Professor David Bell
School of Management
University of Stirling

Lord Hollick
Chairman, Economic Affairs Committee
House of Lords
London
SW1A 0PW

29 February 2016

Dear Lord Hollick,

Comment on The Agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's Fiscal Framework

This letter describes and analyses the agreement on the fiscal framework that has been reached between the Scottish and UK Governments. The timing of the agreement should enable the Scottish Parliament to give the Scotland Bill legislative consent before it is dissolved prior to the May 2016 Scottish elections. Hence it is likely to pass into law though the fiscal framework agreement will have no statutory basis.

What has been agreed?

1. The Barnett formula will continue to be used to determine Scotland's block grant, confirming the Smith Commission agreement. Except for welfare spending, the process of baselining the block grant will continue to be based on UK Government Spending Reviews. The exception being made for welfare spending reflects the distinction between DEL and AME. It will presumably be reconciled on an annual basis, with initial estimates based on forecasts of spending on the relevant benefits in Scotland.
2. The initial baseline for tax will be set equal to UK Government tax receipts in the year prior to the devolution of power. Some adjustment is being made for the acceleration of payments for Stamp Duty Land Tax. No other adjustment will be made for "forestalling" that may arise due to agents seeking to avoid pre-announced higher rates of tax.
3. Cold weather payments are highly sensitive to weather conditions. In 2012-13 such payments cost £146 million this compares with £431 million that was paid out in 2010-11.

Hence, it has been agreed that the initial baseline for the transfer of cold weather payments should be the average of spending on this benefit in Scotland from 2008-09 to the year in which Scotland takes control of these payments.

4. Following the establishment of the initial baseline, Scotland's block grant will be calculated using the "Comparable Model" (CM). This was proposed by Greg Hands in his letter to the Scottish Affairs Committee of February 12, 2016[1]. We discussed this method in a recent observation[2], where we described it as the Tax Capacity Adjusted – Indexed Deduction model. The logic behind it is that Scotland's BGA is increased by its population share of tax increases in rUK *adjusted for Scotland's lower per capita income tax revenues*. (Income tax revenue per person in Scotland is 87.7% of that in the UK as a whole). The adjustment for Scotland's lower tax capacity implies that the "taxpayer fairness" criterion will not be met by the agreement. There will continue to be a net transfer from rUK to Scotland when an increase in rUK tax revenues is allocated to increased spending on "comparable programs" with Barnett consequentials for Scotland. This is because Scotland will receive a payment through the Barnett formula that ultimately depends on rUK's higher per capita tax revenues, but the reduction in its block grant will result from Scotland's lower per capita tax revenues.
5. Although both governments have agreed to CM to calculate the BGA, *it will not be implemented.* Instead, the PCID method, which ties the reduction in Scotland's block grant to the rate of growth of per capita tax revenues in rUK adjusted for Scotland's rate of population growth will be used. For the Scottish Government, this is the most preferred BGA mechanism since it offers protection against the risk that Scotland's population grows more slowly than that in rUK, an outcome that is generally expected to occur. The agreement implies that CM will provide the baseline, but that the PCID method will be implemented. This somewhat confusing solution is described as follows:
   "the block grant adjustment for tax should be effected by using the comparable model (Scotland's share), while achieving the outcome delivered by the indexed per capita (IPC) method for tax and welfare." (Para 17).
   This is a further concession to the Scottish Government insofar as, under most assumptions, the reduction in Scotland's block grant will be smaller with PCID than with the CM. This

[1] Hands, G. (2016) Letter to Pete Wishart, Chair of Scottish Affairs Committee, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500284/CST_response_SAC.pdf

[2] Bell, D., Eiser, D, and Philips, D. (2016). "Adjusting Scotland's Block Grant-the Options on the Table", Institute for Fiscal Studies. http://www.ifs.org.uk/publications/8172

outcome therefore represents a second deviation from the "taxpayer fairness" principle. Our estimate is that, assuming that income tax revenues per capita grow at 4% per annum in both Scotland and rUK between 2015-16 and 2020-21, the Scottish block grant will be £280 million per annum larger by 2020-21 due to the application of the PCID model rather than CM. Further, CM will cost rUK taxpayers around £350 million more in 2020-21 than would levels deduction (LD), a method which fully maintains the "taxpayer fairness" principle. The LD method increases the BGA by Scotland's population share of the *increase* in income tax revenues in rUK. LD provides taxpayer fairness because it is effectively the Barnett formula applied to tax revenues: the size of Scotland's Barnett consequentials arising from increased tax revenues in rUK would be exactly offset by the reduction in its block grant.

6. The arrangements for the BGA are described as a transitional solution for the period up to 2021-22. During this period, there will be an annual process which will compensate the Scottish Government should the block grant fall short of the PCID outcome. It appears therefore that the agreement gives the Scottish Government the best possible outcome within the set of BGA mechanisms under consideration, at least until 2020-21. Correspondingly, the outcome for the UK government is relatively bad in terms of revenues forgone.
7. The introduction of the taxes will be staggered, starting with the full devolution of income tax rates and thresholds in April 2017. Air passenger duty will be devolved in 2018.
8. The agreement suggests that the welfare budget will be determined by the Barnett Formula. Thus, the annual increase in the UK government provision for the Scottish welfare powers will be given by Scotland's population share of the increase in spending on the relevant welfare benefits. There is no adjustment for the higher per capita spend on these benefits in Scotland. Our initial assessment is that, had the Barnett formula have been used to determine relevant welfare spending in Scotland from 1996-97 to 2013-14, expenditure would have been around £147 million less than its actual value in 2013-14 which was based on the assessed need of claimants.

   However, paragraph 17 of the agreement includes the phrase "and welfare" in relation to the PCID outcome. Our understanding (from HM Treasury) is that as with tax revenues, Scotland's welfare budget will be protected should the Barnett formula outcome reduce its budget relative to that which the PCID method would have generated.
9. The Scottish Fiscal Commission will provide the forecasts for tax revenues in Scotland and will form a working relationship with the OBR. This is a welcome development in that the

Scottish Government had argued that forecasts should be constructed in house, which would inevitably have led to the suspicion of political bias.

10. The calculation of "no detriment" is discussed in the agreement in relation to "direct effects" and "behavioural effects". The governments have agreed to account for all direct effects which will arise mechanically and directly as a result of policy change.

What has not been agreed?

1. The review process in 2021 will comprise an independent report with recommendations from both governments. The agreement does not indicate how differences between governments will be reconciled at this stage, nor does it specify how the terms of reference for the independent report will be agreed. The agreement does not put forward any resolution process that will avoid further disharmony between the Scottish and UK governments at that time. The key issue is likely to be whether to adopt CM for both the calculation and the implementation of the BGA or to retain the proposed, rather peculiar, interim arrangements where CM is used for the calculation but the implementation is based on PCID. Recall that even CM will involve some transfer of resources from rUK taxpayers to Scotland relative to the LD method.
2. There is no agreed date for the introduction of the welfare powers. This will be determined by the joint ministerial working group on welfare and will likely be dependent on decisions around how far the Scottish welfare system will wish to mirror DWP structures and systems. Significant change from DWP arrangements is likely to increase the cost and also delay implementation.
3. The implementation of VAT assignment will have to be agreed between HMRC and the Scottish Government. This is likely to be a lengthy procedure since many companies have locations on both sides of the border and issues such as the geographical assignment of tax for online sales will have to be agreed.
4. In relation to no detriment, the agreement proposes to take account of "material" behavioural effects. However, it provides no indication as to what level of financial spillover effect might be considered 'material', so this will be entirely a matter for each Government to decide on a case-by-case basis. Economists find causal impacts extremely difficult to calibrate: effects have to be measured in the real world, where many other factors are at play, and not in the controlled environment of a laboratory. Estimates are likely to be

subject to significant uncertainty, and the agreement contains no third-party arrangements which might be used to adjudicate disputes over such evidence.

Yours sincerely,

David Bell

University of Stirling