HM Treasury

The UK government's response to the Lords Economic Affairs Committee Report:

"A Fracturing Union? The Implications of Financial Devolution to Scotland"

20 January 2016

Contents

1. Introduction

1.1. The UK government warmly welcomes the Report of the Lords Economic Affairs Committee (LEAC). The Committee has collated and analysed a considerable body of evidence which is invaluable as the UK and Scottish governments continue to work on a new fiscalframework for the Scottish government. The UK government isgrateful to all those who took time to submit evidence to the Committee and allowed their analysis to be made publically available.

1.2. In this response the government sets out its approach to the new fiscal framework and addresses each of the Committee'srecommendations. The government stands ready to engage further with the Committee at its request.

1.3. The Referendum on Scottish Independence in September 2014 showed clear support for Scotland remaining part of the United Kingdom. Before the referendum the leaders of major political parties in Westminster committed to deliver "faster, safer and better change"[1] with further powers to be devolved to the Scottish Parliament, and at the same time committed to maintain the Barnett formula.

1.4. The Smith Commission was set up by the Prime Minister after the result of the Scottish independence referendum. It was chaired by Lord Smith of Kelvin, and comprised two representatives of each major political party in Scotland. The Smith Commission was tasked with agreeing a package of powers to be devolved to strengthen the Scottish Parliament within the UK.

1.5. The Smith Commission agreed that a number of tax powers be transferred, including income taxon earnings, air passenger duty, the aggregates levy, as well as assigningthe first 10 percentage points of the standard rate of VAT.It also agreed on specific policy areas that should be devolved, including carer's allowance, attendance allowance, and disability living allowance.

1.6. The Smith Commission took evidence from a wide variety of sources, which included economic and constitutional experts, as well as over 18,000 submissions from members of the public. The decision on the powers the Smith Commission agreed to be devolved wasinformed by this evidence. Following their analysis it was agreed that the powers in theirreport were the right powers to devolve to the Scottish Parliament.

[1] The Vow,Daily Record, 16 September 2014, www.dailyrecord.co.uk/news/politics/david-cameron-ed-miliband-nick-4265992

1.7. These powers which formed the Smith Agreement did not emerge in a vacuum, at Second Reading the Parliamentary Under Secretary of Scotland, Lord Dunlop,said:

"[the Smith commission] emerged from four years of lively constitutional discussion and debate in Scotland, which was informed by the body of evidence compiled by the Calman commission, and from a discussion punctuated by the publication of numerous reports from Scottish Labour's devolution committee, the home rule commission chaired by the noble Lord, Lord Campbell of Pittenweem, and the commission chaired by my noble friend Lord Strathclyde, alongside academic and think tank contributions, such as Reform Scotland's devo plus and IPPR's devo more reports. Indeed, I believe the Smith agreement was made possible because common ground had already been established by this body of preceding work."[2]

1.8. The government has made good progress on the Scotland Bill, which will implement the legislative elements of the Smith Commission. The Bill is currently in the Committee stage of the House of Lords. Lord Smith commented on the progress of the Bill when he addressed the House of Lords at Second Reading:

"The agreement reached with the Scottish parties, and subsequently tested with the electorate across the UK, demonstrated a clear intent. I believe the Bill honours that intent and I hope noble Lords can work to support its progress"[3]

1.9. Reflecting the commitment to retain the Barnett Formula, the funding floor that the government has introduced for the Welsh government has been specifically designed to work alongside it. Consequently, the Welsh government's funding will be determined through the normal operation of the Barnett Formula if the relative level of funding they receive remains higher than 115% of comparable English spending per head. The implementation of the floor provides the Welsh government with certainty that it will not fall below that level for the duration of this parliament. The floor recognises that there has been significant convergence in the Welsh government's funding since the start of devolution, for instance, and this mechanical outcome of the Barnett formula is a particular concern in Wales.

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[2] Lord Dunlop, 24 November, Hansard, http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151124-0001.htm#15112445000203

[3] Lord Smith of Kelvin, 24 November, www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151124-0001.htm#15112445000239

2. Scotland - The Fiscal Context

2.1. The UK government responded to the Commission in the Command Paper: 'Scotland in the United Kingdom: An enduring settlement'[4]. In that report the government outlined the current fiscal arrangements, some of that evidence is presented below.

2.2. Under the Scotland Act 1998 (the 1998 Act), the Scottish Parliament is responsiblefor almost 60 per cent of public spending in Scotland, but is responsible for only around 10 per cent of Scottish tax..

2.3. Under the 1998 Act, the fiscal framework comprises three elements:

- **Fiscal rules** – consistent with the approach taken in other OECD countries, theScottish government is required to run an annual balanced budget, whereby itsspending must be fully funded each year;
- **Funding** – to fund its devolved spending responsibilities (e.g. health, education,housing, policing, justice etc) the Scottish government receives a block grant fromthe UK government and retains revenues from business rates in Scotland (withScottish local authorities retaining revenues from council tax). The block grant isfunded from tax revenues pooled across the UK and UK government borrowing.Changes in the block grant are determined by the Barnett formula, through whichthe Scottish government receives a population share of changes in comparable UKgovernment spending; and
- **Tools to manage volatility** – the 1998 Act provided the Scottish governmentwith the power to borrow up to £500 million from the UK government for cashmanagement purposes.

2.4. The Scotland Act 2012 (the 2012 Act) devolvedfurther tax and borrowing powers to theScottish Parliament. Stampduty land tax (Land and Buildings Transaction Tax) and landfill tax (Scottish landfill tax) were devolved alongside new borrowing powers in April 2015. The Scottish rate of income tax will become operational from April 2016.

2.5. The Scottishgovernment is alsoable to operate a cash reserve, or 'rainy day' fund, sothat it can build up reserves from existing budgets in advance of these new powersbeing implemented.

2.6. While the Scottish government is already able to allocate its budget towards devolved policiesand priorities as it chooses, the new powers agreed by the Smith Commission provide the Scottish government withthe ability to further vary the level of tax and spending in Scotland. The Smith

[4] Scotland in the United Kingdom: An enduring settlement, January 2015, https://www.gov.uk/government/publications/scotland-in-the-united-kingdom-an-enduring-settlement

Commission therefore agreed that the fiscal frameworktherefore must be updated to reflect these new powers and responsibilities.

3. A new fiscal framework for the Scottish government

3.1. The Smith Commission reached agreement on devolving a range of tax and welfare powers to the Scottish Parliament. The agreement strikes a careful balance between increasing the autonomy and accountability of the Scottish government, while ensuring that Scotland retains the benefits of remaining as part of the United Kingdom: the pooling and sharing of risk, preserving the single market, and the national state pension.

3.2. However, the Smith Commission recognised that the devolution of powercan have a significant fiscal impact – following the implementation of the agreement, more than half of the Scottish government's funding will be provided by Scottish tax. The Smith Commission therefore agreed that a new fiscalframework was required[5].

3.3. TheSmith Commission'sreport explained that the framework is the set of rules and institutions that will underpin the operation of the powers being devolved. However, rather than seeking to define the new framework, the Smith Reportinstead laid down important outcomes for what the framework has to achieve. A summary of these outcomes is set out below:

> 95(1) <u>Barnett formula:</u>the Barnett formula will continue to determine changes in the block grant from the UK government to the Scottish government in relation to departmental spending within Departmental Expenditure Limits.
>
> 95(2) <u>Economic responsibility</u>- The Scottish government should bear the full consequences of its decisions. That means the Scottish government willkeep the benefits if its policies either increase devolved tax revenue or decrease devolved spending; and manage the consequences if its policies reduce devolved tax revenue or increase devolved spending
>
> 95(3) <u>No detrimentas a result of the decision to devolve further power</u>- The initial transfer of powers should have no impact on the funding for Scotland or the rest of the UK. The Barnett-based block grant will therefore be increased to reflect the welfare powers being devolved, and reduced in relation to tax devolution/assignment
>
> 95(4) <u>No detriment as a result of policy decisions after devolution</u>- There are two parts to this principle:

[5] Paragraph 94 of the Smith Commission Report which stated "The devolution of further responsibility for taxation and public spending, includingelements of the welfare system, should be accompanied by an updated fiscalframework for Scotland, consistent with the overall UK fiscal framework."

a. Government budgets - where decisions by one government affect the tax or spending of the other, the decision-making government should meet the cost or receive the benefit
b. Taxpayer fairness –changes in devolved taxes in Scotland will only affect spending in Scotland so changes in corresponding taxes in the rest of the UK should only affect spending in the rest of the UK

95(5) Borrowing powers – There are two types of borrowing powers:

a. To manage Scotland-specific shocks -The Scottish government should have additional resource borrowing powers to manage risks and ensure budgetary stability in the event of shocks, consistent with a sustainable overall UK fiscal framework.
b. For capital investment - The Scottish government can already borrow over £2bn for capital investment (under Scotland Act 2012). The Smith Agreement states that the Scottish government should have sufficient capital borrowing powers, consistent with a sustainable overall UK fiscal framework, and that the UK and Scottish governments should consider the merits of delivering this through a prudential regime.

95(6) Implementable and sustainable– The effective operation of the fiscal framework should not require frequent negotiation but should be periodically reviewed.

95(7) Independent fiscal scrutiny -The Scottish Parliament should expand and strengthen independent scrutiny of the Scottish government's finances

95(8) UK economic shocks - The UK government should continue to manage risks and economic shocks that affect the whole the UK, with the Scottish government therefore managing marginal Scotland-specific risks in devolved areas.

95(9) Implementation – The new fiscal framework should be agreed by the two governments through the Joint Exchequer Committee, based on the above principles.

3.4. Work to develop the arrangements for the new fiscal framework has been ongoing since the Smith Commission Report was published, with negotiations beginning in earnest after the UK General Election. The UK government set out itsapproach to the framework in the Command Paper, making very clear that it would be guided by the above principles to ensure that the Smith Agreement was delivered in full.

3.5. Negotiations on the fiscalframework are conducted bilaterally between the UK and Scottish governmentsthrough the Joint Exchequer Committee

(Scotland). The Committee has met 6 times so far since the General Election:

7 July 2015

4 September 2015

23 September 2015

9 October 2015

7 December 2015

8 January 2016

3.6. After each meeting a communiqué is published and made available to Parliament, on 2 November a written ministerial statement[6] included an update on the negotiations,these documents are included in annexes A and B.

3.7. The government is committed to delivering the All-Party Smith Agreement in full. The framework will radically enhance the fiscal accountability of the Scottish government. If the Scottish government makes good policy decisions it will keep the resulting benefits. But if the Scottish government does not make good policy decisions it will bear the costs.

[6] Written Ministerial Statement, 2 November, www.parliament.uk/business/publications/written-questions-answers-statements/written-statements/?page=1&max=20&questiontype=AllQuestions&house=commons%2clords&member=1512

4. Response to individual Recommendations

The Fiscal Framework

1. The fiscal framework will be central to future devolution arrangements and the Scotland Bill cannot be properly understood or considered in its absence. (Paragraph 15)

2. The lack of an agreed fiscal framework leaves a significant gap in the information before Parliament. It is to be regretted that the Bill passed through the House of Commons without MPs having the opportunity to scrutinise the fiscal framework. (Paragraph 16)

3. We recommend that the Government:
    a. provides up-to-date information to Parliament on the progress of the fiscal framework negotiations; and
    b. gives a date by which the fiscal framework will be agreed. (Paragraph 17)

4. We recommend that the Scotland Bill does not proceed to Committee stage in the House of Lords until the fiscal framework is published. (Paragraph 18)

4.1. The government welcomes the Committee's findings and has taken steps to address the points raised by the Committee.

4.2. The government is committed to implementing the Smith Agreement,fully and as a package. As Smith set out, the new powers in the Scotland Bill and the fiscal framework (once agreed)will *together* set out the powers and responsibilities of the Scottish government (and Parliament) and how they will be financed. The governmenttherefore agrees with the recommendation that the Bill and the fiscal framework are best considered together.

4.3. It is the government's strong preference that the House of Lords should see the fiscal framework before the Bill completes its passage through the House. The Chancellor has made clear that the UK government stands ready to complete the negotiations:

"Let us sit down – we can sit down tomorrow, next week or whenever – to agree a fair fiscal funding framework."[7]

[7] Chancellor of the Exchequer, November 2015, http://www.publications.parliament.uk/pa/cm201516/cmhansrd/cm151125/debtext/151125-0002.htm

4.4. The governmentis pleased to co-operate withParliament's scrutiny of the negotiations[8].Thegovernment submitted written evidence to the Scottish Affairs Committee in the House of Commons and the Constitutional and Economic Affairs Committees in the House of Lords, and takes the findings and recommendations of the Committees extremely seriously.

4.5. The government has committed to provide updates on the progress of negotiations but not to provide a running commentary. Itwill:

- deposit updates on the negotiations after each JEC
- announce the date of each JEC before it takes place
- make officials available to brief MPs and Peers (where appropriate)
- participate in the Scottish Affairs Committee inquiry into the framework (and any other such inquiries)
- make the framework available to Parliament once agreed
- invite scrutiny from Parliament on the framework once agreed

4.6. The government has always been transparent about itsobjectives for when the agreement is to be reached. Itagreed with the Scottish government in mid-2015 that both governmentsshould aspire to agree the framework by the autumn[9]. Unfortunately this was not possible. Both governmentshave since been clear that negotiations were ongoing and agreement would take place after the Scottish government's December 2015 budget and the UK Spending Review announcement.

4.7. The UK government cannot unilaterally give an end date for the negotiations as it involves two parties. Both governments have agreed to the bilateral negotiation process, rushing an agreement could easily deliver an outcome that is sub-optimal given the complexity of the issue. The UK government has been clear that its objective is an agreement that is fair to Scotland, fair to the UK, and built to last.

[8] Including oral and written Parliamentary Questions, members' correspondence.
[9] Joint Exchequer Committee Communique, 4 September, Annex A

The Barnett Formula

5. Given the declaration of continued support for the Barnett Formula by themajor political parties, the Smith Commission had to accept that the existingmechanism for funding devolved administrations would be retained. Butif the aim is to produce a sustainable, long-term solution, retention of theBarnett Formula is the wrong decision. (Paragraph 28)

6. It is generally assumed that on the basis of relative need, funding per headshould be greater in Scotland, Wales and Northern Ireland than it is inEngland. The present system however can produce arbitrary and unfairresults. The funding mechanism needs to be replaced, particularly in light ofthe forthcoming changes to the fiscal framework. The report of the House ofLords Select Committee on the Barnett Formula recommended allocatingfunding on the basis of relative need. We believe this approach could providea long-term, sustainable solution. We endorse that Committee's conclusionsand recommendations and recommend that the Government considers thecase for introducing such an approach. (Paragraph 30)

4.8. The government notes the Committee's findings. As noted in the report, there is a clear commitment across Parliament to retain the Barnett Formula.This was one of the key principles set out by the Commission.

4.9. The Barnett Formula will therefore continue to determine changes in the block grant from the UK government to the Scottish government in relation to departmental spending within Departmental Expenditure Limits (which broadly covers UK government spending on public services). An explanation of the mechanical operation of the Barnett Formula is contained in the Statement of Funding Policy[10], which was recently updated at the Spending Review.

4.10. The fiscal framework will set out funding arrangements for the new powers being devolved to the Scottish government thatwork alongside the Barnett Formula i.e. where the Barnett Formula determines changes to the block grant in relation to public services spending, we need to develop analogous arrangements in relation to tax and welfare consistent with the Smith principles. This will ensure a sustainable, long-term solution will be achieved.

4.11. The outcome is that, as these powers come into effect, Scottish government spending will increasingly be funded through the taxes it raises

[10] Statement of Funding Policy, HM Treasury, November 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479717/statement_of_funding_2015_print.pdf

in Scotland and less so by the block grant allocated by the UK government. Changes in the Scottish government's funding will therefore increasingly be determined by changes in Scottish tax rather than changes in the block grant.

4.12. In his evidence to the Lords Economic Affairs Committee the previous Chief Secretary to the Treasury, Sir Danny Alexander defended the Barnett Formula:

"During my time in office, I do not recall once there being any great row or debate about whether or not the calculation of the Barnett formula had resulted in the right numerical outcome; I think that it is proposed that an independent body should oversee those sorts of calculations. I do recall that on one occasion there was an error on a spreadsheet, which was picked up pretty quickly by a civil servant and corrected. One of the strengths of the Barnett formula is precisely that people might disagree about the politics that lie behind different policies—they might, for example, criticise the deficit reduction and the fiscal consolidation that has led to reduced spending over the years, which I support; I think that you do, too—but the rows tend to be at that level. In my experience, there has not really been a row, an argument or a question mark over whether or not the Barnett formula itself has been applied correctly."[11]

[11] Sir Danny Alexander, Evidence to the Lords Economic Affairs Committee, http://www.parliament.uk/documents/lords-committees/economic-affairs/devolution-public-finances/The%20devolution%20of%20public%20finances%20in%20the%20United%20Kingdom.pdf

No Detriment and Adjustment of the Block Grant

7. Of the three methods proposed to the Committee for how to adjust the Scottish block grant to account for devolution of income tax receipts, there is no obvious choice. There are also many other methods that could be chosen. The decision will influence the size of Scotland's block grant. The choice is difficult as the UK and Scottish Governments have not enunciated any principles from which to derive a solution: it has not been made clear what risks—for example, a UK-wide recession or slower population growth—Scotland should bear when it has greater income tax raising powers. It is therefore difficult to assess the political choice as to which of the three methods, if any, is preferable. This is a critically important component of the new regime in Scotland and the UK and Scottish Governments must be clear about what is proposed. (Paragraph 48)

8. We agree with many of our witnesses that the second no detriment principle is unworkable. It is a recipe for future disagreement. The Government must set out in the fiscal framework how it intends to implement the second no detriment principle. (Paragraph 57)

4.13. The government notes the Committee's findings and agrees that there is a choice to be made between various potential block grant adjustment mechanisms. However, while the UK and Scottish governments have not enunciated any principles, this is because the Smith Agreementsets out a range of principles that the fiscal framework needs to deliver against. The purpose of the ongoing negotiations is to agree the arrangements that best deliver against these principles.

4.14. In relation to risks, the Smith Agreement is clear (in paragraph 95.8) that the UK government should hold UK-wide risks, with the Scottish government therefore managing the marginal Scotland-specific risks in devolved areas.This is consistent with the way in which the Barnett Formula works, as well the arrangements agreed for the Scottish rate of income tax under Scotland Act 2012.Delivering a consistent approach to risks for tax and spending will deliver a fair and sustainable long-term solution.

4.15. However, it is important to be clear that this is as much about potential upside opportunities as it is about managing downside risks. The Smith principles therefore provide the Scottish government with the opportunity to use its new powers to grow the Scottish economy, while being shielded from UK-wide impacts that the UK government is better placed to manage.

4.16. When it comes to the second 'no detriment' principle (paragraph 95.4) the Smith Commission set out two elements:

- Taxpayer fairness –changes in devolved taxes in Scotland will only affect spending in Scotland so changes in corresponding taxes in the rest of the UK should only affect spending in the rest of the UK

- Government budgets - where decisions by one government affect the tax or spending of the other, the decision-making government should meet the cost or receive the benefit

4.17. In relation to taxpayer fairness, the Scottish government will retain and spend revenues from taxes that only apply in Scotland. Any changes in these tax revenues will therefore only impact on spending in Scotland. For example, any increase in Scottish income tax will be retained by the Scottish government and spent in Scotland.

4.18. However, when the UK government spends any increase in income tax generated by taxpayers in the rest of the UK, this will also benefit Scotland – either from UK government spending on reserved areas, or through the Barnett Formula allocating the Scottish government a population share of changes in UK government spending in devolved areas.

4.19. As noted earlier, there willtherefore need to be a block grant adjustment mechanism for tax devolution that works alongside the Barnett Formula to deliver a similarly fair outcome for taxpayers in Scotland and the rest of the UK. This will avoid a scenario where extra revenues generated only by taxpayers in the rest of the UK partly funds extra Scottish spending; and similarly, it will avoid reductions in revenues from taxpayers in the rest of the UK being partly funded by cuts in Scottish spending.

4.20. In relation to government budgets, the UK and Scottish governments are working to develop a shared understanding of this principle in order to deliver a workable outcome.However, due to the integrated nature of the UK's tax and welfare system, this is a complicated area that needs to be considered carefully.

4.21. For example, while some policy decisions will impact directlyon the tax or spending of the other government, other policy decisions may only have more indirect effects. We need to ensure that the arrangements put in place are consistent with the Smith Agreement, while delivering the increased autonomy and accountability that are key features of devolution.

4.22. Indeed the importance of this economic responsibility has been recognised by both the Chancellor and the Deputy First Minister. In evidence to the Treasury Select Committee, the Chancellor said:

“I think it is important—this is fundamental to what everyone is trying to establish with this further devolution—that people live with the consequences of their actions”

4.23. Similarly, the Deputy First Minister’s evidence to the Scottish Parliament’s Finance Committee included his view that:

"If we take on a responsibility and make a success of it, we should bear the fruit of that; if we get it wrong, we must bear the consequences."[12]

4.24. The UK and Scottish governments will set out how all parts of no detriment will be implemented as part of the fiscal framework.

[12] Deputy First Minister, http://www.scottish.parliament.uk/parliamentarybusiness/report.aspx?r=9994

Income Tax Devolution

9. The UK Government is relinquishing full receipt, and almost full control, of £11 billion of income tax revenues in Scotland. No comparable central government has ever done this. While we agree that income tax is a suitable candidate for devolution, we are concerned that a decision to devolve nearly all revenue, uniquely amongst countries in a similar position to the United Kingdom, has been adopted with undue haste and little assessment of the economic and political consequences. It may not be clear to people in Scotland how they fund reserved services and which Government is accountable for them. There is a risk that this will weaken the connection between the Scottish electorate and the UK Government. (Paragraph 62)

4.25. The government notes the Committee's findingsandwelcomes agreement on the suitability of income tax for devolution. However, the government disagrees that it has beenselected without full consideration of the consequences.

4.26. As the Committee sets out it this Report and as heard from evidence to the Committee, income tax is a strong candidate for devolution. Successive investigations, including the Calman Commission through to the Smith Commission agreed that devolving a visible tax such as income tax improves visibility and with that accountability. The Calman Commission set this out clearly in comparison to other non-income taxes:

A much more substantial way to provide financial accountability is through income tax. Income tax rates have a clear and direct impact on many family budgets, and so can be a significant factor in how people vote – this makes politicians who set those rates keenly aware of the implications of their decisions. Almost all income tax payers are voters. It is also the highest yielding tax, raising about £10 billion a year in Scotland and so is capable of making up a significant proportion of the Scottish Budget.[13]

4.27. The government agrees with this view: devolution means each government being accountable for the services they deliver. Until now, the Scottish Parliament has been responsiblefor almost 60 per cent of public spending in Scotland, but only for around 10 per cent of Scottish tax. Building on the Scotland Act 2012, the further devolution of income tax provides the most sensible way of rebalancing this issue as set out in the Smith Agreement.

[13] Paragraph 28, Serving Scotland Better: Scotland and the United Kingdom in the 21st Century, June 2009, http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/15_06_09_calman.pdf

4.28. As the Committee is aware, the Smith Commission stopped short of devolution where analysis and evidence suggested this could be problematic. The Commission and other commentators have advised that further business taxes such as corporation tax and capital gains tax should remain reserved. After analysis and risk assessment devolution of these taxes to the Scottish Parliamenthas been shown to jeopardise the smooth operation of the single market. Lord Smith in his evidence to the Scottish Affairs Committee said:

"The five parties agreed that we would not devolve corporation tax. In that, we were assisted a great deal by information we had had from civic Scotland, where a lot of people understand corporation tax. The STUC and business organisations strongly said, 'Do not devolve corporation tax', and unimpeachable organisations such as the Institute of Chartered Accountants of Scotland, of which I am a member and which understands tax, said, 'Do not devolve corporation tax.' There was a very strong body of evidence from all these people that devolving corporation tax would lead to behavioural issues, if I can put it that way, and it would not be in the interests of Scotland to devolve. That was the STUC and business organisations all coming together to say that, and the five in the room all agreed it should not be devolved"[14]

4.29. However, the government believes we have given appropriate scrutiny to the level of income tax devolution in the Scotland Bill before including it in that legislation. This is not the first phase of income tax devolution to the Scottish Parliament, the Scottish Variable Rate and Scottish Rate of Income Tax are already devolved. There has therefore been time for risks to be analysed, systems to be put in place and steps to be taken to make the electorate aware of where the decisions are taken.

4.30. Commentators have also made the case that the devolution of income tax under the Scotland Bill corrects deficiencies in the current system, whereby less control of income tax is devolved – the IFS pointed out in 2014 that:

"*devolving all income tax revenues (from non-savings non-dividend) will provide the Scottish Government with better aligned incentives to change tax rates compared to the partial devolution envisioned under the existing legislation*"[15]

[14] Lord Smith, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/scottish-affairs-committee/the-smith-commission-proposals-for-further-devolution-to-scotland/oral/16114.html

[15] The Smith Commission's Proposals – how big a change do they represent? And what questions remain to be addressed, Institute for Fiscal Studies, December 2014, www.ifs.org.uk/uploads/publications/bns/BN157.pdf

4.31. The Scottish electorate should be made aware of exactly how their taxes are being used when being asked to elect a Scottish government to represent them. The same is true for reservedservices controlled by the UK government for which the Scottish electorate also have a say. The link between specific taxes and the services they fund becomes clearer. Devolved taxes(income tax, LBTT, etc.) will be retained by the Scottish government to fund devolved services (health, education, etc.). Reserved taxes (corporation tax, national insurance contributions, etc.) will continue to be pooled across the UK in order to fund reserved services provided by the UK government (defence, international development, etc.) and the block grant.This model and pooling of risks and resources is not unprecedented internationally. Whilst the Scotland Bill will make the Scottish Parliament one of the most powerful in the OECD, this level of income tax devolution is not unique to the UK: countries such as the United States, Canada, Switzerland and Spain have devolution settlements which give considerable power over income tax to at least some of their devolved parliaments[16].

4.32. The government does not agree that the link between the Scottish electorate and the UK government will be weakened. In fact we believe there will be a clearer link to both governments.With the Scottish government providing some services from the income tax revenue they retain, and the UK government providing reserved services from the remaining aspects of income tax and reserved taxes, the Scottish people will retain a link to both Parliaments. Work is already underway to ensure that Scottish taxpayers are aware of the changes being made to income tax in Scotland: in December 2015 HMRC began writing to income tax payers to make them aware of the Scottish Rate of Income Tax.

4.33. The government is committed to working with the Scottish government to ensure income tax devolution under the Scotland Bill works for both governments and for taxpayers. Consistent with the approach taken with the Scottish Rate of Income Tax, the UK government will need to workclosely with stakeholders on the detailed implementation of income tax devolution inother areas, for example the operation of both pensions tax relief and Gift Aid. The Scotland Bill includes a power to make these changes in secondary legislation, which will bebrought forward in due course to set out the detailed mechanics for this.

[16] Based on internal HMT and OECD research and the paper “Scotland’s fiscal future in the UK” by David Eiser and David Bell. Available at https://esrcscotecon.files.wordpress.com/2014/09/scotlands-fiscal-future2.pdf

Borrowing Powers

10. The borrowing powers granted to Scotland will be an important part of the fiscal framework. We recommend that the UK and Scottish Governments agree simple and clear rules for borrowing including a ceiling on Scottish Government debt. We consider that any 'no bail-out' rule would not be believed by the markets. The assumption that the rest of the UK would bailout Scotland would prevail.(Paragraph 72)

4.34. The government notes the Committee's findings.A summary of the Smith Commission's principle on borrowing is below:

95(5) Borrowing powers – There are two types of borrowing powers:
To manage additional economic risks, including marginal volatility of tax revenues - The Scottish government should have additional resource borrowing powers to manage risks and ensure budgetary stability in the event of Scotland-specific shocks and forecast error, consistent with a sustainable overall UK fiscal framework.

4.35. The Scotland Act 2012 enabled Scottish Ministers to borrow for capital purposes. The Scottish government is able to borrow up to an aggregate limit of £2.2 billion. An annual limit equivalent to 10% of the capital block grant (approximately £300m) is also in place. These powers came into effect on 1 April 2015.

4.36. The Scottish government also has existing powers over resource borrowing, with a total borrowing limit of £500m which it may use in limited circumstances. The Scotland Act 1998 first enabled the Scottish government to borrow up to £500m from the National Loans Fund (NLF) to meet an in-year excess in expenditure over income or to provide a working balance in the Scottish Consolidated Fund.

4.37. The Scotland Act 2012 extended this facility to enable the Scottish government to borrow from the NLF when devolved tax revenues are lower than forecast. This form of borrowing is repayable within four years as opposed to in-year repayment. An annual limit of £200m was set administratively within the existing statutory £500m aggregate limit.

4.38. The governments are considering what borrowing powers will be appropriate for the Scottish government as part of the negotiation on the fiscal framework.

4.39. The government is committed to delivering the Commission's recommendations in full. As such, fiscal framework negotiations are being carried out in order to meet the principles on borrowing set out in the

Commission's Report. Any changes to existing borrowing powers will be fully set out in the fiscal framework agreement once it is reached.

4.40. The Chancellor gave oral evidence on this matter in January 2015 when he said:

"The Scottish Government should take responsibility for the fiscal choices it makes, and not operate under the assumption that financial mismanagement of borrowing powers will be met with a bail out by the UK Government. However, while such a situation should be avoided, the UK Government recognises that the Scottish Government is part of the UK and therefore would be entitled to financial protection in an extreme situation."[17]

[17] Chancellor of the Exchequer, http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/proposals-for-further-fiscal-and-economic-devolution-to-scotland/oral/17701.html

Scrutiny

11. We recommend that the Office for Budget Responsibility scrutinise the ongoing operation of the fiscal framework and the funding of the devolved governments. In Scotland this work should be done in co-operation with theScottish Fiscal Commission. (Paragraph 85)
12. To enable the OBR to conduct effective scrutiny, data on the workings of devolution, including the operation of and adjustments to the Barnett Formula, must be published. This was a recommendation of the Select Committee on the Barnett Formula that has not been implemented. It is a recommendation we endorse. (Paragraph 86)
13. We agree with the conclusions of the Constitution Committee: it is vital that inter-governmental relations become more transparent. In practice this means that meetings are regular; that dates and agendas are announced in advance; and that information published after the meeting is sufficient to allow scrutiny and debate. (Paragraph 89)
14. Parliamentary scrutiny of financial devolution will be an important component of overall accountability. It is a matter for each legislature how it arranges this scrutiny. The number of interested devolved legislatures gives rise to a potential for duplication of this work. Closer co-operation should mitigate this risk. We propose that the chairs of the finance committees of the national and devolved legislatures meet regularly to ensure effective and co-ordinated scrutiny. (Paragraph 93)

4.41. The government notes the Committee's findings and fully agrees with the principle that the fiscal framework should receive scrutiny from Parliament and other expert bodies.

4.42. The government invites and welcomes scrutiny of the fiscal framework from Parliament and wider stakeholders. We welcome the recently launched enquiry by the Scottish Affairs Committee in the House of Commons[18] and the work of this Committee in the House of Lords.

4.43. As well as this scrutiny of the framework as a whole, Parliament will have a role in translating the agreement into action. For example, elements of the fiscal framework such as changes to the Scottishgovernment's ability to borrow may require legislation. Likewise significant secondary legislation will be required to implement the Scotland Bill, which will be scrutinised in the usual way.

4.44. The Commission agreed that:

[18] http://www.parliament.uk/business/committees/committees-a-z/commons-select/scottish-affairs-committee/inquiries/parliament-2015/fiscal-framework-15-16/

95(9) Implementation: The two governments shouldprovide updates to the Scottish and UK Parliaments, including through thelaying of annual update reports, setting out the changes agreed to Scotland'sfiscal framework.

The UK government will implement this agreement as part of the fiscal framework.

4.45. The government is considering how to ensure scrutiny of the framework once it is operational and welcomes scrutiny from any and all stakeholders. There are a range ofoptions forbuilding this scrutiny into the agreement – including asking the OBR to take a more formal role. The government has some concerns that this expansion to their remit would call into question the independence of the OBR and conflicts with current legislation. As the committee is aware the government believes that the OBR is a vital part of our successful fiscal framework – and as such its independence must be preserved beyond doubt.

4.46. The Charter for Budget Responsibility states that:

(4.12) The OBR should not provide normative commentary on the particular merits of government policies.[19]

This would need to change should the OBR have a formal role in scrutinising the framework – and the government is not convinced that the benefits outweigh the risks to fiscal credibility if this principle were to be amended.

4.47. No decisions have been taken in this area and the government commits to updating Parliament as the negotiations progress. As the recommendation implies, the Scottish government should be expected to put in place similar scrutiny by a similarly independent body in Scotland.

4.48. The operation of the Barnett formula is already the subject of a good level of transparency. The comparability factors used in the application of

[19] HM Treasury, Charter for Budget Responsibility: Summer Budget 2015 Update, www.gov.uk/government/uploads/system/uploads/attachment_data/file/442821/Charter_for_Budget_Responsibility_-_Summer_Budget_2015.pdf

the Formula are published in the 'Statement of Funding Policy'[20], which was recently updated at the Spending Review. Furthermore, the adjustments to the budgets of the devolved administrations as a consequence of the operation of the Barnett Formula are already provided to the Welsh, Scottish and Northern Ireland Affairs Committees as a part of the Estimates Memoranda.Nevertheless further transparency for the Barnett Formula could prove helpful, and the government will consider the Committee's recommendation ahead of Report stage of the Bill.

4.49. The Constitution Committee's report[21] was well timed as the governmentcontinues work to review the Memorandum of Understanding between administrations in the United Kingdom, which was commissioned by the Prime Minister and the heads of the Devolved Administrations at the plenary meeting of the Joint Ministerial Committee in November 2014[22]. As part of this process, the four administrations are considering the reports of the Silk and Smith Commissions, as well as other recent reports on intergovernmental relations.

4.50. This work is continuing, and the outcomes of the review will need to be considered by the Heads of all four administrations.

5. Conclusion

5.1. The government welcomes the Committee'sReport andstands ready to engage further with the Committee as needed.

[20] Statement of Funding Policy, HM Treasury, November 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479717/statement_of_funding_2015_print.pdf
[21] Scotland Bill, Constitution Committee, 20 November 2015, http://www.publications.parliament.uk/pa/ld201012/ldselect/ldconst/184/18402.htm
[22]Joint Ministerial Committee communiqué, December 2014, https://www.gov.uk/government/news/joint-ministerial-committee-communique-december-2014

6. Annex A – JEC Communiques

JOINT EXCHEQUER COMMITTEE- 7 JULY 2015

From: HM Treasury, The Scottish Government and The Rt Hon Greg Hands MP
First published: 7 July 2015
Last updated:7 July 2015, see all updates

Joint communique published following a Joint Exchequer Committee between the UK Government (represented by Chief Secretary to the Treasury Greg Hands MP) and the Scottish Government (represented by Deputy First Minister John Swinney).

The Joint Exchequer Committee met today, chaired by the Chief Secretary to the Treasury, Rt Hon Greg Hands MP. The Scottish Government was represented by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy.

This was the fourth meeting of the JEC and the first since the publication of the Smith Commission Report. The Chancellor of the Exchequer, the Chief Secretary to the Treasury and the Deputy First Minister met on 8 June where they agreed that they would aim to conclude negotiations on the fiscal framework that will underpin the financial provisions of the Scotland Bill by the autumn, in tandem to the timetable for the Bill. This was the first consideration of substantive elements of the fiscal framework under the auspices of the JEC.

The Ministers considered high level options for future funding of the Scottish Government in relation to the new tax and spending powers to be devolved alongside a consideration of the principles of "no detriment" that Smith outlined in his report. Building on the good progress that has been made in relation to the Scottish Rate of Income Tax and other taxes devolved under the Scotland Act 2012, Ministers considered additional tax implementation issues in relation to devolution of the Smith taxes. The Ministers also acknowledged the importance of information sharing between the two governments both as an aid to ensuring successful negotiations on the fiscal framework and the ongoing operation of the fiscal framework. In addition, the Ministers agreed arrangements for the sharing of tax information in order for the Scottish Government to take a decision on the Scottish Rate of Income Tax later this year.

Ministers noted that officials from the two governments had been working together on analysis and evidence, and that further detailed planning and collaboration was continuing. They also agreed the importance of ensuring their respective Parliaments are updated on the negotiations as appropriate.

The next meeting of the JEC will take place in September, in Edinburgh, chaired by the Deputy First Minister.

Scottish and UK Governments

July 2015

JOINT EXCHEQUER COMMITTEE – 4 SEPTEMBER 2015

The Joint Exchequer Committee met in Edinburgh today, chaired by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy. The UK Government was represented by the Chief Secretary to the Treasury, Rt Hon Greg Hands MP.

This was the second meeting of the JEC since the publication of the Smith Commission Report. Ministers continued their detailed discussions on the substantive elements of the fiscal framework that will underpin the financial provisions of the Scotland Bill.

Following a joint assessment against the Smith Commission Report principles, Ministers considered a range of options for adjusting the Scottish Government's block grant in the future in relation to the new tax and spending powers being devolved. This included discussion of the balance of risks, economic responsibility and how the mechanisms can operate transparently and mechanically without frequent negotiation. Ministers also considered the administration costs associated with implementing and operating the Smith Commission Report.

Ministers also considered various methodologies for assigning VAT receipts to the Scottish Government's budget noting the interdependency with the associated block grant adjustment. Overall economic principles for fiscal rules and capital borrowing options were also discussed, including how Scottish Government borrowing would sit within the context of the overall UK fiscal framework.

Finally Ministers considered fiscal scrutiny and the current roles of the Scottish Fiscal Commission and the Office for Budget Responsibility in relation to devolved public finances. Ministers discussed the Scottish Government's recent consultation on legislative proposals for the Scottish Fiscal Commission and noted that a Bill would be introduced to the Scottish Parliament shortly which would place the Commission on a statutory footing. Ministers agreed to return to this issue at a future discussion on the fiscal framework to ensure that future fiscal scrutiny arrangements reflect the detail of the agreed fiscal framework.

The next meeting of the JEC will take place later in September, in London, chaired by the Chief Secretary to the Treasury. Ministers continue to aim to reach final agreement this autumn.

Scottish and UK Governments

September 2015

JOINT EXCHEQUER COMMITTEE – 23 SEPTEMBER 2015

The Joint Exchequer Committee met in London today, chaired by the Chief Secretary to the Treasury, Rt Hon Greg Hands MP. The Scottish Government was represented by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy.

This was the third meeting of the JEC since the publication of the Smith Commission Report. Ministers continued their detailed discussions on the substantive elements of the fiscal framework that will underpin the financial provisions of the Scotland Bill.

The ministers discussed resource borrowing and the need to ensure the Scottish Government has the flexibility to smooth public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework.

The meeting also covered the initial baseline transfers for adjustments to the block grant and financial issues associated with the more complex items to be devolved such as the Crown Estate.

Ministers also had an initial discussion on the element of the no detriment principle in the Smith Agreement relating to the decisions made by either Government post devolution.

Finally, Ministers considered options for the future governance of the fiscal framework.
The next meeting of the JEC will take place in October, in Edinburgh, chaired by the Deputy First Minister. Ministers continue to aim to reach final agreement this autumn.

Scottish and UK Governments

September 2015

JOINT EXCHEQUER COMMITTEE – 9 OCTOBER 2015

The Joint Exchequer Committee met in Edinburgh today, chaired by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy. The UK Government was represented the Chief Secretary to the Treasury, Rt Hon Greg Hands MP.

This was the fourth meeting of the JEC since the publication of the Smith Commission Report. Ministers continued their detailed discussions on the substantive elements of the fiscal framework that will underpin the financial provisions of the Scotland Bill.

The Ministers discussed administration costs for devolved taxes and spending powers, both on-going costs and one-off implementation costs, and how these should be allocated without the need for continued negotiation.

The Ministers considered further options for resource borrowing and assessing spillover effects associated with the no detriment principle, building on discussions from the previous JEC in September.

The methodology for VAT assignment was discussed, as were further options for the funding arrangements for the Crown Estate and Employability Programmes.

The meeting also considered draft Terms of Reference for the on-going operation of the Joint Exchequer Committee.

Finally, Ministers considered the structure and outline content of the framework. Ministers will meet again soon to continue discussions. Ministers continue to aim to reach final agreement this autumn.

Scottish and UK Governments

October 2015

JOINT EXCHEQUER COMMITTEE – 7 DECEMBER 2015

The Joint Exchequer Committee met in London on Monday (7 December 2015), chaired by the Chief Secretary to the Treasury, Rt Hon Greg Hands MP. The Scottish Government was represented by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy. Both Ministers reaffirmed their commitment to reach an agreement.

This was the fifth meeting of the JEC since the publication of the Smith Commission report. Ministers continued detailed discussions on the substantive elements of the fiscal framework that will underpin the financial provisions of the Scotland Bill. Ministers noted the progress made since they last met and the interest taken by both the UK and Scottish Parliaments.

In particular, the Ministers discussed options for adjusting the Scottish Government's block grant funding as a result of new powers over tax and spending.

The Ministers also agreed an adjustment to the Scottish Government's block grant in 2016/17 to take into account the devolution in the Scotland Act 2012 of responsibilities for taxation of land and buildings transactions and disposals to landfill.

Ministers will meet again shortly to continue discussions, with the aim to reach final agreement in the New Year.

UK and Scottish Governments

December 2015

JOINT EXCHEQUER COMMITTEE – 8 JANUARY 2016

The Joint Exchequer Committee met in Edinburgh today, chaired by John Swinney MSP, Deputy First Minister and Cabinet Secretary for Finance, Constitution and Economy. The UK Government was represented by the Chief Secretary to the Treasury, Rt Hon Greg Hands MP.

This was the sixth meeting of the JEC since the publication of the Smith Commission report. The Ministers continued their discussion on the methodologies for the Block Grant Adjustment and also discussed administration and implementation costs associated with devolution of new powers. The Ministers also reviewed and agreed the over-arching structure of the fiscal framework document.

Both Ministers agreed to meet again shortly in order to make further progress in the negotiations.

UK and Scottish Governments
January 2016

7. Annex B – Written Ministerial Statement

WRITTEN MINISTERIAL STATEMENT – DAVID MUNDELL – 2 NOVEMBER 2015

The UK Government is delivering on its commitment to make the Scottish Parliament one of the most powerful devolved parliaments in the world. Every deadline has been met in bringing forward new powers to the Scottish Parliament, and another milestone will be reached on 9 November when the Scotland Bill has its Report and Third Reading.

The Scotland Bill delivers the Smith Commission Agreement in full. The Agreement was reached by Scotland's five main political parties, and it means the Scottish Parliament will have control over around £11 billion of income tax revenues and responsibility over welfare benefits worth approximately £2.7 billion (by 2014-15 figures). For the first time, more than 50 per cent of the Scottish Parliament's budget will be funded from revenues raised in Scotland.

The Joint Exchequer Committee has met four times since June 2015 to take forward negotiations on Scotland's fiscal framework. The meetings have focussed on key elements of the framework - block grant adjustment and subsequent indexation mechanisms, administration and implementation costs, the no detriment principle, capital and resource borrowing, VAT assignment, fiscal scrutiny and governance.

Discussions have been constructive and are focused on securing a fair and workable fiscal framework which delivers the recommendations made by the Smith Commission in its report of November 2014.

Work is continuing and both Governments aim to complete this work as soon as possible in order to give respective Parliaments time for due consideration of both the Fiscal Framework and the Scotland Bill. This is likely to be after both the UK Spending Review and the draft Scottish Budget.

Since the Scotland Bill's introduction to Parliament in May 2015 it has been subject to healthy and productive scrutiny, including five days of debate in the House of Commons so far. During this time I have spoken to people from organisations representing the range of Scottish public life about the new powers the Bill contains, as have my Ministerial colleagues. I have worked with the Scottish Government to seek their views, and committees of the UK and Scottish Parliaments have taken evidence and reported on the Bill's provisions. Throughout this work I have been clear that I would reflect on sensible and constructive suggestions made.

Today I am tabling amendments to the Scotland Bill. I have listened to the debate and I am responding with amendments designed to improve the effectiveness of the legislation and to ensure that the new powers for the Scottish Parliament work as the Smith Commission intended.

Part 1 of the Bill relates to constitutional arrangements. An amendment will strengthen the clause on the permanence of the Scottish Parliament and Scottish Government by including a provision that includes a requirement that the Scottish Parliament and Scottish Government should not be abolished except on the basis of a decision of the people of Scotland. Whilst the UK Government is clear this is a scenario that has never been envisaged, the amendment is intended to make clear that there is absolutely no doubt:

Holyrood is here to stay. Additional amendments to Part 1 provide technical refinements to the elections clauses, and ensure the Scottish Parliament is responsible for relevant provisions related to the operation of the Scottish Parliament and Scottish Government.

Part 3 of the Bill includes provisions on welfare. The amendments will give further flexibility to the Scottish Parliament on benefits in relation to carers, and will enable the Scottish Parliament to legislate to provide for forms of non-financial assistance with a view to reducing maternity expenses, funeral expenses or expenses for heating in cold weather. There will no longer be a cap on the amount of discretionary financial assistance an individual who is in receipt of a reserved benefit can receive to assist with rental costs. The discretionary financial assistance must still be provided to help the individual with their housing costs and additional spending must be funded by the Scottish Government.

The Smith Agreement stated that Universal Credit will remain a reserved benefit to be administered and delivered by the Department for Work and Pensions, and Scottish Ministers to make decisions about varying the housing costs within Universal Credit for claimants who rent their homes as well as deciding when to pay those housing costs direct to landlords. A co-operative approach between the UK and Scottish Governments will be essential and amendments will clarify the Secretary of State’s role in agreeing to Universal Credit regulations that can be laid by Scottish Ministers. Paragraph 54 of the Smith Agreement relates to the power to create new benefits in devolved areas. A new clause will be tabled to address this. The remaining parts of the Bill transfer substantial powers to the Scottish Government and Scottish Ministers. Amendments will be tabled to clarify the approach taken to the devolution of tribunals and to the Crown Estate. In response to feedback from stakeholders the clause on equal opportunities has been amended in order to better set out the powers to be devolved. Other amendments strengthen the delivery of the Smith Agreement on the clauses relating to fuel poverty, onshore oil and gas licencing, consumer advocacy and advice and the Office of Communications. A new clause ensures the destination of Scottish fines, forfeitures and fixed penalties can be made explicit in primary legislation where necessary.

The Smith Commission Agreement outlined a number of areas for further consideration, and the UK and Scottish Governments have taken forward discussions on each of those. As a result of those discussions I am tabling amendments to devolve abortion policy and responsibility for welfare foods to the Scottish Parliament.

The amendments tabled today will strengthen the Scotland Bill and represent another milestone in making the Scottish Parliament one of the most powerful devolved parliaments in the world. I look forward to this important piece of legislation returning to the House for debate next week.