

# The Fiscal Framework and the Scotland Bill: Right on the money

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On the 25<sup>th</sup> February 2016, the UK and Scottish Governments agreed the Fiscal Framework associated with the Scotland Bill<sup>1</sup>. The Fiscal Framework set out a number of the aspects governing the devolution of additional taxation and welfare spending powers as a result of the Smith Commission Agreement<sup>2</sup>. This is a good deal for both Scotland and the UK.

It should be noted that the Fiscal Framework is a complex agreement covering a number of aspects of the additional powers. Elsewhere I have set out various aspects of the Fiscal Framework in detail and I have provided some analysis on the most controversial aspect of the agreement, which deals with the determination of Scotland's remaining block grant, and how it is adjusted (indexed) over time<sup>3</sup>.

The block grant adjustment (BGA) mechanism for the devolution of additional income tax powers was at the centre of much of the debate. An excellent analysis of the different types of indexation is offered in a number of sources<sup>4</sup>.

The bargaining position between the two governments, as far as one could discern from public sources, was the following: the Scottish Government had argued that the basis for the BGA should be the per-capita indexed deduction method (PCID)<sup>5</sup>. This method would give Scotland the incentive to grow its tax base relative to the rest of the U.K., but would protect Scotland against demographic risks in addition to those present through the Barnett formula. The argument is that anything other than PCID fails to meet the Smith Commission's first no-detriment principle, and would have undermined the Smith commitment to maintain the Barnett formula as the cornerstone of the agreement.

The U.K. Government seemed to initially focus on a levels deduction (LD) approach, which in a sense is a 'Barnett formula for tax'. The UK government's position was that PCID does not meet one part of the Smith Commission's Agreement's second no-detriment principle, around 'tax-payer fairness'. This would imply, for instance, that an increase in UK government spend on devolved areas such as the English NHS, financed using devolved income taxation would unduly benefit Scotland through the Barnett

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<sup>1</sup> See

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/503481/fiscal\\_framework\\_agreement\\_25\\_feb\\_16\\_2.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf)

<sup>2</sup> <https://www.smith-commission.scot/smith-commission-report/>

<sup>3</sup> See my evidence to the Devolution (Further Powers) Committee at Holyrood

[http://www.scottish.parliament.uk/S4\\_ScotlandBillCommittee/Inquiries/devolution\\_committee\\_-\\_AM\\_-\\_Final.pdf](http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/Inquiries/devolution_committee_-_AM_-_Final.pdf) and my recent Stevenson lecture at the University of Glasgow -

[http://www.gla.ac.uk/schools/socialpolitical/research/politics/stevensontrust/newsandevents/headline\\_445809\\_en.htm](http://www.gla.ac.uk/schools/socialpolitical/research/politics/stevensontrust/newsandevents/headline_445809_en.htm)

<sup>4</sup> David Bell, David Eiser and David Phillips offer a survey of the three main approaches to the BGA – see <http://www.ifs.org.uk/publications/8060> and the update in

<http://www.centreonconstitutionalchange.ac.uk/blog/adjusting-scotland's-block-grant-options-table>.

<sup>5</sup> A rationale for PCID was originally published in the Fraser Economic Commentary (Vol. 39, No. 1, June 2015) by Jim Cuthbert – see [http://strathprints.strath.ac.uk/53549/1/FEC\\_39\\_1\\_2015\\_CuthbertJ.pdf](http://strathprints.strath.ac.uk/53549/1/FEC_39_1_2015_CuthbertJ.pdf)

formula as Scottish taxpayers would gain additional funding net of the BGA. This is because the Scottish population share as a proportion of the UK is larger than Scotland's share of UK income taxation<sup>6</sup>.

In my evidence to the Devolution Committee<sup>7</sup> I set out these two BGA methods and the Indexed Deduction (ID) method, a third method similar to PCID but which does not adjust for population changes.

I argued in a number of interventions during the debate and in my evidence to this Committee and to the House of Commons Scottish Affairs Committee that PCID is the only method which satisfies the *major* aspects of the Smith Commission Agreement. The Smith Commission agreement placed Barnett at the centre of the fiscal framework. The LD (and ID) methods erode Barnett over time and violate the first no-detriment principle. They expose Scotland to additional demographic risk when Scotland does not have the policy levers to offset these trends. The current differential demographic trends between Scotland and the rest of UK as projected by the Office for National Statistics (ONS) are starkly different. Based on ONS population projections, the costs to Scotland of adopting LD instead of PCID would have amounted to a cumulative £7bn loss in real terms over the first 10 years of the Scotland Bill being enacted. Even with ID the losses would be very marked<sup>8</sup>. Hence anything but PCID erodes Barnett and does not deliver Smith.

In the end, in the Agreement the governments reached, the following compromise position.

There was a decision to use Barnett as the formula for the indexation mechanism for welfare with a 100% comparability factor, which seems appropriate given the nature of the welfare devolution envisaged in the bill.

The BGA adjustment indexation mechanism for tax (see Paragraphs 17-19 of the Agreement) is a compromise. A 'Comparable Model' will be used *'to effect the BGA'*. In essence this is a modified version of the levels deduction (LD) method. It is modified by a factor which reflects Scotland's differential share of the UK tax pool for each of the devolved taxes. This is described in detail by Bell, Eiser and Phillips<sup>9</sup>. Indeed Bell et al call this modified LD 'tax-capacity adjusted levels deduction' (TCA-LD). In essence this BGA mechanism moves some way to take account of the Scottish Government's concern that LD exposes Scotland to additional risk by reducing the adjustment in the block grant in those taxes (like income tax) where Scotland has a lower share of the UK tax pool than its population share.

Unlike Level Deduction (LD) the TCA-LD mechanism addresses the problem of Scotland initially having a lower share of UK tax revenues, but it still does not protect Scotland's block grant from the additional demographic risk due to Scotland's population growth being slower than that in the rest of the UK. The detriment relative to the 'no-devolution case' of adopting TCA-LD is shown in Table 1 in Bell et al.

<sup>6</sup> *The problem is neatly set out in an example in Bell, Eiser and Phillips*

<http://www.centreonconstitutionalchange.ac.uk/blog/adjusting-scotland's-block-grant-options-table>.

<sup>7</sup> See Slide 4 in my presentation

[http://www.scottish.parliament.uk/S4\\_ScotlandBillCommittee/Inquiries/devolution\\_committee\\_-\\_AM\\_-\\_Final.pdf](http://www.scottish.parliament.uk/S4_ScotlandBillCommittee/Inquiries/devolution_committee_-_AM_-_Final.pdf)

<sup>8</sup> *Indeed ID has other undesirable features which are explored in detail in the literature.*

<sup>9</sup> see <http://www.centreonconstitutionalchange.ac.uk/blog/adjusting-scotland's-block-grant-options-table>.

Curiously, in offering this compromise with the hybrid TCA-LD method the UK government in effect abandoned its demands for the 'tax-payer fairness' part of the second no-detriment principle.

However, whilst this TCA-LD mechanism is *notionally* calculating the BGA, in para. 20 in the agreement it is clear that this BGA mechanism is *de facto* overridden. Paragraph 20 of the agreement states that the outcome until 2021-22 will be that the BGA will shadow the per-capita indexed deduction method (PCID), which as noted above is the Scottish government's preferred method, and the approach I had supported.

In essence, the TCA-LD method will be a shadow formula which is not operational during the initial duration of this Fiscal Framework Agreement (i.e. until 2021-22), during which *de facto* PCID will determine the BGA.

The key question is what happens after 2021-22. This is set out in para. 20-23 of the Agreement and which was clearly one of main sticking points in the negotiation.

The Agreement makes it clear that there will be an independent review which will inform the two governments' views. The governments will decide, through a new negotiation post-2021, what the future indexation mechanism should be. In effect this is a 'sunset clause' for the BGA indexation mechanism post 2021-22. The important point is that there is no presumption that a particular method will be used after that date. The agreement does not specify what might happen if a methodology is not agreed in time for 2021-22.

I have suggested that this agreement by the two governments is good for Scotland and for the UK. The reasons for this are the following:

1. For Scotland, it ensures that PCID is *de facto* used to determine the BGA, thus avoiding additional demographic risk.
2. For Scotland, it is important that the first no-detriment principle as embedded in the PCID method is still operative and does not automatically lapse after 2021.
3. For the UK, although PCID does not, during the period until 2021-22, deal with the issue of 'tax-payer fairness' (the second part of the second Smith no-detriment principle) it ensures that this principle is not forgotten, and will be part of the 2021 review. It is important to stress that TCA-LD would not have dealt with the 'tax-payer fairness' principle either, whilst LD would have. As I set out in my evidence to the House of Commons Scottish Affairs Committee, and in a recent Stevenson Trust lecture at the University of Glasgow, a modified version of PCID might have addressed the 'tax-payer fairness principle' more directly, by adjusting the block grant further whenever additional income-tax changes are made by the UK government to reflect changes in devolved spending.
4. For the UK, the use of PCID in the next few years will not impact greatly on the 'tax-payer fairness' issue, as the period until 2021-22 is likely to be a period of continued fiscal consolidation, which

means that the issue of the UK government raising additional income taxation to fund additional UK spend in devolved areas such as NHS and education is unlikely to be substantive issue. Indeed the Finance Act 2015 included the UK Government's 'tax lock commitment' which notionally prohibits the UK government increasing income tax rates during the current parliament. This further limits any 'unfair' benefit from UK taxes to Scotland.

5. For both Scotland and the UK, the period until 2021-22 provides a period in which we will learn more about the actual economic and demographic risks that emerge from the framework without having to rely on modelling assumptions and forecasts.

6. For both Scotland and the UK as I stressed before it is important that the Agreement provides a stable framework. It is important that the different spending and taxation policy proposals for the 2016 Scottish Parliamentary election by the political parties can be evaluated, and that this debate happens against the background of a Fiscal Framework which will not trade off changes in taxation and welfare spending decisions that would be swamped by an unstable block grant due to demographic effects. This Agreement provides that stability by taking away the issue of demographic risk, violating the first no-detriment principle.

My conclusion is that this agreement comes to the right decision on the BGA method. It is a pragmatic solution by the two governments which produces the right result, whilst conceding that a final decision on the BGA will not be considered until 2021, and it will need to be arrived at, following an independent review, by mutual agreement. It goes without saying that this review will be important as it will be difficult for either government to deviate from the conclusions of a genuinely independent review.

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