Is the Scottish budget for 2019/20 disadvantaged by UK Government policy decisions on income tax? The Scottish Government argues that it is. The government's case is reasonable – but potentially undermined by its own stated policy commitments.

The Smith Commission identified two 'no detriment' principles which it said should apply to Scotland's new fiscal framework.

The first was that there should be 'no detriment' simply as the result of the initial transfer of a particular power.

The second – and the one relevant to this blog – was that neither government should face detriment as a result of a policy decision taken by the other. Specifically, *'where either government makes a policy decision which effects the revenues or expenditure of the other, the decision-making government should reimburse the other where there is an additional cost, or receive a transfer if there is a saving'*.

The Fiscal Framework subsequently agreed that where a policy decision has a direct and mechanical effect on the revenues or spending of the other government they will be 'accounted for' (i.e. compensated in some way).

Budget detriment in 2019/20

The Scottish Government has recently raised the issue of a potential policy spillover with the UK Government. The spillover arises from the increase to the Personal Allowance (PA).

The PA – set by the UK Government and applicable across the UK – was increased from £11,850 in 2018/19 to £12,500 in 2019/20. This is substantially larger than would have occurred under the 'default' uprating. Increasing the threshold in line with CPI inflation would have seen the PA rise to £12,160.

Why might the PA increase cause detriment to the Scottish budget?

An increase in the PA represents a tax cut for the majority of income taxpayers (as tax is paid on a smaller proportion of income). So a PA rise reduces the government's tax revenues, all else being equal.

In principle, the way the fiscal framework works should protect the Scottish budget from the loss of revenues resulting from the PA increase. This is because, whilst the PA increase will reduce revenues from Scottish income tax, it will also reduce revenues from rUK income tax revenues by an equivalent percentage. As a result, the infamous 'block grant adjustment (BGA)' – the amount that is deducted from the Scottish block grant to account for the devolution of income tax – should also fall. In theory, the BGA should fall by about the same amount as Scottish income tax revenues fall, offsetting the budgetary effects of the PA increase on the Scottish budget.

So where's the problem? It lies in the fact that Scotland has a different distribution of taxpayers from rUK.

The income tax personal allowance does not apply to all income taxpayers. It is tapered away from those with incomes above £100,000, and falls to zero for those earning over £125,000. And the issue is that Scotland has proportionately fewer of these high income individuals than rUK. So an increase in the PA represents a tax cut for proportionately more Scottish income taxpayers than rUK taxpayers. In turn, this means that the PA increase is likely to reduce Scottish revenues by more than it reduces the BGA.

There is therefore some logic to the argument that the Scottish budget may be disadvantaged by the PA increases.

We don't yet know the scale of the 'detriment' as the Scottish Government has not made public its estimates.

We can probably guesstimate that the detriment to the Scottish budget as a result of the PA increase is in the tens of millions of pounds range, possibly increasing towards £100m if the effect of PA increases across subsequent years since 2016/17 is taken into account. But estimating precisely the effect of the PA increase on the BGA is challenging at the moment given the way the policy is costed at UK level.

So these are potentially significant sums of money, or 'detriment', and it seems not unreasonable to conclude that the detriment has been caused directly and mechanically as a result of UK Government income tax policy.

But can you be disadvantaged by your own policy?

But there is an interesting policy wrinkle to all this. In its 2016 Manifesto, the SNP committed to increase the 'income exempt from income tax' to £12,750 by the end of the parliament in 2021/22. The PA was £11,000 at the time that this commitment was made.

The UK Government-set PA is on course to reach £12,750 by 2021/22 (the substantial PA increase in 2019/20 represented the bringing forward of the 2020/21 increase – on current plans the UK PA is expected to remain unchanged in 2020/21 and then increase by CPI in 2021/22, which will take it to £12,750 in that year).

So whilst the ‘no detriment’ principle should apply without prejudice to other commitments or policies, it could be argued that the Scottish Government is making a claim of ‘detriment’ in relation to the implementation of its own policy commitment.

If the UK PA reaches any value below £12,750 by 2021/22, then the only way for the Scottish Government to meet its manifesto commitment would be to set a zero-rate band of income tax that would apply to income between the UK PA and £12,750. The revenue costs of this to the Scottish budget would be far more significant than a UK-wide PA increase to £12,750 – as the loss of Scottish revenues would not be offset at all by a fall in the BGA.

To conclude, the Scottish budget probably is worse off as a result of PA increases since 2016/17 than it would have been had the PA been frozen. But we don’t yet know the scale of this detriment or whether the two governments will agree on the scale of that detriment. What we can say is that the Scottish budget would be even worse off if the Scottish Government had had to meet its manifesto commitment unilaterally.

It will be interesting to see how the two governments resolve this first test of the ‘no detriment’ principles.