In an article in yesterday's Commentary, David Eiser and Graeme Roy preview the 2021 review of the Fiscal Framework. This blog provides a quick overview of that article.

The review

In recent years, the Scottish Parliament has been taking on new fiscal responsibilities – with more to follow. In 2021, the process for how these powers are operationalised – the Fiscal Framework – will be reviewed.

But what will the review cover? Will it be a 'broad review'? Or a more narrowly focussed technical review? Will it open up debates about further devolution? And will politicians – perhaps elsewhere in the UK – seek to open up a debate about devolved funding?

The stakes are likely to be high, not least given Brexit and the prospects for a second independence referendum

The Block Grant Adjustments

The key aspect of the review will be the Block Grant Adjustments (BGAs).

The BGAs lie at the heart of the Fiscal Framework. They adjust the Scottish block grant to take account of the new tax (and spending) responsibilities.

For taxes, each BGA is effectively a measure of the revenues that the UK Government has foregone as a result of transferring the tax in question to Holyrood.

Whilst this might sound rather dry and technical, how these BGAs are calculated can have a significant impact upon how much money the Scottish Government has to spend each year.

Indeed, the Scotland Act (2016) very nearly did not happen because of a lack of agreement between the UK and Scottish Governments on the appropriate methodology for calculating these BGAs.

In the end, a temporary solution was 'fudged', with the final decision parked until the 2021 review.

But both governments are still likely to be just as far apart as they were back in 2016. [For 2019/20, the Scottish Government would have £90m less if the BGAs were calculated according to the UK Government's preferred method rather than the method that is currently used today.]

Managing risks

A second major theme in the review will be risk.

Scottish budgets are now exposed to two aspects of risk.

The first – the potential for divergence between Scottish and rUK tax bases – was something that the Scottish Government was well aware of in 2016. And it was a risk that they were prepared to trade-off for the promise of more powers.

The second (but linked) risk – the existence of forecast errors – was also well known. However, the likelihood of large forecast errors was perhaps underappreciated at the time.

Taking each risk in turn.

Under the Fiscal Framework, the Scottish budget should 'benefit in full' from policy decisions by the Scottish Government, and bear the costs of decisions that reduce revenues.

This is fine as a principle, but the reality is that the Scottish budget actually bears the effects of ***any*** differences in Scottish devolved revenue growth relative to rUK revenue growth, regardless of the causes of that differential growth (with the exception of population).

Whilst Holyrood would certainly hope to be able to grow the Scottish tax base, the link between policy and growth is often weak and many of the factors determining revenue growth are dependent on devolved policy to a limited extent.

At the same time, factors outside Holyrood's control – Brexit, the downturn in oil and gas, Scotland's ageing population – will all impact on Scotland's tax performance. And because it's actually *relative performance* that matters, Scotland also now bears the risk of factors that make the rUK perform much better (for example, if there is strong growth in the City of London).

We've seen these risks already come to fruition.

Whilst in 2019/20, Scottish taxpayers are paying some £500m more in income tax than they would pay under the UK policy, the revenue effects of the Scottish tax policy have been completely offset by weaker performance in the Scottish tax base.

Some may argue that this transfer of risk should be part of the review. But it's important to note that this is actually the framework working effectively. Whether or not it is 'fair' might be a valid question, but these are risks that the Scottish Government was willing to take on board when it signed up to the Fiscal Framework in the first place.

The second area of risk relates to risks of forecast error. The next three financial years will see the first of the income tax 'reconciliations' (the reckoning between tax forecasts and outturn data).

In May 2019, the Scottish Fiscal Commission published its latest assessment of the extent of reconciliations: £229 million in 2017/18, £608 million in 2018/19 and £188m in 2019/20.

These figures are well in excess of the government's annual borrowing limit for forecast error of £350m.

A key aspect of the review therefore is likely to be whether or not the current borrowing limits are sufficient to manage reconciliations of such a scale.

But we shouldn't lose sight of a key point. The Scottish Government has sought to emphasise that the £1bn of reconciliations that they face are simply due to 'forecast error'. This is true, but the underlying 'error' is that the initial forecasts were for Scottish earnings to perform broadly in line with the UK as a whole. But they haven't. We've heard less from government on why this is the case, whether they think it will continue and what – if anything – they can do to tackle it.

Other issues

In the paper, we discuss other potential policy issues that the review may cover.

- Brexit: Whatever the final EU Withdrawal Agreement, Holyrood's responsibilities will change. As the Fiscal Framework was signed before the EU referendum, it was not envisaged that such matters would be an issue. However, it will be hard to disentangle any debate about new powers post-Brexit from wider discussions around devolved funding.
- VAT: As we pointed out in earlier blogs here and here, there are challenges in assigning VAT – not least in working out how much is raised in Scotland. It is possible that VAT assignment will be delayed and looked at again as part of the review.
- New powers: Whether or not the review will touch on what additional powers could be devolved is an open question. Some could argue that this does deserve consideration,

particularly in the light of the changing economic and constitutional situation since the Smith Commission published.
- Social security: One final policy area is the transfer of social security powers. They bring many of the financial risks we've highlighted above in the context of income tax, but perhaps on an even more uncertain scale. Given timescales however, it may be too early for any lessons to feed into the 2021 review.

There are also some other – more technical issues – that are likely to be touched upon, such as –

- The flow of information between governments and the wider public (including parliament);
- Any remaining legal barriers to devolution of powers (e.g. Air Departure Tax);
- The limits on what can and cannot be put in the Scotland Reserve (and what can be taken out); and,
- The scale, time profile and purpose of borrowing powers;

Back when the fiscal framework was agreed in 2016, it was anticipated that the review would focus on the unresolved question of the method for calculating the block grant adjustments.

But a range of unanticipated developments since then – including the scale of emerging income tax forecast errors, legal and administrative barriers to tax devolution, Brexit, and the implications of global economic factors on Scotland's relative economic performance – may lead to calls for a broader review.

Many of the issues should not need to become overtly politicised. But even agreeing even the precise scope of the review is likely to prove challenging, particularly given the highly charged political atmosphere at the current time.

Nonetheless, the possible outcomes of the review will likely have profound implications for Scotland's fiscal settlement, and deserve serious scrutiny.