FINANCE AND CONSTITUTION COMMITTEE

AGENDA

2nd Meeting, 2020 (Session 5)

Wednesday 29 January 2020

The Committee will meet at 10.00 am in the David Livingstone Room (CR6).

1. **Budget Scrutiny 2020-21**: The Committee will take evidence on the strategic context of the Scottish Government's Budget 2020-21 from—

   Mairi Spowage, Deputy Director, Fraser of Allander Institute.

2. **Work programme (in private)**: The Committee will consider its work programme.

Jim Johnston

Clerk to the Finance and Constitution Committee

Room T3.60

The Scottish Parliament

Edinburgh

Tel: 0131 348 5215

Email: James.Johnston@parliament.scot
The papers for this meeting are as follows—

**Agenda Item 1**

Cover note  
FCC/S5/20/02/1

**Agenda Item 2**

PRIVATE PAPER  
FCC/S5/20/02/2 (P)
Purpose

1. This paper provides information relating to the Committee’s evidence session with the Fraser of Allander Institute on the strategic context of the Budget 2020-21. The Committee will take evidence from—

   - Mairi Spowage, Deputy Director, Fraser of Allander Institute

Annual Scotland’s Budget report

2. The Fraser of Allander published its fourth annual Scotland’s Budget report on 12 November 2019 which included an examination of the strategic context to the budget, the divergence between Scottish and UK income tax policies and the fiscal outlook for the remaining two budgets of this Parliament. The Executive Summary is attached at Annexe A and the full report can be accessed at—

   https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf

Strategic context to the budget 2020/21

3. The Executive summary of the report outlines the strategic context to the budget 2020/21 as follows—

   - The outlook for the Scottish resource block grant has improved throughout this parliamentary term. It had been on course to fall by 3% in real terms by 2019/20, but subsequent UK Government spending increases means that the block grant increased slightly over this time period.
   - In each of the last three years, the Scottish Government has used its new income tax powers to raise additional revenues. However, the anticipated positive revenue impact of such decisions has been offset by weaker growth in the Scottish tax base.
   - As this weaker growth had not been forecast when the first budgets were set, a series of reconciliations (i.e. downwards adjustment) will apply to the next couple of budgets.
   - The Scottish Government’s general approach has been to set ‘progressive’ tax schedules that raise income. For example, Scotland’s income tax schedule aims to increase liabilities on individuals in the top half of the income distribution; Scottish tax schedules for council tax and LBTT are also more ‘progressive’ than their equivalent in the UK.
   - In contrast, policy on non-domestic rates has been characterised by an expansion of reliefs and tax cuts in order to supposedly secure a ‘competitive’ tax regime.
The Scottish Government has protected health budgets, with spending up almost £800m or 5.2% in real terms between 2016/17 and 2019/20. Spending on most aspects of education and skills, enterprise, and the police has been protected.

But inevitably, some areas have seen real terms declines. These include spending on universities, local government and many areas of the justice portfolio outside of police.

Divergence of Scottish and UK income tax policies

4. The report examined the growing divergence between Scottish and UK income tax policies and outlines the following key considerations for each ‘Scottish’ tax—

- Income tax – with a more progressive charging structure than in the rest of the UK, the possible behavioural reactions to increasing costs for higher earners, relative to those in the rest of the UK, will need to be factored into decision making.
- The size, shape and potential mobility of the Scottish income tax base create challenges
- UK decisions may increase the tensions.
- LBTT – the most visible divergence is in the rates charged.
- VAT assignment - does not bring the scope for any distinctiveness or divergence to Scottish tax policy; nor can it be clearly linked to the Scottish Government’s economic policy – and this may be an unwanted power.

The Fiscal Outlook

5. The report considered the fiscal outlook for 2020/21 and 2021/22 and stated that the outlook is dependent on the following—

- The block grant from the UK Government (determined by the Barnett formula).
- Forecasts of the tax revenues likely to be raised from taxes in Scotland.
- The corresponding deductions to the block grant to reflect the revenues foregone by the UK Government (the block grant adjustments).
- The size of tax ‘reconciliations’ (adjustments to reflect the scale of forecast error in previous years).
- Additions to the Scottish budget to reflect new social security powers.

6. The report summarised the fiscal outlook as follows—

- The outlook for the resource block grant this year and next has improved substantially following the UK Government’s Spending Round in September. The resource grant for 2019/20 is now £600m higher than at the time of the draft budget in December last year. From this higher 2019/20 baseline, the block grant will grow by a further £1.1bn (2.1%) in 2020/21, and looks likely to grow by a similar amount in 2021/22. This would mean the resource block grant in 2021/22 would be 1.7% lower than its pre-austerity peak of 2010/11.
- However, some of this improved outlook will be offset by negative tax reconciliations (of £200m) that will apply in 2020/21. The latest official
forecasts imply a potentially much larger negative reconciliation of £600m in 2021/22.

- These same forecasts imply that the relatively weaker revenue outlook for Scotland will persist for the foreseeable future. Some of the most recent data - on GDP per capita, average earnings growth and PAYE income tax revenues – does indicate that conditions in Scotland have picked up, which may help to improve the outlook.
- Based upon the latest official forecasts for tax revenues however, the resource budget available to the Scottish Government will grow by less than 1% in real terms in 2020/21 and 2021/22. This will mean another two budgets of challenging departmental settlements, despite the wider UK rhetoric of an end to austerity.

Social Security

7. The report highlighted that financial responsibility for the new devolved social security powers will transfer to the Scottish Budget in full in April 2020 and spending on social security in Scotland is forecast to add around £3.5bn to the budget in 2020/21. The table below from provides details of the spending on devolved social security benefits—

<table>
<thead>
<tr>
<th>Table 4.1: Forecast expenditure on social security benefits in 2020/21</th>
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<tbody>
<tr>
<td>Attendance Allowance</td>
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<tr>
<td>Cold Weather Payments</td>
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<tr>
<td>Disability Living Allowance</td>
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<tr>
<td>Industrial Injuries Benefit</td>
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<tr>
<td>Personal Independence Payment</td>
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<tr>
<td>Severe Disablement Allowance</td>
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<tr>
<td>Winter Fuel Payment</td>
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<tr>
<td>Carer’s Allowance (inc supplement)</td>
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<tr>
<td>Discretionary Housing Payments</td>
</tr>
<tr>
<td>Best Start Grant</td>
</tr>
<tr>
<td>Funeral Support Payment</td>
</tr>
<tr>
<td>Scottish Welfare Fund</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Scottish Fiscal Commission (Economic and fiscal forecasts, May 2019)

8. The report explained that the budget 2020/21 will be exposed to new risks—
• First is the risk that spending on the social security benefits in Scotland is higher than the increase in the Scottish block grant that accompanies the transfer of responsibility. For each major benefit, an increase in the block grant (a block grant adjustment) from the UK budget will be made to reflect spending foregone by the UK government. This adjustment will be calculated by assuming that spending on each benefit in Scotland would have increased at the same per capita rate as in rUK in the years after transfer takes place.

• If actual spending in Scotland is higher than the BGAs, then any difference will have to be funded from the Scottish Government’s remaining resource budget, implying reduced resources for other areas of spending.

• Second is the risk of forecast error. The 2020/21 budget (and budgets thereafter) will be underpinned by forecasts of social security spending in Scotland made by the SFC, and forecasts of the social security BGAs based on spending projections for the equivalent benefits in rUK by the OBR.

• The 2020/21 budget will be based on these forecasts, but there will subsequently need to be a reconciliation between these forecasts and outturn expenditure data. If outturn Scottish spending is higher than forecast but the outturn BGA is lower than forecast, a negative reconciliation will apply to a subsequent budget.

Committee Clerks
January 2020
Executive Summary

Chapter 1: Strategic context to Budget 2020/21

- The outlook for the Scottish resource block grant has improved throughout this parliamentary term. It had been on course to fall by 3% in real terms by 2019/20, but subsequent UK Government spending increases means that the block grant increased slightly over this time period.

- In each of the last three years, the Scottish Government has used its new income tax powers to raise additional revenues. However, the anticipated positive revenue impact of such decisions has been offset by weaker growth in the Scottish tax base.

- As this weaker growth had not been forecast when the first budgets were set, a series of reconciliations (i.e. downwards adjustment) will apply to the next couple of budgets.

- The Scottish Government’s general approach has been to set ‘progressive’ tax schedules that raise income. For example, Scotland’s income tax schedule aims to increase liabilities on individuals in the top half of the income distribution; Scottish tax schedules for council tax and LBTT are also more ‘progressive’ than their equivalent in the UK.

- In contrast, policy on non-domestic rates has been characterised by an expansion of reliefs and tax cuts in order to supposedly secure a ‘competitive’ tax regime.

- The Scottish Government has protected health budgets, with spending up almost £800m or 5.2% in real terms between 2016/17 and 2019/20. Spending on most aspects of education and skills, enterprise, and the police has been protected.

- But inevitably, some areas have seen real terms declines. These include spending on universities, local government and many areas of the justice portfolio outside of police.
Taxation – Growing divergence?

The key questions:

- Only a few years in from the Scotland Act 2016, there is growing divergence between Scottish and UK income tax policies – but will this continue?
- Will UK tax measures, and the potential for radical ‘Brexit’ tax proposals, cast a shadow over the forthcoming Scottish budget?
- Can a Scottish budget be fully considered if the UK budget proposals are not yet known?

The key considerations for each ‘Scottish’ tax:

- Income tax – with a more progressive charging structure than in the rest of the UK, the possible behavioural reactions to increasing costs for higher earners, relative to those in the rest of the UK, will need to be factored into decision making.
- The size, shape and potential mobility of the Scottish income tax base create challenges.
- UK decisions may increase the tensions.
- LBTT – the most visible divergence is in the rates charged.
- VAT assignment - does not bring the scope for any distinctiveness or divergence to Scottish tax policy; nor can it be clearly linked to the Scottish Government’s economic policy – and this may be an unwanted power.

Overall, there is a distinctive tax regime, but it is one which is intertwined with the UK tax system. There are considerable constraints which are in part due to the politics that any government faces, and in part due to the intertwining of the Scottish and UK tax systems so that Scotland only has access to some of the fiscal levers.

It is not yet clear either how measures in the 2019 UK Budget (for example any decision to increase the personal allowance or the higher rate threshold) may affect the Cabinet Secretary’s ability to maintain, or increase, the divergence of Scottish taxation in the next Scottish Budget.
The Fiscal Outlook

- The outlook for the resource block grant this year and next has improved substantially following the UK Government’s Spending Round in September. The resource grant for 2019/20 is now £600m higher than at the time of the draft budget in December last year. From this higher 2019/20 baseline, the block grant will grow by a further £1.1bn (2.1%) in 2020/21, and looks likely to grow by a similar amount in 2021/22. This would mean the resource block grant in 2021/22 would be 1.7% lower than its pre-austerity peak of 2010/11.

- However, some of this improved outlook will be offset by negative tax reconciliations (of £200m) that will apply in 2020/21. The latest official forecasts imply a potentially much larger negative reconciliation of £600m in 2021/22.

- These same forecasts imply that the relatively weaker revenue outlook for Scotland will persist for the foreseeable future. Some of the most recent data - on GDP per capita, average earnings growth and PAYE income tax revenues – does indicate that conditions in Scotland have picked up, which may help to improve the outlook.

- Based upon the latest official forecasts for tax revenues however, the resource budget available to the Scottish Government will grow by less than 1% in real terms in 2020/21 and 2021/22. This will mean another two budgets of challenging departmental settlements, despite the wider UK rhetoric of an end to austerity.

- Whilst full administrative control and policy autonomy for the new devolved social security powers will not take place for a few years, financial responsibility will transfer to the Scottish budget in full in April 2020. This means that budget 2020/21 will be exposed to new risks.

- There are particularly significant levels of uncertainty around all these projections – not least the potential implications of new spending pledges made during the upcoming general election campaign.

- At the same time, any policy changes on UK income tax would also have a material impact on the Scottish block grant, principally via the block grant adjustments, but also in framing the bounds of the income tax debate in Scotland. The UK Conservatives have indicated they may cut income tax rates on higher earners, whilst UK Labour have suggested a preference for tax increases.
An uncertain Outlook

- Notwithstanding short-term uncertainty, a number of important structural challenges will continue to impact upon future budgets. Many of these are challenges but they also provide opportunities to do things differently, hopefully securing better outcomes.

- A wellbeing approach to budget setting could, through viewing the outcomes of spending through a different lens, help refocus priorities more effectively. The risk however, is that such a shift is little more than a presentational exercise with no material impact on how funds are allocated in practice.

- The challenges of demographic change have been extensively described, but progress on reform of public services remains slow.

- Attitudes toward levels of taxation and spending are important in framing the bounds of what policy approaches are viable. Preferences seem to be influenced by the prevailing political discourse as least as much as the other way around.

- Local government’s funding has been disproportionately cut since 2010. Spending has been re-profiled significantly. Moves are afoot to allow some greater local autonomy, but these will generate meaningful resources to relatively few councils.

- The Fiscal Framework is due to be renegotiated in 2022. This will have important – and potentially significant - implications. The outcome could influence the financial risks faced by the Scottish budget, and the tools available to address these.

- Scotland receives significant EU funds, including structural funds and for agriculture. There remains little detail on what will replace such funding streams in the future and how they will be allocated across the UK.