House of Commons

Scottish Affairs Committee

Revising Scotland's fiscal framework

Third Report of Session 2015–16

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The Scottish Affairs Committee

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1 Introduction

1. The relationship between Scotland and the rest of the United Kingdom is changing. The Smith Commission, set up in the wake of the 2014 referendum on Scottish independence, recommended that further powers be devolved to the Scottish Parliament. The UK Government accepted the Commission's recommendations in full and transposed those powers into legislation in the form of the Scotland Bill 2015. The Bill is currently being considered in the UK Parliament and soon the Scottish Parliament will do the same when it is invited to scrutinise and give its consent to the legislation.

2. However, the Scotland Bill 2015 is only part of the process of further devolution. In order for the tax and spending provisions contained in the Bill to be successfully devolved, the way in which Scotland is funded must change. The Smith Commission recognised this and recommended:

> The devolution of further responsibility for taxation and public spending, including elements of the welfare system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework.[1]

The fiscal framework for Scotland underpins the devolution settlement. The success of this latest round of devolution will depend to a large extent on the outcome of negotiations over the framework. Both governments have agreed not to comment on the negotiations while they are ongoing but this has led to concerns of a lack of debate over the appropriate degree of risk and incentives that Scotland should face as a result of the new settlement. As we aim to set out in this Report, these questions are fundamental to the whole process.

What is a fiscal framework?

3. The UK Government defines a fiscal framework as "the set of rules and institutions that are used to set and coordinate sustainable fiscal policy."[2] In the Command Paper which accompanied the publication of the draft Scotland Bill, the UK Government identified two key elements to a fiscal framework:

- Fiscal rules–these are designed to constrain fiscal policy, typically by setting limits on borrowing and/or debt over a defined period, in order to ensure fiscal responsibility and debt sustainability; and

- Fiscal institutions–these are non-governmental bodies responsible for overseeing fiscal policy decisions of the Government. In the UK this role is performed by the Office for Budget Responsibility (OBR), which also produces official economic and fiscal forecasts.[3]

The UK's fiscal framework is set out in the Budget Responsibility and National Audit Act 2011. The Act requires the Government to lay before Parliament a 'Charter of Budget Responsibility'. The purpose of the Charter is to improve the transparency of the

1 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 94

2 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.2.3

3 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.2.4

Government's fiscal policy. The Charter must set out the Government's approach to fiscal policy, management of public debt and its objectives for fiscal policy.[4] The 2011 Act also established the Office for Budget Responsibility.

4. The UK's fiscal framework stipulates that devolved authorities must work within the constraints imposed by the UK Government's fiscal policy while at the same time being allowed to exercise their devolved powers.[5] Scotland's fiscal framework—as defined by the Scotland Act 1998 and amended by the Scotland Act 2012—sits within the wider UK fiscal framework.

5. Scotland's existing framework states that the Scottish Government must run a balanced budget, that its funding is primarily derived from a block grant determined by the Barnett Formula and that Scotland has tools to manage volatility including the ability to operate a cash reserve and limited current borrowing powers to allow the Scottish Government to cope with variations in forecasts. The framework also allows the Scottish Government to borrow to fund capital expenditure. The Scottish Government has created the Scottish Fiscal Commission to scrutinise the reasonableness of its forecasts for devolved taxes. The Smith Commission notes that the revised framework should encompass a number of elements including:

> the funding of the Scottish budget, planning, management and scrutiny of public revenues and spending, the manner in which the block grant is adjusted to accommodate further devolution, the operation of borrowing powers and cash reserve, fiscal rules, and independent fiscal institutions.[6]

Why does Scotland's fiscal framework need revising?

6. The Smith Commission process will see the amount of revenue the Scottish Parliament is responsible for raising double to approximately £16 billion. It will also be assigned a further £5 billion in VAT revenues. Together, these revenues will account for over half of the Scottish Government's annual Budget and around 40% of all revenues raised in Scotland. However, the Scottish Parliament will not just be taking on more responsibility for raising revenues, it will also be taking on the Scotland-specific fiscal risks associated with them. As the Scottish Government's reliance on revenues increases then its exposure to volatility in its income base also rises. In order to be able to manage those risks effectively and be able to smooth any fiscal shocks the Scottish Government will need greater borrowing powers. This has been recognised by both the Smith Commission and the UK Government. Determining what those powers should look like is one of the key elements of the inter-governmental negotiations on revising Scotland's fiscal framework.

7. The second key part of revising the fiscal framework concerns the question of how to adjust the block grant to take account of the devolution of tax and spending powers. Different methods of adjustment can lead to substantial differences in the size of the block grant and the level of risk to which Scotland might be exposed.

4 Budget Responsibility and National Audit Act 2011, Part 1; the most recent Charter was published in September 2015. It sets out the UK Government's current aims for public sector net debt to be falling as a percentage of GDP, a target for a surplus on public sector borrowing by the end of 2019–20, and a cap on welfare spending.

5 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.2.7

6 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, para 95

8. Aside from borrowing powers and the block grant adjustment, in this Report we also discuss other important areas of the fiscal framework including the assignment of VAT revenues, the devolution of welfare powers, scrutiny arrangements and the operation of the Smith Commission principles of no detriment. The section of the Smith Agreement which relates to Scotland's fiscal framework is set out in the Appendix.

Accountability and powers

9. The Smith Commission and the devolution of further powers to Scotland are as much about making the Scottish Parliament and the Scottish Government more accountable to the people of Scotland—by making them more responsible for raising the revenues they spend—as it is about devolving to the Scottish Government levers to grow the Scottish economy and develop a distinct welfare policy. As we will discuss in this Report, having more powers does not automatically translate into economic prosperity but it does expose Scotland to greater risks. Whether the Scottish Government will have the tools to manage those risks effectively and whether it will be able to use the further powers to its benefit will largely come down to the design of the fiscal framework.

10. The stability of the devolution settlement is dependent on both governments getting the fiscal framework right. We had originally hoped to examine the framework once it had been published in the autumn. As this did not happen we have instead chosen to consider what we perceive to be the most important elements of a revised framework and in this Report we set out our views on what they should look like. This will give us a base from which to judge the framework when (or if) it is finally agreed.[7]

7 At time of considering this Report some clear differences in opinion between the two governments remained to be resolved.

2 Fiscal institutions

11. A fiscal framework consists of fiscal rules and fiscal institutions. The OECD defines fiscal institutions as "publicly funded, independent bodies under the statutory authority of the executive or the legislature which provide non-partisan oversight and analysis of, and in some cases advice on, fiscal policy and performance".[8] The IMF states that key features of effective independent fiscal institutions include:

- Strict operational independence from politics;
- Provision or public assessment of budgetary forecasts;
- Strong presence in the public debate (notably through an effective communication; strategy); and
- Explicit role in monitoring fiscal policy rules. [9]

12. The Smith Commission recognised the important role that fiscal institutions will have in the new devolution settlement for Scotland. It recommended that independent scrutiny of Scotland's public finances be expanded and strengthened "in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process".[10] This can be achieved either by enhancing the role of the Office for Budget Responsibility (OBR) (which already forecasts devolved revenues), or that of the Scottish Fiscal Commission (SFC),[11] or the creation of new body in Scotland. The UK Government has been clear in its view that the "remit and capacity" of the Scottish Fiscal Commission should be enhanced, "fully consistent with OECD principles and reflecting the UK experience with the OBR".[12]

13. The Scottish Fiscal Commission is currently responsible for assessing the 'reasonableness' of Scottish Government forecasts for those taxes already devolved to the Scottish Parliament. In its inquiry into the fiscal framework the Finance Committee of the Scottish Parliament identified "a general consensus that the SFC should produce its own forecasts […] there was also strong support for the SFC having a wider role in monitoring the adherence of the Scottish Government to its fiscal rules and the sustainability of the public finances".[13]

14. The Scottish Government is legislating to put the Scottish Fiscal Commission on a statutory footing but the current bill falls short of the recommendations of the Finance Committee. In its report on the Bill the Finance Committee concluded that the

8 OECD, Recommendation of the Council on Principles for Independent Fiscal Institutions, February 2014
9 SPICe, Financial Scrutiny Unit Briefing, Scotland's Fiscal Framework, December 2015
10 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.7
11 The Scottish Fiscal Commission was established in June 2014 "to provide independent scrutiny of Scottish Government forecasts of receipts and economic determinants from taxes devolved to Scotland. At present there are two devolved taxes in Scotland, Scottish Landfill Tax and Land and Buildings Transaction Tax. The Commission also scrutinises the Scottish Government's assumptions about the economic determinants that drive income from Non-Domestic Rates." Its remit does not currently include analysis and scrutiny of expenditure.
12 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.4.34
13 Scottish Parliament Finance Committee, Scotland's Fiscal Framework, SP Paper 771, June 2015, para 117

Commission's role should be "widened substantially" from that stated in the Bill to include production of official forecasts on devolved taxes and assessment of the sustainability of Scotland's public finances.[14] This would give it a similar role to that of the OBR.

15. The accuracy and independence of forecasts will be a key element of the new devolution settlement. As more powers are devolved to the Scottish Parliament then the cost of forecast errors will be proportionally greater.[15] The importance of accurate forecasting is not limited to Scottish revenues. The adjustments to the block grant will most likely be determined by forecasts of rUK revenues. Professor Bell, Professor of Economics at Stirling University, told us that this will require a degree of coordination between the OBR and Scotland's fiscal body because "you do not want to have two completely different views of the prospects for the economy".[16]

16. Connected to the issue of forecasting is the question of reconciliation in light of actual outturns. If the block grant adjustments were subsequently amended to reflect the outturn figures it could be argued that the forecasts are less important. However, David Eiser, Research Fellow in the Department of Economics at Stirling University, cautioned that these circumstances might generate political arguments around how good the forecasts were and the implications for budgetary planning. In David Eiser's view this is a further reason why who does the forecasting is an important issue.[17] David Bell told us:

> I think it is essential that the forecasting is done outside Government, then you will know if they are wrong, which is probably going to be true; they will be honestly wrong rather than dishonestly wrong.[18]

17. ***Economic forecasts will have a key role in the new fiscal framework. There is a clear consensus that forecasting should be done by a body independent of government. We agree with the conclusions of the Finance Committee of the Scottish Parliament and recommend that an enhanced Scottish Fiscal Commission be made responsible for forecasting in Scotland.***

18. We make further recommendations on the role of the Scottish Fiscal Commission later in this Report.

14 Scottish Parliament Finance Committee, Report on the Scottish Fiscal Commission Bill, SP Paper 877, 5 January 2016
15 Written evidence submitted by Professor David Bell to the Finance Committee's Fiscal Framework inquiry
16 Q84
17 Q76
18 Q84

3 Borrowing powers

19. The Smith Agreement recommended that Scotland be given greater borrowing powers to reflect the additional economic risks, including volatility of tax revenues, which the Scottish Government will have to manage when further financial responsibilities are devolved. The Agreement states that those borrowing powers:

> should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.[19]

The Smith Commission stopped short of stating what those fiscal rules should look like.

20. Borrowing powers fall into two categories: to support current expenditure, and to support capital expenditure and we discuss each in turn below.

Borrowing to support current expenditure

21. The Scottish Government is currently able to borrow up to £200m per year, up to a cumulative ceiling of £500m, to deal with circumstances where revenues are lower than forecast and there are insufficient funds in the cash reserve to maintain spending. It is not clear what criteria these specific limits are based on.[20] What is evident is that these borrowing powers will be insufficient to cope with the volatility of those taxes due to be devolved to Scotland as a result of the Smith Agreement.

22. Without borrowing powers, if there were a shock to revenues then a government would be forced to cut spending (at a time when demand for public spending support might be increasing) or increase taxes. At a basic level, borrowing powers allow governments to continue to fund spending commitments through a downturn and to compensate for errors in revenue and spending forecasts. David Phillips, Senior Research Economist at the Institute for Fiscal Studies, confirmed to us that, following this latest round of devolution, Scotland "will need to be able to borrow to smooth the cycle, not just undo the mistakes it makes in its forecasts".[21] This is recognised in the Smith Agreement, which recommends:

> Scotland's fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework.[22]

23. What therefore needs to be calculated is how much volatility there is in the revenues that are to be devolved to the Scottish Parliament and the level of risk that both governments deem it appropriate for Scotland to be exposed to. This question of risk and reward goes to the heart of the latest round of devolution. The Smith Agreement stipulates that the UK

19 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.5

20 Written evidence submitted by Peter Jones to the House of Lords Economic Affairs Committee; the £500m ceiling was not increased when further responsibilities over taxation were devolved under the Scotland Act 2012

21 Q37

22 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.5

Government "should continue to manage risks and economic shocks that affect the whole of the UK,"[23] and that the Scottish Government should bear the risk and rewards from its own policy decisions but, as David Phillips explained, what the Smith Commission does not cover is who should bear the risk of exogenous shocks that hit only Scotland.[24] There has been little public debate on this point. In the view of the UK Government:

> if Scotland experiences an economic shock when the rest of the UK does not, the funding model would not provide the Scottish Government with additional funding to offset its lower tax receipts or higher spending pressures. The tools available to the Scottish Parliament [...] should therefore enable it to respond to such an event.[25]

24. In order to address the question of what level of risk Scotland should bear one first needs to consider what tools Scotland will have to deal with situations such as an exogenous shock to revenues. When a recession occurs the number of people in need of benefit support tends to rise while tax revenues tend to fall. Under the Smith Commission proposals the majority of the welfare system, including housing benefit and unemployment benefit, will remain reserved. The Scottish budget is therefore relatively protected from a recession on the spending side. This is not the case on the revenue side. A Scottish recession would hit revenues, particularly those derived from Income Tax on earnings and the level of VAT receipts assigned to Scotland might also be affected as consumer spending would be expected to fall in a downturn.

25. In our view, it would only be acceptable for Scotland to bear the risks of an exogenous shock if it had the tools to address them but David Heald, Professor of Public Sector Accounting at the University of Glasgow, explained to us that "key taxes like VAT and corporation tax are in the control of the UK Government, and monetary policy is and immigration policy is".[26] Professor Heald continued:

> to say that the Scottish Government should carry all the risks and rewards in terms of income tax revenues, I find that rather implausible, because I do not think the levers are there.[27]

John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance and Sustainable Growth, told us that, while the Scottish Government would assume responsibility for an exogenous shock, "there is a necessity for [Scotland] to have sufficient financial flexibility" to deal with its implications.[28] ***We welcome the devolution of further powers to Scotland but there is a danger that, while those tax powers being devolved may look substantial, they are not particularly suited to addressing the problems caused by an economic shock. The fiscal framework should ensure that Scotland's exposure to exogenous shocks is commensurate with the Scottish Government's ability to take effective action to mitigate them. In the event of a substantial exogenous shock we would expect the Joint Exchequer Committee to be convened to discuss how such costs should be shared.***

23 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.8
24 Q15
25 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.4.22
26 Q16
27 Q28
28 Q123

26. This leaves the question of what level of risk Scotland should carry. To some extent this will depend on the method chosen to devolve tax and spending powers. As will we discuss in the next chapter, the Smith Agreement states that there should be no detriment from the initial transfer of powers and that the amount deducted from the block grant to account for the devolution of a tax should be indexed over time (so that its value is not eroded by inflation or economic growth). The method of indexation is relevant to the question of borrowing powers. If the adjustment to the block grant is indexed to changes in the yield of the equivalent tax in the rest of the UK (rUK) then, if there were a UK-wide recession and rUK revenues fell, the amount deducted from the block grant would also fall. Under this mechanism Scotland therefore has some protection from shocks that affect the UK and the risks it faces are less than if other methods of indexing adjustments to the block grant were chosen.[29]

27. There are a number of different ways of indexing adjustments to changes in rUK revenues and each method has a different impact in terms of the size of the adjustment. **Whichever method of block grant adjustment is chosen, we support the principle that adjustments to the block grant should be indexed to changes to rUK tax yields as this approach will limit Scotland's exposure to UK-wide fiscal shocks**.

28. If exposure to UK-wide economic shocks is reduced then the level of risk Scotland faces and therefore the level of borrowing powers required will also be lower. It has been suggested that the Scottish Government might want additional borrowing powers in order to enable it to follow a different path of fiscal consolidation to that of the UK Government. The UK Government has however been clear that:

> the fiscal framework must require Scotland to contribute proportionally to fiscal consolidation at the pace set out by the UK Government across devolved and reserved areas.[30]

Witnesses to our inquiry doubted that the Scottish Government would be given sufficient borrowing powers to adopt a different fiscal stance. [31]

29. Professor Heald told us that during debates on the Smith Commission and Scotland Bill there seemed to be an assumption that Scotland having more powers over welfare would lead to more welfare spend. It has been suggested that borrowing powers could be used to top up UK benefits. Professor Bell told the Devolution (Further Powers) Committee of the Scottish Parliament that "borrowing for welfare is normally thought not to be good overall macro policy."[32]

30. The additional current borrowing powers that Scotland requires will more likely be determined by the perceived risk of volatility in its tax base and the level of trust in official forecasts. As David Eiser explained to us, "the borrowing is largely going to be about smoothing revenues, smoothing differences between forecasts and outturns and

29 Scotland would not be completely protected because if UK revenues fell then it can be assumed that spending would also fall. The size of the block grant would be affected due to the effects of the Barnett Formula; if other methods of adjustment were chosen, such as indexing at a fixed rate, then the size of the adjustment would increase even if receipts were falling. This would go against the Smith Agreement principle that the UK Government should bear shocks that affect the whole of the UK.

30 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.2.7

31 Q87

32 Oral evidence taken by the Devolution (Further Powers) Committee of the Scottish Parliament on 21 January 2016

smoothing general year-to-year fluctuations. It is not about enabling very different levels of spending relative to GDP".[33]

Balanced budget rule

31. The existing fiscal framework demands that the Scottish Government run an annually balanced budget. This not only constrains the Scottish Government's ability to pursue a fiscal policy distinct from that of the UK but, as the Scottish Government's dependence on Scottish revenues rises, then the inflexibility of this rule becomes increasingly detrimental to good economic practice as it forces Scotland to cut spending or raise taxes in a downturn.[34] The Deputy First Minister told us that the Scottish Government would require a degree of flexibility to counter-balance the greater exposure to risk.[35]

32. With appropriate constraints in the fiscal framework the annually balanced budget rule could be relaxed to provide the Scottish Government with more flexibility without detriment to the UK's overall fiscal position. But, as the Chief Secretary to the Treasury told us, such a rule would have to be consistent with the UK fiscal framework.[36] ***The UK Government has a commitment to run a balanced budget over the economic cycle and we expect the negotiations over revising Scotland's fiscal framework to provide a similar level of flexibility to the Scottish Government, subject to clear fiscal targets. An enhanced Scottish Fiscal Commission should monitor and report on the Scottish Government's performance against those targets.***

Capital borrowing

33. We asked the witnesses to our inquiry whether they thought the powers being transferred would increase the Scottish Government's ability to influence economic growth. In terms of tax powers, we were told that on their own they would not add much to the Scottish Government's existing policy levers (Professor Muscatelli), that their usefulness to stimulate economic growth was questionable (Professor Bell) and that any impact might be at the margins (Professor Heald).[37] The general consensus was that the devolution of revenue raising powers was largely about improving accountability.

34. The view was more positive when it came to capital borrowing powers. Professor Muscatelli, Vice-Chancellor and Principal of the University of Glasgow, told us that if there were a sufficiently permissive cap on capital borrowing that enabled a different mix of spend between revenue and infrastructure spend then this might provide the tools with which the Scottish government could grow its tax base.[38] Dr McCormick, Associate Director Scotland at the Joseph Rowntree Foundation, suggested to the Devolution (Further Powers) Committee that enhanced capital spending powers might be used to reduce future welfare spend:

33 Q87
34 Oral and written evidence by Peter Jones, and Dr Angus Armstrong, to the House of Lords Economic Affairs Committee inquiry into the Devolution of Public Finances across the United Kingdom
35 Q124
36 Q194
37 Q73, Q72 and Q60
38 Q87

> We say that the debate should be much more about investing in the childcare infrastructure and affordable housing supply, which are the drivers of some social security demand. […] Capital spending should be the major draw on borrowing and bond issuing, but we could be more creative about how we define productive investment. Childcare and housing are two good examples of how we could do that. [39]

35. On capital borrowing the Smith Agreement recommends:

> The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework.[40]

In his introduction to the Smith Agreement, Lord Smith notes that "the Parliament will be given increased borrowing powers, to be agreed with the UK Government, to support capital investment and ensure budgetary stability".[41] The Scottish Government is currently able to borrow an additional 10% of its capital DEL budget (around £3bn) each year, up to a total cumulative cap of £2.2 bn.[42]

36. The Scottish Government expected to use this facility for the first time in 2015–16. In the Draft Budget 2015–16, the Scottish Government stated it will "borrow up to £304m in 2015–16, the maximum permitted."[43] When the existing capital borrowing powers were discussed during the passage of the 2012 Scotland Bill, the Scottish Government stated that it:

> does not consider an arbitrary statutory limit on borrowing set by Westminster and lacking any objective justification to be acceptable as the basis for an agreement between Governments […] A regime along the lines of the prudential regime for borrowing which applies to local authorities, where decisions are made based on affordability, would be more appropriate.[44]

37. The Devolution (Further Powers) and Finance Committees of the Scottish Parliament both support the Scottish Government's call for the introduction of a prudential capital borrowing regime and recommend it be put on a statutory basis.[45] Scottish Local Authorities already operate prudential borrowing regimes and can collectively borrow sums far in excess of the current powers of the Scottish Government, but as David Phillips told us, central government can step in and overrule local authorities if they see imprudent borrowing. Mr Phillips sees such a step as being contentious at a sub-national level:

39 Oral evidence taken by the Devolution (Further Powers) Committee of the Scottish Parliament on 21 January 2016
40 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95
41 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, p4
42 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.3.9; Departmental Expenditure Limit (DEL) refers to the budgets allocated to and spent by Government Departments. The DEL budget is set at Spending Reviews.
43 Scottish Government, Scottish Draft Budget 2015–16
44 Letter from the Deputy First Minister to the Convener of the Scotland Bill Committee in the Scottish Parliament, 21 February 2011
45 See Devolution (Further Powers) Committee Report, New Powers for Scotland: An Interim Report on the Smith Commission and the UK Government's Proposals, SP Paper 720, 14 May 2015, Para 225; and Finance Committee of the Scottish Parliament, 12th Report of 2015, Scotland's Fiscal Framework, SP Paper 771, 29 June 2015

> If there were disagreements about whether borrowing was prudential by the Scottish Government I think the politics would be much more difficult. If the UK Government were to grant these powers and then step in and say, "Oh no, we think you're borrowing too much", I think that would cause far more political ramifications.[46]

38. Any extension to the Scottish Government's capital borrowing powers must sit within the UK's overall fiscal framework and be subject to appropriate constraints to guard against imprudent behaviour. It is not for us to determine what the precise limits on capital or current borrowing should be or assess what level of risk Scotland should be exposed to but we make some general observations below.

Sources of Scottish Government borrowing

39. Scotland is currently able to borrow from the UK Government via the National Loans Fund, from commercial lenders and by issuing Scottish Government bonds. One of the advantages to the Scottish Government of borrowing via the National Loans Fund is that it is able to access the relatively favourable borrowing terms enjoyed by the UK Government. The extent to which borrowing from other sources would be more expensive depends on a number of factors including the perceived credit-worthiness of the Scottish Government, the transparency of its fiscal arrangements and its fiscal discipline. Arguments for borrowing directly from the markets are that doing so can impose market discipline and the transparency of a government's fiscal activities is increased.[47]

40. The cost to a subnational government of borrowing directly from the market can be reduced if it is perceived that the debt would be underwritten by the national government, in other words whether, *in extremis*, the subnational government would be bailed out. Opinion on whether the UK Government should impose a 'no bail out' clause in the fiscal framework appears mixed. Arguments have been made that inserting a no bail out clause would be a means of imposing discipline on the Scottish Government and would protect the UK's overall fiscal position.[48]

41. While we agree that the Scottish Government should not be able to operate on the basis that if it made mistakes with its borrowing then it would simply be bailed out, we think a no bail out rule is inappropriate for a number of reasons. First, as Professor Heald explained such rules exist elsewhere but:

> One has to remember that the UK is a very integrated economy that is geographically very small, so things that you can do in the United States and Canada, for example, because of much greater physical space, are much more difficult to do in the UK.[49]

42. Given the inter-connectedness of the Scottish and rUK economies and the relatively small size of Scotland compared to the rest of the UK we do not think that the markets would believe that the UK would not bail out Scotland. Second, if the UK Government

46 Q37

47 Q41; Q83

48 See Para 189 of House of Lords Economic Affairs Committee Report, A Fracturing Union? The Implications of Financial Devolution to Scotland, 20 November 2015, HL 55

49 Q60

were to let Scotland go bankrupt it would inevitably harm the UK economy.[50] Third, such a rule goes against one of the main arguments made by the UK Government during the referendum campaign—that remaining part of the union provides people of Scotland with a greater degree of economic security than the alternative. Finally, if it was thought that Scottish debt was being underwritten by the UK then the cost to Scotland of borrowing on the markets should be similar to those borne by the UK.[51]

43. One of the purposes of this latest round of devolution is to increase the accountability of the Scottish Government to the people of Scotland. Dr Angus Armstrong from the National Institute for Economic and Social Research argued that Scotland should be free to borrow but only under its own name from the capital markets because, "Only then will Scottish taxpayers be able to judge the benefit and true cost of Scottish government policies".[52] David Phillips told us that borrowing from the markets "would instil market discipline".[53] We are sympathetic to these arguments but it would not benefit either Scotland or the UK if Scotland were to borrow from the markets if the costs were higher than borrowing from the National Loans Fund. Any no bail out clause or similar provision would have a negative effect on the cost of Scottish Government borrowing.

44. ***It is our view that borrowing from the markets will instil a degree of market discipline and transparency to the Scottish Government's borrowing. Such transparency should in itself act as a check on imprudence. If the cost of doing so is similar to that of borrowing via the UK, which it could well be if the UK Government were to be explicit that the debt would be fully underwritten, then this should be the default approach of Scottish Government borrowing.***

Limits to Scottish Government borrowing

45. The Scotland Act 1998 provided the Scottish Government with the power to borrow up to £500m from the UK Government to manage situations when revenues are less than forecast. Despite the additional tax powers delivered by the Scotland Act 2012, the limit on current borrowing remained unchanged but the Act did include the provision for the Scottish Government to borrow up to £200m in any one year. Furthermore, in addition to being able to borrow from the UK Government via the National Loans Fund (NLF), the 2012 Act gave the Scottish Government the option to borrow from commercial lenders and issue Scottish Government bonds for capital purposes.

46. A number of commentators have argued that rather than a precise numerical limit on Scottish Government borrowing it should instead be linked to a measure of affordability such as a percentage of Scotland's GDP.[54] It has also been suggested that an upper limit for current borrowing is unnecessary as the Scottish Government will already be constrained by the need to balance its budget over at least the economic cycle. Professor Heald told us that limits were important:

50 Q83 [Professor Bell]

51 Q46

52 Written evidence submitted by Dr Angus Armstrong to the Scottish Parliament's Finance Committee inquiry into the Fiscal Framework

53 Q47

54 This is discussed in the Devolution (Further Powers) Committee Report, New Powers for Scotland: An Interim Report on the Smith Commission and the UK Government's Proposals, SP Paper 720, 14 May 2015, para 207

> I think the reason there should be limits—whether they are negotiated limits or statutory limits is a separate matter—is because Scotland is part of the United Kingdom and its numbers count in fiscal numbers for the UK, there has to be some method by which the UK Government know what the Scottish borrowing is going to be.[55]

The Chief Secretary to the Treasury observed that, while limits were a matter for negotiation, "what I can say is that with international best practice in this area, when you look at countries that have powerful devolved parliaments like Canada and Germany, they have limits."[56]

47. We note that the limits for current borrowing did not change when a number of tax powers were devolved in 2012. Indeed it is not clear to us on what basis the existing limits were chosen in the first place. As part of the devolution of tax powers, the Scottish Government's current borrowing powers must be increased significantly but in proportion to the additional risk Scotland will be taking on. ***We recommend that a specific limit on current borrowing be set and the criteria on which that limit is based be published. Transparency is vital if the fiscal framework is to be a lasting agreement. A specified limit for current borrowing will help people in Scotland understand the additional risk that Scotland is taking on as a result of the devolution of further powers and make them better able to judge the Scottish Government's performance in managing that risk.***

48. We also believe that there should be limits to capital borrowing for the reasons set out by Professor Heald. Lord Smith indicated that existing capital borrowing powers would be increased but the Agreement does not specify by how much or on what terms. We are aware of the arguments in favour of capital borrowing limits being determined by measures of affordability. Under this approach the amount borrowed by the Scottish Government would be directly related to its ability to support that borrowing by its own tax revenues. ***There is merit in both governments exploring whether limits to the Scottish Government's capital borrowing powers should be based on a measure of affordability rather than a specific set value. Such an approach would better align Scottish Government borrowing powers with the performance of the Scottish economy. The methodology behind whatever debt rules are agreed must be clearly set out in the fiscal framework. This will provide clarity to those holding the Scottish Government to account and certainty to those pricing Scotland's debt.***

49. Peter Jones observes that forecasts of UK Government debt are made twice a year by the OBR—at the time of the Budget and Autumn Statement.[57] ***We have already given our view that transparency will be key to discouraging imprudent borrowing. To that end, we recommend that an enhanced Scottish Fiscal Commission be required to give regular borrowing forecasts to the Scottish Parliament. The Commission should also be required to assess the state of Scotland's public finances and their sustainability over the longer term.***

55 Q39

56 Q129

57 Written submission to House of Lords Economic Affairs Committee inquiry into the Devolution of public finances in the UK. Peter Jones is a freelance journalist. (The Economist, The Times, The Scotsman)

Servicing the cost of borrowing

50. Currently the cost of Scottish Government borrowing is borne by the UK. If more revenues are devolved then Scotland will contribute less to the cost of servicing that borrowing (as the UK has less revenue to draw upon) and rUK taxpayers would effectively be asked to shoulder a larger proportion of borrowing costs. Furthermore, it could be argued that if the Scottish Government gets increased borrowing powers and chooses to borrow via the UK's National Loans Fund there would also be costs that, for Scotland to bear, would need to be untangled from the UK's overall borrowing costs. However, Professor Muscatelli explained that the costs of Scottish borrowing would have an "infinitesimal" impact on the overall cost of servicing the UK's £1.6 trillion debt and as such it was something to maybe consider in the future.[58]

51. John Swinney told us that "when the Scottish Government takes on any borrowing it will be up to the Scottish Government to service that borrowing arrangement" and that raising borrowing at the cheapest price would be uppermost in his mind.[59] **We reiterate our view that the cost of borrowing is likely to be reduced if the criteria on which Scottish borrowing powers are based are seen to have been decided on objective and transparent criteria and that the issue of moral hazard is explicitly addressed in the fiscal framework.**

58 Q81
59 Q126

4 Adjusting the block grant

52. The block grant is the main source of funding for Scotland. When taxes are devolved to Scotland, receipts are paid directly into the Scottish budget and the block grant is reduced by the amount of revenue foregone by the UK Government. This presents two challenges. First, both governments must agree a method for calculating the initial deduction and second—and far more complex—they must agree a method of indexing that adjustment over time so that its value is not eroded by inflation and economic growth. The Smith Agreement offers some guiding principles as to how these challenges might be met (set out in the Appendix) but the Commission left it to the two governments to decide how the system would operate in practice.

The initial adjustment

53. The Smith Agreement states that the initial adjustment to the block grant must correspond to the amount of revenue foregone by the UK Government. The amount of revenue foregone is not necessarily as straightforward a calculation as it first appears and past experience shows that it will be subject to political negotiation. Professor Heald explained to us that "even on the initial deduction, one has to be careful because the state of the economy and where you are in the economic cycle and particular big events can make a difference."[60] Not only do tax receipts vary year-by-year but the Scottish Government and OBR might produce different forecasts of the amount of revenue that will be foregone. This is what happened when Stamp Duty Land Tax was devolved under the Scotland Act 2012. For this tax the UK and Scottish Governments eventually agreed a block grant deduction for 2015–16 of £494 million, reflecting the average of the OBR and Scottish Government forecasts for the tax revenues that would be foregone by the UK Government.[61] **The method of determining the initial adjustment from the block grant must be transparent and fair to both sides. If there is any perception of unfairness over the initial adjustment then the prospect of a stable settlement will be remote. To prevent the initial adjustment capturing the effects of an atypical year in the economic cycle we suggest the forecast be based on an average of outturns over several years.**

Indexing the adjustment

54. There are a number of different ways in which the adjustment to the block grant might be indexed going forwards. In a letter to the Devolution (Further Powers) Committee, the Deputy First Minister lists three categories that have been considered: linking the adjustment to the block grant; to corresponding UK Government tax receipts, or tax base or UK Government expenditure; and linking to the economy.

55. The method of calculating the adjustment to the block grant needs to accommodate the principle that Scotland should benefit in full from policy decisions that increase revenues or reduce expenditure and bear the costs of policies that do the opposite.

60 Q11

61 UK Government, Third Annual Report on the implementation and operation of part 3 (financial provisions) of the Scotland Act 2012, March 2015

In other words the adjustment to the block grant cannot simply be to deduct the amount equivalent to the revenues raised by the Scottish Parliament in that year. The Scottish Government would lack any incentive to boost tax revenues if any change were simply to be cancelled out by adjustments to the block grant.

56. The calculation must also have regard to the two no detriment principles put forward by the Smith Commission. The first of these states that there should be "no detriment from the decision to devolve further powers" and that future growth in the adjustment "should be indexed appropriately".[62] The second principle states that "changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK."[63] This has been coined the 'taxpayer fairness' principle. Rt Hon Greg Hands MP, Chief Secretary to the Treasury, explained the UK Government's view of how these principles should be applied:

> Consistent with paragraph 95.3 [of the Smith Agreement], we will ensure that funding for Scotland and the rest of the UK is unchanged at the point of devolution and thereafter, consistent with paragraph 94.4(b), Scottish taxpayers will benefit from growth in Scottish taxes so taxpayers in the rest of the UK should similarly benefit from growth in their corresponding taxes. […] Put simply, this means that neither Scotland nor the rest of the UK should be better or worse off as a result of the initial act of devolution.[64]

57. While the UK Government's view looks straightforward in practice, behind it lies a complicated debate on the key question that the Smith Commission left unanswered—how to index the adjustment to the block grant so that both the principle of 'no detriment from devolution' and the principle of 'taxpayer fairness' are satisfied. As we set out below, the answer may rest on how both these terms are interpreted.

No detriment from devolution

58. Of the different possible ways in which to adjust the block grant listed by the Deputy First Minister, the one that has received the most attention from commentators—and the one we focus on in this Report—is for the adjustment to be linked to what happens to equivalent revenues in the rest of the United Kingdom. We focus on this option because we consider it best meets the Smith Agreement recommendation that the UK Government should continue to manage risks and economic shocks that affect the whole of the UK. Under this option, if rUK revenues were to fall then the size of the deduction to the block grant also falls. Scotland therefore receives a degree of protection from shocks to the UK economy. As many of the levers required to respond to economic shocks will remain reserved it is only right that the UK should continue to bear most of the risk from UK-wide fiscal shocks.

59. The question for those negotiating the fiscal framework is which of the several ways of measuring change in rUK revenues is most suitable for the adjustment to be indexed to. If the adjustment were simply to be indexed to the rate of growth in rUK revenues—as is the case with the Scottish Rate of Income Tax (SRIT) devolved under the 2012 Act—then

62 Smith para 95.3

63 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.4

64 Q157

if rUK revenues increased by 5% the size of the adjustment would increase by 5%. This method, known as 'Indexed Deduction', allows Scotland to benefit if its revenues grow at a faster rate than the equivalent revenues in rUK.

60. However, there is a strong link between population growth and tax revenues. As Scotland's population is growing at a much slower rate than rUK's and has a lower proportion of earners in the higher tax brackets, we heard that there is a risk that over time, the growth of Scotland's revenues will not keep pace, let alone exceed, that of rUK.[65] Over the next 25 years Scotland's population is forecast to grow by 7.5%, while over the same period the population of the rest of the UK is forecast to increase by 15%. David Eiser told us, "the idea that the Scottish Government have the powers to fundamentally change the relative rates of population growth with respect to the rest of the UK is probably unreasonable."[66] The Chief Secretary to the Treasury however, disagreed. He told us:

> I think the Scottish Government should have and does have levers to increase its population. [...] Population is also about being able to do things like grow your economy, use planning powers, which the Scottish Government has. It is about housing powers, which the Scottish has. It is about the high quality universities in Scotland and the high quality skills base. All of these other things are perfectly within the powers of the Scottish Government to be able to attract more people coming to Scotland. I am talking not just about more people from within the UK but in terms of people coming to the UK, the Scottish Government is well placed to be able to make Scotland an attractive destination for those immigrating to the UK or coming in for one reason or another.[67]

61. We note the Scottish Government's arguments that a method of indexation that does not take account of Scotland's relatively slower rate of population growth would see Scotland's budget adversely affected. This might be considered unfair if it is considered that Scotland lacks the policy levers required to increase its population. Under such circumstances arguments have been made that such an approach would breach the Smith principle that Scotland should not be worse off as a result of the initial act of devolution.

62. The concerns described above could be avoided if comparative population change were removed from the equation. Basing indexation on relative revenue changes *per capita* would insulate Scotland from the effects of a comparatively slower rate of population growth. Under this approach Scotland would not be able to reap the benefits from a faster rate of population growth. Professor Heald told us:

> It is very obvious the one that is more fiscally neutral is the per capita indexation. The other methods imply, over a long period, very substantial reductions in the Scottish budget. Ever since the Act of Union, Scotland's population has gone down relative to the population of the UK.[68]

63. In addition to concerns over relative population growth, Professor Muscatelli told us that he also preferred the Per Capita method because it did not diminish the effect of the Barnett Formula which "was reiterated as the central principle of the Smith Commission

65 See Office for National Statistics 2014-based Statistical Bulletin
66 Q71
67 Q168
68 Q21

agreement, anything else is likely to erode Barnett over time".[69] Under the Per Capita method of indexation Scotland would still bear the risks of falling revenues, if Scotland did not grow its tax income as fast as the rest of the UK (in relative per capita terms), it would lose in terms of the block grant adjustment.[70] We see this as an appropriate level of risk for Scotland to bear.

Taxpayer fairness

64. We have considered the first principle, that there should be no detriment from the act of devolving a power, but policy-makers must also have regard to the second principle, the 'taxpayer fairness' question. The Vow and the Smith Agreement that followed were clear that the Barnett formula should be retained as the mechanism for determining Scotland's block grant. The Barnett Formula allocates to the devolved nations a population-based share of the change in spending on those areas in England (or England and Wales) where the equivalent is devolved. Because Scotland's tax revenues are lower per person than those in rUK, Scotland currently benefits by receiving a share of spending that is based on population. In Professor Muscatelli's view, because Barnett is central to the latest round of devolution it should be expected that such redistribution would continue.

65. The questions facing those negotiating the fiscal framework are the extent to which the redistribution of funding should continue, in order for the principle of 'no detriment as a result of devolution' to be satisfied, and at what point will the level of redistribution be considered to breach the second principle of taxpayer fairness. The two Governments appear to have opposing views on the answer to these crucial questions.

66. The principle of taxpayer fairness looks reasonable in theory but far from straightforward when subject to scrutiny, not least because taxes are not hypothecated. For example, how will it be determined that an increase in a particular rUK tax has contributed to an increase in a particular area of spend? One suggestion is to index the adjustment to the block grant to an amount equivalent to a population share of the change in rUK revenues. This is known as the Levels Deduction method. It has the advantage of operating on a similar basis to the Barnett formula by using population share as the prime determinant. Under this approach, increases in rUK spending that would otherwise benefit Scotland, would be cancelled out by a commensurate adjustment to the block grant. The Levels Deduction method would therefore appear to satisfy the taxpayer fairness principle.

67. However, the adjustment to the block grant is intended to represent the amount of revenue that would have been generated in Scotland had devolution not occurred. If the trends of relatively lower tax revenues per person in Scotland and comparatively slower rate of population growth continue, this suggests that, in the absence of devolution, the growth in Scottish revenues would not equal an adjustment based on a population share of revenues raised in the rest of the UK. In effect, under the Levels Deduction approach, tax revenues in Scotland would need to increase at a faster rate than in rUK in order for the existing levels of public spending in Scotland to be maintained. Phillips, Eiser and Bell point out that this approach:

69 Q67
70 Q79

> Does not seem to satisfy the spirit of the principle that there should be 'no detriment from the decision to devolve': there will be detriment to Scotland under this approach, unless revenues in Scotland grow at a faster rate both per person, and in aggregate than in rUK. This might be seen as an unfair challenge for Scotland to meet.[71]

68. The Per Capita method of indexation addresses this problem to some extent because it protects Scotland from relative lower population growth and the associated dampening effect on revenue growth. This approach locks in the current level of redistribution and therefore satisfies the first no detriment principle, i.e. under Per Capita Indexed Deduction (PCID) Scotland will not have to grow its taxes faster to maintain the same levels of public spending. However, left unchecked this approach would see the level of redistribution rising. This is because a population-based share of spending would be greater than a revenue-based adjustment to the block grant and that gap would be expected to grow if current population trends continued. This would breach the taxpayer fairness principle. David Eiser explained:

> What the Barnett formula does is effectively rewards Scotland for having relatively slower population growth than the rest of the UK. You might say if the Barnett formula is rewarding Scotland for relatively slower population growth on the spending side, why should the indexation method for the block grant adjustment protect it from that relatively slower population growth on the revenue side?[72]

69. John Swinney told us that "this issue has to be addressed as part of the discussions. We are perfectly happy to address that."[73] The UK Government states that "the tax deduction element of the funding model therefore needs to work alongside the Barnett Formula to ensure that increases in 'rest of UK' tax do not fund higher spending in Scotland."[74] In their paper *Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options,* Phillips, Eiser and Bell conclude that:

> It therefore turns out that it is impossible to design a block grant adjustment system that satisfies the spirit of the 'no detriment from the decision to devolve' principle at the same time as fully achieving the 'taxpayer fairness' principle: at least while the Barnett Formula remains in place. [75]

However, we heard that it might be possible to satisfy the two seemingly mutually exclusive principles. Professor Muscatelli told us that he believed that it would be possible to have an additional adjustment, which could be mechanistic and automatic:

> Every time the UK Government tries to increase spend or, for that matter, decrease spend, because it can work both ways, let's see whether we can correct the per capita index deduction to take account of those situations. I think you can make it reasonably automatic and reasonably self-administering.[76]

71 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015
72 Q71
73 Q132
74 UK Government, Scotland in the United Kingdom: An enduring settlement, Cm 8990, January 2015, para 2.4.14
75 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015
76 Q91

David Eiser suggested that the governments could consider opting for Per Capita Indexed Deduction combined with a ceiling on the Barnett consequential so that Scotland's funding per capita does not increase beyond a certain point relative to rUK.[77] Professor Bell told us that adjusting the PCID approach would be adding complication on top of complication but doing so to ensure that there is no redistribution from English taxpayers to Scotland when there are spending increases in rUK "is probably the least worst option".[78]

70. **The method of indexing the adjustment to the block grant to account for devolved revenues should not expose Scotland to risks that it lacks the powers to mitigate. We note the UK Government told us that the Scottish Government has the levers to increase Scotland's population. Furthermore, we consider any method of indexation that requires Scotland to increase its tax revenues at a faster rate, per person or in aggregate, than in rUK in order to maintain existing levels of public spending as breaching the first principle of no detriment. The Per Capita Indexed Deduction method both removes the risk arising from slower population growth and satisfies the Smith principle of 'no detriment at the point of devolution'. It also exposes the Scottish Government to revenue risks allowing it to bear the costs or reap the benefits of its own policy decisions.**

71. ***However, implemented unchecked the Per Capita Indexed Deduction method would breach the second no detriment principle, that of taxpayer fairness. It would be unfair on the rest of the UK if the method of adjusting the block grant were to exacerbate the existing redistribution of funding from rUK to Scotland. We heard that an additional adjustment could be made to the Per Capita Indexed Deduction approach to ensure that Scotland's funding per capita does not increase beyond a certain point relative to rUK. We recommend that both governments explore this option to determine whether it provides a suitable compromise between their respective positions.***

72. We heard from the Deputy First Minister that the same method of adjustment should be used for all revenue streams. The Chief Secretary to the Treasury echoed this view. He told us, "the most important thing there is to have, if at all possible, is the same model across the different areas. I think that is consistent and explicable."[79] **We support the views of the Deputy First Minister and Chief Secretary to the Treasury that the same approach to indexation should be used across the range of devolved and assigned taxes.**

Reserved spending

73. The question of taxpayer fairness is not limited to those areas which affect the Scottish Government's budget via Barnett. In the Command Paper which accompanied the publication of the draft Scotland Bill, the UK Government argued that the tax deduction mechanism should also account for increases in rUK revenues that are spent on reserved areas as such spending would also be for the benefit of Scotland. David Phillips told us that "given that there is a reserved powers model of devolution, Scotland needs to contribute to these reserved matters."[80] Mr Phillips explained:

77 Q104
78 Q94
79 Q167
80 Q31

> I think that is important for fairness. If more money is being spent on things that benefit Scots, as well as people in the rest of the UK, Scots should make a contribution to that. They had a vote in the UK Government elections, these things have to pass double majorities with the English votes for English laws even, so they have a say in these matters.[81]

74. Dr James Cuthbert however viewed the idea that the UK Government can use increases in rUK income tax to pay for reserved services and then demand a contribution from Scotland through adjusting the block grant as "profoundly unsatisfactory" and "counter to the popular conception of the scope of the extra powers promised under Smith".[82] Dr Cuthbert's concerns centred on the possibility that the contribution might be calculated in a way that was unfair to Scotland. The solution is not obvious, as Phillips et al observe, "no simple method of indexing the BGA will necessarily exactly offset other changes in spending for the benefit of Scotland."[83] We were surprised to learn from the Chief Secretary to the Treasury that "reserved areas will still be financed by reserved taxes [...] that situation would be unchanged by the devolution of most of income tax".[84]

Compensatory transfers

75. In circumstances where policy changes of one government impact on the budget of the other, the Smith Agreement recommends that "the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving."[85] The UK Government observes that there "will need to be a shared understanding of this principle in order to deliver a workable outcome."[86] Witnesses to our inquiry found this element of the Smith Agreement to be fraught with problems. David Phillips told us:

> I think this is a bit of a can of worms in terms of implementing it as a day-to-day feature of the fiscal framework. Virtually all policies by one government or the other will have knock-on effects on the other. [87]

76. Professor Bell agreed, he observed, "I do not think it is implementable. I think it is just too complicated [...] to have people spending lots of time trying to research the implications of tax changes would be fruitless because no one would agree on them".[88]

77. The UK Government offers a number of examples where this principle might take effect including employment programmes, benefits paid net of income tax and benefits used as eligibility criteria for other benefits.[89] Professor Nicola McEwen, Professor of Territorial Politics at the University of Edinburgh, offers the following example:

81 Q30

82 Written evidence submitted by Dr James Cuthbert to the House of Lords Economic Affairs Committee inquiry into Devolution of public finances in the UK

83 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015

84 Q183

85 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 95.4

86 UK Government, Scotland in the United Kingdom: an enduring settlement, Cm 8990, January 2015, para 2.4.16

87 Q47

88 Q97

89 UK Government, Scotland in the United Kingdom: an enduring settlement, Cm 8990, January 2015, para 2.4.16

> The Work Programme is largely financed by savings in social security spending. If this programme (or its equivalent) designed and delivered by the Scottish Government, failed to meet DWP expectations and targets for getting the long-term unemployed back to work, the Scottish Government may be expected to compensate the UK Government for higher than expected benefit costs.[90]

While some mechanical interaction effects might be clear there are any number of behavioural effects which will be more difficult to capture.

78. The issue of whether detriment has occurred and compensation is due is not limited to the welfare side. If the Scottish Government were to increase the top rate of tax and this caused high earners to shift their income into dividends, UK revenues from tax on dividend income would increase; it could be argued that the UK should compensate the Scottish Government but how does this fit with the Smith Agreement recommendation that the Scottish Government should bear the cost of its policy decisions? In this example, the tax changes may also have behavioural consequences such as high earners relocating or working less. Phillips et al point out that "estimating models of how people respond to tax changes is notoriously difficult and even once an agreed method is chosen, subject to wide margins of error."[91] The Institute for Chartered Accountants in Scotland counsels that "isolating what constitutes 'no detriment' from such a range of policy aims will require considerable care".[92]

79. In evidence to the Finance Committee of the Scottish Parliament Professor McEwen observed that it is not clear "which authority would be entrusted to determine when detriment had occurred, the precise cost incurred as a result of policy decisions, and the level of compensation which should be paid."[93] The Deputy First Minister suggested that, given the sensitivity involved, it would benefit from third-party scrutiny to ensure that there was an independent assessment of the many implications.[94] Professor McEwen also questioned whether "one possible consequence of the 'no detriment' principle is that it may present a disincentive to develop divergent policies likely to have cross-border effects." In evidence to the Finance Committee, Professor Holtham, Chair of the Holtham Commission on Funding and Finance for Wales, simply observed "it is absurd to worry about negative detriment", "I do not think that there is any possibility of this principle being made operational",[95] an opinion shared by both the House of Lords Economic Affairs Committee and Scottish Parliament's Finance Committee.[96]

90 Written evidence submitted by Professor Nicola McEwen to the Finance Committee inquiry's into the Fiscal Framework
91 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015
92 Written evidence submitted by ICAS to the Finance Committee's inquiry into the Fiscal Framework
93 Written evidence submitted by Professor Nicola McEwen to the Finance Committee's inquiry into the Fiscal Framework
94 Q143
95 Written evidence submitted by Professor Holtham to the Finance Committee's inquiry into the Fiscal Framework
96 Finance Committee of the Scottish Parliament, 12th Report of 2015, Scotland's Fiscal Framework, SP Paper 771, 29 June 2015; House of Lords Select Committee on Economic Affairs, 1st Report of Session 2015–16, A Fracturing Union? The implications of financial devolution to Scotland, HL 55, 20 November 2015

80. Some of the witnesses we heard from did see an element of merit in this aspect of the Smith Agreement. David Phillips was slightly less pessimistic than others. He told us:

> I think it might be worthwhile having some principle that where there are significant knock-on effects and they can be easily and demonstrably linked to a particular policy, there is scope sometimes for compensation payments to be made. But that would rely on it being something you can be fairly concrete about, otherwise I think it would just be disagreements and difficulties and it would become unworkable. Having it as a backstop measure in this somehow may not necessarily be a completely crazy idea, but trying to implement it on every case of a policy decision would quickly become unworkable.[97]

81. In any case, given the relative sizes of their economies any spillover from Scotland to the rest of the UK is likely to be relatively minor and worth consideration in only a few cases. The same might not true for effects in the other direction. Professor Muscatelli gave the example of a major change in pension law or the way National Insurance is structured as something that might have sufficient effect on the Scottish tax base to require a transfer between governments. This suggests to us that, in a small number cases where the effect might be substantial, there is merit in the principle of compensation. The Chief Secretary to the Treasury told us that any solution would have to be as mechanical as possible, as well-informed as possible and of a certain magnitude. The Chief Secretary was optimistic that the question of spill-over effects could be resolved and contained within the fiscal framework.[98]

82. **There is some sense behind the principle of compensatory payments, but we think that it can only work in a small number of cases where the effects are substantial and mechanical rather than behavioural. In those cases, for the principle of compensatory transfers to work without dispute, they must be well-evidenced and either be set out in the fiscal framework in advance or agreed separately by both governments. Although we have heard the case for an independent arbiter, within the current constitutional settlement of the UK we believe such matters are best solved at a political level.**

97 Q47
98 Q200

5 Devolution of welfare powers

83. The Scotland Bill will see approximately £2.5 billion of spending powers devolved to Scotland. The block grant will need to be increased to take account of the devolution of these spending responsibilities. As with tax powers, this adjustment must be indexed so that its value is not eroded over time. The issues involved in finding a suitable method of indexing spending powers are similar to those on the tax side and, as with the devolution of tax powers, the Smith Agreement stopped short of saying what form indexation should take. The UK Government paper that accompanied the draft clauses of the Scotland Bill did not offer a way forward other than to highlight the need for cooperation:

> The UK and Scottish Governments will need to work together to determine how this funding changes in subsequent years to dynamically and mechanically reflect changes in the welfare spending that would have been undertaken by the UK Government over time.[99]

Indexation

84. There are several elements to the devolution of spending powers that require consideration. The first issue is the indexation of the adjustment to the block grant. Here the effects are the reverse of those we discussed for tax powers. It seems likely that the governments will want the adjustment to be indexed to what happens to equivalent revenues in rUK. If the adjustment were based on some form of needs assessment then, as well as being incredibly complicated, the Scottish Government might be insulated from spending risk. As David Phillips et al's paper argues, "this might remove any incentive for the Scottish Government to reduce welfare spend. A definition of 'need' would also have to be introduced into the block grant process for the first time."[100] We also note the work of Professor Bell which shows that the main source of variation in benefit projections over the next 30 years is associated with changes in the costs of the state pension. Professor Bell states that "the implication of these projections is that the UK Government will continue to bear a significant proportion of the risks associated with population ageing in Scotland."[101] **We intend to examine Scotland's population trends and their impact on the development of public policy in a future inquiry. As part of that inquiry we will consider the extent to which Scotland, under the devolution settlement, bears the risks associated with an ageing population.**

85. As with tax powers, in determining the appropriate method of indexing spending powers the governments must consider whether to account for relative population growth. As rUK's population is growing faster than that of Scotland's then demand in rUK for those benefits is also expected to rise more quickly than demand in Scotland. Under these circumstances, unless the population differential is taken into account, then Scotland's share of that spending might exceed its expected need.[102] In our view this would breach the second 'no detriment' principle of taxpayer fairness. However, if a per capita approach is taken the gains from a comparatively slower population growth are removed. A Per

99 UK Government, Scotland in the United Kingdom: an enduring settlement, Cm 8990, January 2015, para 2.4.10

100 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015

101 Written evidence submitted by Professor Bell to the Devolution (Further Powers) Committee inquiry into the Fiscal Framework

102 This is the reverse of the effect of differential population growth on the devolution of tax powers

Capita Indexed *Addition* approach would also mirror the method we recommend the Governments explore for indexation on the tax side, providing welcome simplicity to this aspect of the fiscal framework.

86. Although we think indexation has obvious merits there is the question of what happens if the rUK benefit against which the adjustment is being indexed changes beyond recognition. Professor Bell has raised the hypothetical example of disability benefits being devolved to local government to build up support for social care.[103] We offer no solution but note it as something both governments should reflect on.

87. ***We recommend that both Governments explore basing the adjustment to the block grant to take account of the devolution of spending powers on a Per Capita Indexed Addition approach. This is consistent with the mechanism we recommend the Governments explore for indexing tax powers, it also keeps the adjustment process relatively simple and mechanical. Alternative options based on an assessment of need risk adding a substantial degree of complication while blunting incentives for the Scottish Government to reduce welfare spend.***

Eligibility

88. The second element of the devolution of welfare powers that the governments must address is the relationship between benefits that are being transferred and those that are not. Professor Heald and David Phillips both observed that addressing the interaction between devolved and reserved powers is the key issue to solve in relation to the devolution of spending powers. It is also one in which Professor Heald told us that he foresaw "lots of difficulties";[104] David Phillips et al have pointed to the "scope for significant (and reasonable) disagreement".[105] We discuss some of those challenges below.

89. A number of the benefits that are due to be devolved are used to determine eligibility for benefits that will remain reserved. For example, Carers Allowance (to be devolved) reduces eligibility for other out-of-work benefits such as Income Support or Universal Credit (reserved). Complications may arise if the Scottish Government decides to change the eligibility criteria for particular benefits, as Phillips et al explain:

> For instance, eligibility for Personal Independence Payments (PIP)—one of the benefits which will be devolved to Scotland—are used to determine whether people are also eligible for a range of things that will not be devolved—such as disability premiums in Housing Benefits, Tax Credits and Universal Credit, and exemptions or deductions from Vehicle Excise Duty, for instance. Any change in the eligibility criteria for PIP after devolution, or a change in the nature of the benefit, could therefore have knock-on effects for UK Government spending on these benefits.[106]

103 Oral evidence taken by the Devolution (Further Powers) Committee of the Scottish Parliament on 21 January 2016
104 Q49
105 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015
106 David Phillips, David Eiser and Professor David Bell, Adjusting Scotland's Block Grant for new Tax and Welfare Powers: Assessing the Options report published by the Institute for Fiscal Studies, November 2015

90. Such issues are not limited to the welfare side. The inter-relationship between devolved taxes and reserved benefits adds further complexity. For example, the Universal Credit is based on an assessment of net income; if the Scottish Government were to cut taxes this would lead to an increase in people's net income which in turn would lead to a reduction in the amount of Universal Credit that could be claimed.[107] In these circumstances there would be a saving to the UK Government. Under the second 'no detriment' principle the UK Government might be expected to transfer that saving to the Scottish Government. While understanding mechanical interactions might be complicated, they are likely to be more straightforward to determine than secondary behavioural effects, as Professor Bell cautions:

> Determining liability for consequent adverse (or beneficial) effects on the other government's policies and funding would be extremely complex and time consuming if second and subsequent round effects were included in the calculations.[108]

The Chief Secretary to the Treasury told us that "the best thing to go for is something that can be assessed mechanically between the two Governments, based on an agreed set of criteria, which I hope would be laid out in the framework."[109]

Complexity

91. The transfer of benefits to the Scottish Government under the Scotland Bill is likely to add to the complexity of the welfare system. This complicated division of responsibilities is not just a challenge that governments and those charged with implementing policy will have to grapple with. It will also present a challenge to the large number of people in Scotland who are partly dependent on those benefits—the majority of them older members of the population—and to those agencies and organisations who support them.[110] Many of the people claiming benefits will have to interact with both Scottish and UK-administered systems of welfare. In our Work of the Committee inquiry, Parkinson's UK told us that this could cause:

> real issues for people who look like they are going to be stuck between two systems, which are possibly moving in different directions, where a number of key issues have not been resolved and the impact that that has on people who are probably claiming multiple benefits is of great concern to us.[111]

There is a clear risk that a system in which some benefits are devolved and some are reserved will create confusion and uncertainty for those who depend on welfare support. Both governments must work together effectively to ensure that claimants are not disadvantaged by the process of transition from one system to another or by the

107 Q49

108 Written evidence submitted by Professor David Bell to the Devolution (Further Powers) Committee inquiry into the Fiscal Framework

109 Q188

110 Written evidence submitted by Professor David Bell to the Devolution (Further Powers) Committee inquiry into the Fiscal Framework

111 Written evidence submitted by Parkinson's UK to the Scottish Affairs Committee inquiry into The Work of the Committee

interaction of those separate systems in the future, not least because those claiming multiple benefits are likely to be on the lowest incomes. The needs of those who rely on benefits should be at the heart of the process of devolving spending powers to the Scottish Government. We expect to monitor progress in this area as part of our future work.

6 VAT

92. The Scotland Bill proposes to provide Scotland with the first 10 per cent of standard rate VAT revenue raised in Scotland (and the first 2.5 per cent of the reduced rate VAT). The UK Government does not set out in its Command Paper how this amount will be calculated. According to ICAS "considerable analytical and statistical work will be required if there is to be an amount that can be identified which truly reflects the VAT attributable to Scotland and will in future reflect any changes in the Scottish economy."[112] Professor Bell told us that he foresaw a number of difficulties in just getting a baseline for the tax.

93. When we put these concerns to the Deputy First Minister, he explained that, for the purposes of the fiscal framework, agreement had been reached that VAT would be assessed at the point of consumption and that further data sets would be created "to try to establish the levels of VAT that are appropriate to be allocated towards Scotland."[113]

94. It has been questioned whether the assignment of VAT revenues actually delivers any benefit to Scotland. PWC have raised concerns that the Scottish Government would "bear the risk of any fluctuations or falls in [VAT] revenue, whilst having no direct influence on the setting or collection of the tax."[114] Dr James Cuthbert observed that:

> Overall, it is difficult to see that Scotland gains anything from the proposal to hypothecate to Scotland a share of VAT revenues. Scotland gains absolutely no extra powers: but is exposed both to the short term fluctuations, and the long run indexation risk, which will be associated with this tax. And given the large element of uncertainty about the assignment of VAT receipts to Scotland, it is difficult to see that it adds much to the principle of fiscal responsibility.[115]

95. The Deputy First Minister told us that he welcomed the new powers and disagreed with those who questioned the merit of the Scottish Government being assigned a share of VAT revenues:

> It is an incentive for us to improve the performance of the Scottish economy because if we do that then there will be the potential for it to be a benefit as a consequence of more successful economic activity.[116]

96. **We agree with the Deputy First Minister that linking the Scottish Government's budget to economic activity through the assignment of a share of VAT revenues provides incentives for growth. The fiscal framework should make it clear that if estimates of VAT revenues are exceeded then the Scottish Government retains the benefit of that improved economic performance and consequential improved VAT take.**

112 Written evidence submitted by ICAS to the Finance Committee's inquiry into the Fiscal Framework
113 Q146
114 Written evidence submitted by PWC to the House of Lords Economic Affairs Committee inquiry into the Devolution of the Public Finances
115 Written evidence submitted by Dr James Cuthbert to the House of Lords Economic Affairs Committee inquiry into the Devolution of the Public Finances
116 Q147

97. **We are concerned at the potential for inaccuracy in the data and forecasts on which VAT assignment and subsequent indexation will be based. Any method that is unreliable may lead to disagreement between governments and it will almost certainly lead to forecast errors. This latter risk must be factored in when the governments are negotiating what the Scottish Government's enhanced current borrowing powers should look like.**

7 Conclusion

98. In this Report we have focused on what we perceive to be the key challenges faced by those charged with revising Scotland's fiscal framework. We have made recommendations against which we will judge the framework when it is published but this was not our original intention. We had hoped that we would be able to scrutinise a published fiscal framework at the same time as the House of Commons was considering the Scotland Bill so that our work could inform Parliament's scrutiny of the legislation.

99. The Deputy First Minister has described the fiscal framework as "just as important, arguably more so, than the legislation on new powers"[117] and yet Parliament has been required to consider the legislation without any sight of the framework underpinning it. This latest round of devolution looks, and is, rushed. This cannot make for good policy. Such circumstances make effective scrutiny all the more important but the opportunity for such work has been severely constrained. **The way in which the Scotland Bill and fiscal framework have been progressed has been unsatisfactory. Substantial changes are going to be made to the relationship between Scotland and the rest of the United Kingdom and it is to the detriment of everyone who will be affected that the process will not have been subject to the level of examination it deserves.**

100. The Chief Secretary to the Treasury told us that he was "committed to there being parliamentary scrutiny of the fiscal framework." He continued, "I am happy to look at what is being proposed in the Scottish Parliament and to look at whether doing something similar would be appropriate here in our Parliament."[118] We are encouraged by the Chief Secretary's comments and look forward to the House of Commons being given the opportunity to debate the fiscal framework once it is made public.

101. The agreement of the fiscal framework and enactment of the Scotland Bill (which, at the time of writing do not appear guaranteed, at least in the short-term), is not the end of the process. Much work remains to be done, in creating the environment to enable the powers to be transferred, the process of moving the powers across and their implementation. There are crucial roles for HM Revenue and Customs and the Department for Work and Pensions and a good working relationship between these bodies and the Scottish Government will be essential and must be reinforced by goodwill at a political level. This will be put to the test as the governments negotiate how the costs of setting up and administering the new system will be met.

102. More and better data will also be required to determine such things as VAT assignment and whether detriment has occurred. The calculation of the block grant may come under more scrutiny. A number of witnesses to our inquiry felt that there should be a great deal more transparency over how devolved funding is determined. Professor Heald told us that nobody will be able to judge whether the system is fair unless there is transparent information.[119]

117 Daily Record, John Swinney: We do not just want these powers. We insist upon them. But not at any price, 31 January 206
118 Q180
119 Q8

103. We also heard calls for there to be an independent arbiter who would step in when disputes over fairness and detriment could not be resolved at a political level. If the system that has been agreed is sufficiently mechanical then we hope such a role will be unnecessary. There are, however, a number of areas where dispute might arise, for example in judging the accuracy of forecasts or determining whether detriment has occurred and a transfer is required. Experience will tell us the extent to which these can be resolved at a political level alone. ***We recommend that the operation of the fiscal framework be subject to review after four years. Such a period is long enough for it to be determined whether the framework is working but short enough to prevent any perceived unfairness from having a substantial impact. A four year period will also mean that the effects of at least one spending round are included in the review.***

104. Throughout this inquiry we have sought to examine how the powers recommended by the Smith Commission will operate in practice. For the settlement to work it is important that the system is fair to both governments and to people either side of the border. This means that both no detriment principles should be respected. We cannot have a devolution settlement that requires one government to have to increase tax revenues just to maintain the status quo on the spending side, that does not constitute fairness. Equally, whatever agreement is reached should not affect the current level of funding redistribution. We have discussed a compromise that should prevent such situations from occurring.

105. We are conscious that the existing funding framework is perceived to favour Scotland but we do not believe that the implementation of the Smith Agreement and fulfilment of the Vow represent the appropriate juncture to address such concerns, not least because the Barnett Formula was placed at the heart of this latest round of devolution. Any change to the way in which the devolved administrations are funded should not be solely dictated by the Treasury but require proper debate involving all the devolved administrations.

106. Finally, during this Parliament we expect to scrutinise progress of the implementation of the Scotland Bill and the effectiveness of the fiscal framework that will underpin it. From the outset, this latest round of devolution has been about increasing the accountability of the Scottish Government to the people of Scotland and giving it more powers to address their needs. Through our work we will examine the extent to which this has been achieved and assess whether the Scotland Bill has truly delivered the recommendations and spirit of the Smith Agreement.

Appendix: Smith Agreement recommendations on an updated fiscal framework for Scotland

Scotland's Fiscal Framework

Para 94. The devolution of further responsibility for taxation and public spending, including elements of the welfare system, should be accompanied by an updated fiscal framework for Scotland, consistent with the overall UK fiscal framework.

Para 95. Scotland's fiscal framework encompasses a number of elements including the funding of the Scottish budget, planning, management and scrutiny of public revenues and spending, the manner in which the block grant is adjusted to accommodate further devolution, the operation of borrowing powers and cash reserve, fiscal rules, and independent fiscal institutions. The parties agree that the Scottish and UK Governments should incorporate the following aspects into Scotland's fiscal and funding framework.

(1) Barnett Formula: the block grant from the UK Government to Scotland will continue to be determined via the operation of the Barnett Formula.

(2) Economic Responsibility: the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure.

(3) No detriment as a result of the decision to devolve further power: the Scottish and UK Governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

   a) This means that the initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK Government, and that future growth in the reduction to the block grant should be indexed appropriately.

   b) Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK Government, including any identified administrative savings arising to the UK Government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved, sufficient to support the functions being transferred, at the point of transfer.

   c) The future growth in the addition to the block grant should be indexed appropriately.

(4) No detriment as a result of UK Government or Scottish Government policy decisions post-devolution

a) Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments.

b) Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.

(5) Borrowing Powers: to reflect the additional economic risks, including volatility of tax revenues, that the Scottish Government will have to manage when further financial responsibilities are devolved, Scotland's fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK Governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK framework.

a) The Scottish Government's borrowing powers should be agreed by the Scottish and UK Governments, and their operation should be kept under review in conjunction with agreement on the mechanism to adjust the block grant to accommodate the transfer of taxation and spending powers.

b) Borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK Governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.

(6) Implementable and Sustainable: once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

(7) Independent Fiscal Scrutiny: the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process.

(8) UK Economic Shocks: the UK Government should continue to manage risks and economic shocks that affect the whole of the UK. The fiscal framework should therefore ensure that the UK Government retains the levers to do that, and that the automatic stabilisers continue to work across the UK. The UK Parliament would continue to have a reserved power to levy an additional UK-wide tax if it felt it was in the UK national interest.

(9) Implementation: the Scottish and UK Governments should jointly work via the Joint Exchequer Committee to agree a revised fiscal and funding framework for Scotland based on the above principles. The two governments should provide updates to the Scottish and UK Parliaments, including through the laying of annual update reports, setting out the changes agreed to Scotland's fiscal framework.[120]

120 The Smith Commission, Report of the Smith Commission for further devolution of powers to the Scottish Parliament, 27 November 2014, Para 94-5

Conclusions and recommendations

Fiscal institutions

1. ***Economic forecasts will have a key role in the new fiscal framework. There is a clear consensus that forecasting should be done by a body independent of government. We agree with the conclusions of the Finance Committee of the Scottish Parliament and recommend that an enhanced Scottish Fiscal Commission be made responsible for forecasting in Scotland.*** (Paragraph 17)

Borrowing powers

2. ***We welcome the devolution of further powers to Scotland but there is a danger that, while those tax powers being devolved may look substantial, they are not particularly suited to addressing the problems caused by an economic shock. The fiscal framework should ensure that Scotland's exposure to exogenous shocks is commensurate with the Scottish Government's ability to take effective action to mitigate them. In the event of a substantial exogenous shock we would expect the Joint Exchequer Committee to be convened to discuss how such costs should be shared.*** (Paragraph 25)

3. **Whichever method of block grant adjustment is chosen, we support the principle that adjustments to the block grant should be indexed to changes to rUK tax yields as this approach will limit Scotland's exposure to UK-wide fiscal shocks.** (Paragraph 27)

4. ***The UK Government has a commitment to run a balanced budget over the economic cycle and we expect the negotiations over revising Scotland's fiscal framework to provide a similar level of flexibility to the Scottish Government, subject to clear fiscal targets. An enhanced Scottish Fiscal Commission should monitor and report on the Scottish Government's performance against those targets.*** (Paragraph 32)

5. ***It is our view that borrowing from the markets will instil a degree of market discipline and transparency to the Scottish Government's borrowing. Such transparency should in itself act as a check on imprudence. If the cost of doing so is similar to that of borrowing via the UK, which it could well be if the UK Government were to be explicit that the debt would be fully underwritten, then this should be the default approach of Scottish Government borrowing.*** (Paragraph 44)

6. ***We recommend that a specific limit on current borrowing be set and the criteria on which that limit is based be published. Transparency is vital if the fiscal framework is to be a lasting agreement. A specified limit for current borrowing will help people in Scotland understand the additional risk that Scotland is taking on as a result of the devolution of further powers and make them better able to judge the Scottish Government's performance in managing that risk.*** (Paragraph 47)

7. ***There is merit in both governments exploring whether limits to the Scottish Government's capital borrowing powers should be based on a measure of affordability rather than a specific set value. Such an approach would better align Scottish Government borrowing powers with the performance of the Scottish economy. The methodology behind whatever debt rules are agreed must be clearly set out in the fiscal framework. This will provide clarity to those holding the Scottish Government to account and certainty to those pricing Scotland's debt.*** (Paragraph 48)

8. ***We have already given our view that transparency will be key to discouraging imprudent borrowing. To that end, we recommend that an enhanced Scottish Fiscal Commission be required to give regular borrowing forecasts to the Scottish Parliament. The Commission should also be required to assess the state of Scotland's public finances and their sustainability over the longer term.*** (Paragraph 49)

9. **We reiterate our view that the cost of borrowing is likely to be reduced if the criteria on which Scottish borrowing powers are based are seen to have been decided on objective and transparent criteria and that the issue of moral hazard is explicitly addressed in the fiscal framework.** (Paragraph 51)

Adjusting the block grant

10. **The method of determining the initial adjustment from the block grant must be transparent and fair to both sides. If there is any perception of unfairness over the initial adjustment then the prospect of a stable settlement will be remote. To prevent the initial adjustment capturing the effects of an atypical year in the economic cycle we suggest the forecast be based on an average of outturns over several years.** (Paragraph 53)

11. **The method of indexing the adjustment to the block grant to account for devolved revenues should not expose Scotland to risks that it lacks the powers to mitigate. We note the UK Government told us that the Scottish Government has the levers to increase Scotland's population. Furthermore, we consider any method of indexation that requires Scotland to increase its tax revenues at a faster rate, per person or in aggregate, than in rUK in order to maintain existing levels of public spending as breaching the first principle of no detriment. The Per Capita Indexed Deduction method both removes the risk arising from slower population growth and satisfies the Smith principle of 'no detriment at the point of devolution'. It also exposes the Scottish Government to revenue risks allowing it to bear the costs or reap the benefits of its own policy decisions.** (Paragraph 70)

12. ***However, implemented unchecked the Per Capita Indexed Deduction method would breach the second no detriment principle, that of taxpayer fairness. It would be unfair on the rest of the UK if the method of adjusting the block grant were to exacerbate the existing redistribution of funding from rUK to Scotland. We heard that an additional adjustment could be made to the Per Capita Indexed Deduction approach to ensure that Scotland's funding per capita does not increase beyond a certain point relative to rUK. We recommend that both governments explore this option to determine whether it provides a suitable compromise between their respective positions.*** (Paragraph 71)

13. **We support the views of the Deputy First Minister and Chief Secretary to the Treasury that the same approach to indexation should be used across the range of devolved and assigned taxes.** (Paragraph 72)

Compensatory transfers

14. **There is some sense behind the principle of compensatory payments, but we think that it can only work in a small number of cases where the effects are substantial and mechanical rather than behavioural. In those cases, for the principle of compensatory transfers to work without dispute, they must be well-evidenced and either be set out in the fiscal framework in advance or agreed separately by both governments. Although we have heard the case for an independent arbiter, within the current constitutional settlement of the UK we believe such matters are best solved at a political level.** (Paragraph 82)

Devolution of welfare powers

15. **We intend to examine Scotland's population trends and their impact on the development of public policy in a future inquiry. As part of that inquiry we will consider the extent to which Scotland, under the devolution settlement, bears the risks associated with an ageing population.** (Paragraph 84)

16. ***We recommend that both Governments explore basing the adjustment to the block grant to take account of the devolution of spending powers on a Per Capita Indexed Addition approach. This is consistent with the mechanism we recommend the Governments explore for indexing tax powers, it also keeps the adjustment process relatively simple and mechanical. Alternative options based on an assessment of need risk adding a substantial degree of complication while blunting incentives for the Scottish Government to reduce welfare spend.*** (Paragraph 87)

17. **There is a clear risk that a system in which some benefits are devolved and some are reserved will create confusion and uncertainty for those who depend on welfare support. Both governments must work together effectively to ensure that claimants are not disadvantaged by the process of transition from one system to another or by the interaction of those separate systems in the future, not least because those claiming multiple benefits are likely to be on the lowest incomes. The needs of those who rely on benefits should be at the heart of the process of devolving spending powers to the Scottish Government. We expect to monitor progress in this area as part of our future work.** (Paragraph 91)

VAT

18. **We agree with the Deputy First Minister that linking the Scottish Government's budget to economic activity through the assignment of a share of VAT revenues provides incentives for growth. The fiscal framework should make it clear that if estimates of VAT revenues are exceeded then the Scottish Government retains the benefit of that improved economic performance and consequential improved VAT take.** (Paragraph 96)

19. **We are concerned at the potential for inaccuracy in the data and forecasts on which VAT assignment and subsequent indexation will be based. Any method that is unreliable may lead to disagreement between governments and it will almost certainly lead to forecast errors. This latter risk must be factored in when the governments are negotiating what the Scottish Government's enhanced current borrowing powers should look like.** (Paragraph 97)

Conclusion

20. **The way in which the Scotland Bill and fiscal framework have been progressed has been unsatisfactory. Substantial changes are going to be made to the relationship between Scotland and the rest of the United Kingdom and it is to the detriment of everyone who will be affected that the process will not have been subject to the level of examination it deserves.** (Paragraph 99)

21. ***We recommend that the operation of the fiscal framework be subject to review after four years. Such a period is long enough for it to be determined whether the framework is working but short enough to prevent any perceived unfairness from having a substantial impact. A four year period will also mean that the effects of at least one spending round are included in the review.*** (Paragraph 103)

Formal minutes

Monday 8 February 2016

Members present:

Pete Wishart, in the Chair

Mr David Anderson	Margaret Ferrier
Kirsty Blackman	Mr Stephen Hepburn
Mr Christopher Chope	Chris Law
Mr Jim Cunningham	Maggie Throup

Draft Report (*Revising Scotland's Fiscal Framework*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 106 read and agreed to.

A Paper was appended to the Report.

Resolved, That the Report be the Third Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available (Standing Order No. 134).

[Adjourned till Wednesday 24 February 2016 at 2.00pm.

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the Committee's inquiry page.

Wednesday 13 January 2016	*Question number*
David Phillips, Senior Research Economist, Direct Tax and Welfare Programme, Institute for Fiscal Studies, and **Professor David Heald**, Professor of Public Sector Accounting, Adam Smith Business School, University of Glasgow	Q1–64

Monday 25 January 2016, Morning session

Professor Anton Muscatelli, Principle and Vice-Chancellor, University of Glasgow, **David Bell**, Professor of Economics, University of Stirling, and **David Eiser**, Research Fellow, Economics, University of Stirling	Q65–106

Monday 25 January 2016, Afternoon session

John Swinney MSP, Cabinet Secretary for Finance, Constitution and Economy and Deputy First Minister, Scottish Government and **Sean Neill**, Head of Fiscal Responsibility Division, Scottish Government	Q107–156

Wednesday 3 February 2016

Rt Hon Greg Hands MP, Chief Secretary to the Treasury, **Ms Lindsey Whyte**, Deputy Director, Devolved and Local Government, HM Treasury.	Q157–207

Published written evidence

The following written evidence was received and can be viewed on the Committee's inquiry page. FIS numbers are generated by the evidence processing system and so may not be complete.

1 David Phillips (FIS0001)

2 Rt Hon Greg Hands MP, Chief Secretary to the Treasury (FIS0003)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the Committee's website at www.parliament.uk/scotaffcom.

Session 2015–16

First Report	Work of the Scottish Affairs Committee	HC 332
Second Report	Creative industries in Scotland	HC 331