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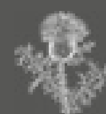

Scottish Policy Foundation

Foreword

Supported by Deloitte.

Welcome to the Fraser of Allander Scotland's Budget Report: 2019

Welcome to the fourth annual Fraser of Allander Institute (FAI) Report on Scotland's Budget, which Deloitte are proud to support.

With the postponement of the UK budget and an upcoming general election, scrutinising the tax and spending plans for Scotland becomes increasingly challenging. As the Scottish Government takes on more tax and spending responsibilities, it will become increasingly important to understand the strengths and weaknesses of the Scottish economy, the impact these will have on the Scottish Government's ability to meet its objectives and the challenging trade-offs that will be required. This makes this report one of particular significance as the FAI provides an up to date, factual analysis of where Scotland's economy is placed together with a view on its fiscal outlook ahead of the 2002/21 Budget.

We are delighted to support the creation of this report and to facilitate the debate on it.

John Macintosh
Tax Partner
Deloitte

The Fraser of Allander Institute (FAI) is a leading economic research institute with over 40 years experience of researching, analysing and commentating on the Scottish economy.

The FAI undertakes a unique blend of cutting-edge academic research, alongside applied commissioned economic consultancy in partnership with business, local and national government and the third sector.

For over 40 years, *The Fraser of Allander Institute Economic Commentary* has been the leading publication on the Scottish economy providing authoritative and independent analysis.

The Fraser of Allander Institute is a research institute of the Department of Economics at the University of Strathclyde.

For regular analysis on the Scottish economy and public finances please see our blog

www.fraserofallander.org

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Scotland's Budget Report 2019

Lead author David Eiser

Chapter 2 drafted by Charlotte Barbour, ICAS

Foreword

This is our fourth annual Scotland's Budget Report.

When we published our first report in 2016, we had little expectation that the political environment would still be so uncertain. Three years on, we are now on to our second General Election, with little clarity about what may happen next.

The fiscal context has changed dramatically since 2016.

Back then, the outlook was for a further sustained period of belt-tightening as the UK Government sought to bring down both the annual deficit and stock of debt. Now, all sides in the election campaign are promising major increases in public expenditure – albeit with little in the way of a plan to manage the public finances over the long-term.

We have also had the first round of fiscal devolution.

The Scottish Government has used these powers perhaps more extensively than many thought, including setting new rates and bands for income tax.

However, these changes have been set against a weak economic backdrop. As a result, despite these policy changes raising around £500m in additional income tax revenues than if the UK policy applied, the net impact on this year's budget has been offset by slower growth in the Scottish tax base.

Official forecasts are that this trend may continue for the foreseeable future. As a result, some of the major boost to public spending now promised across the UK will be offset by weaker tax growth here in Scotland.

A second round of fiscal devolution is due to take place from April 2020, with the devolution of a number of important social security payments. Whilst it will be well into the next decade before the Scottish Government has full policy and administrative control over these benefits, the fiscal risk for such payments will impact upon the Scottish Budget from next year.

All of these changes bring with them major opportunities. But they also bring challenges. Careful stewardship of the devolved public finances is more important than ever, with an ever important role for analysis and evaluation. It will also require the government – even in a more uncertain world – to be more transparent about Scotland's budget outlook over the medium to long-term.

Once again, we are grateful for the significant support that we have received to help continue our research into the Scottish economy and public policy. We pass on our thanks to our supporters for today, Deloitte and the Scottish Policy Foundation.

We also wish to extend our grateful thanks to Dr Jim Walker of Asianomics for his amazing support for the work of our fiscal team.

We are also grateful to Paul, Charlotte, Caroline and Andy for joining us to present their own insights at our launch event.

2020 will be 45 years since the Fraser of Allander Institute was established. To mark the occasion we will be running a series of events and seminars to look forward to the next 45 years.

We look forward to seeing you then.

Professor Graeme Roy
Director of the Fraser of Allander Institute
University of Strathclyde

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.

The 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.

Throughout the first three budgets of this parliament, the Scottish Government has sought to raise additional revenues to support the 'social contract' by making progressive changes to tax policy. At the same time, the outlook for the block grant has improved at each budget event, whilst there has simultaneously been a deterioration in the forecasts for Scottish income tax revenues. The government is also taking on new social security powers. This chapter examines how these elements come together to influence the size of the Scottish resource budget. It also considers how this evolving budget has been prioritised across different areas of public spending.

1.1 Introduction

Budget 2020/21 will be fourth of five budgets in this parliamentary term. This chapter sets the scene through the lens of the policy choices and political decisions – of both the UK and Scottish Governments – that have shaped the first three budgets of this term.

Like almost every other aspect of UK and Scottish policy, the past three years have been defined by the EU referendum result.

The fallout, and the subsequent three-and-a-bit years of debate, negotiation and wrangling have influenced inter-governmental relations. A widening gulf exists between the UK and Scottish Governments – including around the repatriation of EU powers and fiscal responsibilities – which is only adding to uncertainty around how the Scottish Budget might evolve in future.

The referendum result has also influenced the UK (and Scottish) economic outlook. In the medium to longer term, a less frictionless relationship with the EU for movement of goods, services, people and investment is expected to lead to weaker economic growth (and hence a weaker outlook for the UK public finances).

But in the more immediate term, Brexit induced uncertainty has also dented the UK's short-term economic prospects. Whilst the UK avoided the recession that George Osbourne predicted should the UK vote 'leave', growth has slowed. Indeed, recent research as part of the IFS Green Budget indicates that UK GDP by 2019 is around 2.5-3.0% below where it would have been had the UK voted to remain[1].

[1] Nabarro and Schulz (2019) 'Recent trends to the UK economy'. In IFS Green Budget: October 2019. IFS, London.

Brexit has not been the only unexpected development since 2016. There have been big changes to the UK's fiscal stance. The pre-referendum target to achieve a fiscal surplus by 2019/20 was abandoned in favour of achieving a cyclically adjusted deficit of 2%. Phillip Hammond's successor, Sajid Javid, has gone further and has implicitly jettisoned that target in favour of an alternative much looser (albeit yet undefined) fiscal mandate. The main beneficiary of this has been departmental spending.

As a result, the outlook for the Scottish resource budget has improved during the parliament. What looked like being, in 2016, a three year period of further fiscal austerity has turned out to be one of (mild) fiscal expansion, with the promise of further spending increases ahead.

One development in this parliamentary term that was anticipated was the transfer of significant new fiscal powers to the Scottish Parliament, and the introduction of a new Fiscal Framework. The Fiscal Framework exposes the Scottish budget to a number of risks, particularly in relation to Scotland's economic performance relative to the rest of the UK. Several of these risks are being realised, with tangible implications for the Scottish budget.

This chapter considers how these issues have shaped the outlook for the Scottish budgets of 2017/18, 2018/19 and 2019/20. It then examines the choices that the Scottish Government has made in these budgets for both taxation and spending.

1.2 The evolution of UK fiscal policy and implications for the block grant

The UK Government's fiscal policy stance has evolved materially since 2016.

Former Chancellor Phillip Hammond's first fiscal event – November 2016's Autumn Statement – left the departmental spending plans of his predecessor George Osborne largely unchanged, despite substantial downgrades to forecasts of UK economic growth, consumer spending and tax revenues in the light of the EU referendum.

By the time of the Spring Budget in 2017, the economic outlook had marginally improved and the Chancellor was able to announce some additional resource and capital spending increases, generating consequentials for the Scottish block grant. This pattern was repeated at the Autumn Budget in 2017. Taken together this improved the outlook for the Scottish block grant, but not sufficiently to alter the conclusion that the Scottish resource block grant would decline over the two years from 2017/18.

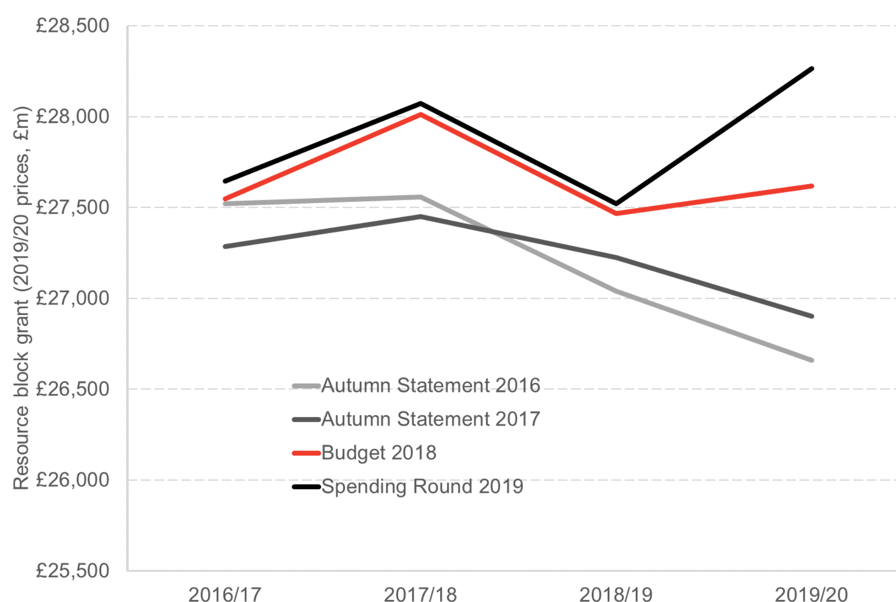
The October 2018 budget forecasts included some good news for the Chancellor, with tax revenues coming in more strongly than forecast, despite continued weak economic growth. This allowed Phillip Hammond to make two significant policy decisions whilst remaining on course to meet his fiscal target. First he announced a significant increase in funding for NHS England, generating additional consequentials of £600m to the Scottish resource grant. The impact was to change the outlook for the Scottish resource block grant from a position of real terms decline to real terms 'flat' between 17/18 and 19/20. Second was the announcement that the higher rate threshold of income tax would increase from £46,350 to £50,000 in 2019/20 in rUK. With Holyrood now responsible for such a policy in Scotland, this raised the prospect of the first major difference between devolved and rUK income tax policies post devolution.

As we discuss in Chapter 3, in September of this year, new Chancellor Sajid Javid announced a further £13.4bn of real terms departmental spending in 2020/21. The announcement provides a further £1.1bn boost to the Scottish resource block grant for 2020/21.

So at UK level, the story of the past few years has been one of persistently weak forecasts for economic growth. But public revenues have surprised slightly on the upside. This, together with the adoption of looser fiscal targets, has led to departmental spending increasing more quickly than had been originally planned.

The consequence is that, rather than *declining* over the course of the first three years of this parliament by just over 3% in real terms – which was the prospect Derek Mackay faced when he set his first Scottish budget for 2017/18 back in December 2016– the Scottish resource block grant actually remained broadly *constant in real terms* between the budget of 2016/17 and that of 2019/20 (and, a result of changes subsequently announced throughout 2019, it has increased by 2%). See Chart 1.1.

Chart 1.1: Evolution of the Scottish Government's resource block grant at successive budget events



Source: Scottish Budget documents, various years, FAI calculations

1.3 The Scottish fiscal framework and budgetary risks[2]

The first three budgets of this parliament have seen the initial transfer of tax and spending powers that was envisaged by the Scotland Act 2016.

Revenues from non-savings, non-dividend income tax were transferred in April 2017, and although there have been some teething issues (such as challenges around identification of Scottish income taxpayers), the new powers have been extensively exercised, as discussed below. Other taxes have been beset by some delays (Aggregates Levy and Air Passenger Duty for various legal reasons, VAT for technical estimation issues). Fiscal responsibility for all new devolved Social Security benefits will transfer to the Scottish budget in April 2020.

Scotland's new fiscal framework also came into operation at the start of this session. This not only sets out how the Scottish block grant will be adjusted to reflect its new responsibilities, but also covers the tools available to the Scottish Government to manage volatility and forecast error. Politicians, the media and policy-makers continue to grapple with

[2] For a discussion of the new fiscal framework see Eiser D., 2017, "A primer on the Scottish Parliament's new fiscal powers: what are they, how will they work, and what are the challenges?", Fraser of Allander Economic Commentary. 41, Vol. 2, p. 26-41.

the complexities and (at times) apparently abstruse workings of the framework. We attempt to debunk some myths throughout this report.

At the heart of the fiscal framework is the concept of so-called 'block grant adjustments'. There is a block grant adjustment (BGA) for each tax being transferred to the Scottish budget[3].

The BGA for each tax is intended to represent the revenues foregone by the UK Government as a result of transferring the tax to Scotland. The BGAs are calculated by assuming that, if a tax had not been transferred, then revenues from that tax in Scotland would have grown at the same per capita rate as revenues from the equivalent tax in the rest of the UK.

The BGA is deducted from the resource block grant. If the revenues raised in Scotland are greater than the BGA, then the Scottish budget is 'better off' than it would have been without tax devolution. This could happen under two circumstances: the tax base in Scotland might grow relatively faster than the equivalent tax base in rUK; or the Scottish Government might choose to set a policy that raises relatively more revenues.

Whilst the notion of the BGAs might seem unnecessarily complex, the BGAs do serve several functions:

- They protect the Scottish budget from UK-wide cyclical variations in revenues. If Scottish revenues fall during a UK-wide recession, then a corresponding fall in the BGA will protect the Scottish budget from the revenue decline.
- They protect Scottish taxpayers from the impacts of changes in UK tax policy. For example, suppose that the UK Government cuts rUK income tax rates, and as a result reduces departmental spending. In this case, the Scottish block grant (determined by the Barnett formula) would fall, despite the tax cut not applying in Scotland. However, the corresponding fall in the income tax BGA would offset this reduction in the block grant thus protecting Scottish spending levels[4].
- They also allow the Scottish budget to realise the budgetary impact of Scottish policy decisions. An increase in Scottish income tax should, all else equal, lead to an increase in revenues relative to the BGA.

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[3] There are also BGAs for each social security benefit being devolved – see Chapter 3

[4] This case is discussed from a more practical perspective in Chapter 3, when we discuss the implications of Boris Johnson's proposed increase in the higher rate threshold in rUK.

But there are risks for the Scottish budget. If the Scottish tax base (e.g. average incomes in the case of income tax, or property transactions and prices in the case of LBTT) grow less quickly than the corresponding rUK tax base, then Scottish revenues could be lower than the BGA. This outcome may reflect Scottish Government policy choices, but equally it could reflect factors beyond the government's control[5].

The general principle behind the BGAs is therefore quite straightforward. What matters for the Scottish budget is whether revenues are higher than the BGA or vice versa.

But the operation of the BGA is complicated by the fact that neither revenues nor the BGAs are known with certainty when budgets are set. Instead, budgets are based on forecasts for both. The subsequent reality can (and always will) differ. Once the reality becomes known, budget plans may have to adapt in subsequent years to offset any forecast error.

As the largest devolved tax, this is principally an issue in relation to income tax.

Budgets are set based on a forecast of the BGA (based in turn on OBR forecasts of rUK income tax revenues) and a forecast of Scottish revenues (made by the SFC). Scottish revenues are collected by HMRC, and the UK Government makes available to the Scottish budget the SFC's forecast level of revenues. Outturn income tax data is not available until 15 months after the end of the financial year.

Any difference between the forecast position and outturn must be reconciled in the subsequent budget. So, forecast error in respect of 2017/18 will be reconciled in budget 2020/21 (and so on).

1.4 Relative economic performance and forecast error: the risks realised

As we have just seen, the Scottish budget is now exposed to two types of risk:

1. The risk that the Scottish tax base grows relatively more slowly than the equivalent tax base in rUK. The implication of this is that the Scottish budget is worse off than it would have been had tax devolution not occurred.

[5] For example, the downturn in the North Sea is likely to impact upon Scottish earnings growth more significantly than for the UK as a whole. The Scottish Government clearly has limited ability to influence such trends.

2. The risk of forecast error. This is the risk that a Scottish budget is based on a set of forecasts that turn out to have been too optimistic. If this happens, then a subsequent budget will need to address any shortfall[6].

We have seen both these risks crystallise in recent years.

In 2017/18, Scottish revenues were lower than the BGA by £97m. This is despite the Scottish Government's decision to freeze the higher rate threshold at £43,000 rather than increase it to £45,000 as in rUK[7]. The reason revenues were lower than the BGA is that earnings grew less quickly in Scotland than rUK. So this is an example of the *first risk crystallising* – the Scottish tax base grew relatively less quickly than the rUK tax base.

Moreover, when the 2017/18 budget was set, this differential performance was not foreseen. The Scottish tax base was forecast to grow at broadly the same rate as the rUK tax base. As a result, Scottish revenues were forecast to be £107m higher than the BGA (largely reflecting the effect of the Scottish policy decision). So this is an example of the *second risk crystallising* – forecast error.

The difference between the 'net tax' forecast of £107m, and the outturn of -£97m is -£204m (Table 1.1). This means that the 2020/21 budget will be adjusted downwards (reconciled) by £204m. *Effectively, the 2017/18 budget was planned on an assumption that the Scottish Government would have £204m more resources available to it than we now know to be the case.*

Some interesting interpretations of the reconciliation process accompanied the release of the 2017/18 outturn data, not least from HM Treasury, whose analysis was heavily criticised, as discussed in Box 1.1.

[6] Of course, there are upside risks too. Should forecasts be too pessimistic then the budget will be boosted in subsequent years.

[7] In principle, this should have raised more revenues in Scotland as taxpayers earning above the higher rate threshold in Scotland would have been paying a higher rate of tax on a greater proportion of their overall income.

Table 1.1: Forecast and outturn income tax revenues and BGA in 2017/18 (£m)

	Revenues	BGA	Net position
Budget 2017/18	11,857	11,750	+107
Outturn	10,916	11,013	-97
Change	-941	-737	-204

Source: Fiscal Framework Outturn Report (Scottish Government, 2019)

The story in 2018/19 is similar. Latest forecasts imply that Scottish income tax revenues could be £179m lower than the BGA, despite further changes to Scottish income tax rates and bands that were intended to raise additional revenues[8]. Again, this largely reflects a weaker outlook for Scottish earnings growth.

The 2019/20 budget was based on forecasts that income tax revenues would be £182m higher than the BGA, although the latest (May 2019) forecasts imply a weakening in this position, with revenues forecast to be £5m below the BGA.

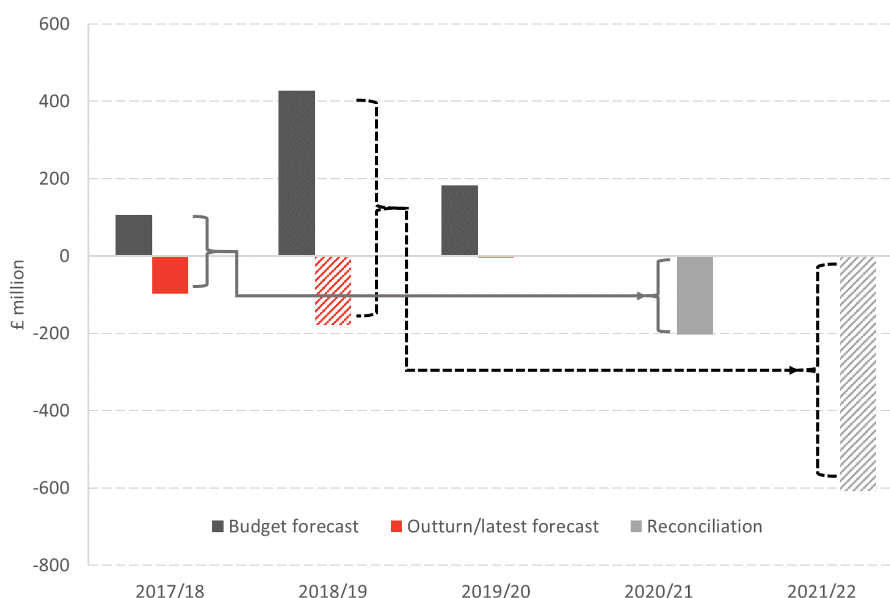
This is in the context of Scottish tax policy which is expected to raise £500m more in revenues than would be the case if the UK Government tax policy applied in Scotland.

In summary, the budgets in 2017/18 and 2018/19 were underpinned by forecasts that implied the Scottish income tax base would grow at more or less the same rate as in rUK. As a result, the Scottish budgets in these years were boosted by the government's income tax policy decisions.

Subsequently however, the outlook for Scottish tax base growth deteriorated, reflecting higher than forecast earnings growth in rUK and weaker than forecast earnings growth in Scotland. Because the weaker outlook was not foreseen when budgets were set, future budgets will be adjusted downwards – and we discuss this in Chapter 3.

[8] Note that the 2018/19 budget was planned on the basis that income tax revenues would be £428m higher than the BGA. If the outturn data for 2018/19 reflects the latest (more pessimistic) forecasts, a downward reconciliation of £608m will be applied to the 2021/22 budget.

Chart 1.2: Income tax forecasts and reconciliations



Source: FAI analysis of Fiscal Framework Outturn Report (Scottish Government, 2019)

Box 1.1: Interpreting the 2017/18 reconciliation

In its press release[9] relating to the income tax outturn data, HM Treasury said that Scottish income tax revenues for 2017/18 were £941m lower than 'expected', implied that this shortfall was due to slower economic growth in Scotland, and stated that this shortfall would be 'offset' by increased UK Government funding of £737m as part of risk sharing mechanisms.

This interpretation is somewhat disingenuous on a couple of counts. First, Scottish revenues were not £941m lower because of slower economic growth, but largely reflected lower than anticipated outturn data for 2016/17.

This 2016/17 outturn data had not been published when the 2017/18 forecasts were made, but it forms the baseline on which the BGA is calculated in subsequent years.

In other words, most of the explanation for the lower than forecast outturn data reflects that revenues turned out to be lower than expected *before income tax was transferred*.

[9] www.gov.uk/government/news/scottish-income-tax-shortfall-offset-by-uk-funding

Secondly, the UK Government did not offset this lower outturn with increased funding to reflect some risk-sharing mechanism; rather, the block grant adjustment was lower than forecast (i.e. less was deducted from the block grant) reflecting the lower 2016/17 outturn – which meant that the UK Government had been collecting less income tax revenue from Scotland than had been thought, and as a result was implicitly foregoing less revenue by transferring income tax to Scotland. The Fiscal Framework contains no 'risk-sharing mechanism' that protects the Scottish budget from slower than rUK growth – the Scottish budget is exposed in full to any such divergence, which is why it bears the risk of its revenues being lower than the BGA.

It is puzzling why HM Treasury chose to use such language. Indeed, reflecting these points, the UK Statistics Authority upheld a complaint from Mr. Mackay that the UK Government's interpretation of the reconciliation was 'incorrect'.

The UK Statistics Authority subsequently wrote to the UK Treasury, stating: "future HM Treasury press statements based on these statistics provide better explanations of the causes of changes to the Scottish income tax revenues and the associated Block Grant Adjustment. This will reduce the risk that users draw misleading conclusions from the statistics and the statements that draw on them."[10]

1.5 The Scottish Government's policy decisions this session: tax

The Scottish Government's general approach to taxation this parliament has been to set 'progressive' tax schedules that aim to raise additional revenues to support the social contract and public services spending in Scotland. This is particularly the case with income tax, but also LBTT and council tax. The approach to non-domestic rates has been slightly different – the aim here has been to ensure a 'competitive' tax regime to support economic growth, which in practice has meant real terms tax cuts and expansions of some reliefs.

The flagship policy of this parliamentary session has been the decision to raise additional revenues from income tax through changes to the structure of rates and bands.

The decision to freeze the Scottish higher rate threshold in 2017/18 was anticipated at the time to raise around £100m in additional revenues; the introduction of the five-band structure

[10] https://www.statisticsauthority.gov.uk/correspondence/income-tax-reconciliations-for-scotland/

in 2018/19 was forecast to raise just over £400m; and the freeze of the higher rate threshold in 2019/20 was forecast to bring in an additional £500m. The distributional impact of the policy is described in Box 1.2.

Remember that the figures presented in the preceding paragraph represent the impact on Scottish *revenues* of implementing Scottish rather than rUK tax policy. The overall *budgetary* impact of tax devolution can differ from this. If the Scottish tax base grows relatively less quickly than it does in rUK, then the 'net tax' position – the difference between revenues and the BGA - may look much less positive.

This is indeed what happened in 2017/18, as described above – the BGA was higher than Scottish revenues, despite revenue raising tax policy.

The government has also sought to raise additional revenues through LBTT, again through 'progressive' changes. Residential properties transacting for less than £333,000 pay somewhat less tax in Scotland than they would in England, but those transacting for more than £333,000 pay more. Additionally, a slightly higher Additional Dwelling Supplement of 4% applies in Scotland in 2019/20, compared to the 3% equivalent levy that applies in England and NI.

As with income tax, the net impact of LBTT on the Scottish budget depends not only on the revenue effects of tax policy, but also on the relative growth of the tax base (in this case, property prices and the number of transactions). The net impact of LBTT on the Scottish budget was slightly negative in 2017/18 (reflecting slightly weaker tax base growth), but was positive in 2018/19 and forecast to be so again in 2019/20 reflecting a combination of tax policy and differences in tax base growth. In 2019/20 LBTT is forecast to raise £76m more than the BGA, in part reflecting policy choices – the increase to the ADS is forecast to raise £28m, whilst changes to the non-residential LBTT are forecast to raise £13m.

In considering the government's tax policy, it is worth a brief digression to consider council tax and non-domestic rates.

Responding to the recommendations of the Local Tax Commission (2015)[11], the government introduced modest reforms to council tax in 2017/18. These amounted to a relative increase

[11] Commission on Local Tax Reform (2015) 'Just change: a new approach to local taxation'. http://localtaxcommission.scot/download-our-final-report/

in liability for properties in bands E, F, G and H – a reform that was expected to raise around £110m, and improve slightly the relationship between property value and tax liability.

The nine-year council tax freeze was also ended, with councils able to increase rates by up to 3%. Council tax increases were capped at 3% in 2018/19 and 4.79% in 2019/20. If all councils chose to increase bills by 3% and 4.8%, this could raise between £70m - £110m nationally.

Box 1.2: Distributional impact of income tax and council tax reforms

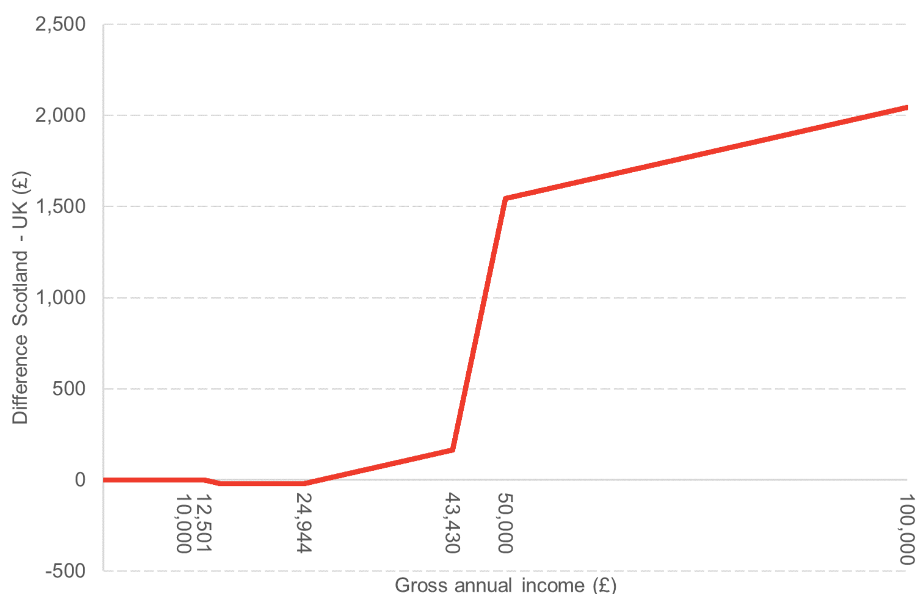
Chart 1.3 shows how the difference in income tax liability under the Scottish 2019/20 tax schedule differs from liability under the rUK tax schedule at different levels of income.

Chart 1.4 considers the distributional impact of income tax and council tax policy choices on household level net incomes, taking into account the actual distribution of household incomes in Scotland.

Specifically, the chart considers the distributional impact of implementing the Scottish income tax schedule in 2019/20 rather than the UK schedule. The changes are progressive: the net income of households in the top decile is 2% lower as a result of this policy whilst those on lower incomes are unaffected.

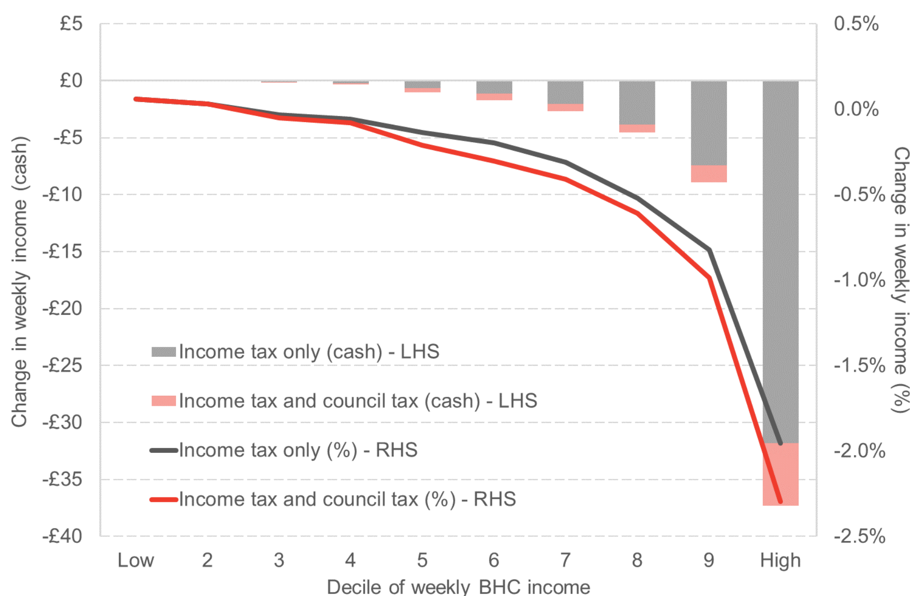
Chart 1.4 also shows the combined distributional impact of the income tax and council tax changes. The council tax policy assessed is the impact of using the reformed banding structure rather than the pre-2017 banding structure. This change is also progressive in the sense that households in the lower half of the income distribution are protected from the impacts of the change, and households in the top two deciles of the income distribution are more likely to live in properties banded in E-H.

Chart 1.3: Difference in income tax liability, Scotland compared to rUK, 2019-20



Source: FAI analysis

Chart 1.4: Distributional impacts of changes to income tax and council tax structures in Scotland



Source: FAI analysis

On non-domestic rates too, the government has been keen to structure a tax policy that can be claimed to be more progressive than the equivalent policy in England. Scotland has a more generous system of tax reliefs, most notably in terms of reliefs for small businesses in

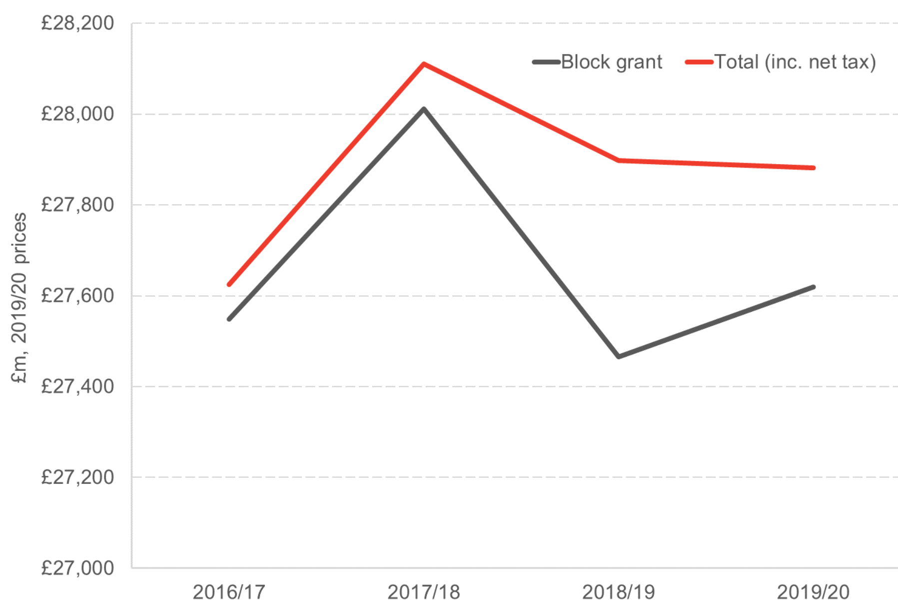
Scotland[12]. Scotland also has a 'large business supplement' which charges a 2.6 pence supplement on the poundage of businesses occupying premises with a rateable value in excess of £51,000.

However, whilst, as explained above, there has been a tendency in this parliament to make changes to income tax and council tax to *raise* additional revenues, NDR policy has been characterised by an expansion of reliefs and tax cuts. NDR reliefs introduced in 2018/19 are forecast to cost over £80m. The 2019/20 policy to increase the NDR 'poundage' (rate) by slightly less than inflation is forecast to cost £35m.

In summary, the impact of the tax policy decisions of the past three budgets has been to raise additional revenues – and to do so (for the most part) in a progressive manner.

The budgetary effect of all these tax policy decisions – together with the tax forecasts made when budgets were set – is that the Scottish resource budget was 1% (£250m) higher in 2019/20 than 2016/17.

Chart 1.5: The Scottish Government resource budget at successive budget events



Source: Scottish budgets, various years and FAI calculations

[12] Businesses occupying premises with a rateable value of less than £15,000 qualify for 100% relief in Scotland, against a threshold of £12,000 in England

1.6 The Scottish Government's policy decisions this session: spending

How has the pattern of resource spending evolved over the course of this parliament?

Comparing Budget 2016/17 and Budget 2019/20, resource spending is higher by a shade over £1bn in real terms (a real terms increase of 3.8%).

You might wonder how resource spending can increase by £1bn if the resource budget has apparently increased by only £250m. There are three explanations:

- First, the 2019/20 budget plans include an additional transfer of £290m to support the implementation of new social security powers.
- Second, the 2019/20 budget plans have been supported by the transfer of £220m resources from the Scotland Reserve (reflecting underspends and a better-than-forecast position on the fully devolved taxes in 2018/19).
- Third, the 2019/20 budget plans were based on almost £300m of 'anticipated budget transfers' – that's to say, additions to the resource budget that had not yet been formally confirmed by the UK Government, and thus not yet in the official block grant allocation.

Analysing how the distribution of spending has evolved across portfolios over time (even a relatively short time period such as the last four years), is challenging for various reasons, set out in Box 1.3. But these challenges notwithstanding, how has the distribution of spending changed since 2016/17?

Box 1.3: Challenges in comparing Scottish Government spending over time
Analysing how the distribution of spending has evolved across portfolios over time is challenging for two main reasons. First, changes to the structure of Scottish Government Portfolios, announced in June 2018, mean that the spending attached to several Portfolios in the 2019/20 budget cannot be compared between years. For example, spending associated with the 'Finance, Fair Work and Economy' portfolio in 2018/19 was subsumed into three portfolios in 2019/20, the 'Rural Economy and Connectivity' portfolio was effectively split into two, and a new 'Social Security and Older People' portfolio was created, removing some spending that

had previously been included in the 'Communities' portfolio. The 2019/20 backdates these changes to 2017/18, so portfolio changes can be compared over the last three budgets.

Second, the 2019/20 budget made changes to the way that Scottish Government operating costs are presented. In previous budget documents, some of the Scottish Government's operating costs were implicitly included in the portfolio spending plans to which those costs related, whilst some were identified separately as part of the 'Administration' chapter. In 2019/20, the Administration chapter was removed, and all Scottish Government operating costs are aligned with the portfolio budget that they support.

The 2019/20 budget explicitly identifies total operating costs for each portfolio (total operating costs for a portfolio are all the core Scottish Government staff and associated operating costs incurred by the portfolio, plus a share of the costs, such as accommodation, IT, legal services and HR, which cannot be readily attributed to a portfolio). This is a welcome improvement, and will in due course allow greater transparency and scrutiny of operating costs over time.

In the short term however, this change inhibits scrutiny as it makes comparisons between 2019/20 and previous years problematic. The reallocation of spending that was formally classified as 'Administration' spending to specific portfolios will potentially create the impression that portfolio spending has increased by more than is the case in reality. Unfortunately there is no reliable way to adjust the 2019/20 portfolio spending numbers to be on a consistent basis with previous years (or to adjust previous years to be on a consistent basis with 2019/20). This caveat should be borne in mind when interpreting the portfolio spending changes discussed below.

Fortunately, the Administration chapter has in recent years represented less than one per cent of total resource spending, so the issues described here will likely have a relatively minor impact on the analysis of spending trends over time.

Nonetheless, it is disappointing that the government has not done more to produce comparable numbers for previous years, as the failure to do so inhibits scrutiny of spending changes, and does little to improve overall transparency.

The first point is that the distribution of Scottish Government spending is evolving to reflect the transfer of new social security powers. In particular, in 2019/20, spending on Carer's

Allowance and the Carer's Allowance Supplement in Scotland was forecast at £320m. Spending on other new responsibilities (employability services, plus the Best Start Grant, Funeral Expenses Assistance) accounts for a further £30m. So new social security and employability responsibilities account for £350m of the £1.05bn real terms increase in spending since 2016/17.

Reflecting the government's commitment to pass on health related consequentials, resource spending on health has increased £780m in real terms since 2016/17, an increase of 5.2%.

So whilst Scottish Government resource spending has increased by £1.05bn between 2016/17 and 2019/20, the increases to social security and health means that real terms spending on non-health, non-social security functions has declined slightly since 2016/17.

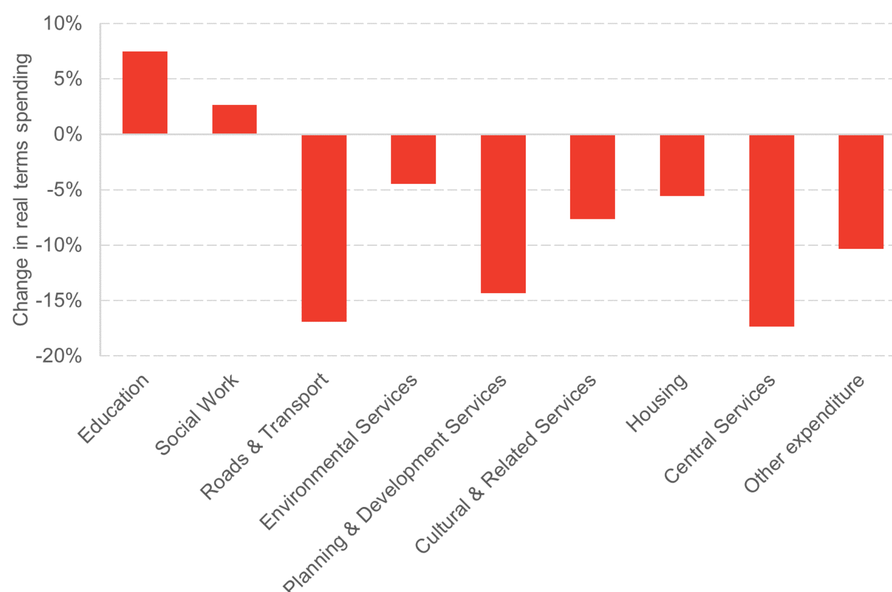
The government's strategy to manage this has been to disproportionately reduce the level of its resource budget that is directly allocated to local government. The direct resource allocation to local government (including both the general revenue grant and specific resource grants) has fallen by just over £300m, a real terms fall of 3.7%.

Of course, the local government settlement also includes the redistributed revenues from Non-Domestic Rates, together with various specific grants. Redistributed NDR revenues have increased around 6% in real terms this parliament, whilst there have also been increases in the amount of specific grant paid to local authorities (largely associated with new commitments, including pupil equity funding and the expansion of early learning and childcare). The local government revenue settlement including these elements has declined by £200m, or 2% in real terms, since 2016/17[13].

Local authorities have responded by protecting expenditure on education (which has grown by 7.5% or £300m in real terms between 2016/17 and 2019/20) and social work (which has grown by 2.6% in real terms). Spending on all other areas of local government responsibility is anticipated to fall in real terms between 2016/17 and 2019/20 (Chart 1.6).

[13] Burn-Murdoch and Campbell (2019) Local Government finance: facts and figures 2013/14 to 2019/20. Scottish Parliament Information Centre, July 2019

Chart 1.6: Change in local authority real terms spending by service, 2016/17 – 2019/20



Source: analysis of provisional outturn, various years, figures for 2019/20 are budget estimates

By reducing the share of its resource budget that is allocated to local government, resource spending on areas other than health, local government and social security has actually increased in real terms by £230m, or 3.1% between 2016/17 and 2019/20.

As a result, the Scottish Government has largely been able to insulate many other areas from real terms cuts. But this certainly does not mean that remaining areas of the budget have been prioritised equally.

Spending on enterprise, skills and education has been relatively well protected. Spending on enterprise (the enterprise agencies) has increased in each of the last two budgets – although this comes on the back of cuts in previous years. Spending associated with education has generally increased, particularly relating to the expansion of childcare and closing the attainment gap, alongside the budget for Skills Development Scotland and colleges. But these have been largely offset by real terms reductions of over 5% in allocations for universities and in grant support to students.

Spending on the Scottish Police Authority has increased slightly in real terms. But the Justice portfolio more broadly has seen a real terms decrease in spending, with decreases in spending on legal aid, criminal injuries compensation and the Scottish Prisons Service and the Scottish Fire Service.

Spending on environmental services – which includes funding for agencies including SEPA, SNH, Zero Waste Scotland and the national park authorities has declined by 4% in real terms.

Spending on many aspects of transport, including ferry services, air services, and motorways and trunk roads, has increased (in the case of motorways, largely reflecting increasing costs associated with PFI projects).

The Scottish Government's capital grant allocation has increased healthily over the course of this parliament, and is almost £1bn higher (6%) than it was in 2016/17. This has supported the funding of commitments around new childcare facilities (via local authorities) and a substantial affordable homebuilding programme. However, the health and education portfolios have seen their capital budget allocation fall in real terms over the course of the parliament.

1.7 Conclusions

The first three budgets of this parliament have been marked by substantial economic and policy uncertainty.

But UK fiscal policy has also evolved unexpectedly. The resource block grant underpinning the 2019/20 budget was in the end broadly the same as in 2016/17 – a sharp contrast to the 3% real terms cut Mr. Mackay had been originally planning for.

Throughout this parliament, the Scottish government has sought to raise additional resources through its tax choices. A clear theme emerges from the Scottish Government's tax policy choices so far this parliament, which is the setting of tax structures that can be framed as being more progressive and hence fairer than the equivalent taxes in the rest of the UK.

This is most obviously the case with income tax, where (very marginal) reductions in tax liabilities for those in the bottom half of the income distribution have been combined with more substantial increases in tax liability for those in the upper half.

The aspiration to set more progressive tax policy is also seen in terms of the rates of LBTT (where the Scottish Government can argue that 90% of Scottish residential transactions pay less tax than an equivalent property in rUK), council tax (where the distribution of ratios between tax bands is more pronounced than in rUK) and Non-Domestic Rates (where the

government can say that 90% of businesses pay less than they would in England, as a result of below inflationary increases in the Scottish poundage and the presence of the large business supplement).

The Scottish Government has justified its income tax policy choices on the basis of the requirement to raise revenues to support the 'social contract' – Scotland's more generous provision of universal public services compared to other parts of the UK.

At the same time however, the government has also emphasised how much lower council tax rates are in Scotland compared to England and Wales.

Meanwhile the increasing personal taxation burden (relative to rUK) has to be juxtaposed against the expansion of NDR reliefs. These reliefs now cost £750m annually, and whilst a large proportion of these reliefs is for justifiable reasons (e.g. for nurseries, charities, places of worship, etc.), the government's claim that the policy on business rates sets Scotland at a competitive advantage relative to the rest of the UK is difficult to verify.

How this tax policy should be viewed as a package is open for debate. Does it reflect a sensible way to balance potentially competing objectives for tax policy – the need to raise revenues and the need to support the economy – or does it lack some coherence in articulating and realising these objectives? Is it largely a 'pr' exercise to claim that Scotland is more 'progressive' than the rest of the UK?

The tax policy decisions this parliament – in particular the decisions on income tax – have increased the resources available to the government in each of the first three years of this parliament, relative to what it would have received through the block grant alone (although, as alluded to above, some of these impacts are being unwound in future budgets, as a result of the reconciliation process).

In terms of expenditure, the distribution of spending across the Scottish budget already looks quite different in the 2019/20 budget compared to 2016/17. This partly reflects changing responsibilities, notably around social security. It also reflects some reconfiguration of portfolios to support this and other changes in emphases, including the role of the civil service in managing new financial powers and planning for EU exit.

Stripping these new responsibilities out, spending increases continue to be dominated by health. Real terms increases in the health budget are generous compared to most other

areas of the budget, (but perhaps less so when viewed through the lense of population increase and demographic change – an issue considered further in chapter 4).

If health spending is the clear winner, local government is the clear loser. The resource allocation to local government has fallen 3.7% in real terms between the 2016/17 and 2019/20 budgets. The total revenue settlement to local government has fallen by less than this, as it is supported by revenues from Non-Domestic Rates. But this does not alter the conclusion that local government's allocation has been disproportionately squeezed.

Local authorities have responded by protecting in real terms spending on social care and increasing real terms spending on education. With these two areas accounting for around two-thirds of local government spending, it follows that remaining areas of spend have seen substantial spending falls, even since 2016/17.

Beyond health and local government, the story is more one of reconfiguration between portfolios rather than big changes to portfolios as a whole. There have been real terms spending increases on many aspects of education spending, offset by real terms spending reductions for HE. Police spending has increased, but other aspects of justice spending have fallen.

The overall story then of this parliament is that devolved public spending has become more concentrated on health, social care, social security and pre-tertiary education spending.

The next chapter considers how these trends may play out in over the next two budgets.

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 Scotland Act of 2016 has brought significant tax devolution to Scotland. And only a few years in, there is growing divergence between Scottish and UK income tax policies. This chapter asks whether Scotland will continue to set its own path – or will UK tax measures, and the potential for radical 'Brexit' tax proposals, cast a shadow over the forthcoming Scottish budget? There is also the question of whether a Scottish budget can be fully considered if the UK budget proposals are not known.

2.1 Income tax

The largest source of tax revenue in Scotland is income tax where the distinctiveness of Scottish income tax policy is illustrated by the range of tax bands and rates. The direction of travel was set in 2018/19 with the introduction of five bands – providing a more progressive charging structure than in the rest of the UK. With this structure, the profile of Scottish income tax has been raised as the differentials between Scotland and the rest of the UK have grown across thresholds and rates, and from one year to another. The Scottish Government may choose to stay with this income tax structure; however, 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. UK decisions may increase the tensions.

Across the UK, the self-employed have always had the choice of operating as a sole trader or partnership (liable to income tax) or via a company (liable to corporation tax, whilst the owner may reward themselves by way of salary and/or dividends liable to income tax). A number of factors can influence this choice, including limited liability, tax and pension provision.

The tax differential for the Scottish taxpayer may be up to around £4,000 depending on the level of profits up to £100,000 and how funds are extracted from the company. For the smaller business, the interaction between Scottish and UK tax regimes may encourage incorporation by Scottish taxpayers at an earlier stage in the business's evolution than compared to those in the rest of the UK.

This decision around the form of trading entity adopted not only influences the amount of tax payable by the trader but also determines which jurisdiction receives the taxes paid. Corporation tax is payable to the UK Exchequer, as is income tax on dividends. Scotland will only directly receive funds from Scottish income tax levied on non-savings, non-dividend income (earnings).

For the individual Scottish taxpayer, Scottish income tax rates, determined by the Scottish Government, will be factors to consider; as will the UK corporation tax rate, determined by Westminster. The corporation tax rate is currently set to reduce to 17% but post Brexit this could change.

Under existing rules, HMRC does not have sufficient resource to police all one-man companies; however incoming 'IR35' rules put the onus on the 'employing' company, which may lead to more conservative decisions, and lead to more contractors being within payroll. This would benefit the Scottish Exchequer and would help prevent incorporations of disguised employees.

2.2 The tax base- how many will pay income tax?

The UK Government has direct influence over the amount of Scottish income tax available to the Scottish Government. The personal allowance is set by Westminster and applies to all UK taxpayers, with the effect that significant numbers of the Scottish population are lifted out of income tax altogether (44.6% in 2019/20[14]), reducing the size of the Scottish taxpaying base.

There are 2.5 million income taxpayers in Scotland and the average annual salary is estimated to be £25,000. In 2019/20[15] 7.7% of Scottish adults (351,000 in absolute numbers) were expected to pay higher rate of income tax at 41% - compared to 40% in the rest of the UK (rUK) - and 16,000 adults (0.3%) the top 46p rate. There are not that many, and it is desirable to attract more higher rate and additional rate jobs and job holders to Scotland which may prove difficult if further divergence arises.

Whilst many believe in a more progressive income tax system there are tensions and challenges arising from the size, shape and potential mobility of the Scottish income tax base, which need to be factored in when developing tax policy, particularly if there is increasing divergence from the rest of the UK.

The tensions inherent in a more progressive tax system are potentially threefold: the desire to encourage inward migration and discourage outward migration; whilst there may also be exposure to electoral punishment. The first two are risks to the Scottish budget. The latter would be the case if the Scottish Government policy does not align sufficiently with the higher earning portion of the electorate's wishes.

14 https://www.gov.scot/binaries/content/documents/govscot/publications/factsheet/2018/12/scottish-income-tax-2019-2020/documents/analytical-note-on-impacts-on-income-levels-and-equality/analytical-note-on-impacts-on-income-levels-and-equality/govscot%3Adocument see key findings

15 As in footnote 1 above

2.3 Is National Insurance tax?

Divergence in income tax rates has led to a costly National Insurance (NIC) problem for middle earners in Scotland, which may be exacerbated if higher rate thresholds diverge further. One may wonder why changes in income tax affect NIC but for some years now, legislative provisions have ensured that the upper NIC threshold mirrors the rUK income tax higher rate threshold.

It is a matter that goes virtually unnoticed but in the rest of the UK if the 20% band is extended, so is NIC at 12%; less income tax may be collected, whilst more NIC is payable.

In Scotland, in 2019/20, those who earn amounts between the Scottish threshold of £43,430 and the UK threshold of £50,000 pay income tax at 41% and NIC at 12% - each pound earned in this bracket is subject to 'payroll taxes' totalling 53%. This is an expensive marginal rate, which taxpayers may seek to minimise through behavioural change.

It is difficult to quantify attempts to minimise taxable income in the middle band, where the 53% charge sits. Employers may decide to reconfigure remuneration packages to enable their employees to exchange salaries/wages for NIC-efficient items such as pensions or further holiday entitlement; or individuals may increase their pension contributions, reduce their hours or not take on overtime and hence reduce their taxable pay. Small changes for individuals, but the cumulative effect could be significant for the Scottish Government in terms of tax take and in terms of productivity with both fiscal and economic impact.

Scotland has set a distinctive path for itself in its Scottish income tax measures but in a tax regime where income tax is partially devolved, the rUK measures – both tax and NIC - will also have a significant impact. The Scottish Government will have difficult decisions to make if it wants to raise funds, maintain divergent policies, and keep Scottish income taxpayers on board. These decisions are also made more difficult if the UK tax proposals for 2010/21 are unknown.

2.4 Land and Buildings Transaction Tax (LBTT)

When LBTT was introduced in Scotland in 2015 there was an innovative move away from the UK SDLT slab system. However, only a few years on, the rUK and Scottish land taxes are both on a 'progressive' basis. Each jurisdiction has also introduced a surcharge on the purchase of additional residential properties, and the policy measures seem to be converging.

Where there is visible divergence is in the rates charged – both for residential and non-residential property.

It remains to be seen whether the Scottish Government will maintain these distinctive rates or whether pressures to reduce property taxes will have an effect in the future.

It also remains to be seen whether policies may again become more distinctive. For example, there is a UK proposal to introduce a non-resident surcharge, although this is currently on hold. Should such a measure be introduced in England, would the devolved jurisdictions do likewise? Or has Scotland already partially addressed this by increasing the Additional Dwelling Supplement to 4% in January 2019?

2.5 New taxes – fund raising or behaviour management?

The Scotland Act 2016 provides that Scotland can introduce new taxes. These would allow Scotland – or its local authorities - to introduce new taxes and the most recent Scottish budget saw late amendments to allow for a Transient Visitor Levy (TVL, more commonly referred to as a 'tourist tax') and a workplace parking levy.

A constraint on the proposed new taxes is that the amounts involved are relatively small, but they can add to burdens on business. Also, some of the new tax options being discussed are designed to drive behaviour change, rather than primarily to raise revenues.

Further analysis is required before considering other new taxes, along with some of the issues such as who will receive the money (the Scottish Government, or local authorities), and whether it might be ringfenced towards certain expenditures. There is also the consideration that if the aim is to change behaviour and it is successful, the authorities may not get much, if any, revenues. It is a complex matrix.

2.6 Unwanted devolved taxes?

Questions remain around the devolved powers in the Scotland Act 2016 that have not yet been fully implemented, although the Scottish Government has gone some way towards doing so.

The Air Departure Tax (Scotland) Act 2017 received Royal Assent on 25 July 2017, but implementation remains on hold due to EU state aid issues. With the shape of Brexit unknown at the time of writing, it is not clear whether, or when, issues around state aid will be resolved and the new ADT introduced. The Scottish Government has said, however, that due to climate change concerns it no longer intends to reduce the rates of tax when it is

introduced, thereby removing much of its distinctiveness. It is also interesting to note that the UK Government has recently said it will not devolve Air Passenger Duty to Wales because competition on rates would be likely to damage nearby English airports. Clearly, divergent policies may not be helpful.

One major source of 'devolved' tax revenue that was recommended by the Smith Commission, and provided for in the Scotland Act 2016, was the assignment of a proportion of Scottish VAT to Scotland. The underlying aim was to align tax revenues with the performance of the economy but, despite much negotiation, a satisfactory methodology has yet to be identified.

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 it is a moot point as to whether VAT assignment brings any benefits to either government (UK or Scottish).

2.7 Policy making

Something which has been innovative is a new Scottish Government policy-making approach to taxation. A new and, in our view, successful process was used in November 2017 when the Scottish Government issued a paper, 'The role of Income tax In Scotland's Budget', prior to the Scottish Budget. This set out a number of options for exercising income tax powers and was followed by a series of round table discussions. This was a most constructive and helpful exercise, which helped to pave the way for the introduction of the new structure for Scottish income tax, with the five rates and bands. By contrast, the unexpected late amendments to last year's budget relating to the new tourist tax and the workplace parking levy (which were added without prior consultation), were unfavourably received.

The Scottish Government has been consulting about its tax policy making[16] and seems likely to adopt a more collaborative approach than in the rest of the UK. This is welcome.

[16] https://www.gov.scot/publications/devolved-taxes-policy-framework-consultation-analysis/

2.8 Positive messaging

In the main, tax is seen as a cost by both businesses and individuals in any evaluation of whether Scotland is an attractive location. To inform taxpayers' decision making there should be clear explanations of how the various 'Scottish taxes' work and how they link to public expenditure as well as other factors tied to locating in Scotland. There is also a need to consider the cumulative effect on individuals and businesses of the different taxes, such as income tax, council tax, business rates and LBTT.

It is important that existing Scottish taxpayers understand and support their contribution to public finances; it is equally important that those who may wish to move to Scotland understand the purpose of Scottish taxation policy, the relationship between tax and public spending and the benefit that Scottish taxpayers enjoy from that public spending and different policies. The Scottish Government is currently considering a public education campaign to raise awareness of Scottish taxes and their role, which is helpful.

2.9 In conclusion

The Scottish Government has established, in a short space of time, a distinctive tax regime but it is one which is intertwined with the UK tax system. Hence, 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.

The outlook for the Scottish block grant in 2020/21 improved substantially following September's Spending Round. Some of that improvement is offset by the income tax reconciliations and forecasts for continued relative weak revenue performance in Scotland, although there are some signs that the outlook for Scottish tax revenues may be marginally better than first thought. All this, together with major new financial responsibilities for social security spending mean that 2020/21 will be another budget of challenging choices. But there is huge uncertainty around this outlook, particularly in advance of the UK General Election. The next UK Government's fiscal policy stance, its spending choices, and its tax policy decisions will all affect the Scottish budget outlook. This chapter considers how these moving parts fit together.

3.1 Introduction

Chapter 1 examined how the Scottish budget has evolved over the first three budget events of this parliament.

This chapter examines the outlook for the remaining two budgets of the parliament, 2020/21 and 2021/22. The outlook for the Scottish resource budget now depends on:

- 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

There is an unprecedented level of uncertainty around these different elements this year. In 'normal times' a UK Budget would proceed the Scottish budget by at least three weeks and would set the broad parameters for that process. UK Government departmental spending plans would determine the block grant. UK Government tax policy decisions combined with the OBR's tax forecasts (and the DWP's social security forecasts) would determine the size of the block grant adjustments.

The cancellation of the 2019 UK Budget and subsequent announcement of a General Election has necessitated the postponement of the Scottish budget, (which had initially been

planned for the 12th December). No decision has yet been made on an alternative. It seems unlikely that the Scottish Government would choose to publish its budget before a UK Government budget has been published. There is significant uncertainty around many of the Scottish Government's budget parameters before more details emerge of the UK Government's plans. The most likely outcome is that the Scottish budget for 2020/21 will not be published until sometime in January. As a result, timescales for parliamentary scrutiny of the Scottish budget will be substantially curtailed this year.

Without knowing who will win the General Election it is difficult to anticipate what tax and spending policies will prevail in the UK, and how these will affect the Scottish budget. If the current government are re-elected, the outlook for the block grant in 2020/21 may not evolve materially from the September Spending Round (although the long-awaited Spending Review in 2020 may alter the outlook for 2021/22. Should there be another outcome to the election, departmental spending (and hence the block grant) may increase relative to existing plans.

Given these uncertainties, we approach the analysis of the outlook in two parts. The first part considers the outlook based on the latest estimates of the block grant, and the latest forecasts of the tax BGAs and Scottish revenues. This analysis reveals that the outlook for the Scottish resource budget has already evolved materially since the 2019/20 budget was set.

The second part considers the risks to these forecasts.

3.2 Latest assessment of the fiscal outlook

The resource block grant

The outlook for the resource block grant in 2019/20 and 2020/21 has improved substantially following the UK Government's Spending Round in September.

The resource block grant for 2019/20 is now £600m higher than it was when the draft 2019/20 budget was published in December last year. Around half of these additional consequentials had been anticipated when the 2019/20 budget was set (as discussed in

chapter 1), and flow from increases in UK Government spending associated with a range of spending functions, including by the Ministry of Justice, and Brexit-related funding[17].

From the higher 2019/20 baseline, the block grant will grow by £1.1bn in 2020/21. These consequentials flow mainly from increased UK Government spending on health (accounting for £635m), education (£324m), local government (£244m) and police (£83m).

The £1.1bn increase in the block grant is equivalent to an increase of 2.1% in real terms. This is a healthier rate of growth than the Scottish Government has been used to in recent years, and the fastest rate of increase since the late 2000s.

The UK Government has not yet set departmental spending plans beyond 2020/21. However, the UK Government has announced multi-year settlements for the NHS and schools in England which imply multi-year real terms spending increases. Both Labour and the Conservatives have announced their intentions to target a balance on current spending (i.e., to fund day-to-day public spending from revenues, and borrowing only to fund capital spending). This target implies broadly that resource spending can grow in line with the growth in tax revenues. In recent years, that has been just short of 2% in real terms annually[18].

On that basis, it seems reasonable to assume that the Scottish block grant (before any adjustments for tax powers, reconciliations, or new social security powers) will increase by a further 2% in real terms in 2021/22[19]. That would take the resource block grant to around £29.4bn, just around 1.5% lower than its peak of 2010/11.

Budget impact of devolved and shared taxes

As discussed in Chapter 1, as well as the block grant, the Scottish resource budget is partly determined by revenues from income tax, land and buildings transactions tax (LBTT) and landfill tax.

The effect on the budget of these three taxes depends not simply on the revenues raised from each of these taxes, but their performance vis-à-vis the corresponding 'block grant adjustment' (BGA) for each tax (see Chapter 1).

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[17] The remainder flows from higher spending to meet increased pension costs of public bodies. As such this does not translate into additional spending power for the Scottish Government.

[18] Of course, should Brexit weaken the UK (and Scotland's) long-term growth prospects, then it follows that public spending will have to shift to be a smaller level in the long-run.

[19] There is clearly a particularly high level of uncertainty around this figure, and this uncertainty will remain until the next UK Government sets out its budget following the December's election.

Table 3.1 shows the forecasts of the 'net tax' position that informed the 2019/20 budget, and the latest forecasts for 2020/21 and 2021/22.

Table 3.1: Forecasts of the net tax position (December 2019 and May 2019)

	2019/20	2020/21	2021/22
Income tax	182	48	6
LBTT	76	88	80
Landfill Tax	13	1	80
Total	271	41	6

Source: Medium Term Financial Strategy (Scottish Government, 2019). Note: the 2019/20 figure is the forecast from December 2018 which informed the 2019/20 budget. The figures from 2020/21 and 2021/22 are the latest forecasts from May 2019

As discussed in Chapter 1, the draft budget 2019/20 forecasts for income tax implied that revenues would be only £182m more than the BGA in 2019/20, despite the fact that the Scottish Government's tax policy is estimated to increase Scottish revenues by around £500m relative to the position if the UK policy was implemented.

Since then, the forecast 'net tax' position for income tax has deteriorated further (to zero), and is expected to be negative in 2020/21.

LBTT revenues are forecast to be around £80m per annum higher in each of the next three years than the BGA. This reflects the more progressive tax rates in Scotland, the lower price distribution of Scottish properties which increase the effects of 'fiscal drag', and the higher rate of Additional Dwelling Supplement.

The net tax position for landfill tax is forecast to be marginally positive in 2019/20 and 2020/21, but significantly negative in 2021/22. This reflects a forecast fall in revenues as a result of the planned ban on Biodegradeable Municipal Waste that is due to come into force in 2021, (combined to a lesser extent with new waste incineration capacity coming on stream).

Across the three taxes combined, and according to the latest data from the OBR and SFC, Scotland's 'net tax' position is forecast to deteriorate in 2020/21 and 2021/22.

These are forecasts of course; the BGA forecasts were made in March 2019 whilst the Scottish forecasts were made just two months later. We discuss subsequently the risks associated with these forecasts.

Income tax reconciliations

As explained in Chapter 1, the outturn 'net tax' position for income tax in 2017/18 was not as positive as had been forecast. As a result, a downwards reconciliation of £204m will be applied to the 2020/21 budget. *Effectively, the 2017/18 budget was planned on an assumption that the Scottish Government would have £204m more resources available to it than we now know to be the case.*

The block grant in 2017/18 will therefore be reduced by £204m in the 2020/21 budget. The Scottish Government can mitigate this by using its borrowing powers, drawing down any resources it may have 'saved' in the Scotland Reserve, or by reducing its spending plans.

Income tax outturn data for 2018/19 will not be available until summer 2020, and any reconciliation required will be made in budget 2021/22. However, although outturn data is not available, the latest forecasts for the 2018/19 financial year should in principle be closer to the eventual outturn than the forecasts that were made to inform the 2018/19 budget (as the latest forecasts are able to draw on provisional PAYE tax receipt data).

The forecasts made at the time of the 2018/19 implied that Scottish revenues would be £428m higher than the BGA, and the budget was planned on that basis. The latest forecasts however imply that Scottish revenues will be £179m lower than the BGA. This implies a downwards reconciliation of £608m to be applied to the 2021/22 budget.

The new social security powers

Under the Scotland Act 2016, eleven social security benefits are being devolved.

Whilst full administrative control and policy autonomy will not take place for a further few years, financial responsibility for these benefits is transferring to the Scottish budget in full by April 2020.

In practice, this means that the Scottish Budget for 2020/21 will be exposed to broadly two sets of fiscal risks (mirroring those in relation to devolved taxation).

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[20]. This adjustment will be

[20] This includes Attendance Allowance, Cold Weather Payments, Disability Living Allowance, Personal Independence Payment, Industrial Injuries Benefits, Severe Disablement Allowance and Winter Fuel Payments.

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.

This could happen through deliberate choice, i.e. if the Scottish Government decides to change policy in some way that increases spending relative to rUK. But it could also happen as a result of demographic, socio-economic or population health change[21].

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[22]. Outturn spending data for 2020/21 will be available by autumn 2021, enabling reconciliations for the 2020/21 budget to apply to 2022/23 spending plans. Slightly complicating matters however, an interim social security reconciliation will apply midway through the 2020/21 year, reflecting updated forecasts at that point.

The fact that the Scottish budget will take on full fiscal responsibility for all devolved social security benefits from April next year has perhaps not been widely appreciated. Spending on social security in Scotland is forecast to add around £3.5bn to the budget in 2020/21.

Initially, a large proportion of this expenditure will continue to be administered by DWP. The new social security agency, Social Security Scotland, will begin to accept new claims for each of the benefits between 2020 and 2022[23], although the transfer of existing recipients will take place over the period to 2024.

A Block Grant Addition has been applied for Carer's Allowance since 2018-19. Smaller benefits – such as the Best Start Grant – have additions to the Block Grant indexed using the Barnett formula.

[21] For example, a more rapidly ageing population in Scotland than rUK will tend to result in spending per capita increasing relatively more rapidly (as the claimant rate for many of the benefits being transferred increases with age.

[22] Of course a positive reconciliation is in principle equally as possible.

[23] See Scottish Government (2019) Delivery of devolved Social Security benefits: Stakeholder Toolkit https://www.gov.scot/publications/delivery-devolved-social-security-benefits-stakeholder-toolkit/

The budget risks here are real. Claimant rates could feasibly increase relatively more quickly in Scotland than rUK under a number of circumstances, regardless of policy decisions. Moreover, forecasting spending on social security is challenging, particularly when policy changes are being made.

The only major benefit that has been transferred so far is Carer's Allowance, which was transferred midway through 2018/19 (although payments to Scottish claimants are still administered by DWP). Outturn data for 2018/19 indicate that expenditure on Carer's Allowance was actually £5m less than the BGA in 2018/19. Current forecasts are that expenditure and the BGA will broadly cancel out in 2019/20 and the subsequent two years. However, the government's new Carer's Allowance Supplement – forecast to cost £37m in 2019/20 – will have to be funded from through the Scottish Government's overall resource budget.

For all other benefits requiring a BGA, no BGA forecasts have yet been published (although the SFC has published indicative spending forecasts). In 'normal times', the BGAs for 2020/21 would have been published alongside the UK budget in November, enabling them to inform the Scottish budget. The absence of a UK budget before the Scottish budget is problematic. Even if the SFC forecasts Scottish expenditure on the newly transferred social security benefits, not knowing how much its grant will increase to fund this expenditure is a real problem for the Scottish Government.

Outlook for the resource budget: summary

We can bring these elements together to outline the outlook for the Scottish resource budget. It is important to stress that this outlook will change. We reflect below on what factors might cause the outlook to change.

Just to recap, the impact of tax policy decisions, together with a relatively positive outlook for the performance of the Scottish tax base, acted to boost the government's resource budget in 2017/18 and 2018/19. But by the time of the 2019/20 budget, the size of this positive impact had fallen somewhat, following a deterioration in the relative outlook for the performance of the Scottish tax base relative to the rest of the UK.

The latest forecasts for 2020/21 and 2021/22 continue this trend. They anticipate a largely neutral net tax position, despite the Scottish Government's policy to continue to set higher taxes than in the rest of the UK.

On top of this, the government will have to factor in the -£200m income tax reconciliation for 2020/21 and forecast -£600m reconciliation for 2021/22. The effect will be to offset much of the growth in the block grant announced in September's UK Spending Round.

Taken all together – i.e. the forecast net tax position, and the impact of reconciliation – the Scottish resource budget is likely to grow only 0.6% in real terms in 2020/21, despite the block grant increasing 2.1%.

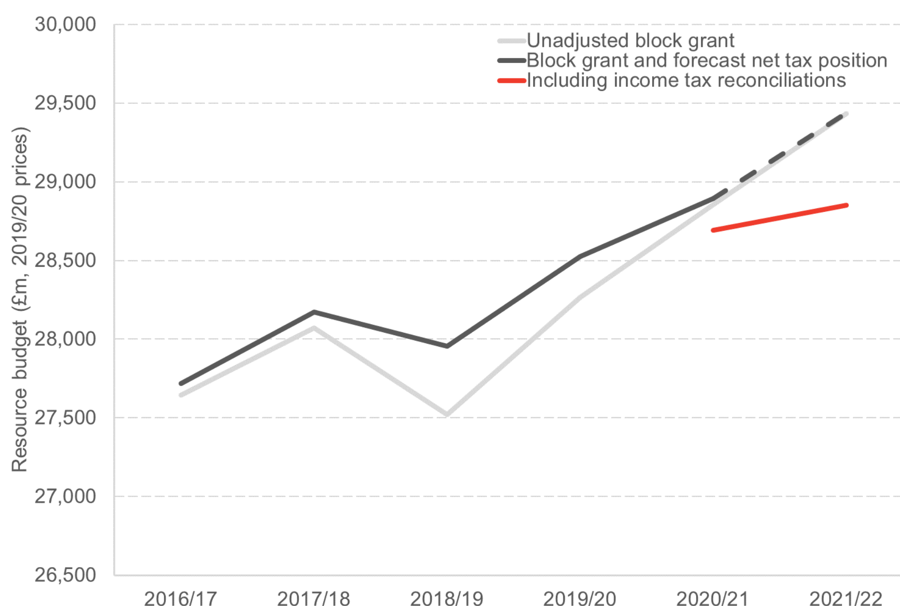
And if the block grant grows 2% in 2021/22 and the latest tax forecasts remained largely unchanged, then the Scottish resource budget would grow only 0.6% again in 2021/22.

Of course the transfer of new social security responsibilities, and associated funding, means that the total headline value of the resource budget will increase significantly more than this. But this additional funding will be offset by increased expenditure which, at least over the next year or two, should broadly cancel out the budget increase.

It should also be noted that the assignment of VAT revenues to the Scottish budget, which was due to take effect from budget 2020/21, has been postponed, possibly until after the Fiscal Framework review in 2022. The reason for postponement is the has been no resolution to the problematic issue of how to reliably estimate Scotland's share of UK VAT receipts[24].

[24] VAT assignment: paused for now, but will it be pulled for good? FAI blog, 14 May 2019. https://fraserofallander.org/scottish-economy/fiscal-policy/vat-assignment-paused-for-now-but-will-it-be-pulled-for-good/

Chart 3.1: Outlook for the Scottish resource budget excluding social security (£m, 2019/20 prices)



Source: FAI analysis of budget documents and forecasts. Note: excluding social security means that the figures are comparable on a like-for-like basis

The implication of spending commitments and priorities

On the basis of the latest forecasts therefore, the resource budget is likely to grow slightly but not significantly over the next two years.

What might this mean for spending priorities and choices? The purpose of the Scottish Government's Medium Term Financial Strategy, published in May 2019, is ostensibly to set out broad financial plans for coming years, set out the financial implications of existing commitments, and thus to assess the longer term sustainability of Scotland's public finances.

Unfortunately this year's MTFS contained no information about the government's spending plans, causing the Auditor General to express concern at the 'sparseness' of the document which makes it difficult for parliament (and others) to 'hold the government's spending commitments up to the light'[25].

Our analysis of government spending commitments and priorities is thus derived from previous budget reports and financial documents. [26]

[25] How stable are Scotland's finances? Blog by the Auditor General for Scotland (30 October 2019) https://auditscotland.wordpress.com/2019/10/30/how-stable-are-scotlands-finances/#more-1063

[26] See previous Scotland Budget reports for a full discussion of spending commitments: www.strath.ac.uk/fraser

Given what we know about the government's existing spending commitments and priorities, this implies that the government will face a further two budgets of tough choices.

The government has committed to 'pass on' health related Barnett consequentials. Given that health related consequentials totalled £600m of the total £1.1bn increase in the block grant in 2020/21, this commitment in itself constrains the budgetary increase that can be made available to other portfolios.

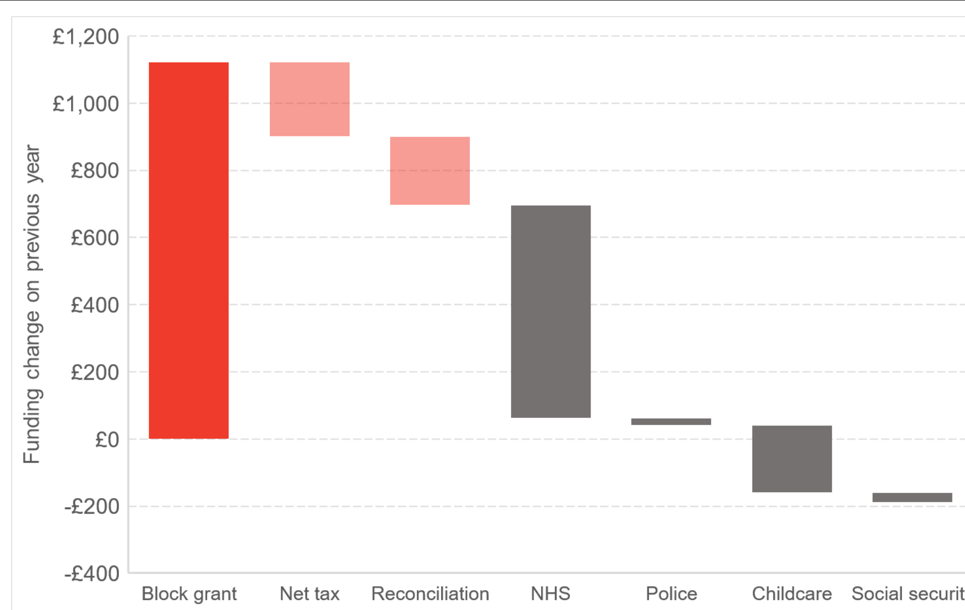
The commitment to maintain funding of the Scottish Police Agency in real terms is retained. The government also has flagship commitments to reduce the attainment gap – supported by a £750m Attainment Fund – and to roll-out a significant expansion of funded childcare.

The government has also made a number of pledges in relation to social security. These include a commitment to fund the Carer's Allowance Supplement (forecast to cost £40m in 2020/21 and £42m the following year). They also include a new 'income supplement'. Once fully implemented (to eligible low-income households with children aged under 16) this is anticipated by the government to cost £180m per year. The government aims to have rolled it out to families with children aged under 6 by the end of 2021, which we assume, based on information provided, will imply costs of around £80m in 2021/22.

If we take the funding outlook described above as given (and assume that increased spending on new social security powers is exactly offset by additional funding, other than new policy commitments alluded to above), what does this imply?

The implication is that the government's resource budget for spending on areas other than health, social security, police, and its childcare and attainment priorities, could fall by 2.5% in 2020/21. (That falling could fall in real terms may come as a surprise but the arithmetic explanation is simple - in cash terms, the resource block grant will increase by £1.1bn, of which £600m will be passed on to health, plus the net tax position will deteriorate by £200m, there will be £200m of income tax reconciliations, so by the time spending increases on the other commitments are factored in, the cash budget available for other areas will actually decline).

Chart 3.2: Changes to revenues and spending in 2020/21



Source: FAI analysis of various Scottish budget documents

In reality, the spending budget will not be quite as constrained as this. This is because the government will almost certainly use resources in the Scotland Reserve (flowing from underspends and unanticipated Barnett transfers) to offset some of the pressures. Nonetheless, the clear conclusion is that, despite talk of austerity having ended, the combination of downgrades to Scottish forecasts, weaker than forecast income tax outturn figures in 2017/18, and spending commitments already made, there is certainly no guarantee that all areas of devolved public spending will see real terms increases next year.

In 2021/22, spending areas outside of health, social security, police, and the childcare and attainment priorities could see real terms spending falls again, should the reconciliation of £600m turn out to be realised.

Box 3.1 : Outlook for capital spending
The outlook for the Scottish Government's capital block grant has improved at each budget event of this parliament (Chart 3.3). The capital grant has increased in real terms by almost £1bn between 2016/17 and 2019/20, and was set to increase by a further £300m (6%) in 2020/21. In real terms, this will take it back to levels last seen in the pre-austerity days of 2010/11.

The Scottish Government can also fund capital investment by using its capital borrowing powers, or through revenue-financed investment.

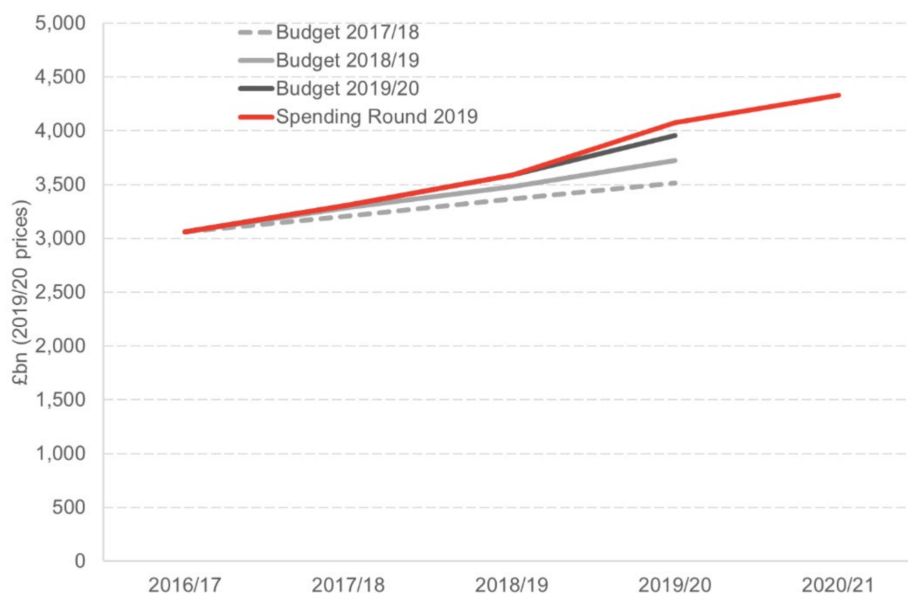
The government borrowed its maximum annual level of £450m in 2017/18 (for a 25-year term), and a further £250m in 2018/19 (for a ten-year term). Repayments (capital and interest) on this borrowing will total £48m in budget 2020/21. The government has announced plans to borrow between £250m and £450m in future years.

In its 2018 Programme for Government, the government announced significant commitments on future infrastructure investment. These included a 'Mision' to 'increase annual infrastructure investment so it is £1.5 billion per year higher at the end of the next Parliament [2025-26] than in 2019-20'. The government has not set out much detail as to how this target will be achieved.

It is possible, given pledges made in the run-up to next month's General Election, that this target may be easier to meet than may have been envisaged. Sajid Javid has pledged to increase net investment by up to £22bn per year. Labour has gone further and pledged to increase capital spending by as much as £50bn per year. Such commitments will fuel further real terms increases in the capital block grant. On the basis of these pledges, the Scottish Government's commitment to increase infrastructure investment by £1.5bn a year by 2025/26 is likely to be met through increases to the block grant alone, negating the need to rely on additional borrowing or revenue financing methods.

As well as 'traditional' capital investment in infrastructure, another form of capital spending relates to 'financial transactions' (FTs). FTs can only be used to support equity or loan schemes to the private sector. The Scottish Government's allocation of FTs has expanded substantially in recent years (around £500m in 2019/20 and £600m in 2020/21). The Scottish Government plans to use these to provide initial capitalisation (of around £300m) for the Scottish National Investment Bank (SNIB).

Chart 3.3: Outlook for the Scottish Government's capital block grant at successive budget events



Source: Analysis of Scottish budget documents and UK Spending Round

3.3 Near term risks and uncertainties

The extremely high levels of political and economic uncertainty that exist currently mean that any assessment of the Scottish Government's budget outlook comes with relatively wide margins of error, even in the relatively short-term. Here we highlight three areas of uncertainty.

The block grant

More than usual uncertainty surrounds the outlook for UK Government departmental spending plans, given the forthcoming election.

Both Labour and the Conservatives have signalled that they would adopt significantly looser fiscal targets, accepting higher levels of borrowing. The Conservatives would abandon plans to achieve borrow less than 2% of GDP, instead aiming to balance the current budget (spending excluding investment) on a rolling three years ahead basis, whilst allowing borrowing of 3% of GDP to fund capital investment. But a new rule would seek to ensure

debt servicing costs to remain below 6% of revenues, meaning that borrowing might have to fall if interest rates increase.

Labour's proposed fiscal rules would also aim for a balance on the current budget (in normal times) but allow even more borrowing for capital investment, with a target to keep debt servicing costs below 10% (rather than 6%) of revenues, and for public sector net worth (government assets minus liabilities) to be rising throughout the next parliament.

Aspirations for debt to be falling as a percentage of GDP have effectively been abandoned by both parties.

The main implication of the parties' announcement is thus for significant increases in capital investment, particularly under Labour (discussed in Box 3.1).

In terms of current spending, the two parties' fiscal rules are more similar, with both targeting (broadly) a balance on current spending. However, Labour's apparent willingness to raise revenues through taxation, compared to the Conservatives pledges to cut tax, suggests that absolute levels of resource spending will be higher under Labour.

Looking beyond 2021/22, some resource spending commitments have been made in relation to the NHS and schools in England, and the rhetoric of the current Chancellor has certainty been of an end to austerity. Real terms resource spending increases therefore seem inevitable.

Spending under a Labour government is anticipated to be higher than under a Conservative government, with pledges having been made in its 2017 manifesto on university tuition, childcare and a range of other areas.

At the time of writing, less information is available on the Liberal Democrats proposed fiscal policy, although it seems highly unlikely that it would involve spending reductions relative to those set out at the UK Spending Round.

In the short term then, the direction of travel would appear to be for real terms departmental resource spending increases, with consequent increases in the Scottish block grant.

But in the medium to longer term it is possible that, even if spending as a percentage of GDP increases, this might mean lower real terms spending if the economy grows more slowly as a result of Brexit than it otherwise would have done.

However, until the publication of a future UK Budget (likely in January 2020), this all remains subject to significant uncertainty.

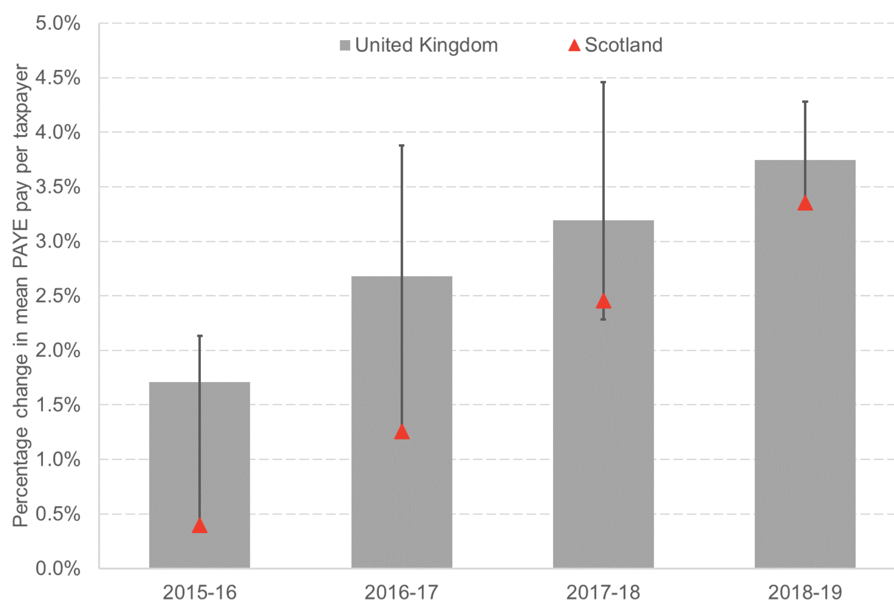
The balance of probabilities suggests that our current assumption that the Scottish block grant will increase 2% in real terms in 2021/22 is on the cautious side.

Relative economic performance

As is well known now, Scotland's economic performance relative to the rest of the UK matters for the Scottish budget. This is particularly the case for income tax, where fairly small differences in the rate of growth of revenues per capita can translate into relatively significant budgetary impacts.

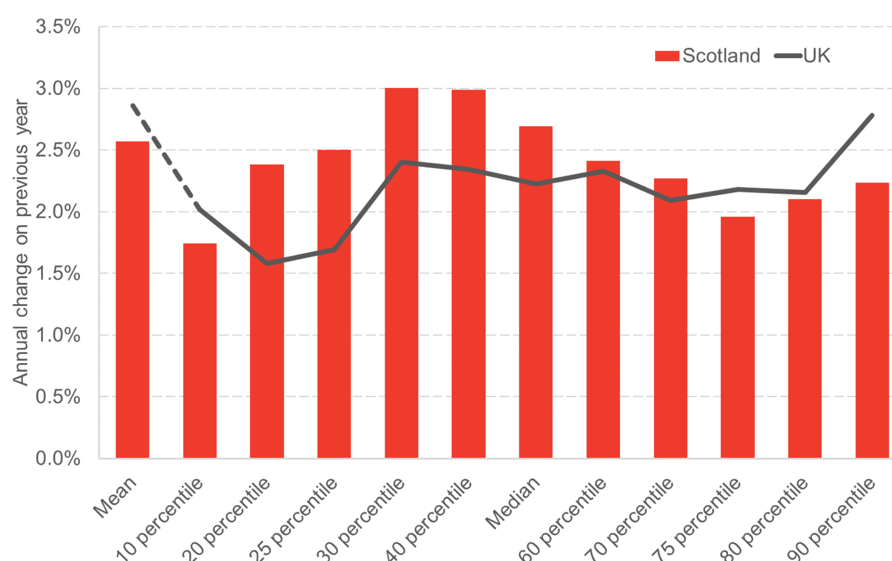
In 2017/18, Scottish income tax revenues were almost £100m lower than the BGA, despite the policy to freeze the higher rate threshold in cash terms. The main driver of this is slightly slower growth in average earnings in Scotland compared to rUK. According to some (but not all) data sources, Scotland's performance on earnings has been weak for several years (Chart 3.4). There is also some evidence that earnings growth in rUK in 2017/18 was stronger in the upper half of the earnings distribution (Chart 3.5), which has further helped to drive relatively faster revenue growth.

Chart 3.4: Annual percentage change in PAYE pay by taxpayer, Scotland and UK



Source: HMRC, Real Time Information Statistics. Notes: Bars show growth in mean PAYE pay for the UK. Error bars show maximum and minimum pay growth by UK region. Red triangles denote Scotland.

Chart 3.5: Earnings growth across the distribution in Scotland and UK, 2017 - 2018



Source: ASHE. Notes: chart shows growth in average earnings between April 2017 and April 2018 at various points in the earnings distribution.

Income tax outturn figures for 2018/19 and beyond are not yet available, and are subject to significant uncertainty. The picture that has been painted most recently is one of relative weakness in the performance of the Scottish economy – and consequently Scottish income tax revenues – relative to rUK.

The latest published forecasts imply that Scotland's GDP per capita will grow relatively more slowly in 2019 and beyond vis-à-vis the rest of the UK (Table 3.2). Of more direct importance, they also imply that average earnings will grow relatively more slowly in Scotland.

Table 3.2: Latest forecasts of GDP per capita and average earnings growth: UK and Scotland

		2018	2019	2020	2021	2022	2023
GDP per person	UK (OBR Mar-2019)	0.8	0.6	0.9	1.1	1.1	1.1
	Sco (SFC May-2019)	0.9	0.5	0.6	0.9	1.0	1.0
Average earnings	UK (OBR Mar-2019)	3.0	3.1	3.0	3.1	3.1	3.3
	Sco (SFC May-2019)	2.6	2.6	2.7	2.9	3.1	3.3

Source: SFC forecasts May 2019; OBR Economic and Fiscal Outlook, March 2019

It is these latest forecasts – particularly for weaker earnings – that explains the deteriorating outlook for the effects for Scottish income 'net tax' position.

But how much uncertainty is there in this outlook? The latest picture – on GDP per capita, earnings, interim income tax data – is actually relatively more positive than in recent years.

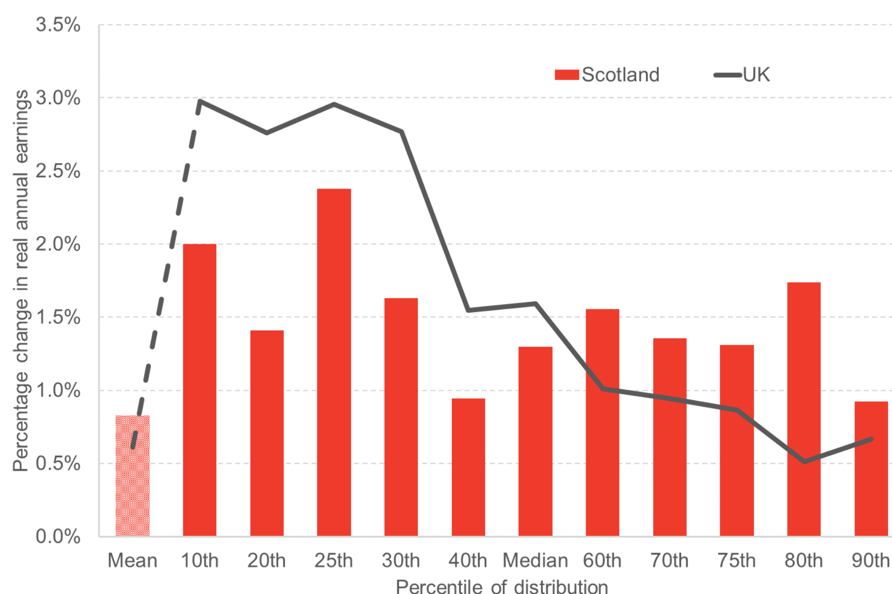
Scottish GDP per capita grew slightly more quickly than in the UK as a whole in 2018/19, reversing the position since 2014/15 (Chart 3.6).

The latest data on employee earnings – released at the end of October – shows that average annual earnings grew more quickly in Scotland than the UK between April 2018 and April 2019, again reversing the position of the previous year. Earnings growth in Scotland was also relatively stronger at the top end of the distribution – a good sign for tax revenues, if not for inequality (Chart 3.7).

Chart 3.6: GDP per capita growth in Scotland and UK

Source: Scottish National Accounts

Chart 3.7: Growth in average annual earnings, April 2018 – April 2019



Source: Annual Survey of Hours and Earnings (ASHE)

Taking the shine off this analysis slightly, the employment rate in Scotland grew slightly less quickly than in the UK in 2018/19, but the difference is only marginal. (The working age employment rate grew 0.2 percentage points to 74.5 in Scotland, compared to a growth of 0.4 percentage points to 75.2 in the UK).

In recent months, unemployment has risen sharply in Scotland. It is not clear if this is part of a wider trend or short-term volatility.

Finally, and possibly most importantly, data from HMRC's 'Real Time Information' shows that revenues per capita from PAYE income tax grew more quickly in Scotland than in rUK in 2018/19 (Table 3.3). Of course we might expect that Scottish revenues per capita would grow more quickly than in rUK in 2018/19, given the introduction of measures to raise additional revenues in Scotland that year.

But, as discussed previously, the implication of the latest SFC and OBR forecasts is that Scottish revenues per capita will actually decline relative to rUK in 2018/19, despite this policy (as witnessed by forecast Scottish revenues being lower than the forecast BGA). The RTI information suggests, on the contrary, that this may be a somewhat pessimistic outlook.

Table 3.3: Growth in tax revenues per capita from PAYE

	Scotland	rUK
2017/18	2.0%	2.5%
2018/19	5.7%	4.4%

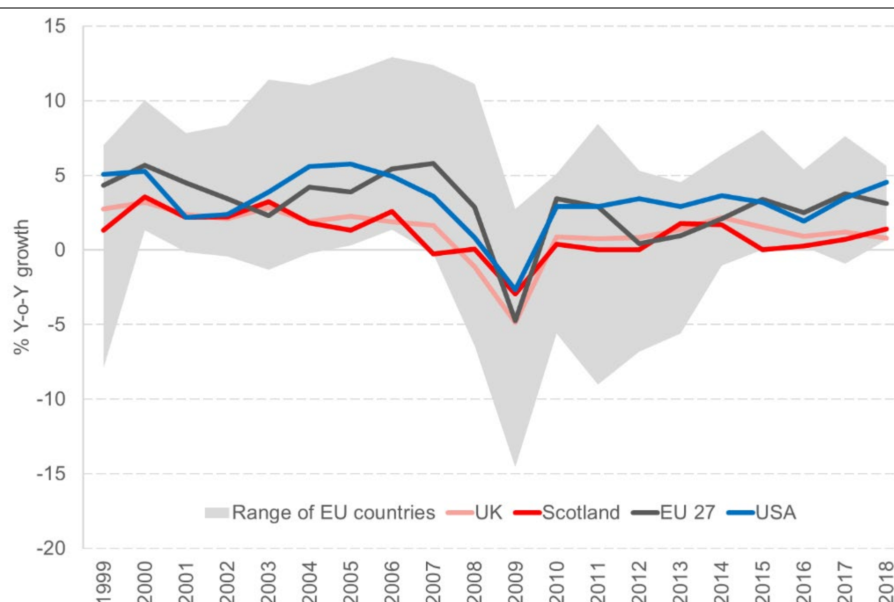
Source: HMRC Scottish income tax outturn statistics

There are some important caveats. The SFC is cautious about reading too much into the RTI data, pointing out that it has not necessarily been strongly correlated with the outturn in 2016/17 and 2017/18. If this sounds puzzling, it is because it is.

Nonetheless, a tentative conclusion one might draw from the latest data is that the outlook for Scotland's performance relative to rUK – on GDP per capita, earnings and interim tax data – does not look as bad as it did earlier this year (or over the last couple of years). Only time will tell of course, and the uncertainty is heightened by the fact that the last OBR forecasts for the UK were in March, and it seems unlikely that those forecasts will be revised until early in 2020.

Finally, it is worth reiterating that, whilst the focus here has been on Scotland's position relative to rUK – as that is what matters for the budget – Scotland's and the UK's economic performance has generally been weak compared to other EU countries and the US recently (Chart 3.8).

Chart 3.8: GDP per capita growth in Scotland, UK, EU and USA



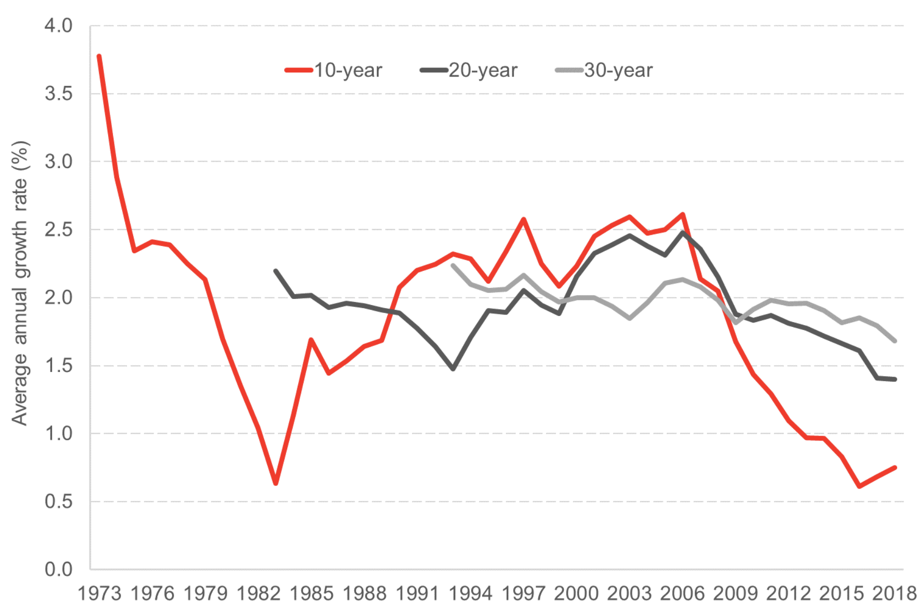
Source: World Bank; Scottish National Accounts

Moreover, Scotland's long-term growth performance has been weak for some time now. The chart below shows Scotland's 10, 20 and 30 year average annual growth rates.

Whist debate is often dominated by comparisons between Scotland and the UK or changes from quarter-to-quarter, there are clearly some major long-term challenges facing our economy. Issues around the decline in the North Sea and population ageing – not to mention structural changes from automation and climate change – will all have major impacts on Scotland's long-term growth potential.

The fact that such issues have been largely crowded out in recent times is a major concern (Chart 3.9).

Chart 3.9: Long-term trends in GDP growth



Source: Scottish National Accounts

UK tax policy

The Scottish budget will be influenced by changes to UK Government tax policy in relation to taxes that have been transferred to Scotland.

With a UK General Election underway, there is uncertainty around any future UK Government's taxation policy. Both Labour and the Conservatives have made substantial spending pledges, but (thus far) have said relatively little about those pledges will coincide with tax changes. Broadly speaking, Labour has pledged to increase taxes on higher earners, whilst the Conservatives have pledged to lower tax rates, with a particular emphasis on reducing tax rates faced by higher earners.

Rather than outline the possible effects of a range of UK Government tax policy scenarios on the Scottish budget, we first discuss the implications of a hypothetical increase in the higher rate threshold of income tax in the UK on the Scottish budget. We then generalise this to other potential tax policies.

An increase in the higher rate threshold would represent a tax cut to income taxpayers with incomes over £50,000. As income tax is devolved, the policy would not apply in Scotland. Instead, there would be a reduction in the income tax BGA.

How much would the BGA fall? This depends ultimately on what difference the policy makes to rUK revenues from non-savings, non-dividend income tax. A fall in UK income tax revenues would translate into a fall in the BGA and a consequent increase in Scotland's block grant.

If this all sounds perverse, it is worth remembering how the BGA interacts with the operation of the Barnett formula. In principle, the UK Government might respond to the reduction in its income tax revenues by reducing its spend on 'comparable' public services in England – health and schools and so on. If it did, this would result in a fall in Scotland's Barnett formula determined block grant.

It would clearly be unfair to Scottish taxpayers if public spending in Scotland fell following a tax cut that did not apply in Scotland. In this case therefore, the fall in the income tax BGA would offset (roughly) the fall in the block grant. The principle that the BGA is trying to achieve is to ensure that public spending in Scotland is not affected by tax changes that do not apply in Scotland.

The UK Government might not cut comparable spending following the tax cut. Instead, it might choose to cut social security spending; or increase borrowing, both of which in principle effect taxpayers in different parts of the UK equally. In this case, the cut in the BGA would lead to an increase in the Scottish block grant, in theory providing the necessary resources to implement the same tax in Scotland as applies in rUK without any corresponding reduction in public service spending.

The key takeaway is that changes to UK Government tax policy could have myriad impacts on the Scottish Government's budget and budget choices. An increase in income tax rates or in Stamp Duty Land Tax will increase the BGA for those taxes. If there is no corresponding increase in departmental spending (perhaps because the tax increase is part of a tighter fiscal policy stance), then the outlook for the resources available to the Scottish budget may actually deteriorate – unless the Scottish Government were to implement an equivalent increase in Scotland.

Similarly, whilst a UK tax cut may increase the net resource budget available to the Scottish Government, it would also make the equivalent tax cut more politically viable in Scotland. UK tax policy therefore has the potential to shift the choices (or at least the viability of those choices) to the Scottish Government.

Box 3.2: Boris Johnson's income tax policy: A tax grab?
During the Conservative leadership contest, Boris Johnson pledged to increase the higher rate threshold of income tax to £80,000. Triangulating from various sources, we estimate that the policy would reduce equivalent rUK NSND income tax revenues by around £16bn. In turn, this would equate to a reduction in the BGA of around £1.2bn. Given that the BGA is deducted from the block grant, this implies an *increase* in Scotland's block grant of £1.2bn. In principle, this should offset the effects on the Scottish budget of the UK Government reducing departmental expenditure to offset the decline in its tax revenues. This policy would not apply in Scotland. When the Boris Johnson tax policy was first mooted, there were claims that it represented a 'tax grab' on Scottish taxpayers. This claim was on the basis that, at UK level, the upper earnings limit for employees (and upper profits limit for self-employed), above which a lower NICs rate of 2% is paid, is aligned with the higher rate threshold of income tax. Therefore, the effect of the policy for a NICs taxpayer in rUK with earnings of £80,000, is that she will pay a marginal income tax rate of 20% rather than 40% on the band or income from £50,000 to £80,000, but this will be offset by the fact that she will pay 12% rather than 2% over the same band of income. NICs however is not devolved to Scotland, so the increase in the NICs upper earnings limit (and upper profit limit) would apply in Scotland, as it does in rUK. Scottish employees with employment earnings in the range £50,000 to £80,000 would pay a marginal tax rate in this band of 41% higher rate Scottish income tax plus 12% UK NICs. So this policy was characterised as a tax grab because Scottish taxpayers are seen to be 'paying' for the UK income tax policy cut (which do not apply in Scotland) through increases in NICs contributions (which do apply in Scotland). This is a red herring. The fiscal framework is designed to insulate Scottish taxpayers in full from the budgetary effects of the income tax cut. NICs is simply a reserved tax, whose revenues are pooled at UK level and shared back out. If NICs or any other reserved tax were to increase tomorrow, independently of a change of IT, it would not be framed as a

tax grab on Scotland. But the coinciding of the NICs increase with the IT cut makes it seem intuitive to argue that Scots are paying for the IT cut through higher NICs.

3.4 Conclusions

The outlook for the Scottish resource block grant has improved throughout this parliament, and substantially so following the 2019 Spending Round. The addition of £1.1bn of consequentials to the 2020/21 budget more than offsets the decline in the forecast 'net tax' position for 2020/21 and the downward reconciliation of £200m flowing from forecast error associated with the 2017/18 budget.

Nonetheless, under current projections the resource budget – whilst increasing in real terms – remains constrained by relatively weaker tax forecasts and a series of existing spending commitments.

There is particularly large uncertainty around the outlook, even over the next two years.

Both the Conservatives and Labour have announced plans to significantly increase capital spending in future years, with implications for the Scottish Government's capital block grant.

If the current government is re-elected there is a case for saying that resource spending plans (and hence the resource block grant) will not change much from those set out in the Spending Round. If the next UK Government is formed by another party(s) then spending plans may be subject to further change – although there would arguably be limited scope to reduce departmental spending allocations for 2020/21 at this stage.

Regardless, there remains significant uncertainty over the tax policy decisions of the UK government, which will influence the choices of the Scottish Government both directly (through the BGAs) and indirectly (through voters' comparisons of tax policy across jurisdictions)

The latest forecasts imply that weaker earnings growth in Scotland will continue to feed through to relatively weak income tax revenues compared to the BGA. This has implications for the 'net tax' position in 2020/21 and beyond, and also implies a potentially substantial income tax reconciliation applying to budget 2021/22.

But there is uncertainty around these elements too. Theoretically the outlook could decline further or improve, but recent data for earnings, GDP per capita and 'real time' PAYE tax receipts all point to a higher probability of the outlook improving rather than worsening.

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.

Long-term structural pressures bring significant challenges to the Scottish budget, but also an opportunity to do things differently. This chapter outlines some of those opportunities and challenges. They range from new approaches to budget-setting to the possibility of new fiscal powers; and from challenges around managing expectations with shifting priorities.

4.1 Introduction

The last three budgets have been framed by references to high levels of political and economic uncertainty.

But if anything, levels of uncertainty affecting the budget outlook are greater now than they have been at any point in the past three years.

The General Election in December should pave the way for a UK Budget in January. The election is generally accepted as very difficult to predict – and so too therefore is the outlook for UK fiscal policy.

Moreover the EU Withdrawal Agreement Bill still has to go through parliament and only then can negotiations around the UK's future relationship with the EU commence. All of this will have major implications for the UK's economic and fiscal outlook.

And in practice there may continue to be uncertainty around this future relationship at the end of 2020, by which point the Scottish Government will be preparing its final budget before heading into Holyrood elections in 2021.

The purpose of this chapter therefore is not to assess the implications of any particular economic or political scenario.

Instead, the objective of this chapter is to discuss a number of key budgetary structural issues that will need to be addressed under *any* economic and political scenario. These are:

- Making better budgets – by focussing on wellbeing outcomes
- The fiscal challenge of demographic change
- Public attitudes to fiscal policy challenges
- The role and fiscal responsibilities of local government
- Delivering on the vision for social security spending
- The fiscal framework review
- The successor to EU structural funding

4.2 Making better budgets – a focus on wellbeing?

With so many competing pressures on the Scottish budget, would a different approach to budget setting make some of those decisions in some way easier, more obvious, or more transparent?

One idea that is gaining traction is the concept of a 'well-being budget'. Scotland is part of a newly established Wellbeing Economy Governments group, bringing together as founding members the countries of Scotland, Iceland and New Zealand. New Zealand published its first 'wellbeing budget' in 2019 (Box 4.1), and Nicola Sturgeon, in a recent TED talk, said she wanted to: 'put well-being at the heart of everything that we do'[27].

But what does a wellbeing budget mean in practice? And is it the case that past budgets have not been about trying to improve the people of Scotland's well-being?

There can be no doubt that budgets should not be set without *any* consideration of the outcomes that they will generate. But the link between spending activities and subsequent outcomes is often difficult to pin down or estimate, both ex ante and empirically ex post.

Moreover, whilst the pursuit of 'wellbeing' could hardly be questioned conceptually, it is clear that wellbeing will be influenced by everything from health to the environment, from job satisfaction to income security, and to a whole range psychosocial factors that influence wellbeing, from friendships to hopes and aspirations.

There is clearly a risk that a wellbeing approach to budgeting is ultimately used to justify a government's pre-existing policy choices, in much the same way that a focus on 'inclusive growth' has been used to simultaneously justify progressive income tax increases with cuts in non-domestic rates (with the latter argued to be important in sustaining jobs growth).

The government's approach on inclusive growth has revealed many of these challenges. For all the work on messaging, people – in policy or outside – often struggle to define what it actually means in each and every policy area. At the same time, the level of analysis showing how policies are actually *impacting* upon inclusive growth - however defined – remains weak (or non-existent).

[27] See www.ted.com/talks/nicola_sturgeon_why_governments_should_prioritize_well_being?language=en

The Scottish Government has long had a focus on improving outcomes. The first National Performance Framework (NPF), since updated, was a clear signal of intent of reshaping public policy around more than just economic growth.

The first spending review of the SNP government in 2007[28] detailed this new approach, and how spending was supporting five strategic objectives of a wealthier and fairer, a smarter, a greener, a healthier, a safer and stronger Scotland. Progress would be tracked through the NPF, with Purpose Targets setting out high level key outcomes to be delivered over a ten year period. Ten years on, many Purpose targets were unmet and quietly dropped in the NPF refresh in 2017.

A major recession, austerity, two referendums, a long drawn out period of uncertainty and the devolution of new powers, may help explain the distraction away from outcomes being front and centre of every Scottish budget. But few will argue that these outcomes have become less important and the refreshed NPF still echoes much of what was first talked about in 2007. And if we are being honest, has it actually changed anything? And what evidence is there that the NPF has led to major shifts in budget priorities that otherwise would not have taken place anyway?

Could a new approach focussed on wellbeing be different from what has come (and gone) before? And how does it move beyond an exercise where civil servants congratulate themselves on a nice piece of policymaking and presentation into genuine changes in behaviour?

Before going any further, it is worth a note of caution. Evidence that supported the Scottish Parliament's Budget Process Review Group (BPRG)[29] cautioned against placing too much emphasis on outcomes budgeting, given potential issues of accountability. The impact of a spending line on a change in an outcome is hard to attribute, may impact on many outcomes, and may take longer than the period of the budget to be realised.

The final report of the BPRG therefore recommended that such information (on alignment of spend to outcomes) should be contained elsewhere, for example, in policy documents but, wherever possible, there should be a clear link between individual policies and plans and

[28] www.webarchive.org.uk/wayback/archive/20171002004132/http://www.gov.scot/Publications/2007/11/13092240/4

[29] Joachim Wehner (2017) Good practice in parliamentary budget scrutiny: international comparisons. https://www.parliament.scot/S5_Finance/Reports/2017.03.09_Joachim_Wehner.pdf

budget documentation – something which we found last year was not the case for Child Poverty[30].

How the Scottish Government will reconcile these recommendations with Derek McKay's announcement that he will this year present a wellbeing budget is yet to be seen. So far, he has said that child poverty, climate change and inclusive growth will be themes. Will this be a case of rearranging the deck chairs or a serious effort to align spending to align to these, and only these, priorities? And can this approach survive the impulse to sprinkle a bit of spend all over to keep everybody happy, and the negotiations that will be required to get support from at least one other party?

Whilst no budget document will ever be able to identify – reliably – exactly which outcomes might be associated with which spending, it is important that a move to a well-being budget is not simply a presentational exercise used to retrospectively justify existing spending decisions.

Building on the experience of New Zealand, an approach to wellbeing budgeting should:

- Identify what the government means by well-being
- Identify the case for spending on a particular budget element is anticipated to contribute to wellbeing
- And most importantly, set out an approach to monitor changes in wellbeing, and to appraise and evaluate the contribution of policy to those changes

In this way, a well-being approach to budgeting may help government and its stakeholders to consider spending decisions through a different lens, potentially leading to different – and hopefully better – budget decisions.

Box 4.1: New Zealand's approach to setting a well-being budget
New Zealand published its first wellbeing budget in 2019. In 2019, the 'wellbeing' budget process was adopted for 'new' areas of spending (not existing spend). It was set in the context of a budget surplus and money to spend. Nonetheless, tricky decisions are still needed to be made around what spending to prioritise.

[30] See https://fraserofallander.org/scottish-economy/budget/how-does-the-scottish-government-assess-the-impact-of-its-budget-on-tackling-child-poverty/

It appears a key part of building consensus came far ahead of the budget process, with the development of priorities on which new spending proposals needed to align to. This was an evidence-based process, analysing indicators of wellbeing and understanding where there were particular gaps that needed attention – either due to New Zealand's performance relative to other countries or due to inequalities clearly evident within the population.

Another notable feature was the requirement for collaboration. New budget proposals were marked down if they did not have cross-government/agency support. This encouraged a broader coalition of proposals and no doubt improved the quality of the bids that were received.

The NZ Treasury had a process by which they considered the strength of each bid based on its alignment to priorities and the evidence of impact on wellbeing. Evidence did not need to be only quantitative but did need to be credible. Crucially – and a major lesson for Scotland - all proposals were required to have an evaluation framework, along with an appropriate level of funding to ensure that the evaluation could be carried out as proposed.

The reality was that, alongside this process, the financing of pre-existing services needed to be considered as well. Whilst there was a less intensive process of looking at whether existing budgets could be reduced, top-up or 'cost pressure' funding inevitably took a slice of the available budget. The recognition that you cannot change the whole course of government spending in one year is important however, particularly when faced with significant demand led spend – e.g. staffing costs of an NHS facing increasing demand.

4.3 The fiscal challenge of demographic change

It is by now common knowledge that old age dependency ratios (the ratio of people aged above the state pension age relative to those of working age) are increasing in most countries.

Scotland is no exception. Its old age dependency ratio is projected to increase from 30 in 2019 to 42 over the period to 2040. This rate of 'population ageing' as it is colloquially referred is slightly faster than the rate projected for the UK as a whole, but less rapid than in many other European countries.

From a fiscal perspective, population ageing presents real challenges. Levels of spending on health and social care increase exponentially by age (as set out in Chart 5.2 of our 2017

Budget Report). At the same time, those above the state pension age tend to have lower incomes and pay less tax on average than those of working age (although the difference is not nearly as marked as the difference in levels of healthcare expenditure).

The combination of demographic change and increases in healthcare technologies has clear implications for budgets. Health spending accounted for 37% of the Scottish resource budget in 1999, and is almost at 50% today.

The strategy to address these challenges is to undertake wide-scale reforms aimed at reducing demand for (costly) acute hospital services by delivering care closer to home. The successful integration of health and social care services is at the heart of this objective. NHS territorial boards now delegate over half their budgets to Integration Authorities, whose aim is to shift services from hospitals to community and social care.

Effective integration of health and social care services is critical to reducing budgetary pressures on the NHS. But a recent review by Audit Scotland again finds that progress has barely got going[31].

NHS Boards are continuing to make savings, but these are increasingly from one-off – and hence unsustainable – measures (such as not re-filling vacancies). At the end of 2018/19, the Scottish Government wrote off £150m of outstanding loans to NHS Boards that had been granted to help meet funding deficits.

But whilst reform aims to reduce the growth in demand for acute hospital services, the pace of demographic change and other cost pressures is such that real terms spending on health will continue to increase. The Scottish Government's Medium Term Health and Social Care Framework (2018)[32] estimated that NHS spending would need to grow around 3.5% per annum in real terms to meet demographic and other cost pressures if no reforms are made. Even if reforms are successful in reducing demand by as much as is anticipated (although 'hoped for' is probably the more correct term), spending is likely to continue to rise by 1.5% in real terms to meet demand.

There is therefore an ongoing question around how the government's overall fiscal strategy should respond to these pressures. One response is to accept that health will continue to account for an increasingly large share of the Scottish budget. But unless the budget outlook

[31] Audit Scotland: NHS in Scotland 2019 www.audit-scotland.gov.uk/uploads/docs/report/2019/nr_191024_nhs_overview.pdf

[32] Health and Social Care: medium term financial framework, www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/

improves significantly (i.e. unless future UK Government's consistently accept higher rates departmental spending which feed through to the block grant), this will imply further cuts to other areas of devolved spending.

Another response is to accept higher rates of taxation. But this may prove a difficult sell to the public who have just experienced ten years of unprecedentedly weak earnings growth.

4.4 Public attitudes to fiscal policy challenges

In assessing how to respond to these challenges, consideration of public attitudes is important. Public attitudes influence what is likely to be seen as politically viable, although attitudes themselves are of course shaped by the nature of the political debate.

This is shown clearly in Chart 4.1, which shows levels of support for the notion that government should tax more and spend more. Support for 'more tax and spend' in Scotland declined from 63% at the start of the 2000s to 37% in 2009, when the effects of the recession influenced all major parties to propose fiscal consolidation of varying degrees.

The period of austerity since 2010 has corresponded with growing support for the notion of 'more tax and spend', as the public's patience with the austerity agenda has worn thin, and the political discourse shifts towards the importance of ending austerity.

Chart 4.1 also suggests that, whilst attitudes to tax and spend evolve over time, there is no strong evidence – at least from the Scottish and British Social Attitudes Surveys – that people in Scotland are systematically supportive of more tax and spend than people in England.

On some other indicators however, there is more evidence for Scottish preferences being different. Evidence from the same survey suggests that there are somewhat greater concerns over the level of inequality, with a corresponding greater preference for redistribution.

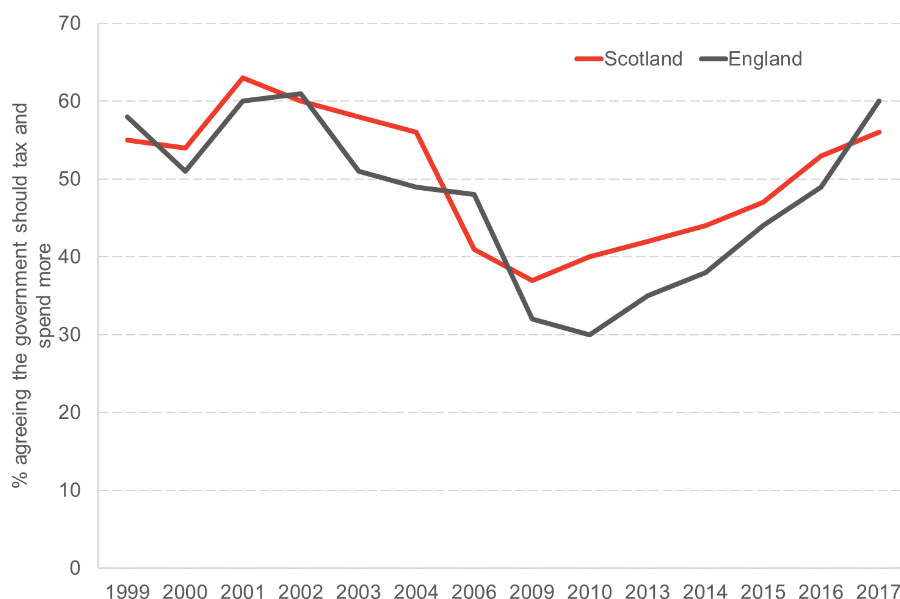
And there also appears to be general support for the notion of differential tax policy in Scotland. Almost half (48%) of Scots support the notion of having different tax bands, compared to 36% who oppose (17% were unsure).

This does appear to suggest that there is greater acceptance of fiscal policy differences now than a few years ago (survey analysis in 2014 found less evidence of a willingness for tax

policy divergence in Scotland). Nonetheless, given that these latest results derive from surveys conducted in 2017, it will be interesting to see whether they change in subsequent years, particularly in light of the tax changes now introduced.

Nonetheless, if there is a conclusion to be drawn here it is not so much about whether there are or are not differences in preferences between Scotland and other parts of the UK, but that public preferences can be shaped by the nature of the political discourse.

Chart 4.1: Public support for 'more tax and spend'



Source: Scottish and British Social Attitudes Surveys

4.5 Delivering on the vision for social security

Over the next few years, the Scottish Government will take on significant new responsibilities for designing and delivering new social security benefits to over one million people.

In 2018, the Scottish Government began paying the Carer's Allowance Supplement and Best Start Grant Pregnancy and Baby Payment. During 2019, the government plans to introduce four new benefits: Best Start Grant Early Learning Payment, Best Start Grant School Age Payment, Funeral Expense Assistance, and Young Carer Grant.

As we described in Chapter 3, financial responsibility for all remaining social security benefits being devolved will transfer to the Scottish budget in 2020/21 – even though those benefits will continue to be delivered by the DWP for the time being.

Spending on devolved social security benefits is forecast at £3.5bn in 2020/21 (Table 4.1).

Table 4.1: Forecast expenditure on social security benefits in 2020/21

	2020-21
Attendance Allowance	£530
Cold Weather Payments	£16
Disability Living Allowance	£628
Industrial Injuries Benefit	£82
Personal Independence Payment	£1,607
Severe Disablement Allowance	£8
Winter Fuel Payment	£168
Carer's Allowance (inc supplement)	£344
Discretionary Housing Payments	£66
Best Start Grant	£16
Funeral Support Payment	£7
Scottish Welfare Fund	£33
Total	£3,505

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

Over time, these legacy UK benefits are expected to be replaced by new Scottish specific benefits that will be delivered by the Scottish Social Security Agency (SSSA). It is anticipated that the SSSA will start accepting new claims from 2020. However, the transfer of existing claimants from legacy UK benefits administered by DWP to the equivalent new Scottish benefit will take place gradually over the period to 2024/25.

The Scottish Government has set out its objectives to create a social security system based on dignity, fairness and respect. The new benefits are anticipated to differ in a number of important respects from the equivalent UK benefits. In some cases, benefits rates may differ (the Scottish Government has already implemented its commitment to pay a Carer's

Allowance Supplement). In some cases, eligibility may be extended (Winter Heating Assistance, the replacement for the Winter Fuel Payment, will be extended to families with severely disable children). In some cases, assessment processes will differ, and the Scottish Government has committed to ensuring that eligibility for new disability benefits will not be carried out by the private sector.

These new responsibilities are significant. There will clearly be an intense scrutiny of the way the new benefits are being experienced by those receiving them, and how effectively the SSSA administers both the new claimants, and the transfer of existing claimants from DWP.

The new benefits will also have substantial budgetary implications. Where the Scottish replacement benefits imply higher levels of expenditure than the legacy benefits – either because of higher benefit rates, wider eligibility criteria, or different assessment processes – then this implies that expenditure on the benefits by the Scottish Government is likely to be higher than the increase in its block grant.

Any gap will have to be met by the Scottish Government from reduced spending elsewhere or from increased tax revenues.

An additional challenge is that Scottish budgets will be determined by forecasts. Forecasting changes to social security spending following policy change is particularly challenging, as the data required to assess the impact of changes to eligibility criteria on claimant rates is often lacking, and the implications for benefit uptake are hard to predict[33].

Errors in forecasting the differences between benefit spending and the block grant additions for the social security benefits will have to be accommodated within the Scottish Government's existing budget management tools – the Scotland Reserve and resource borrowing limits – alongside the other uses for these tools.

The transfer of the new social security powers thus provides a source of substantial budget risk. Critical trade-offs may emerge between the achievement of stakeholders' vision for Scottish social security policy and the government's broader budget aspirations.

[33] To illustrate, the SFC revised up its forecast of spending on the new Best Start Grant by 67% between December 2018 and May 2019 in response to much higher levels of take-up.

4.6 The role and fiscal responsibilities of local government

Local government has borne a disproportionate share of fiscal consolidation since 2010. Local government fiscal revenues (the sum of resources from central government including non-domestic rates and specific grants, plus revenues from council tax) have fallen by around 8% between 2009/10 and 2019/20. On a per capita basis, fiscal revenues have fallen by 12%.

These calculations control for the fact that police and fire services were removed from local government responsibility in 2013/14 (i.e. revenue funding has fallen by 12% excluding the fall associated with police and fire services). At the same time however, local government has taken on new responsibilities, notably in relation to the provision of childcare.

A 12% cut in funding is clearly significant. At the same time, the proportion of funding accounted for by specific (ring-fenced) grants has increased to 5% in 2019/20 (up from virtually nothing in 2013/14), whilst the proportion of funding that is tied to the achievement of particular objectives (even if the funding is not specifically ring-fenced) has also increased[34].

Funding reductions have forced councils to adapt and reprioritise. Councils have made efficiency savings through improvements in back office functions such as human resources, payroll and finance systems, property rationalisation, and delivery of shared services.

But efficiency savings in themselves are not sufficient to avoid the need for more fundamental changes.

Many councils are making increases to charges. The Accounts Commission[35] reports that councils had increased 11 types of charges by more than inflation between 2016/17 and 2018/19. The impact of these charges is seen in falling real terms 'net spending' on many services. For example, analysis of spending data show that councils spent £1.6m on cremation and mortuary services in 2016/17, but by 2019/20 these services were actually *raising* £4.5m.

Despite efficiency savings and efforts to raise more through fees and charges, councils have also had to reprioritise. Chapter 1 set out the broad implications of this, in terms of the

[34] Burn-Murdoch and Aiton (2019) Local government finance: facts and figures 2013/14 to 2019/20. SPICe briefing 19-45, Scottish Parliament.

[35] Local Government in Scotland: Financial Overview 2017/18. Accounts Commission www.audit-scotland.gov.uk/uploads/docs/report/2018/nr_181129_local_government_finance.pdf

increasing concentration on education and social work. Councils are spending less in real terms now on other areas of spending. Since 2016/17, real terms spending is down on libraries (7%), sports facilities and parks (both 12%), and most aspects of transport (road maintenance and community transport) and planning.

Evidence as to the outcome of these changes in mixed. On the one hand, analysis of the Improvement Service's Benchmarking Framework suggests that outcomes associated with many areas of council service provision have improved slightly or remained stable (for example, there is little evidence that numbers of visitors to libraries, museums or sports facilities has fallen, despite significant funding reductions). On the other hand, public satisfaction with a range of local services – including schools, transport and local health – has been falling since 2007[36].

But further funding reductions will undoubtedly put further pressure on local service delivery, perhaps forcing councils to decide which public services to withdraw from.

As well as funding challenges, councils face other challenges around changes to governance and accountability[37].

Partly as a result of financial pressure, there are now moves afoot to provide local authorities with some additional autonomy. The Transport Bill, recently approved by the Scottish Parliament, gives local authorities the power to introduce a 'Workplace Parking Levy' – an employer charge based on the number of parking spaces provided at the workplace. Meanwhile the 2019 Programme for Government sets out an intention to 'create a discretionary power for local authorities to apply a tax or levy on overnight visitor stays'.

Whilst both these policies have their own merits however, neither will raise substantial revenues – at least for the majority of councils.

If the objective is to significantly raise local autonomy, and given the composition of the budget, it seems likely that the focus will return to reform of property taxation. There is theoretically scope to raise relatively more revenue from a more proportionate tax on domestic (and potentially also commercial) land and property.

[36] Local Government in Scotland: challenges and performance 2019. Accounts Commission www.audit-scotland.gov.uk/uploads/docs/report/2019/nr_190321_local_government_performance.pdf

[37] Including for example in relation to shared governance arrangements with Integrated Joint Boards, greater collaboration with other councils, ensuring a stronger role for communities in planning services, and in the increasing use of Arms Length External Organisations.

As part of last year's budget, the government committed to convene cross-party talks on replacing the current council tax. If agreement can be reached, the intention would be to publish legislation by the end of this parliament. Of course we have been here before (more than once).

For local government therefore, big long-term questions remain around how their funding allocations will change, and to what extent their flexibilities for determining the use of that funding and to raise revenue locally will evolve. Ultimately, these questions are important because of what they mean for both the breadth and quality of public services provided by local government.

4.7 The fiscal framework review

Scotland's Fiscal Framework sets out how the new powers, being devolved through the Scotland Act 2016, are operationalised. This includes the mechanisms for adjusting Scotland's block grant and for managing the volatility associated with forecast error, including borrowing limits and use of the Scotland Reserve.

Although it sounds dry and technical (it is) the Fiscal Framework has direct consequences for the nature of the risks that the Scottish budget is exposed to. Because of this, the Fiscal Framework was only agreed after a prolonged period of negotiation. Debate centred on the extent to which the Scottish budget should bear the risk of differential population growth, and how to balance a number of (sometimes conflicting) Smith Commission principles.

The Fiscal Framework is due to be reviewed in 2022, following the publication of an independent report in 2021.

There are uncertainties around what the precise scope of the review will include[38]. The review might focus narrowly on the approach to calculating the block grant adjustments: questions here will include the extent to which the Scottish budget should or should not be exposed to the risk of differential population growth, a different distribution of income taxpayers by band, or different demographic trends.

[38] For further discussion see Eiser and Roy (2019) The Fiscal Framework: 2021 Review. In Fraser of Allander Economic Commentary 43(2) https://pureportal.strath.ac.uk/en/publications/the-fiscal-framework-editorial-introduction

The review is likely also to consider the adequacy of the tools for dealing with the scale of forecast error that has emerged so far in the operation of the Fiscal Framework. The Review might also consider how various policy spill-over issues are dealt with.

The Scottish Government appears to be building a position that they would like to see the review go further than this – including reopen discussion about the nature of the fiscal powers that are devolved. For example, is there scope for greater flexibility over some of the existing powers (such as various allowances and reliefs in income tax)? Is there scope for devolution of further fiscal powers, particularly if some (notably the assignment of VAT) appear to have hit implementation challenges. The government might also want the review to consider other funding issues, such as how any replacement EU funding is allocated across the UK.

Of course, the UK Government will have their own views, and it is not inconceivable that they will want to have a narrower focus. Whatever the terms of the review, securing the right deal for Scotland will be challenging politically but also economically. The issues involved are complex and uncertain. If the Scottish budget is protected against one form of budget risk it will tend to be protected against the flipside benefits. And just because a risk has crystallised in one direction over the first few years of operation does not mean the risk will realise itself in the same way in future.

For these reasons, the review of the Fiscal Framework should ideally take place much more transparently than was the case for the negotiation of the 2016 framework. The outcomes of the Review will have profound implications for the policy flexibilities and budgetary risks that the Scottish budget is exposed to in the years to come.

4.8 The future of EU funding

When the UK leaves the EU it will no longer receive various streams of EU funding, including European Structural Funds funding associated with the Common Agricultural Policy (CAP), and a number of other funding streams. Of course, at the same time, the UK will no longer be making an annual payment to the EU.

In terms of Structural Funds, Scotland benefits from over £780 million of funding through the European Regional Development Fund and the European Social Fund over the current 2014-2020 round.

The UK Government has indicated its intention to provide successor funding following Brexit through a UK Shared Prosperity Fund (UKSPF) aimed at reducing inequalities between communities across the UK.

The UK Government has said[39] that the UKSPF *'will tackle inequalities between communities by raising productivity, especially in those parts of our country whose economies are furthest behind. The UKSPF will achieve this objective by strengthening the foundations of productivity as set out in our modern industrial strategy to support people to benefit from economic prosperity.'*

Beyond this, few details are yet available, including the funding associated with it, and their allocation. Some detail had been expected as part of the Spending Review, but the postponement of this has extended the period of uncertainty.

The Scottish Government has identified a number of key points it wishes to see in any replacement funding[40]. These include that Scotland should not lose out financially compared to the current level of funding; that the Scottish Government should have an integral role in development of the UKSPF, as partners rather than consultees; and that any new scheme should be ready for implementation in early 2021, so as not to create any funding gaps.

There have also been calls for Scotland to should be able to determine how UKSPF funds are allocated within Scotland, and that the UKSPF should build on the best characteristics of ESIF including longer timeframes, needs-driven and the ethos of partnership working.

The Common Agricultural Policy (CAP) is by far the largest source of EU funds for Scotland. Scotland was allocated €4,096 million of Pillar 1 funds and €478 million of Pillar 2 funds for the CAP programme 2014-2020[41]. This represents around 17% of the total UK CAP budget.

Guarantees have been provided to replace most CAP funds until 2022. No commitments have yet been made for the long term.

The UK is allocated €243 million from the European Maritime and Fisheries Fund (EMFF) for the 2014-20 funding period. Scotland is allocated 44% (€108 million) of that UK figure[42].

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[39] Written statement by James Brokenshire, Secretary of State for Housing, Communities and Local Government, 24 July 2018 https://hansard.parliament.uk/Commons/2018-07-24/debates/18072456000031/LocalGrowth

[40] Structural Funds Post EU-Exit: Scottish Government consultation www.gov.scot/publications/replacement-european-structural-funds-scotland-post-eu-exit/pages/3/

[41] Thom and Kenyon (2018) European Union Funding in Scotland. Spice Briefing 18-61 https://sp-bpr-en-prod-cdnep.azureedge.net/published/2018/9/28/European-Union-funding-in-Scotland/SB%2018-61.pdf

[42] ibid

There is no certainty at present on what might replace the EMFF, the role of the Scottish Government in the design of the fund, or the way in which funding may be allocated to Scotland[43].

A further complication in determining what happens next relates to a constitutional question about what the roles and responsibilities of the devolved institutions should have in determining how successor funding works.

Many of the policy areas that EU funds relate to cover policy areas that are fully or partially devolved (agriculture, environment, employment and skills, business support). To date however, despite being technically devolved, some of these policy areas are in practice 'Europeanised' in the sense that these policies are largely determined by the EU. The freedom of the Scottish Government to diverge from existing rules has been constrained by the policy frameworks being set by the EU. Agriculture and the environment are perhaps the most obvious examples.

The question of where control over elements previously with the EU should reside once Brexit occurs has caused substantial tension between the UK Government and devolved governments. The Scottish Government has argued that powers repatriated from Brussels should be devolved to the Scottish Parliament. The UK Government has argued the need to agree UK-wide "common frameworks" with the devolved administrations to limit divergence to allow the UK single market to operate without unfair competition – and to allow the UK Government to negotiate future trade deals.

Whilst the Scottish Government does not dispute the need for Common Frameworks, the question of how these Common Frameworks are developed – and what role the devolved institutions will have in this – remains a point of contention.

In summary, the clear theme that emerges is that, across all EU funding streams, there remains a lack of detail about how the UK will replace these funds post Brexit. Another theme is that all these funding streams are proportionately more important for Scotland than for most of the rest of the UK, often substantially so. It also remains unclear how the aims of successor funds will be developed, how much of a role the Scottish Government will have in this process, and how much policy flexibility it will have, in the context of the Common Frameworks, to determine its own policy objectives if it chooses to do so.

[43] McAngus, C. et al. (2019) Brexit, fisheries and Scottish devolution: an intergovernmental disruption. The Political Quarterly, October 2019

4.10 Conclusions

The Scottish budget faces some substantial structural issues over the coming years. These issues will bring both challenges and opportunities. They can be grouped into three broad areas:

- New fiscal responsibilities and budget mechanisms;
- Long-term fiscal pressures and challenges; and
- Budget design and policy targeting.

New fiscal responsibilities include the new social security powers, which will impact the budget in full from April 2020. The risk that spending on these new payments exceeds the increase in the block grant is very real given the government's aspirations for the Scottish social security system.

Looking slightly further ahead, the replacement of EU funding streams could have implications for the Scottish budget – although significant uncertainty remains over the financial scale of replacement funding, and the role of the Scottish Government (and other Scottish organisations) in designing and implementing these schemes.

And the fiscal framework review, scheduled to take place in 2022, will influence the nature and scale of fiscal risks faced by the Scottish budget, by determining the way that Scotland's block grant is calculated, and the scale and flexibility associated with budget management tools.

The long-term fiscal challenges associated with an ageing population have been extensively documented. Reforms aimed at reducing the growth in demand for health spending have yet to have major impact. The scale of the challenge indicates that spending on health and social care spending will continue to increase as a share of the overall budget.

A long-term consequence of this has been a decline in the resources allocated to local government. The long-term vision for local government – the breadth and quality of services it should provide, and the degree of funding autonomy it should have – remains unclear.

These are substantial challenges for the government to grapple with. Would a change in the way that budgets are planned or prioritised make it easier for these challenges to be effectively addressed?

The government has indicated a shift towards delivering a 'wellbeing' budget. In practice in remains unclear what difference this will make. It is hoped that, by considering spending

choices through a different lens, a wellbeing approach could help refocus priorities more effectively. But there is an obvious danger that a budget described as being a wellbeing budget becomes a presentational exercise, relying on a broad and vague definition of wellbeing to justify an existing set of spending priorities.

More than ever, there is uncertainty around the budget outlook. This is partly because of uncertainty over the budget numbers, as set out in chapter 3. But in many ways, uncertainty over these more fundamental structural issues is even more challenging.

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Fraser of Allander Institute
University of Strathclyde
199 Cathedral Street
Glasgow G4 0QU
Scotland, UK

Telephone: 0141 548 3958
Email: fraser@strath.ac.uk
Website: www.strath.ac.uk/fraser
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