Scottish Budget Guide

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The Scottish Budget sets out the Scottish Government's proposed spending and tax plans for a given year. Scotland has a devolved government and with that comes an intricate, and often confusing, framework for its finances.

This article attempts to disentangle the Budget, answering the following questions –

- What is the Scottish Budget?
- What powers does the Scottish Government have?
- How is the budget created?
- What does the Scottish government spend on?
- Where does the Scottish Government get its money from?
- How is the Block Grant calculated?
- Why do we need Block Grant Adjustments?
- How can I stay up to date with the budget?

What is the Scottish Budget?

The Scottish Budget is an annual document published by the Scottish Government detailing the government's plans for taxation and spending in the coming fiscal year. The fiscal year runs from the 1st April to the 30th March the next year. The Budget Document is accompanied by the Budget Bill, which sets out the plans in a legal document.

The Budget Bill is debated and discussed by Members of Scottish Parliament (MSPs), who vote in the Scottish Parliament on amendments before voting on the bill to be made into law, at which point it becomes the Scottish Budget Act for that year. The Scottish Budget Act legally authorises the Scottish Government to carry out its expenditure and taxation plans.

Within the Budget are detailed plans for how the Scottish Government will allocate its funds to each department - and the reasonings for doing so -, changes in tax rates and bands, and changes to welfare benefits. Proposals for new taxes, welfare benefits and public services are also set out in the budget.

If you live or work in Scotland, the budget affects many parts of every-day life. It determines how much tax you will pay, and the public services and benefits available to you. Changes to NHS funding, to tax rates or higher investment in infrastructure are all government initiatives that are set out in the budget.

What powers does the Scottish Government have?

To better understand the Scottish Budget, it is important to know the powers of the Scottish Government. Spending by the Scottish Government is importantly linked to what public services are devolved to Scotland, and not administered at a UK level.

Since the Scottish Government and Parliament was first established in 1999, the Scottish Government has seen its responsibilities rapidly grow. The 1998, 2012 and 2016 Scotland Acts all saw its powers over public services, taxation and welfare benefits expanded.

The 1998 Scotland Act ruled that anything that was not explicitly written as a "reserved matter" (one still managed by the UK government), would automatically be a devolved responsibility.

Reserved matters include things like:

- defence;
- international relations;
- most economic policy;
- currency;
- immigration;
- most business regulation and;
- most social security payments.

Among the Scottish Government's responsibilities are:

- health and social care;
- education and training;
- local government;
- police;
- environment;
- many aspects of transport;
- justice;
- tourism and economic development;
- sport and the arts;
- equal opportunities and;
- housing.

In 2019-20, about 58% of total spending for the benefit of the people of Scotland was spent by Scottish Government and Scottish local government, compared to 41% from the UK government bodies (GERS, 2020).

As of 2019-20, 76% of all social security spending was still managed by the UK government. (GERS, 2020). Council Tax Reduction was devolved in 2013/14 while financial responsibility of other welfare benefits – including Disability Living Allowance, Attendance Allowance and PIP – were transferred in the 2020/21 budget however, administration of these benefits is being phased over time until at least 2024/25, with the Department for Work & Pensions (DWP) still currently delivering services in Scotland.

The Scottish Government also has some limited tax powers. Importantly, since 2017/18, power of non-savings and non-dividends (NSND) income tax was devolved to the Scottish Government – in 2019/20, NSND tax receipts made up around two thirds of devolved tax revenue (GERS, 2020). Additionally, the Scottish Government have the power to change income tax bands.

While tax powers are limited, they still represent a large revenue source for the Scottish budget. The Scottish Government also has some power to create new taxes, benefits and public services.

The Scottish Budget only sets out the plans for taxation and spending within the scope of the devolved responsibilities.

How is the budget created?

Since 2018, the Scottish Budget has been created in a year long process leading up to the start of the next financial year. The new budgetary process was developed as a way to increase scrutiny of the budget by parliament, government bodies and the public.

The first 9 months of the budget process, starting in April, allow Members of Scottish Parliament, public bodies and auditors to evaluate and influence budget priorities.

In May during this time, the Scottish Government publish their Medium-Term Financial Strategy document (MTFS). This document highlights some of the Scottish Government's spending and tax priorities for the next 5 years, as well as looking at key financial challenges and opportunities.

MSPs organise into committees to scrutinise the budget priorities, and make recommendations. This is the primary way for the Scottish parliament to affect the budget before its publication.

Then in the final 6 weeks before the publication of the budget, the parliamentary committees submit pre-budget reports to ministers on their perspective on budget priorities.

Finally, after the publication of the UK Autumn Statement on the UK Budget, the Draft Budget is introduced to the Scottish Parliament. Within the budget document, the Government must respond to the suggestions from each parliamentary committee.

Following the introduction of the Draft Budget the parliament debates, scrutinises and can propose amendments to the budget.

Before the start of the financial year in April, the Budget Bill is voted on. When the Bill gets enough votes to pass it becomes law, becoming the Budget Act for that year.

The government therefore needs a majority of MSPs to vote in favour of the Budget Bill. When a party is running a minority government they will require the votes of opposition MSPs.

If the Budget Bill does not get through parliament then law mandates that public spend is capped at last year's spend. This can have serious implications – if prices in the economy have risen over the year then this cap would mean a real term decrease in spend for the budgets of different services like the NHS and local government.

If the Budget Bill is passed through parliament then, from April, the Scottish Government starts implementing the commitments set out in the budget.

After the Budget Act passes, the government may amend the budget twice (and under some circumstances three times) in Budget revisions. These Budget revisions are done to reflect changes in circumstances during the year, including responding to changes in UK spending which would affect the Scottish Budget. There is usually a Spring and Autumn Budget revision. These amendments to the Budget Act must also be passed by parliament.

What does the Scottish Government spend on?

Scottish Government spending can generally be broken down into three categories:

- 1. Capital;
- 2. Resource¹; and,
- 3. Annually Managed Expenditure (AME).

AME accounts for about £9 billion of the total budget and counts funding that are a devolved responsibility of the Scottish Government but continue to be annually funded by the UK Government on the basis of demand.

These amounts are typically associated with NHS and teacher pensions and are ringfenced so the Scottish Government cannot influence them much. As AME is funded by the UK Government, its funding is separate from the usual budget mechanisms, like the block grant and devolved taxes.

Most of the budget which the Scottish Government has influence over is in resource and capital. The resource budget is for the day-to-day spending required to run public services. The capital budget is for investment in assets, infrastructure like buildings and roads. These budgets are allocated to the relevant departments to carry out the Government's plans. The resource budget makes up the majority of Scottish Government's total managed expenditure.

Chart 1 highlights the breakdown of Scottish Government spend on Fiscal Resource, AME, Capital & Non-cash expenses.

¹ Resource spending is sometimes presented to include a non-cash element (these 'expenses' involve things like depreciation of assets) however, it is the cash element that organisations actually get to spend.

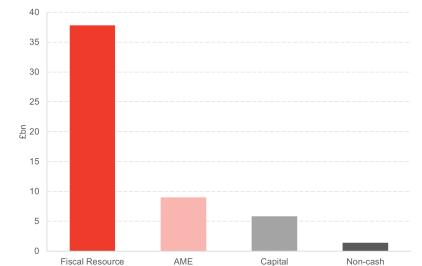
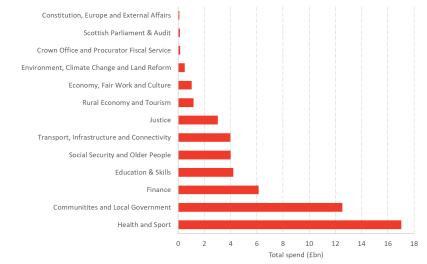


Chart 1: 2021-22 Breakdown of the Scottish Budget - Resource, AME, Capital and Non-cash expenditure

So, where does the money in the Scottish Budget go? The following chart provides a breakdown of the Scottish budget portfolio. Health and Local Government are by far the largest categories, encompassing spending for the NHS, primary and secondary education. **Chart 2**.





Source: Budget 2021-22

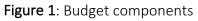
Source: Scottish Budget 2021-22

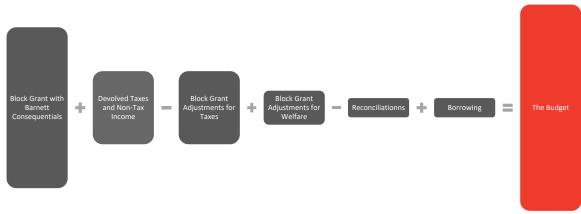
Where does the Scottish Government get its money from?

The <u>Fiscal Framework</u> sets out the framework that currently governs the funding of the Scottish Budget. The Fiscal Framework was developed using advice from the Smith Commission, a set of recommendations made following discussions across Scotland and UK about devolution in Scotland after the 2014 Scottish independence referendum.

The Scottish Budget is currently made up of a few major components -

- Block Grants determined by the Barnett Formula;
- Devolved taxes and non-tax income;
- Block Grant Adjustments to account for devolved taxes and welfare;
- Reconciliation payments (payments to correct for earlier forecasting errors); and,
- Borrowing.





Source: FAI

The Block Grant

The Block Grant has been the Scottish Government's core source of funding since Scotland's first major devolution of powers in 1999; when the Scottish Government and Scottish Parliament was first established. It is the primary method used by the UK to fund the devolved administrations of Scotland, Wales and Northern Ireland.

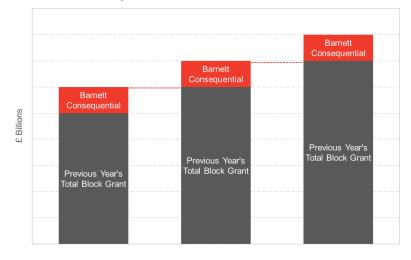
It is essentially an annual lump sum transfer from the UK Government to the Scottish Government. This transfer of money makes up the majority of the funding for the budget. The large "block" of money can be spent in any way the Scottish Government sees fit.

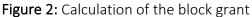
It is worth noting that the UK's budget is made up from taxes from all of the UK's nations, including Scotland. So, the lump sum payment is *not* just a transfer from England to Scotland – to understand the relationship between Scotland and the UK's finances, see our guide to <u>Government Expenditure and Revenues Scotland</u> (GERS).

The block grant is composed of two parts. The first is the baseline block grant, equivalent to the total block grant from the previous year. The baseline block grant in 2018-19 was £30.9 billion.

The second component is called the Barnett Consequential, which is the *change* to the total block grant from the previous year. The Barnett Consequential allocates to the Scottish budget a population share of the change in 'comparable' UK Government spending in England. Barnet Consequentials added on another £3.5 billion to the baseline block grant.

See <u>"How is the Block Grant calculated?"</u> for more on the block grant and Barnett Consequentials.





Source: FAI

Devolved and Assigned Taxes

The second largest component of the budget is from fully devolved, partially devolved, and assigned taxes.

Fully Devolved taxes are taxes that are wholly determined within Scotland, and administered and collected by bodies in Scotland such as Scottish Government or local councils in Scotland. These include Land and Buildings Transactions Tax (LBTT), Landfill Tax, and council tax and Non-Domestic Rates.

Income tax is partially devolved. This means that revenues from NSND income tax raised in Scotland contribute to the Scottish budget, but control over income tax powers is shared between the Scottish and UK Governments. The Scottish Government can set rates and bands, but the UK Government determines the reliefs and allowances (including the Personal Allowance).

VAT is planned to be an assigned tax. A proportion of revenues from VAT raised in Scotland will be allocated to the Scottish budget, but the Scottish Government has no powers over how the tax operates.

The fully devolved taxes are administered and collected within Scotland (by Revenue Scotland or local authorities), whilst the partially devolved income tax and assigned VAT are administered and collected by HMRC on behalf of the Scottish Government,

Through the Fiscal Framework, Scotland also gained the ability to create new taxes. One tax that this would permit is the proposed Transient Visitor Levy ("tourist tax") which would enable local authorities to charge visitors staying overnight in Scotland.

The Scotland Act 2016 allowed for the devolution or assignment of 6 taxes to the Scottish Government. Of these 6, the taxes currently/planned to be completely devolved to the Scottish Government are:

- The Land & Buildings Transaction Tax (LBTT);
- Landfill Tax;
- Aggregates-Levy, when it comes into effect; and,
- Air Departure Tax, when it comes into effect.

Revenues from non-savings and non-dividend income tax were transferred to the Scottish budget in 2017/18. There are plans to assign a proportion of VAT revenues to the Scottish budget, but the date for this to happen has not yet been confirmed.

Air Departure Tax, Aggregates-Levy and VAT have not yet been devolved/assigned.

Chart 3 shows the relative sizes of 4 of these 6 taxes.

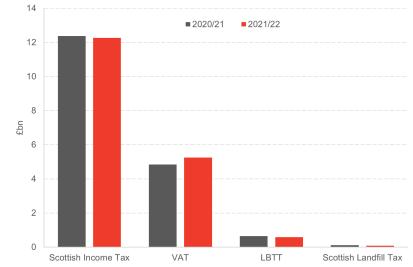


Chart 3: Income tax, Vat, LBTT and Landfill Tax Forecast Revenue, 2020/21 – 2021/22

Source: 2021-22 Budget Document

Table 1 provides a summary of the taxes devolved to Scotland that factor into the Scottish budget.

Tax	Date of transfer	Revenue forecast 21/22 (£m)	Degree of control by Scottish Parliament	Administration and Collection
Land & Business Transactions Tax (LBTT)	2015	586	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	88	Fully devolved; complete autonomy.	Revenue Scotland.
Income tax	2017	12,263	Scot Gov sets rates and bands. UK Gov defines tax base & sets allowances. Scotland has powers over NSND income tax.	HMRC
VAT	tbc	5,246	Assigned revenues; no autonomy	HMRC
Air Passenger Duty	tbc	145	Fully devolved; complete autonomy	Revenue Scotland
Aggregates Levy	tbc		Fully devolved; complete autonomy	Revenue Scotland

Source: Scottish Budget 2021-22; Scottish Fiscal Commission (Scotland's Economic and Fiscal Forecasts 2021)

Block Grant Adjustments – tax

Alongside each devolved and assigned tax is a block grant adjustment (BGA). These BGAs are just as important in determining the Scottish budget as the revenues from the devolved and assigned taxes themselves. So what are these BGAs and how are they calculated?

The Smith Commission, which recommended the devolution/assignment of income tax, landfill tax, property transactions tax, aggregates levy, VAT and Air Passenger Duty, was unanimous that the Scottish block grant should continue to be calculated by the Barnett Formula after devolution of these taxes.

The challenge was to design a way of making a deduction from the block grant each year which would reflect the revenues foregone by the UK Government as a result of transferring a given revenue stream to the Scottish Budget – whilst simultaneously enabling the Scottish Government to capture the revenue effects of any policy decisions it might make.

To operationalise tax devolution within the setting of the Barnett formula, a so-called block grant adjustment (BGA) is calculated for each devolved tax separately. Each BGA consists of two elements: an initial deduction and an indexation mechanism (Bell et al. 2016).

The initial deduction is equal to the tax revenues collected in Scotland in the year immediately prior to the devolution of the tax power. For example, if income tax is devolved in 2017-18, the initial deduction is equal to income tax receipts in Scotland in 2016-17. The indexation mechanism provides a measure of the rate at which 'comparable revenues' have grown in the rest of the UK (rUK) between the date of the initial deduction and any subsequent year. The BGA thus provides an estimate of a counterfactual: what level of tax revenue would have been raised in Scotland in any given year, had tax policy been the same in Scotland as in rUK, and had the tax base grown at the same rate in Scotland or Wales as in rUK over the period since the tax was devolved?

The key implication of the BGA arrangement is that, if the sum of the revenues raised from the devolved taxes is greater than the sum of the BGAs, then the Scottish budget is better off than it would have been without tax devolution. This could happen under two circumstances: if the tax base grows relatively more quickly in Scotland than in rUK; or if tax rates in Scotland increase relative to those in rUK. Of course, the opposite is possible: the sum of revenues raised could be less than the sum of the BGAs, if the devolved tax base grows relatively more slowly or devolved tax rates are cut.

These arrangements ensure that the devolved Scottish budget benefits in full from policy decisions by the Scottish government that increase revenues, and conversely bears the costs in full of policy decisions that reduce revenues or increase expenditures. But it also means that the UK Government manages economic shocks and budgetary risks that affect the whole UK. If a major UK-wide shock (such as Covid) causes devolved revenues to fall, then as long as rUK revenues fall in a similar proportion, the devolved budget is protected by the corresponding fall in the BGA. However, the devolved governments bear the risk that their tax base might grow relatively less quickly over time compared to the equivalent rUK tax base, regardless of what might cause that.

You can read more on BGA calculations here.

Block Grant Adjustments – social security

As well as BGAs for the tax powers devolved through the Scotland Act 2016, there are also BGAs for each social security benefit devolved through the Scotland Act 2016.

Whereas the BGAs for tax are deducted from the budget, the BGAs for social security spending are added to the Scottish budget. They are designed to reflect the spending foregone by the UK government as a result of transferring certain spending responsibilities to the Scottish budget.

There is a BGA for each social security responsibility devolved. The social security BGAs are calculated in a similar way to the tax BGAs. Read more on the funding of Scotland's social security powers <u>here</u>.

There are two components to calculating a BGA:

- An initial addition. This is the amount that the UK Government spent on a payment (e.g. Carer's Allowance) in Scotland in the year prior to that payment being devolved.
- An indexation measure: a measure of the growth in spending on 'comparable' social security payments per capita in England and Wales.

Effectively what the BGA calculation is saying is:

Let's assume that, if Carer's Allowance had not been devolved, the UK Government's spending on it in Scotland would have grown at same per capita rate as in England and Wales (E&W).

This amount is transferred to the Scottish budget. The BGAs are not ring-fenced in any way, they are effectively just added to the 'pot' from which the Scottish Government must fund all devolved public services and social security payments.

Reconciliations

When the Scottish budget is published, outlining plans for the forthcoming financial year, it has to be based on forecasts of revenues raised from devolved and assigned taxes, and social security spending. It also has to be based on forecasts of the tax and social security BGAs (as these BGAs are in turn based on tax and social security forecasts made for rest of the UK).

Once outturn data on tax and spending is available, adjustments are made to the Scottish budget to reflect differences between the budget forecasts and the 'reality'.

These adjustments are known as reconciliations. Understanding the reconciliations is slightly complex because the process for reconciliations differs for different taxes and social security spending, depending on the timescales over which outturn data becomes available.

In the case of income tax, reconciliations do not occur until three years after the budget in which they were set (forecast errors made in respect of budget 2018/19 are not reconciled until budget 2021/22). This is because full outturn data is not available until 15 months after the end of the financial year to which it applies.

But other reconciliations happen over shorter timeframes, based on when outturn data is available, and whether a particular tax or social security payment is administered within Scotland, or by a UK agency such as HMRC. (When taxes or social security payments are administered within Scotland, BGAs are updated on a regular basis throughout the year as interim outturn data becomes available – this helps the Scottish Government to manage its cash flow. But this approach is not necessary for income tax, because HMRC administers the tax in Scotland, and there is therefore no implication for the Scottish Government's in-year cash flow of receipts in Scotland and rUK falling short of forecasts). For further information on the reconciliation process, see the government's annual Fiscal Framework Outturn Report.

If the original forecasts were too optimistic, reconciliations will reduce the size the Scottish budget in the subsequent year; but if the original forecasts were too pessimistic, the reconciliation could result in an increase in resources.

You can read more on reconciliations here.

Borrowing

The Scottish Government's resource borrowing powers are limited. The Scottish Government has no ability to borrow to fund discretionary increases in public services spending. Instead, resource borrowing can only be used to address forecast errors (whether those are forecast errors associated with devolved or assigned tax revenues or the corresponding BGAs, or social security spending or BGAs).

On capital, the Scottish Government can borrow up to £450 million in any year, up to a total cap of £3 billion.

Additionally, the Fiscal Framework makes provisions for the 'Scotland Reserve' – a cash reserve of revenues that can be saved up when revenues exceed forecasts. Read more about the Scotland Reserve <u>here</u>.

How is the Block Grant calculated?

The block grant is calculated each year using the Barnett Formula. The Barnett Formula determines the *change* in the block grant from the previous year. This Barnett Consequential is added to the baseline block grant of the previous year

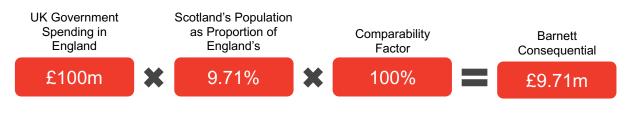
The Barnett Formula allocates the Scottish budget a population share of changes in UK Government spending on 'comparable' services in England. 'Comparability' is a measure of the degree to which a particular public service is devolved to Scotland. This Barnett consequential is calculated by multiplying the change in comparable UK Government spending in England by Scotland's population as a proportion of England's (about 10%).

Barnett Consequential = Change in UK Government Expenditure × Scotland's Population as Proportion of England × Comparability Factor

Comparable spending is measured by the comparability factor. The comparability factor is a measure of the extent to which a given spending line is devolved in Scotland. Each department has its own comparability factor. Education is completely devolved, so has a comparability factor of 100%, whereas others (like transport) have lower comparability factors. Comparability factors are set out in HM Treasury's <u>Statement of funding policy</u> (2015).

To show how the Barnett Formula works, if the UK Government increases spending on Education in England by £100m, the Barnett Consequential would be £100m x 9.71% (population share of Scotland) x 100% (comparability factor), which would result in an additional £10m for the block grant. The Scottish Government is free to spend this additional £10m on whatever they see fit.

Figure 3: Barnett formula calculation



Source: FAI

How are BGAs calculated?

The current methodology for calculating BGAs was a compromise agreed on the day of the Scottish Parliament's deadline in negotiating the Fiscal Framework after tough negotiations. The process has two parts:

- an initial amount; and,
- a method for indexing (changing) the BGAs in the following years.

The initial Block Grant Adjustment is given by the amount of revenues raised and welfare spent in the year before devolution, for those taxes and benefits that were to be devolved.

This initial deduction is then grown each year in line with the growth in equivalent tax receipts (or social security spending) per capita in the rest of the UK.

This method for indexing the BGAs is called the Indexed Per Capita (IPC) method.

The IPC method updates BGAs each year such that if Scotland's devolved tax revenues and welfare expenditures grow at the same rate *per capita* as those in the rest of the UK, Scotland's budget would be no better or worse off as if there had been no devolution.

If Scotland's tax base performs better than this benchmark, the budget can grow in size. Scotland's budget is thus tied to the relative performance between the rest of the UK's tax base and Scotland's.

Why do we need Block Grant Adjustments?

Block Grant Adjustments were designed as the way of upholding the principles of the Smith Commission, the cross-party recommendations on which the Fiscal Framework is based. These principles included that:

- There should be 'no detriment' to the devolved budget from 'the decision to devolve'.
- The UK Government should continue to manage economic shocks and budgetary risks that effect the whole UK, given that the Scottish Government does not have major borrowing powers or other tools to manage major cyclical tax revenue risks.
- But nonetheless that the devolved budget should 'benefit in full' from policy decisions by the Scottish government that increase revenues (and conversely bear the costs in full of policy decisions that reduce revenues or increase expenditures).

Consider each of these principles in turn.

No detriment from the decision to devolve: Let's say that the Scottish Government received their new devolved tax revenues alongside the same size block grant as prior to devolution; in that case the UK Government would have the same expenses (the block grant), but lower revenues (as a result of taxes being devolved to Scotland), while Scotland would see an increase in the size of the budget from the new taxes.

Similarly, it would be detrimental for the Scottish Government not to be compensated for the higher costs they now incur as a result of the devolved welfare benefits.

The existence of the 'initial deduction' in the calculation of the BGA ensures that the devolved governments' relative spending power is not affected by the initial revenue transfer of taxes or social security spending.

UK Government of economic shocks: If a major UK-wide shock (such as Covid) causes devolved revenues to fall, then as long as rUK revenues fall in a similar proportion, the devolved budget is protected by the corresponding fall in the BGA. Similarly, a rise in spending on devolved social security payments would be offset by a rise in the BGA associated with those payments, if expenditure on the equivalent rUK payments similarly increased.

Benefit from devolved policy decisions: The BGAs also ensure that the Scottish Government benefits from policy decisions it makes. If for example the Scottish Government increases a tax rate, then in principle this should result in Scottish revenues increasing relative to the tax BGA. The Scottish budget therefore captures the revenue impact of the tax change. Similarly, if the Scottish Government chose to increase spending on a social security payment, then its spending would increase relative to the spending BGA.

Note also however that of the Scottish economy (or Scottish earnings) grow relatively less quickly than in rUK, then this may cause Scottish tax revenues to fall below the corresponding tax BGAs (which are deducted from the budget). Slower growth in the Scottish economy *might* be the result of Scottish Government policy, but it could also be the result of external factors beyond the control of either government (such as a collapse in the global oil price). In practice therefore, the BGAs expose the Scottish budget to the risk of differential performance of the Scottish economy regardless of the cause. This doesn't necessarily contradict the Smith principles, but it does go somewhat beyond what they intended.

How can I stay up to date with the budget?

Understanding how the budget is formed and what it is spent on is vital to understanding the achievements and failures of the Scottish Government, as well as the various constraints it faces.

The budget is published annually, but factors that affect the budget are continuous; changes in UK spending, outturn tax revenue data, economic crisis and elections all make predicting and evaluating the budget difficult.

To help you stay up to date with the latest developments, we publish frequent articles on the <u>budget outlook here</u>, research and analysis on the <u>Scottish economy here</u>.

We also publish our Scotland's Budget Report each year. Here we provide an in-depth, independent evaluation of the Scottish budget, including the outlook for the block grant, BGAs, reconciliations and borrowing, as well as analysis of the Scottish Government's spending plans and priorities. You can find all of our <u>annual budget reports since 2016 here</u>.