broader objectives are to grow the economy relative to other economies. This specific LBTT issue should be addressed in the budget.

Beyond this immediate budget, a process is needed in which to address such matters. There is a need for 'care and maintenance' measures in the existing tax law so that if stakeholders such as Revenue Scotland find parts of the legislation do not work as intended, or the legislation does not work as taxpayers may wish from a commercial perspective, there is an opportunity to revisit the law. Thus far, the Scottish budget process has largely been expenditure focused and so possible amendments to tax law need to be raised on an ad hoc basis.

It may be noted that from a tax perspective an annual budget is needed in the UK because income tax is an annual tax – it must be enacted every year. In Scotland, there is no such requirement,

other than for an annual vote on the income tax rates and bands. This limited annual tax procedure is not enough, and to maintain and improve Scottish taxes a regular, formal, tax process is needed.

Furthermore, there is a tendency to use secondary legislation instead of primary legislation and ICAS does not believe that this is an appropriate way to exercise tax powers because it lacks both visibility and active parliamentary consideration.

2.6 Assigned taxes: VAT

The Scotland Act 2016 provides that, where there is agreement between the Treasury and Scottish Ministers for identifying VAT attributable to Scotland, the first 10 percentage points of the standard VAT rate and the first 5 percentage points of the reduced rate shall be paid into the Scottish Consolidated Fund. This is due to be applicable from April 2019 onwards so will not have a direct impact on the forthcoming budget for 2018/19.

Initially the benefit of the VAT assigned to Scotland will be counterbalanced by a corresponding reduction in the block grant. If the Scottish economy subsequently outperforms the rest of the UK, it will see some benefit from assigned VAT in future years. As a stronger economy with higher spending, the share of VAT to be assigned to it will be increased. The opposite applies if it underperforms relative to the rest of the UK.

At this stage of Brexit negotiations there is no clarity of what changes to VAT record keeping, if any, will be required post Brexit. At one end of the spectrum, if a deal is struck for the UK to remain within the EU VAT union, then there will be minimal change. At the other end, there could be a total break such that it would be within the UK Government's powers to totally reshape VAT. And, unless the Scotland Act 2016 powers are changed after Brexit, this source of 'Scottish tax' will continue to be UK based with a proportion of the receipts assigned to Scotland.

2.7 Scope for new Scottish taxes

There is scope to create new devolved taxes and, for example, suggestions put forward periodically are a tourist tax or a charge on particular goods such as single-use paper cups.

Given the time and work involved in legislating for the existing devolved taxes, where each of these is largely a cut and paste from the UK legislation, the Scottish Government would need considerable resources to design the policy and the supporting legislation to create new taxes. In policy terms, it is also probable that there would be some constraints, such as having the locus of the tax in Scotland. Without this, it would be difficult to establish the basis of the charge to tax and the means and authority to collect it. Consideration would also need to be given to how a proposed new tax would support the wider economic policy objectives and influence any potential behavioural impacts; for example, a tourist tax might reduce the number of tourists.

Any new taxes would take time to develop, would benefit from wide consultation, and are unlikely to feature in the next budget as a means of raising revenue for 2018/19. However, in the longer term, the Scottish Government may wish to consider new devolved taxes as part of a more distinctive use of the powers and to meet spending commitments.

2.8 Conclusion

Accountability by Scottish politicians to the electorate can only come with clarity around tax raising policies and public understanding of tax. With a package of fully devolved, partially devolved, assigned and local taxes, many of which have had different implementation dates, it is questionable whether there is as yet widespread understanding of 'Scottish taxes'. Measures around the forthcoming budget should seek to inform individuals and businesses about the tax powers, with clear explanations of the choices and why particular options are being put forward.

The Scottish Parliament does have the power to make some radical changes but the practical implications of this could be dramatic and unpredictable. There are also challenges in adopting a fundamentally different approach, most of which result from comparison with tax in the rest of the UK. The comparison may be a sense that, collectively, taxes are more expensive, or it may be in relation to individual taxes. Challenges if the tax rates are felt to be too expensive may include:

- The burden of taxation leading to behavioural changes. There are only a relatively small number of additional rate taxpayers in Scotland. If even a few of these chose to move to the rest of the UK or, say, incorporate, then there might be little or no benefit for Scotland from seeking to raise income tax at the upper end of the income spectrum

- UK wide businesses may choose to prioritise their operations outside Scotland if there is a perceived increased tax or administrative cost of transactions in Scotland

- Taxpayers familiar with the current system that has evolved over a long period may react negatively to fundamental reforms. Changes introduce uncertainty and are therefore unlikely to encourage investment unless they are introduced gradually over time and widely publicised to encourage public understanding and engagement

- Radical changes to the tax system in Scotland might result in economic growth, but the additional yield might augment revenues from non-devolved taxes such as corporation tax or capital gains tax. The potential to make radical changes may therefore be limited because Scotland has only limited levers in relation to the largest yielding tax – income tax

- Administrative costs are generally underestimated, for example, the costs to businesses of updating systems to deal with changes.

A key element of tax policy should be, where possible, to enhance and support the economy: at the very least, administrative measures should not add to the complexity of doing business in Scotland and should not put Scottish businesses at a competitive disadvantage.

A five-year roadmap to set out the objectives of Scottish tax policy would be helpful: this should set out policy objectives and provide clarity of purpose. For example, to what extent is the tax being levied to raise funds or direct certain behaviours, and to what extent and in what way is tax policy being designed to encourage economic growth.

About ICAS

The Institute of Chartered Accountants of Scotland ("ICAS") is the oldest professional body of accountants. We represent over 21,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK or in almost 100 countries around the world.

ICAS has a public interest remit – a duty to act not only for its members but for the wider public good. Our technical experts work in a positive and constructive manner to advise policy makers on legislation and to raise issues of importance to our members, individual taxpayers and business alike.

Taxation is one such area of importance and ICAS has contributed, and will continue to contribute, to tax policy in Scotland, the UK and beyond.

The Tax Board's objectives in establishing its policy positions are to:

- act in the public interest
- provide constructive input to the authorities, and
- represent ICAS members, affiliates and students' interests.

Chapter 3: Outlook for the Scottish budget

- Based on current UK Government plans, Scotland's resource block grant is expected to decline by 2.9% in real terms between 2016/17 and 2020/21. But the profile is not even across years; the block grant increased slightly in 2017/18, but is on track to fall by 1.5% in 2018/19.
- By 2020/21, the Scottish Government's resource block grant is expected to be 8.4% lower in real terms (before any adjustments for devolved powers) compared to 2010/11.
- As well as the block grant, the budget now depends on whether Scottish revenues are likely to under or outperform the amount implied by the BGAs. Whether more or less is raised, depends on the growth in the Scottish and rUK tax bases and the tax policy choices made.
- There is clearly uncertainty around estimating the extent to which Scottish revenues will differ from the respective BGAs in any future year. But even relatively small differences in economic performance can make significant differences over time.
- We set out a range of possible scenarios. Whilst the exact outcome will no doubt differ from the scenarios here, they provide a useful illustration of the overall financial envelope the Scottish Government should prepare for.
- Under a central scenario – where the Scottish Government sets a lower threshold for the higher rate of income tax; where the income tax revenues per capita grows at the same rate in Scotland as rUK; where LBTT revenues marginally underperform the BGA; and where cuts to ADT go ahead – the total Scottish resource budget (grant and tax revenues) is forecast to fall by 2.3% in real terms between 2016/17 and 2020/21.
- Under alternative but arguably equally realistic scenarios (an upside and downside), the Scottish resource budget could decline by 1.2% or by up to 3.8% by 2020/21. One thing that is clear, is that the balance of probability points towards cuts in real terms.
- With the current fragility of the Scottish economy, there is the prospect of the government being able to unlock – for 2018/19 – emergency borrowing powers. This could boost the budget by up to £600 million (and feasibly for every year in which the trigger applies). This could change the profile of the cuts, but of course the money would have to be re-paid.
- There is more flexibility on the capital budget than on the resource budget. The capital block grant from Westminster is set to increase 5% per year up to 2019/20, and by the end of the parliament in 2021 it will almost have returned to the historic peak of 2010/11.

The Scottish Government is likely to continue to face a challenging budget settlement over the remainder of the current parliamentary term (and quite possibly beyond). The resource block grant from Westminster, following an increase in 2017/18, is currently on track to fall in each financial year to 2020/21. How Scottish tax revenues perform will have an impact at the margin. Based upon a set of scenarios for how taxes could evolve, we believe that the Scottish Government should be preparing itself for further cuts to its resource budget of up to 3.8% between 2016/17 and 2020/21.

3.1 Introduction

From the establishment of the Scottish Parliament in 1999 until March 2015, the resource budget of the Scottish Government essentially depended on one thing only: the block grant from Westminster.

Under the new arrangements, the block grant will continue to be determined by the Barnett Formula and will still shape the overall budget envelope the Scottish Government faces.

However, the block grant will be subject to a number of block grant adjustments (BGAs) to take account of the taxes (and social security powers) being devolved.

As was discussed in Chapter 1, in this respect, the critical question is the extent to which the revenues raised in Scotland exceed or underperform the BGA.

If less (more) is raised in Scotland from tax than is deducted from the block grant, the Scottish budget will be worse (better) off than it would have been without tax devolution.

For any given tax, the revenues raised in Scotland may differ from the BGA for two reasons:

- If the Scottish tax base grows differently relative to the rUK (for example, if wages grow more quickly, then income tax revenues per capita are likely to increase more quickly); or
- If tax policy is varied in Scotland in such a way as to raise relatively more or less revenue relative to elsewhere in the UK.

In this chapter, we examine the outlook for the Scottish budget over the course of the current parliamentary term – from 2016/17 to 2020/21[23].

We consider first in Section 3.2 the outlook for the block grant from Westminster.

We then consider in Section 3.3, the outlook for devolved and assigned taxes and the equivalent BGA. As discussed in Chapter 1, given the recent performance of the Scottish economy, the Scottish Fiscal Commission (SFC) may take a cautious approach to its forecasts for revenues. It would not be

[23] In certain instances, our analysis also extends to 2021/22 where data allows.

surprising therefore if – short of any specific policy announcements – their upcoming set of tax forecasts turn out to be slightly lower than the suite of BGAs.

That being said, ultimately what matters is how outturn Scottish revenues *actually* compare to rUK revenues.

As the purpose of this chapter is to examine the profile of the budget over the lifetime of the parliament – to 2020-21 and 2021/22 where possible – we set out a range of possible *scenarios* for how taxes and the BGA may evolve rather than specific *forecasts*.

Section 3.4 brings together, the material in Sections 3.2 and 3.3 to consider the overall outlook for the Scottish Government's resource budget.

In Section 3.5 we consider the outlook for capital spending. Section 3.6 concludes.

3.2 Outlook for the block grant

Based upon the latest plans from the UK Government, having grown slightly in 2017/18, the fiscal resource DEL block grant (i.e. the Scottish Government's resource budget)[24], before any adjustments for new tax and social security powers, is expected to decline by 1.5% in 2018/19 and 1.3% in 2019/20 (Table 3.1).

Over the course of this parliament, from 2016/17 to 2020/21, the block grant is expected to decline 2.9%.

Table 3.1: Outlook for the Scottish Government's resource block grant – 2016/17 to 2021/22 (£ million)

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	*Change 16/17 - 20/21*
Cash terms	£26,088	£26,647	£26,664	£26,746	£27,074	£27,505	*£987*
2017/18 prices	£26,512	£26,647	£26,253	£25,904	£25,737	£25,655	*-£775*
Real terms annual change		*0.5%*	*-1.5%*	*-1.3%*	*-0.6%*	*-0.3%*	*-2.9%*

Notes: table shows outlook for 'Fiscal rDEL'. Figures for 2016/17 – 2019/20 are derived from HMT estimates of the allocation to the Scottish Government published in the 2017 UK Spring Budget.

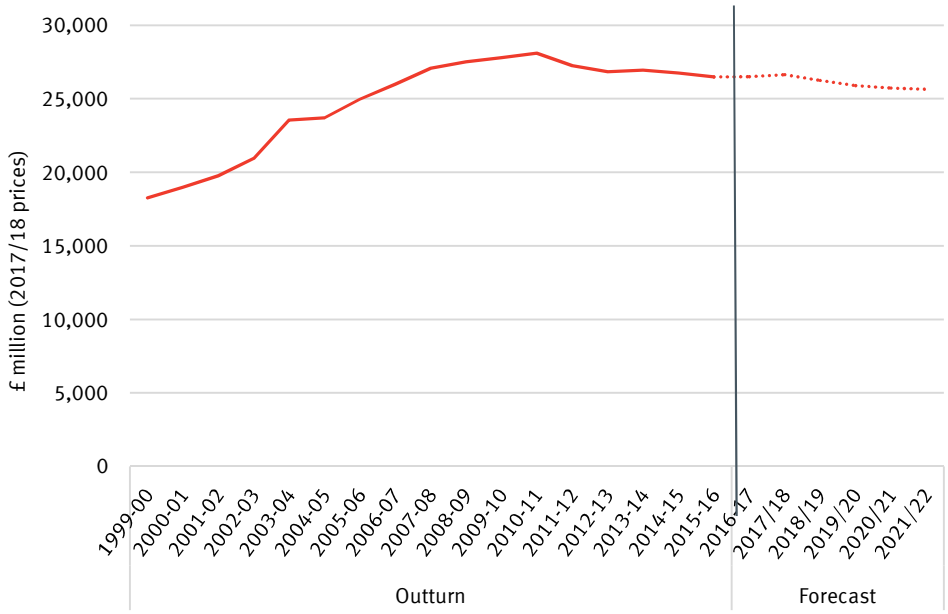
Figures for 2020/21 and 2021/22 are derived by FAI from the UK Government's 2017 Spring Budget, which sets out plans for total DEL spending but does not allocate this total between spending departments.

[24] The amount of money the government has to spend is split into DEL and AME. DEL covers day-to-day public services like health and education. AME is spending not controlled directly but instead varies year-on-year (like pensions). Within DEL, spending is divided into Resource (RDEL) and Capital (CDEL). Excluding non-cash items – principally depreciation – gives Fiscal RDEL which is widely seen as the most accurate measure of the discretionary spending power of government.

Chart 3.1 places these figures in a longer term context.

By 2020/21, the Scottish Government's resource block grant is expected to be 8.4% lower in real terms (before any adjustments for new devolved powers) compared to the peak of resource spending in 2010/11[25].

Chart 3.1: Real terms Scottish Government resource spending 1999/2000 to 2021/22, £ million (2017/18 prices)



Source: Outturn from Public Expenditure Statistical Analyses, various years. Forecast derived from UK Government Spring Budget 2017

Of course there is a possibility that the block grant may turn out to be somewhat higher or lower than the Chancellor set out this March.

The UK Government intends to deliver a further £3.5 billion of efficiency savings in 2019/20. Depending on how any savings are achieved, the Scottish Government's resource block grant could be smaller than the estimate set out in Table 3.1.

If £2.5 billion[26] of net efficiency savings are made evenly across departments, this could imply a reduction in the Scottish Government's block grant, relative to the number in Table 3.1, of around £200 million in 2019/20.

[25] On a like-for-like basis, the actual funding reduction has been slightly greater than indicated above. The Scottish Government's responsibilities increased during this time, notably as a result of the transfer of Council Tax Reduction to the Scottish Budget in 2013/14.

[26] The Treasury aims to reallocate £1 billion of the £3.5 billion in efficiency savings to 'priority areas'.

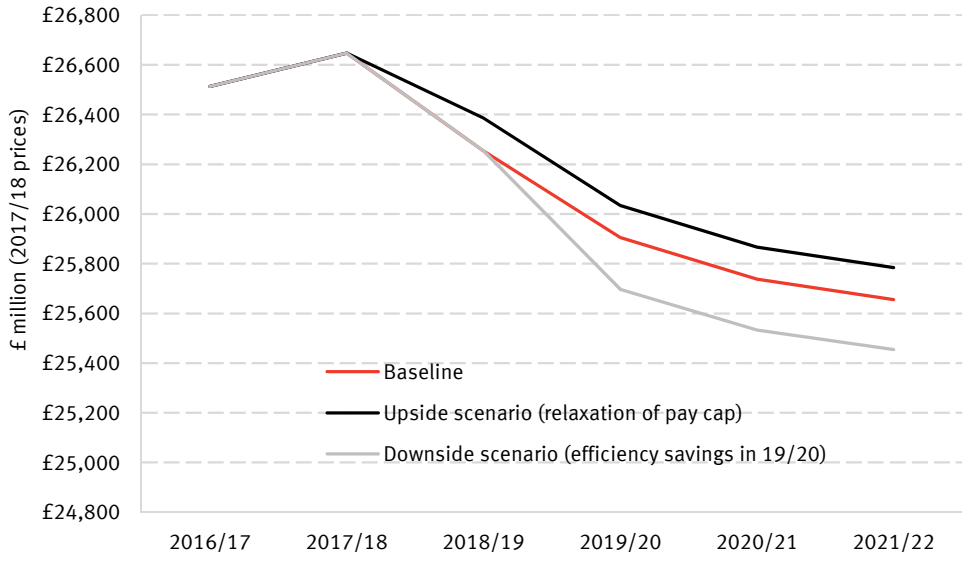
On the other hand, it is not unusual for UK Chancellors to use Budget events to increase spending relative to previous plans.

Under the OBR's March 2017 forecasts, the Chancellor is on course to meet his new Fiscal Target of structural borrowing being below 2% of GDP by 2020/21 with around £26 billion 'headroom'. If this forecast continues to hold, the Chancellor may decide to increase public spending – for example, to relax the 1% cap on public sector pay. Indicatively, a further 1% rise on top of the cap could deliver around £130 million of additional consequentials for the Scottish budget[27].

Chart 3.2 shows the outlook for the Scottish resource block grant in real terms under three scenarios – the current base case, an 'upside' scenario which assumes the 1% cap on public sector pay is relaxed in 2018/19, and a 'downside' scenario which assumes that £2.5 billion efficiency savings are made by UK departments in 2019/20[28].

The upside scenario assumes that the relaxation of the pay cap results in a further 1% pay increase (above the cap). Of course the cap could be relaxed more than this; for each 1 percentage point increase in public sector pay, this would result in around £130 million of additional consequentials for the Scottish budget, under our assumptions.

Chart 3.2 Scenarios for the real-terms Scottish resource block grant: 2016/17 to 2021/22



Source: FAI Analysis

These are uncertain times politically and economically, and the possibility of more significant change in the outlook for the block grant (up or down) should not be ruled out.

[27] On the assumption that public sector pay accounts for around half of UK Government resource spending on public services that are subject to Barnett consequentials.

[28] By 'upside' and 'downside' we mean in the context to the value of the Scottish budget going forward, rather than a positive or negative policy position.

3.3 The outlook for revenues and block grant adjustments

In this section, we consider the outlook for revenues and the BGA for each of the taxes currently – or soon to be – devolved or assigned. We calculate the BGAs based on the Indexed Per Capita method[29].

For completeness, we present the most recent available revenue forecasts for Scottish and comparable UK taxes. But these should be viewed with caution.

Firstly, the latest rUK revenue forecasts – which determine the calculation of the BGAs – were published in March 2017; but the latest Scottish revenue forecasts were published four months earlier in December 2016. The emergence of more recent data between these two dates means that they are not strictly comparable.

Secondly, it is important to remember the difference between *forecasts* and *outturn*:

- When the 2018/19 Budget is published in December, the size of the budget available to the Cabinet Secretary for Finance will be determined by the forecasts for revenues and the forecasts for the BGAs.

- But there will inevitably be a degree of error associated with these forecasts (Box 3.1), and what is ultimately important in determining the budget over time is how the outturn revenues compare with the BGAs.

It is this second point that matters the most when looking at the outlook for the budget over the course of the parliament to 2021. We draw on a range of evidence to underpin our assessment.

Box 3.1: Forecasting and uncertainty

The Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) are both obliged to produce 'point estimate' forecasts for revenues (for Scotland and the UK respectively) for up to five years into the future.

Point estimates are necessary for budgeting purposes. But they hide significant uncertainty and margins of error. What might happen in future is of course unknowable with complete certainty.

Uncertainty is present in all forecasts. But economic forecasts are arguably associated with particularly high levels of uncertainty. We only have an imperfect notion of how the economy works, we only have partial information about the state of the economy at any point in time, and the economy is constantly hit by unanticipated shocks.

[29] The Fiscal Framework identifies two methods for calculating the BGAs: Indexed Per Capita (IPC) and the Comparable Method (CM). Over the period up to 2021/22, the BGAs will be calculated according to the IPC method (although the results of the Comparable Method will also be published). The Scottish and UK Governments will need to agree a methodology for 2022/23 and beyond.

The SFC's 'point estimate' forecasts will, like the OBR's, implicitly be probabilistic. The actual forecast is effectively a 'central' or 'median' forecast. This means that the risks are perceived to be balanced in that the actual outcome is as likely to be above expectations as below.

From a Scottish budget point of view, what is ultimately critical is how Scottish revenues perform relative to the comparable revenues in rUK. In this sense, what is just as important as the error associated with the Scottish forecasts, is the extent to which it is correlated with error in the rUK forecasts.

For example, outturn revenues in Scotland could turn out to be 10% lower than forecast. But if rUK revenue outturn for the comparable tax is also 10% down on forecast, the Scottish budget will be no worse off.

Income tax

The Scottish Government published its most recent income tax forecasts in February 2017. These forecast income tax revenues of £11.9 billion in 2017/18, rising to £14.6 billion by 2021/22 (Table 3.2). This forecast took into account the decision to freeze the higher rate Threshold at £43,000 (rather than set it at £43,430 as had initially been proposed in the Draft Budget).

This forecast exceeded the forecast for the BGA – published in the Scottish Budget in December 2016 - in each year until 2021/22. The difference between the forecast for Scottish revenues and the BGA was partly due to the Scottish Government's policy to set a lower threshold for the higher rate of income tax throughout this parliament. But it also reflects different modelling approaches and assumptions.

Table 3.2: Income tax revenue and BGA forecasts (£ million): 2017/18 to 2021/22

	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)	11,750	12,159	12,672	13,233	13,898
BGA forecast (March 2017)	11,636	11,924	12,326	12,833	13,460
Scottish forecast (Feb 2017)	11,857	12,320	12,943	13,681	14,595

Source: Fraser of Allander calculations

At the time of the UK Spring Budget in March 2017, the OBR published updated forecasts – based on new data – for rUK income tax revenues over the period to 2021/22. By implication, the forecast for the BGA was reduced, relative to the November estimate.

Based on the most recently available statistics therefore – the BGA forecast from March this year and the Scottish Government's forecasts from February – it might be tempting to conclude that the gap between the two is strongly in the Scottish Government's favour. However, the forecasts that really 'count' as far as the 2018/19 budget is concerned are those that will be published later in 2017. This is because it is almost inevitable that the forecast for Scottish revenues will be revised

downwards to reflect the more recently available data, and the anticipated cautious approach of the Scottish Fiscal Commission.

Notwithstanding these evolving forecasts, how likely is it that Scottish income tax revenues will match or better the BGA in 2017/18 and beyond?

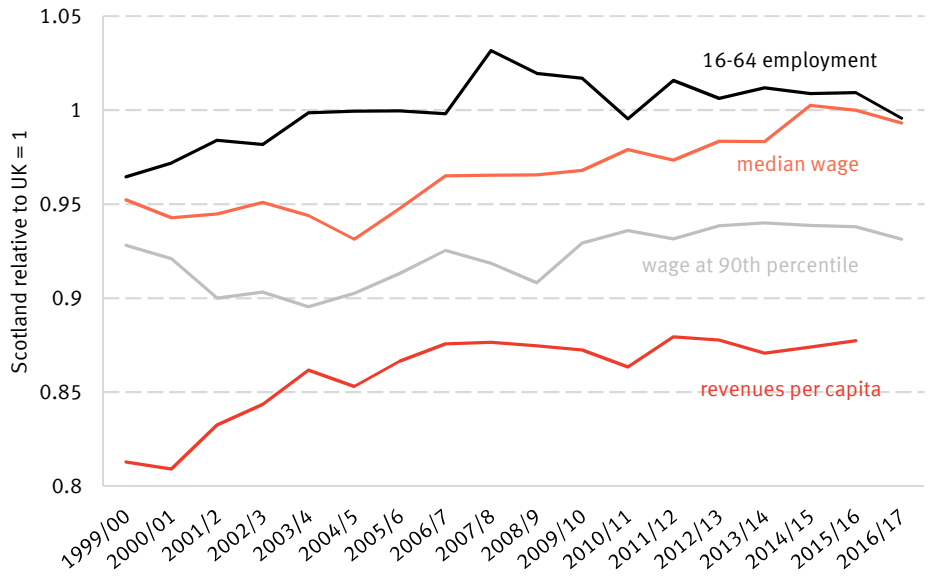
Chapter 1 discussed the overall outlook for the economy.

But to answer the question for income tax, we also need to consider how trends in the major determinants of the tax base (wages and employment) are likely to evolve in Scotland relative to rUK, *and* how tax policy may change.

Recent trends in tax revenues and the tax base

Between 2007/08 and 2015/16, income tax revenues per capita have grown at broadly the same rate in Scotland as the UK (Chart 3.3).

Chart 3.3: Trends in Scottish employment, wages and income tax revenues per capita, UK = 1



Source: Employment rate from Labour Force Survey; Wage data from Annual Survey of Hours and Earnings, various years (latest April 2016); income tax data from HMRC tax outturn statistics

On the one hand, the employment rate in Scotland has declined relative to the UK. But over the same period, wages in Scotland have performed slightly better (more accurately, Scottish wages have not declined quite as much).

But changes in income tax policy at UK level have played a role in influencing relative revenue growth too.

Two key changes are worth noting.

1. Since 2007/08, the Personal Allowance has increased in real terms. By 2017/18 it has reached £11,500 – compared to £9,500 if it had been indexed to inflation.

2. Tax rates on the highest earners have also increased. During the last UK parliament, the higher rate threshold was reduced in real terms by around 13%[30]. Furthermore, an Additional Rate of tax was introduced in 2010/11, initially at 50% before being reduced to 45% in 2013/14.

Taken together, these changes have resulted in tax liabilities becoming more concentrated on higher earners. As a result, tax revenues per capita have grown more quickly in the parts of the UK (i.e. London and the South East) which have a greater proportion of high earners[31].

Whether Scotland continues to match UK growth in per capita income tax revenues will depend on how these determinants evolve.

Note from Chart 3.3 however that the omens for 2016/17 specifically are not particularly positive. Employment and wages in Scotland declined relative to those in the UK[32]. The extent to which 2016/17 was a one-off 'blip' or the start of a trend is not yet clear (comprehensive wage data for 2017 will be released this October).

The FAI's income tax microsimulation model[33] can be used to assess the risks to the budget from relatively faster or slower wage growth in Scotland.

Table 3.3 shows how Scottish income tax revenues would evolve if average wages in Scotland grew 0.3 percentage points faster or slower than wages in rUK, and if wages grew 0.8 percentage points faster or slower than wages in rUK[34].

A difference in wage growth of just 0.3 percentage points equates to a revenue difference of over £50 million after one year; 0.8 percentage points around £150 million in one year. Clearly, the effects of differential growth are magnified over time.

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[30] A reduction in the higher rate threshold means that the level of income that people pay the higher rate of tax is lower – hence a tax rise.

[31] Chart 3.3 also shows that wages at the 90th percentile in Scotland have not grown as quickly as wages at the 90th percentile in rUK; wages at the top end of the distribution have a particularly strong influence on tax revenues

[32] The Scottish budget is not directly affected by income tax revenue performance in 2016/17, as tax devolution does not occur until 2017/18. Lower Scottish revenues in 2016/17 simply mean a lower 'initial deduction' and thus a lower block grant adjustment in 2017/18.

[33] Based on analysis of: HM Revenue and Customs. KAI Data, Policy and Co-Ordination. (2017). *Survey of Personal Incomes, 2014-2015: Public Use Tape*. [data collection]. UK Data Service. SN: 8239, http://doi.org/10.5255/UKDA-SN-8239-1

[34] During the past ten years, average weekly earnings have grown more quickly in Scotland than the UK in six years, and in these years Scottish wages have grown on average 0.8 percentage points more quickly; average weekly earnings have grown less quickly in Scotland than in UK in four years, and in these years Scottish wages have grown on average 0.3 percentage points more slowly. The 0.3 and 0.8 figures are chosen simply to illustrate the potential magnitude of differential growth in one year. Of course, based on past experience, it would be unlikely that such differential growth is observed over consecutive years.

Table 3.3: Effect on Scottish income tax revenues (£ million): Faster or slower wage growth in Scotland compared to rUK

	2017/18	2018/19	2019/20	2020/21	2021/22
0.3 pp slower growth	-55	-115	-180	-251	-329
0.3 pp faster growth	+55	+116	+182	+255	+336
0.8 pp slower growth	-146	-620	-475	-661	-864
0.8 pp faster growth	+147	+311	+489	+688	+909

Source: FAI income tax microsimulation model. Notes: 'pp' stands for 'percentage point'.

Income Tax policy

The Scottish Government has the ability to vary its budget directly through tax policy.

Box 3.2: Determining policy baselines in the fiscal framework

Under the new framework, determining the policy 'baseline' against which the revenue effects of alternative policies can be assessed is not straightforward. This is because, although the Scottish Parliament sets tax rates and thresholds independently of the UK, UK Government policy also influences the Scottish budget via the BGAs.

To illustrate this, consider the case of the differences in the higher rate threshold that emerged in 2017/18.

It could be argued that the decision to freeze the HR threshold in cash terms effectively represents a policy of 'no change' (in the same way that the Additional Rate remained unchanged at £150,000). There is no presumption in legislation that Scottish tax thresholds will increase in line with inflation, or mirror the UK Government; any change must be agreed by the Scottish Parliament through a Rate Resolution.

Instead, the actual 'boost' to the Scottish budget stemmed from the UK Government's decision to raise the HR threshold in the rest of the UK! This can be characterised as a tax cut, and effectively reduces the BGA. Because the BGA is deducted from the block grant, this increases the grant to the Scottish Government.

Thus although the tax thresholds set in Scotland are legislatively independent of those in rUK, what actually matters for the budget is how policy in Scotland is set *relative* to policy in rUK. Therefore, fiscal policy decisions in Scotland will necessarily continue to be framed by reference to UK decisions.

Freezing the higher rate threshold at £43,000 is likely to raise an additional £141 million in 2017/18, compared to if the government had followed UK policy and set the threshold at £45,000

(Box 3.2 discusses difficulties in determining policy change under Scotland's new Fiscal Framework).

Looking forward, Table 3.4 illustrates how much could be raised from continuing with a different HR threshold.

The estimates of the income tax BGA are based on two scenarios – i) the UK Government increases the higher rate threshold in line with CPI, and ii) the UK Government follows through with the Conservative manifesto commitment to increase the threshold to £50,000 by 2020/21.

If both governments increase the HR threshold by CPI from their (now different) 2017/18 baselines, the difference between the two will grow in cash terms – boosting Scottish revenues by £172 million by 2020/21 (and by £191 million by 2021/22).

A UK Government decision to increase the threshold to £50,000 by 2020/21 would result in the Scottish budget being £288 million better off in that year.

As discussed in Chapter 2, the lower HR threshold in Scotland may have behavioural effects. Taxpayers with income between £43,000 and £45,000 will pay a higher marginal rate of tax than in rUK, whilst those with income above £45,000 will face a higher average tax rate.

Table 3.4: Effects on Scottish budget of various higher rate threshold policy parameters (£ million)

Policy		2017/18	2018/19	2019/20	2020/21	2021/22
Baseline: inflationary increase in HRT in Scotland and rUK	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	45,000	46,200	47,270	48,210	49,260
	Revenue effect (£m)	*0*	*0*	*0*	*0*	*0*
Freeze higher rate in Scotland 17/18, then CPI	*UK threshold*	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*141*	*149*	*160*	*172*	*191*
Increase UK threshold to £50,000 by 2020/21	*UK threshold*	45,000	46,667	48,333	50,000	51,089
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*141*	*178*	*227*	*288*	*315*

Source: Fraser of Allander calculations

These differences may instigate some offsetting reductions in taxable income if behaviours change.

However on balance, such effects are likely to be small. The OBR estimates that the behavioural effects of the lower threshold in Scotland are likely to reduce revenues by just £9 million per annum in 2017/18 and beyond.

A number of other revenue raising options available to the Scottish Government are discussed in Chapter 5.

Land and Buildings Transaction Tax (LBTT)

At the Draft Budget in December 2016, revenues from LBTT were forecast to be somewhat higher in 2016/17 than the BGA (Table 3.5).

Provisional LBTT outturn data shows £484 million being raised from LBTT in 2016/17. Provisional outturn data has also been published for the 'equivalent' Stamp Duty Land Tax revenues in rUK (these raised £11.7 billion). This suggests that the BGA for LBTT in 2016/17 will be £522 million (Table 3.5).

The implication is that the BGA for LBTT is likely to have been some £38 million higher than Scottish revenues in 2016/17[35].

Table 3.5: LBTT revenues and BGA – outturn and forecasts (£ million)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
A: Nov 2016: BGA forecast		504	545	585	634	689	741
B: BGA outturn/ March 2017: forecast		*522*	580	619	656	700	747
C: Scottish outturn/ Dec 2016: forecast	*425*	*484*	507	543	571	597	624
Difference between revenue forecast and BGA (Nov 2016) (C-A)		-20	-38	-42	-63	-92	-117
Difference between revenue forecast and BGA (Mar 2017) (C-B)		*-38*	-73	-76	-85	-103	-123

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (June 2017) and OBR forecasts for rUK Stamp Duty (March 2017). Notes: Data in red italics relate to provisional outturn data. Table 3.5 does not show a BGA for LBTT in 2015/16, the first year of devolution. This is because for 2015/16, the Scottish and UK Governments agreed a one-year BGA for LBTT and SLfT combined of £494m, which is independent of outturn rUK data. Outturn data for Scotland suggests that in 2015/16, £425 million was raised from LBTT and £147 million was raised from Scottish Landfill Tax. This total, £572m, is greater than the BGA by £78m. In 2015/16 the Scottish Budget was thus £78 million better off than it would have been had a strictly 'no-detriment' policy been applied.

What about the outlook?

The OBR's latest (March 2017) forecasts for rUK Stamp Duty imply that the BGA will increase to £580 million in 2017/18, and then by 6-7% each year until 2021/22.

This is a faster rate than the Scottish Government was forecasting for LBTT in December 2016 – at a net cost of around £100 million per year by 2020/21.

[35] The exact figure may change once final audited figures are published.

The difference between the Scottish Government and OBR forecasts is due to different modelling approaches but also different assumptions about house price growth and transactions[36]. In particular, the OBR assumes price growth in excess of 4% per year, whereas the Scottish Government's forecast is less than half this. The OBR also assumes somewhat faster growth in rUK residential transactions.

There are some grounds for believing that property prices could grow relatively more slowly in Scotland than in rUK. In the two years since LBTT was devolved, house prices have grown 2.5% per annum in Scotland compared to 6.5% in the UK[37].

Against this however, residential transactions have tended to grow just as strongly in Scotland as in rUK. In 2015/16, the number of transactions grew by about 10% in both Scotland and in rUK, whilst in 2016/17 they declined 13% in rUK compared to a fall of 7% in Scotland.

In terms of the non-residential market, whilst the number of transactions grew more quickly in Scotland between 2015/16 and 2016/17 (10%) than rUK (7%), revenues declined more rapidly.

In our central scenario, we thus assume that LBTT revenues grow at the same rate as the BGA. Implicitly, what this means is that Scottish revenues underperform the BGA by 7%, reflecting a continuation of the relative performance observed in 2016/17 (i.e. we do not assume that LBTT growth 'catches back up' the ground lost).

The forecasts for both Scottish LBTT and the BGA should be treated with caution, as revenues from property transactions are particularly difficult to forecast[38].

LBTT tax policy

LBTT, introduced in April 2015, marks a significant improvement on the previous system of Stamp Duty. This is because, whereas Stamp Duty operated a 'slab' structure (whereby tax rates were levied on the entire value of a property), under LBTT, each additional tax rate is applied only to the property value above that threshold.

Some concerns however have been raised that the structure of LBTT – which implies a higher average tax rate on properties over £333,000 than in the previous UK stamp duty system – has reduced activity in the mid to higher end of the market. This view stems, in part, from the fact that the LBTT forecasts in the 2015/16 Draft Scottish Budget overestimated revenues in the £325,000 - £750,000 bracket by some 37%[39].

However, it is difficult to infer too much from this alone; the Scottish Government was developing its forecasting approach, and the market was complicated by 'forestalling' (i.e. transactions brought forward into 2014/15 to avoid the higher tax rates in 2015/16, which had been pre-announced).

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[36] Assumptions about non-domestic property price and transaction growth are broadly similar

[37] Comparing prices in May 2017 with May 2015 according to ONS House Price Index.

[38] As an example, between November 2015 and November 2016, the OBR revised its SDLT forecast for 2017/18 downwards by £2 billion (14%)

[39] Scottish Fiscal Commission Outturn Report, Sep 2016

Nonetheless, concern remains about the effect of the 10% tax rate on this segment of the market.

A number of organisations have called for a review for properties in the £325,000 plus range[40]. Our modelling suggests that an extension of the 5% tax rate to properties worth £500,000 would cost around £45 million assuming no behavioural response, whilst extending the 5% tax rate to £700,000 would cost around a further £15 million.

To offset a reduction in revenues of £60 million, the number of transactions in this band would need to increase by around 3,750 per annum[41]. This is roughly a doubling in transactions. The likelihood of seeing such a significant behavioural response seems remote.

Landfill Tax

According to provisional data, £149 million was raised from Landfill Tax in Scotland in 2016/17. Based on provisional data for comparable revenues in rUK, Scottish revenues are likely to be around £15 million higher than the Landfill Tax BGA (Table 3.6).

Table 3.6: Landfill Tax revenues and Landfill Tax BGA – outturn and forecasts (£ million)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
A: Nov 2016: BGA forecast		137	119	104	97	92	90
B: BGA outturn/ March 2017: forecast		*134*	108	100	93	91	89
C: Scottish outturn/ Dec 2016: forecast	*147*	*149*	149	118	109	112	106
Difference between revenue forecast and BGA (Dec 2016) (C-A)		12	30	14	12	20	16
Difference between revenue forecast and BGA (Mar 2017) (C-B)		*15*	41	18	16	21	17

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (May 2017) and OBR forecasts for rUK Landfill Tax (March 2017). Notes: Data in red italics relates to outturn. For 2015/16, a combined BGA for LBTT and Landfill Tax was agreed, see text for further details.

In future years, landfill tax revenues are forecast to decline, as alternative infrastructure (e.g. incinerators) comes on stream and rates of recycling increase.

Under the latest (December 2016) forecasts, Scottish landfill tax revenues are expected to bring in somewhat more revenue than the BGA (based on the OBR's March 2017 forecasts).

But the Scottish Government has announced an aspiration to reduce waste to landfill at a quicker rate than in England. To help with this aspiration, the 2017 Programme for Government introduced a

[40] See Finance and Constitution Committee's Report on the First Year of Operation of the Land and Buildings Transactions Tax www.parliament.scot/parliamentarybusiness/CurrentCommittees/102523.aspx#e

[41] Revenue Scotland data indicate that the average revenue from transactions in the £325k-£750k band was £16,000 in 2007/8.

target to eliminate biodegradable waste to landfill by 2020. If the aspiration to reduce waste to landfill at a faster rate than in England is achieved, it would likely affect the budgetary position.

Air Departure Tax

In April 2018, Air Passenger Duty (APD) will cease to operate in Scotland. In its place, the government has announced plans to establish an Air Departure Tax (ADT).

ADT is expected to be similar in scope and structure to APD. However the Scottish Government is committed to reduce the burden of ADT by 50% by the end of this parliament[42].

The OBR estimates Scottish APD revenues in 2016/17 at £301 million, whilst the Scottish Government's latest GERS puts the estimate at £264 million.

Based on a combination of these estimates, and OBR forecasts for APD revenue growth in the UK as a whole, we anticipate the BGA for ADT to be £294 million in the first year of its devolution (Table 3.7). Assuming ADT revenues per capita rise at the same rate as APD revenues per capita are forecast to rise in rUK, ADT revenues would reach £336 million in 2021/22[43].

Reducing the burden of ADT by 50% will likely lead to a reduction in revenues. Of course, if the policy has behavioural effects (i.e. additional passengers travel from Scottish airports), a reduction in the burden of ADT by 50% may not imply a like-for-like fall in revenues.

But there is little evidence to support the alternative view that revenues might not fall by as much[44].

In the absence of any Scottish evidence to the contrary, we assume that a 50% reduction in the burden of ADT – phased over the period to 2021/22, is associated with a 50% reduction in revenues. The policy thus represents a source of budgetary risk.

Table 3.7: Forecasts for Air Departure Tax revenues and the BGA - forecasts, (£ million)

	2018/19	2019/20	2020/21	2021/22
BGA forecast	294	306	321	336
Scottish revenue forecast (no policy change)	294	306	321	336
Difference between revenues and BGA	0	0	0	0
Scottish revenue forecast (50% reduction in burden)	294	252	210	168
Difference between revenues and BGA	0	-54	-111	-168

Notes: Revenue and BGA forecasts derived from OBR March 2017 Economic and Fiscal Outlook.

Source: FAI calculations

[42] Policy Memorandum to the Air Departure Tax Bill

[43] The Scottish Government did not produce a forecast for ADT in its 2017/18 Budget, and the Scottish Fiscal Commission is not due to produce its first official forecasts until later in 2017.

[44] Estimating the extent to which a reduction in ADT rates may stimulate increased passenger travel is difficult, not least because of a lack of data or evidence on the effects of similar policy changes internationally. Critical questions include the extent to which an ADT reduction is passed through to ticket prices, and the sensitivity of customers to changes in prices.

VAT

From 2019/20, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced VAT rate will be assigned to the Scottish budget[45].

No official forecasts for the assigned element of Scottish VAT have yet been published. At the UK level, the OBR forecasts VAT revenues to grow at an average of 4% per year to 2021/22. Between 2010/11 – 2015/16 Scotland's share of UK VAT has remained stable around 8.5% to 8.6%.

Assuming that this share remains stable, then based on the OBR's UK forecast and the estimate of assigned Scottish VAT in 2015/16, Scottish VAT revenues will raise around £5.8 billion in 2019/20.

With VAT assignment some 18 months away, it is currently too early to say whether VAT assignment is likely to have net fiscal costs or benefits. As already noted, the Scottish share of UK VAT has remained robust in recent years, and other than the general economic outlook there is little evidence in existing data to suggest this trend might change.

Our working assumption is that the BGA for assigned VAT will match the Scottish revenues in the later years of the forecast period.

Aggregates Levy

No date has yet been agreed for the devolution of Aggregates Levy[46]. The OBR forecasts revenues to remain broadly unchanged in cash terms at UK and Scottish levels after 2017/18. We assume that Aggregates Levy is devolved in 2020/21, with Scottish revenues of £54 million offsetting an equivalent block grant adjustment.

The net impact on the budget is therefore zero.

3.4 Our scenarios

Table 3.8 brings together the outlook for the Scottish budget, taking account of the block grant, the BGAs and revenues for each tax.

This central scenario assumes that -

- Scottish income tax revenues grow at the same per capita rate as those in rUK, and that the Scottish Government increases the income tax higher rate threshold in line with inflation, but that the UK Government increases it to £50,000 by 2020/21;

- LBTT revenues slightly underperform the BGA – to the same extent as was the case in 2016/17 – throughout the forecast period. In other words, LBTT revenues are 7% lower than the BGA each year;

[45] A number of technical issues around how Scottish VAT revenues will be estimated are being investigated by a VAT Assignment Working Group, due to report in September 2017.

[46] Aggregates levy is a tax on the importing or extraction of sand, gravel and rock.

- Landfill Tax revenues grow in line with the Scottish Government's December 2016 forecasts, whilst the BGA grows in line with the latest OBR forecasts for the comparable rUK taxes;

- The Scottish Government implements a 50% reduction in the burden of ADT phased over the period to 2021/22, with an equivalent reduction in tax revenues; and,

- Finally, for both Aggregates Levy and assigned VAT, we assume that revenues per capita in Scotland grow in line with those in rUK.

Table 3.8: Outlook for Scottish Government revenue budget, £ million (cash terms)

		2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Block grant		26,088	26,647	26,664	26,746	27,074	27,505
	BGA		11,636	11,924	12,326	12,833	13,460
Income tax	Revenues		11,777	12,102	12,553	13,121	13,775
	Difference		*141*	*178*	*227*	*288*	*315*
	BGA	522	580	619	656	700	747
LBTT	Revenues	484	538	574	608	649	692
	Difference	*-38*	*-43*	*-45*	*-48*	*-51*	*-55*
	BGA	134	108	100	93	91	89
Lft	Revenues	149	149	118	109	112	106
	Difference	*15*	*41*	*18*	*16*	*21*	*17*
	BGA			294	306	321	336
ADT	Revenues			294	252	210	168
	Difference			*0*	*-54*	*-111*	*-168*
	BGA				5,752	5,978	6,197
VAT	Revenues				5,752	5,978	6,197
	Difference				*0*	*0*	*0*
	BGA					54	55
Aggregates	Revenues					54	55
	Difference					*0*	*0*
Total		26,064	26,786	26,814	26,886	27,222	27,615

Source: FAI analysis

Under this scenario, the Scottish Government's budget outlook is only slightly different from the outlook for the block grant. Additional revenues from income tax (from the lower higher rate threshold) are offset by slower growth in LBTT revenues, and the reduction in ADT.

There is clearly uncertainty around the outlook for Scottish revenues and the BGAs.

Therefore, Chart 3.3 sets out alternative for the Scottish resource budget in real terms based on our 'central scenario', and two other scenarios designed to capture upside and downside risk.

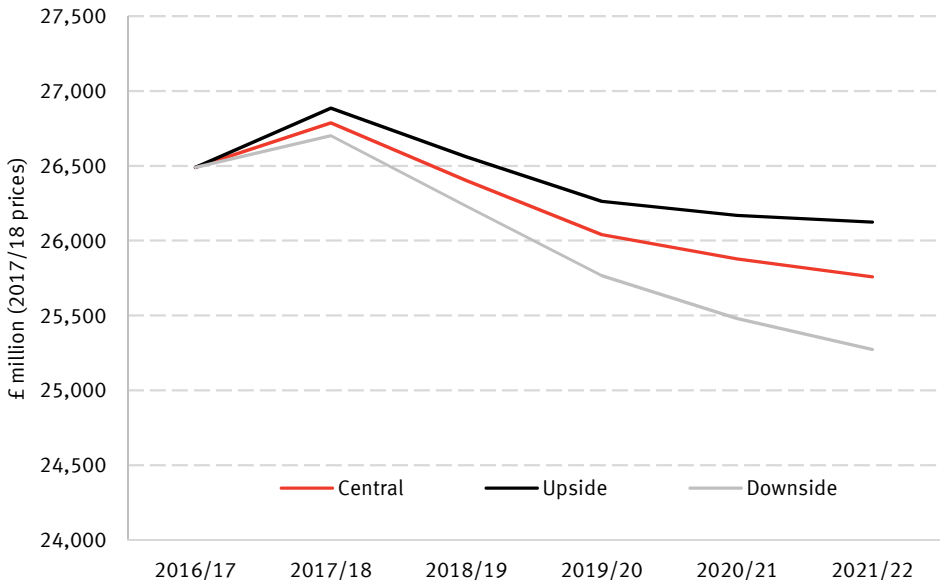
- Relative to the central scenario, the 'upside' scenario assumes that Scottish wages grow 0.3 percentage points faster than rUK wages over the forecast period[47], and that LBTT revenues match the BGA. All other assumptions of the central scenario are held.

- Relative to the central scenario, the 'downside' scenario assumes that Scottish wages grow 0.3 percentage points less quickly than in rUK; that the UK Government chooses to increase the higher hate by inflation (but not to increase it to £50,000), and that outturn LBTT revenues match the Scottish Government's December 2016 forecast (which in turn implies that revenues are around 13-15% lower than the BGA over the forecast period). All other assumptions of the central scenario are held.

Between 2016/17 and 2020/21, the resource budget is forecast to decline 2.3% in the central scenario, by 1.2% in the upside scenario, and by 3.8% in the downside scenario. [48]

All three scenarios take the outlook for the block grant as given in Table 3.1. However, as discussed previously, it is possible that the block grant may evolve differently.

Chart 3.4: Real-terms outlook for the Scottish resource budget (£ million): 2017/18 prices



Source: FAI analysis

In the scenario where the block grant follows the more positive scenario set out in Chart 3.2 (i.e. the UK Government relaxes the public sector pay cap) is combined with the upside scenario above, then the Scottish budget may decline by less than 1% over the period from 2016/17 to 2020/21.

[47] As noted previously, Scottish wages have grown faster than UK wages in six of the last ten years, in these years averaging 0.8 percentage point higher growth; while they have grown more slowly in four of the last ten years, in these years lagging UK growth by 0.3 percentage points on average. The 0.3 percentage point figure is therefore taken as a realistically indicative indication of the potential difference in wage growth.

[48] It is important to note that these are not detailed forecasts but instead scenarios to illustrate how the budget could evolve under certain outcomes and policy choices.

But if the UK Government's planned efficiency savings materialise, the budget – under the downside scenario for revenue growth – could decline by 4.6% over the parliament. So the range that the government needs to prepare for is larger than usual.

Finally, the Scottish Government may choose to unlock the emergency borrowing powers embedded within the Fiscal Framework to account for the fragility in the Scottish economy.

These enhanced borrowing powers are designed for asymmetric shocks and allow for annual resource borrowing of up to £600 million for each financial year in which the trigger applies, plus the following two financial years. The 'trigger' is when onshore Scottish GDP growth is below 1% (on a rolling four quarter basis), and one percentage point below UK GDP growth over the same period.

Borrowing £600 million in 2019/20 would bring the resource budget back above the 2016/17 level. The Scottish Government may justify this as a 'buffer' against Brexit uncertainty, although the powers can only be exercised in the specific circumstances outlined above. And it is important to note that such borrowing has to be paid back (with interest). Therefore, whilst it might give some 'wriggle room' to manage the profile of future cuts, with the public finances likely to be under pressure to the mid-2020s, this would just delay – rather than solve – some tough decisions.

3.5 The outlook for capital expenditure

The Scottish Government's block grant for capital expenditure increased by 5.5% in real terms between 2016/17 and 2017/18. Relatively strong real terms growth is in the pipeline for 2018/19 and 2019/20 based upon current UK Government plans[49]. (Table 3.9)

From April 2017, the Scottish Government has been able to borrow up to £450 million in any year for capital investment, within an overall limit of £3 billion. The 2017/18 Budget indicates that the Scottish Government plans to utilise its £450 million capital borrowing powers in full in 2017/18.

To date no borrowing has been drawn down in 2017/18, although this is consistent with prudent budget management, in the sense that borrowing should only occur once the full CDEL allocation has been used up.

At the same time however, it is likely that the Scottish Government may not be able to utilise its borrowing powers in full in 2017/18. This is because some of its borrowing powers are still likely to be required to provide 'cover' for NPD schemes re-classified by the ONS as public sector expenditure (Box 3.3).

[49] This follows the UK Government's announcement of £23 billion of additional capital spending in the 2016 Autumn Statement.

Box 3.3: Implications for NPD re-classification for capital borrowing

The Non-Profit Distribution programme involves private sector funding capital projects (schools, hospitals etc.) with the public sector committing to pay fees to cover capital costs, interest repayments and maintenance/ service charges (usually for 25-30 years).

In 2015/16, the ONS reclassified various NPD projects as being public sector. The Scottish Government subsequently reached an accounting agreement with HM Treasury to use its capital borrowing allocation for 2015/16 to provide budget 'cover' for the reclassified schemes. This does not mean that the Scottish Government borrowed in that year (and thus there will be no interest rate charges); but the full value of the capital project will score on the balance sheet, and count as part of the Scottish Government's borrowing limit.

The Auditor General's report of October 2016[50] suggests that around £328 million of capital budget was freed up from 2014-15 and 2015-16 budgets to accommodate the change in those years. In 2016/17, £398 million of reclassified NPD schemes were scored against the borrowing limit[51].

A proportion of the Scottish Government's 2017/18 borrowing limit is also likely to be required to provide budget cover for reclassified NPD projects. As set out in evidence provided to the Scottish Parliament's Public Audit Committee[52], a combined capital spend of around £860 million to be delivered over the period to April 2018 is likely to be reclassified. The implication is that around £134 million of the £860 million remains to be 'covered' by capital borrowing in 2017/18.

Table 3.9: Outlook for Scottish Government capital budget

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Cash terms	2,892	3,100	3,320	3,533	3,663	3,767
2017/18 prices	2,939	3,100	3,269	3,422	3,482	3,513
Real terms annual change		*5.5%*	*5.4%*	*4.7%*	*1.8%*	*0.9%*
Borrowing limit		450	450	450	450	450

Notes: figures for 2016/17 – 2020/21 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget. Figures for 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total CDEL spending but does not allocate this total between spending departments.

[50] Auditor General (2016) 2015/16 Audit of the Scottish Government Accounts www.gov.scot/Resource/0050/00506454.pdf

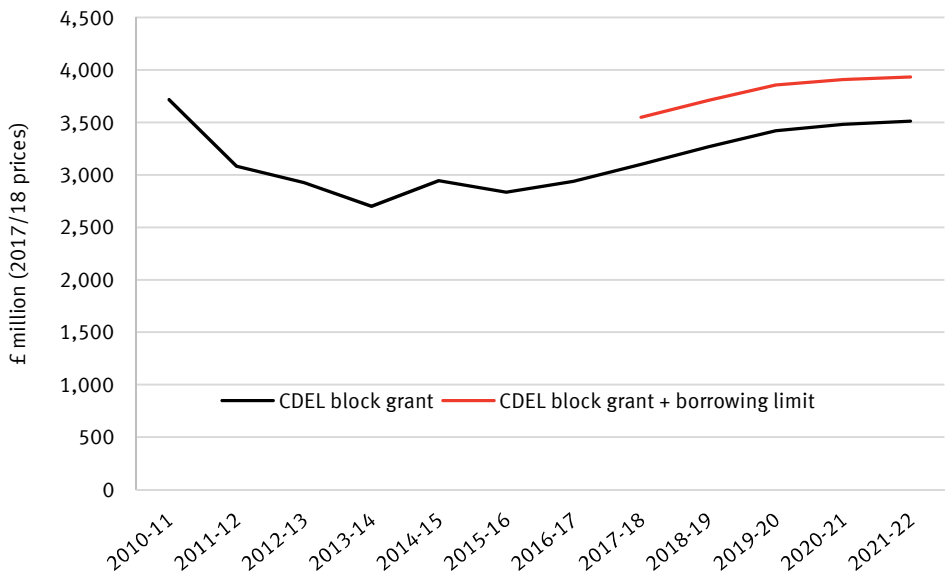
[51] Source: Letter from Cabinet Secretary to Convenor of Finance and Constitution Committee, January 2017. www.parliament.scot/S5_Finance/General%20Documents/Cab_Sec_FC_to_FinConvenor_-_05Jan17.pdf

[52] www.parliament.scot/S5_Public_Audit/2016_10_06_SG-PAPLS_MCP_Progress_Report_Sept_16.pdf

Following declines from a historic high in 2010/11, the Scottish Government's capital allocation is forecast to approach a new historic high of £3.5 billion by 2019/20 (Chart 3.5)[53].

If the Scottish Government's borrowing powers are utilised in full, capital investment could reach close to £4 billion per year by 2021/22. We have yet to see a long-term strategic plan for whether or not this borrowing will be used 'to the max' going forward.

Chart 3.5: Real terms outlook for Scottish Government capital spending (£ million): 2017/18 prices



Source: FAI Analysis

3.6 Conclusions

As we set out in Chapter 1, under the new fiscal framework, the relative performance of the Scottish economy – and by implication devolved Scottish revenues – is critical in shaping the size of the Scottish budget.

That said, the block grant remains the key component in determining the overall size of the Scottish Government's spending envelope.

The block grant increased slightly in real terms in 2017/18. But, based on current UK spending plans, reductions in the resource block grant of 1.5% and 1.3% are expected in 2018/19 and 2019/20. Over the course of the parliament (2016/17 to 2020/21), this would mean that the resource block grant would be reduced by 2.9% in real terms.

[53] Table 3.9 does not include 'financial transactions'. Financial transactions are not resources to spend on capital resources per se, but they enable the Scottish Government to support equity/loan schemes (such as Help to Buy) to build new homes. The 2017/18 budget includes financial transactions of £285 million, and this amount has increased substantially since 2010/11, reflecting the policy decisions of the UK Government.

There is clearly some uncertainty around the extent to which the Scottish revenues are likely to be higher or lower than the respective BGAs in any given future year. Recent slower growth in key Scottish economic aggregates may result in the Scottish Fiscal Commission adopting a relatively cautious approach to its forecasts.

Setting a lower threshold at which the higher rate of income tax is paid will raise between £150 million and £180 million in 2018/19, depending on what the UK Government decides to do. On the other hand, the commitment to reduce the burden of ADT is likely to reduce revenues. In 2020/21, this could amount to over £110 million.

Under a central scenario – where the Scottish Government continues to set a somewhat lower threshold for the higher rate than in rUK; where the income tax base per capita grows at the same rate in Scotland as rUK; where LBTT revenues marginally underperform the BGA; and where cuts to APD go ahead – the Scottish Government's resource budget is forecast to fall by 2.3% in real terms between 2016/17 and 2020/21.

Under an upside scenario – where LBTT revenues do better and Scottish wages grow more quickly – the resource budget is predicted to fall 1.2% over the period. Under a more challenging scenario, where Scottish wages grow more slowly and LBTT revenues underperform – the resource budget could fall by 3.8% in real terms.

These scenarios are of course indicative but they illustrate, on the balance of probability, further real terms cuts are likely over the coming years.

As we outline in the next chapter, this means that the government will have to prioritise its commitments.

The outlook for the capital budget is more positive, with capital budgets on track to return to their pre-financial crisis levels in real terms.

Chapter 4: Spending commitments and constraints

- Through various manifesto commitments and Programme for Government announcements, the Scottish Government has set out a number of budget priorities for the next few years.
- At a time of significant fiscal restraint, delivering these plans will require tough settlements for some other public services.
- A number of the commitments announced thus far carry price tags. For example, the government has committed to increase health spending by £500 million more than inflation by the end of this parliament, to maintain real terms spending on policing, to double free childcare provision and to invest an additional £750 million in an attainment fund.
- Taking these commitments – just on their own – means that over half the Scottish resource budget can be viewed as 'protected'.
- But this carries the implication that 'non-protected' areas will shoulder a greater share of the burden. As an illustration, using the scenarios set out in Chapter 3 and just taking these four commitments on their own, 'non-protected' areas could face real terms cuts of between 9% to 14% over the parliamentary term (2016/17 to 2020/21).
- On top of this can be added other commitments like free higher education tuition, protecting college places and free personal and nursing care. Funding for school education is also likely to remain a priority, whilst the 2017 Programme for Government confirmed that the government will lift the 1% pay cap. A 3% increase in pay – to be in line with inflation – could cost nearly £400 million.
- All of this is likely to re-ignite the debate about the future of local government finance.
- In the medium term, Scotland's new social security powers carry significant opportunities to design better policies and to take advantage of synergies with existing devolved levers.
- But they also carry budget risks including –
  - Initial estimates for set-up costs point to a gap of over £100 million over 2017 to 2021 between monies provided by the UK Government for all devolved powers and projected social security set-up costs;
  - The same estimates suggest a gap of over £80 million per annum between the monies provided by the UK Government and the cost of social security administration; and,
  - The Scottish Government may wish to use their new powers either to increase payments or widen entitlement.

The government has set out a number of spending commitments. At a time of tight resources, this will require a tough re-prioritisation of spend across – and within – portfolios. With the overall resource budget likely to decline in real terms, commitments to increase or maintain spending in some areas means that others face picking up more of the burden. These non-protected budgets could face average real terms cuts of between 9% and 14% between 2016/17 and 2020/21.

4.1 Introduction

Chapter 3 considered how the overall spending envelope the Scottish Government is likely to have at its disposal might evolve over the coming years.

How might it distribute this budget? This is the question we consider in this chapter.

As Chapter 3 made clear, the Scottish budget will remain highly constrained to the end of – at least – this parliamentary term. Further real terms cuts look inevitable.

The Scottish Government therefore faces a difficult choice when deciding how to allocate these resources to meet both immediate policy commitments and longer-term aspirations[54].

A number of pledges have been set out and costed. We have known for a number of years now that the health resource budget will continue to increase in real terms. New commitments are now being added however, including the intention to move away from the 1% pay award for public sector workers. Some schemes are also being reviewed, such as subsidised concessionary travel[55]. Others – including many in this month's Programme for Government – are likely to be borne within portfolios.

Over the medium term, further spending pressures are emerging. Of most significance is the delivery of Scotland's new social security powers.

In this chapter we set out what the outlook could be like for particular parts of the budget over the next few years.[56]

[54] www.gov.scot/About/Performance/scotPerforms

[55] A consultation is underway looking at options to make sure the scheme remains affordable in the coming years.

[56] In the main, we compare the budget for 2018/19 with 2017/18 and 2020/21 with 2016/17 (i.e. the full parliamentary term). When considering changes we use Draft Budget to Draft Budget comparisons.

In Section 4.2, we outline some core spending pledges and their associated costs, before considering the implications for non-protected areas. The pledges we focus on are educational attainment, health, police and childcare[57].

But that is not the end of the story. Sections 4.3 and 4.4 consider some of the wider spending pressures facing the government in the coming years, particularly around pay, revenue financing of infrastructure and the need for a more strategic approach to manage the public finances.

In Section 4.5, we discuss the issue of social security and how this will no doubt emerge as arguably the most unpredictable – and potentially expensive – element on the government's financial risk register.

Section 4.6 focusses on the outlook for capital spending. In Section 4.7, we close with a discussion of local government[58].

Section 4.8 concludes.

4.2 Explicit resource spending commitments

Next year, the Scottish Government will spend around £27 billion on running day-to-day public services[59]. At first glance, this looks as though Ministers have significant resources at play to change spending priorities and find savings.

But in reality, much of this spend is difficult to alter (at least in the short-term).

Some of this rigidity stems from the costs of running government, such as pay and pensions, heating costs for public buildings, infrastructure payments, maintenance obligations and the costs associated with minimum legal commitments in certain areas.

But it also comes from the fact that political commitments can build in their own inertia. For example, it is hard to imagine the government moving away from free higher education tuition.

All this has knock-on effects in other areas which, faced with tight budget settlements, will feel the squeeze even more acutely.

[57] It should be noted that our focus on these areas is not to suggest our assessment of prioritisation. Instead the aim is simply to illustrate the scale of the overall financial outlook dictated by certain commitments.

[58] Based upon the analysis set out in this report, the scale of the financial challenge facing local authorities is likely to remain significant. It will undoubtedly spark a debate about the future of local government finance and local services. The Programme for Government has committed to facilitating such a debate.

[59] Excluding Capital spending.

To illustrate how commitments can have an impact on the overall shape of the budget, we focus upon four major policy commitments on the resource budget that have been outlined for this current Parliamentary term:

- Health
- Police
- Childcare
- Educational attainment fund

It should be noted that the Scottish Government clearly has other priorities, some of which could be argued are just – if not even more – politically important. Improving standards in education overall (outside the attainment commitments) is a case in point.

The Scottish Government is also a minority government. So they will require others in the Scottish Parliament to either support or acquiesce to their budget. Many of the commitments that the Scottish Government are committed to are also likely, particularly commitments to health spending, to be supported by most of the other parties.

So while it is rightly the responsibility of the current government to deliver their budget, it will also be a challenge to the other parties to wrestle with the same balancing act of priorities. Simply criticising the government for not spending enough in one area or cutting budgets elsewhere is not enough.

Health spending

Health has been a budget priority since devolution.

There are a number of drivers behind this trend, alongside the clear policy commitment by successive administrations.

Firstly, the Scottish population has been growing (up 7% between 1999-2000 and 2017-18) and is getting older (aged 65+ has increased by 25%)[60]. Secondly, costs have also been rising as a result of new treatments and ambitious service delivery commitments.

The Scottish Government has pledged to increase the NHS revenue (or resource) budget by £500 million more than inflation by the end of the parliament.[61] Based on the latest inflation figures, this now implies an increase in the health resource budget from £12.3 billion in 2016/17 to £13.9 billion by 2021/22. This is equivalent to a 3.2% real terms funding increase.

[60] Chapter 5 discusses long-term trends in health spend in more detail.

[61] The Scottish Government has stated that the commitment to the "end of the Parliament" is for the final budget set in this Parliament, which would be for financial year 2021/22.

For 2017/18, the Scottish Government allocated £12.7 billion to the health revenue budget. So funding will have to rise by a further £1.2 billion over the remainder of the Parliament to meet the commitment.

As the exact profile has yet to be set out, for simplicity in the analysis that follows, we assume that the increase is phased equally over the forecast period.

Police spending

The Scottish Government has committed to protect the police resource budget in real terms over the course of the parliament.

This implies an increase in funding for the Scottish Police Authority from £1.07 billion in 2016/17 to £1.14bn in 2020-21 (£1.17 billion in 2021/22).

The transition to Police Scotland has continued to remain challenging with Audit Scotland critical of the apparent lack of a long-term financial strategy[62].

Childcare

The government has also committed to doubling the number of hours of free early learning and childcare to 1,140 hours per year for all 3 and 4 year olds, and eligible 2 year olds, by 2020.

In March, the government published a Blueprint and Action Plan[63] for its Childcare Strategy. But there has yet to be any detailed costings of how much it will cost to deliver the commitment. The Programme for Government has committed to guaranteeing a multi-year package of funding for local authorities to plan for and implement the expansion. The Programme for Government indicates that this will be published this autumn.

We will see more detail in the near future, but the most recent figure remains the 2016 SNP Holyrood Manifesto which highlighted a cost of an additional £500 million per annum by the end of the Parliament[64]. In 2016-17, £402 million was estimated to have been spent on Early Learning and Childcare[65].

The expansion is being delivered by local authorities. As such the transfer of funds will be subject to a negotiation with COSLA about how to deliver the increased service.

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[62] Audit Scotland identified that, even after the commitments given to maintain funding in real terms, financial pressures are likely to see the Scottish Police Authority face deficits of between £18m and £60m each year from 2016/17 to 2020/21. See: http://audit-scotland.gov.uk/uploads/docs/report/2016/s22_161222_spa.pdf. Since then, Police Scotland have set out a longer term plan in their Policing 2026 Strategy.

[63] www.gov.scot/Resource/0051/00515637.pdf

[64] www.snp.org/manifesto_2016

[65] www.gov.scot/Resource/0050/00506148.pdf

Educational Attainment

The First Minister has made improving Scotland's attainment record in education – both in terms of overall performance and closing the gap between those from the poorest and most affluent backgrounds – a key priority.

Recent results from the Programme for International Student Assessment (PISA) showing the performance of Scottish students declining in some key areas compared to comparator countries[66] has only served to increase the level of scrutiny around this commitment.

The government has earmarked a total of £750 million through the Scottish Attainment Fund over the course of this parliament. In 2017/18, £120 million was allocated according to how many children in primary school and the first three years of secondary school were entitled to free school meals. Schools have significant autonomy to determine how to use this funding, with the government and local authorities providing guidance to head teachers about successful approaches and interventions.

Protecting these 4 areas has implications for other non-protected budgets…..

These four commitments represent a significant investment by the Scottish Government.

Table 4.1 shows the financial implications for spending on health, police, childcare and educational attainment by 2020/21.

We have followed Scottish Government practice of expressing spending plans and commitments at a portfolio level to include 'non-cash' DEL[67].

It is estimated that total spend in these areas will total just over £15 billion (or 55% of Resource DEL) in the final financial year of this Parliament (2020/21). This is a real terms increase on 2016/17 of 5.2%.

Delivering these commitments will require substantial reprioritisation elsewhere.

Chart 4.1 sets out the implications of these commitments for non-protected portfolios, under a variety of budget scenarios – as set out in Chapter 3 (See Box 4.1 for an overview).

Under the central scenario, the implication for non-protected portfolios is that they could see real terms cuts of 10.9% by the end of the parliament. This is an annualised rate of -2.9%. The estimated cuts are concentrated in 2018/19 and 2019/20.

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[66] See www.gov.scot/Publications/2016/12/7252

[67] Non-cash DEL is an accounting adjustment to cover depreciation and impairments and does not represent actual spending power. Non-cash DEL accounts for just over £1 billion in 2017/18, rising to £1.1 billion in 2019/20.

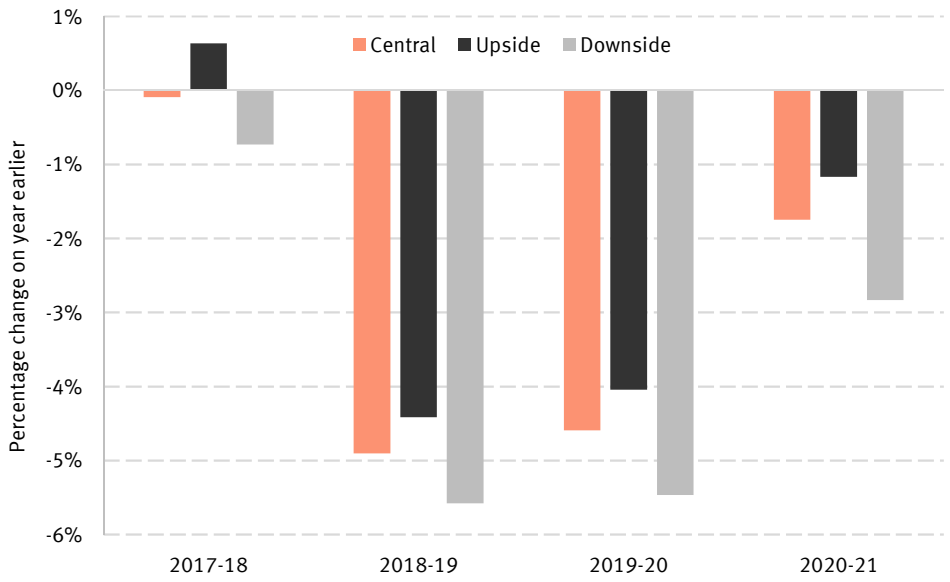
Under a more 'upside' budget risk scenario, non-protected portfolios would see average real terms cuts of 8.8%.

Table 4.1: Real terms spending commitments and implications for the Scottish Government resource budget, 2017/18 prices, (£ million)

Commitments	Allocation 2016/17	Allocation 2017/18	Expenditure in 2020/21 (£m)	*% Change 16/17 to 20/21*	*Annualised % change 16/17 to 20/21*
NHS – spend £500 million more than inflation by end of Parliament	12,554	12,660	12,961	*3.2%*	*0.8%*
Police Scotland – protect in real terms[68]	1,087	1,092	1,087	*0.0%*	*0.0%*
Childcare – double provision	409	561	857	*110.0%*	*20.4%*
Educational Attainment - £750 million over parliament	0	120	150	*n/a*	*n/a*
Total spend on committed areas		*14,533*	*15,091*	*5.2%*	*1.3%*

Source: Fraser of Allander calculations

Chart 4.1: Real terms budget implications for non-protected portfolios under a variety of budget scenarios, 2017-18 prices, (£ million)



Source: Fraser of Allander Calculations

[68] The Scottish Government allocated fractionally more that it needed to in 2017-18 to meet its real terms protection of police commitment.

But under a more 'downside' budget risk scenario, non-protected portfolios could face cuts of 13.9% in real terms.

The exact point estimates of each scenario are not especially important per se. And clearly, any combination of factors could occur.

What is important however, is the *scale* of the challenge. Changing the assumptions will not change the overall direction of travel.

To put these numbers in context, a 10.9% reduction in spending on non-protected portfolios is equivalent to just under £1.5 billion in today's prices. A cut of £1.5 billion is equivalent to the entire 2017-18 spend on the 'finance and constitution', 'economy jobs and fair work', 'environment, climate change and land reform', 'culture, tourism and external affairs' and "administration' portfolios.

Clearly any savings will not be distributed evenly across non-protected areas, but the average cut is clearly substantial. Many of the areas impacted are ones which have been dealing with significant fiscal consolidation over a number of years.

Box 4.1: Recap of scenarios

- Central scenario: Block grant remains the same outlined in March 2017. Scottish income tax base grows at the same per capita rate as that in rUK, where the Scottish Government continues to set a lower threshold for the higher rate than in rUK, LBTT underperform the BGA as per 2016/17, and where the Scottish Government implements its commitment to halve the burden of Air Departure Tax.

- Upside budget risk scenario: Block grant remains the same as outlined in March 2017. Scottish wages grow slightly faster than UK wages, LBTT revenues match the BGA.

- Downside budget risk scenario: Block grant remains the same as outlined in March 2017. Scottish wages grow less quickly than UK wages, the UK Government decides not to raise the higher rate threshold above the rate of inflation, and Scottish LBTT revenues underperform the BGA to the same extent as in 2016/17

4.3 Other policy commitments

The examples provided in Section 4.2 are just a snapshot of the government's current policy commitments.

Here we highlight a further two – public sector pay; and the continuing goal to improve standards in education.

Pay pressures

In last year's report, we highlighted the risk from higher inflation. In August, the UK Consumer Price Index (CPI) increased to 2.9%.

Higher inflation reduces the real terms value of a given level of cash spending; costs go up meaning spending buys less. It also means that protecting certain budgets in real terms, like Police and Health, become more expensive.[69]

But the most significant way in which higher inflation is likely to manifest itself as a cost is in terms of the pressure on public sector pay.

Public sector pay is the largest call on the day-to-day spending of the Scottish budget. The latest available estimate suggests that pay equated to approximately £15 billion in 2016/17- or over 55% of the government's entire resource budget.

The Scottish Government has adopted a twin-track approach to pay in recent years.

The first strand has been a policy of no-compulsory redundancies, maintenance of 'progression', and pay awards targeted at those on the lowest incomes (including delivering the Living Wage). These are not without cost.

The second strand has been pay restraint with modest (below inflation) pay awards. Mirroring UK-wide policy, public sector pay awards in Scotland have largely been capped at 1% since 2013, following two years of freeze in 2011 and 2012.

However in the 2017 Programme for Government, the government committed to unilaterally lift the 1% cap on public sector pay[70]

Increasing public sector pay above the 1% pay cap will have significant budgetary implications. As a rule of thumb, a 1% uplift across all public sector workers adds £150 million to the pay-bill. Based on the latest CPI figures for August (2.9%), protecting public sector wages against inflation would incur a gross cost of approximately £450 million[71]. The Scottish Government will be no doubt

[69] "Real terms" budget calculations are made using the GDP deflator. This is a different measure of inflation to CPI which is what most households are interested in. Economy wide measures of inflation may not be wholly accurate for individual portfolios where local inflation rates may look quite different – e.g. the NHS.

[70] The Scottish Government does not set pay policy for all of the Scottish public sector. For example, Local Government employees are not covered by the Scottish Government pay policy.

[71] Of course, a proportion (we estimate around £80m) of the money allocated to the pay-bill will return to the Scottish budget via income tax receipts, but nevertheless it is a significant commitment.

hoping that the UK Government moves away from the pay cap thus releasing Barnett consequentials to help fund this commitment[72].

Education – the "defining mission"[73]

The other significant commitment worth highlighting is education.

In Section 4.2, we incorporated the commitment around the Attainment Fund.

It seems likely that given the scrutiny on education standards at the current time, the government will seek to find some funding to maintain – at least in some form – the investment in school education outside these attainment commitments.

The commitment in 2017/18 to maintain the pupil:teacher ratio and to secure teacher placements for all probationers who required one cost £51 million and £37 million respectively. Similar investments – although the programme may differ – are likely.

It is not just school education that is likely to be a priority. The government is committed to maintaining the number of college FTE places[74] which stood at 116,000 in 2017-18.[75] A reasonable assumption might be that such a commitment will require the college resource budget to be maintained, at least in cash terms, at £550 million.

On university funding, the outlook is more uncertain. Alongside this however, one thing that is more certain is continuation of the government's flagship free tuition commitment (at a cost of over £217 million per year).

A scenario where free tuition is continued, the college budget is protected in cash terms and a further £90 to £100 million is invested in school education would tie-up a further near £900 million of spending.

Adding this to the commitments above would suggest that closer to 60% of the government's resource budget would be committed by the end of the Parliament[76]. As a result, the challenge placed on non-protected portfolios will be that bit greater.

4.4 Additional financial constraints

Alongside these explicit policy commitments, some other elements need to be factored in.

[72] Although the recent announcement of pay rises for both prison officers and police officers by the UK Government was to be paid for within current departmental limits.
[73] See https://beta.gov.scot/publications/first-minister-speech-priorities-for-government/
[74] www.snp.org/manifesto_2016
[75] www.gov.scot/Resource/0051/00511808.pdf
[76] 59% in 2020-21.

We focus on two here –

- Repayment commitments for Non-Profit Distributing (NPD) and Private Finance Initiative (PFI) programmes.

- The need to build resource in the Scotland Reserve to support in-year cash management and respond to forecast errors associated with the new tax and social security powers.

Revenue financing of capital investment

The government faces funding obligations arising from ongoing public private partnership (PPP) projects in the form of NPD and PFI legacy contracts[77].

Estimated payments under past PFI and NPD contracts are expected to be around £1.1 billion in the current financial year (2017/18).

Annual repayments come from the Scottish Government's resource budget.

Table 4.2: Estimated payments under PPP Contracts, (£ million)

	2016/17	2017/18
Health and Sport	244.1	248.9
Finance and the Constitution	-	-
Education and Skills	351.0	357.7
Justice	51.5	51.5
Communities, Social Security and Equalities	148.0	149.9
Rural Economy and Connectivity	94.0	96.4
Culture, Tourism and External Affairs	-	-
Economy, Jobs and Fair Work	-	-
Environment, Climate Change and Land Reform	151.3	154.8
Administration	-	-
Total	*1,039.9*	*1,059.2*

Source: Scottish Government Draft Budget 2017/18, Annex H

The government has committed to spending no more than 5% of its total DEL budget on repayments from revenue financing (NPD, PFI and regulatory asset base (RAB) rail investment) along with any repayments resulting from its new borrowing powers.

[77] Under such projects, the private sector finances the upfront capital costs associated with a project and, on completion, continues to maintain and, in some cases, operate, the asset. The public sector then makes annual payments ("unitary charges") to cover the capital costs, interest costs and maintenance/service charges usually over 25-30 years.

Based on current plans, the government will spend just over 4% of its total DEL budget on such payments in 2017/18, rising to just under 4.5% in 2020/21.

Strategic budget management and the importance of establishing reserves

As we discussed in Chapters 1 and 3, the devolution of tax and social security powers will mean that the Scottish budget is now subject to much more uncertainty.

Not only are tax revenues and demand-led social security spending inherently volatile within year and from one year to the next, but there will also be a degree of error associated with any given forecast.

And as well as being exposed to error in the Scottish forecasts, the Scottish budget will also be exposed to forecast error in the BGAs.

Managing these financial risks will be a key consideration for the Finance Secretary.

Of course, the government now has access to a number of tools to help smooth the effects of forecast errors and other in-year cash management issues. These include the ability to borrow £500 million per year for cash management and £300 million per year for forecast error. These are modest amounts when compared to the overall size of revenues and the BGA, so while giving some flexibility to the Scottish Government they still face a much firmer bottom line than the UK Government.

The Fiscal Framework also makes provisions for a cash reserve – the Scotland Reserve –which can be used to provide funds which can be drawn upon when needed[78]. The government is able to build up reserves of £700 million and draw these down at a rate of up to £250 million for resource spending and £100 million for capital spending each year.

Use of either the borrowing powers or the Scotland Reserve will have implications for the government's remaining budget. Borrowing in any given year will boost the budget but will incur repayment costs in the future. Building up the Scotland Reserve implies an opportunity cost (in terms of reduced expenditure) today but greater resilience in future years.

There may be a temptation to assume that the Scotland Reserve will build up naturally, perhaps as a result of using underspends (whereas in the past such monies would have been used to support additional spending commitments in subsequent years). However, a more strategic and pre-planned approach is likely to be needed.

[78] Using own resources is always likely to be preferable to borrowing money (which carries a charge).

4.5 Social Security

As highlighted in Chapter 1, a number of social security powers are being devolved. Spending on these benefits in Scotland in 2017-18 is estimated at around £2.9 billion.

These powers offer an opportunity to implement a different 'type' of social security system in Scotland. At the same time, there are also opportunities to make long term savings for the public finances if these new powers can be more effectively combined with existing devolved health, social care and education responsibilities.

But they also bring with them new spending pressures and also responsibilities[79].

First, the Scottish budget will bear the risk that expenditure per capita on devolved benefits increases more quickly than equivalent benefits in rUK.

Just as the block grant adjustments for tax are designed to represent the 'revenues foregone' by the UK Government, the block grant adjustments for social security are designed to represent the 'spending foregone' as a result of transferring the powers to the Scottish Parliament.

Spending pressures could arise if demand rises relatively more rapidly (e.g. because of an ageing population). Higher uptake, perhaps as a result of improved awareness of eligibility (which the Scottish Government is keen to encourage), could also result in higher costs. Of course, if demand rises less quickly then the Scottish budget will recoup the savings.

Secondly, the Scottish Budget will bear the costs (or savings) of any policy differentiation. The costs of a higher benefit rate, or expansion of eligibility, relative to rUK will be borne by the Scottish budget.

In this regard, Ministers have committed to a number of social security policies for 2018/19:

- Increasing the annual value of Carers Allowance to match Jobseekers Allowance; and
- Replacing the Sure Start Maternity Grant with an enhanced Best Start Grant.

The Financial Memorandum to the Social Security Bill sets out indicative cost estimates of around £34 million per year for Carers Allowance and around £17 million per year for the Best Start Grant. These commitments come on top of the existing policy to mitigate the effects of the 'bedroom tax' (which costs around £47 million per year)[80] and £38 million for the Scottish Welfare Fund in 2017-18[81].

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[79] The transfer of some social security and the successful transition to a new system in Scotland is arguably one of the most significant transfers of power since devolution in 1999. The political risk associated with this transfer and the smooth delivery of critical benefits is high.

[80] Similarly rUK policy changes will also have budgetary implications via the block grant. The introduction of means testing for the Winter Fuel Payment, to take a hypothetical example, would result in a reduction to rUK spending and a smaller block grant addition.

[81] http://www.gov.scot/Resource/0051/00511808.pdf

Thirdly, the Scottish Government will bear any additional costs (beyond those agreed with the UK Government) from the establishment and operation of the new Scottish social security system. This includes not just the new Social Security Agency itself, but also arrangements for the benefit assessment process, forecasting, policy design, and so on.

The Financial Memorandum to the Social Security Bill contains preliminary estimates of the costs of the new Social Security system. Set-up costs are estimated at £308 million over the four year period to 2020/21. Running costs, once fully operational, are estimated at between £144 million - £156 million per annum[82].

Under the deal to ensure support for the Fiscal Framework, the UK Government has agreed to transfer up to £66 million per annum to cover these administration costs. They are also making a one-off transfer of £200 million to cover implementation costs (of which £100 million has been transferred so far). Note that these transfers are to cover *all* costs associated with the newly devolved powers, not just social security.

Clearly the costs put forward by the Scottish Government exceed the transfer from the UK Government for all devolved powers – set-up costs of £308 million vs. £200 million and running costs of around £150 million vs. £66 million.

Finally the devolution of social security powers, together with the process for adjusting the Scottish block grant, also poses a degree of in-year cash management risk which has to be managed. Box 4.2 discusses these issues and the implications for the Scotland Reserve.

Box 4.2: Forecasting expenditure on devolved social security benefits and the implications for in-year cash management

The Scottish Fiscal Commission (SFC) will be responsible for producing the official forecasts for spending on the devolved social security benefits in Scotland.

The Block Grant Adjustments (BGAs) for the social security benefits will initially be based on UK Government (DWP) forecasts for spending on 'equivalent' social security benefits in rUK. The forecast BGA will be added to the Scottish block grant.

Once outturn expenditure on the benefits is known, the forecast BGA will be 'reconciled' with the outturn BGA.

This process creates a cash management risk for the Scottish budget.

A practical example is as follows:

[82] This is around 5% of the value of benefits being devolved.

- Imagine that the Personal Independence Payment (PIP) has been devolved, and that on the basis of rUK expenditure forecasts, a BGA of £1.5 billion is transferred. The SFC forecasts Scottish spending at £1.5 billion, so the budget is in balance.
- However, imagine that higher than anticipated demand results in expenditure in rUK on PIP being 7% higher than forecast, and for the same reasons, expenditure is also 7% higher than forecast in Scotland.
- The Scottish Government now faces a cash management issue, in that its spending on PIP is higher than its BGA.
- Once it emerges that the UK Government realises that its expenditure is higher than was forecast, there is scope for the BGA to be revised upwards 'in-year'. Nonetheless, there will be a lag between the initial transfer to the Scottish budget (based on the UK Government forecast), and the upward revision to the BGA, and during this period of lag the Scottish Government will need to fund any expenditure on PIP over and above the BGA from within its existing resources.

4.6 Capital Spending

Table 4.3: Scottish capital budget allocation, (£ million)

	2016/17	2017/18	change 16/17 to 17/18	*change 16/17 to 17/18 %*
Health and Sport	524.5	408.1	-116.4	-22.2%
Finance and Constitution	3.5	2.0	-1.5	-42.9%
Education and Skills	99.5	171.4	71.9	72.3%
Justice	74.8	91.5	16.7	22.3%
Economy, Jobs and Fair Work	138.5	137.7	-0.8	-0.6%
Communities, Social Security and Equalities	1,319.5	1,485.1	165.6	12.6%
Of which Local Govt	*606.9*	*756.5*	*149.6*	*24.6%*
Environment, Climate Change and Land Reform	20.2	142.8	122.6	606.9%
Rural Economy and Connectivity	1,294.7	1,407.8	113.1	8.7%
Culture, Tourism and External Affairs	32.4	32.0	-0.4	-1.2%
Administration	13.1	13.1	0.0	0.0%
Crown Office and Procurator Fiscal	3.6	3.6	0.0	0.0%
Total	*3,526.0*	*3,895.1*	*369.1*	*10.5%*

Source: Scottish Draft Budget 2017/18. Notes: figures include Financial Transactions and assume that the Scottish Government's borrowing powers are utilised.

The Scottish Government's capital budget allocation by portfolio is shown in Table 4.3.

The Communities, Social Security and Equalities portfolio has the largest capital budget of any portfolio at just under £1.5 billion. Around half of this capital allocation goes to Local Government (£756.5m) with nearly £700 million going to Housing, principally the construction of affordable homes.

The Rural Economy and Connectivity portfolio has an allocation of £1.4 billion, with motorways and trunk roads (£627m) and Rail Services (£462m) the largest elements.

As set out in the previous Chapter, the outlook for capital spending is relatively positive, with the capital grant from Westminster on track to increase by around 5% in real terms in both 2018/19 and 2019/20.

4.7 Local Government

Our report last year highlighted that, given budgetary constraints and commitments made to various other portfolios, the settlement for local government in 2017/18 was likely to be particularly constrained.

In the end, the local government settlement was indeed the subject of both significant scrutiny and contention.

The financing arrangements for local government are complex. Local government revenue is derived from a number of sources:

- The General Resource Grant & Specific Revenue Grants
- Non-Domestic Rates Income
- Council tax revenues
- Income from fees and charges[83]

The revenue funding provided by the Scottish Government consists of the General Resource Grant (GRG), Specific Revenue Grants (SRG), and Non-Domestic Rates Income (NDRI). The GRG and ring-fenced SRGs are paid to local authorities from the Scottish Government's budget. Non-Domestic Rates on the other hand are collected by local authorities, paid into a central pool and then re-distributed.

The Scottish Government guarantees to provide the total of GRG and NDRI. Council tax revenues raised by each local authority are retained.

[83] Ranging from parking fees to income from social care services.

The local government settlement has declined by around 9.5% since 2010/11[84], equivalent to around £1 billion in real terms (this includes the £120 million allocated in 2017/18 for the Attainment Fund).

Box 4.3: The local government settlement in 2017/18

In presenting its Draft Budget 2017/18, the Scottish Government stated that spending to support local authority services would increase by over £200 million between 2016/17 and 2017/18.

The core settlement for local government however, included a reduction of around £100 million in the General Resource Grant, and a reduction of around £100 million in the level of redistributable Non-Domestic Rates[85].

The amount of funding that local government received from the Scottish Government to fund discretionary spending thus declined. But against this, the settlement included –

- £120 million in specific, ring-fenced grants to support school attainment; and
- Funding of £107 million for Health and Social Care Integration (mainly for paying the Living Wage to social care workers), albeit this had already been included in the Government's health spending line.

Additionally, the government included in its definition of 'local authority services' the revenue from increases to the council tax via both an uplifting of the freeze and changes to property bands (which could have raised £70 million and £111 million respectively).

The Scottish Government argued that the amount of money being diverted toward local services was increasing. Opposition parties pointed out that the amount of direct funding to local authorities to pay for existing services was falling.

The presentation of local government vis-à-vis funding for local services is likely to remain a source of much debate. Whilst it is entirely appropriate that funding pools are shared and different service providers work together to maintain or improve *outcomes*, too often the presentation of budget lines are for political purposes rather than informing debate. A much more open and transparent approach would be a step forward – as has been called for by the Local Government and Communities Committee[86].

[84] This controls for the fact that police and fire services were removed from local authority control in 2013/14.

[85] These figures reflect those at Stage 2 of the Budget Bill, after the Government had reached agreement with the Green Party to increase local government funding.

[86] "The Committee believes that greater transparency is required, and that the Draft Budget for local government, and the allocations to local authorities are very difficult to follow. It is essential in scrutiny terms that this Committee and the Parliament as a whole is clear on exactly how much money local authorities can be expected to receive and from what sources and with what conditions, if any, on their purpose." From: www.parliament.scot/S5_Local_Gov/Reports/LGCS052017R02.pdf

Has the local government settlement fallen disproportionately in the context of the Scottish Government's overall budget?

Perhaps, but not as much as might be expected. Local government's revenue funding (general resource grant, specific grant and NDRI) as a share of the Scottish Government's RDEL grant plus NDRI, has fallen from 35% to 33% between 2010/11 and 2017/18 – this is equivalent to around £570 million in 2017/18.

The reason the local government settlement has not declined more is that NDRI has proved relatively buoyant.

NDRI grew by an average of 3.5% per year in real terms between 2010/11 and 2016/17. This was partly due to 'buoyancy' of the tax base (i.e. growth in the number of premises subject to tax) and inflationary increase in the 'poundage' (i.e. the tax rate).

What is the outlook for local government funding?

The first point to note is that unpicking the outlook for local government could look particularly complex. For example, if the government chooses to invest 'new' money in childcare and education the budget for local government could increase. But that is of course money for 'new' spending, so existing pressures remain.

There are two elements to the question of the outlook for local government budgets – the outlook for the General Resource Grant and the outlook for NDRI.

Local government is arguably the largest element within the 'non-protected' part of the Scottish budget. Earlier in this chapter we set out a central scenario which would see cuts to non-protected portfolios of 10.9% in real terms between 2016/17 and 2020/21. Our upside scenario sees cuts of 8.8% whereas a downside scenario sees cuts of 13.9% to non-protected portfolios.

Offsetting this, some buoyancy in Non-Domestic Rates Income is expected. With the poundage set to increase in line with inflation, these forecasts suggest that Non-Domestic Rates revenues will remain buoyant.

Box 4.4: The NDRI pool

The non-domestic rate income (NDRI) pool came to prominence during the 2017/18 Budget when, at stage 2 of parliamentary proceedings, the government transferred £60 million from the pool to help fund £220 million of new commitments over and above the those allocated in the Draft Budget.

How could they find such money just a few short weeks after the draft budget was published?

Each year the government makes a forecast for non-domestic rates (NDR) and guarantees the revenues from that forecast to local government. This acts like a withdrawal from the pool. The

Scottish Government then receives the NDR revenue as the year progresses, which acts as a payment into the pool.

Over time the withdrawals from and income to the pool should balance out.

But the most recent year for which we have audited information on, the balance of the NDRI pool in 2015-16 was a *deficit* of £215 million leading to a cumulative net deficit in the NDRI pool by 31 March 2016 of £289m.

It is entirely appropriate for the pool to be in deficit in certain years, what matters is the profile of the pool going forward and – if in deficit – how the Scottish Government plans to manage it back to balance. With a deficit of £289 million in 2015/16, it is highly likely that the room for manoeuvre will be especially tight in the coming years. With any pool shortfall representing a further risk on the Scottish Budget.

With the Fiscal Commission soon to be forecasting business rates income from now on, how these new forecasts will reconcile with the government's current expectations for future income will have a bearing on the resources at its disposal.

Whatever the trajectory is for the NDRI pool, one take-away from this process is that opposition policymakers are likely to press the government much more in the future over whether the Budget initially introduced to parliament is indeed the complete picture of the resources available.

When it comes to Non-Domestic Rates however, a further complication is that what is 'collected' in any given year is not quite the same as what is available to be 'redistributed' to local government. The somewhat complicated arrangements underpinning the NDRI pool are described in Box 4.4.

Combining these two elements – the outlook for the General Resource Grant and the outlook for NDRI – provides a picture of the likely balance of the local government settlement (Table 4.4)

Table 4.4: Outlook for local government general revenue budget (Resource grant + NDRI), 2017/18 prices, (£ million)

				Change, 2016/17 – 2020/21	
	2016/17	2017/18	2020/21	£ million	%
Central scenario	9,774	9,428	8,854	-920	-9.4%
Upside scenario	9,774	9,428	8,956	-818	-8.4%
Downside scenario	9,774	9,428	8,691	-1,083	-11.1%

Source: Local Government Finance Order 2017 and Fraser of Allander calculations

As highlighted above the funding to local authorities may differ from this outlook if additional monies to help deliver on any of the government's broader objectives – e.g. funding to support delivery of the childcare commitment or aspects of the new social security powers. But the settlement is likely to be especially challenging.

What about council tax?

The nine-year council tax freeze ended in 2017/18 with local authorities able to increase rates by up to 3%[87].

Whilst the decision not to increase rates might seem surprising, with council tax accounting for only around 15% of local government revenue a percentage increase in the tax rate (which is very visible to local residents) results in a proportionately small increase in budgets.

As well as the end of the freeze, 2017/18 also marked a change to council tax bands with those in more expensive bands paying more – raising an additional £180 million in total for local government in 2017/18.

It remains to be seen whether councils will increase tax rates further in 2018/19, although this seems likely. Further reform to the banding structure may happen at some point, but may be seen as politically inexpedient in the near term.

Local Government - Summary

Given priorities in other areas, it is no surprise that local government budgets have been under pressure. The cuts would have been worse had it not been for the relatively strong performance of Non-Domestic Rates.

The last few years have seen changes in overall funding, the responsibilities of local government, and the way in which money has been spent. Yet partly because these changes are happening gradually, there has been little public debate around the evolving nature of local government service delivery, or how these services are funded.

These challenges highlight why many are now calling for a debate about local government's role in service delivery, and how these services are funded in the future. The Programme for Government stated that the Scottish Government is "committed to work with local authorities to review their roles and responsibilities".

[87] 21 of Scotland's 32 councils chose to increase rates by the maximum 3%, whilst eight froze them for a tenth year. The remainder increased their rates by less than 3%.

4.8 Conclusions

The Scottish Government has committed to increase real terms spending on health, continuing a trend that has been observed since 1999.

The Government has also made flagship commitments to increase provision of childcare, maintain real terms spending on police and direct resource at closing the educational attainment gap. These four commitments alone account for over half of the government's resource budget.

There is clearly some uncertainty around exactly what level of resource the government will have available for each of the remaining years of this parliament.

But the projections suggest that these three commitments will imply that non-protected portfolios may have to plan for cuts after inflation of 9-14% between 2016/17 and 2020/21.

Of course, with a tight settlement those who argue against such cuts need to put forward where money will be saved elsewhere – including not following through with these commitments on health, childcare and policing – or to outline where taxes will rise.

In this context, the First Minister has committed to bringing forward a publication to frame the public debate on income tax which will precede the budget. Like the Scottish Government, the Scottish Parliament will have to consider the right balance between tax and revenue for both the economy and public services.

Looking forward, the government is also facing a number of other spending pressures. Some of these reflect explicit policy choices – for example the pledge to remove the 1% public sector pay cap – whilst others – such as the costs of building up the Scotland Reserve and in delivering a new Social Security Agency – are necessary commitments tied to the new fiscal framework.

Whatever the source, it is clear that the Scottish Government is going to have a careful balancing act over the coming years if it wishes to deliver on all its commitments and ambitions.

Chapter 5: Long-term fiscal challenges

- The size and distribution of the Scottish Devolved budget has changed markedly in recent years. Both are forecast to change further in the years to come.
- As highlighted in Chapter 3, in order to restore the public finances to a sustainable level, there have been reductions in the real terms value of public spending across the UK. With a growing population, these reductions have been even more significant on a per capita basis. The Scottish Government's resource spending per head – including income raised from NDRI – is likely to be around 10% lower in real terms by 2020/21 compared to 2010/11.
- Within this period, the health resource budget has been a priority. Real terms health resource spending is forecast to increase by around 10% between 2010/11 and 2020/21. As a result, non-health resource spending has seen substantial declines. On a per capita basis, average resource spending in areas other than health is, on current projections, expected to be 19% lower in 2020/21 in real terms than a decade earlier.
- Demographic change and other cost pressures mean that the health resource budget is likely to have to increase by around 2% per year in real terms over the period to 2030 just to stand still.
- If the prioritisation of the health resource budget is continued, the implication is that further spending reductions will be required elsewhere or new sources of revenue found. A strategic look at the long-term sustainability of Scotland's devolved budget is required.
- On spending, options include reforms to the way in which public services are delivered, with a view to a more preventative and strategic approach; a more targeted approach to the allocation of scare public sector resources; and a reappraisal of the services provided by the state.
- On revenue, a number of options are possible – particularly around income tax. But as set out in Chapter 2, there are also some practical constraints.
- Of course, the Scottish budget could grow by implementing policies to stimulate the economy, and more particularly, by growing revenues from the taxes that are devolved. But these ambitions are easier said than done. What is clear is that growth needs to be part of an overall package of measures. Current increases in GDP per head of under 2% in 10 years is not going to sustain much – if any – new investment.
- Substantial changes are happening to the balance of and scale of public spending, and the way in which devolved revenues are raised. An open and transparent debate about Scotland's devolved public finances is now essential.

Major changes in the size of the Scottish resource budget and the way in which it is distributed across different public services will take place between 2010/11 and 2020/21. Spending on health is being prioritised in the face of a growing and ageing population, and rising non-demographic costs. But non-health areas of the Scottish budget will decline by 15% over the course of the decade. On a per capita basis, spending on non-health areas will decline by 19%. Despite this, increases in the health budget are only just sufficient to keep up with changes in the population. Over the period to 2030, health spending will need to rise by around 2% per year to keep up with demographic and other cost pressures, further constraining non-health budgets. Options for cutting spending or raising revenue are limited. A larger economy will generate higher revenues, but basing fiscal policy on an expectation that growth rates will rise is risky. A more strategic approach is required. An open and transparent debate is needed about the scale of the long-term fiscal challenge and how we might address it.

5.1 Introduction

In the chapters so far, the analysis has centred upon the outlook for the Scottish budget up to 2020/21 or 2021/22. But a focus solely on the short term risks overlooking more profound trends over the longer term.

Over the past 15 years, we have seen significant changes in the distribution of public spending in Scotland. Health resource spending has been prioritised, but even then, it is struggling to keep pace with the pressure of demographic change let alone wider costs.

Nevertheless, the focus on health has meant that there have been major changes to spending in non-health related areas. If anything, the pressure is for this trend to accelerate. As our population ages and as the prevalence of chronic health conditions increases, Scotland's public finances are likely to come under significant pressure over the medium to long term from rising health costs.

Our analysis leads us to conclude that 'the status quo' is not an option. In short, Scotland's current devolved budget is not sustainable in the long term. It is a challenge that all political parties must face.

Of course, Scotland is not unique in facing such challenges. All governments face similar pressures. But that is no excuse for policymakers to ignore such pressures[88].

A debate is required about the long-term sustainability of Scotland's public finances. This will not be easy, but it is crucial.

The aim of this chapter is to help provide some context for such a debate.

In Section 5.2, we review trends in the level and distribution of spending since devolution.

In Section 5.3, we analyse the medium to long-term pressures that are likely to face the NHS. Whilst other elements of spending will undoubtedly change over time, the outlook for health is the single most important factor influencing the medium-term outlook.

Section 5.4 sets out the need to outline a clear medium term strategy for managing Scotland's fiscal challenge. In the remainder of the chapter we outline some themes in which we believe a debate around Scotland's fiscal priorities should focus.

Section 5.5 considers options for reducing or refocussing public spending and section 5.6 looks at the scope – and appetite – for revenue raising.

Section 5.7 concludes.

5.2 Recent and planned changes to Scottish Government spending

The size and distribution of the Scottish resource budget has changed markedly in recent years – and is forecast to change further in the years to come. We noted in Chapter 3 that the Scottish Government's resource block grant in 2020/21 is likely to be around 8.4% lower than it was in 2010/11[89].

The overall outlook for resource spending is not quite as constrained as this implies. Revenues from NDRI have been relatively buoyant, and are forecast to continue to be so over the period to 2020/21. Although ostensibly a local tax, the central government controls both the rate and base – unlike council tax – and it therefore forms a key part of the resource that government allocates to local authorities.

Taking account of the outlook for the block grant, the outlook for Scottish revenues and BGAs discussed in Chapter 3, and the revenues from NDRI, the Scottish Government's resource spending power is forecast to be around 5½% lower in 2020/11 than a decade earlier.

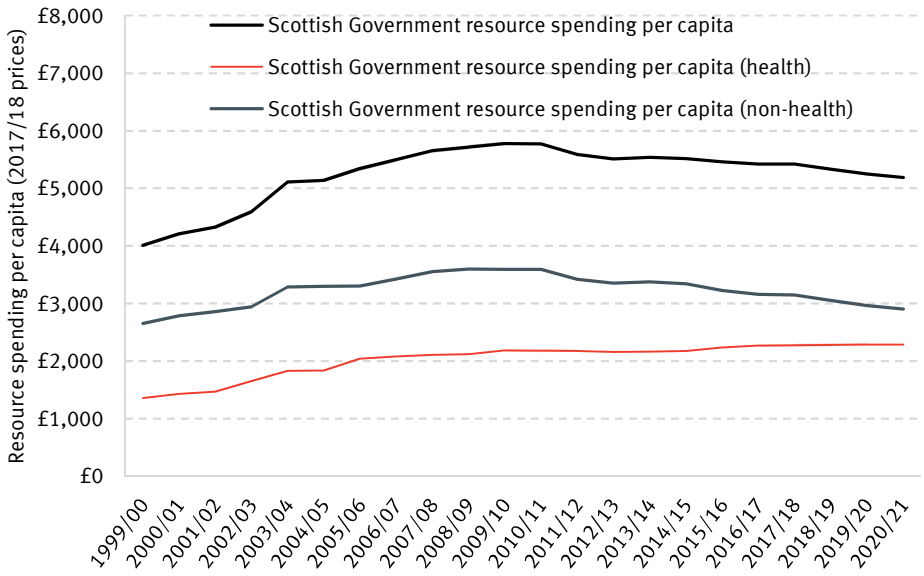
[88] Given Scotland's ageing population and comparatively poor public health record, there are grounds for thinking that such effects might be particularly acute in Scotland.

[89] Discounting the 'new' spending associated with the devolution of social security

But at the same time, Scotland's population has increased from 5.3 million in 2010/11 to 5.4 million today. It is projected to reach over 5.5 million by the end of the decade.

The combination of spending retrenchment plus a growing population means that, in per capita terms, the Scottish Government's resource spending (including NDRI) is likely to be 10% lower in real terms by 2020/21 compared to 2010/11 – see Chart 5.1. This will take resource spending per head back to 2004/05 levels[90].

Chart 5.1: Scottish Government resource spending (including NDRI) per capita, (£), 2017/18 prices



Source: Public Expenditure Statistical Analysis, various years; FAI analysis

To put this in context, to achieve the same level of spending per capita in 2017/18 as in 2010/11, the Scottish resource budget (including NDRI) would need to have grown to £31.3 billion – this is £1.9 billion more than the current budget. By 2020/21, assuming that Scotland matches the UK's tax performance in the years ahead, the gap is projected to rise to £3.2 billion.

This is not to argue that the levels of public spending in 2010/11 should be a target to which we return. But it helps illustrate the scale of the challenge.

As well as changes to the scale of spending, the distribution of spending has also changed.

As Chart 5.1 highlights, throughout this period, the health resource budget has been prioritised. Real terms health spending is forecast to increase by 10% (£1.2 billion) between 2010/11 and 2020/21 – rising from 38% of the Scottish resource budget (including NDRI) to 44%[91].

[90] The equivalent decline excluding NDRI is 12%.

[91] In 1999/2000 health spending accounted for 34% of the resource budget including NDRI.

But as a consequence, on a per capita basis, real terms resource spending in areas other than health is, on current projections, expected to be 19% lower in 2020/21 than a decade earlier[92].

5.3 Spending pressures in the medium term – the significance of health

The OBR project[93] that (non-interest) UK public spending will rise as a proportion of GDP by six percentage points, from 38% to 44% between 2016/17 and 2066/67[94]. The majority of this is driven by health spending, which is expected to rise from 7.3% to 12.6% of GDP.

Box 5.1: The pressures on health spending

Demand for healthcare spending is driven by demographics, trends in morbidity, and other cost pressures (e.g. drugs).

When allocating resources to Health Boards, NHS Scotland takes into account the demographic structure of the population each Board serves. The very young, and those of older ages, are associated with higher average allocations – see Chart 5.2.

As an illustration of the effects of demography on cost, we combine the age-sex cost profile in Chart 5.2 with population projections from National Records of Scotland.

A limitation with this approach is that, implicitly, it assumes no improvement in *healthy* life expectancy.

To capture this, we assume that the proportion of life spent in good health is around half the total life expectancy at 65. Life expectancy is projected to increase by one year every eight years. In turn this implies that healthy life expectancy will increase by one year every 16 years. The cost curves in Chart 5.2 are then pushed out to reflect this assumption[95].

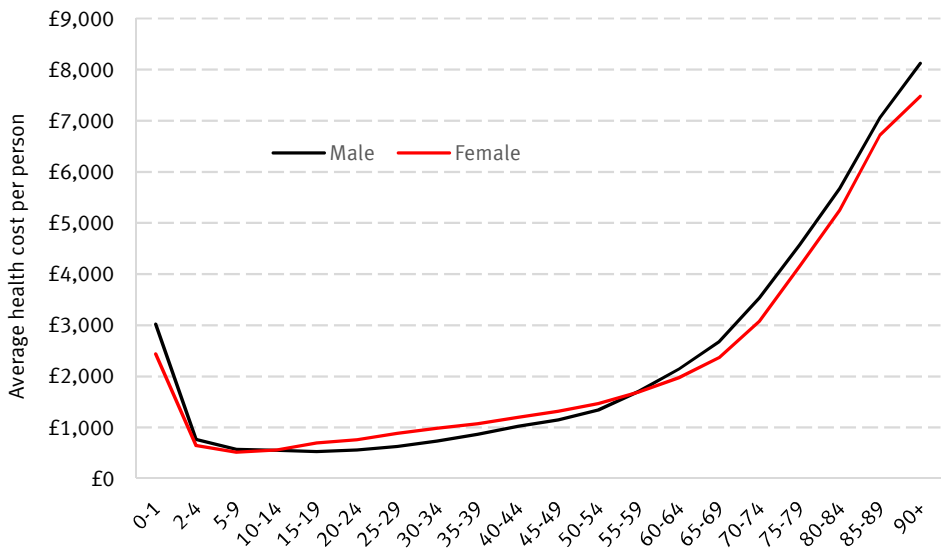
But health spending pressures are driven by more than demographics and morbidity. Non-demographic cost pressures (e.g. technological advances in treatments) have tended to be just as significant in recent years.

[92] Excluding NDRI, spending per capita by the Scottish Government on public services other than health is forecast to decline 24% between 2010/11 and 2020/21.
[93] OBR (2017) Fiscal Sustainability Report http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/
[94] Non-interest public spending is essentially all public spending excluding that which is spent on servicing debt interest repayments.
[95] This approach is similar to that undertaken by the OBR.

The IMF estimates that non-demographic cost pressures in the UK averaged 2.2% per year between 1995 and 2008[96]. Audit Scotland estimates that drug costs increased 10% between 2012/13 and 2014/15[97].

In its modelling of long-term fiscal sustainability in the UK, the OBR assumes that non-demographic costs converge to a long-term average of 1% per year in real terms. The OECD has assumed that non-demographic pressures might increase costs by 1.7% per year[98].

Chart 5.2: Age-sex cost profile



Source: NHS Scotland, FAI analysis.

Notes: the age-cost profiles have been derived by combining (with appropriate weights) the age-cost profiles used by NHS Scotland to allocate resources to Health Boards in the following programmes: Acute, Care of the Elderly, Mental Health and Learning Difficulties, Community, and GP Prescribing. We assume that the £9.3 billion spending of NHS territorial boards is in line with this profile, but that the remaining 30% of NHS resource expenditure is driven by population. This is a fairly conservative assumption, hence our estimated costs associated with old age are lower than those calculated by the OBR[99].

In the analysis that follows, we make a similar assumption – i.e. that non-demographic cost pressures increase health costs – and use the OBR's 1% per annum growth rate as a conservative assumption.

[96] International Monetary Fund, 'Macro-fiscal implications of health care reform in advanced and emerging economies', December 2010, www.imf.org/external/np/pp/eng/2010/122810.pdf

[97] Audit Scotland, NHS in Scotland (2016) http://audit-scotland.gov.uk/uploads/docs/report/2016/nr_161027_nhs_overview.pdf

[98] OECD (2013), "What Future for Health Spending?", OECD Economics Department Policy Notes, No. 19 June 2013. www.oecd.org/economy/health-spending.pdf

[99] OBR (2016) Fiscal Sustainability and Public Spending on Health http://budgetresponsibility.org.uk/docs/dlm_uploads/Health-FSAP.pdf

Health spending has risen in most OECD countries over the past 40 years. Most predictions are for health spending to continue to rise in the future.

As Chart 5.1 highlighted, health resource spending in Scotland has been increasing since devolution. But what appears at first glance to be relatively generous commitments, is not nearly as significant once changes in population are factored in.

The 10% real terms increase in health resource spending between 2010/11 and 2020/21 amounts to only a 5% real terms increase in spending per capita. And this is before taking into account the effects of an ageing population and other cost pressures.

It is possible to provide some illustrative projections for the impact of demographic change and other cost pressures on health spending. Box 5.1 sets out one such methodology.

Health resource spending in Scotland will need to increase by 3.4% in real terms between 2016/17 and 2020/21 simply to keep up with demographic change, including the size of the population and its age structure (Table 5.1).

The Scottish Government's commitment – to increase health resource spending by £500 million more than inflation by 2021/22 – is equivalent to increasing real terms spending by 3.2% between 2016/17 to 2020/21. Thus the commitment is broadly sufficient to 'keep up' with Scotland's growing population.

Introducing the assumption that non-demographic cost pressures increase by 1% per year implies that health resource spending would need to increase by 6.5% between 2016/17 and 2020/21.

The implication is that – whilst generous in the context of the overall budget outlook – the settlement for health may not be sufficient to keep up with demographic trends and a conservative assumption about cost growth.

Table 5.1: Real-terms projected health resource expenditure (2017/18 prices) given various cost pressures, (£ million)

	2016/7	2020/21	2030/31	*Annualised increase to 2020/21*	*to 2030/31*
Costs associated with demographics only	12,554	12,976	14,151	0.8%	0.9%
Incorporating an assumption that costs increase 1% per annum	12,554	13,369	16,105	1.6%	1.9%
Factoring in morbidity improvements	12,554	13,304	15,765	1.5%	1.8%

Source: Fraser of Allander calculations

Pushing such projections forward, we estimate that real terms health resource spending will need to increase by 13% between 2016/17 and 2030/31 to keep pace with demographic change. Accounting for non-demographic pressures implies that health resource spending will need to increase by 28% over the period – a 1.9% average real terms increase per year[100].

If we incorporate an assumption that health improves as the population ages (i.e. a compression of morbidity), this implies that costs will increase by slightly less – an increase of 26% by 2030. The extent to which health improves as life expectancy increases remains to be seen, with some suggestions that physical health is improving to a greater extent than mental health – with unclear budgetary implications in aggregate.

Of course, different assumptions about cost pressures and/or changes in healthy life expectancy will understandably change the exact figures. Much also depends on productivity in the health service and technological change. But whatever scenarios are put in place, the key conclusion that health spending will likely rise significantly in the coming years does not change.

What are the implications for other budgets?

If the Scottish resource budget was to remain fixed in real terms over the period to 2030, a 25% real terms increase in health spending would imply a 19% reduction in non-health spending. If the budget increases at 1% per annum, the majority of this increase will be required to be allocated to health, for spending to keep up with demographic and conservative cost pressures outlined here – leaving an annual increase of around 0.3% for non-health areas.

5.4 Outlining a strategic way forward

As with all such long-term projections, there are understandably significant uncertainties with regard to how future budgets will evolve exactly. The analysis should be viewed as projections to illustrate the likely effects. Whilst policymakers need to be aware of these uncertainties, they should not use them as an excuse for ignoring the challenges that lie ahead.

In the sections that follow, we set out the options for how to respond to such pressures.

If there is one area of political consensus, it is arguably the view that the state should protect individuals against the risks of illness, disability and longevity; and that public health service delivery should adapt to reflect demographic and other cost pressures.

But in this context, there is an important debate to be had about what exactly we mean by healthcare, and where the limits of public sector provision should lie. In the face of ever emerging technologies and treatments, some form of service restriction seems as inevitable in future as it is

[100] To put this in context, real terms health resource spending in Scotland increased almost 5% per year between 1999/00 and 2009/10 and by 1% per annum on average since 2010/11.

now. Yet until we have a debate around where the limits of healthcare provision lie, the remainder of the budget is likely to face ongoing restraint.

And ultimately, continued real terms increases in the health budget have to be paid for, either through taxation or lower spending elsewhere.

As Section 4.3 outlined, the pressures on the public finances over the long-term will inevitably mean that some public services will be squeezed.

Hard decisions need to be taken on what services are to be prioritised. Picking 'winners' and 'losers' is always going to be controversial.

In this regard, greater awareness is needed of the opportunity costs of budget choices. In the context of declining resources, protecting a given service is all well and good, but there is a need for strategic choices in unprotected areas too.

Given the scale of the long-term challenge, it is likely that some 'big' political commitments may have to be reviewed. Such commitments are easy to make in good times when budgets are rising. But once implemented they become difficult to reverse – especially where they have become totemic in political terms – even if the long-term financial environment makes them harder to justify.

A strategic look at the sustainability of Scotland's public finances may help to overcome this 'path-dependence' in policy making.

Overall, rather than making pledges based on inputs, greater thinking about the impacts of policy over the medium to longer term, and how these will support the delivery of key performance outcomes is needed.

5.5 Reducing pressures on spending

Efficiency and public service reform: what scope for savings?

Since 2009/10 there has been much emphasis on securing 'efficiency savings' – measures intended to produce cost savings without affecting the quality of service provision.

The public sector in Scotland has implemented many efficiency measure in recent years. These include restructuring, reductions of back office 'support' functions, management 'de-layering', reduction in estate costs and changes to commissioning and procurement.

In health, the National Clinical Strategy sets out a case for reorganising services. This includes reducing the number of acute units, greater provision of support within communities and a focus on

'prevention'. This is perhaps most clearly the case in relation to the government's health and social care agenda[101].

However, realisation of the benefits from major reconfigurations of service delivery are difficult – particularly if the reform involves 'closing' an existing service provider or scaling back a service whilst any benefits take time to realise[102]. As the King's Fund have put it 'Proposals to reduce capacity in hospitals will only be credible if there are robust plans to provide alternatives in the community before the number of beds is cut…'[103]

As well as service redesign, new technologies may provide some opportunities to achieve savings. For example, assisted living technology may help to promote independence and reduce pressure on care costs.

Overall, it seems likely that the scope for major efficiency savings in public services will become progressively exhausted.

Prioritising 'who benefits'

As the public finances come under increased pressure, the debate around which services should be universally provided and which should be restricted to those who lack financial means – or have particular challenging health or other conditions – is likely to rise to prominence.

Some argue that 'means testing' – in certain instances – can provide an efficient use of public funds by targeting resources where they are most needed. They also require those that can afford to pay to contribute more with any income saved/raised re-distributed to other priority areas. Against that, it can often require greater administrative effort and others argue that it can create social stigmatisation and/or erode public support for redistribution.

Of course, all governments provide some services universally and others on a restricted basis. The boundary is a matter for political debate. So what options are available?

The Scottish Government has committed to a number of universal services which are subject to restrictions elsewhere in the UK. As is well documented, these include –

- Concessionary travel (£195 million in 2017/18)[104]
- Free Personal Care (£498 million in 2015/16)[105]

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[101] NHS boards and councils are required, as a minimum, to combine their budgets for adult social care, adult primary healthcare and aspects of adult secondary healthcare. The intention is that this will lead to a change in service provision, with a greater emphasis on preventative services, avoiding unnecessary admissions to hospital, and enabling patients to be discharged more quickly.

[102] Audit Scotland (2016) Changing models of health and social care www.audit-scotland.gov.uk/uploads/docs/report/2016/nr_160310_changing_models_care.pdf

[103] www.kingsfund.org.uk/sites/default/files/field/field_publication_file/STPs_proposals_to_plans_Kings_Fund_Feb_2017_0.pdf

[104] Table 11.10 Draft Budget 2017-18 http://www.gov.scot/Resource/0051/00511808.pdf

[105] Source: http://www.gov.scot/Resource/0052/00523923.pdf

- Prescription costs (£63 million in 2017/18)[106]
- NHS eye examinations (£76 million in 2017/18)[107]
- NHS dental examinations (£27 million in 2015/16)[108]
- Free higher education tuition (£217 million in 2015/16)[109]

Moving away from any of these will not be easy but, given the overall trends in the public finances, what is the opportunity cost of providing such universal services in terms of forgone investment elsewhere? And what services might be valued more or less? Are such monies of a scale to warrant the significant attention they receive in the debate?[110]

One priority could be to be more open about the trade-off between universal provision and a targeted approach in new policy areas – e.g. social security powers.

Box 5.2: The implications of means testing the Winter Fuel Payment

The Winter Fuel Payment (WFP), currently provided to all individuals aged 64 or over, will soon be devolved to the Scottish Parliament.

Several organisations in Scotland have already called for options to be considered as to whether the benefit should be means tested or at least focussed on those who are deemed to need it most (including the Fuel Poverty Strategic Working Group, the Rural Fuel Poverty Task Force and the government's independent adviser on poverty and inequality). What might the budgetary effects of introducing means testing for the Winter Fuel Payment?

The WFP is a one-off payment of between £100 and £300 depending on circumstances[111].

Just over one million individuals in Scotland will receive the WFP in 2017/18 – costing around £180 million.

Chart 5.3 shows what proportion of Scotland's total WFP expenditure is allocated to individuals living in each of ten equal sized groups, ranked from the lowest income 10% of the Scottish population to the highest income 10% of the Scottish population.

[106] In 2011-12, health boards received £57m in their baseline settlement to compensate for the reduced income from the full abolition of charges. The £57m figure has been uprated by inflation.

[107] An allocation of £67 million in 2009/10 has been uprated by inflation

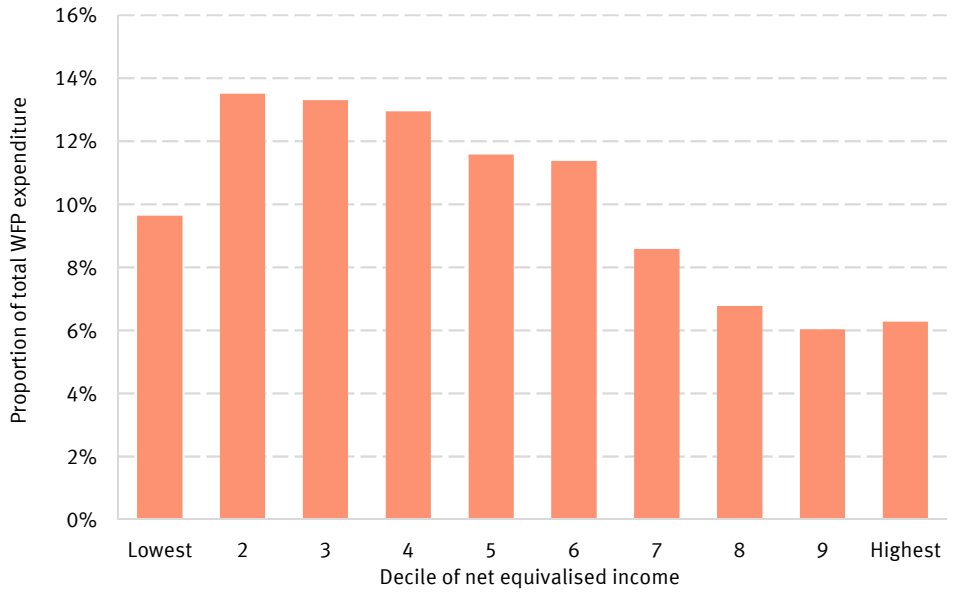
[108] Table 1b of www.isdscotland.org/Health-Topics/Dental-Care/Publications/2016-09-20/2016-09-20-Dental-Treatments-Fees-Report.pdf?9232729674

[109] SAAS, p.67 of: http://www.saas.gov.uk/_forms/statistics_1516.pdf

[110] For example, reintroducing prescription charging would inevitably raise income but a share of that would go on administration and even full recovery would only be around half a percentage point of the total health budget.

[111] Those aged 80 or over receive higher payments; people living alone receive more than those who live together; and those in receipt of certain benefits, including Pension Credit are eligible for higher payments.

Chart 5.3: Winter Fuel Payment expenditure in Scotland by decile of net income (2015/16)



Source Households Below Average Income dataset, FAI analysis

The majority (61%) of Scotland's Winter Fuel Payment expenditure is received by people living in households in the bottom half of the income distribution. But because many pensioner households are relatively well-off. As Chart 5.3 highlights, 39% of the expenditure is received by people living in households in the top-half of the distribution. Around 12% of expenditure (£22 million) is going to the top fifth of households.

To put this in context, for a household in the bottom fifth of the income distribution, average annual income (from all sources, including social security, and for all individuals in the case of two or more adult households) is £11,500, whereas for a household in the top fifth, average income is around £64,000.

If the WFP was available only for those in the bottom two deciles (roughly equivalent to those pensioners living in poverty), costs would fall to around £41 million, allowing £136 million to be re-invested elsewhere (e.g. in tackling fuel poverty, increasing WFP for poorer households, or supporting increased investment in other public services).

Of course, such a policy would be controversial and would not be without administrative costs. But it does serve to illustrate the scale of savings that could be freed up for other services if such options were considered.

Box 5.2 discusses the case of Winter Fuel Payments as an example of one such area. Again this is not to advocate a position either way, but to simply illustrate the choices involved and that the status quo itself has implications.

Another avenue for debate is, rather than looking at individual policies on a case-by-case basis, what about the design of the tax/benefit system as a whole? Funding a universal benefit through a progressive system of taxation is in many senses just as fair as having a means tested benefit alongside a less progressive tax system.

So if there is concern about relatively well-off individuals receiving a universal service, an alternative to means testing would be to increase rates of progressive taxation whilst retaining universal provision.

Clearly there are trade-offs to be had, but we have yet to have such a debate in Scotland on such issues.

The role of government

In recent years, the public sector has made substantial efficiency improvements. But in some areas, services have been reduced, diluted or stopped. Many of these are those which do not have 'statutory' protections[112]. Arguably, the quality of provision in some statutorily protected areas has also declined.

The public sector has also become more reliant on fee income, not only through day-to-day charges (like car parking) but through charging for services which were previously 'free at the point of use', such as bulk waste collection.

Of course, there have always been constraints to what the public sector can deliver. But some of the more recent changes have been redefining the relationship between citizens and the state (for example, reducing provision of community facilities and placing a greater expectation on local groups to 'self-organise'). Pressure on the public finances will only intensify this. Therefore, arguably the time is right for a debate around the nature of the public services the state provides, and which services should be provided elsewhere.

The debate around Higher Education funding is the most politically visible example. The view as to whether tuition should be funded through tax revenues, or by individual fees (underpinned by a government-provided loan) has long been contentious.

On the one hand is the view that education is part of a country's 'social contract', the denial of which would 'diminish the potential of Scottish society' and 'discriminate against the poorest'[113].

On the other is the view that HE is only ostensibly a universal service (as participation is strongly linked to school attainment and social background) and therefore fees backed by income-contingent loans is a more progressive way of distributing resources.

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[112] For example, most local authorities have reduced the number of libraries or community facilities, the frequency of some services (such as refuse collection or maintenance of public spaces) and in some areas, arts and culture activities have experienced withdrawals of subsidy, or service rationing.
[113] Scottish Government (2014) White Paper on Independence www.gov.scot/Publications/2013/11/9348/0

How much the government would save if it introduced tuition fees in Scotland is unclear. The government currently allocates around £220 million to cover the tuition fees for full-time HE students (excluding the value of grants, loans and bursaries)[114]. But any savings would also depend on the extent to which the government felt able to reduce its core grant to universities and what provision was made for grants to support students from poorer backgrounds.

Again the purpose of this discussion is not to argue for or against tuition fees but simply to highlight the need to debate – in a world of increasingly tight resources – the priorities for government intervention.

5.6 The scope for raising revenue

If there is limited appetite or scope for reducing expenditure, what are the opportunities for revenue raising? The Scottish Parliament now has more revenue powers should it choose to use them.

As discussed in Chapter 2, there are some practical constraints on how radical policymakers can be in terms of tax differentials in a devolved context. For example, the fact that not all taxes are devolved – and even on elements like income tax, some key features such as the Personal Allowance and rules around reliefs etc. are reserved – limits options. This is particularly true if there is a concern about avoiding skewing the overall tax burden on to one tax or one particular group in society.

Despite such caveats, a debate about the potential for revenue raising by the Scottish Government is needed. The 2017 Programme for Government outlined the government's plans to hold such a debate.

To inform this debate, some context is necessary. Recent years have seen substantial changes in the taxes that are now devolved or assigned to Scotland –

- The Council Tax freeze from 2007/8 reduced the real terms bill for a Band D property by around £230 by 2016/17, before being only partially undone in 2017/18;

- The introduction of LBTT in 2015/16 – although designed to be broadly revenue neutral – increased the effective tax rate for properties valued at over £333,000, equating to roughly the top 8% of property transactions;

[114] See Table A10 of www.saas.gov.uk/_forms/statistics_1516.pdf

- Perhaps most significantly, the real terms increase to the Personal Allowance (which by 2017/18 was £2,000 higher in real terms than in 2007/08) has provided a tax cut of £400 per year for all but the richest taxpayers[115]; and,

- At the same time, the introduction of the Additional Rate and the freezing of the higher rate threshold has resulted in an increase in the proportion of income tax that is paid by the highest earning 10%.

The recent trend for several of the taxes now under the control of the Scottish Parliament is of the tax burden reducing for some, but at the same time becoming relatively more concentrated on a smaller number of individuals or transactions.

The extent to which the tax system should be 'progressive' is a political question and many may feel that the tax burden needs to be more concentrated. But from a technical point of view, the narrowing of the tax base can make revenues more volatile and more sensitive to the behaviours of a smaller proportion of the population.

So what revenue raising options exist?

Effectively, there are three groups of taxes under the Scottish Parliament's control –

- Local taxes – council tax and business rates;

- Income tax

- Other devolved taxes

It is important to note that taxation serves purposes beyond revenue raising. It can for example, be used to achieve objectives relating to redistribution. It can also be used to discourage less desirable behaviours (e.g. activities that cause environmental harm).

Local tax

To fund the Council Tax freeze between 2007/08 and 2016/17, the Scottish Government effectively committed to transferring resources to local authorities; by 2016/17, the value of this transfer had reached £630 million annually. Whatever the merits of the current system of Council Tax or the freeze itself, this represents a substantial opportunity cost.

There have been repeated calls for reform of local taxation[116]. In response, in 2017/18 the Scottish Government relaxed the freeze and increased the rates applied to higher banded properties. These

[115] As a result, around £1 billion less income tax revenues are raised in Scotland than would have been the case had the Personal Allowance increased in line with inflation.

[116] Commission on Local Tax Reform (2015) 'Just Change' http://localtaxcommission.scot/ In their 2016 Manifestos, both Labour and the Greens made the case to move towards a system of taxation based property value (although the Labour proposals were revenue neutral in respect of the Council Tax).

two changes raised around £180 million. The government have also left the door open to reform in the future, although it remains to be seen how far this will go.

In contrast, Non-Domestic Rate revenues have been buoyant – rising 22% between 2007/08 and 2016/17 in real terms.

A number of reliefs reduce the tax burden for some. Most notably the 'Small Business Bonus' (SBS). But other reliefs are also available – for properties that are unoccupied, properties occupied by charities or sports clubs, properties in rural areas, and properties fulfilling various other criteria. These reliefs cost just under £600 million 2015/16. The rationale for some reliefs is clearer than for others, with the SBS subject to particular criticism. The recently published Barclay Review made a number of recommendations to improve the functioning of NDR (Box 5.3).

Box 5.3: The Barclay Review of Non-Domestic Rates

The Barclay Review was established to make recommendations to enhance how NDR supported business growth and investment.

The Review's recommendations included introducing a 12-month delay to rate increases following any improvement or expansion to a business property (costing £45 million); a reduction in the large business supplement (costing £62m by 2020); and a new relief for day nurseries (costing £7 million).

These measures are to be balanced by reducing avoidance and closing loopholes (saving £21 million) and reforming reliefs (including for private schools and so-called 'Arms-Length External Organisations' set up by councils to deliver services such as leisure facilities).

The Review also recommended that the Small Business Bonus should be evaluated, hinting that it could perhaps be better targeted, or include some element of incentivisation (e.g. offering Modern Apprenticeships). The Review also recommended that revaluations should take place every three years rather than five.

The recommendations have generally been viewed as positive. If enacted, they should support economic activity. The call for evaluation of the Small Business Bonus mirrors the call we made last year. Whilst there is some rationale for the relief, it also has the potential to distort economic activity in favour of more low-value properties and fewer high value properties. Moreover, evidence suggests that in the long-run, the impact of rates reliefs is passed on to the owners of property via higher rents[117], and there is thus a need for evaluation to ascertain who are the ultimate beneficiaries of schemes that have committed over £1.3 billion of public funds[118].

[117] For a more in-depth analysis of these issues, see Adam and Miller (2014) www.ifs.org.uk/budgets/gb2014/gb2014_ch11.pdf
[118] Source: Barclay Review of Non-Domestic Rates, paragraph 4.33

But the Review was not asked to consider the rationale for NDR more generally. It could be argued that, as an intermediate input to the production process, the case for taxing business property is relatively weak. Taxing instead the value of land excluding the value of any buildings on it is, as the Group noted, likely to be less distortionary. However, they also acknowledged that there is 'very limited support' for such a replacement.

Income tax

The power to vary rates and thresholds for non-savings, non-dividend income tax provide perhaps the greatest revenue raising source available to the Scottish Government.

In the 2017 Programme for Government, the Scottish Government has set out its intention to consult on the future direction of income tax in Scotland.

Some indicative estimates of revenues raised from particular policies are as follows[119]:

- Putting 1p on the basic, higher and additional rates of income tax would raise just under £500 million;
- Freezing the higher rate threshold at £43,000 in 2018/19 (rather than increasing it in line with inflation) would raise around £87 million;
- Putting a penny on both the higher rate and Additional Rate (so that these are 41p and 46p respectively) would raise around £128 million in 2018/19;
- Reducing the threshold at which the Additional Rate becomes payable, from £150,000 to £80,000, would raise around £130 million in 2018/19; and,
- Raising the Additional Rate from 45p to 50p would raise around £145 million, assuming no behavioural effects.

The policy costings outlined here exclude the possibility of behavioural effects. Behavioural change has the potential to make a material influence on the revenues raised from particular policies.

But there is significant uncertainty around the potential magnitude of such effects, particularly in relation to the often-debated proposal to increase the Additional Rate to 50p (Box 5.4). The Scottish Government has tasked the Council of Economic Advisers to consider the "revenue risks and possible mitigating actions associated with differential additional rates of income tax between Scotland the rest of the UK."[120]

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[119] FAI income tax microsimulation model based on analysis of: HM Revenue and Customs. KAI Data, Policy and Co-Ordination. (2017). *Survey of Personal Incomes, 2014-2015: Public Use Tape*. [data collection]. UK Data Service. SN: 8239, http://doi.org/10.5255/UKDA-SN-8239-1

[120] https://beta.gov.scot/publications/council-of-economic-advisers-minutes-august-2016/

Box 5.4: The additional rate and behavioural effects

In direct terms (i.e. assuming no behavioural effect), an increase to in the Additional Rate from 45p to 50p would raise some £145 million per annum[121]. This represents around 1% of Scottish NSND income.

There is sometimes a preconception that the policy would raise more than this, but it raises relatively little because there are few (around 21,000), AR taxpayers in Scotland.

But it could raise significantly less in practice, as the propensity of AR taxpayers to vary their income is high. For example, taxpayers could – in theory – vary the amount they work, take advantage of tax reliefs (e.g. put more money into a pension), rearrange their affairs to attract rUK rather than Scottish rates or convert earned income into dividend income (assuming this was still taxed at a lower UK rate). Some of these options will be more viable for some taxpayers than others.

We do know that NSND income is less responsive to tax changes than savings and dividend income[122].

There remains little in the way of hard evidence of any behavioural response to an increase in the AR.

The IFS has estimated that it is plausible that raising the Additional Rate to 50p in the UK could either *raise* £1 or £2 billion of revenue or *cost* £1 or £2 billion of revenue[123]. The uncertainty is due to difficulties in assessing behavioural responses to previous tax rate changes, given complications in disentangling temporary from permanent responses, and the effects on other revenue sources. If there is uncertainty at the UK level, then the degree of uncertainty at the Scottish level will be even greater.

The £145 million estimate of the revenue effects of the Additional Rate increase should be seen as an upper bound figure therefore – with the actual revenue raised potentially being significantly less than this.

Note finally that, if the UK Government increases the Additional Rate in rUK to 50p, this would represent a double-edged sword. On the one hand, the risk of behavioural effects from Scottish taxpayers diminishes if the policy is implemented UK-wide. On the other hand, the additional revenues raised in rUK would increase the Scottish BGA, negating any positive revenue effects for the Scottish Government.

[121] FAI income tax microsimulation model based on analysis of: HM Revenue and Customs. KAI Data, Policy and Co-Ordination. (2017). *Survey of Personal Incomes, 2014-2015: Public Use Tape*. [data collection]. UK Data Service. SN: 8239, http://doi.org/10.5255/UKDA-SN-8239-1

[122] IFS (2017) How do the rich respond to higher income tax rates? https://www.ifs.org.uk/publications/9678

[123] IFS (2017) How do the rich respond to higher income tax rates? https://www.ifs.org.uk/publications/9678

Other devolved taxes

On the remaining devolved taxes, the scope to raise significant amounts of revenue is relatively limited.

Indeed on two of them, Air Departure Tax and Landfill tax the intention is to reduce revenues.

In total the fully devolved taxes (Landfill Tax and LBTT) are estimated to raise £687 million in 2017/18 so even very large percentage increases would only raise a relatively small amount of additional money for the Scottish budget.

As noted in Chapter 3, in recent years revenues from LBTT have on the whole been somewhat below expectations, though not much more so in Scotland than England. The introduction of the Additional Dwelling Supplement in 2016/17 – which raised around £90 million that year[124] – does however serve to remind that tax policy has not only been about narrowing the tax base.

The political narrative around LBTT more broadly at the moment appears to be moving towards tax reductions in the upper end of the market, which, as noted in Chapter 3, will almost certainly reduce revenues – barring an almost improbable change in behaviour in response.

The government has committed to reducing the burden of Air Departure Tax. However, the mechanisms through which this might significantly stimulate the economy remain somewhat unclear. In a time of significant budget constraint, the lack of hard economic evidence published by the government pointing to how such a loss of tax revenue will stimulate the economy seems puzzling.

On a much smaller scale, the policy aspiration to reduce waste to landfill implies that Landfill Tax will also provide only a declining source of revenues in future years.

Of course, the Scottish Parliament could decide to introduce new taxes if they so wished (although they would require Treasury consent). There has been little discussion in Scotland of what these taxes could look like.

Delivering economic growth

Of course, any discussion of how to raise revenues must also be mindful of growing the tax base through economic growth.

As we have highlighted on a number of occasions, what matters in the context of the new Fiscal Framework is not simply growth in Scotland but also Scotland's growth relative to the rest of the UK.

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[124] The Additional Dwelling Supplement raised £90 million in 2016/17, but this does not mean that the Scottish budget was boosted by £90 million as a result. In 2016/17 the UK Government introduced the Second Homes Levy. This policy increased the block grant adjustment. The introduction of the ADS in Scotland can thus be seen as a desire by the Scottish Government to mitigate the effect of the Second Homes Levy on its budget.

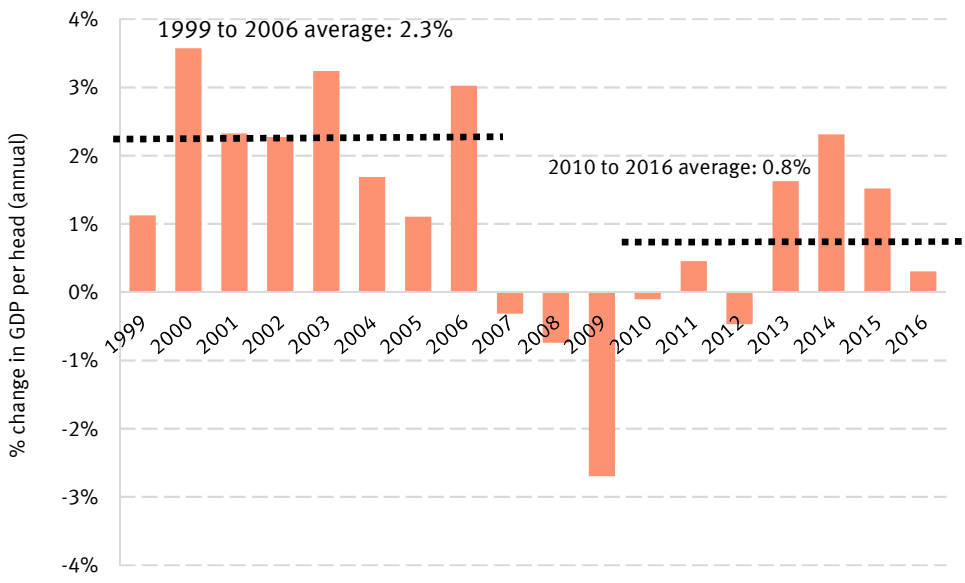
The Scottish Government now faces strong incentives (if it did not already) to stimulate economic growth. A larger economy tends to generate larger tax receipts. Moreover, with a progressive tax system, a given percentage increase in the size of the economy tends to lead to a larger proportionate increase in tax revenues.

For the UK as a whole, economic growth figures have consistently disappointed since the Great Recession. As a result, the most recent set of official forecasts is for the UK's GDP in 2019–20 to be 14.1% below the level implied by the March 2008 Budget.

Slow growth has had a knock-on effect on revenues. In fact despite slow economic growth, revenues from income tax as a share of GDP have actually fallen, from 10% in 2007/8 to 9% in 2015/16. This fall is partly due to tax policy decisions discussed earlier. But it is also because growth has not been particularly 'tax rich' in the sense that wage growth has been disappointing, (as discussed in Chapter 1).

In Scotland too, rates of economic growth have been weak since the recession. Between 1999 and 2007, GDP per head in Scotland grew by around 20%. Between 2007 and 2016, GDP per head has grown by under 2% (Chart 5.4)

Chart 5.4: Scottish trend growth 1997 to 2007 versus 2010 to 2016



Source: Scottish Government Q1 2017 GDP & Fraser of Allander

It is harder for governments to stimulate economic growth than is often assumed. Growth prospects for individual countries are increasingly shaped by global macroeconomic conditions and the sentiments of businesses and consumers over which policymakers have little in the way of direct influence.

This is even more so the case for the Scottish Government, given its relatively limited powers over fiscal policy even after the Smith Commission, and its limited powers over labour market, competition policy, monetary policy, and so on.

Nonetheless, the Scottish Government can certainly do things to influence economic growth.

As we discussed in our most recent Fraser of Allander Commentary, there is significant scope to review how we are currently supporting economic development. We currently spend around £100 per head more than the rest of the UK on 'economic development' but we lag behind most parts of the UK in key areas like business formation and research and development.

The First Minister's signal that she is willing to consider getting more out of the £2 billion the public sector spends every year supporting enterprise and skills is a welcome step. A key part of that should be about making an explicit link between the two debates of growing our economy and the sustainability of our public finances.

Investing in infrastructure investment improves longer term growth prospects, and helps to boost aggregate demand in the near term. And in a general sense, policies such as investing in education and supporting R&D are generally viewed as being conducive to growth in the long-term. On the tax side, as we have noted elsewhere, there is a case for saying that taxing land rather than business property (which is an input to the production process) might be more conducive to growth. And taxing property transactions (as with LBTT) risks constraining mobility and in turn meaning that labour markets function less effectively.

But there are few easy answers to the question of what a government can do to enhance growth, particularly in the near term. In some cases, there may be trade-offs between growth objectives and sustainability or equity objectives. But we rarely have sufficient evidence to know exactly where these trade-offs lie, or how absolute they are.

For example, we want our tax system to achieve some redistribution from richer to poorer, but this has to be balanced against the risks of creating disincentives – in the form of high marginal effective tax rates (including benefit withdrawal) – for both groups.

So the Scottish Government – and other political parties – are right to aspire to increase rates of economic growth, and doing so does not need to contradict its broader policy priorities. But to rely solely on a growing economy as a solution to longer-term fiscal challenges is likely to be a risky approach.

5.7 Conclusions

The Scottish Government faces a significant fiscal challenge. The population is ageing and health costs are increasing due to people living for longer with increasingly complex conditions which require ever more complex treatment.

Most if not all the political parties support the premise that the quality of public services – particularly health care – should be maintained in the face of these rising costs.

But the implication is that non-health related areas will continue to face constraint. An honest debate is required about the scale of this challenge, and how it might be addressed.

Of course, the UK as a whole faces challenges of a similar nature. One approach for the Scottish Government is to simply wait and hope the UK Government responds to its own challenge with additional Barnett consequentials for the Scottish budget.

But Scotland in many ways faces a more acute challenge due to comparatively poor public health and a low population growth. And with new fiscal powers, there is an opportunity for the Scottish Government to take a more strategic approach to these long term issues.

But what are the options?

On the spending side, the scope for significant further efficiency savings is likely to be limited, at least without substantial reconfiguration in the way in which services are delivered. More fundamental public service reform to deliver more integrated or preventative services will yield savings in the longer term, but such reforms take time and the exact financial benefits are often uncertain.

There may be scope to target some types of public spending in different ways, and there is always scope to consider the balance of what is provided by the state and what is not. But such decisions are not easy.

The extent to which the response to the fiscal challenge should come through spending consolidation or tax increases will likely depend on political judgements about the appropriate size of the state. But in reality some mix of both may be required.

The Scottish Government does have options to raise tax, but there are also constraints. At the current time there is limited political appetite for increases to Council Tax or NDR, there is an inclination towards making cuts to LBTT and ADT, and revenues from Landfill Tax are forecast to decline.

That leaves income tax. Significant revenue raising will require broad based tax increases rather than increases over a narrow range of taxpayers. Perhaps ironically, the past ten years have witnessed quite substantial cuts to income tax for most taxpayers.

Some will argue that the approach to raising revenue should be to grow the economy and by implication the tax base. But this is easier said than done although linking the renewed debate how we boost our current weak growth rates alongside a debate on the public finances is crucial.

Ultimately, a combination of all of the above is likely to be required.

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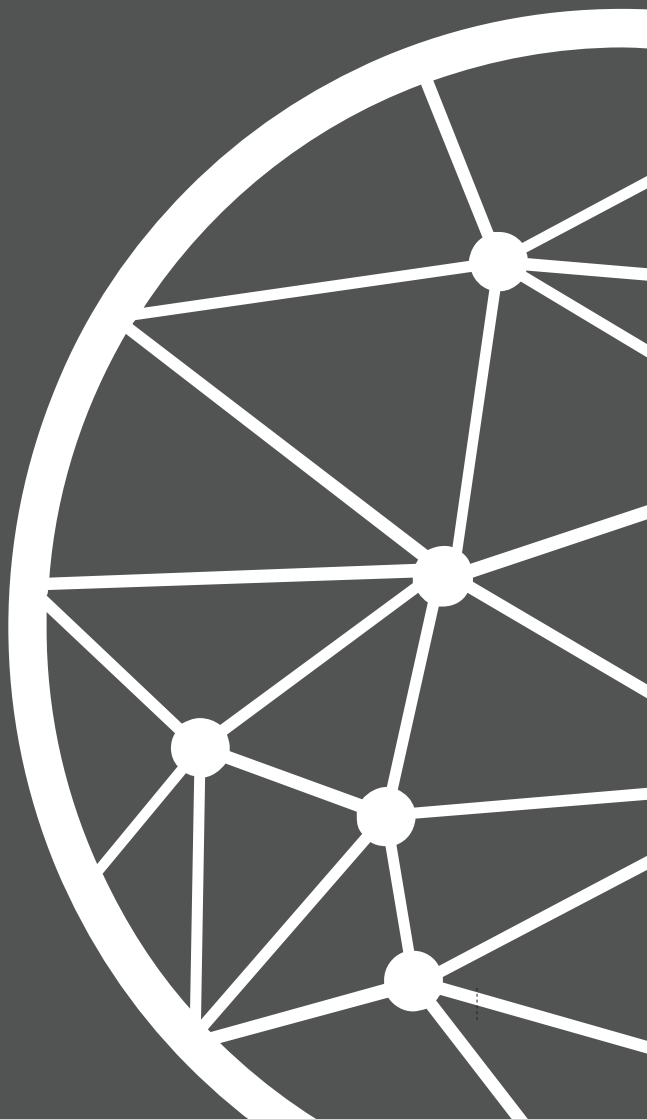

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