Patricia Ferguson MP
Chair of the Scottish Affairs Committee
House of Commons
London
SW1A 0AA

3 January 2025

Dear Chair,

I welcome this opportunity to respond to the Committee's inquiry into the financing of the Scottish Government.

The Scottish Fiscal Commission is the independent fiscal institution for Scotland. We produce Scotland's official, independent economic and fiscal forecasts to accompany the Scottish Government's Budget cycle. The Commission was set up following fiscal devolution in the Scotland Acts 2012 and 2016. We are directly accountable to the Scottish Parliament for the delivery of our functions which were set out in the Scottish Fiscal Commission Act 2016. A short video overview of the Scottish Fiscal Commission can be found on YouTube.

We produce forecasts each year to accompany the Scottish Budget and the Scottish Government's Medium-Term Financial Strategy. These reports provide forecasts of the Scottish economy, revenues from devolved taxes and spending on devolved social security benefits. We provide an overview of the Scottish Government's funding position and assess its plans for borrowing and use of the Reserve. We also produce reports on the long-term sustainability of the Scottish Government's public finances, a short visual guide of our first report is available on our website.

As well as producing regular reports on the Scottish Government's finances we also seek to improve understanding of the operation of the fiscal framework and the Scottish Budget process. A short video explaining the fiscal framework is available on YouTube. We recently produced a series of short bite-sized videos which explain the Scottish Budget and fiscal framework. These can be found on our website.

The annex to this letter includes a response to the specific questions raised in the inquiry. As an independent and politically impartial organisation we do not take a view on how the Scottish Government should be funded, but we can explain how the current arrangements work and refer the Committee to relevant reports we have published. Our latest forecast report is Scotland's Economic and Fiscal Forecasts – December 2024.

The Head of Fiscal Sustainability and Public Funding in the Scottish Fiscal Commission, Claire Murdoch, has been invited to give evidence to the Committee as part of its inquiry later this month. Thank you for this opportunity for the Scottish Fiscal Commission to provide further input, we are happy to do all we can to aid the work of the Committee.

Yours sincerely

GD Roy

Professor Graeme Roy

Annex: Responses to the questions raised in the Committee's Inquiry

Question 1. How effective is the Barnett formula in calculating the amount of money made available to Scotland for providing essential public services?

- *What was the original design intention behind the Barnett Formula, and to what extent has it fulfilled this purpose?*
- *What potential reforms to the Barnett formula could improve its effectiveness?*
- *How transparent is the UK Government's decision making regarding the application of the Barnett Formula?*
- *What impact could putting the Barnett formula on a statutory footing, or otherwise formalising it, have on its effectiveness?*

The Scottish Fiscal Commission does not have views on the Barnett formula, its design or effectiveness.

We have commented on the challenges in tracking Block Grant funding and the transparency of that information. Our most recent Statement of Data Needs recommended improvements in how information on Block Grant funding is published.[1]

The Block Grant is the main source of funding for the Scottish Government. Each time the UK Government changes its spending plans in a devolved area, HM Treasury updates the Block Grant based on the latest Statement of Funding Policy and in consultation with devolved administrations. The data is then made publicly available by HM Treasury through the Block Grant Transparency (BGT) dataset.[2]

Spending plans for departments are set in Spending Reviews. However, the UK Government often announces changes to tax and spending plans at its fiscal events, such as changes to business rates or extra spending for the NHS in England. When measures are paid from new or previously unallocated funding, there are increases in the devolved administrations' Block Grants. When this happens, UK fiscal event documents include a headline figure for changes in devolved administrations' budgets.

Detail on how the change in the Block Grant has come about is found in the BGT dataset. However, it is not published regularly, and there is no update schedule for the dataset. While there have been twelve UK fiscal events since the first edition of the BGT in December 2017, the dataset has only been updated six times. The latest published version is from July 2023 and since then there have been significant changes in the Scottish Government's funding.

[1] Scottish Fiscal Commission (2024) Statement of Data Needs – August 2024
[2] HM Treasury (2023) Block Grant Transparency – July 2023

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In the absence of timely BGT releases, Barnett consequentials are hard to reproduce. The UK Government publish a Policy Decisions spreadsheet alongside each UK fiscal event.[3] However, it does not set out detail on spending measures if these are funded from unallocated reserves set aside at the time of the Spending Review.

We note that between BGT releases HMT does update the data as part of the Supply Estimates process. However, getting the data relies on the Scottish Affairs Committee uploading documents on its website. While this is normally done promptly, depending on the parliamentary cycle there may be a significant lag between Supply Estimates being published and the Scottish Affairs Committee making available the additional information.

As a result, consequentials sometimes must be roughly estimated by comparing tables of departmental expenditure limits between fiscal events. Having the BGT dataset publicly updated regularly in the public domain would enable us to more easily assess the Scottish Government's confirmed and assumed Barnett funding.

In our August 2024 Statement of Data Needs we recommended that HMT should update the Block Grant Transparency dataset alongside each UK fiscal event. Our recommendation was also that if HMT does not publish the Block Grant Transparency dataset alongside each fiscal event, the Scottish Government should publish timely details of Barnett consequentials received. This information should be published in a consistent format each time.

Question 2. Following its review in 2023, to what extent does the current Fiscal Framework effectively govern the mechanisms for Block Grant Adjustments and fiscal flexibilities of the Scottish Government?

- *To what extent could changes to Scottish Government borrowing powers enable more effective fiscal management, and mitigate against the impact of inflation and economic shocks in Scotland?*
- *Does the current methodology for calculating Block Grant Adjustments effectively reflect the associated transfer of tax revenues or welfare spending?*

The Scottish Fiscal Commission does not take a view on how the Scottish Government's fiscal framework and fiscal flexibilities should operate. We do however regularly comment on and explain how the fiscal framework is operating. There are four relevant areas of our commentary to highlight; the flexibilities available to the Scottish Government, how the Scottish Government's forecast tax revenues compare to the

[3] For example HM Treasury (2024) Table 5.1 Autumn Budget 2024 Policy Decisions

Block Grant Adjustments (BGAs), how forecast devolved social security spending compares to the BGAs, and income tax reconciliations.

Flexibilities available to the Scottish Government

The Scottish Government's borrowing powers and Scotland Reserve limits are set out in the fiscal framework. Prior to the review of the fiscal framework in 2023 the borrowing and Reserve limits were fixed in nominal terms but from 2023-24 onwards these have increased in line with inflation. The Scotland Reserve has become a more flexible tool as the drawdown limits have been abolished. However, as we noted in our December 2023 report, with the size of the Scottish Budget growing faster than inflation, managing underspends will likely still use most of the Reserve's capacity.[4]

The Scottish Government uses capital borrowing to provide additional capital funding in a given financial year. The Scottish Government's latest plans are to borrow £300 million in 2024-25, £472 million in 2025-26 and £300 million each subsequent year.[5] Based on these plans we forecast the Scottish Government reaching 93 per cent of its overall capital borrowing cap in 2029-30.

The Scottish Government can only use resource borrowing when a negative forecast error arises for tax or social security. These forecast errors relate to our forecasts of Scottish revenues and spending, or the OBR's forecasts of UK revenues and spending which inform the Block Grant Adjustments.

Although the fiscal framework sets out the flexibilities available to the Scottish Government, there have been occasions in the past where HM Treasury has agreed to flexibilities which effectively allowed the Scottish Government to by-pass the limits of the Reserve. In our September 2020 Fiscal Update we gave three examples:[6]

- Barnett consequentials of £148 million were received late in 2018-19. The Scottish Government agreed with HM Treasury that these would be held within UK reserves and re-allocated to the Scottish Government in 2019-20, rather than pass through the Scotland Reserve for 2018-19.
- In 2019-20, HM Treasury agreed to allow the Scottish Government to draw down a total of £181 million in capital and financial transactions, well above the £100 million capital drawdown limit. This was to address negative Barnett consequentials of £128 million that arose from a UK budget capital spending decision.
- The in-year reconciliation for the fully devolved taxes and benefits in 2019-20 was deferred until 2020-21 and included in the Scottish Budget based on the position at

[4] Scottish Fiscal Commission (2023) Scotland's Economic and Fiscal Forecasts – December 2023
[5] Scottish Fiscal Commission (2024) Scotland's Economic and Fiscal Forecasts – December 2024
[6] Scottish Fiscal Commission (2020) Fiscal Update – September 2020

February 2020. This avoided a late in-year reconciliation after the UK Budget in March.

Another example of HM Treasury providing additional flexibility was during the COVID-19 pandemic. Ordinarily funding changes during a financial year and the Scottish Government has its final funding confirmed at supplementary estimates. Funding can increase or decrease during the financial year. In July 2020 the UK Government announced a guaranteed minimum level of funding for the Scottish Government. The UK Government recognised the unusual circumstances and the need for the Scottish Government to have certainty about the level of funding being received and it therefore guaranteed that COVID-19 funding would not be reduced in-year. The guarantee was set in July 2020 but then increased in October, November and December as public health restrictions were changed in England.[7]

The ad hoc nature of the flexibilities suggests there is recognition that the current system can create challenges for the Scottish Government in managing its Budget. And where those challenges are significant additional flexibilities may be provided at the discretion of HM Treasury.

<u>Scottish Government tax revenues compared to the Block Grant Adjustments</u>

Our most recent forecasts show how the forecast devolved tax revenues compare to the reduction in funding from the Block Grant Adjustments (BGAs).[8] Figure 4.4 from our December 2024 report shows that overall the net tax position is positive and rising. This is because of differences in tax policies between Scotland and the rest of the UK. In general, income tax rates are higher and income tax thresholds are lower in Scotland, raising additional funds.

Our August 2024 Fiscal Update discussed how the income tax net position was lower in 2022-23 than might be expected based on policy differences alone, because of relatively slower earnings growth in Scotland since income tax was devolved in 2016-17.[9] The latest outturn shows a positive income tax net position of £257 million in 2022-23. However, because of relatively slow growth in the Scottish economy since income tax was devolved, there is still a gap between the net position and where it might be based on policy differences alone. We estimate this 'economic performance gap' means that the net position in 2022-23 was around £624 million lower than it would have been had Scottish economic performance matched the rest of the UK.

[7] Scottish Fiscal Commission (2021) Fiscal Update – January 2021
[8] Scottish Fiscal Commission (2024) Scotland's Economic and Fiscal Forecasts – December 2024
[9] Scottish Fiscal Commission (2024) Fiscal Update – August 2024

Figure 4.4: Projected tax net positions

£ million	2022-23 outturn	2023-24 [1]	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Income tax	blank	blank	blank	blank	blank	blank	blank	blank
BGA	-14,909	-16,527	-18,389	-19,639	-20,468	-21,207	-21,862	-22,675
Scottish revenue	15,169	17,315	19,099	20,477	21,782	22,980	23,913	24,930
Net position	260	788	711	838	1,314	1,774	2,051	2,255
LBTT [1]	blank	blank	blank	blank	blank	blank	blank	blank
BGA	-697	-526	-574	-660	-761	-862	-961	-1,047
Scottish revenue	848	784	911	1,019	1,058	1,102	1,158	1,223
Net position	151	259	337	358	298	240	197	176
SLfT [1]	blank	blank	blank	blank	blank	blank	blank	blank
BGA	-95	-74	-75	-57	-54	-37	-40	-41
Scottish revenue	110	68	54	40	24	25	25	26
Net position	14	-6	-21	-16	-30	-13	-15	-15
Total net position	426	1,041	1,027	1,180	1,582	2,001	2,233	2,416

Source: Scottish Fiscal Commission, Scottish Government.

Negative figures for the net position represent a negative funding effect on the Scottish Budget, where the BGA reduces funding by more than the tax revenue.

[1] The 2023-24 column shows a forecast for income tax and outturn for SLfT and LBTT.

Figures may not sum because of rounding.

Scottish Government social security spending compared to the Block Grant Adjustments

In 2025-26 social security spending is forecast to be £1.3 billion higher than the corresponding funding provided by the UK Government. This gap is a result of the Scottish Government's long standing approach to social security which can be thought of in terms of the following four factors.

First there are the new payments introduced by the Scottish Government where there is no UK equivalent. The most significant of these is Scottish Child Payment. Second, are the policy and delivery changes introduced with disability payments with aim of increasing take-up and improving the experience of people applying. The third factor is the more expansive approach for replacement payments. The main example here is the expansion of Pension Age Winter Heating Payment to all pensioner households next year. Finally, there are policies which seek to mitigate UK Government decisions such as the existing mitigation of the bedroom tax and benefit cap through Discretionary Housing Payments and the planned policy on mitigating the two-child limit in Universal Credit.

Figure 5.8 shows the social security net position which is the difference between spending on payments with a BGA and the BGAs, it also shows spending on payments which are unique to Scotland and payments that replaced UK Government payments but which do not have an associated BGA. It should be noted that Figure 5.8 does not include the effect of proposed spending on the mitigating the UK two-child limit in Universal Credit from 2026-27 onwards by the Scottish Government. We will publish a report presenting the effect of this additional spending on 7 January 2025.

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Figure 5.8: Effect of social security spending on the Budget

£ million	2023-24 outturn	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Social security net position [1]	-198	-263	-529	-619	-616	-601	-568
Spending on payment without a BGA, of which:	blank	blank	blank	blank	blank	blank	blank
Payments unique to Scotland [2]	-569	-618	-644	-674	-697	-713	-732
Other social security spending [3]	-132	-162	-161	-160	-161	-162	-163
Effect on the Budget	-899	-1,042	-1,334	-1,453	-1,475	-1,476	-1,463

Source: Scottish Fiscal Commission.

[1] Compares spending on social security payments with a Block Grant Adjustment to the Block Grant Adjustment funding. This includes the disability payments, Carer Support Payment, winter heating payments for adults and Employment Injury Assistance.

[2] 'Payments unique to Scotland' includes Scottish Child Payment, Carer's Allowance Supplement, Child Winter Heating Payment, Best Start Grant Early Learning Payment, and Best Start Grant School Age Payment. We also include spending through Discretionary Housing Payments on bedroom tax mitigation and the extra costs of the commitment to mitigating Benefit Cap deductions.

[3] 'Other social security' includes spending on Best Start Grant Pregnancy and Baby Payment, Best Start Foods, Discretionary Housing Payments, Funeral Support Payment, Employability Services, and Scottish Welfare Fund. Funding for these payments comes through the general Block Grant and it is not possible to provide an estimate of funding received for individual payments.

Figures may not sum because of rounding.

Income tax reconciliations

Reconciliations are funding adjustments once outturn data is available, these are a product of our and OBR's forecast errors for income tax. Smaller adjustments apply for fully devolved taxes and social security payment BGAs and are either managed in-year or in the financial year following the publication of outturn data. As one of the largest components of the Budget, income tax funding is fixed for the financial year. Income tax outturn data is available around 16 months after the end of the financial year and therefore feeds into the following year's budget. For example, the 2022-23 income tax reconciliation, which is based on outturn data published in summer 2024, applies to the 2025-26 Scottish Budget.

We forecast the Scottish economy and Scottish income tax revenue. The OBR forecasts the UK economy and UK Government income tax revenues. The income tax net position depends on how our forecasts compare to the OBR's forecasts for the UK. The income tax reconciliations depend on how our forecasts compare to outturn data on Scottish income tax revenue and how the OBR forecasts compare to outturn data on UK Government income tax revenues.

In January 2021 we published analysis as to how big income tax reconciliations might be in the future, how much they might vary and how these would compare to the borrowing limits.[10] Note this analysis was conducted before the borrowing limits were revised as part of the fiscal framework review in 2023. Income tax reconciliations are the result of errors in our forecasts of Scottish income tax revenues and errors in the forecasts of the BGA. While we do not yet know the likely variation of reconciliations, we do have a sense of the likely range of errors in both ours and the OBR's income tax forecasts which inform the BGA. In January 2021 we simulated 100,000 income tax reconciliations, based on some assumptions about income tax forecast errors, to provide an indication of the possible scale and variation of future income tax reconciliations.

The key conclusions emerging from these simulations are as follows:

- Over time reconciliations should be positive as often as they are negative.
- We estimate that negative reconciliations exceeding £300 million – the Government's annual borrowing limit at the time – could occur around three times every ten years.
- Larger negative reconciliations exceeding £600 million could occur around once every ten years.
- Positive reconciliations exceeding these thresholds should occur with similar frequency.

Based on historic data, we see that income tax forecasting errors can be persistent over time. In other words, a negative forecasting error in one year is likely to be followed by

[10] Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – January 2021

several other negative forecasting errors. A series of negative or positive reconciliations in a row are therefore more likely, and we have already seen this in 2017-18 and 2018-19. In the future, we may see a series of positive reconciliations.

Our most recent forecasts project the income tax reconciliation for 2024-25 to be a negative £701 million, this reconciliation would be applied to the 2027-28 Budget and is larger than the £654 million resource borrowing limit currently forecast for that year.[11]

Question 3. Within the existing devolution settlement, what steps could the UK Government take to offer Scotland more financial certainty?

- *Is there an appropriate level of coordination between the UK and Scottish Governments regarding in-year fiscal changes?*
- *To what extent can HM Treasury's decisions regarding the block grant be challenged by the Scottish Government?*

The Scottish Government's funding position is intrinsically linked to the UK Government's tax and spending decisions. Where UK fiscal events have not taken place to the usual timetable, or have been late in the financial year this has created challenges for the Scottish Government in managing its Budget. We have noted that the new UK Government's commitment to a more regular cycle of spending reviews should mean that Block Grant funding is more certain and that it is easier for the Scottish Government to provide multi-year spending allocations as part of its Medium-Term Financial Strategy.

The timing of UK fiscal events also directly affects when the Scottish Government can hold its Budget. If the UK Budget is held late in the autumn this can limit the time available for the Scottish Government to prepare its Budget, for the Scottish Fiscal Commission to prepare its forecasts to accompany that Budget, and for the subsequent scrutiny of the Budget by the Scottish Parliament.

The OECD undertook a review of the Scottish Fiscal Commission in 2019. Regular independent reviews are required by the Scottish Fiscal Commission Act. The OECD noted "A particular challenge for the SFC is establishing itself within a context in which there has been recent evolution both in the budget process it supports and in the taxes and benefits that it forecasts. Of note, the new budget process … means that, when there is a late UK Budget, the Scottish Government has limited time in which to develop its Draft Budget before it is presented to Parliament. This puts pressure on the Scottish

[11] Scottish Fiscal Commission (2024) Scotland's Economic and Fiscal Forecasts – December 2024

Government's budget planning and this may hamper the ability of the SFC to deliver good quality and accurate forecasts accompanying the Draft Budget."[12]

The OECD recommended "The Scottish Government, the SFC and the Scottish Parliament should keep the process under review to ensure the SFC has sufficient time to deliver good quality and accurate forecasts. This may involve discussions with the UK Government."

The Scottish Fiscal Commission commissioned a stakeholder survey in 2024.[13] There were several comments about the timing of UK fiscal events creating challenges and the need for UK and Scottish fiscal events to be aligned.

> "Lack of harmony between UK budgets and other analytical data makes it hard for stakeholders to consider the SFC's forecasts alongside other important information. The timing of reports and forecasts by the SFC and other bodies across the UK (e.g. the OBR and Westminster) is recognised by participants as not being aligned. Stakeholders feel it would be easier to make use of the data from all these bodies, and the SFC, if outputs were produced in a more streamlined way."
>
> "Whilst participants acknowledge that this is not an issue within the SFC's control and their influence is limited in this area, it was suggested that the SFC could lobby governments (i.e. Holyrood and Westminster) to adjust the timings of budgets to allow for more harmony. Again, it was suggested that this action could be undertaken in collaboration with the other UK fiscal institutions. "
>
> *"The alignment and timing (re. UK budgets) is important…so the autumn statement is really crucial for our budget. The later the autumn statement is…it pushes our budget back in and it was very late this year…it was very late on and then it squeezes parliamentary time. So the two UK fiscal events are really important to the devolved fiscal commissions and the budget processes. So getting some greater certainty on them would help."*

As well as the timing of UK fiscal events, the level of certainty around the effects of UK Government announcements on the Scottish Government's funding can also present challenges for the Scottish Government. A recent example is the UK Government's announcement increasing employer National Insurance Contributions (NICs). This rise will have a direct impact on the public sector paybill in Scotland and is therefore

[12] OECD (2019) OECD Independent Fiscal Institutions Review Scottish Fiscal Commission (SFC)
[13] JRS the research consortium (2024) Scottish Fiscal Commission Stakeholder Research – Final Report

indirectly funded from the Scottish Budget. The UK Government has said it will compensate UK public sector organisations and allocated £4.7 billion for this in 2025-26. However, the share the Scottish Government receives will only be confirmed at the UK Main Estimates which are presented to the UK Parliament after the start of the financial year.

The Scottish Government presented the 2025-26 Budget in December with no assumed NICs funding from the UK Government and no associated spending plans. Our report in December highlighted how the funding from the UK Government is unlikely to meet all the increased costs the Scottish Government face.[14] Therefore once the UK Government confirms the funding for the NICs rise, the Scottish Government's 2025-26 Budget will be larger than has been presented. But as this funding is unlikely to cover the full cost of the NICs rises the Scottish Government will need to manage this as part of its wider pay and workforce plans. We noted this as a risk to the Budget.

Question 4. Are there any comparative perspectives that should be considered when assessing the effectiveness of fiscal devolution in Scotland?

- *What learnings can be drawn from Wales and Northern Ireland's funding settlement arrangements?*
- *Are there any learnings from international perspectives that should be considered?*

The Commission does not take a view on the effectiveness of fiscal devolution.

[14] Scottish Fiscal Commission (2024) Scotland's Economic and Fiscal Forecasts – December 2024

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