Finance and Public Administration Committee

30th Meeting 2023, (Session 6), Tuesday 21 November 2023

Scottish Fiscal Framework: Independent Report and Review

Purpose

1. The Committee is invited to take evidence on the outcome of the Scottish Fiscal Framework review, the Independent Report which informed that review and VAT assignment in Scotland from the Deputy First Minister and Cabinet Secretary for Finance, Shona Robison MSP, supported by:

    - Matthew Elsby - Deputy Director of Fiscal Policy and Constitution; and
    - Niall Caldwell - Corporate Treasurer, Scottish Government.

2. This evidence session builds on that received at the Committee's meeting on 14 November 2023 when the Committee heard from witnesses representing Audit Scotland, Chartered Institute of Taxation, Fraser of Allander Institute, Institute for Fiscal Studies and the Scottish Fiscal Commission. Submissions received from witnesses at that meeting can be found in the relevant Committee papers.

Background

3. The Scottish Fiscal Framework, agreed in 2016, sets out the funding arrangements that help determine the size of the Scottish Budget each year. It also provided for the Framework to be reviewed following the Scottish Parliament elections in 2021. That review was to be informed by an independent report with recommendations to both Governments by the end of 2021. The technical annexe to the Fiscal Framework also stated that issues to consider under the review "could include operation of the fiscal framework including the BGA [Block Grant Adjustments] and indexation methods, no detriment and spillovers, borrowing limits and, if used, operation of the dispute resolution procedures."

4. On 28 October 2020, the Finance and Constitution Committee, the Social Security Committee and the Cabinet Secretary for Finance jointly agreed a report ("the joint report") to the Chief Secretary to the Treasury setting out initial areas where the independent report and review should have a particular focus.

5. In November 2021, the then Cabinet Secretary for Finance and the Economy, Kate Forbes MSP wrote and confirmed that the independent report will focus on

BGAs only, however "In return, CST has agreed this will inform a review that will be wider in scope. This should ensure that the current arrangements are thoroughly assessed and options for reform considered, and that input is obtained from a wide range of stakeholders as part of the overall process."

Fiscal Framework Review 2023

6. On 2 August 2023, the Deputy First Minister wrote to the Committee confirming that "I have now reached agreement with the Chief Secretary to the Treasury (CST) on a package of changes to the Scottish Government's Fiscal Framework". The Deputy First Minister explained that she had judged it appropriate to concede to a narrower scope for the review (than the more fundamental review originally envisioned) "in the interest of securing long sought practical borrowing and reserve flexibilities, and to protect those arrangements that we already have in place which work in our favour".

7. Alongside the letter, the Scottish Government published an updated Fiscal Framework ("Fiscal Framework 2023") agreed between the UK and Scottish Governments. The Scottish Government has provided an explainer on the outcomes of the Fiscal Framework Review which is attached at Annexe A.

8. At the Committee meeting on 3 October 2023 the Deputy First Minister explained that whilst the Scottish Government wanted an expansive review, in discussion with the UK Government "it became clear that that was not on the table." As a result, the review process became about "increasing our borrowing and reserve capacity and securing the use of the index per capita methodology". The resulting Fiscal Framework 2023 was a pragmatic solution involving compromise from both the Scottish Government and UK Government. The Deputy First Minister added that the changes "are quite technical" and the increased borrowing powers, of up to £600 million per year, means that "we can smooth out the negative tax reconciliation [in 2024-25] over the next few years".

9. In its August 2023 blog on Bank of England interest rates, the Fraser of Allander Institute (FAI) sets out how the changes would affect the Fiscal Framework limits (see table below), using the set of deflators produced by the Office for Budget Responsibility (OBR) at the Spring Budget, both in terms of annual limits and overall caps. Under the terms of Fiscal Framework 2023, the GDP deflator forecast published by HM Treasury, at the time of the Scottish Government's draft Budget (for 2024-25), will be used to set limits in 2023-24 prices.

£m	2023-24	2024-25	2025-26	2026-27	2027-28
Resource Borrowing Limit	600	609	615	623	633
Capital Borrowing Limit	450	457	461	467	475
Scotland Reserve Cap	700	711	718	726	738
Resource Borrowing Cap	1,750	1,777	1,795	1,816	1,846
Capital Borrowing Cap	3,000	3,047	3,076	3,113	3,165

Independent Report

10. Alongside the updated Fiscal Framework, the Independent Report commissioned to inform the review of the Fiscal Framework was also published. To inform this Report, authors Professor David Bell, David Phillips and David Eiser, had previously issued a call for views, to which the FPAC responded.

11. In its response to the call for views, the FPAC recommended that the final agreed framework should, to the extent possible, “set out the factors and evidence considered, as well as any trade-offs made, in reaching the decision on which BGA mechanism should be used”.

12. In particular, the FPAC noted that which BGA mechanism is chosen will be clearly linked to each Government’s views of the fiscal relationship between Scotland and the rest of the UK. As such, the Committee considered it important for transparency that the Fiscal Framework arising from the Review sets out the extent to which the BGA mechanism, agreed by the UK and Scottish Governments, meets each of the Smith Commission principles, as well as any trade-offs between principles.

13. The Committee also set out a range of other areas that it considered the Independent Report should explore, a summary of which is set out in Annexe B (alongside a summary of the key issues in the Session 5 joint report).

14. In their Report, the authors summarise the remit of the Independent Report as follows —

> "This report evaluates the current and alternative methods for calculating BGAs. It assesses the extent to which different methods for calculating BGAs are consistent with the Smith Commission's principles. It also considers the balance of fiscal risks and incentives faced by the Scottish Government under the different BGA approaches, and whether these differ from the balance of fiscal risks and incentives under the Barnett formula, which continues to be used to calculate the underlying Scottish block grant."

15. Following their analysis, the report authors conclude that:

- The BGAs must be indexed to the change in equivalent revenues or spending in the rest of the UK (rUK) if the key principles identified by the Smith Commission are to be met in broad terms.
- No single BGA method can simultaneously achieve all the Smith Commission's principles in full, especially when the 'no detriment' principle is interpreted dynamically, as some of the principles are mutually incompatible with each other. Fundamentally there is a tension between the taxpayer fairness principle and the no detriment principle. Both the Index Per Capita (IPC) and Comparable Model (CM) broadly achieve the economic responsibility principle, although the CM achieves it more comprehensively. The IPC method is arguably more consistent with the principle that the UK Government should bear the risk of shocks affecting the whole of the UK.
- In relation to social security, when considering the BGA approaches of the IPC and Barnett Formula, the authors note that the Barnett Formula is not consistent with the 'no detriment' principle in its dynamic sense (post devolution). The IPC slightly better achieves the economic shock principle, whilst the Barnett Formula slightly better achieves the economic responsibility principle.
- Given all this, the process of selecting a specific BGA to use in the Scottish Fiscal Framework will inevitably require some compromise. The authors also request that both governments should aim to set out transparently the rationale for whatever compromise solution is ultimately agreed, and the implications of that for the way in which various fiscal costs and risks are shared.

16. The Report also concludes that there may be a case in principle to incorporate some element of fiscal insurance explicitly into the BGA process but that it is very difficult to design such a mechanism that would work satisfactorily once tax divergence exists.

Oral evidence at the Committee's meeting on 14 November.

17. The Committee took evidence from the Fraser of Allander Institute and the Institute for Fiscal Studies on the Fiscal Framework review on 14 November. In a wide-ranging discussion, some of the key areas highlighted included that the agreed Index Per Capita (IPC) Block Grant Adjustment (BGA) mechanism

takes account of Scotland's initial lower tax capacity (and its lower population growth) compared with the rest of the UK. This means that the IPC mechanism reduces the BGA by £50 million per annum when compared to the CM method. IPC better addresses the Smith Commission no detriment principle but addresses less well the 'taxpayer fairness' principle. As such, it is for the UK and Scottish Governments to decide where the appropriate balance lies between these two conflicting principles.

18. The manner in which the Fiscal Framework Review was undertaken and then announced was discussed, including the impact on Parliamentary scrutiny. It was highlighted that, with no opportunity to scrutinise or provide views during the review, it was challenging to determine from the revised Fiscal Framework what BGA mechanisms were considered before the decision was taken to use the IPC method going forward. There was a sense that the UK and Scottish Governments had each compromised to reach agreement and had each avoided the big risks that they were respectively concerned about.

19. Given the lack of transparency over the breadth of the discussions, it was not clear what the Scottish Government's approach had been to the negotiations and what had been prioritised. For example, why the decision was taken to index the capital borrowing powers to the GDP deflater, which is currently lower than capital inflation. Allied to that was the extent to which such negotiations were informed by any assessment by the Scottish Government of the current limits on capital investment such as the limits on capital borrowing powers or issues relating to supply side capacity.

20. The Fiscal Framework 2023 explains that the Fiscal Framework as a whole will be reviewed "periodically" on a 5-yearly basis, but not more than once in any Scottish or UK electoral cycle. It will also be open to either Government to propose changes to the Fiscal Framework as part of future reviews. The extent to which the next review will provide an opportunity for consultation and scrutiny (that was not offered this time or in 2016) was discussed, along with the possibility that the approach taken may lend itself to small-scale periodic reviews rather than a more wide-ranging review of the Framework as a whole.

21. In considering the extent to which the economic power of London inflates UK economic performance compared to that of Scotland and the subsequent impact on the Fiscal Framework was discussed. It was stressed that any reductions in revenues through the Fiscal Framework as a result largely of the economic performance of London has to be considered alongside any increases achieved through the Barnett formula or through Barnett consequentials arising from spending in England. It was observed that the Barnett formula was based on needs which had not been substantially reviewed since 2010 and there was evidence of some Barnett convergence of public spending across the UK.

22. The Scottish Economic Shock provisions have been removed from the updated Fiscal Framework, with the annual borrowing limits doubled to £600 million (from £300 million) index-linked to the GDP deflator published by HM Treasury.

This borrowing can only be used to address changes in revenues arising from forecast error (rather than any downturn in revenues) and it was observed that, previous modelling by the SFC had indicated, the new borrowing limits could still be exceeded 1-2 times a decade. Where this can be foreseen, it was suggested that the Scottish Government could choose to increase the level of its Reserves, for example, to address large reconciliations in future. Whether a future review might wish to consider additional 'insurance' provisions for the Scottish Government to ensure it can manage unexpected and significant decreases in revenues or increases in spend was debated but it was recognised this may have to come with limits and timescales within which such borrowing had to be repaid.

23. The ability to manage down forecast error was also discussed and the extent to which the Scottish Fiscal Commission had access to data of the same quality and detail as the Office of Budget Responsibility (OBR). Whilst it was recognised the forecast error will always be present in the Fiscal Framework, the work that the OBR was undertaking in relation to Scottish forecasts was highlighted. The recent challenges of reduced survey return rates as well as particular issues with self-assessment data and predicting Social Security spending when new benefits are implemented, were highlighted as potentially exacerbating forecast error. The forecast evaluation reports published by the OBR and SFC, as well as close working (whilst maintaining independent forecasting), were identified as ways in which both forecasters seek to improve forecasting accuracy.

VAT assignment in Scotland

24. The updated Fiscal Framework (Fiscal Framework 2023) explains that consideration of when and how to implement VAT Assignment will be picked-up in a future meeting of the HM Treasury/Scottish Government Joint Exchequer Committee (JEC).

25. The Scotland Act 2016 provided for the first 10 pence of the Standard Rate of Value Added Tax (VAT) and the first 2.5 pence of the Reduced Rate, to be assigned to the Scottish Government. This gave effect to a recommendation made by the Smith Commission.

26. The Fiscal Framework published in 2016 set out that VAT will be implemented in 2019-2020. There was to be a one-year transitional period during which VAT assignment would be forecast and calculated, but with no impact on the Scottish Budget. From 2020-21 the Scottish Government's budget would then, in part, be determined by forecast and final estimated VAT receipts in Scotland.

27. The assignment of VAT was to be based on a methodology developed jointly by the Scottish Government, HM Treasury and HMRC – the Scottish VAT assignment model - which was published in November 2021. This model is based on HMRC's VAT Total Theoretical Liability (VTTL) model, which is "an internationally recognised method for calculating the theoretical amount of VAT that should be received by a tax jurisdiction."

28. To allow the development and testing of the methodology for calculating Scotland's aggregated share of VAT liabilities, Fiscal Framework 2016 explained that there would be a transitional operational period during which VAT assignment will be forecast and calculated each year, but with no impact for the Scottish Government. The effectiveness of the methodology will be reviewed in the final year of the transition period.

29. The Scottish Fiscal Commission (SFC) set out its approach to forecasting VAT in September 2018 and it has subsequently published illustrative forecasts of VAT as supplementary figures to its biannual publication of Scotland's economic and fiscal forecasts. The latest such publication was in May 2023. HMRC, with support from the Scottish Government, also produces experimental statistics which present an estimate of VAT assignment in Scotland. The latest release of these statistics published in September 2023 contains a first estimate for the Scottish VAT share of UK VAT for 2021 and a revised back series to 2011.

30. A briefing note on VAT assignment in Scotland and the experimental statistics has been produced by SPICe and is contained in Annexe C.

31. VAT assignment has yet to be commenced. On 12 February 2021, the Session 5 Finance and Constitution Committee published the report of the Legacy Expert Panel which confirmed that "the Scottish Government and HM Treasury have, however, agreed to delay implementation due to the current economic uncertainty and the desire not to introduce new volatility to the Budget at this time. Furthermore, the proposed assignment methodology has yet to be agreed. VAT assignment will form part of the planned review of the Fiscal Framework."

32. Subsequently, the Fiscal Framework 2023 states that once the assignment methodology and operating arrangements for assigning VAT in Scotland have been developed and agreed by HMRC and Scottish Government officials, they will be presented for joint ministerial sign off at a future meeting of the JEC.

Committee scrutiny

33. In March 2019, the Finance and Constitution Committee held a roundtable to explore the methodology to be used for VAT assignment given the impact that VAT assignment will have on the Scottish Budget. That roundtable explored three aspects of VAT assignment – a summary of which has been set out in Annexe D.

34. Since VAT assignment in Scotland was considered by the Session 5 Finance and Constitution Committee in March 2019:

    - Devolved taxes, Scottish income tax and social security benefits have been operational for a number of years,

- the UK has exited the European Union with the subsequent EU-UK Trade and Cooperation Agreement and the Windsor Framework approved,
- the COVID-19 pandemic, inflation and a cost-of-living crisis have all had a significant impact on Scotland's finances and economy,
- a revised Fiscal Framework has been agreed by the UK and Scottish Government's in 2023,
- falling response rates to some surveys has been observed and
- the implications for the Scottish Budget of the demographic challenge Scotland faces, of an ageing as well as a declining population, has become more prominent.

35. At a roundtable session on 14 November, the Committee explored the issues discussed its predecessor Committee in March 2019 and in the written submissions provided by those giving evidence[1] at the meeting on 14 November 2023. The Committee heard that many of the previous concerns, expressed in March 2019 about VAT assignment in Scotland and the risks that it posed to the Scottish Budget remain.

36. In particular, the Committee heard it was not clear that there was any close connection between the assignment model (which is a statistical model rather than one based on actual VAT receipts) and the limited policy decisions about VAT that the Scottish Government could take. There also remained considerable volatility in the estimates and any efforts to address those issues would make the model more complicated, thus reducing transparency and public understanding. Whilst there has been new data published using the 2018 VAT methodology (such as indicative forecasts using the assignment model), there remain a number of areas where the assignment model is unclear.

37. Another issue raised was that VAT forecasts are impacted by regular revisions to National Accounts data or methodology which can go back a number of years. A recent revision to VAT forecasts had resulted in impacts totalling £1 billion. This makes forecasting and reconciliation (based on apportioned estimates from UK VAT) much more difficult. For the SFC, it would have to forecast not only VAT but also the estimate error present in the model, given there would not be any figures on actual VAT receipts in Scotland. Whilst borrowing powers are available to manage changes in revenues due to forecast error, they cannot be used to manage estimate error under current arrangements. This estimation error is a new element, not present in the other devolved taxes or income tax, and as such poses a potential new risk to the Scottish Budget.

38. In terms of public confidence in the VAT system, it was recognised that volatility and complexity was not unusual with the Fiscal Framework, however, in relation to VAT assignment the extent to which an audit opinion could be provided was questioned. Whilst auditors could assess how well the process works, a firm audit opinion, as is seen with the devolved taxes, seems unlikely.

[1] Audit Scotland, Chartered Institute of Taxation, Fraser of Allander Institute, Institute for Fiscal Studies and the Scottish Fiscal Commission

The Office for Statistics Regulation could have a role in accrediting the assignment model as a national statistics publication (as it does with other publications). That accreditation, whilst suitable for a statistics publication is not, however, robust enough to use for budgetary purposes.

39. There was discussion about whether the estimation error could be reduced through, for example, using actual credit card or debit card transactions. However, the Committee heard that such an approach would also pose significant issues. There was a view that, unless Scotland was to have a significantly different policy on VAT, then devolving VAT in order to secure data on VAT receipts could be outweighed by significant administrative and compliance burdens. It was further highlighted that VAT is designed to operate across a bigger single system.

40. The reasons why the Smith Committee proposed assignation of 50% VAT to the Scottish Parliament was discussed. Witnesses suggested that it could have been, in part, to open up an increased portion of the budget to the performance of the Scottish economy, or to provide a broader basket of taxes with which to improve economic performance. It was also proposed at a time when the UK was part of the European Union and, as such, VAT devolution was precluded by EU law. Whatever the intention, general consensus was that, despite years of further investigation and research (with the associated costs that has entailed), VAT assignment still has significant practical issues posing considerable risks to the Scottish Budget.

41. As such, it was questioned whether the UK and Scottish Governments should continue to pursue the Smith Commission proposal for assigning VAT in Scotland or whether other approaches might be better able to deliver the Commission’s ambitions for Scottish Government accountability for the performance of the economy.

42. **The Committee is invited to discuss with the Deputy First Minister the issues in this paper.**

Scottish Government Explainer – October 2023

Fiscal Framework Review – 2023 – Outcome

Background

- The Fiscal Framework was created in response to the recommendations of the Smith Commission, a cross-party commission set up to reach agreement on the devolution of further powers to the Scottish Parliament following the 2014 Scottish independence referendum.
- The 2016 Fiscal Framework Agreement set out the new fiscal arrangements required to enable the devolution of new tax and social security powers through the 2016 Scotland Act.
- This included the ‘Block Grant Adjustment’ arrangements that account for the devolution of tax revenues and social security expenditure.
- It was agreed at the time that the Fiscal Framework would be reviewed periodically, with the initial review to be informed by an independent report into the block grant adjustment arrangements.
- The new agreement announced on 2 August 2023 is a result of this process.
- The changes outlined below will take effect from the financial year 2024-25.
- These changes require no Scottish legislation, though subsequent Budget decisions will be subject to the usual process.

Summary of changes agreed via the review

Block Grant Adjustment Methodology

- In 2016, the Scottish and UK Governments agreed to use the Indexed Per Capita methodology for calculating Block Grant Adjustments on an interim basis.
- The original agreement was clear that a permanent Block Grant Adjustment methodology would be considered and agreed as part of a Fiscal Framework Review, to occur after a parliament’s worth of experience.
- The outcome of this review is that the Indexed Per Capita mechanism for calculating Block Grant Adjustments will now be adopted permanently.
- This ensures that the Scottish Budget is protected from the risk of slower population growth; if the BGA were calculated using the alternative Comparable Method, it is estimated by the authors of the Independent Report that “the BGA would exceed revenues by over £400 million” by 2026-27 (Ref: page 36/7, Independent Report)[2]

[2] Analysing the options for Scotland’s block grant adjustments: An independent report (www.gov.scot)

- The main impact is primarily on the Block Grant Adjustment for tax, where the Independent Report estimates that this agreement could be worth around £200 million a year after five years and ~£400 million a year after 10 years.

Borrowing & Reserve

- The Scottish Government's resource borrowing capacity to deal with forecast error will be increased by £300m (to £600m) in 2023-24 prices. As such, this limit will be indexed in line with inflation, as measured by the GDP deflator.
- Capital borrowing limits will also increase in line with inflation from next financial year. Currently, we can borrow up to £450m per year for capital expenditure.
- The drawdown limits on Scotland's reserve will be abolished. The overall reserve limit will also be indexed in line with inflation from the next financial year.
- The provision for a Scotland-specific Economic Shock has been removed; this is now improved by unconditional resource borrowing limits.

Tax

- Once completed and agreed by officials, the VAT Assignment methodology and operating arrangements will be presented for joint ministerial sign-off at a future meeting of the Joint Exchequer Committee (JEC).
- The JEC will also agree a suitable point for the commencement of VAT Assignment in a future meeting.

Other

- The reduction applied to the Scottish Block Grant as part of the devolution of Crown Estate revenues – currently £6.6m p.a. – will increase incrementally to £40m by 2028-29, profiled at £10m / £10m / £15m/ £20m / £40m, at which point it will remain flat and unindexed.
- The Block Grant Adjustment for Fines, Forfeitures, and Fixed Penalties (FFFPs) will be converted to a fixed amount, given the relative steadiness of this income stream.
- Due to the removal of the indexation, this will now be a fixed adjustment to the block grant, at a level of ~ £25m per year, but final arrangements to be agreed with HMT.
- The baseline addition to the block grant for the UK's Coastal Communities Fund will be subject to the usual operation of Barnett; this will have no immediate effect on our funding position but means that if the UK Government were to reintroduce the Coastal Communities Fund, Scotland would receive a Barnett share.

Summary of Changes to the Fiscal Framework

	Original agreement – 2016/17 – 2023/24	Updated agreement – from 2024/25
BGA Mechanism	Run both Indexed per Capita (IPC) and Comparable methods (CM), but only use the IPC in practice.	IPC mechanism agreed on a permanent basis.
Resource borrowing	Up to £300m p.a. to cover forecast error.	Up to £600m p.a. to cover forecast error, indexed to inflation (GDP deflator).
Capital borrowing	Up to £450m, p.a.; £3bn cumulative cap.	Up to £450m p.a., £3bn cumulative cap, both indexed to inflation (GDP deflator).
Reserve drawdown limits	£250m resource; £100m capital.	No limits.
Overall reserve limit	£700m	£700m indexed to inflation (GDP deflator)
VAT Assignment	The two Governments agreed that VAT Assignment will be implemented in 2019-20.	How and when to implement VAT Assignment will be discussed at a future Joint Exchequer Committee.
Crown Estate	Deduction to the block grant of £6.6m (rounded) p.a.	Deduction to the block grant profiled at £10m / £10m / £15m/ £20m / £40m. Fixed in nominal terms at £40m beyond.
Fines, Forfeitures, and Fixed Penalties (FFFPs)	Block Grant Adjustment to fines and penalties revenue.	Flat deduction of £25m to the block grant.
Coastal Communities Fund	A baseline addition was made equal to the UK government spending on CCF in the year immediately prior to devolution.	Absorbed into Barnett (no immediate impact on funding).
Scotland Specific Economic Shock	Forecast Error Borrowing powers temporarily increased to £600m when triggered.	Provision removed – now covered by improved unconditional resource borrowing powers.

Summary of the Finance and Public Administration Committee submission to the Independent Report which informed the Fiscal Framework Review

In its consultation response the Committee highlighted the following as key issues for consideration by the Independent Report and the subsequent Fiscal Framework review:

- How any BGA mechanisms respond to the impact of different timings of the Scottish and UK Budgets and what might be considered reasonable risks in such circumstances;
- In considering the BGA mechanisms, the relevant data used to forecast the BGAs and to determine tax and welfare receipts should also be reviewed to ensure it is sufficiently robust and comprehensive for those purposes;
- Whether the baseline adjustment taken to date for each operational tax or welfare power represented a ‘normal’ year as compared with the multi-year approach;
- Whether some of the Smith Commission principles should have greater priority than others, in order to support the Smith Commission’s overall ambition to strengthen the financial responsibility of the Scottish Parliament;
- The risks of fully implementing the compensation principle and what, if any, approaches to interpreting the counterfactual ‘no change’ scenario could be applied
- Whether the risks arising from differences in forecast timings are reasonable and appropriate given the size of the Scottish Budget and whether the OBR and SFC forecasts could be better tied to minimise this risk
- How asymmetric shocks might be identified and the risks they could pose to the Scottish Government and UK Government

The need for greater transparency over the reasons why any particular BGA approach is agreed to by the UK Government and Scottish Government was also requested[3] by FPAC in its response to the Independent Report consultation. This was in order to promote greater understanding around the Fiscal Framework and support effective scrutiny. Alongside that request, the Committee also called for:

- More detailed information made available on the reasons for changes in the BGAs year to year;
- An agreed procedure as to how any changes to BGA methods are communicated to this Committee and the Scottish Parliament; and

[3] Finance and Public Administration Committee response to the Fiscal Framework Independent Report Consultation, 20 September 2022

- A clear communication plan alongside the Fiscal Framework, agreed following the review, setting out in plain English to the extent possible what the Framework is, what the changes are and why they have been made.

Summary of key recommendations from the joint report of the Finance and Constitution Committee, Social Security Committee and from the Cabinet Secretary for Finance and the Economy, 28 October 2020

1. The joint report set out two structural risks that had been identified from the operation of the Fiscal Framework to date:

    a. Demographic risks: whether the Fiscal Framework:
        - sufficiently recognises the impact of demographic divergence on income tax and social security (including the impact of immigration policy and demographic differences between Scotland and the UK);
        - provides sufficient policy and budget management tools to address the potential risk arising from demographic divergence in Scotland relative to the rest of the UK.

    b. Distributional Risks: whether there are potential structural risks inherent within the Fiscal Framework arising from the distribution of the tax base in Scotland relative to the UK including:
        - the incentives that tax devolution presents;
        - how the benefits of economic growth accrue across the tax base and are reflected in the Fiscal Framework operation; and
        - whether there are sufficient budget management tools for the Scottish Government to address the potential risks arising from the distribution of the tax base in Scotland relative to the rest of the UK.

2. The joint report also recommends that the review considers:

    a. Whether the reconciliation process within the Fiscal Framework should be revised to better enable the Scottish Government to manage forecast error (in terms of the magnitude of errors and timescales for reconciliation);
    b. The extent of the risk arising from the potential divergence in forecast error between the SFC and OBR (and the potential for any differences between forecasts to be amplified);
    c. Whether the Scottish Government and SFC have access to data of a comparable quality to that available to the OBR and whether there is the same level of transparency regarding the publication of Scottish data;
    d. The limits and caps on the resource borrowing powers and reserve to ensure they are sufficient to manage the volatility created by the Fiscal Framework and whether those limits should be protected in real terms (and retrospectively)

e. Re-examining the capital borrowing arrangements and merits of a prudential borrowing regime
f. The experience of the governmental response to COVID-19 (and also at that time the agreement in the short term regarding additional flexibilities and powers to enable devolved governments to more effectively manage their budgetary response to COVID-19)
g. Whether the implementation costs agreed as part of the Fiscal Framework are sufficient given what is known about the scope of recharges (including reasonableness of the Scottish Government meeting the costs of devolution of the social security powers within the funding envelope already agreed for implementation and administration);
h. Re-examining how policy spill over effects are accounted for through the Fiscal Framework and flexibilities and constraints of the Fiscal Framework in responding to policy changes at Scottish or rest of the UK level
i. The effectiveness of dispute resolution provisions and the governance arrangements (to ensure that both governments have an opportunity to respond timeously to each other's policy decisions).

SPICe The Information Centre
An t-Ionad Fiosrachaidh

Finance and Public Administration Committee

Tuesday 14 November 2023

VAT assignment statistics

Introduction

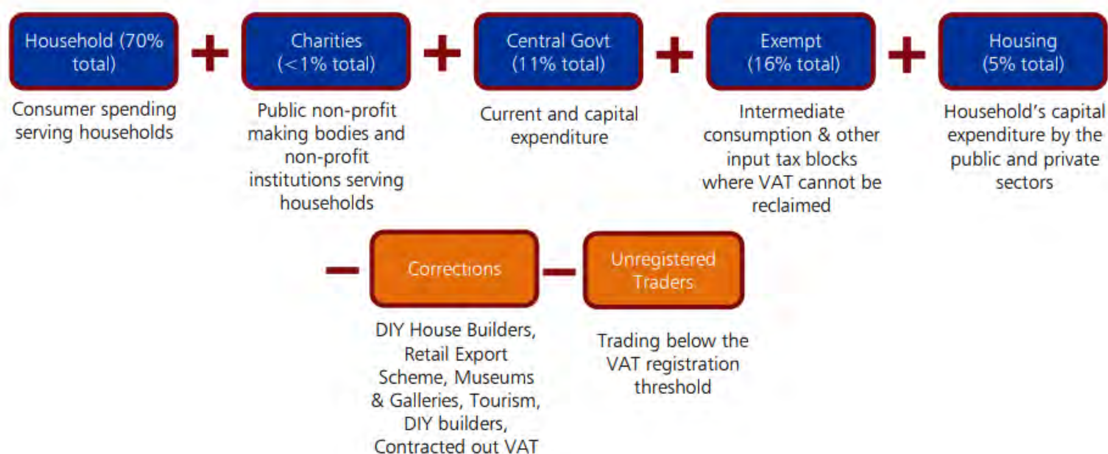
This paper summarises some of the issues arising from the Scottish VAT assignment experimental statistics. What these statistics make clear is that VAT assignment data fluctuates to a larger extent than the other devolved taxes. As the Finance and Constitution Committee found when it looked at VAT assignment in the previous Parliamentary session, this is a key reason behind a lack of progress in implementation of the Smith Commission recommendation that VAT be assigned to the Scottish budget.

The VAT assignment model

The Scottish VAT Assignment: Summary of Assignment model publication of 2018 set out the agreed methodology for assigning a Scottish share of VAT.
HMRC VAT compliance work does not specify which UK region goods and services liable to VAT were consumed. To calculate the Scottish share of UK VAT, a VAT assignment model was required to estimate the VAT incurred on goods and services consumed in Scotland compared with other UK regions.

So how does the assignment model calculate Scottish share of VAT?
In short, the model uses UK expenditure data, together with Scottish shares of that expenditure, and applies relevant VAT rates to derive an estimate of the VAT receipts attributable to consumption in Scotland. This model therefore calculates the VAT Total Theoretical Liability (VTTL) for Scotland. The VTTL is a measure of the theoretical VAT collected by a jurisdiction’s tax authority assuming there are no losses in collections from non-compliance.

The VAT assignment model is made up of five spending components and two adjustment components. These are as follows:



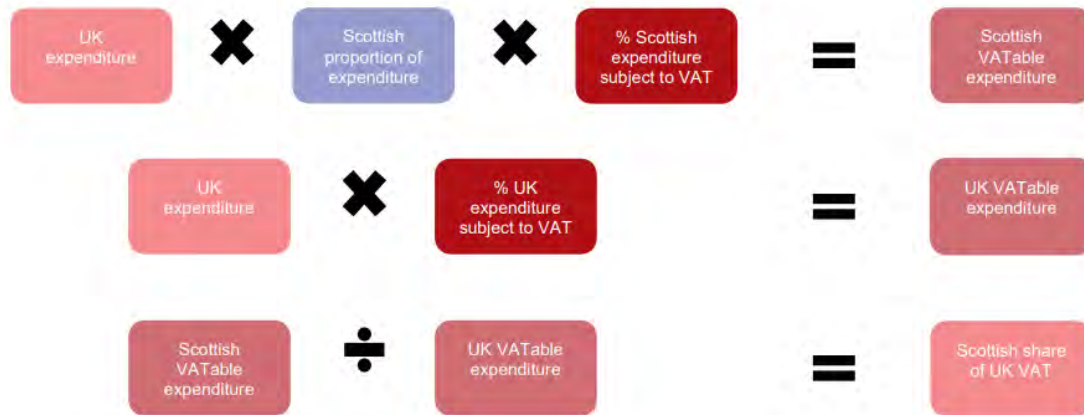
The VAT Assignment model takes the expenditure in Scotland in each of the above expenditure components and then estimates the amount of that expenditure that is subject to VAT. This can be compared to the same expenditure component analysis for the whole of the UK to calculate the Scottish share of UK VAT. The Scottish share of VAT can then be applied to VAT receipts to calculate the Scottish share of UK VAT receipts.

The model analyses these expenditure components using data from multiple, mostly publicly available, sources of information including, but not restricted to: the ONS Blue Book, ONS Living Cost and Food Survey, ONS International Passenger Survey, VisitBritain and Statistical tables published by other government departments.

The VAT liability of the expenditure components outlined above is determined by the VAT treatment of the goods and services that are included in the expenditure component. Although most goods and services are subject to 20% VAT, many are subject to the zero and reduced rates (5%) of VAT. Therefore, expenditure categories need to be disaggregated to goods and services that have consistent VAT rate treatment in order to accurately calculate the VAT liability relating to that expenditure.

For example, certain foods in the UK are subject to the zero rate of VAT. The model must therefore disaggregate food expenditure by type of food in order to determine the proportion of food consumption which is subject to VAT at 20%. This analysis can then be used to calculate the VAT liability of the total food expenditure.

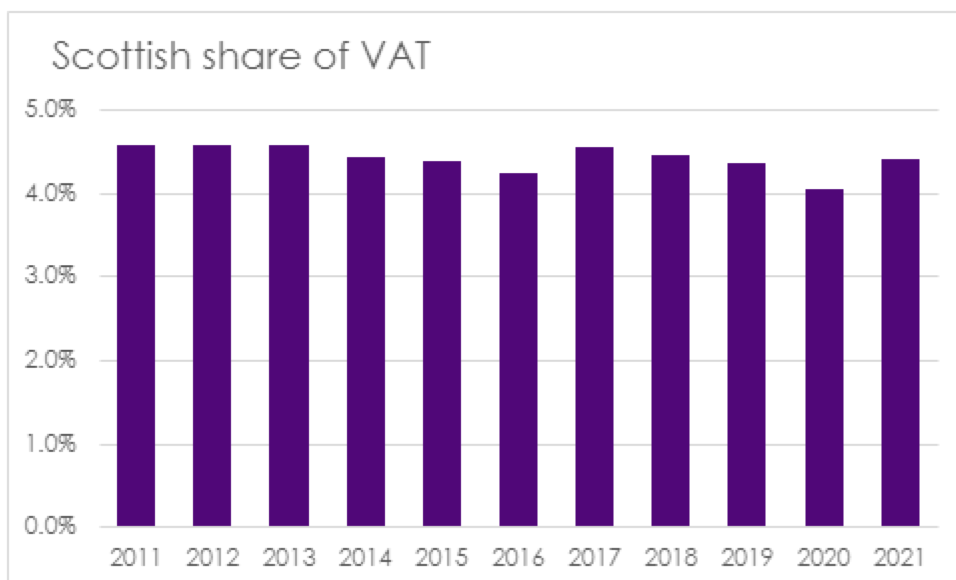
Simplified calculation of Scottish share of UK VAT

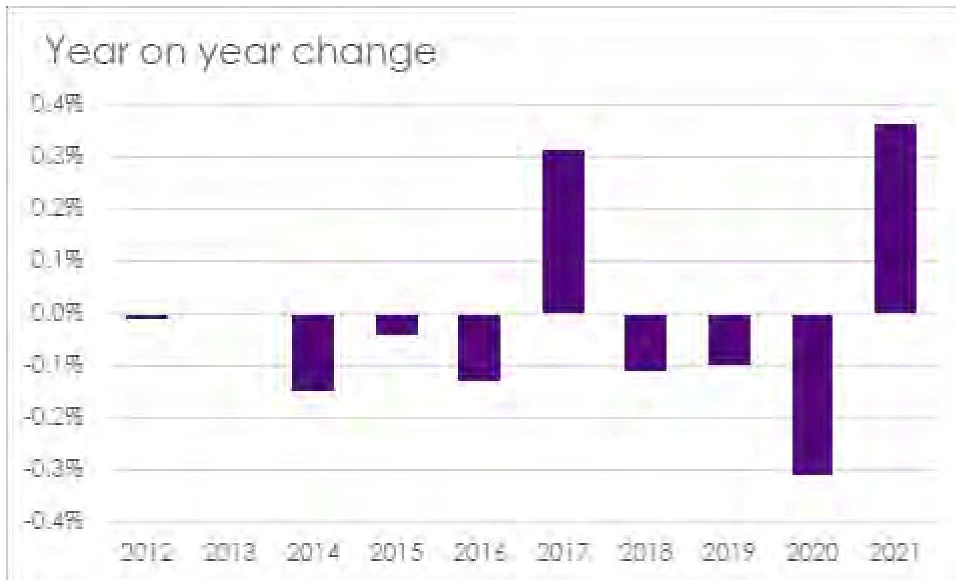


What the experimental statistics show

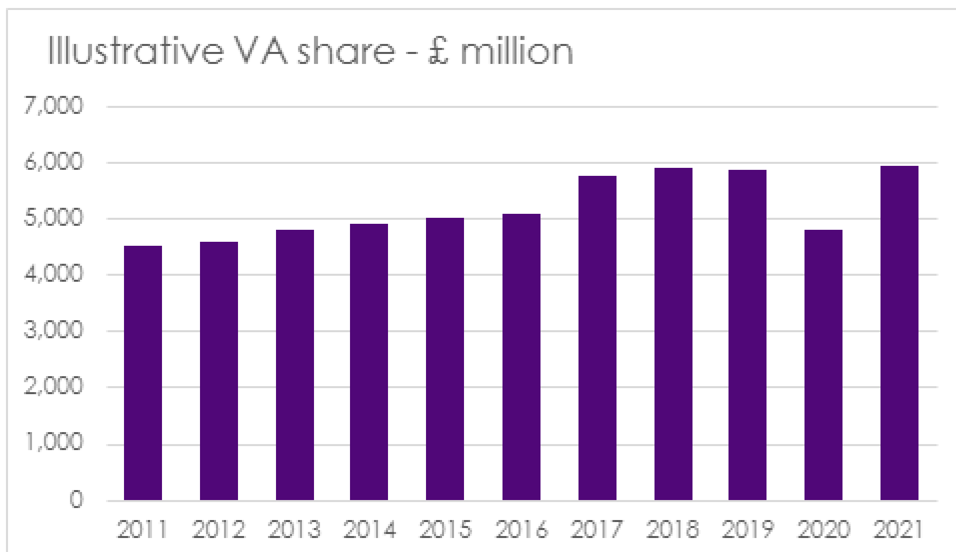
The most recent Experimental statistics on VAT Assignment (VA) for Scotland were published on 28 September 2023. These are produced by HMRC with support from the Scottish Government.

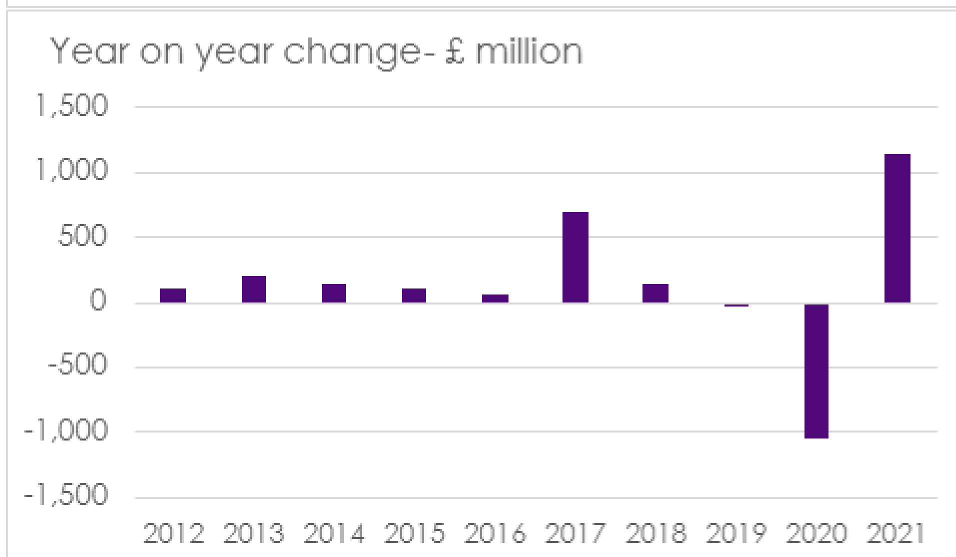
The following visuals shows the degree to which Scottish VAT assignment has fluctuated as a share of UK VAT receipts.





And what this has meant in revenue terms and how that has changed year-on-year.

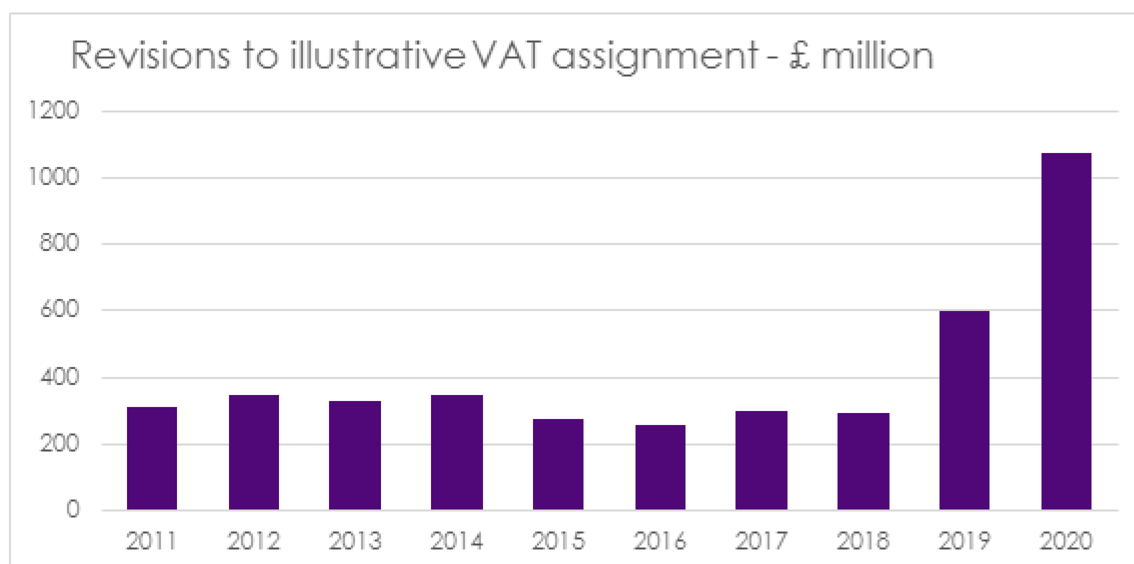




Main points to note from the above charts are as follows:

- The Scottish VA share fluctuates between 4.03% and 4.57% during the period 2011 to 2021.
- The VA share was lowest in 2020 at 4.03% due to COVID-19 effects, in particular lower domestic tourism expenditure in Scotland from rest of the UK (rUK) residents.
- The VA share has recovered in 2021 to 4.39%; this increase has been driven mostly by recoveries in domestic tourism expenditure in Scotland, closely followed by growth in household expenditure.
- Across the rest of the time series, fluctuations in VA share are mostly driven by changes in household expenditure, which is the largest expenditure sector of the model.

The data is also subject to revisions which are presented in the following chart. These have typically been around the +£300 million mark, but there were large revisions made to the initial 2019 and 2020 figures. This raises questions discussed below around how any kind of reconciliation process would work, given the scale of the revisions which have taken place over the period covered by the data.



The Scottish VA share has been revised in all years as underlying National Accounts aggregates have been revised. These have increased the VAT assignment figures, as shown in the above chart.

Are we any further forward?

It appears that we remain some way from solving the issues arising from VAT assignment uncertainty. There is nothing in the public domain to suggest that the Scottish and UK government are any further forward in addressing the concerns raised when the previous Parliament’s Finance and Constitution Committee

considered this issue in 2018 in its pre-Budget scrutiny report. That Committee was concerned that VAT was being assigned to the Scottish budget based on estimates from a model, rather than actual outturn numbers as happens with income tax and the fully devolved taxes. It concluded as follows:

> "The Committee is concerned that basing VAT assignments for Scotland on estimated figures could potentially introduce further volatility into Scotland's public finances. The Committee recommends that both Governments should continue to review the methodology used for assigning VAT to Scotland during the implementation year to ensure its robustness and reduce the level of risk from forecast error."

The Scottish VAT Assignment: Summary of Assignment model publication of 2018 remains the model used for publishing VAT assignment data, and it is still based on estimates.

The VAT Assignment model also states that:

> "The block grant adjustment for VAT assignment will work in broadly the same way as the adjustments applied for Scottish Income Tax."

However, one crucial difference is that Scottish Income tax is based on outturn data, whereas there is still no mechanism for basing VAT assignment on any kind of audited set of outturn information.

There are also questions on how the significant revisions highlighted above would be accounted for and accommodated by the Fiscal Framework? These have typically been of the order of £300 million, but rose to around £600 million in 2019 and over £1 billion in 2020.

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ANNEXE D

Summary of Finance and Constitution Committee roundtable on VAT assignment in Scotland, 19 March 2019.

The purpose of VAT assignment

1. Pillar 3 of the Smith Commission report concerned with Scotland's fiscal framework, including the tax raising and borrowing powers of the Scottish Parliament. The Smith Commission stated that these powers are intended to strengthen the financial responsibility and accountability of the Scottish Parliament and that "the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure."

2. The Session 5 Finance and Constitution Committee Adviser, David Eiser, confirmed in his March 2019 briefing that the Scottish Government has no power to vary VAT rates or exemptions. The Scottish Budget will be influenced by the growth rates of the assigned VAT revenues relative to the equivalent rest of the UK rates (rUK). At the Committee meeting in March 2019 Professor Graeme Roy explained that the principle behind the assignment of VAT is the correlation with the strength of the economy such that if the economy does well, "you benefit; if it does worse you are accountable for that." However, as the Scottish Government cannot change VAT rates or the VAT model, this raised questions about what levers the Scottish Government has to control the economy and to control the changes in VAT revenues. It was suggested that consumption might be the lever but Professor Roy asked whether a Government would wish to "encourage people to spend more and save less."

3. In considering the Smith Commission objective to build in accountability for the performance of the Scottish economy, Professor Roy considered that there was a question over whether, even if the Scottish economy was changing relative to the rest of the UK, that would be reflected in the VAT revenues that were received in Scotland. He argued that there are "fundamental questions about whether the link on accountability is achievable with the assignation of VAT given the complexities of the process."

4. Dr Mathews from the Office of Budget Responsibility (OBR) explained that its VAT forecasts for the UK in the period to 2019 were quite stable given there were relatively few policy changes. As such "if there was desire to boost consumption in the short term and VAT was used as a policy lever, things could move quite dramatically."

5. Charlotte Barbour from the Institute of Chartered Accountants in Scotland (ICAS) cautioned about the policy consequences that could flow from VAT assignment – for example would the Government look to support industries that result in increases in VAT revenues rather than, for example, the food industry which tends to be zero rated for VAT? She was also not sure about that the correlation between individual policies and VAT assignment is that strong.

6. John Cullinane from the Chartered Institute of Taxation (CIOT) highlighted distributional issues and the connection between VAT assignment and the progressivity of the income tax system – “the belief is that, if incomes are spread more evenly, there will be more consumption” but that might be of products which are zero rated for VAT. He added that he hadn’t seen a lot of analysis about how those policies might fit together. Professor Roy also questioned whether it would be possible to trace how any changes in Scottish Government policy would impact on VAT.

7. Alternative models for assigning VAT which might be based on actual VAT outturn data were discussed. John Cullinane explained that that would require designing a set of rules to determine what Scottish receipts are and then ensuring business follows them. John Cullinane and Charlotte Barbour considered that an outturn-based approach would be burdensome and would not address the issues with the VAT assignment model proposed. As Charlotte Barbour observed the “whole point of VAT is that it is designed for a single big market, because it goes in and out with production, adding value as it goes along.”

8. Charlotte Barbour also highlighted the challenges in identifying what is Scottish VAT when Scottish based business may trade out with Scotland and consumers purchase online.

The VAT assignment methodology

9. As the SPICe briefing note explains the model proposed for VAT assignment in Scotland uses both estimates to inform the forecasts of VAT followed by use of a VAT Total Theoretical Liability (VTTL) model to provide estimates for subsequent reconciliation. VTTL itself is calculated using a range of data from multiple, mostly publicly available, sources of information.

10. As John Cullinane explained, in terms of having to use estimates for VAT assignment. “It does not matter so much if the estimates are inaccurate on Day 1 as long as they constantly remain inaccurate in the same way.” This is because in that scenario the same amount is taken away through the Block Grant adjustment. However, as Mark Taylor from Audit Scotland highlighted, the challenge is in knowing whether it is consistently wrong.

11. There were a number of calls for greater transparency over the details of the assignment model. At the time of the roundtable in 2019, the size of reconciliations that would arise from Income tax, devolved taxes and social security was not known. At that time the VAT model was conceptual but as Mark

Taylor from Audit Scotland explained there was "no detail behind it." He added that there also need to be greater transparency "on the interpretation and assessment of things such as the extent of risk" as well as how that risk is aggregated up.

12. Professor Graeme Roy observed that more detail was needed on the numbers used in the methodology and assessments of sensitivity (such as with sample size) as to how those numbers will change. As an example he highlighted how 70% of VAT under the assignment model involved looking at consumer spending relying on one survey – the living costs and food survey. By boosting the numbers in this survey the impact on the GERS numbers in 2016-17 was to take £300 million out of Scottish VAT. This he explained "had nothing to do with performance, it was just because the Scottish Government had increased the sample size of the survey."

13. Dr Mathews added that it was also important to establish how important the outliers in the sample and how they feed through the Scottish VAT. "In future years, if the sample changes and more of these outlier households come in, how much effect will that have?"

14. In his briefing paper the Session 5 Committee adviser, David Eiser highlighted some of the challenges with the robustness of the publicly available survey data being used for estimation:

    - What the sample size will be following any boosts to surveys and any assessments of the adequacy of sample size;
    - The robustness of the other data sources used such as the various Tourism and visitor surveys;
    - Why some approaches have been used over others (such calculating the Scottish share of central government expenditure using labour market data rather than drawing on public spending data);
    - The partial information given on what some data sources are, such as references to 'construction industry data from ONS' or 'HMRC internal data.' This, he observes, is particularly marked in relation to VAT exempt businesses where 'HMRC confidential data' and 'immediate consumption figures' are referenced but no further information is given.

15. The volatility and uncertainty of the estimation process and the lack of actual outturn figures was discussed. John Ireland from the SFC explained the challenges for the SFC of forecasting on the basis of estimates "The job of the Commission will be not just to estimate the underlying trend but to forecast the random error in the assignment model, which is very hard." Forecasting that random error on a year by year basis will be difficult.

16. In addition, as Dr Mathews explained in relation to the forecasts from estimates, the OBR could forecast in a different way than the SFC. There was added complexity in that, if the UK budget had a policy event "the next forecast would require the Fiscal Commission to react and feed through what that would mean for the Scottish assignment." As a result the SFC forecast could reflect a different time and context with a resulting impact on reconciliation.

17. Under the Fiscal Framework the block grant baseline adjustment for VAT assignment will be equal to the UK Government's receipts generated from Scotland in the year immediately prior to the devolution of powers. The extent to which that year represented a 'usual' year was discussed. Professor Roy highlighted that it would be helpful to see how sensitive the estimates are when a one, two or three year transition period is used.

18. Dr Mathews highlighted the 'VAT gap' at the UK level– that is the difference between the VAT theoretical liability and actual receipts – was quite large at 8% (in 2019). The causes of the VAT gap were not clear but could include avoidance or evasion; or aspects not captured by the model such as businesses under the VAT threshold. The VAT gap was not, he contended, an issue if it is constant across the forecast albeit he acknowledged that in relation to the Scottish VAT assignment the VAT gap would never been known since actual VAT receipts will not be known.

19. Professor Roy queried whether the pace of change in statistics and data available in the UK can 'cope' with what is happening in the context of the wider fiscal framework. He highlighted Canada where there are national economic accounts which are also produced at a state or province level with much more accurate information (albeit a portion of that is based on data from provincial level taxes). He observed, however, that the focus in Canada is more about apportioning national revenues across the provinces than accountability for economic performance.

Risks to the Scottish Budget

20. As Professor Roy explained there is much more complexity in the VAT system than the income tax system. How all the risks associated with devolved taxes, income tax and VAT assignation interact is a key challenge. The volatility in both the estimates of the BGA and the tax take could cancel each other or build on each other. Mark Taylor from Audit Scotland highlighted two key aspects to managing the risks of VAT assignment within the Scottish Budget:

    - What is the Scottish Government policy on reserves and borrowing? And how does it set up that policy so that it copes with future uncertainty?
    - In relation to adjustments, how do spending plans cope with the inevitable year to year volatility - "to what extent does everything get based lined meaning that you are storing up problems for the future".

21. He added that key is knowing what permanent and recurring effects are due to economic performance and what are due to volatility and error within the assignment model. In addition to which is the question about the extent to which Audit Scotland and the National Audit Office are able to design an approach that provides assurance over how the methodology is working in practice given the calculations are based on a variety of sometimes confidential survey data. Dr Matthew provided the example that if outturn data changed dramatically and the

reason why lay within confidential data, it would be challenging for the forecasters, and also others, to explain.

22. John Ireland explained that if the OBR forecast error for VAT of 2.4% was applied to Scottish VAT then the error would be between £100 million - £200 million (in 2019). Reconciliation then depends upon the combination of the forecast error for Scottish VAT and rUK VAT. Dr Mathews added that understanding behavioural response to policy changes is hard to understand, which adds another potential source of variance. “There is the economy variance plus the methodology error in relation to the survey, and then there is the policy costing error on top of that, so we could have wide confidence intervals.”

23. Responding to whether the using of a multi year average (say over three years) for surveys would reduce the methodology error, Professor Roy considered it could. He added, however, that using multi year averages would break the link between accountability, policy changes and actual outcomes since it will smooth the numbers over time.

Other factors

24. Following the evidence session in March 2019 the Finance and Constitution Committee wrote to the then Cabinet Secretary for Finance, Economy and Fair Work recommending that the VAT assignment methodology should continue to be reviewed. That Committee highlighted the evidence it heard of the increased risk to the Scottish Budget due to the statistical uncertainty inherent in the method proposed and in the data sources used.

25. In his letter to the then Chief Secretary to the Treasury on 15 May 2019, the then Cabinet Secretary considered that the “lack of the verifiable outturn data available for all other devolved taxes, is not an appropriate basis for assigning annual revenues of almost £6 billion.” He also highlighted the uncertainty of EU exit, adding that Scotland does not have the full levers necessary to combat such volatility. He therefore also called VAT assignment to be delayed and considered as part of the Fiscal Framework review.