

# Fraser of Allander Institute

## Scotland's Budget Report 2018

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Welcome to the third annual briefing of the Fraser of Allander Institute's Report on Scotland's Budget.

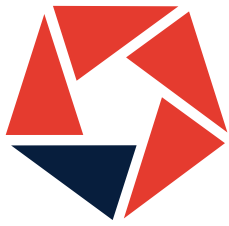
As many of us eagerly await how Scotland's budget will fair amidst the backdrop of Brexit, the First Minister has already hinted that it will stand in stark contrast to what's been set out by Chancellor Philip Hammond in the UK Budget.

There is no one better placed than the Fraser of Allander Institute to produce a report which considers how Scotland's 2019/20 budget will be delivered against the opportunities and risks faced by the Scottish Government in such a challenging climate.

Our priority at Morton Fraser is to provide the best support and advice to individuals and organisations who are working, investing and doing business in Scotland and we share in the hope that this budget will deliver the best outcomes for everyone.

As always, we are delighted to support the Fraser of Allander Institute and Mackay Hannah in facilitating such an important debate and I'm sure the report will deliver an interesting insight into complexities and opportunities facing Scotland's economy today.

Chris Hart  
Chief Executive



UNIVERSITY of STRATHCLYDE  
**FRASER OF ALLANDER  
INSTITUTE**

**The Fraser of Allander Institute (FAI) is a leading economic research institute with over 40 years experience of researching, analysing and commenting 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

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# Scotland's Budget Report 2018

## **Lead author**

David Eiser

## **Contributors**

Charlotte Barbour (ICAS)  
Anna Murray  
Geoffroy Duparc Portier  
Graeme Roy  
Mairi Spowage

## **Copy-editors**

Annmarie Campbell  
Eleanor Malloy  
Isobel Sheppard

# Foreword



## ***The economic context***

The past year has been dominated by one issue: Brexit.

As the negotiations have meandered forward in no apparent direction, extensive analysis has been undertaken of the implications of different scenarios, to which the FAI has been an active contributor. However, there remains a powerful sense that no one knows where this will end: indeed, the range of possible outcomes seems as wide as ever.

Whatever the outcome to the negotiations, it is far from apparent that the fog enveloping the current outlook will miraculously roll away to reveal a clarity that has been so starkly absent thus far. Indeed, at best, many critical elements of the negotiations may simply be fudged, or more openly deferred, leaving uncertainty for many more months, if not years.

Such a scenario seems preferable to the potential chaos of a no deal Brexit, but it carries risks, including a further decay in confidence and an erosion of the competitiveness of the UK and Scottish economies.

It is worth noting that, in addition to the vacuum created by Brexit, the global context has become similarly concerning, with future growth scenarios – and the all-important implications for fiscal revenues and expenditures – subject to significant uncertainty.

## ***The Fraser's Approach***

As in previous years, this publication – and the seminar which it underpins – is focussed on the analysis of the Scottish fiscal environment and outlook, dependent as they both are on the UK fiscal stance and policy direction.

It articulates the critical questions that the Scottish Government must address in the coming months prior to the publication of its own Budget at the end of the year.

## ***The Economic and Fiscal Outlook***

The UK Budget surprised many observers in several respects, including the claims surrounding the life expectancy of UK austerity and the revisions to future UK growth forecasts.

These are considered in detail in the report, with a particular focus on the more optimistic outlook for Scotland following the Chancellor's Budget announcements, as well as the risks that remain for domestic fiscal stability.

What is certain is that this UK picture is exceptionally vulnerable and hence the life expectancy of the UK Budget is itself open to the question. In consequence, so is that of the - as yet unborn - Scottish Budget.

Amidst this hugely uncertain economic picture, several stark realities remain.

With or without Brexit, two areas stand out as concerning.

The first is the outlook for the Scottish Budget in the context of the new Fiscal Framework, a framework that is still only bedding in and for which the full significance is still far from fully appreciated. As the report

makes clear, the new framework provides a process that is now increasingly dependent on the relative performance of the Scottish and UK economies. Brexit may complicate and exacerbate the challenge here, but the fundamental priority of Scotland's relative growth performance remains.

Secondly, the sustainable growth challenge is arguably still something that is inadequately addressed in the political and economic discourse. As we have observed for many years, the focus on these longer term critical structural questions remains weak. We have through the year pointed to the weaknesses in economic strategy and in the lack of coherence of economic thinking within policymakers.

These key issues will remain of paramount importance over the coming year. In the short term, on the bright side, if the fiscal underpinning is indeed somewhat more positive than might have been anticipated a few months ago, there may be unexpected resource to direct to the enhancement of sustainable economic growth. For how long this relative optimism prevails remains to be seen.

### ***Our future work***

In the coming year, we will continue our regular briefings and analysis on the Scottish and UK Budgets and the Scottish economy.

We shall continue to extend the range of services that we offer across Scotland, particularly in the area of learning and development through our suite of CPD and Executive Education programmes. And we will continue to work directly with government and industry to help them understand how changes in the economic and fiscal environment might impact on their organisation.

Finally, I want to acknowledge the great support of many different people and organisations without whom the Institute would not be able to play the role that it does.

In particular, we continue to benefit immensely from the support of the University of Strathclyde, the Scottish Funding Council and Dr Jim Walker.

We are indebted to them for their support but we also seek to work with them as partners and contributors in the analysis that we undertake. For this reason, we are keen to continue extending our range of collaborators and would warmly welcome exploring new partnerships.

Our membership scheme is an ideal way for your organisation to help support independent analysis of the fiscal and economic challenges and opportunities set out so clearly in this report. For further details contact [fraser@strath.ac.uk](mailto:fraser@strath.ac.uk)

**Professor Andrew Goudie**  
Chair, Fraser of Allander Institute Advisory Board  
University of Strathclyde

November 8th, 2018

# Executive Summary

## The economic context for Scotland's Budget

- The Scottish economy has picked up in recent months, with growth nudging ahead of that in the UK as a whole.
- Employment remains at high levels and conditions have certainly improved relative to our 2017 Scotland's Budget report.
- However, growth remains weak by historical standards. Annual growth of 1.4% on a 4Q-on-4Q basis remains well below trend. Growth has not been above 2% on an annual basis since early 2014.
- Brexit uncertainty continues to weigh heavily on the outlook, with most forecasters predicting that both the UK and Scottish economies are in the midst of an unprecedented period of uncertainty. Looking forward, most forecasts are for growth to remain fragile for the next few years with weak productivity being the key factor.
- Of course, what matters most in the context of Scotland's new Fiscal Framework is how the Scottish economy, and revenues from Scotland's devolved taxes, are performing relative to the rest of the UK. Whilst economic growth has picked up in recent times, this follows a number of years when Scotland had been lagging the UK.
- The Scottish Fiscal Commission will publish updated forecasts for the Scottish economy and tax revenues alongside December's Budget. Their previous forecasts have assumed that the Scottish economy would grow slightly slower in per capita terms than the OBR has assumed for the UK. It seems unlikely that relatively positive news recently on economic growth will result in a major revision to the SFC's outlook for GDP growth in the near term.
- What is also critical is the SFC's forecasts for employment and earnings, the key drivers of income tax revenue growth. In May, the SFC revised down its forecast for Scottish earnings growth, which had a knock-on impact for the outlook for Scottish income tax revenues.
- Under the Fiscal Framework, these forecasts did not have an immediate impact on Scottish public spending in 2018-19, but should the SFC adopt a similar pessimistic outlook this December then it will have a significant impact on the Cabinet Secretary's potential spending power for 2019-20.



## Scotland's budget 2019/20: practical tax considerations

- The Scottish Government has reorganised its finance function with a dedicated taxation resource, with the appointment of a Minister for Public Finance and Digital Economy and the establishment of a post of Director of Taxation, and this is to be welcomed.
- As we discussed last year, whilst it may appear as though the Scottish Government has significant control of Scottish revenue raising, the practical realities may be limited – and more so than anticipated at first sight.
- Devolution has introduced new opportunities, but also new complexities, with many moving parts to manage – with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions.
- ICAS continues to call for minimum complexity, maximum transparency, and pro-active collaboration between the Scottish and UK Governments to ensure that the two tax systems operate cohesively.
- Scottish income tax was implemented on 6 April 2017 and its profile has been raised as the differentials between north and south of the border have increased across thresholds and rates, and from one year to another.
- Using an extrapolation methodology for VAT assignment is helpful for business; the Scottish and UK Governments have agreed that requiring businesses to report their VAT separately for Scotland and the UK would impose an unwanted administrative burden.
- In essence, VAT assignment is a funding mechanism, designed to bring further linkage to the Scottish economy. Although it may bring significant revenue, the Scottish Government will have no direct levers to exercise in relation to its amount.
- It is encouraging to note that included in the Scottish Government's legislative programme for 2018/19 is a pledge to reform the way in which devolved tax decisions are planned, managed and implemented. It is hoped this will be put in place as soon as possible.
- A five-year roadmap setting out the objectives of Scottish tax policy would be helpful: this should provide clarity of purpose and tie in with the Scottish Fiscal Framework. Transparency of data and the link between Scottish tax receipts and the operation of the Fiscal Framework will be crucial if the public are to maintain faith in the process.

## The Scottish Government's resource budget: an end to austerity?

- The outlook for Scotland's resource block grant has improved significantly since this time last year. It had been on course to fall by over one per cent between 2018/19 and 2019/20, but subsequent spending decisions of the UK Government mean it will now increase slightly. The outlook for subsequent years has also improved, with the block grant now set to grow by 3% over the remaining three years of the parliament.
- However, the outlook for Scotland's income tax revenue has deteriorated. At budget 2018/19, Scottish revenues were forecast to raise over £400m more than the income tax Block Grant Adjustment (BGA), due to a combination of tax policy and growth in the Scotland's tax base. But by May 2018, this forecast had changed significantly, resulting in a deterioration in the outlook of around £400m.
- These forecast revisions do not affect the 2018/19 budget. However if the SFC maintains such a pessimistic outlook it will impact on the 2019/20, acting to offset some of the increase in the block grant in 2019/20.
- The Scottish Government has used its income tax powers in each of the last two budgets to raise additional revenue. The changes have been progressive across the income distribution, with the highest earning 14% of Scottish income taxpayers seeing the largest increase in average tax rate.
- More significantly the government has altered the structure of the income tax system in Scotland with different thresholds, tax rates and bands. This year, the debate is likely to focus on the extent to which the government should or should not follow UK policy and increase the Higher Rate threshold by significantly more than inflation.
- The latest forecasts imply that Land and Buildings Transactions Tax (LBTT) and Landfill Tax will contribute marginally to revenue growth over the next few years. The timing of the assignment of VAT, and devolution of Air Passenger Duty remain subject to significant uncertainty.
- Overall, the government's resource budget will be around 4% higher at the end of the parliamentary term than it was back in 2016. But it will still be below the peak of 2010/11, and on a per capita basis it will have grown by only 1% over the course of this parliament.
- So whilst austerity may be ending, the outlook for the public finances remains challenging.

## Choices and trade-offs for public spending

- The Scottish Government has set out its high level plans for spending over the five years from 2018/19 in Scotland's Fiscal Outlook 2018. This set out a range of commitments on the NHS, childcare, policing, higher education and social security.
- The implication, given the budget outlook at the time, was that spending on non-priority areas would decline by 12% over the remaining three years of the parliament.
- As Chapter 3 has highlighted, the outlook has improved since then.
- Given the commitment to 'pass on' health related consequentials to the NHS, health spending is now on track to increase by around 2.7% per annum over the remaining three years of the parliament, almost double the previous projection. At the same time the outlook for non-priority areas is better (but still challenging), with spending now set to decline by 4% over the remainder of the parliament.
- However the government faces many difficult decisions on spending. Health spending may need to rise 3.5% per annum if preventative and public health programmes do not mitigate demand growth as much as hoped. The government could decide to increase spending on NHS Scotland further, but this would clearly have implications for other portfolios.
- The core local government resource budget has declined by over 8% since 2010/11. Social care and some education services have been relatively protected from these cuts, but spending in some non-statutory areas has declined by over 20%. Relatively little is known about the detail of these changes, nor their impacts.
- Spending choices should not just be viewed as a trade-off between local government and health, not least given the potential synergies within the social care agenda. Spending challenges exist within all portfolios, including both those that are and are not 'protected'.
- In reality, the government has little room for manoeuvre, unless it is prepared to make radical changes to the way it delivers some services, or aims for a step change in the level of revenues it raises.
- The next few years are likely to see a continuation of the trend of retrenchment of public sector spend on core areas. Health spending is soon likely to absorb around half of the government's resource budget by the end of the parliament – if not before – up from 41% at the start of the austerity period.

## Trade-offs in funding capital investment

- Net public sector investment spending in Scotland (gross spending minus depreciation) is, as a percentage of GDP, somewhat below average in an international context, and lower now than at the start of the austerity period.
- The 2018 Programme for Government set out an aim to raise Scotland's infrastructure spending to 'internationally competitive levels'. It has set out investment commitments relating to early learning and childcare facilities, affordable housing, broadband infrastructure, sustainable travel, transport infrastructure, schools and colleges, NHS facilities and early learning facilities.
- The majority of the government's investment programme is funded by a block grant from Westminster (£3.4bn in 2018/19). Additionally it can now borrow up to £450m annually (with a £3bn borrowing cap). The government and other public sector organisations also fund investment through revenue borrowing methods. These have delivered between £400m - £800m investment annually in recent years.
- The capital block grant is projected to increase by 25% in real terms over the course of this parliament. Despite this it will remain below its pre-austerity peak, even by 2020/21.
- The government has used its new borrowing powers in full in 2015/16, 16/17 and 17/18, and has indicated that it is minded to do so again in 18/19. The government is able to borrow at relatively low rates of interest. But if it continues to borrow its full allocation each year for a loan term of 25 years, it is likely to hit its borrowing limit in 2022/23.
- When it comes to revenue financed projects, the government's key constraint is a self-imposed limit that the annual value of repayments should not exceed 5% of its total budget. It is on course to remain within this limit, although repayments for historic and planned revenue financed projects are currently around £1.2bn annually. The value for money of revenue funded schemes remains unclear.
- Local government also funds capital investment through a combination of grant, borrowing, and revenue financing. Pilot projects seek to test innovative models to investment financing, although the scope of these models to achieve a step change in investment levels may be limited.
- A clearer strategy is needed to establish the principles and implications of the government's investment approach, including the opportunity costs, to current and future generations of taxpayers.

## Options for reforming taxes

- Taxes (and charges) serve a range of purposes, including revenue raising and influencing behaviours. Recent times have seen a range of proposals put forward for reform of existing taxes, or the creation of new taxes, to serve either or both of these objectives.
- At a local level, proposals include a levy on visitors staying in short-term accommodation, a levy on employer provided parking spaces, and a tax on vacant land. None of these policies is likely to raise significant revenue in their own right, but they could provide local authorities with useful additional tools to meet their own particular funding and broader policy objectives.
- In terms of local taxation, there remains a strong case for reform of council tax. As has often been highlighted, the lack of recent revaluation and the structure of the banding system contrive to create an unfair tax. Reform could achieve a fairer tax structure in such a way to be revenue neutral, or to raise additional revenue with minimal distortion.
- Political momentum for reform appears to be growing, and the enthusiasm for reform held by the Scottish Green Party – who have supported the minority government's budget proposals in the last two years – will push this issue further up the agenda. One option could be a further change to the ratios between bands, similar to the one in 2017/18. Whilst this would raise just over £100m in 2019/20, and be broadly progressive across the distribution, it would not address the underlying weaknesses with council tax.
- If it wanted to raise revenues from income tax, the Scottish Government could consider any number of policies. Putting a penny on the basic, intermediate or higher rates could raise around £170m, £130m or £60m respectively.
- Much political debate will focus on the government's choices for the higher rate threshold. Compared to a policy to increase the threshold in line with inflation, freezing it in cash terms would raise around £60m, increasing it to £46,850 would cost £130m, and increasing it to £50,000 – to match rUK – would cost £280m.
- Of course, bolder tax policy measures are possible. The Welsh Government has been exploring the possibility of establishing a social security fund, where capped, income linked contributions are used to establish a fund that could be invested to yield a flow of revenues to support growing demand for social care. There are many practical obstacles to such a fund. It is perhaps the sort of radical thinking that is required in Scotland but is not yet being debated.

## Financing Higher Education in Scotland

- The Scottish Government has adopted a different position to HE funding compared to England.
- Higher education in England is increasingly funded through tuition fees which most students pay by taking out a fee loan. This policy is not costless for the taxpayer however given that loans repayments are income contingent and outstanding loan is written off after 30 years.
- In Scotland, the costs of tuition for fulltime, first time Scottish domiciled students remain wholly funded by the Scottish Government, although most students are expected to fund their own maintenance costs, and a majority take out maintenance loans to do so.
- Where the Scottish Government chooses to fund HE through grants – whether these are grants to students to pay fees or support living costs, or allocations directly to universities via the Scottish Funding Council – this is funded from the Scottish Government's total resource allocation.
- The provision of student loans has no impact on the Scottish Government's resource budget. Instead, loans issued score as 'Annually Managed Expenditure' (AME), whilst the estimated value of the impairment associated with student loans is scored as 'ring-fenced non-cash', with both elements being provided to the Scottish budget by the UK Government. The limits of the government's AME and ring-fenced non-cash budgets are not determined by fiscal rules as such, but are subject to negotiation with the UK Government in the event that the Scottish Government wants to change its loan policy.
- In principle HM Treasury would countenance any Scottish Government loans policy that could be interpreted as broadly equitable – in relation to the loan amount and repayment conditions – to what was available in other parts of the UK. But these limits have not to date been tested, given the much lower reliance on loans in the Scottish system.
- In 2018 the Scottish Government announced changes to the loan repayment conditions that will apply to maintenance loans offered to Scottish domiciled students. The loan repayment term will fall from 35 years to 30 years and the repayment threshold (the income above which repayments are due) will increase from £18,300 to £25,000, aligning Scottish loan repayment policy with England. However, the interest rate on Scottish loans will remain significantly lower than is charged on English loans. These changes will reduce the repayments of Scottish graduates in the lower half of the distribution of lifetime income.
- On average, the tuition costs associated with a full-time, first time, Scottish domiciled undergraduate are £7,000 per annum, or £28,000 for a typical four year degree. These costs are met from the Scottish Government's resource budget, and are channelled to universities partly through the Student Awards Agency for Scotland, and partly through the Scottish Funding Council.
- The Scottish Government could if it wished introduce an element of tuition fee payable by students with the support of loan. Some proportion of the resource budget freed up could be used to provide funding or bursaries for students from less advantaged backgrounds. The burden of

funding HE would shift to students themselves (through loan repayments) and the UK government (through loan default).

- Replacing the publicly funded element of the £7,000 tuition cost entirely by a tuition fee could save the government around £800 million per year once it was rolled out across cohorts. However, a fee at this level would imply substantial loan write-off, and would probably not be countenanced by the UK Government (at least without more stringent loan conditions being put in place). It would also impose a substantial debt burden on students, and even though loan repayment conditions would ensure that the profile of lifetime repayments was proportionate to lifetime income, there would be fears about the implications of such levels of debt for participation rates. In contrast, a loan of £1,000 per annum would reduce the Scottish Government's resource allocation to HE by just over £100m.
- The ONS is currently undertaking a review of the treatment of student loans in the public finances, and will report in December 2018. Its recommendations are quite likely to influence the capacity of the Scottish Government to provide loans. The impairment element of loans may be treated more like grant - if so, this may provide the Scottish Government with additional budget flexibility to provide its current (no fee) policy.

# The economic context for Scotland's Budget

- The Scottish economy has picked up in recent months, with growth nudging ahead of that in the UK as a whole.
- Employment remains at high levels and conditions have certainly improved relative to our 2017 Scotland's Budget report.
- However, growth remains weak by historical standards. Annual growth of 1.4% on a 4Q-on-4Q basis remains well below trend. Growth has not been above 2% on an annual basis since early 2014.
- Brexit uncertainty continues to weigh heavily on the outlook, with most forecasters predicting that both the UK and Scottish economies are in the midst of an unprecedented period of uncertainty. Looking forward, most forecasts are for growth to remain fragile for the next few years with weak productivity being the key factor.
- Of course, what matters most in the context of Scotland's new Fiscal Framework is how the Scottish economy, and revenues from Scotland's devolved taxes, are performing relative to the rest of the UK. Whilst economic growth has picked up in recent times, this follows a number of years when Scotland had been lagging the UK.
- The Scottish Fiscal Commission will publish updated forecasts for the Scottish economy and tax revenues alongside December's Budget. Their previous forecasts have assumed that the Scottish economy would grow slightly slower in per capita terms than the OBR has assumed for the UK. It seems unlikely that relatively positive news recently on economic growth will result in a major revision to the SFC's outlook for GDP growth in the near term.
- What is also critical is the SFC's forecasts for employment and earnings, the key drivers of income tax revenue growth. In May, the SFC revised down its forecast for Scottish earnings growth, which had a knock-on impact for the outlook for Scottish income tax revenues.
- Under the Fiscal Framework, these forecasts did not have an immediate impact on Scottish public spending in 2018-19, but should the SFC adopt a similar pessimistic outlook this December then it will have a significant impact on the Cabinet Secretary's potential spending power for 2019-20.



*A cloud of uncertainty hangs over the public finances in both Scotland and the UK. Unlike in his previous budget and autumn statements, at the 2018 Autumn Budget the Chancellor had relatively little to say about the economic context and focussed instead on announcing increased spending and tax cuts. The spending announcements will help boost the Scottish budget beyond original plans. But under the new fiscal framework what will also determine how much Mr Mackay has to spend is the outlook for the economy. Growth in Scotland has picked up after a challenging few years with output now running ahead of the Scottish Fiscal Commission's (SFC's) forecasts. However, there are concerns about how 'tax-rich' this growth is. Should the SFC continue to take a relatively pessimistic view of Scotland's devolved public finances, then the Scottish Government may find that at least some of the boost from the Chancellor's pre-Brexit giveaway is offset by weaker tax revenues.*

## **1.1 Introduction**

After a sustained period of weak growth, and despite ongoing political uncertainty, the Scottish economy has been showing some signs of strengthening.

Growth has picked up and employment remains at relatively high levels.

This has been a relatively positive turnaround on twelve months ago.

In last year's budget report we highlighted how the Scottish economy had been lagging behind the UK on a consistent basis ever since the collapse of the oil price in late 2014/early 2015. Our prediction was that the government's official forecaster – the Scottish Fiscal Commission (SFC) – would set out a relatively bleak outlook for Scottish growth prospects. In the end, their forecasts were even more pessimistic than we had predicted, with their view that the Scottish economy would grow at less than 1% until 2022.

Of course, under the new fiscal framework, Scotland's economic performance now has a direct bearing on the amount of money that the Cabinet Secretary for Finance can expect to have at his disposal.

What was equally surprising therefore, was that whilst the SFC forecast growth to be lower than the UK, tax revenues were thought to hold up much better. As a result, Scotland's devolved tax revenues – on the whole – were forecast to either match or outperform the equivalent taxes in the rest of the UK.

However, the SFC's assessment of the fiscal outlook changed markedly in May 2018 with revised forecasts for growth and Scottish devolved tax revenues. In particular, the SFC revised down their forecasts for Scottish tax revenues in 2018/19 by over £200m.

This – coupled with stronger forecast tax growth at the UK level – poses a major concern for the Scottish Government. Should the Scottish Fiscal Commission continue to forecast weaker tax growth in Scotland than the OBR forecasts for the rest of the UK, part of any increase in the Scottish block grant could be offset by weaker Scottish revenue performance.

So what does the outlook now look like for the Scottish economy? How might this differ from the UK as a whole? And what approach might the SFC take when they come to update their forecasts next month?

These are the key questions that we seek to answer in this short chapter<sup>1</sup>.

Section 2 reviews the key points from last month's OBR assessment of the UK economy and public finances. Section 3 considers the recent performance of the Scottish economy.

Section 4 brings all of this together to summarise the key judgement calls the SFC will face when reaching an assessment of where they think Scottish tax revenues may go over the next 12 months.

Section 5 concludes.

## **1.2 The economic and fiscal outlook for the UK**

### *The UK economy*

Overall, the UK economy continues to underperform, both relative to its historical average and to its key competitors.

Growth has also been below expectations. Last month, the OBR revised down their forecasts for real GDP growth in 2018 to 1.3% from 1.5%.

The UK economy grew by just 0.5 per cent in the first half of the year, in part due to the bad weather in March. But it is hard not to conclude that the ongoing Brexit uncertainty has weakened the economy, particularly over the last year.

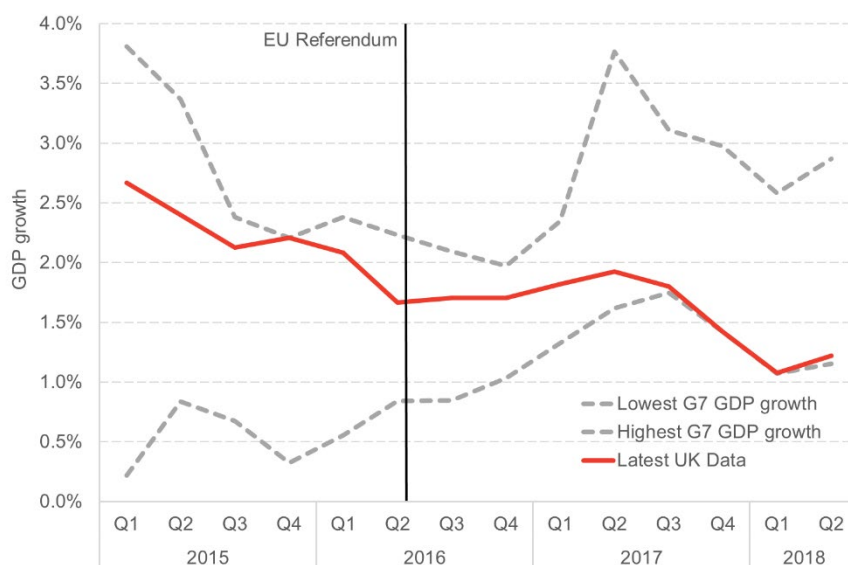
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<sup>1</sup> For a more detailed discussion of our assessment of the Scottish economy see the Fraser of Allander Quarterly Economic Commentary, published in partnership with Deloitte. See [www.strath.ac.uk/business/economics/fraserofallanderinstitute/economic\\_commentary/](http://www.strath.ac.uk/business/economics/fraserofallanderinstitute/economic_commentary/)

The fall in the pound has squeezed real household incomes and consumption, with little in the way of a significant boost to net trade. Business investment has arguably taken the biggest hit.

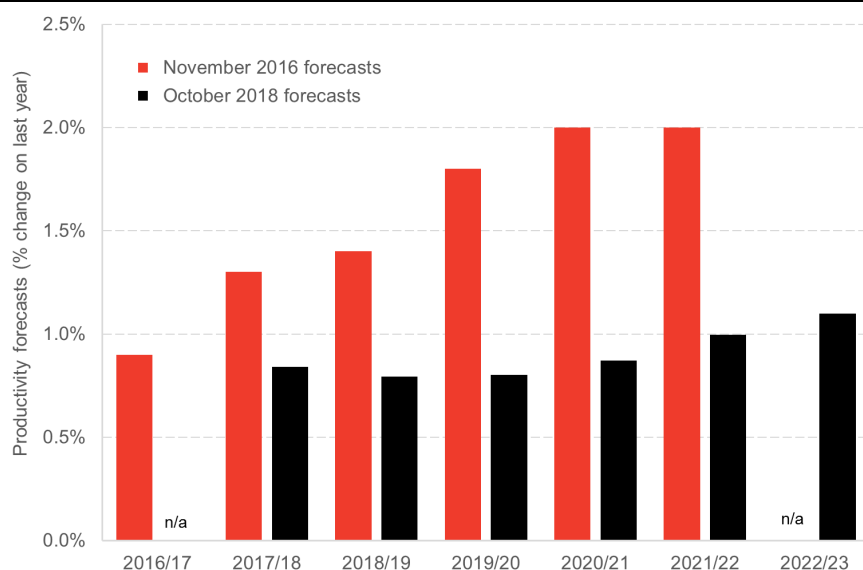
Of course, predicting where the economy 'would have been' had a referendum not been called is fraught with difficulty. What we can at least conclude is that those that predicted a sharp recession immediately after June 2016 were wrong, but so too were those people who suggested that leaving the EU would have no negative impact – see Chart 1.1.

**Chart 1.1:** Economic growth in the UK and the G7



Source: ONS and OECD

Interestingly, much of the OBR's relatively pessimistic outlook for the UK economy is not driven by short-term factors, such as Brexit uncertainty or even a more fragile and volatile global economic policy environment. Instead, it is driven by continued weak productivity growth. It is this, more than anything else that is holding back the growth forecasts (Chart 1.2).

**Chart 1.2:** Weaker productivity growth forecasts for UK for next 5 years

Source: Office for Budget Responsibility

What is particularly striking is just how much consensus there is over weak forecasts for the UK economy over the next few years (Table 1.1).

**Table 1.1:** Latest growth forecasts for the UK economy

	2018	2019	2020	2021
Bank of England	1.5	1.7	1.7	1.7
OBR	1.3	1.6	1.4	1.4
NIESR	1.4	1.7	n/a	n/a
European Commission	1.3	1.2	n/a	n/a
IMF	1.4	1.5	n/a	n/a
OECD	1.4	1.3	n/a	n/a

Source: HM Treasury

Whilst the OBR are predicting real household earnings to rise over the coming years, this will do little to offset the significant fall in earnings since the financial crisis. Much of the debate over 'austerity' and whether or not it is over tends to focus on public spending and whether or not this is going up or down. But in reality, for most households 'austerity' is instead about the ongoing squeeze on real earnings, rising housing costs and fuel bills.

### The UK public finances

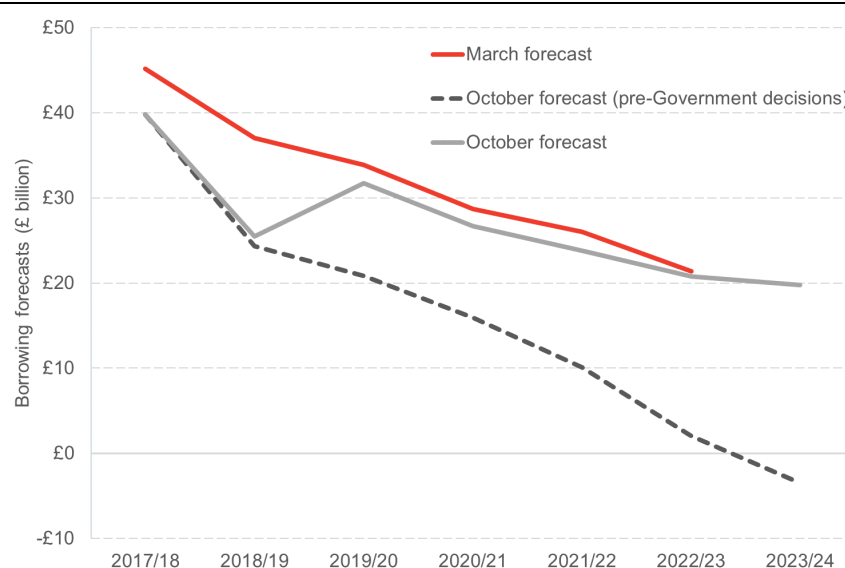
Over the long-term, weak economic growth will limit the scope the Chancellor has to support growth in public spending.

Debt will remain relatively high as a percentage of GDP and achieving the government's stated fiscal objective of running a fiscal surplus by the middle of the next decade will be that much tougher. Indeed the Institute for Fiscal Studies has indicated a high degree of scepticism over whether or not this is actually a realistic priority for the Chancellor<sup>2</sup>.

However, despite the economy growing less quickly than anticipated and with a weak outlook forecast, the public finances have surprised on the upside this year compared to forecasts made back in March.

The reason has been due to unexpectedly higher tax revenues arising from income tax, VAT and corporation tax receipts, combined with a slower than anticipated increase in spending.

**Chart 1.3:** Public sector net borrowing: revisions and impact of UK Budget decisions 2018



Source: Office for Budget Responsibility

As has been well documented, and is highlighted in Chart 1.3, the Chancellor chose to spend almost all of this improvement in the public finances (the so-called £12 billion fiscal 'windfall'). This unexpected bonus enabled the UK Government to fund its pre-announced increase in NHS spending and to accelerate the timing of the government's commitment to increase the personal allowance to £12,500 and the Higher Rate Threshold to £50,000 whilst

<sup>2</sup> See [www.ifs.org.uk/tools\\_and\\_resources/budget/526](http://www.ifs.org.uk/tools_and_resources/budget/526)

remaining on course to meet its fiscal mandate (which is to ensure a cyclically adjusted budget deficit of less than 2% of GDP by 2020/21).

The UK Government has yet to set out firm spending plans beyond 2019/20. These are anticipated to be set out in the Spending Review in 2019 – by which point the terms of the UK's exit deal from the EU should be known with more certainty. But it is still unclear how many years the Spending Review will cover.

As we will discuss in detail in Chapter 3, all of this has important implications for the Scottish Budget.

Firstly, the increase in public spending announced by the Chancellor will directly feed through to the Scottish block grant. It is then up to the Scottish Government to decide how to spend these 'consequentials'. They have already made clear that they intend to pass on many of the increases to the NHS.

Secondly, the decision to use some of the fiscal 'windfall' to fund an income tax cut by raising the higher rate threshold poses the Scottish Government with an interesting dilemma. The decision to increase the Personal Allowance to £12,500 will benefit all Scottish income taxpayers. However, responsibility for the Higher Rate threshold is devolved. It will be up to the Scottish Government to decide if it will match the UK Government's tax policy or take a different path. The indications are that they will not follow the UK Government – at least in full – leading to a wider gap between the Higher Rate thresholds in Scotland and the rest of the UK. This is discussed further in Chapter 3.

### *Brexit and the public finances*

All of this discussion and outlook will of course change fundamentally should there be a major shift – either way – in the Brexit negotiations over the coming weeks.

The Chancellor has indicated that should a 'no-deal' outcome become a reality, he is likely to implement an emergency budget to introduce measures to support the economy. The economic consequences of a 'no-deal' are beginning to resonate amongst business with greater evidence of scenario planning. It has not yet resonated with some policymakers.

A 'no-deal' outcome would represent a significant economic shock to the UK economy. Whether or not the UK would slip into recession is hotly contested and uncertain. What is clear however, is that growth would slow significantly and both the UK Government and the Bank of England would be required to take significant action to support the economy through a period of turmoil.

If a 'positive' deal is secured – a favourable trade agreement and an appropriate transition period – the Chancellor has indicated that there would be a 'double-dividend'. This would consist of a pick-up in growth (yielding faster growth in tax revenues and therefore – in theory – more money for public spending) and the unlocking of funds that he has stored away for Brexit contingencies. This is however, a little disingenuous as there is unlikely to be – at least in the short-run – much in the way of a Brexit dividend for growth or the public finances. The terms of any Brexit deal, once finalised, are unlikely to tell us much about the nature of the UK's future trading relationships with the EU or other countries. Most independent economists believe that the UK economy will grow more slowly post-Brexit than would otherwise have been the case.

### **1.3 The economic and fiscal outlook for Scotland**

#### *An upturn in economic performance – but outlook remains fragile*

Even after the tax powers identified by the Smith Commission have been incorporated into the Scottish Budget, the amount of money that Holyrood has to spend will still be determined predominantly by what the Chancellor chooses to do at the UK level. This determines the overall size of the spending envelope the Scottish budget has.

However, with over £12bn of devolved taxes at their disposal, the performance of these Scottish taxes – and the economy that drives them – is also important.

Under the Fiscal Framework, a deduction is made from the Scottish block grant to compensate the UK Government for the fact that devolved taxes have been transferred to Holyrood. These so-called block grant adjustments – there is one for each tax – grow each year in line with the growth of equivalent tax revenues per capita in the rest of the UK. Of course, added to the block grant are the revenues raised in Scotland from these devolved taxes.

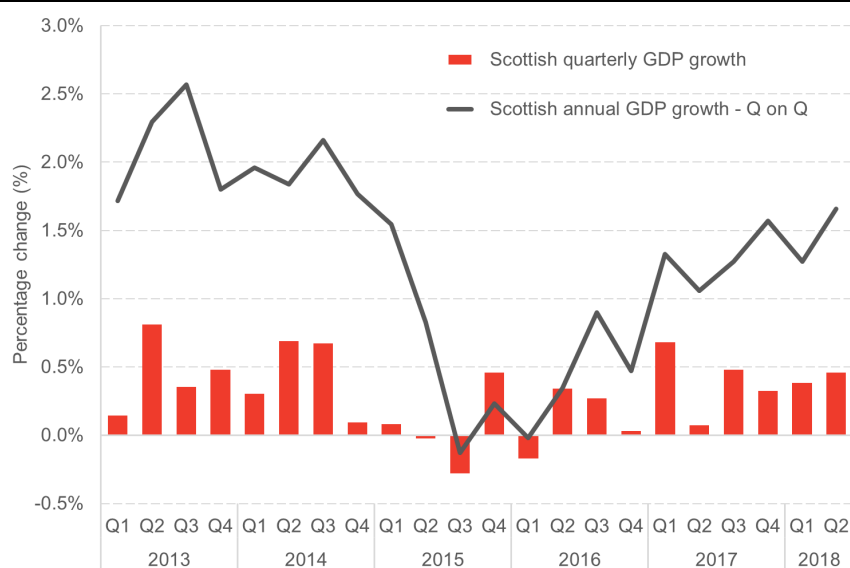
Therefore, what matters for the Scottish budget is how Scottish tax revenues are faring *relative* to these BGAs and, therefore, how quickly Scottish revenues per capita are growing *relative* to the growth of tax revenues in the rest of the UK.

Tax revenue growth is driven by and correlated with the performance of the economy. So how is the Scottish economy performing?

Activity has undoubtedly strengthened in recent months.

Growth over the year to June 2018 – whilst still below average – was the fastest since late 2014/ early 2015 and the Scottish economy has outpaced the UK for the last two quarters (Chart 1.4).<sup>3</sup>

**Chart 1.4:** Scottish economic growth (year and quarterly)



Source: Scottish Government

Scotland's recent performance has been boosted by major revisions undertaken by the Scottish Government to their construction series in the more recent data. This has raised growth significantly in both 2016 and 2017, but lowered it in earlier years.

As outlined in our recent economic commentary, Scotland's near-term economic prospects seem slightly more positive than this time last year.

Why?

First, whilst there is undoubtedly heightened uncertainty around Brexit, many businesses appear to be 'looking-through' such concerns and are getting on with day-to-day activities. But this is clearly fragile.

Second, the outlook for oil and gas – and its all-important supply chain – remains more positive than it has been in almost three years.

<sup>3</sup> That being said, annual growth of 1.7% (quarter-to quarter) and 1.4% (4Q-on-4Q), still lags Scotland's long-term historical growth rates.



Third, there are signs that the recent upturn is relatively broad-based with most sectors currently posting rising activity.

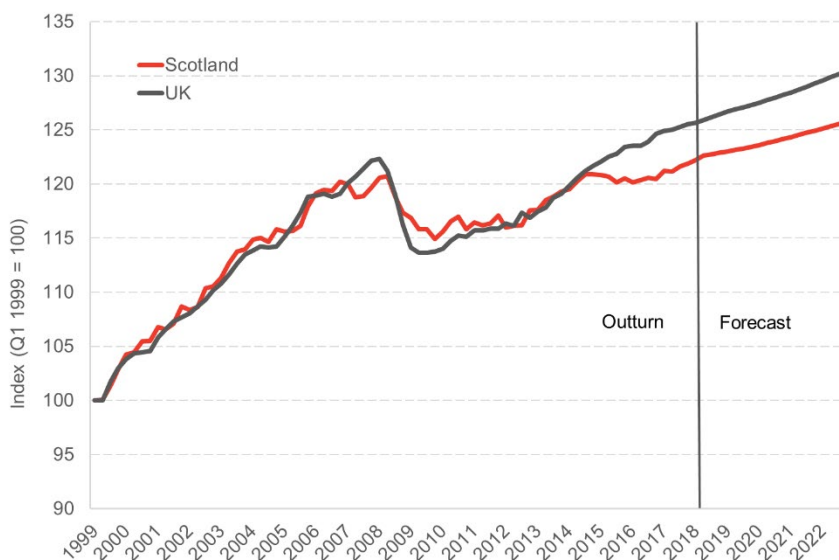
That being said growth is likely to remain below trend for the foreseeable future.

At the Fraser of Allander Institute, we are forecasting growth of 1.3% this year and 1.4% in 2019 and 2020. We would stress the heightened degree of uncertainty around such point estimates at the current time. For example, these forecasts are based upon a broad-based agreement being reached between the UK and the EU and they will change materially should a 'no-deal' outcome become a reality.

It is also important, particularly from the perspective of the Fiscal Framework (where what matters is the growth of revenues per capita in Scotland relative to rUK), to consider Scotland's recent economic performance on a per capita basis.

As the chart below highlights, since late 2014 the Scottish economy has been lagging behind the rest of the UK. The last six months have helped stop this trend to an extent. But it remains to be seen whether the Scottish economy will show any 'bounce-back'. The SFC's latest forecasts envisage GDP per capita to grow at more or less the same rate as the OBR forecasts for the UK, on which basis the performance gap is not anticipated to close (Chart 1.5).

**Chart 1.5:** GDP per capita in Scotland and the UK, Q1 1999 = 100



Source: Scottish Government, ONS, SFC and OBR

### Tax rich growth?

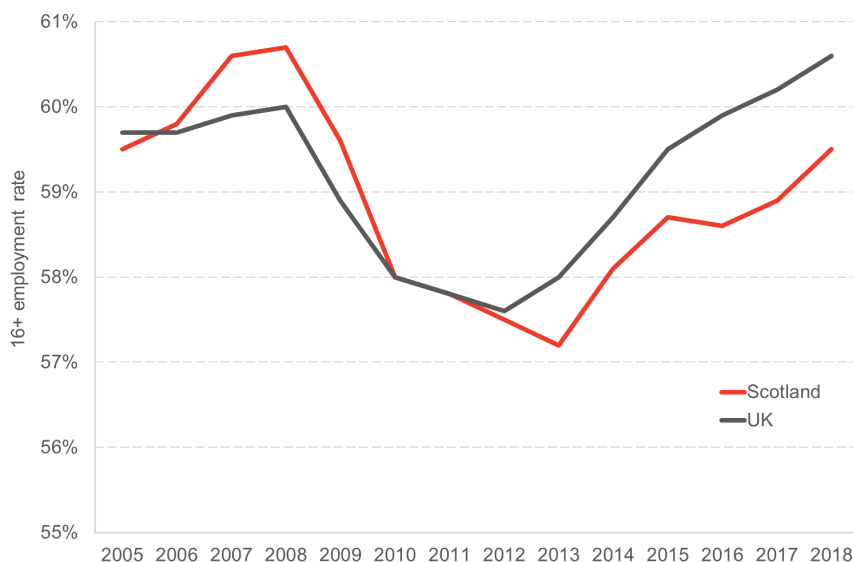
Whilst on balance, growth in the Scottish economy has undoubtedly picked-up, what matters most for revenues is how tax-rich this growth is (more precisely, what matters for the Scottish budget is how quickly Scottish revenues per capita growth relative to the equivalent revenues in rUK).

This will vary from tax to tax. For Land Buildings Transaction Tax, house price growth and turnover of properties are the two key components of the tax base – the latest forecasts are discussed in Chapter 3.

For income tax, the most significant devolved revenue by far, the two most important elements are employment and earnings.

Mirroring the trend in GDP performance, Scotland's employment rate fell in 2016, as falling demand manifested itself in the labour market as well as the measure of economic output. As was the case with GDP per capita, the employment rate in Scotland is now growing at the same rate as in the UK, but it remains unclear to what extent there may be 'catch-up' (there is unlikely to be a full closure of the employment rate gap, in part, due to demographics, and the fact that Scotland's working age population is projected to grow somewhat more slowly than the UK's).

**Chart 1.6:** Employment rate (16+) in Scotland and the UK



Source: Annual Population Survey (Data is for the 12 months to June for each year)

### What about the performance of earnings?

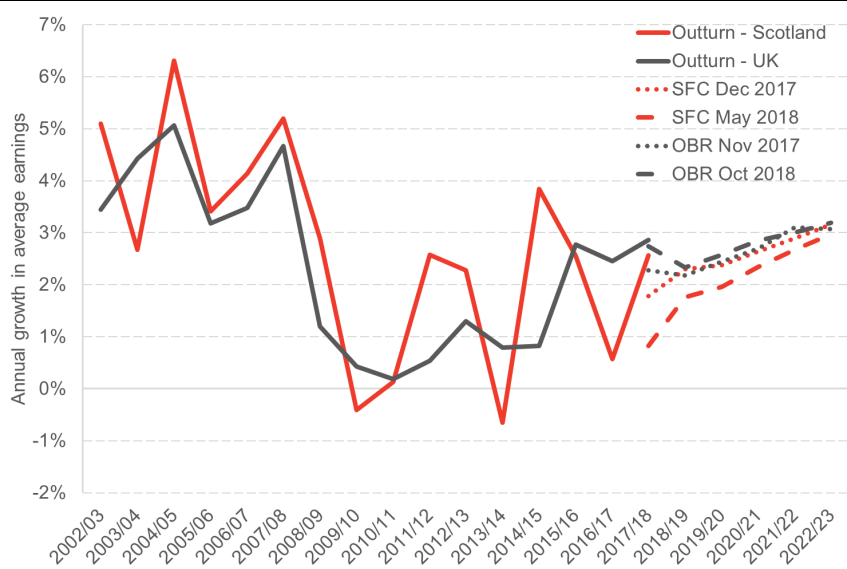
Data on earnings performance in Scotland is relatively sparse. In our view, the best source is the Annual Survey of Hourly Earnings (ASHE). This is a relatively large sample of approximately 1% of employees in Scotland, although it only relates to employment income and excludes the income of those who are self-employed.

Chart 1.7 compares outturn data from ASHE on average annual earnings in Scotland and the UK, alongside two recent forecasts of average annual earnings growth from the SFC and OBR.

The outturn figures do indicate that the Scottish data is subject to greater annual fluctuation, making the forecasting job of the SFC more difficult. Note in particular that annual growth in 2016/17 in Scotland was below 1%. In light of this, the SFC's forecast in December 2017 for growth of 1.8% in 2017/18 did not appear particularly optimistic. Nor in fact does its May 2018 forecast of 0.8% seem especially low.

However, the 2017/18 outturn data suggests annual average earnings growth of 2.6%, much closer to the UK figure of 2.9%, and above the average for the post-recessionary period.

**Chart 1.7:** Annual growth in earnings (outturn) and SFC & OBR forecasts



Source: ASHE, various years; SFC (May 2018 and Dec 2017); OBR (Oct 2018 and Nov 2017)

## 1.4 Issues for the Scottish Fiscal Commission in their Budget forecast

So what might the Scottish Fiscal Commission make of all of this information?

The SFC forecast a number of different variables around their now twice yearly fiscal reports. But this will all, undoubtedly, be underpinned by an 'overall' view of how they think the Scottish economy is faring and the outlook. Based upon past experience and the data thus far, it is hard to see them moving away from their cautious approach.

The first thing that the SFC will have to do is reflect upon how their forecasts compare with the most recent data on Scottish GDP.

When the SFC published its May 2018 forecast, it had access to three quarters of GDP data for 2017/18. On that basis, it forecast growth for 2017/18 of 0.7% (unchanged from December 2017).

In the end, and according to the latest data published in August, outturn GDP growth for the whole year is estimated to have been 1.3%. Furthermore, as Scottish Ministers have pointed out, growth in the first six months of the year has been faster than the SFC predicted for the year as a whole.

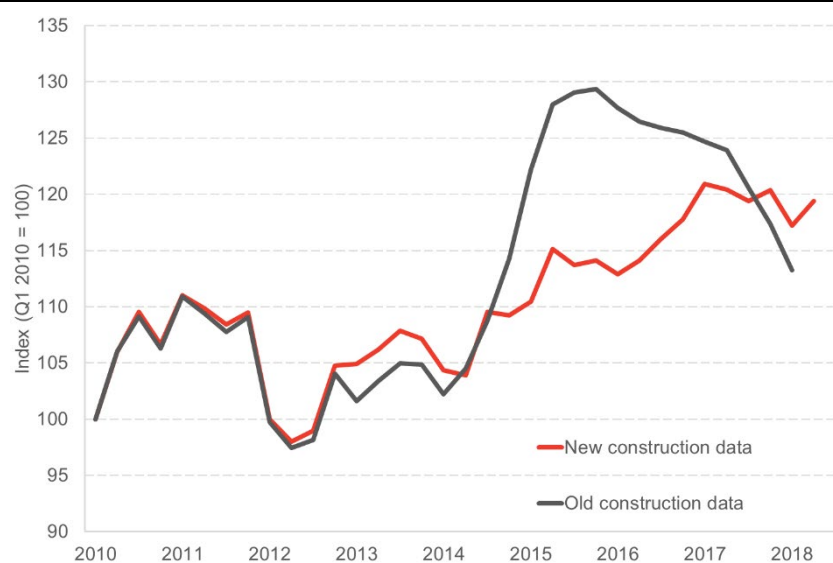
**Table 1.2:** Latest GDP growth forecasts and outturn

	2017/18	2018/19	2019/20	2020/21
SFC (May 2018)	0.7%	0.8%	0.8%	0.9%
SG (Sept 2018)	1.3%	-	-	-
	2017	2018	2019	2020
FAI (Sept 2017)	1.2%	1.4%	1.7%	-
FAI (Sept 2018)	-	1.3%	1.4%	1.4%

Source: Scottish Fiscal Commission (May forecasts); Scottish Government GDP statistics; FAI analysis

The main reason behind such a large discrepancy was due to major revisions to the estimates of growth by the Scottish Government (Chart 1.8).

Indeed, as recently as June, the Scottish Government published growth estimates for 2017/18 of just 0.8%.

**Chart 1.8:** Revisions to construction series

Source: Scottish Government

The SFC would be correct to argue that, whilst some revisions were anticipated, it is not the SFC's role to assess the accuracy of the government's estimates of GDP. Ultimately, the quality of their forecasts are constrained by the quality of the official data provided. As we have argued before, the challenge is really on the Scottish Government to respond more quickly if the statistics are displaying odd patterns.

Crucially, it is highly likely therefore, that the SFC will revise up their growth forecasts for the next few years but keep them below trend.

We see little evidence that they will take a more positive outlook to productivity growth than they have done in their first two sets of forecasts.

The second key element that the SFC will have to consider is not just the rate of GDP growth but the performance of the tax base and, crucially, the key determinants of income tax: employment and earnings.

As highlighted above, the employment rate in Scotland, apart from a wobble in 2015/2016, has tended to track the UK rate in recent times.

It will be on earnings however, where the biggest judgment call will have to be made.

In May of this year the SFC revised down its forecasts for income tax revenues in Scotland following a major downward revision to its expectations of earnings growth in each year of the forecast period (illustrated above in Chart 1.7).

The revisions are due, in part, to an 'evolution of judgement' on the part of the SFC about the likely future path of earnings growth and its relationship to productivity and underlying capacity in the labour market. In its May 2018 forecasts, the SFC states that real wages have grown '*significantly weaker than we would have expected just from looking at changes in productivity and labour market tightness since 2010.*' (Para 2.48). The SFC discuss a range of potential explanations for this including limited confidence and increasing uncertainty; rising non-wage labour costs; technological change; and structural factors (such as a growth in low-paid, the gig economy and restructuring of the oil and gas supply).

But at the same time, the SFC also justified their revision on the basis of new data having emerged, which appear to show slower growth in earnings in Scotland than in the UK (as discussed above).

Last month's ASHE data confirmed somewhat slower earnings growth in Scotland, consistent with the SFC's assessment. However, the good news for the Scottish outlook is that the gap between Scottish and UK earnings growth – at least according to ASHE – is not as large as indicated by the SFC and OBR forecasts earlier this year.

What will be crucial therefore for the Scottish budget will be what the SFC do next on their forecasts for earnings. It seems likely that that they will continue to forecast weaker earnings growth in Scotland relative to the UK as a whole. One year of data is not likely to cause a fundamental shift in the perspectives of the medium term outlook.

Should the SFC retain a weaker forecast for earnings than they did last year, this will constrain the extent of any increase in the size of the budget in 2019/20, as we discuss further in Chapter 3. Slower growth in the drivers of the tax base in Scotland could offset the revenue effects of the income tax policy decisions of the Scottish Government to some extent.

The third key element that the SFC will have to consider is how they think income tax receipts themselves are performing.

In May 2018, the SFC forecast that Scottish income tax revenues in 2016/17 were around £11.28bn. This forecast was made by taking the estimate of Scottish liabilities in 2015/16 from the Survey of Personal Incomes (SPI, a large survey of taxpayer incomes maintained by HMRC), and making assumptions about changes in the drivers of tax growth (e.g. wages, employment etc.)

HMRC has now published the first estimate of Scottish income tax outturn data, showing that income tax liabilities were £10.7bn in 2016/17.

This is some £550m below the SFC's forecast for 2016/17. What is behind such a difference?

It is important to understand that this large discrepancy does not appear to be because the SFC made inaccurate judgements about the growth in the number of taxpayers or taxpayer incomes from the 2015/16 SPI into 2016/17.

Instead, it appears to be due to major underlying differences between the survey data that has been used to make income tax forecasts and administrative outturn data.

Previous HMRC estimates of income tax receipts assumed there to be 18,000 additional rate taxpayers and 337,000 higher rate taxpayers in 2016/17. The outturn data shows that there were in fact 13,000 additional rate and 294,000 higher rate taxpayers.

Despite Scottish outturn revenues in 2016/17 being lower than forecast, this in itself has had no effect on the resources available to the Scottish budget in 2018/19.

This is because 2016/17 is used as the baseline for adjusting the Scottish block grant for the new income tax powers. The lower revenues are, the smaller the 'initial deduction' is. What matters going forward is how quickly income tax revenues grow after 2016/17 in Scotland compared to the rest of the UK<sup>4</sup>.

However, there are some important issues to consider.

In particular, if the outturn data is correct, it would appear that Scotland has fewer higher and additional rate taxpayers compared to rUK than was previously thought.

What might be the implications of this?

On the one hand it could mean that it is less likely that the growth of Scottish income tax revenues per capita will match the growth of rUK tax revenues per capita.

Why?

Consider what might happen if a larger share of Scottish taxable income is earned at the basic rate of income tax, compared to rUK. In this case, UK-wide factors which reduce taxable income at the basic rate have more of an impact on total tax revenue in Scotland compared with rUK. For example, the SFC may make a judgement that the real terms increase in the Personal Allowance will reduce Scottish revenues proportionately more than it would reduce rUK revenues (and hence the BGA).

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<sup>4</sup> A lower than forecast outturn figure does not tell us anything about the relative growth rate of Scottish revenues in the future. Yes, it will mean that the SFC revises down its forecast of Scottish revenues for 2017/18 and beyond. But the block grant adjustments for income tax will be revised down too.

At the same time, if the incomes of those at the top end of the income distribution are growing faster than the incomes of basic rate taxpayers – as appears to be the case from both the Scottish and UK data – the SFC may make the judgement that this will have less of an impact on Scottish revenues compared to a similar judgement at the UK level.

## 1.5 Conclusions

The UK and Scottish economic picture will once again set the scene for the upcoming Scottish Budget.

The Scottish Government will no doubt highlight the ongoing costs of Brexit uncertainty on the Scottish economy and on the public finances.

That being said, the decision by the Chancellor to use his 'fiscal windfall' to substantially increase NHS spending in England will feed through to the Scottish Budget, giving the Finance Secretary significantly more revenues at his disposal than he would have planned for this time last year.

With weak economic growth, low productivity and a more challenging external environment facing the UK in the future, the prospects of buoyant growth helping to usher in a period of significant public spending increases looks highly unlikely.

Of course, what matters now is also the outlook for the Scottish economy, and crucially Scottish tax revenues.

In December last year, the Scottish Fiscal Commission forecast Scottish tax revenues to hold up relatively well compared to the UK as a whole, despite overall Scottish growth being much weaker.

But since then, they have taken a much more pessimistic outlook as to how 'tax-rich' growth in Scotland will be. In particular, in May of this year, they adopted a more pessimistic outlook for earnings growth, which significantly reduced their forecasts for income tax for the next five years. On its own, this would represent a hit to the Scottish Budget, but when coupled with improved tax forecasts at the UK level, the impact is particularly significant. As a result, the revenues Mr Mackay was banking on for this year's Budget could be several hundred million short of expectations.

Whether or not you agree with the SFC's assessment, we have seen little in the way of new data to suggest that they will change their position. The most recent data – albeit patchy – does suggest that earnings growth, particularly at the top of the income distribution, has



grown more slowly in Scotland than in the UK as a whole over the past year. Against that, the Scottish economy has picked up in recent months and this should help reduce any gap in expectations for wages to some degree.

What is clear from these discussions, however, is that very small judgement calls by the SFC will have a significant bearing on the amount of money that Mr Mackay has at his disposal, particularly to use to secure agreement with other parties to pass his budget.

# Scotland's budget 2019/20: practical tax considerations

- The Scottish Government has reorganised its finance function with a dedicated taxation resource, with the appointment of a Minister for Public Finance and Digital Economy and the establishment of a post of Director of Taxation, and this is to be welcomed.
- As we discussed last year, whilst it may appear as though the Scottish Government has significant control of Scottish revenue raising, the practical realities may be limited – and more so than anticipated at first sight.
- Devolution has introduced new opportunities, but also new complexities, with many moving parts to manage – with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions.
- ICAS continues to call for minimum complexity, maximum transparency, and pro-active collaboration between the Scottish and UK Governments to ensure that the two tax systems operate cohesively.
- Scottish income tax was implemented on 6 April 2017 and its profile has been raised as the differentials between north and south of the border have increased across thresholds and rates, and from one year to another.
- Using an extrapolation methodology for VAT assignment is helpful for business; the Scottish and UK Governments have agreed that requiring businesses to report their VAT separately for Scotland and the UK would impose an unwanted administrative burden.
- In essence, VAT assignment is a funding mechanism, designed to bring further linkage to the Scottish economy. Although it may bring significant revenue, the Scottish Government will have no direct levers to exercise in relation to its amount.
- It is encouraging to note that included in the Scottish Government's legislative programme for 2018/19 is a pledge to reform the way in which devolved tax decisions are planned, managed and implemented. It is hoped this will be put in place as soon as possible.
- A five-year roadmap setting out the objectives of Scottish tax policy would be helpful: this should provide clarity of purpose and tie in with the Scottish Fiscal Framework. Transparency of data and the link between Scottish tax receipts and the operation of the Fiscal Framework will be crucial if the public are to maintain faith in the process.

*The Fiscal Framework sets out the timetable to implement the full exercise of the devolved tax powers in the Scotland Act 2016 – these were intended to be in place by 2020 – and the tax powers are designed to ensure that half of the Scottish Government's resource budget is determined by taxes devolved or assigned to Scotland. In last year's Budget the Scottish Government took bold steps with the income tax powers – but has the course been set or is there to be further change? Assigned VAT is also expected to contribute significantly to Scottish revenues but what does this mean in practical terms? And what has happened to air departure tax? The following chapter discusses these questions and related operational aspects and is designed to inform the debate in relation to the forthcoming Budget.*

## **2.1 Introduction**

With the rollout of the full package of devolved tax powers by 2020 an estimated £22bn of annual tax revenue will be raised in Scotland, representing around 50% of the devolved Scottish Budget. The Scottish Government has reorganised its finance function with a dedicated taxation resource with the appointment of a Minister for Public Finance and the Digital Economy, and the establishment of a post of Director of Taxation, and this is to be welcomed. So, what are the options for the next Budget?

A word of caution is needed at the outset because whilst it may appear as though there is significant control of Scottish revenue raising, the practical realities may be limited – and more so than anticipated at first sight. There are practical limitations in that VAT assignment does not offer direct controls over the amounts collected; revenues from the fully devolved taxes LBTT and SLfT are limited in amounts; the devolved taxes ADT and aggregates levy are on hold due to EU state aid issues; and the potential to have income tax that diverges significantly from the UK rates and bands may be constrained by both political considerations and potential behavioural changes. The headline of having control of around 50% of revenues has significant practical restraints around it.

Devolution has introduced new opportunities but also new complexities, with associated practical and administrative issues that should be evaluated and addressed when setting the 2019/20 Budget. There are many moving parts to manage with the interaction with the UK Budget, understanding how the block grant adjustments work, and the politics of managing perceptions. In this Budget what taxpayers will seek is a clear articulation of the Scottish Government's ongoing direction of travel with tax policy and how it will build upon the income tax measures in last year's Budget. ICAS continues to call for minimum complexity,

maximum transparency, and pro-active collaboration between the Scottish and UK Governments to ensure that the two tax systems operate cohesively.

This chapter focuses on the taxes devolved in the Scotland Acts of 2012 and 2016, which are a number of transactional taxes, VAT assignment, and the income tax rates and bands. There is a discussion about the potential to design and raise new taxes in Chapter 6.

### Box 2.1: The Scottish Budget 2019/20 – which taxes are relevant?

#### Taxes that are already operational:

Land and Buildings Transaction Tax – maintain or change the rates? (2017/18 £546m)

Scottish Landfill Tax – maintain or change the rates? (2017/18 £149m)

Scottish Income Tax on non-savings, non-dividend income – rates and bands need to be set for 2019/20 (2017/18 £10,890m)

#### Taxes that are expected to become operational:

VAT – expected to be assigned from April 2019 on a transitional basis (2017/18 £5,073m)

Air Departure Tax – ready to be implemented but when will the state aid issues be resolved? (2017/18 £275m)

Aggregates Levy – awaits the clearance of state aid issues before proceeding (2017/18 £57m)

Source – GERS <https://www2.gov.scot/Topics/Statistics/Browse/Economy/GERS> , Chapter 4

## 2.2 A Scottish approach to taxation

Scottish taxes do not sit in isolation – they are interwoven with the UK tax regime so it is important that there is a clear understanding of the connections and constraints which this imposes. On the one hand, there is a seemingly automatic reaction by the public to compare any devolved tax measure with that in the rest of the UK (rUK) and, on the other hand, the purpose of devolving taxes is to permit a different tax regime that may be tailored to Scottish circumstances. Because of this tension, it is important the Scottish Government sets out why specific measures have been proposed, particularly if the broader objectives are to grow the economy.

There is also a need to be mindful of the way in which 'rest of UK' tax measures may impact on the Scottish options. It has been helpful having the UK Budget on 29 October 2018 so that the Scottish Government now knows what is proposed by the UK Government and therefore can evaluate its options.

The earlier than expected introduction of the £12,500 personal allowance, a reserved matter and outwith Scotland's control, will make a significant difference to the amount of non-savings, non-dividend income which is capable of being taxed in Scotland. Each Scottish taxpayer will receive an increase in their personal allowance by £650 in 2019/20; reducing the amount of their non savings, non dividend income on which the Scottish Government may levy Scottish income tax.

UK Budget measures have varying consequences for Scottish funding – depending on how they are implemented. For example, if the Chancellor had increased income tax this would be levied only in rUK because Scotland sets its own rates and bands; whereas if, say, national insurance is increased this would be across the UK and a 'Scottish' proportion then reflected in the Barnett Formula. It is therefore vital that there is close liaison between the relevant Governments to implement any potential tax increases smoothly, having considered potential consequences. It is in no-one's interests to have surprises emerging and we welcome the timing of the UK Budget in relation to the forthcoming Scottish Budget.

In recent UK Budgets there have been several measures impacting on stamp duty land tax, each of which has then been mirrored in LBTT – for example, the additional dwelling supplement and the first-time buyer relief – and this begs two questions. If it is thought necessary to mirror such measures in the Scottish legislation has there been adequate intergovernmental liaison to ensure smooth implementation in both jurisdictions? More fundamentally however, is this what is wanted, or should there be a more distinct Scottish path?

Building in differentials between tax systems may lead to concerns that this opens the way for tax planning or avoidance and so there may be a tendency to opt for the same or similar measures. But it does not bring a distinct approach, nor may it necessarily be best suited to longer term Scottish interests, so such decision making should be made against a considered framework. The Scottish Parliament's Finance and Constitution Committee instigated an inquiry into 'a Scottish Approach to Taxation' at the beginning of the current parliamentary session, however this inquiry has yet to report. This is a valuable line of inquiry and the Committee should be encouraged to finalise it and set out a framework in which decisions about a Scottish approach to tax policy can be made.

Last year, the Scottish Government issued a [paper](#) 'The role of income tax in Scotland's Budget' prior to the Scottish Budget containing a number of options for exercising its income tax powers, followed by a series of round table discussions. This was a most constructive and helpful exercise. The options were laid out and discussed and this helped inform the

decision-making in the Budget. Whilst this may not be a necessary step each year for setting income tax rates and bands, it is a process that is highly recommended should there be any proposals that are substantively new or might be contentious, for instance if there is a need to raise significant further funds for the NHS or if there is a desire to consider whether there are new taxes that could be designed, as discussed further in Chapter 6.

As the full suite of tax powers come into operation in Scotland it is important that this is done within a coherent framework – both within a Scottish approach to taxation and, more broadly, in its interaction with the UK tax system.

## 2.3 Scottish Income Tax

The Scotland Act 2016 provided for Scottish income tax, which allows the Scottish Parliament to set whatever rate or rates of income tax it may wish to levy on the non-savings, non-dividend income of Scottish taxpayers and, if more than one rate, the income bands at which these are to be charged. Scottish income tax was implemented on 6 April 2017 and its profile has been raised as the differentials between north and south of the border have increased across thresholds and rates, and from one year to another. Already there is speculation about the higher rate threshold for Scottish income tax following the increase announced for the rest of the UK in the UK Budget on 29 October (with the rUK threshold now set at £50,000 for 2019/20).

**Table 2.1:** SIT take home pay in 2018/19

Earnings	Scottish Tax Liability in 2018/19	Difference in Scotland between 2017/18 and 2018/19	Difference with the rest of UK for 2018/19
£15,000	£610	£90 more in your pocket in 2018	Scots £20 better off
£24,000	£2,410	£90 more in your pocket in 201	Scots £20 better off
£26,000	£2,830	£70 more in your pocket in 2018 (UK personal allowance increase)	Scots no better or worse off
£30,000	£3,670	£30 more in your pocket in 2018	Scots £40 worse off
£33,000	£4,300	No difference	Scots £70 worse off
£60,000	£13,284	£184 less in your pocket in 2018	Scots £924 worse off
£90,000	£25,584	£484 less in your pocket in 2018	Scots £1,224 worse off

Source: ICAS analysis

## Setting the income tax rates and bands for the tax year 2019/20

There are clearly different factors to consider when setting the income tax rates and bands. First, balanced against how much total revenue is needed, income tax offers the Scottish Government the greatest scope to increase or decrease the tax charge for Scottish taxpayers. Second, the direction of travel with five bands and a more progressive charging structure was set last year and the Government may want to confirm this. It may also want to take this further and could do so by, say:

- Changing the rates at which tax is charged and/or;
- Widening or narrowing particular rate bands and/or;
- Leaving some thresholds unchanged (fiscal drag is always an easy policy option).

In considering these options, there are operational aspects that should be evaluated – ease of collection of tax is paramount and the need to use PAYE and other HMRC systems is crucial in achieving this. Scottish income tax is a partially devolved tax: the Scottish setting of rates and bands needs to slot into the UK income tax framework. Hence, bringing in five income tax bands in one part of the tax system makes its interaction with other parts of the income tax system burdensome. This creates an administrative burden – for example in requiring new software for payroll, or in making it difficult to obtain reliefs at the correct rate.

*Relief at source*<sup>5</sup> is a way of giving tax relief on contributions a member makes to their pension scheme and the basic rate is key for giving relief at source. It is also key for withholding tax at source. With the introduction last year of five bands, the Scottish basic rate now applies to a band of income between £13,850 and £24,000 whilst new rates of 19% and 21% were introduced above and below this. This has led to issues around giving tax relief at the correct rate, affecting pension tax relief in the main, but also with other anomalies or complications arising on items such as Gift Aid tax relief, mortgage interest tax relief, deficiencies relief, taxation of state pension lump sums and the basic earnings assessment for childcare.

The UK and Scottish Governments have sought practical solutions to address these issues. For instance, HMRC prepared three technical notes<sup>6</sup> in May 2012, December 2014 and November 2016 on the interaction of Scottish income tax and the wider income tax regime,

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<sup>5</sup> <https://www.gov.uk/guidance/pension-administrators-reclaim-tax-relief-using-relief-at-source>

<sup>6</sup> <https://www.gov.uk/government/publications/clarifying-the-scope-of-scottish-income-tax-powers>  
<https://www.gov.uk/government/publications/clarifying-the-scope-of-the-scottish-rate-of-income-tax-technical-note>  
<http://webarchive.nationalarchives.gov.uk/20140603114240/http://www.hmrc.gov.uk/news/technote-scot-taxrate.pdf>

notably in relation to Gift Aid, pensions and trusts, providing practical guidance on these matters.

In relation to charitable donations the challenges are somewhat in abeyance for the time being, as the UK Government's position is that charities should reclaim Gift Aid at the UK basic rate. There is a theoretical risk<sup>7</sup> at the margins as someone paying tax at the starter rate may not have paid enough tax to cover a Gift Aid claim made on their donation at the UK basic rate.

The practical challenges for pension arrangements operating on a relief at source basis are more of a concern. Following the 2018/19<sup>8</sup> Scottish rate resolution, HMRC issued practical and helpful guidance addressing the issues of tax relief. Nevertheless, the introduction of the intermediate band of 21% means that to take advantage of the full tax relief available to them more Scottish taxpayers will need to claim it through Self-Assessment, or if not a Self-Assessment taxpayer, HMRC expects them to write in to claim the relief. It remains to be seen how many actually understand they need to do so or whether any corresponding adjustment is correct. Few taxpayers understand the intricacies of an adjustment through a PAYE code.

These measures have been addressed in a practical manner in relation to 2018/19 but the fundamental problems described at paragraph 16 above of how tax rates and bands set in Scotland interact with other parts of the UK tax system are not fully resolved, and the issues may re-emerge if rates diverge further. Decisions around rate-setting and thresholds in the short term need to be mindful of these practical and administrative aspects of tax collection. In the longer term they may need addressing at a UK level. (For a fuller discussion see the ICAS/CIOT paper 'Devolving Taxes across the UK: Learning from the Scottish Experience'<sup>9</sup>.)

*The threshold at which higher rate tax is payable:* if it is decided to continue the policy of limiting increases in the higher rate threshold relative to rUK, as has happened in the past two years, this will continue to disadvantage some Scottish taxpayers' claims to Marriage Allowance. This UK-wide allowance is tied to the basic rate as a form of means-testing, and whilst amendments to UK legislation were made last year to enable any Scottish taxpayer on starter, basic or intermediate rates to be eligible, the allowance remains more restricted for Scottish taxpaying couples. This arose in 2017/18 because the higher rate threshold for

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<sup>7</sup> HMRC can reclaim underpaid Gift Aid from the taxpayer, as is the case generally throughout the UK.

<sup>8</sup> <https://www.gov.uk/government/publications/pension-schemes-relief-at-source-for-scottish-income-tax-newsletter-february-2018>

<sup>9</sup> [https://www.icas.com/\\_data/assets/pdf\\_file/0012/388497/Devolving-taxes-across-the-UK.pdf](https://www.icas.com/_data/assets/pdf_file/0012/388497/Devolving-taxes-across-the-UK.pdf)



Scottish taxpayers was £43,000, compared with £45,000 in rUK, became more acute in 2018/19 with higher rate thresholds of £43,430 and £46,350 respectively, and will no doubt be a consideration with the rUK threshold being set at £50,000 for next year. The number of couples likely to be affected is not thought to be high but the issue illustrates the difficulty of UK policy measures (which are expected to be uniform) using the tax system to target allowances when the relevant threshold to which it is tied differs across the UK.

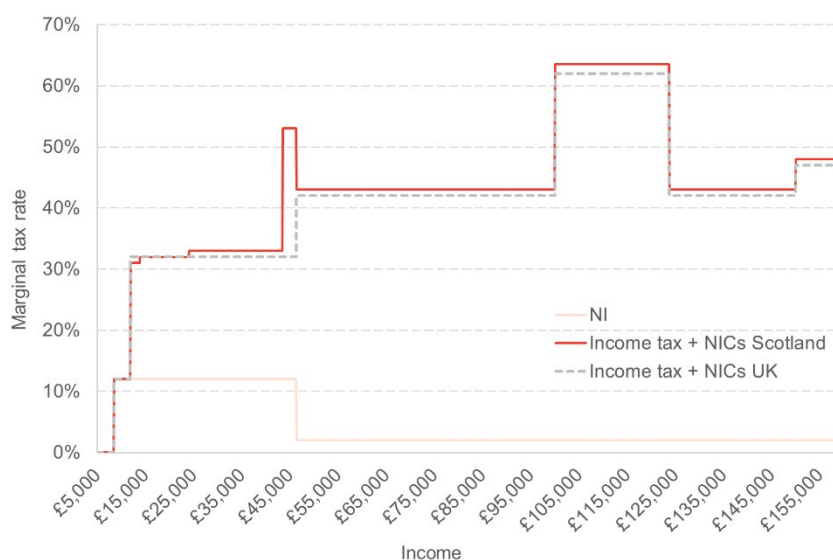
**Table 2.2:** Divergence in income tax higher rate thresholds

	2017/18	2018/19	2019/20
Rest of UK	£45,000	£46,350	£50,000
Scotland	£43,000	£43,430	tbc

Source: ICAS analysis

Concerns also arise in the interaction of thresholds for income tax and national insurance. The NICs upper earnings limit in 2018/19 was increased across the UK in line with the rUK higher rate threshold for income tax, so Scottish taxpayers who are employees with earnings between the two higher rate thresholds of £43,430 and £46,350 suffer a combined marginal rate of 53%, being 41% income tax and 12% NICs (and compared to 32% in the rest of the UK). On self-employed earnings the combined marginal rate is 50%. The UK Budget on 29th October 2018 proposes to retain the alignment of rUK higher rate income tax threshold and the NIC upper limit.

**Chart 2.1:** Marginal rates of income tax plus national insurance, Scotland and rUK



Source: ICAS analysis

With different jurisdictions having different responsibilities, the presentational elements may change as either Government seeks to distance itself from the burden of taxes for which it is not responsible. For example, a Scottish presentation of what income tax is for, and what NIC is for, might suggest a greater element of hypothecation with NIC going towards state pensions and other reserved benefits, whilst Scottish income tax aligns with Scottish Government spending responsibilities. Clarity is required about income tax being devolved, whilst national insurance remains reserved and, therefore, different Parliaments making decisions in relation to each.

**Tax increases and tax mitigation:** wherever there are differentials there is scope for tax planning. Whether it is worthwhile to the taxpayer concerned is more difficult to predict but, of course, the wider the differentials the more attractive tax planning may become.

For those who are Scottish taxpayers, and with a partially devolved tax, consideration needs to be given to 'Scottish income' (broadly, earnings from employment, self-employment, pensions and rentals) and its interaction with other income (savings and dividends). This may particularly be the case if choices around devolved tax policy lead to a further divergence in income tax between Scotland and the rUK.

The impact of any changes in the rates of income tax in Scotland need to be set in context against UK taxes and trends, such as the ability to change between types of income and between income and gains. A business owner may choose to operate as a sole trader (unincorporated and profits liable to income tax) or via a company (incorporated and profits liable to corporation tax). This taxpayer choice can determine some of the tax outcomes so that the main taxes cannot be considered in isolation, nor in this debate can income tax be viewed separately from other policies or matters such as NICs and capital gains tax. A hypothetical case study is set out below by way of illustration.

**Box 2.2. Example: Profit extraction from an owner managed company by the owner, 2018/19**

A company is solely owned by Mr Smith and has taxable profits (before any salary is paid to Mr Smith) of £50,000 for the year ended 31 March 2019. Mr Smith has decided to either pay himself a salary or extract funds via a dividend to the fullest extent that he can. He has no other income for the year; he is a Scottish taxpayer.

**Note:** if the company has profits of £50,000 it cannot pay all of this as salary or it would be unable to pay the employer's NIC.

	£	£
<b>Salary</b>		
Salary must be no more than	44,958	
Employer NIC	<u>5,042</u>	
	<u>50,000</u>	
<b>Dividend</b>		
Profit before tax	50,000	
Less: corporation tax @ 19%	<u>(9,500)</u>	
Amount available to distribute as dividend	<u>40,500</u>	
<b>Tax Payable</b>	<b>Salary</b>	<b>Dividend</b>
	£	£
Salary/dividend	44,958	40,500
Less: personal allowance	<u>(11,850)</u>	<u>(11,850)</u>
Taxable income	<u>33,108</u>	<u>28,650</u>
NSND income tax payable:		
First £2,000 @ 19%	380	
Next £10,150 @ 20%	2,030	
Next £19,430 @ 21%	4,080	
Next £1,528 @ 41%	626	
S&D income tax payable (at UK rates)		
Dividend		
£2,000 at 0%		0
£26,650 @ 7.5%		<u>1,998</u>
National insurance (employee)		
(44,958- 8,424) @ 12%	<u>4,384</u>	
Total tax payable	<u>11,500</u>	<u>1,998</u>
<b>Net cash position (income less tax)</b>		
£44,958-11,500	<u>33,458</u>	
£40,500-1,998		<u>38,502</u>

The difference is £5,044 additional cash in hand using dividends (decision making could be influenced by matters such as potential pension contributions etc). This is primarily the result of UK tax policy but Scottish income tax rates may further influence decision making, particularly if they become higher.

Any taxpayer who views a tax bill as an unwanted cost will seek to minimise this and so divergent rates across income tax (Scottish and UK), corporation tax and capital gains tax lend themselves to tax planning behaviours such as business incorporation by an individual who wishes to be paid in dividends rather than a salary.

When some elements are devolved, this opens the way to greater complexity, wider differentials and therefore potential planning if tax burdens are increased in one jurisdiction or reduced in the other. For instance, if Scottish income tax becomes significantly more expensive (and it is not clear where the behavioural tipping point might be), taxpayers may seek to convert sources liable to Scottish income tax into something else that is liable to, say, UK income tax, corporation tax or capital gains tax. Both corporation tax and capital gains tax are reserved taxes so any increase in receipts will flow to Westminster, as would be the case with receipts from UK income tax, with a corresponding decrease in Scottish income tax.

By way of illustration, if income tax rises by 1p and a basic rate taxpayer decides to incorporate and pay himself a salary up to the UK personal allowance and the rest in dividends, Scotland loses not only the 1p income tax increment, but also the 20p income tax the taxpayer would otherwise have paid into the Scottish purse.

### **Box 2.3. Example: Sole trader versus company tax position, which exchequer benefits?**

#### **Sole trader – income tax and NIC, Mrs Brown, Scottish taxpayer 2018/19**

Mrs Brown's business has taxable profits of £43,430. As a sole trader (or as a partner in a partnership business), she pays Scottish income tax and UK national insurance.

Mrs Brown's top rate of income tax is 21%. She also pays UK NICs Class 4 at 9% and Class 2 NICs at £2.95 a week (£153.40 pa).

**If Mrs Brown earned an additional £1 or more, the income tax on this NSND income would be paid as Scottish income tax and received by the Scottish Government.**

**Company – Brown LTD – owned by Mrs Brown, Scottish Taxpayer 2018/19**

If Mrs Brown runs her business through a limited company and takes out all the £43,430 profit, with a salary just below the NICs threshold and the balance as dividends, she **would have no earnings liable to Scottish income tax.**

The amount paid out as dividends would be after corporation tax had been paid at 19%. The dividends would be taxed at the UK zero rate and then dividend basic rate of 7.5%.

None of the income tax paid would reach the Scottish purse as dividends and savings are not devolved to Scotland.

**If Mrs Brown earned an additional £1 or more, the corporation tax and dividend income tax would be paid to the UK exchequer.**

It remains to be seen what, if any, impact divergent income tax rates might have. The changes to 2018/19 rates and bands appears to have had little behavioural impact on individual Scottish taxpayers but there will always be behavioural challenges to the tax base if there are significant differences in tax costs. This is driven by cost management – why pay more than you must?

There is also the issue of whether Scotland is now portrayed as ‘expensive’ and, alongside the tax equalisation packages put in place by the MoD<sup>10</sup>, there is anecdotal evidence that higher rates may be a disincentive when employers seek to recruit from outside Scotland, particularly for higher-paid, professional staff.

## 2.4 VAT – an assigned tax

### Box 2.4. VAT assignment

- Key legislation is in the Scotland Act 2016.
- To be effective from 2020/21 but with a transitional year commencing 2019/20.
- VAT across the UK will continue to be administered by HMRC.
- 2017/18 – estimated on historical revenues - £5,073m

<sup>10</sup> <https://www.gov.uk/government/news/military-personnel-in-scotland-protected-from-tax-hikes>

The Smith Commission reported in November 2014 and<sup>11</sup> recommended that:

*'84. The receipts raised in Scotland by the first 10 percentage points of the standard rate of Value Added Tax (VAT) will be assigned to the Scottish Government's budget. These receipts should be calculated on a verified basis, to be agreed between the UK and Scottish Governments, with a corresponding adjustment to the block grant received from the UK Government in line with the principles set out in paragraph 95 [fiscal framework and 'no detriment'].*

*85. All other aspects of VAT will remain reserved.'*

The Scotland Act 2016, section 16<sup>12</sup> provides the legislative requirements for VAT assignment: so 10p in the standard rate and also the first 2.5p of the reduced rate, of VAT is to be assigned to the Scottish Government. The methodology identifying the amount to be assigned was to be agreed by the Treasury and the Scottish Ministers, and the principles of this are laid out in the Fiscal Framework; however, this has proved easier said than done. It is due to apply from April 2019 but the methodology of doing so has at the time of writing still to be agreed.

The Framework<sup>13</sup> states that...

*41. The assignment of VAT will be based on a methodology that will estimate expenditure in Scotland on goods and services that are liable for VAT. The full details of the VAT assignment methodology will be jointly developed and agreed by both HMRC and Scottish Government officials. Once completed and agreed by officials, the assignment methodology and operating arrangements will be presented for joint ministerial sign-off at a future meeting of the Joint Exchequer Committee. The JEC will also agree arrangements for production of VAT revenue forecasts.*

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

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<sup>11</sup> <http://webarchive.nationalarchives.gov.uk/20151202171017/http://www.smith-commission.scot/> paras 84 and 85

<sup>12</sup> <http://www.legislation.gov.uk/ukpga/2016/11/section/16/enacted>

<sup>13</sup> <https://www.gov.scot/publications/agreement-between-scottish-government-united-kingdom-government-scottish-governments-fiscal/pages/0/>

Using an extrapolation methodology is helpful for business; the Scottish and UK Governments have agreed that requiring businesses to report their VAT separately for Scotland and the UK would impose an unwanted administrative burden.

Of note, however, is that the assignment of VAT does not require any direct decisions to be made in the Scottish Budget. The power to set VAT rates remains reserved to the UK Government. This means that the Scottish Government has no direct influence over the amount of VAT assigned to Scotland. The rationale for this assignment is to provide revenues that are tied to the Scottish economy but the potential to impact the Scottish Budget depends upon a 'broad strokes' picture of whether the Scottish economy outperforms or underperforms in comparison to rUK.

Initially the benefit of the VAT assigned to Scotland will be counterbalanced by a corresponding reduction in the block grant and the first year is planned as a transitional year only. In due course, if the Scottish economy subsequently outperforms rUK, it will see some benefit from assigned VAT in future years. As a stronger economy with higher spending, the share of VAT to be assigned to it will be increased. The opposite applies if it underperforms relative to rUK.

At this stage of Brexit negotiations there is no clarity of what changes to VAT, if any, will be required post Brexit. At one end of the spectrum, if a deal is struck for the UK to remain within the EU VAT union, then there will be minimal change. Under the current regime, the Scottish Government cannot alter the rates of VAT in Scotland or make VAT focussed attempts to drive economic growth. The Preamble to the relevant EU legislation states: 'The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition, such that within the territory of each Member State similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.'<sup>14</sup> At the other end, there could be a total break such that it would be within the UK Government's powers to totally reshape VAT. And, unless the Scotland Act 2016 powers are changed after Brexit, this source of 'Scottish tax' will continue to be UK based with a proportion of the receipts assigned to Scotland.

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<sup>14</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0112&from=EN> preamble para 7

VAT assignment is a funding mechanism, designed to bring further linkage to the Scottish economy. Although it may bring significant revenue, the Scottish Government will have no direct levers to exercise in relation to its amount.

## **2.5 Scottish devolved taxes: Land and Buildings Transaction Tax and Scottish Landfill Tax**

Two fully devolved taxes will continue to provide sources of funding for the Scottish Government in 2019/20. These are Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT).

LBTT has been notable in that since its commencement in April 2015 there have been several changes to it. These have included:

- A new charge to tax – additional dwelling supplement
- A new relief – first-time buyer relief, and
- Removal of anomalies – for example around group relief.

And there remain further potential changes in the pipeline, such as seeding relief, which is a 100% relief from LBTT for the 'seeding' (initial transfer) of properties into an authorised Property Authorised Investment Funds and Co ownership Authorised Contractual Schemes, and would mirror relief available in the rest of the UK SDLT provisions.

A key issue is that there is no regular process for bringing forward and considering such changes, and it would be helpful if there was. There is also a need for 'care and maintenance' measures in the existing tax law so that, if stakeholders such as Revenue Scotland find parts of the legislation do not work as intended or the legislation does not work as taxpayers require from a commercial perspective, there is an opportunity to revisit the law. To date, possible amendments to tax law have been raised on an ad hoc basis.

An annual UK Budget is needed because income tax is an annual tax – it must be enacted every year. In Scotland there is no such requirement, other than for an annual Scottish rate resolution setting the income tax rates and bands. This limited annual tax procedure, combined with a Budget focused on public spending, is not enough. To maintain and improve Scottish taxes a broader, regular, formal, parliamentary process is needed. It is encouraging



to note that included in the Scottish Government's legislative programme for 2018/19 is a pledge to reform the way in which devolved tax decisions are planned, managed and implemented<sup>15</sup>. It is hoped this will be put in place as soon as possible.

It is highly desirable that any process to implement tax change will be enacted in primary legislation. To date, there has been a tendency to use secondary legislation in the form of Scottish Statutory Instruments instead of primary legislation, such as with the most recent LBTT Group Relief (No.222) and First Time Buyer relief (No.221) orders of 2018. ICAS does not believe that this is an appropriate way to exercise tax powers because it lacks both visibility and active parliamentary consideration. This should encourage full debate about likely repercussions of changes, such as administrative costs to businesses of updating systems – a factor often under-estimated.

## **2.6 Scottish devolved taxes: Air Departure Tax and Aggregates Levy**

Air Departure Tax (ADT) is third in the line-up of Scottish devolved taxes but is currently 'on hold'. The legislation is in place: the Air Departure Tax (Scotland) Act 2017 has received Royal Assent on 25 July 2017 and was designed to replace the UK levy Air Passenger Duty (APD) from April 2018. The tax, as with APD now, will be payable by aircraft operators and charged on the carriage of chargeable passengers on chargeable aircraft on any flights that begin at airports in Scotland.

The delay in implementation is due to state aid rules. Passengers carried on flights from airports in the Scottish Highlands and Islands have been exempt from APD since 2001, but transfer of the exemption to the new Air Departure Tax requires notification to and assessment by the European Commission in compliance with EU law. Issues remain with state aid, which is public assistance given to undertakings on a discretionary basis, having the potential to distort competition and affect trade between member states of the EU. Combined with Brexit-related uncertainties, it is unclear when ADT will be introduced.

In June 2018 the Scottish and UK Governments agreed that it would not be possible to introduce ADT in April 2019 – the beginning of the next fiscal year. Instead, APD at the UK rates and bands, with the Highlands and Islands exemption, will continue to apply in Scotland

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<sup>15</sup> <https://www.gov.scot/publications/delivering-today-investing-tomorrow-governments-programme-scotland-2018-19/> page 61

until further notice. Until a suitable solution is found which produces no financial detriment to the Highlands & Islands region, it seems that ADT will remain in the hangar.

The implementation of a Scottish Aggregates Levy also remains on hold due to state aid issues that have yet to be fully resolved.

## 2.7 Conclusion

In last year's Budget the Scottish Government took certain decisions around Scottish income tax rates and bands. ICAS calls for a more cohesive approach, suggesting that the Scottish Government now needs to map out its future direction of travel on tax policy to create stability of expectation and certainty for Scottish businesses and taxpayers.

A five-year roadmap setting out the objectives of Scottish tax policy is required to provide clarity of purpose and tie in with the Scottish Fiscal Framework. This could show what the Scottish tax landscape might look like in five years' time; to what extent is each tax being levied to raise funds or direct certain behaviours; and how tax policy is being designed to encourage economic growth or achieve other social ends.

To maintain and improve Scottish taxes, the limited annual procedure of a Scottish rate resolution combined with a Budget focused on public spending is not enough. A broader, regular, formal, parliamentary process is needed.

Open and effective public consultation of the kind engaged in last year on 'The role of Income Tax in Scotland's Budget' is a process that is highly recommended should there be any tax proposals that are substantively new or might be contentious.

A key element of tax policy should be, where possible, to enhance and support the Scottish economy: at the very least, measures should not add to the complexity of doing business in Scotland and should not put Scottish businesses at a competitive disadvantage.

## The ICAS role

The Institute of Chartered Accountants of Scotland (“ICAS”) is the oldest professional body of accountants. We represent over 21,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK or in almost 100 countries around the world.

ICAS has a public interest remit – a duty to act not only for its members but for the wider public good. Our technical experts work in a positive and constructive manner to advise policy makers on legislation and to raise issues of importance to our members, individual taxpayers and business alike.

Taxation is one such area of importance and ICAS has contributed, and will continue to contribute, to tax policy in Scotland, the UK and beyond.

### **The Tax Board’s objectives in establishing its policy positions are to:**

- act in the public interest
- provide constructive input to the authorities, and
- represent ICAS members, affiliates and students’ interests.

## The ICAS Tax Board

Within the ICAS governance structure, the Tax Board reports to the Policy Leadership Board, which reports directly to the Oversight Board and to the ICAS Council.

The Tax Board has oversight of five Committees, each of which has responsibility for a certain area of tax and these are:

- Indirect taxes
- International and large business taxes
- Private clients (capital taxes)
- Scottish taxes
- Owner managed business taxes

***Members of the Tax Board and the Committees act in a personal capacity and do not represent the views of their firms.***

# The Scottish Government's resource budget: an end to austerity?

- The outlook for Scotland's resource block grant has improved significantly since this time last year. It had been on course to fall by over one per cent between 2018/19 and 2019/20, but subsequent spending decisions of the UK Government mean it will now increase slightly. The outlook for subsequent years has also improved, with the block grant now set to grow by 3% over the remaining three years of the parliament.
- However, the outlook for Scotland's income tax revenue has deteriorated. At budget 2018/19, Scottish revenues were forecast to raise over £400m more than the income tax Block Grant Adjustment (BGA), due to a combination of tax policy and growth in the Scotland's tax base. But by May 2018, this forecast had changed significantly, resulting in a deterioration in the outlook of around £400m.
- These forecast revisions do not affect the 2018/19 budget. However if the SFC maintains such a pessimistic outlook it will impact on the 2019/20, acting to offset some of the increase in the block grant in 2019/20.
- The Scottish Government has used its income tax powers in each of the last two budgets to raise additional revenue. The changes have been progressive across the income distribution, with the highest earning 14% of Scottish income taxpayers seeing the largest increase in average tax rate.
- More significantly the government has altered the structure of the income tax system in Scotland with different thresholds, tax rates and bands. This year, the debate is likely to focus on the extent to which the government should or should not follow UK policy and increase the Higher Rate threshold by significantly more than inflation.
- The latest forecasts imply that Land and Buildings Transactions Tax (LBTT) and Landfill Tax will contribute marginally to revenue growth over the next few years. The timing of the assignment of VAT, and devolution of Air Passenger Duty remain subject to significant uncertainty.
- Overall, the government's resource budget will be around 4% higher at the end of the parliamentary term than it was back in 2016. But it will still be below the peak of 2010/11, and on a per capita basis it will have grown by only 1% over the course of this parliament.
- So whilst austerity may be ending, the outlook for the public finances remains challenging.

*When, in December 2016, the Scottish Government set out its first budget of this parliamentary session, the outlook for its day-to-day resource budget was extremely challenging, with real terms cuts of 3.1% pencilled in over the period to 2019/20. But the Chancellor has now promised that “the era of austerity is finally coming to an end”. At the same time, the Scottish Government has sought to raise additional revenues through its new income tax powers but recent headlines have drawn attention to a deterioration in the forecasts for Scottish income tax receipts. So has austerity ended? And what is the size of the envelope that Mr Mackay is likely to have at his disposal this December?*

### **3.1 Introduction**

Budget 2019/20 will mark the mid-point of this parliament.

When the Scottish Government set its first budget of this parliamentary session, in December 2016, the outlook for the resource budget was particularly challenging. The block grant from Westminster, which remains the key determinant of the government's spending power, was set to fall in real terms by 3.1% between 2016/17 and 2019/20.

Such cuts would have been challenging in their own right. But this outlook followed on from real terms cuts to resource spending of around 6% between 2010/11 and 2016/17 - bringing the total expected cut over the period to 2019 to around 8% (£2.3bn).

Faced with such an outlook, the Cabinet Secretary for Finance responded by using Holyrood's new income tax powers in both 2017/18 and 2018/19. These changes – which included adding a penny to the higher and additional rates of tax, freezing the rate at which the higher rate becomes payable, and introducing a new intermediate rate of tax at 21p – were anticipated to raise over £300m together (in 2018/19), compared to what would have been raised had he instead simply matched UK Government policy.

Since then, the UK Government has announced plans for a substantial tax cut for higher rate taxpayers. The Scottish Government will be under pressure from some quarters to follow suit – at least to a degree – although securing parliamentary support for such a move will be difficult.

The original outlook has also been improved by a series of spending increases in England, which have generated 'consequential' increases to the Scottish budget in 2017/18 and 2018/19.

Most significantly, at the UK Budget last month, the Chancellor confirmed substantial spending increases on the NHS in England from 2019/20 onwards, which will generate further consequentials for the Scottish budget.

But against this, forecasts have suggested that Scottish tax revenues may be lower than forecast this time last year.

So has the outlook improved or worsened since the start of the parliamentary session, and what factors have influenced this? Is austerity over, and on what basis? What uncertainties remain and how can they be managed?

In the following section we describe how the various components of the Scottish resource budget fit together; Section 3 sets out the outlook for the block grant; Section 4 describes the evolving outlook for income tax; Section 5 discusses the Scottish income tax policy choices made in the last two budgets, and options for further change; Section 6 discusses the outlook for LBTT and Landfill Tax and Section 7 provides an update on the transfer of the remaining Scotland Act 2016 tax powers.

Finally, Section 8 brings all of this information together to provide an overall outlook for the Scottish budget.

## **3.2 The components of the Scottish resource budget**

The Scottish Government's resource budget – the budget for day-to-day public services – is determined by three components.

1. The block grant from Westminster: this block grant – determined by the Barnett Formula – shapes the overall size of the resource budget.
2. The adjustments that are made to this block grant to account for the revenue streams that have been transferred to Holyrood in recent years: these are known as the Block Grant Adjustments (BGAs). There is a separate BGA for each tax, so in 2019/20

there will be three BGAs<sup>16</sup>. Each BGA is a measure of the revenues that the UK Government has foregone as a result of transferring the tax to Scotland<sup>17</sup>.

3. The revenues that are actually raised from these taxes in Scotland.

What then matters for the Scottish budget is not simply the size of Scottish tax revenues, but how Scottish tax revenues compare to the BGAs. For example, if Scottish income tax revenues are £11.5bn and the BGA is £11.4bn, then the Scottish budget is £100m 'better-off' than it would have been without the transfer of income tax (and if it relied on the Barnett Formula only). But if the BGA is £11.6bn (with revenues remaining at £11.5bn), the Scottish budget would be £100m 'worse-off' than it would have been without the transfer of income tax<sup>18</sup>.

Broadly speaking, Scottish revenues could be higher than the BGA under two circumstances. Firstly, if the Scottish Government were to set a tax policy that raised relatively more than UK Government policy. Secondly, if some element of the tax base (e.g. wages and employment in the case of income tax) grew more quickly in Scotland than in rUK.

Additionally, from 2018, a range of social security powers are being transferred to Scotland. For each of these, an increase to the Scottish block grant will be made. This will be based on an estimate of the expenditure that the UK Government has foregone as a result of transferring each social security power to Holyrood. In the future, Scottish spending on these new responsibilities could be higher or lower than the uplift to its block grant, depending on the policy position adopted in Scotland and on the growth in demand or need for the expenditure in Scotland relative to rUK.

These then, are the main determinants of the Scottish resource budget: the block grant, and the interaction between revenues raised in Scotland and the BGAs for each of the devolved taxes.

At the margin, the Scottish budget is influenced by various other factors. There is some scope for funding to be transferred across years. Similarly, if there is error associated with

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<sup>16</sup> For income tax, Landfill Tax and LBTT

<sup>17</sup> For an explanation of how the BGAs are calculated, see Eiser (2017) 'A primer on the Scottish Parliament's new fiscal powers' [https://strathprints.strath.ac.uk/61147/1/FEC\\_41\\_2\\_2017\\_Eiser.pdf](https://strathprints.strath.ac.uk/61147/1/FEC_41_2_2017_Eiser.pdf)

<sup>18</sup> Income tax is used as an example but the budget position depends on the sum of all BGAs and devolved taxes.

forecasts for Scottish taxes, some of the difference between the forecast and the outturn revenue is likely to make itself felt in subsequent years.

### 3.3 The block grant

The outlook for the Scottish Government's resource block grant has improved over the past two years (Chart 3.1).

When, in December 2016, the Cabinet Secretary for Finance published the Draft 2017/18 Scottish Budget, the outlook for the block grant looked particularly challenging.

The block grant was expected to increase fractionally in real terms in 2017/18, but then fall by 3.3% over the subsequent two years to 2019/20.

Two things have changed that position:

- First, over the course of 2017, Chancellor Phillip Hammond announced modest spending increases, which generated Barnett consequentials. This meant that by the time Finance Secretary Derek Mackay set his 2018/19 Draft Budget later that year, the outlook for the block grant in 2018/19 had improved by around £300m. The anticipated real terms cut of 1.9% in 2018/19 had reduced to a cut of 0.8%.
- Second, substantial consequentials were announced at the Autumn 2018 UK Budget. The resource budget was uplifted by £123m in 2018/19, and by £720m in 2019/20. The uplift is largely accounted for by additional spending on the NHS in England, originally announced in June to coincide with the NHS' 75<sup>th</sup> anniversary. The associated Scottish consequential of £550m is combined with consequentials associated with increased social care spending (£63m), the introduction of various business rates reliefs in England, (£43m), and various smaller additions (Table 3.1)<sup>19</sup>.

**Table 3.1:** Resource consequentials announced at Budget 2018 (£m)

	2018/19	2019/20
Consequentials	£123	£720

Source: Scottish Parliament Financial Scrutiny Unit

<sup>19</sup> The £550m consequential for health spending was some £50m less than the Scottish Government was expecting, owing to the way in which HM Treasury has calculated the spending baseline.

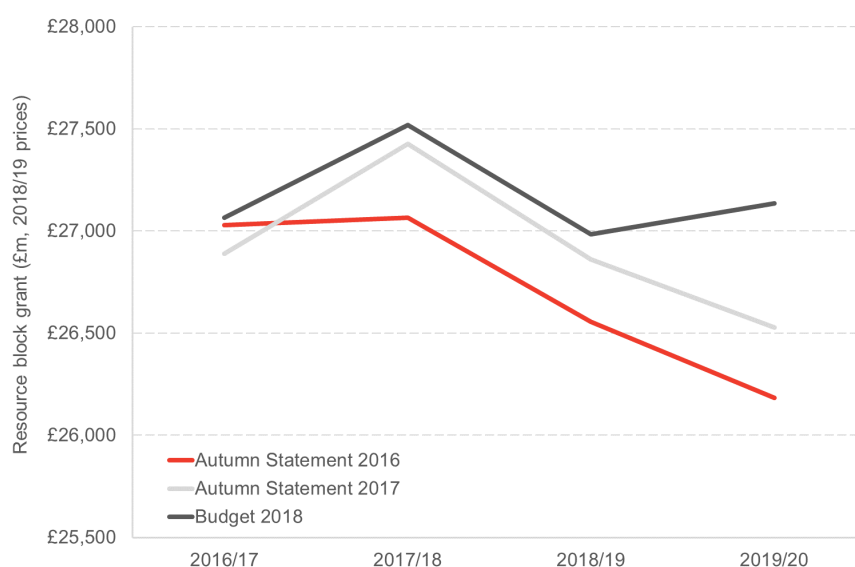


The implication is that the Scottish Government's resource block grant is now expected to increase between 2018/19 and 2019/20 by 0.6%, rather than to fall.

As a result, the resource block grant is expected to be slightly (0.3%) higher in 2019/20 than it was in 2016/17 (Chart 3.1).

By 2019/20 it will be around 5.5% lower in real terms than it was in 2010/11.

**Chart 3.1:** The changing outlook for the Scottish resource block grant



Source: Budget documents, various years. Note: the increase in funding in 2017/18 is largely due to the one-off transfer of £200m to support the implementation of the Fiscal Framework, most of which was placed into the Scotland Reserve. Note also, that changes to the GDP deflators each year account for differences in the size of the 2016/17 budget

In looking further forward, the UK Government has not set-out resource allocations for 2020/21 or beyond and, therefore, the precise level of the block grant for future years is unknown. At a UK level however, the Chancellor announced his intention that departmental resource spending will average 1.2% real terms growth over the next five years.

On the basis of the UK Government's profiled plans for total resource spending, we anticipate the resource block grant to increase by around 1.7% in real terms in 2020/21 and by 1.1% in 2021/22. This will mean that the block grant will be around 3% lower by the end of the parliament than it was in 2010/11<sup>20</sup>.

<sup>20</sup> In comparing the outlook for the Scottish block grant over time, slight differences in quoted figures between us and other analysts can arise, depending on whether the comparison is with budget allocations at the start or end of year, or outturn expenditure, and the precise deflators used.

### 3.4 The evolving outlook for income tax

Revenues from Non-Savings Non-Dividend (NSND) income tax were transferred to the Scottish Parliament in April 2017. The Scottish Government has exercised its tax policy levers in both subsequent budgets.

As set out above, in assessing the overall outlook for income tax what is important is not just the revenues from income tax in Scotland, but the relevant block grant adjustment (BGA).

The difference between Scottish revenues and the BGA depends on both the tax policy choices made in Scotland and the growth of the Scottish tax base relative to the rUK tax base.

When the Scottish Government published its 2017/18 budget, revenues from income tax were forecast to raise £107m more than the income tax block grant adjustment (Table 3.2) - largely explained by the decision to set a lower threshold for the Higher Rate in Scotland<sup>21</sup>.

By Draft Budget 2018/19, the outlook was even more positive (Table 3.2). Scottish income tax revenues were forecast to raise £12.177bn, whilst the BGA was forecast to be £11.749bn, leaving the Scottish budget 'better off' by £428m.

This difference was partly explained by the government's tax policies. The SFC forecast that the Scottish Government's tax policy announcements would raise £219m, relative to a scenario where thresholds had been increased by inflation and there was no change in rates (Scottish income tax policy is discussed further below).

Additionally, the decision of the UK Government to increase the Higher Rate threshold above the rate of inflation meant that the BGA was slightly lower than it might have been had the UK Higher Rate threshold remained constant in real terms (we estimate that the UK Government policy decision reduced the block grant by around £120m compared to a no policy change scenario).

So of the £428m gap between forecast revenues and forecast BGA, around £340m can be accounted for by the divergent tax policies of the Scottish and UK Governments. Implicitly,

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<sup>21</sup> For budgeting purposes, these forecasts remain 'locked-in' until final outturn data for 2017/18 is available in summer 2019, any difference to forecast will be 'reconciled' in Budget 2020/21.

the remaining difference (approximately £90m) stemmed from more optimistic forecasts for how the tax base would grow in Scotland.

However, and as discussed in Chapter 1, things have changed significantly. By the time the government's Fiscal Outlook was published in May 2018, the forecast positive gap between income tax revenues and the BGA had deteriorated markedly. The reason for this was twofold.

- Firstly, the SFC revised down their assumptions about the path of future wage growth in Scotland, and this resulted in a downward revision in its income tax forecasts for Scotland by £208m.
- Secondly, the OBR had moved the other way, deciding that the outlook for the UK had improved. Their upward revision to rUK income tax forecasts drove a £181m *increase* in the BGA.

The effect of these together is that the outlook for the Scottish Budget in 'real time' has deteriorated by £390m (£208m downward revision to Scottish revenues plus £181m upward revision to the BGA). We say 'in real time' because – under the operation of the fiscal framework – such changes do not have an immediate bearing on the actual Scottish budget in 2018/19. The original (higher) forecasts remain 'locked in' until outturn data is available in summer 2020, and it is only from then onwards that any gap will have to be reconciled (Box 1.1).

Of course, such revisions – if they were to continue – will affect the resources available in 2019/20 and beyond. Indeed, compared to the forecasts made in December 2018, the income tax element of the Scottish budget is now forecast to be between £400m and £500m worse off in each of the remaining three years of this parliament (income tax revenues are still forecast to be higher than the BGA, but to a lesser extent than previously).

So, to reiterate, the forecast for the 'net tax' position that the government faces for income tax – the difference between revenues and the BGA – has deteriorated in 2018/19 and 2019/20 since the government set its 2018/19 budget last year. The deterioration in the 2018/19 position however does not (yet) have a material effect on the 2018/19 budget, but it will apply in 2019/20.

What remains to be seen of course is how the most recent forecast position will evolve when the government sets its 2019/20 budget. Our expectation, as outlined in Chapter 1, is that there is likely to be some improvement in the forecasts for Scottish wage growth, but no significant change in the net tax position relative to the May 2018 forecasts.

As discussed in Chapter 1, summer 2018 saw the publication of outturn income tax revenues for Scotland in 2016/17. Outturn Scottish income tax revenues in 2016/17, at £10.7bn, are substantially below previous forecasts (which were £11.5bn in Autumn 2016, and £11.3bn as late as May 2018). It is important to note that these differences have no budget implications. This is because 2016/17 forms the basis of the 'initial deduction' to be made at the time of devolution<sup>22</sup>. However, the difference between the forecasts and outturn does raise important questions for future forecasting and policy-making. The main reason for the discrepancy is that the number of higher and additional rate taxpayers in Scotland turns out to have been lower than indicated by the main survey of income taxpayers, on which forecasts are based.

Specifically, the outturn data shows that there were 13,000 additional rate and 294,000 higher rate taxpayers in Scotland in 2016/17. Previous forecasts had estimated these numbers at 18,000 and 337,000 respectively. The lower than expected numbers of higher and additional rate taxpayers in Scotland is likely to have implications for the revenue effects of some policy choices.

The next set of forecasts – for both Scottish income tax and the BGA – will be lower than the forecasts made earlier in 2018, reflecting the lower outturn. But what remains important for the Scottish budget is the size of the gap between these two elements. Revised forecasts for the BGA will be published by HM Treasury following the Autumn Budget but had not been published at the time writing. The revised Scottish forecasts will be published by the SFC alongside the Scottish budget on 12 December.

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<sup>22</sup> Therefore future forecasts for income tax and the relevant BGA will be revised down by similar amounts.

**Table 3.2:** Recent forecasts for Scottish income tax revenues and BGA (£ million)

	2017/18	2018/19	2019/20	2020/21	2021/22
<b>Forecasts at Budget Bill 2017/18</b>					
Scottish revenues	11,857	12,320	12,943	13,681	14,595
BGA	11,750	12,159	12,672	13,233	13,898
<i>Difference</i>	107	161	271	448	697
<b>Forecasts at Budget Bill 2018/19 (February 2018)</b>					
Scottish revenues	11,584	12,177	12,647	13,152	13,733
BGA	11,523	11,749	12,056	12,477	12,936
<i>Difference</i>	61	428	591	675	797
<b>Forecasts at May 2018</b>					
Scottish revenues	11,467	11,969	12,345	12,805	13,335
BGA	11,626	11,930	12,215	12,612	13,015
<i>Difference</i>	-159	39	130	193	320

Source: 2017/18 data from Draft Scottish Budget 2017/18 and supplementary Scottish Government forecast. 2018/19 Budget Bill Forecasts from SFC's updated (February 2018) income tax forecasts; BGA forecast from Scottish Government budget 2018/19. May 2018 forecasts from SFC's May 2018 forecasts and Scottish Government's Mid-Term Financial Strategy

### Box 3.1: The timeline for income tax reconciliations

When budgets are set, they are based on *forecasts* of tax revenues and *forecasts* of the BGAs. It is only when outturn data is available are any differences with these forecasts 'reconciled'.

For income tax, there are long lags before this can happen. The figure below summarises the timeline using the 2018/19 budget as an example.

The figures in the 2018/19 budget are based on forecasts made in December 2017. There is a forecast made for Scottish revenues (by the Scottish Fiscal Commission) and a forecast for the BGA (based upon OBR forecasts for income tax growth in rUK).

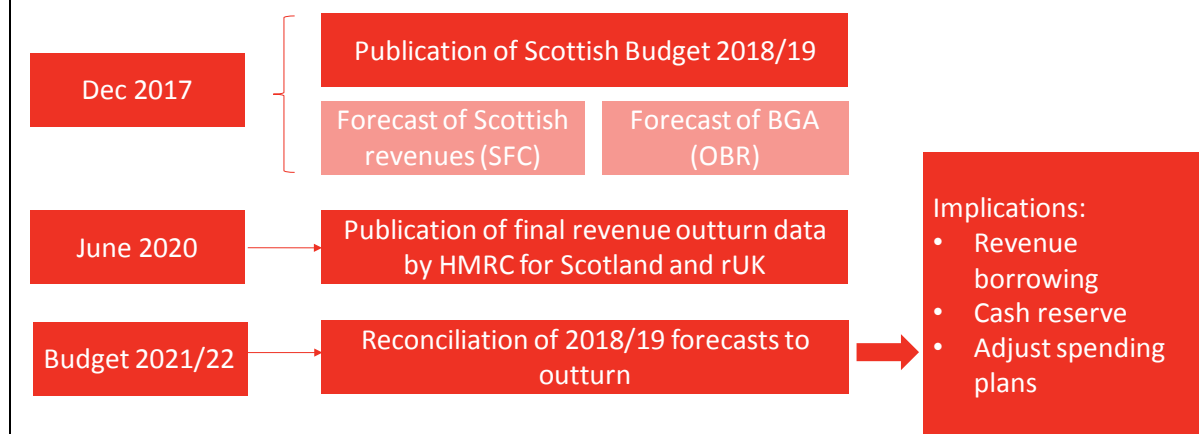
These forecasts remain 'locked in'. This means that any subsequent revised forecasts for 2018/19 do not affect the Scottish Government's spending power, until full outturn data is available.

Outturn data for income tax is available around 15 months after the end of the financial year. For 2018/19, that means summer 2020.

Once this outturn data is available, any reconciliation required is applied to the following year's budget – in this case, Budget 2021/22.

If the outturn position is better than forecast, the Scottish Government could put the difference into the Scotland Reserve, or spend it as a windfall.

If the outturn position is worse than forecast, the Scottish Government could reduce spending in 2020/21, use resources built up in the Scotland Reserve, or use its resource borrowing powers.



### 3.5 Income tax policy: choices so far and options for 2019/20

The Scottish Government has used its income tax powers in each of its last two budgets. In 2017/18, it froze the threshold at which taxpayers pay the higher rate of tax, rather than increasing it in line with inflation. In 2018/19, it introduced a new five-band structure for income tax, with new starter and intermediate rates at 19p and 21p respectively, an increase of 1p to the higher rate, and the replacement of the 45p additional rate with a 46p 'top rate'. The higher rate threshold was increased by less than inflation.

The effects of such changes need to be assessed by reference to a baseline. We follow the SFC's approach to defining the baseline as the policy that would have been in place in Scotland in the absence of policy change by the Scottish Government. For 2018/19 for example, the policy baseline includes the 2018/19 Personal Allowance set by the UK, but otherwise assumes that other tax thresholds would have increased in line with inflation, and rates remained unchanged.

This is an appropriate baseline in the sense that income tax is devolved to Scotland, and politicians should be accountable for changes they make to Scottish income tax. In some cases, however, there is also a case for comparing Scottish income tax policy to a slightly different baseline – the tax policy that operates in rUK.

Table 3.3 sets out income tax policy in Scotland and rUK in 2017/18 and 2018/19. It also shows the 'no policy change' baseline used by the SFC.

**Table 3.3:** Income tax policy in Scotland and rUK

	2017/18		Scotland 'no policy change'	2018/19	
	rUK	Scotland		rUK	Scotland
Personal Allowance	£11,500	£11,500	£11,850	£11,850	£11,850
Starter rate					19% from £11,851-£13,850
Basic rate	20% from £11,501 - £45,000	20% from £11,501 - £43,000	20% from £11,851 - £44,273	20% from £11,851 - £46,351	20% from £13,851-£24,000
Intermediate rate					21% from £24,001-£43,430
Higher rate	40% from £45,001 - £150,000	40% from £43,001 - £150,000	40% from £44,274 - £150,000	40% from £46,352 - £150,000	£41% from £43,431-£150,000
Additional rate*	45% above £150,000	45% above £150,000	45% above £150,000	45% above £150,000	46% above £150,000

\* From 2018/19, the tax rate that applies above £150,000 is known as the 'top rate' rather than 'additional rate'

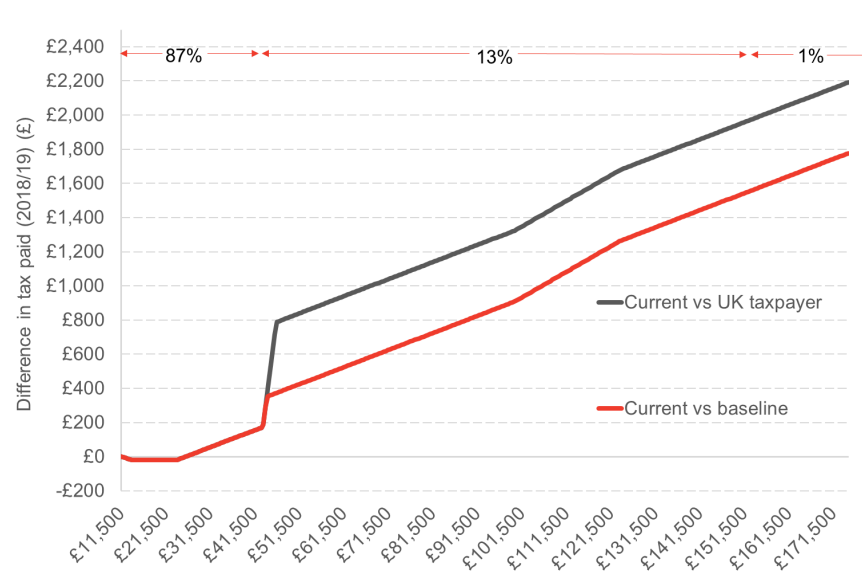
So what are likely to be the effects of the Scottish Government tax policies?

As already noted, the SFC forecast that the policy changes in 2018/19 would raise £219m relative to the 'no policy change' baseline. For individual taxpayers, those earning less than

£26,000 will pay (very slightly) less than they would have done under no policy change, whilst those earning above £26,000 will face an increase in their tax liabilities (Chart 3.2). Compared to taxpayers in rUK, Scottish income liabilities for those earning over £26,000 annually are higher, and markedly so for those earning above £43,430 (owing to the difference between the Scottish and rUK thresholds for the higher rate, a band of income which is taxed at 41% in Scotland compared to 20% in rUK).

The distributional effects of the 2018/19 policy across Scottish households are broadly progressive (Chart 3.3). The bottom four deciles of the income distribution saw small cuts in their tax liability as a result of the introduction of the starter rate, and hence a small rise in their after tax disposable income. Households in the top six deciles saw their tax liabilities increase, reducing their net disposable income. The reduction in net disposable income was around 0.1% for households in decile 7, increasing to 0.8% in decile 10.

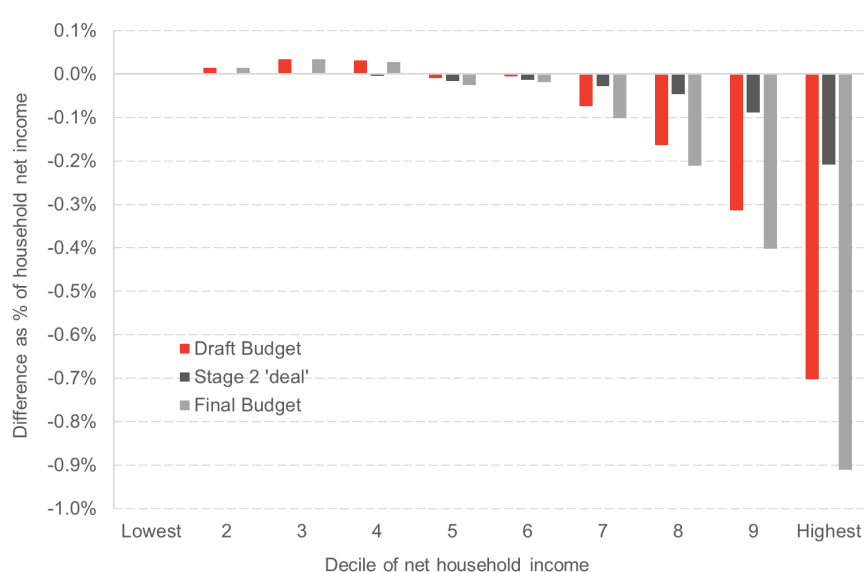
**Chart 3.2:** Comparing differences in individual income tax liabilities in 2018/19



Source: FAI calculations



**Chart 3.3:** Distributional effects of the 2018/19 income tax policy announcements



Source: FAI micro-simulation model. Graph shows distributional effects of tax policy announced in the Draft Budget 2018/19, in addition to the policy announced as part of the Stage 2 budget deal with the Scottish Greens (a lower than inflation increase in the higher rate threshold)

What are the Scottish Government's income tax policy choices for 2019/20?

Giving evidence to the Scottish Parliament in June<sup>23</sup>, Mr. MacKay said that he believed that Scotland's new five-band income tax schedule should be seen as 'settled'. However, he did not rule out changes to the rates or thresholds *within* this structure.

At the UK Autumn Budget, the Chancellor of the Exchequer announced two changes to income tax in the UK, setting a new higher rate threshold of £50,000 for taxpayers in the rest of the UK and a personal allowance of £12,500 for all taxpayers.

The real terms increase to the Personal Allowance will apply in Scotland. Compared to a scenario where the Personal Allowance had increased in line with inflation, the policy provides a tax cut of around £75 per year for most of Scotland's 2.5 million income taxpayers in 2019/20.

The increase in the Higher Rate Threshold – the threshold above which the higher 40% tax rate is charged – represents a tax cut to higher rate taxpayers in rUK. But the increase in the

<sup>23</sup> Evidence to Scottish Parliament Finance and Constitution Committee, 6 June 2018  
<http://www.parliament.scot/parliamentarybusiness/report.aspx?r=11589>

HRT will not apply in Scotland. Instead, it will be up to the Scottish Government to decide how to respond.

Of course, the higher rate threshold is already lower in Scotland than in rUK. An inflationary increase in the threshold in Scotland would take it to £44,470, widening the gap between the liabilities of Scottish and rUK higher rate taxpayers even further (a taxpayer earning £50,000 would face a tax bill some £1,350 higher than an rUK counterpart).

The Scottish Government could increase the higher rate threshold by the same proportion as it has been increased in rUK, taking it to £46,850. Whilst this would reduce the liability differential, the tax cut on higher rate taxpayers would cost the government around £130 million in lost revenues, compared to a policy to increase the threshold in line with inflation. And, politically, it remains to be seen whether this policy could be supported by the Scottish Greens, whose support the minority government has required to get the Budget Bill through parliament in each of the last two years. (Increase the threshold to £50,000 to match rUK would cost almost £300m in revenues).

A further cash freeze in the higher rate would raise around £70m, but increase further the liabilities gap between Scottish and rUK higher rate taxpayers.

The politics of the decisions around the higher rate threshold are likely to be fractious. But the government has other choices. Some of its options for raising revenue in 2019/20 – whilst retaining the existing five band structure – are shown in Table 3.4, together with the revenue effects of these policies.

**Table 3.4:** Indicative revenue effects of various income tax policies in 2019/20 (£m)

	Static effect (no behavioural response)	Dynamic effect (including behavioural response)
1p on Basic Rate	£174	£167
1p on Intermediate Rate	£133	£128
1p on Higher Rate	£83	£64
1p on Additional Rate	£22	£2
Freeze Intermediate Rate threshold rather than increasing in line with inflation	£7	£6
Freeze Higher Rate threshold rather than increasing in line with inflation	£70	£64
Increase Higher Rate threshold to £46,850	-£145	-£132
Increase higher rate threshold to £50,000	-£306m	-£280m

Source: FAI income tax model

In Chapter 6, we discuss opportunities for more significant reforms to income tax.

### 3.6 Land Building Transactions Tax (LBTT) and Landfill Tax

In the same way that the BGA for income tax is at least as important as the revenues from income tax, there are also block grant adjustments (BGAs) for Land and Buildings Transaction Tax (LBTT) and Landfill Tax.

Outturn data for LBTT and Landfill Tax in 2017/18 was published in the summer. Revenues from LBTT were £27m lower than the BGA, but for Landfill Tax, revenues were £35m higher than the BGA (Table 3.5). Not only do these changes broadly cancel each other out, but they were not significantly different from what had been forecast, creating no 'reconciliation' challenges for subsequent years<sup>24</sup>.

What about the remainder of the forecast period?

<sup>24</sup> Further detail on divergence of 2017/18 outturn figures from what had been forecast is contained in the Scottish Government's Fiscal Framework Outturn Report (May 2018).

For 2018/19 and beyond, revenues from Scottish Landfill tax are forecast to be somewhat higher than the BGA for landfill tax, although the differences are not substantial (Table 3.5).

Revenues from LBTT are also forecast to raise more than the corresponding BGA – driven by the SFC forecasting slightly faster domestic price growth than the OBR is forecasting for rUK. The scale of the gap is arguably somewhat surprising in the context of the 2017/18 outturn data. It demonstrates, however, the differences that can emerge when different organisations make marginally different assumptions about future growth of key factors like transactions, prices, and the distribution of transactions by price.

Of course, these forecasts will have changed again by the time Derek Mackay sets the 2019/20 budget. The OBR has revised down its forecast for Stamp Duty Land Tax in 2018/19 and 2019/20 by around 7%, which feed through to a lower BGA for LBTT. It remains to be seen to what extent the SFC will revise its forecast for LBTT in December.

**Table 3.5:** Outturn and forecasts for LBTT and Landfill Tax revenues and BGAs (£ million)

	Outturn		Forecast		
	2017/18	2018/19	2019/20	2020/21	2021/22
<b>Land and Buildings Transactions Tax</b>					
Revenues	557	614	656	697	738
BGA	584	588	606	630	656
Difference	-27	26	50	67	82
<b>Landfill Tax</b>					
Revenues	148	114	93	95	87
BGA	113	106	91	81	77
Difference	35	8	2	14	10

Source: Outturn data from Scottish Government's Fiscal Framework Outturn Report; Forecasts from SFC's May 2018 Forecasts

### 3.7 What of the other Scotland Act 2016 tax powers?

Of the Scotland Act 2016 tax arrangements, the income tax powers became operational in April 2017. Progress on Air Passenger Duty, Aggregates Levy and VAT assignment has been hampered by various technical and legal issues.

The Scottish Government had put in place legislation to replace Air Passenger Duty with a new Air Departure Tax (ADT) from April 2018. However, the transfer of APD has been

deferred, until a legal issue is resolved<sup>25</sup>. Politically, this deferral has arguably been an advantage to the Scottish Government. The minority government has relied on the Scottish Greens to secure the Budget Bill through parliament. But they are unlikely to support a budget that included cuts to Air Departure Tax, creating a tension between the government's own objectives and the need to secure approval for its budget.

The Smith Commission recommended that receipts from the first 10p of the standard VAT rate, and the first 2.5p of the reduced VAT rate, should be assigned to the Scottish budget. With the current and standard rates of VAT at 20p and 5p respectively, this effectively means that around half of Scotland's VAT revenues will be assigned to the Scottish budget.

Under initial timescales, VAT was due to be assigned in 2019/20 as part of a 'transitional' year, with actual VAT revenues not influencing the resources available to the Scottish Government until 2020/21.

The major issue that requires a resolution is how VAT revenues raised in Scotland will be estimated.

VAT is collected by HMRC at a UK level. VAT returns include no information on where the sales of goods and services took place. It is, therefore, not possible to apportion VAT by country, and not possible to calculate VAT raised in Scotland from tax returns. The level of VAT revenues raised in Scotland will thus need to be estimated.

Although the details of the methodology are yet to emerge, it is clear that the methodology will require a complex mix of survey data and economic modelling, and there will be some inevitable uncertainty around any estimate<sup>26</sup>.

Whilst it is possible to see the arguments in favour of VAT assignment – i.e. it aims to inject more accountability for economic performance into the Scottish budget – the practicalities of how this can be done were arguably not fully thought through in the Smith Commission.

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<sup>25</sup> Flights from the Highlands and Islands are currently exempt from APD and the Scottish Government wants to retain this. However, it is believed by both the UK and Scottish Governments that the current exemption to APD has not been notified to the EU, and is unlikely to be compliant with State Aid. Replicating the Highlands and Islands relief will require a notification be made to the EU to exempt such flights under the ADT, and for this notification to be approved. This can only be made by the UK Government. Uncertainties around Brexit have meant that limited progress has been made to date. Until it is resolved, devolution of APD and its replacement in Scotland is likely to be deferred.

<sup>26</sup> The VAT estimation methodology used in GERS has a confidence interval of +/- 223m, or around 2.2% of revenues

The Cabinet Secretary has indicated that he would defer the implementation of VAT assignment if he feels that the assignment methodology exposes the Scottish budget to unnecessary risk. This is an entirely sensible position. Implementing a policy that exposes the Scottish budget with unnecessary risk, simply to increase the impression of accountability, is not a good way forward. A better approach might be to look again at the entire process of VAT assignment – and possible alternatives – when the fiscal framework is due to be revised in 2021.

Aggregates levy is a tax on the commercial exploitation in the UK of rock, sand and gravel. The levy is currently subject to a legal challenge in the European courts, and devolution will not take place until this has been resolved<sup>27</sup>.

### 3.8 Summary for the resource outlook

It is possible to combine all these elements – the block grant and the various forecasts for the BGAs and devolved taxes – to obtain an overall picture of the outlook for the Scottish budget.

This is shown in Table 3.6. This takes the most recent block grant position (following UK Budget 2018), then:

- For income tax in 2017/18 and 2018/19, it takes the forecast position at the 2017/18 and 2018/19 Budget Bill respectively (given these are locked-in until outturn data is available). For 2019/20 and beyond, the latest (May 2018) forecasts are used.
- For LBTT and Landfill Tax, outturn data is used for 2016/17 and 2017/18, whilst the latest (May 2018) forecasts are used for 2018/19 and beyond.
- The other Scotland Act 2016 tax powers are excluded from this analysis, given uncertainties around their transfer to Scotland.

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<sup>27</sup> The Aggregates Levy is intended to create incentives to promote recycled aggregate by increasing the cost of first used aggregate. However, the British Aggregates Association (BAA) disputes the effectiveness of the tax for this purpose, and argues that some of the tax exemptions effectively create issues of State Aid.

The outlook in Table 3.6 differs marginally from the outlook in the Scotland's Fiscal Outlook in that it excludes several minor adjustments for data that is generally not publicly available<sup>28</sup>.

Table 3.6 first presents the outlook for the Scottish resource budget excluding the forthcoming increases to the block grant to account for the transfer of social security powers. This allows for a like-for-like comparison with the present day. It then also includes the anticipated increases in the budget to account for social security transfer.

The resource budget (excluding social security) is anticipated to increase by 4.2% in real terms over the course of this parliament, and by 3.2% over the remaining three years.

In 2019/20, however, the budget is anticipated to fall slightly in real terms – the substantial increase in consequentials merely changed an anticipated cut in the block grant into a small real terms increase, but the increase in consequentials is partially offset by a deterioration in the 'net tax' forecasts.

Chart 3.4 aims to explain this evolution in the outlook for the 2019/20 budget more clearly. When the 2018/19 budget was set, the outlook was for the budget to fall in 2019/20 to £27.1bn – a downward revision in the block grant was partially offset by an increase in the 'net tax' position.

The latest position sees the block grant make a positive contribution to change between 2018/19 and 2019/20, now offset by a deterioration in the net tax position. The budget is still expected to fall slightly in 2019/20, but note that this fall is now from a slightly higher baseline position, given an increase in consequentials for 2018/19 announced at the October budget.

Overall, therefore, the outlook for the budget is now some £200m higher in 2019/20 than it was expected to be this time last year (based upon the latest data).

There is clearly scope for these forecasts to change. For example, if the SFC's May forecasts for income tax in 2017/18 and 2018/19 are borne out, then the Scottish budget may face downward reconciliations of £260m and £380m in 2020/21 and 2021/22 respectively. On the other hand, if the income tax forecasts available in February 2018 are closer to outturn than the forecasts available in May 2018, then resources could be several

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<sup>28</sup> In projecting the Scottish Government's resource budget, Scotland's Fiscal Outlook, published by the Scottish Government in May 2018, includes adjustments for the Migrant Surcharge, the net Non-Domestic Rates position, the Queen's and Lord Chancellor's Remembrancer, and the Rail Resource Grant.

hundred million higher in 2019/20 – 2021-22 than indicated here. And of course, there is scope for the block grant in 2020/21 and beyond to change following the UK Government spending review.

Given the transfer of social security powers, the total Scottish budget will increase more significantly, particularly in 2020/21 and 2021/22.

The implication of these resource budget scenarios for spending choices is discussed in the subsequent section.

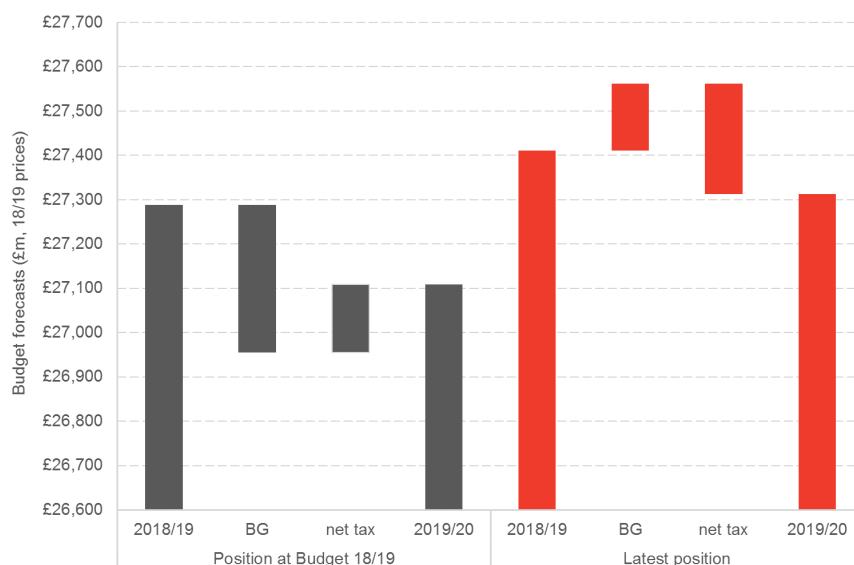
**Table 3.6:** Outlook for the Scottish Government resource budget (2018/19 prices)

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	Change, 16/17 - 21/22
Block grant	£27,065	£27,519	£26,983	£27,134	£27,605	£27,893	3%
Net tax position							
Income tax	£0	£109	£428	£128	£186	£303	
LBTT	£39	-£39	-£12	£49	£65	£78	
Landfill tax	£34	£31	£12	£2	£13	£9	
<b>Total resource budget exc social security</b>	£27,139	£27,620	£27,411	£27,313	£27,869	£28,283	4.2%
<i>Annual change</i>		1.8%	-0.8%	-0.4%	2.0%	1.5%	
Resources for social security	£0	£0	£290	£498	£1,589	£3,277	
<b>Total resource budget inc social security</b>	£27,139	£27,620	£27,701	£27,811	£29,458	£31,560	16%
<i>Annual change</i>		1.8%	0.3%	0.4%	5.9%	7.1%	

Source: FAI analysis



**Chart 3.4:** Changes to the budget forecasts for 2018/19 and 2019/20

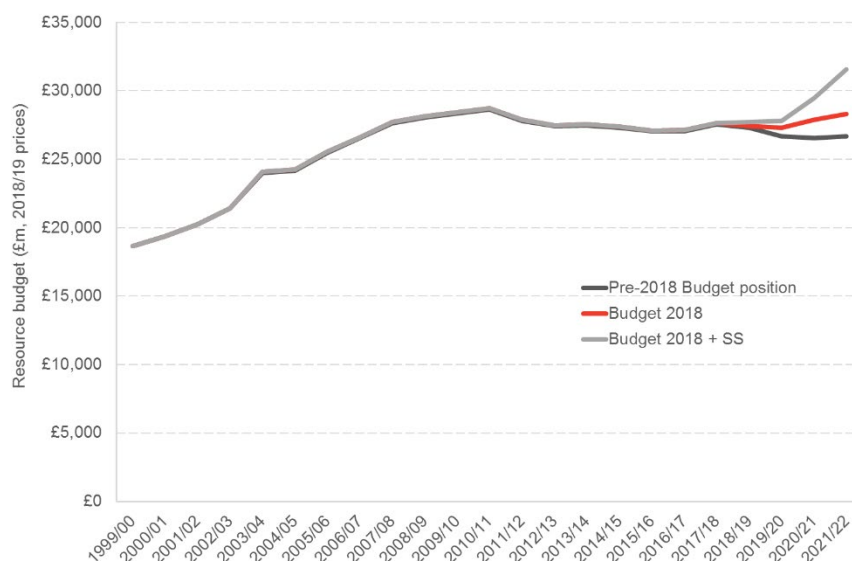


Source: FAI analysis

Chart 3.5 puts these projections into a longer term context.

On a like-for-like basis (i.e. excluding social security), the Scottish budget is projected to be around 1.6% lower in 2021/22 than it was in 2010/11 – a marked improvement on the outlook a few months ago. In per capita terms however, the budget will be around 7% lower by the end of the parliament than it was at the start of the austerity period.

**Chart 3.5:** The Scottish Government's resource budget (£m, 2018/19 prices)



Source: FAI analysis

### 3.9 Conclusions

The overall envelope that Mr Mackay will have at his disposal in December looks – at first glance – a lot healthier than it did this time last year.

Whereas the block grant was due to fall by 3.1% in real terms to 2019/20, when the Scottish Government set the first budget of the parliament, it is now due to increase slightly.

The Scottish resource budget has been further boosted in 2017/18 and 2018/19 by the tax policy choices of the Scottish Government. More recent forecasts suggest some deterioration in the ‘net tax’ position on income tax (the difference between revenues raised and the BGA) and this will have an impact on spending in future years.

The precise outlook for 2019/20 and beyond remains uncertain at least until the SFC publishes its next round of forecasts alongside the Scottish budget.

On the basis of the latest forecasts, the like-for-like Scottish resource budget will be slightly lower in 2019/20 than 2018/19, but will grow by around 4% over the course of the parliament. There is scope for the outlook to improve somewhat (if outturn revenues are closer to those made in December 2017 than in May 2018), but equally some scope for deterioration.

Does this mean that austerity is over, from the perspective of the Scottish resource budget?

This depends partly on how austerity is defined. On one level, the Scottish resource budget is now forecast to increase in real terms over the course of this parliament. Whilst the budget will decline slightly in real terms in 2019/20, it will increase by around 3% between 2018/19 and 2021/22. By then, it will be only slightly below the 2010/11 peak.

However, as we will see in the subsequent chapter, we are unlikely to have seen the last of real terms cuts in some spending areas. Most of the projected real terms increase in the resource budget is likely to be allocated to health, resulting in an ongoing squeeze for several other portfolios.

It is also worth remembering that the Scottish population continues to grow. By the end of this parliament the population is projected to be 3% higher than at the start, and 5.6% higher than in 2010/11. On a per capita basis the Scottish resource budget is anticipated to grow by 1.2% in real terms over the course of this parliament, but by 2021/22 it will be almost 7% lower than in 2010/11 on current projections.

Added to this there are risks of a deterioration in the fiscal outlook, either at UK level (as a result of Brexit for example), or at Scottish level (from a further deterioration in income tax forecasts).

Thus, whilst the severest period of austerity may have passed, the outlook remains constrained. What is clear, therefore, is that the impact of austerity will continue to resonate for years to come.

# Choices and trade-offs for public spending

- The Scottish Government has set out its high level plans for spending over the five years from 2018/19 in Scotland's Fiscal Outlook 2018. This set out a range of commitments on the NHS, childcare, policing, higher education and social security.
- The implication, given the budget outlook at the time, was that spending on non-priority areas would decline by 12% over the remaining three years of the parliament.
- As Chapter 3 has highlighted, the outlook has improved since then.
- Given the commitment to 'pass on' health related consequential to the NHS, health spending is now on track to increase by around 2.7% per annum over the remaining three years of the parliament, almost double the previous projection. At the same time the outlook for non-priority areas is better (but still challenging), with spending now set to decline by 4% over the remainder of the parliament.
- However the government faces many difficult decisions on spending. Health spending may need to rise 3.5% per annum if preventative and public health programmes do not mitigate demand growth as much as hoped. The government could decide to increase spending on NHS Scotland further, but this would clearly have implications for other portfolios.
- The core local government resource budget has declined by over 8% since 2010/11. Social care and some education services have been relatively protected from these cuts, but spending in some non-statutory areas has declined by over 20%. Relatively little is known about the detail of these changes, nor their impacts.
- Spending choices should not just be viewed as a trade-off between local government and health, not least given the potential synergies within the social care agenda. Spending challenges exist within all portfolios, including both those that are and are not 'protected'.
- In reality, the government has little room for manoeuvre, unless it is prepared to make radical changes to the way it delivers some services, or aims for a step change in the level of revenues it raises.
- The next few years are likely to see a continuation of the trend of retrenchment of public sector spend on core areas. Health spending is soon likely to absorb around half of the government's resource budget by the end of the parliament – if not before – up from 41% at the start of the austerity period.

*The outlook for the Scottish resource budget will continue to create difficult spending trade-offs. The government has committed to increase health spending by £2bn more than inflation over this parliament. But this commitment – whilst significant – may not seem sufficient to keep up with the costs of an ageing population. At the same time, and given the outlook set out in Chapter 3, this implies further real terms cuts for other portfolios – many of which have seen significant cuts over a number of years.*

## **4.1 Introduction**

The last chapter outlined the challenging and uncertain outlook for the Scottish resource budget.

Following eight years of fiscal consolidation, the Scottish Government's block grant has fallen by around 6% since 2010/11.

At the same time, the population has increased and been getting older, putting pressure on health and social care budgets. The health budget has been protected since 2010, with its share of Scottish Government resource spending increasing from 41% to 47%. It will not be long before £1 in every £2 of the Scottish budget will be spent on health.

Inevitably this has meant – and will continue to mean – funding cuts across a range of other services, including the main non-statutory services delivered by local councils.

The Scottish Government has set out a number of commitments – including a continued expansion of NHS funding, protecting the police budget, rolling out early years and childcare services, and increased funding to close the attainment gap. The devolution of several social security benefits will provide further challenge to the government's prioritisation of objectives.

With a resource budget that is forecast to increase only marginally over the next few years, what do these commitments mean for how spending is being distributed? And what choices might the Scottish Government face in the next few years if it is to deliver on its objectives for public services and the economy?

In Section 2, we consider the government's spending commitments for this parliament, and the implications for 'unprotected' portfolios.

We then focus on the two largest areas of resource spending – health and local government. In Section 3, we discuss demand for health spending in the context of recent budgetary

allocations, and the implications of 'passing on' any additional health consequential for spending on the NHS and in other areas. In Section 4, we look at implications of recent local government settlements across different service areas. Section 5 considers some of the government's wider spending trade-offs. Section 6 concludes.

## **4.2 Spending commitments in the government's Five Year Financial Strategy**

2018/19 marked the eighth year of the UK's fiscal consolidation programme aimed at reducing the deficit through a combination of tax rises but primarily spending cuts.

In this context, spending decisions are particularly challenging.

In May 2018, the Scottish Government set out its high level plans for spending over the five years from 2018/19 in its Five Year Financial Strategy ('Scotland's Fiscal Outlook')<sup>29</sup>. Scotland's Fiscal Outlook was published as part of new arrangements for a more continuous and strategic approach to budget scrutiny, and is welcome.

Scotland's Fiscal Outlook sets out indicative spending plans in six priority areas:

- To increase resource spending on the NHS by £2bn over the course of the parliament (from 2017/18 to 2020/21)
- To maintain the budget of Police Scotland in real terms
- To achieve a transformative expansion of early years and childcare, increasing the entitlement to funded childcare to 1,140 hours for all 3 and 4 year olds (and vulnerable 2-year olds)
- To reduce the gap in educational attainment by investing in the Attainment Scotland Fund
- To maintain current levels of funding (in cash terms) for Higher Education
- To fund the government's announced commitments on the social security benefits that are being devolved to Scotland: an increased Carer's Allowance – from summer 2018 (backdated to April 2018); the new Best Start Grant (replacing Sure Start Maternity Grant); the new Funeral Expense Assistance from summer 2019, and the introduction of a Young Carer Grant by autumn 2019.

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<sup>29</sup> See [www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-five-year-financial-strategy/](http://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-five-year-financial-strategy/)

From this information, it is possible to infer how spending may evolve over the next few years (Table 4.1).

On the basis of the plans in Scotland's Fiscal Outlook, real terms spending on health is due to increase by 8% over the course of the parliament with spending on the police maintained in real terms.

Spending on early years and childcare will increase in each year, and funding for the Attainment Scotland Fund will soon total £750m. Resource spending on the police is set to rise 3% in real terms.

In contrast, spending on higher education will fall by around 8% in real terms, a consequence of the commitment to maintain the budget in cash terms only.

Spending associated with commitments to pay a higher rate of Carer's Allowance and introduce the new Best Start Grant will cost almost £60m per year by the end of the parliament.

**Table 4.1:** Core government resource spending commitments (£m, 2018/19 prices)

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	Change, 2016/17 - 2021/22
Health	12,533	12,619	12,870	13,045	13,113	13,451	7%
Police	1,038	1,038	1,060	1,073	1,065	1,066	3%
ELC	-	-	96	302	492	540	
Higher Education	1,063	1,029	1,025	1,009	993	976	-8%
Attainment	-	122	180	177	174	86	
<b>Total excluding social security</b>	<b>14,634</b>	<b>14,807</b>	<b>15,231</b>	<b>15,607</b>	<b>15,837</b>	<b>16,118</b>	<b>10%</b>
New social security	-	-	35	55	58	58	-
<b>Total including social security</b>	<b>14,634</b>	<b>14,807</b>	<b>15,266</b>	<b>15,662</b>	<b>15,895</b>	<b>16,176</b>	<b>11%</b>

Source: Figures for 2018/19 and beyond from Scotland's Fiscal Outlook. Spending figures for 2016/17 and 2017/18 are taken from the 2017/18 and 2018/19 budgets respectively.

These commitments account for a significant proportion of the government's resource budget (around 55% in 2018/19).

Whilst the government is keen to emphasise the scale of such commitments, Scotland's Fiscal Outlook says very little about remaining areas of public spending. This includes core allocations to local government, further education, business and enterprise, the environment, legal services, tourism and culture.

Given the outlook when Scotland's Fiscal Outlook was published, the implication of the six commitments listed above on their own was for spending on 'other' areas to decline by 15% between 2016/17 and 2021/22.

The Five Year Financial Strategy did not articulate how the government's plans might change if the budget outlook changed. But as we set out in the previous chapter, the outlook has improved since May, with the UK Government announcing further consequentials.

The extent to which this changes the picture depends on what the Scottish Government decides to do with these additional resources. For example, to what extent will additional resources be passed to the health budget given demand pressures? In the remainder of this chapter, we discuss the context behind some of the choices the government faces, and what the implications of those choices might be.

### **4.3 Demand for health spending, and the case for 'passing on' the health consequentials**

It is clear that health services across the UK – and in many other advanced economies – are under significant pressure.

Some of this comes from a scarcity of resources but the main driver is growing demand.

Over the period from 1999/00 to 2010/11, resource spending on health in Scotland increased by over 4% per annum in real terms<sup>30</sup>. Between 2010/11 and 2018/19, it has increased by under 2% per annum (Chart 4.2).

On the basis of plans set out in Scotland's Fiscal Outlook, spending on the NHS would continue to increase at just under 2% in real terms between 2018/19 and 2021/22. This

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<sup>30</sup> Source: Government Expenditure and Revenue Scotland, Scottish Budget 2017/18 and 2018/19



would meet the government's target that NHS spending should increase by £2bn (in cash terms) over the course of the parliament.

The outcome of successive decisions to protect health spending is that health's share of the government's resource budget has increased substantially. Health's share was 37% when the Scottish Parliament was established, but had reached 47% by 2018/19.

How might the outlook for health funding change as a result of the additional consequentials flowing to the Scottish budget from the increased spending on the NHS in England announced by the Prime Minister in June 2018?

The government has committed to increase health spending by £2bn (in cash terms) over the parliament and to pass on all health related consequentials. In practice, what we interpret this commitment to actually mean is: the government commits to increase the NHS budget from the 2016/17 baseline in line with any health-related consequentials that flow to it from Westminster; if by the end of the parliament this has resulted in a cash increase of £2bn then the commitment is met, but if the increase is less than £2bn, the government commits to increasing health spending from other sources.

The spending plans for the NHS already included some assumptions about how health-related consequentials might increase in future years. 'Passing on consequentials' does not, therefore, mean that the health budget will increase by a further £550m in 2019/20 relative to the plans set out in Scotland's Fiscal Outlook.

Incorporating the latest health related consequentials, then the commitment to pass these on to the NHS in Scotland means that the NHS budget will rise by 2.4% in real terms in 2019/10 (compared to 1.4% under the previous plans) and then by an average of 2.8% in the following two years (compared to 1.5% under the previous plans), see Chart 4.1.

**Chart 4.1:** Annual real terms changes in health resource spending in Scotland



Source: Data until 2015/16 is from HM Treasury's Public Expenditure and Statistical Analyses, various years; data for 2016/17 and 2017/18 is from Scottish budget documents; data from 2018/19 is from the Scottish Government's Five Year Financial Strategy.

The arguments in favour of passing on all health related consequential – as the government has committed to – are strong. Our Scotland's Budget Report: 2017<sup>31</sup> described how demographic trends (a rapidly growing older age population), inflationary pressures in healthcare, and the costs of new treatments, will strain the health budget in coming years. More and more resource is required simply to keep existing levels of service functioning.

But is there a case for increasing the health budget by even more than this?

The Scottish Government's recently published Medium Term Health and Social Care Framework (MTHSCF) estimates that unconstrained demand for NHS services will increase by 5.5% annually to 2023/24<sup>32</sup>. This consists of 1% growth from demographic change, inflationary growth of just over 2%, and non-demographic change of 2%-2.5%.

In its forward funding projections, however, the MTHSCF also assumes that this anticipated cost increase can be constrained by making various savings and reforms, including through preventative strategies and public health improvements. There is also expected to be a 'shift in the balance' of spending, with more funding going toward community health programmes. In net terms, the MTHSCF plans on the basis of demand growth closer to 3.5% per annum in

<sup>31</sup> See Chapter 5: Long-term fiscal challenges - [www.sbs.strath.ac.uk/economics/fraser/20170926/Scotlands-Budget-2017.pdf](http://www.sbs.strath.ac.uk/economics/fraser/20170926/Scotlands-Budget-2017.pdf)

<sup>32</sup> See [www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/](http://www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/)

cash terms, or under 2% in real terms – such increases would be met by the current outlook for the health budget, once the new health consequentials have been factored in.

However, some have argued that some of the MTHSCF assumptions about the opportunities for savings are optimistic, particularly in relation to similar analysis for England conducted by the IFS/Kings Fund, as well as the OBR<sup>33</sup>.

One of the ways in which the government aims to achieve 'savings' is through integration of health and social care. Local authority spending on social care (around £3.1bn in 2016/17) is now pooled, along with substantial resources from the NHS (£5bn in 2016/17) into Scotland's 31 Integrated Joint Boards (IJBs)<sup>34</sup>.

Whether the achievement of such savings is realistic is a moot point. A recent report by NHS Providers in England argues that the scope for sustainable efficiency savings is limited<sup>35</sup>. Furthermore, it argues that the expectation that savings can be made through service integration remains a 'belief, rather than a plan with a clearly evidenced savings target', and that service integration will do little to stem demand growth. Whilst this report focussed on England, its conclusions mirror concerns Audit Scotland, amongst others, has made in relation to Scotland<sup>36</sup>.

Arguably, what this discussion also reveals is the puzzle as to why the government should set an explicit funding target for the NHS, but no specific target for social care funding. In part, this relates to the fact that social care is the responsibility of local government. But it is hard to see how the aspiration to achieve a 'shift in the balance of care' can be achieved without a more explicit recognition of how increases in NHS resources are matched and coordinated with equivalent provision for social care.

Given that the effect of service reforms and improvements in preventative strategies in mitigating the growth in demand for health spending, it is useful to consider how the health budget would have to evolve if it was to keep pace with the 'unconstrained' outlook set out in the MTFs. Annual cash terms increases in the health resource budget of 5.5% for the

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<sup>33</sup> See for example McLaren (2018) Analysis of 'Scottish Government Medium Term Health and Social Care Financial Framework' <http://scottishtrends.co.uk/wp-content/uploads/2018/10/MTHSCFF-Oct-18.pdf>

<sup>34</sup> The IJBs commission health and social care services for their local populations. The intention is that this will lead to a change in service provision, with an emphasis on preventative services, avoiding unnecessary admissions to hospital, and enabling patients to be discharged more quickly.

<sup>35</sup> Making the most of money – efficiency and the long-term plan. NHS Providers, October 2018 <http://nhsproviders.org/making-the-most-of-the-money-efficiency-and-the-long-term-plan>

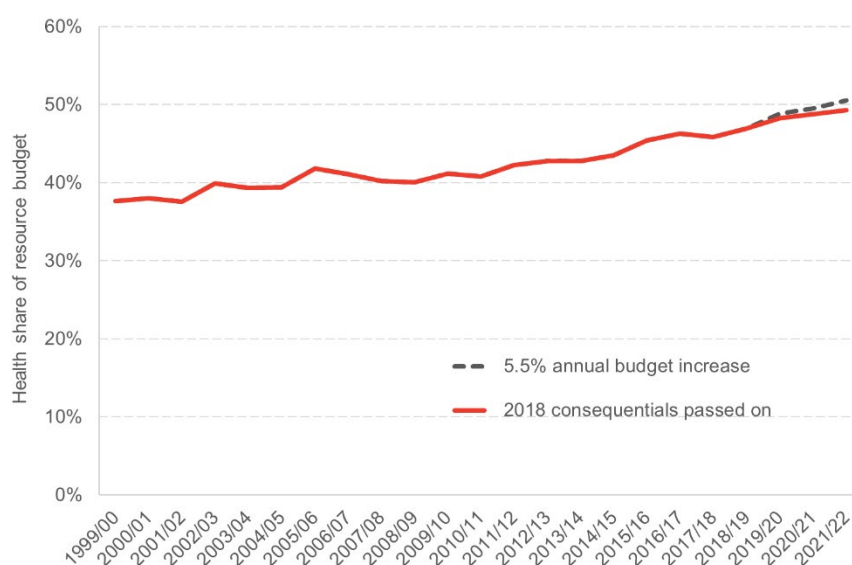
<sup>36</sup> Audit Scotland (2015) Health and Social Care Integration [www.audit-scotland.gov.uk/report/health-and-social-care-integration](http://www.audit-scotland.gov.uk/report/health-and-social-care-integration)

remaining three years of the parliament (equivalent to 3.5% in real terms) would see the health budget reach almost £16bn in the final year of the parliament.

In this scenario, spending on the NHS in Scotland would account for half of the Scottish Government's resource budget by the end of the parliament (Chart 4.2).

Of course, the government can only really assess its spending choices for health in the context of the opportunity costs of increased health funding. We discuss some of these trade-offs in subsequent sections.

**Chart 1.3:** Health share of the Scottish Government's resource budget



Source: FAI analysis

## 4.4 Implications for local government

After the NHS, local government represents the second largest 'call' on the government's resource budget, with a funding settlement of around £9.7bn in 2018/19<sup>37</sup>.

Local government is responsible for a wide range of services, including early years and school education, social work services, and numerous cultural, recreational, transport and environmental services.

Tracking changes in local government spending over time is subject to a number of challenges, with definitions changing over time. However, broad comparisons are possible.

<sup>37</sup> This includes £2.6bn of redistributed non-domestic rates.

Local government's core settlement from government is made up of a General Revenue Grant, a number of specific grants, and revenues from Non-Domestic Rates.

As has been well documented, local government in Scotland has faced a series of challenging settlements in recent years, with its core settlement declining by just under 9% in real terms since 2010/11<sup>38</sup>.

The first budget of this parliament was a particularly challenging one for local government. The resource allocation declined by 2.2% in real terms between 2016/17 and 2017/18. In 2018/19, as part of the deal to secure Scottish Green Party support, the core allocation to local government was maintained in real terms (notwithstanding the £355 million baseline transfer from NHS Boards to Integration Authorities in support for health and social care).

The real terms reduction in the local government settlement since 2010/11 has led to significant restructuring, in an attempt to achieve 'efficiencies'. Inevitably, however, some services have been reduced in scope or ceased. It is relatively easy to find anecdotal evidence of changes in local government services, whether that be in the form of changes to individual services or grants, the introduction of charges (Edinburgh Council has recently announced charges for removal of green waste), or the transfer of assets to community groups.

However, we are unaware of a comprehensive appraisal of how local government service provision has evolved in recent years, and what the implications of any changes have been. Some data on local government spending exists, although there are limits to the extent to which this can be used to assess spending trends in detail.

The latest data reveals that spending on social work has remained largely unchanged in real terms between 2010/11 and 2017/18<sup>39</sup>. Spending on education fell in the initial years of austerity but has been increasing again since 2013/14. Nonetheless, spending on education, which makes up around 40% of local government net revenue expenditure, remains 4% below the 2010/11 peak in real terms.

Within the context of a declining budget, this inevitably means spending cuts have been concentrated elsewhere. In particular, spending on culture and related services has declined by over 20% between 2010/11 and 2017/18, spending on planning and development has

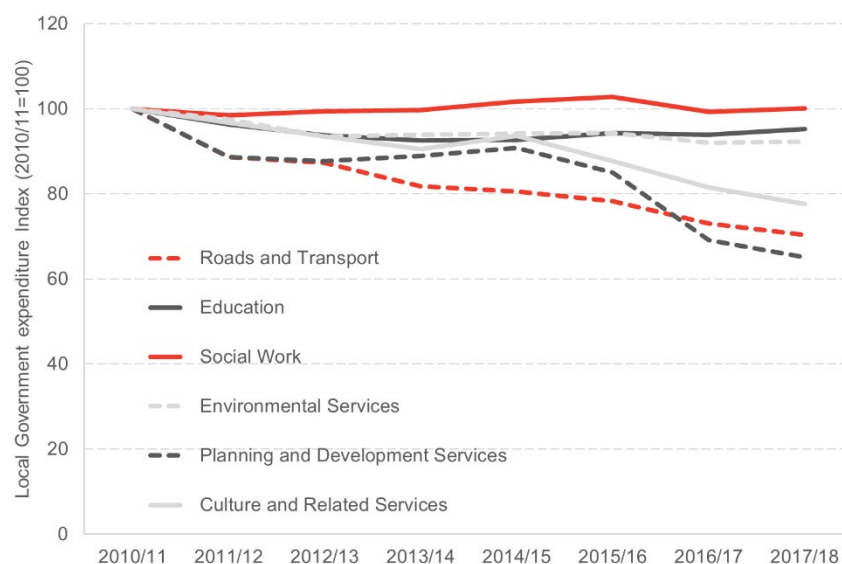
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<sup>38</sup> See for example 'Fiscal issues facing local government in Scotland'. Fraser of Allander Institute, March 2017

<sup>39</sup> Source of figures in this paragraph is the Local Government Provisional Outturn statistics for years 2014 – 2018. [www.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/POBStats](http://www.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/POBStats)

declined 35%, spending on roads and transport has fallen 14%, and spending on environmental services has fallen 9% (Chart 4.3).

**Chart 4.3:** Index of real terms changes in local government outturn expenditure by service area, 2010/11 – 2017/18



Source: Provisional Outturn and Budget Estimate Statistics, various years  
[www.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/POBEStats](http://www.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/POBEStats)

Local government spending is thus increasingly dominated by education and social care, with the share of these two areas increasing from 64.7% to 68.7% between 2010/11 and 2017/18.

Overall, there remains a lack of robust information on the effects of reductions in areas of service spending, and some cause for concern that the individuals most affected might be those who are less well represented in political decision making.

In addition to the trends in financial resources, reforms are also afoot which will change the role of local government in influencing service delivery. In social care, local government resources are now pooled into the Integrated Joint Boards, with local authorities determining policy jointly with their NHS Boards. In education, the Scottish Government is consulting on proposals to reform school funding – including allocating more funding directly to schools on the basis of needs (building on the approach taken in relation to Pupil Equity Funding);

introducing greater standardisation in the way local authorities allocate financial resources to schools; and transferring funding responsibilities and decision-making to head teachers<sup>40</sup>.

It could be argued that these changes to the way in which local government determines budgetary priorities are just if not more significant than the budgetary challenges themselves.

But what is the outlook for the local government settlement in 2019/20 and beyond?

On the basis of the outlook for the government's resource budget discussed in Chapter 3, the spending commitments, the assumption that recently announced health consequentials are 'passed on', and the SFC's latest forecasts for NDRI growth, then local government is on track for

- a real terms increase of around 1% in 2019/20 – assuming all of the government's commitment in respect of childcare and early years is passed onto local government
- a real terms cut of almost 2% excluding the additional resources for early years (so that the figures are compared on a like-for-like basis).

This assumes the General Revenue Grant is uplifted in proportion to the outlook for non-priority areas. And as ever, there is scope for variance around these forecasts.

It remains to be seen for example, to what extent the government will pass on all or a subset of the resources it has allocated for childcare to local government as opposed to other potential delivery partners.

#### **4.5 Assessing the trade-offs**

The implications of the plans set out in Scotland's Fiscal Outlook in May were that spending on non-priority areas would decline by 12% over the remaining three years of the parliament.

The improvement in the outlook since then changes the picture. Given its commitment to 'pass on' health consequentials, the NHS resource budget will now increase by around 8%

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<sup>40</sup> Scottish Government (2017) Fair funding to achieve excellence and equity in education  
<https://beta.gov.scot/publications/fair-funding-achieve-excellence-equity-education/>

over the remainder of this parliament, rather than the 5% the government had planned for in Scotland's Fiscal Outlook back in May.

The outlook for non-priority areas has improved too – although the outlook is still for real terms cuts. Rather than falling by 12% for the remaining three years of this parliament, non-priority areas are set to see their spending fall by 4% over the remaining three years.

But the government could make different choices. Further increases in the health budget – in order to meet the government's projected growth in demand if no savings are realised – would result in non-priority budgets declining by 7% in the remaining three years of the parliament – less than had been pencilled in in May, but more than if it simply passes on consequentials (Table 4.2).

**Table 4.2:** Outlook for real terms spending 2018/19 – 2021/22

	<b>Outlook for health spending</b>	<b>Outlook for non-protected spend</b>
Position in May 2018	5%	-12%
Budget 2018 – health consequentials 'passed on'	8%	-4%
Budget 2018 – health spending growth 3.5% per annum annually	11%	-7%

Source: FAI analysis

In debates about the allocation of the Scottish budget, it is tempting to frame the choice as a trade-off between spending on health and spending on local government.

Whilst this trade-off does exist – the government sets an explicit target for health spending, but not local government – framing the choice in this way is also an oversimplification.

This is especially the case given the increasingly shared role that health boards and local authorities play in social care. But there is also an increasing recognition of the linkages between social exclusion and health inequalities, and the scope for policy synergies in these areas.

Viewing the trade-off as one between health and local government also ignores the changing nature of the services delivered within each portfolio – an increasing focus on community and primary care in health, and a concentration of resources in education and



social care in local government. However, whilst these changes in health are driven by a strategic objective to shift the balance of care away from hospitals, there must be concern that the spending shifts in local government are driven more by necessity.

The government should be commended for setting out its medium term spending aspirations so clearly and transparently. Nonetheless, not enough is said about the vision for non-prioritised areas. These include not only local government, but also budgets relating to the environment, tourism and culture, and economic development. Arguably, and after eight years of fiscal consolidation, a strategy is needed for managing reductions in spending in key areas, and not just a strategy for where new money will be spent.

The case for increased health spending is relatively easy to make in a quantitative sense, and spending on the health service has broad electoral appeal. Nonetheless, we need to understand more about the implications of changes to the overall budgets of – and the distribution of spending within – the range of organisations whose funding is being reduced.

Whilst spending on the police in Scotland has been largely protected since 2010/11, spending on prisons has declined 30% and spending on law courts has fallen by 15%<sup>41</sup>. And whilst spending on pre-primary and primary education has increased, spending on secondary education and higher education have both declined by slightly over 7% in real terms.

Even within 'protected' services, the funding outlook is challenging. The police budget may be protected in real terms, but the higher than inflationary pay settlement of 6.5% agreed for 2018/19 (which will apply until March 2021) has to be accommodated within that<sup>42</sup>. Demands for similar levels of pay increase are likely to be seen across the public sector.

Are there ways that the government could reduce pressure on its budget by making strategic decisions to cut spending on specific areas? This appears unlikely, unless the government is prepared to move away from some of its flagship policies. Scotland spends around twice as much per person on enterprise and economic development than England. Reducing Scottish spend to similar per capita levels as in England would in theory release around £350m but it is not clear how this would fit with the government's aspirations to support innovation, investment or inclusive growth.

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<sup>41</sup> The figures in this paragraph are based on Chapter 10 of HM Treasury's Public Expenditure and Statistical Analyses, various years. The figures include resource and capital spending.

<sup>42</sup> [www.scotland.police.uk/whats-happening/news/2018/September/Significant-police-pay-deal-agreed](http://www.scotland.police.uk/whats-happening/news/2018/September/Significant-police-pay-deal-agreed)

Budget savings to the tune of several hundred million per annum are also possible if the government decided to introduce some form of tuition fee for higher education services, although this would be counter to the government's objectives that higher education tuition should be based on the ability to learn rather than the ability to pay. The issues around higher education funding are discussed in more detail in chapter 7.

Explicitly or implicitly, therefore, big decisions about the distribution of public spending in Scotland are being made, although the incremental nature of changes means that they often go largely unnoticed.

## 4.6 Conclusions

Since the publication of Scotland's Fiscal Outlook in May, the funding outlook has improved. The government's commitment to pass on health related consequential means that the health budget will increase by 2.7% per annum over the next three years, almost double the real terms growth rate set out in May.

At the same time, the outlook for non-priority areas has improved too. Rather than falling by 12% for the remaining three years of this parliament, the government's non-protected budget is now forecast to fall by 4%.

Despite having set out its high level priorities in May in Scotland's Fiscal Outlook, the government still has plenty of difficult decisions to make in its forthcoming budget for 2019/20.

It could allocate additional resources to the health budget, ensuring that NHS resources increase in line with the government's projections for unconstrained demand growth. This choice would of course have to be weighed against the costs of deeper cuts to unprotected budgets.

Depending on how these choices play out, the local government settlement may fall in real terms in 2019/20, although by passing on resources linked to the childcare commitment, the government will likely be able to avoid real terms cuts to the core settlement. However, further cuts to local government non-statutory services, on the back of substantial cuts since 2010/11, seem inevitable.

More evidence is needed on the likely effects of these funding reductions on the communities and individuals that the funding is intended to support.

The government faces plenty of other spending challenges too. One issue is social care. The government explicitly protects the NHS budget, some of which is pooled with Integrated Joint Boards. But there are no explicit commitments on social care funding, which is increasingly at odds with the commitment (and necessity) to shift the balance of care.

# Trade-offs in funding capital investment

- Net public sector investment spending in Scotland (gross spending minus depreciation) is, as a percentage of GDP, somewhat below average in an international context, and lower now than at the start of the austerity period.
- The 2018 Programme for Government set out an aim to raise Scotland's infrastructure spending to 'internationally competitive levels'. It has set out investment commitments relating to early learning and childcare facilities, affordable housing, broadband infrastructure, sustainable travel, transport infrastructure, schools and colleges, NHS facilities and early learning facilities.
- The majority of the government's investment programme is funded by a block grant from Westminster (£3.4bn in 2018/19). Additionally it can now borrow up to £450m annually (with a £3bn borrowing cap). The government and other public sector organisations also fund investment through revenue borrowing methods. These have delivered between £400m - £800m investment annually in recent years.
- The capital block grant is projected to increase by 25% in real terms over the course of this parliament. Despite this it will remain below its pre-austerity peak, even by 2020/21.
- The government has used its new borrowing powers in full in 2015/16, 16/17 and 17/18, and has indicated that it is minded to do so again in 18/19. The government is able to borrow at relatively low rates of interest. But if it continues to borrow its full allocation each year for a loan term of 25 years, it is likely to hit its borrowing limit in 2022/23.
- When it comes to revenue financed projects, the government's key constraint is a self-imposed limit that the annual value of repayments should not exceed 5% of its total budget. It is on course to remain within this limit, although repayments for historic and planned revenue financed projects are currently around £1.2bn annually. The value for money of revenue funded schemes remains unclear.
- Local government also funds capital investment through a combination of grant, borrowing, and revenue financing. Pilot projects seek to test innovative models to investment financing, although the scope of these models to achieve a step change in investment levels may be limited.
- A clearer strategy is needed to establish the principles and implications of the government's investment approach, including the opportunity costs, to current and future generations of taxpayers.

*The Scottish Government's capital block grant – its main source for investment – was cut substantially in the early years of the 'austerity period'. It is now rising but remains below the 2010/11 peak. The government is increasingly funding investment through other channels, including borrowing and revenue-financing. These approaches commit future governments to annual repayments for 25-30 years. But whilst a strong case can be made for shifting some of the costs of investment to future generations, greater transparency is required of the value for money of such funding approaches.*

## **5.1 Introduction**

Capital investment is a critical element of government policy. It creates the conditions to enable public services to be delivered and to ensure the economy functions smoothly.

The government has set out a wide range of priorities for its capital budget. These include investing in early years, affordable housing, superfast broadband, new hospitals and community healthcare facilities, schools and a range of transport improvements covering road, rail and ferry infrastructure.

As well as funding the development of new infrastructure, it also includes maintenance of existing infrastructure.

As with the resource side of the budget, capital faces many competing priorities.

The UK Government's programme of consolidation resulted in significant reductions in investment spending across the UK. Indeed, even with increases in recent years, Scotland's capital block grant remains lower in real terms than in 2010.

Capital spending differs from resource spending in that it creates (or improves) assets that will benefit future generations. Because of this, a case can be made for funding some projects from the revenues of future taxpayers as well as today's.

The Scottish Government has made extensive use of revenue financed methods, particularly in schools, health and community facilities, and transport. It has also gained the ability to borrow, is working to pilot new approaches to leveraging private sector investment, and has access to Financial Transactions.

But these approaches all come with risks and constraints. Borrowing and revenue financed schemes commit the public sector to payments for many years (often 25-30 years). The

government has set itself a self-imposed target that repayments should not exceed 5% of its total (resource and capital) budget.

When it comes to capital spending, therefore, the question of what to fund cannot be divorced from the question of how it is funded, and the extent to which current funding commitments constrain future choices.

We consider these issues in this chapter.

Section 2 provides some context to capital investment in Scotland; Section 3 outlines the government's priorities; Section 4 describes the features and limits of a variety of different funding approaches; Section 5 describes capital investment by local authorities; Section 6 describes issues with Financial Transactions; and Section 7 concludes.

## 5.2 Context

Capital spending in Scotland, by all Scottish and UK government departments and public bodies, totalled £8.7bn in 2017/18. Of this, some £2.3bn was by the Scottish Government, £2.2bn by local authorities, £1.6bn by public bodies, and £2.7bn by other UK government bodies<sup>43</sup>.

These figures are for gross investment (i.e. total investment spending). Net investment (which subtracts the value of depreciation) was £4.2bn, representing 2.6% of Scottish GDP.

As a percentage of GDP, this is an equivalent level of net investment as observed for the UK as a whole.

Whilst caution is required in relation to international comparisons it is interesting to see how Scotland and the UK fare<sup>44</sup>.

Net public sector investment spending in Scotland (and the UK) is somewhat below average in an international context. Across OECD countries, net public sector investment is around 3.1% of GDP on average, with some countries spending in excess of 4% of GDP (Chart 5.1).

Investment in Scotland was higher in real terms and as a percentage of GDP prior to the 2008/09 recession (Chart 5.2), a pattern observed in most countries. Net investment

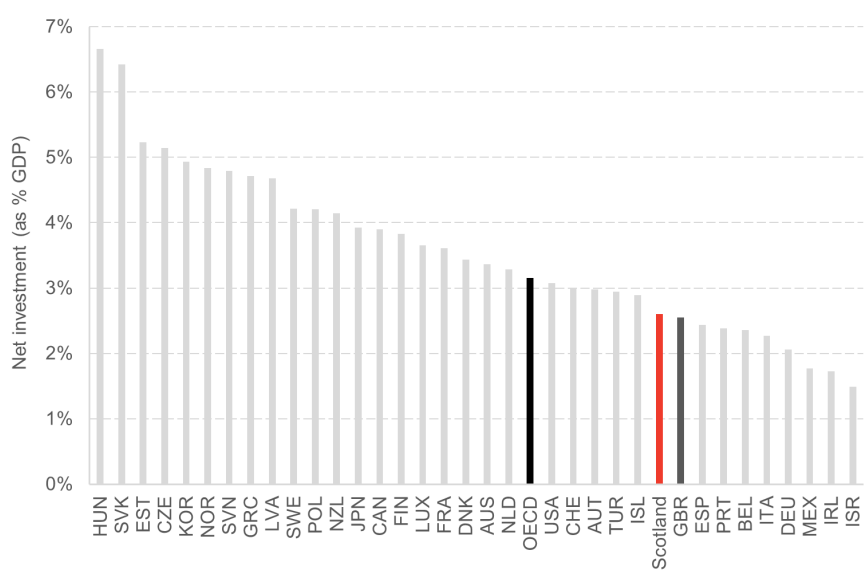
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<sup>43</sup> Government Expenditure and Revenue Scotland 2018 (Table 3.2)

<sup>44</sup> The need to be cautious is that investment spending figures for Scotland quoted above do not generally include investment funded by revenue financed methods (such as PFI or NPD methods)

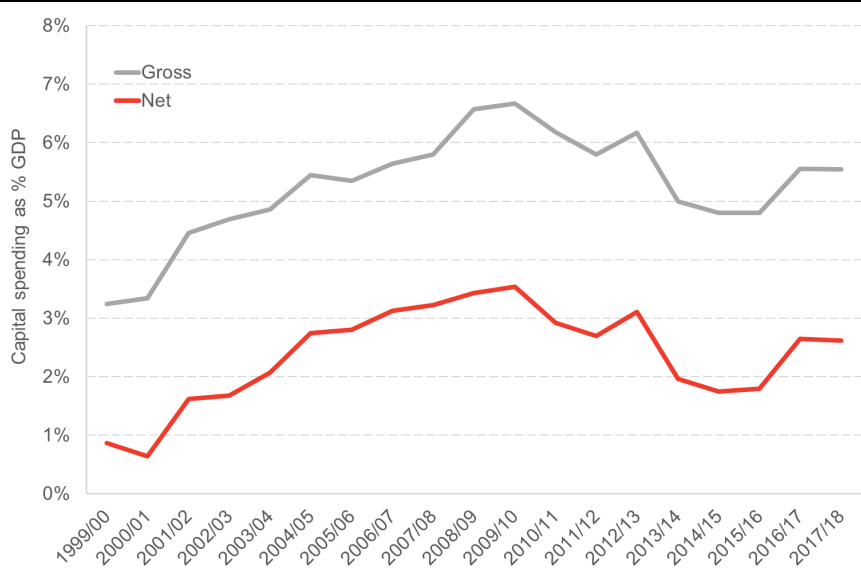
exceeded 3% of GDP between 2006/7 and 2009/10 and then fell to below 2% of GDP, before rising slightly.

**Chart 5.1:** Net investment as a percentage of GDP in 2015, OECD countries



Source: Source: OECD National Accounts Statistics and Government Expenditure and Revenue Scotland (2018)  
Data for Scotland is for 2016

**Chart 5.2:** Capital investment in Scotland as a percentage of GDP



Source: Government Expenditure and Revenue Scotland 2018. Scottish GDP is calculated assuming a population share of North Sea activity to smooth volatility in the 'geographical share' apportionment method.

### 5.3 The government's priorities and plans for capital investment

The 2018 Programme for Government set out an aim to raise Scotland's infrastructure spending to 'internationally competitive levels'. This aspiration is not explicitly defined.

Indicatively, for net investment to reach the OECD average of 3.1% of GDP would require around an increase of around £800m in today's prices. The Programme for Government sets out an ambition that investment in infrastructure should be £1.5bn higher in 2025/26 than in 2019/20.

In its 2018/19 budget, the government set out commitments relating to investments in early learning and childcare facilities, affordable housing, broadband infrastructure, sustainable travel, transport infrastructure, schools and colleges, NHS facilities, and a deep water port facility to support North Sea decommissioning.

It is in the nature of capital projects that funding is spread over years, and may be drawn down at a faster or slower rate than anticipated. It is often difficult therefore to monitor which budget commitments for discrete projects relate to particular years

The Infrastructure Investment Pipeline Update<sup>45</sup> lists the status of projects with a capital value of £20 million or more where Scottish Government has a lead role in procurement/funding, as well as schools and health projects financed through the NPD/hub investment programme.

The most recent (March 2018) iteration of the Pipeline Update lists 87 projects, which includes:

- 7 road projects (including the Aberdeen Western Peripheral Route and A9 dualling). The majority – with the exception of the AWPR - are funded through the government's capital budget;
- 5 rail projects, including the Edinburgh-Glasgow electrification. These are all RAB-funded to the tune of around £1.4bn in total;
- Purchase of 2 new ferries at a cost of £97m, funded through the capital budget;
- 18 health projects, all but one of which are revenue funded to a greater or lesser extent. This pipeline includes projects under construction (such as the Royal Hospital for Sick Children in Edinburgh and a new hospital for Orkney) as well as projects at

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<sup>45</sup> See [www.gov.scot/policies/government-finance/infrastructure-investment/](http://www.gov.scot/policies/government-finance/infrastructure-investment/)



the planning stage (such as centres in Greenock and Clydebank). The total value of these projects is £1.2bn, although revenue financing elements of this account for somewhat less;

- 48 schools projects with a capital value of around £1bn although a number of those included are already operational. The majority are revenue funded;
- 2 colleges (Forth Valley College at a cost of £78m through the capital budget, and Fife College, which will cost £93m with the funding mechanism to be confirmed);
- and 4 prisons, all funded through the capital budget to a cost of £370m, and a Justice Centre in Inverness, also conventionally funded.

One thing that this list indicates is that, whilst a number of the government's strategic priorities for capital relate to digital infrastructure and the promotion of active travel, the vast majority of spending is on traditional public infrastructure projects.

## 5.4 Funding capital investment

The Scottish Government can fund capital investment in a number of ways:

- It receives an annual capital block grant from Westminster (£3.4bn in 2018/19);
- It can borrow up to £450m annually (within a total cap of £3bn), repaid in future years;
- Through revenue-financed methods, whereby the private sector meets the upfront costs of construction and the public sector pays an annual charge to reflect construction costs and interest for 25-30 years;
- Rail investment can be funded through the 'Regulated Asset Base' (RAB) approach, whereby Network Rail funds investment through borrowing which Transport Scotland repays over future years;
- In addition to general and specific grants from the Scottish Government (which are ultimately sourced from the Westminster block grant), local government can add to this through its own capital borrowing programme and revenue financed methods. Local authorities are also beginning to pilot various 'innovative' approaches to unlocking investment funding;
- Encouraging private sector investment to match-fund public sector resources.

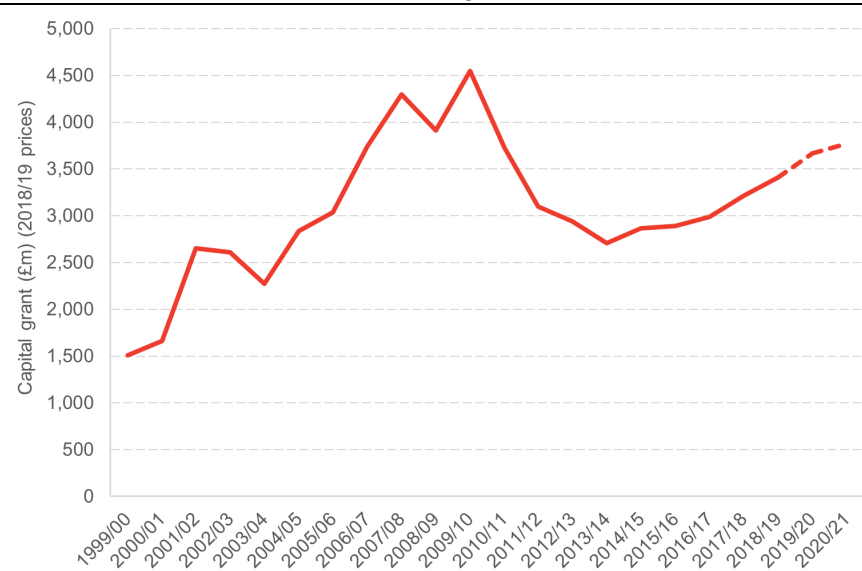
### The block grant for capital spending

The Scottish Government receives a block grant for capital spending from the UK Government. This is determined by the Barnett Formula, so it changes each year in proportion to changes in capital spending in England on 'comparable' functions.

Chart 5.3 shows the evolution of the block grant since 2010/11, and the future outlook.

Having reached a peak of £4.5bn in 2009/10, the block grant fell by 35% in the following two years (the capital allocation in 2009/10 included £300m of funding from 2010/11 that was brought forward as part of an economic stimulus package, exaggerating the scale of the peak and subsequent decline). By 2018/19 the block grant had recovered somewhat but was still well below the pre-recession peak. The block grant is expected to increase by 7.3% in real terms in 2019/20 and 2.5% in 2020/21 (including consequentials from the UK Budget in October 2018).

**Chart 5.3:** Scottish Government capital spending and outlook for the capital block grant



Source: figures for 1999/00 to 2010/11 are outturn expenditure figures from HM Treasury's PESA analyses (various years). Figures from 2011/12 onwards are block grant allocations provided in various Scottish Government budget documents.

### Capital borrowing

The Scottish Government first gained the ability to borrow to fund capital investment in 2015/16 before they were expanded in the Scotland Act 2016.

It can now borrow up to £450m annually, within a total limit of £3bn. It can borrow via the UK Government (the National Loans Fund), by issuing its own bonds, or by borrowing from a

bank or other lender. It is unlikely that the Scottish Government would choose to do anything other than borrow via the National Loans Fund as all other options will be more expensive<sup>46</sup>.

The government used its borrowing powers in full in 2015/16, 2016/17 and 2017/18. However, the borrowing in 2015/16 and 2016/17 was 'notional' to reflect accounting adjustments (Box 5.1).

#### **Box 5.1: Capital borrowing in 2015/16 and 2016/17**

The Non-Profit Distribution programme involves the private sector funding capital projects (schools, hospitals etc.) with the public sector committing to pay fees to cover capital costs, interest repayments and maintenance/service charges (usually for 25-30 years).

In 2015/16, the ONS reclassified various NPD projects as 'public sector'. In consequence, the Scottish Government reached an accounting agreement with HM Treasury to use a combination of its capital allocation in 2014/15 and 2015/16, and its borrowing limit in 2016/17 and 2017/18, to provide budget 'cover' for the reclassified schemes. Specifically:

- The Auditor General's report of October 2016<sup>47</sup> suggests that around £328 million of capital budget was freed up from 2014-15 and 2015-16 budgets to accommodate the change in those years;
- £283m and £333m of reclassified NPD schemes were scored against the Scottish Government's borrowing limit in 2015/16 and 2016/17 respectively<sup>48</sup>.

The scoring of NPD schemes against the government's borrowing limit does not mean that the Scottish Government borrowed in that year (and thus, there will be no additional interest charges other than those already agreed with the private sector); but the full value of the capital project does score on the balance sheet, and counts as part of the Scottish Government's borrowing limit.

As a result, the net additional uplift in investment activity that the government had been planning on has turned out to be less than anticipated.

<sup>46</sup> All Scottish Government borrowing to-date has been through the NLF.

<sup>47</sup> Auditor General (2016) 2015/16 Audit of the Scottish Government Accounts  
[www.gov.scot/Resource/0050/00506454.pdf](http://www.gov.scot/Resource/0050/00506454.pdf)

<sup>48</sup> Source: Letter from Cabinet Secretary to Convenor of Finance and Constitution Committee, January 2017.  
[www.parliament.scot/S5\\_Finance/General%20Documents/Cab\\_Sec\\_FC\\_to\\_FinConvenor\\_-\\_05Jan17.pdf](http://www.parliament.scot/S5_Finance/General%20Documents/Cab_Sec_FC_to_FinConvenor_-_05Jan17.pdf)

The borrowing in 2017/18 will incur an interest rate of 1.9% and will be drawn down over a 25-year loan term. The government will face repayments and interest on this borrowing of around £22.6m per year until 2043 (with interest repayments totalling £120m).

The government has indicated that it is minded to use its borrowing powers in full once again in 2018/19. Its Five Year Financial Strategy published in May 2018 also indicates that it is minded to do the same again in 2019/20.

There are difficult decisions in relation to capital borrowing.

In essence, if the government borrows its maximum amount each year over a long (25-year) loan term, then it will reach its total borrowing cap by around 2022/23. If the government does the same but over a shorter period of 10 years, it will never hit its debt limit (as borrowing is paid off relatively quickly). But the annual repayments would be substantial (Box 5.2).

From an economics point of view, the borrowing powers are a useful tool to achieve a temporary increase in capital expenditure, either because the economy is temporarily weak or there is a bottleneck of important projects. But it is less obvious that capital borrowing is a sensible way for the Scottish Government to achieve a permanent increase in capital investment, given the constraints on its powers.

#### **Box 5.2: Choices and constraints for capital borrowing**

If the Scottish Government were to borrow its maximum annual allocation of £450m in 2018/19, then its debt stock by that point would be £1.46bn, representing 49% of the debt cap<sup>49</sup>. If the government were to continue to borrow at this pace and with a 25-year repayment schedule, it would reach its debt cap at the end of 2022/23.

Instead, if it borrows its full allocation each year but on much shorter terms – say 10 years – it will never reach its debt cap. Past borrowing will be paid off before the debt limit is reached.

But whilst the interest rate charged is likely to be lower than on longer term borrowing, annual repayments would of course be high. Illustratively, if the Scottish Government were to borrow £450m over a ten year term at a 1.5% interest rate, then it would face annual repayments (principal plus interest) of around £49m.

<sup>49</sup> See Table 5.2 of Scottish Fiscal Commission's May 2018 Forecasts, or Table 5.2 of the Scottish Government's Fiscal Framework Outturn Report.

Borrowing for shorter loan terms may at first appear more sustainable as the debt cap is not reached. But the trade-off is that the annual repayments are high even when interest rates are low. By the tenth year of borrowing £450m, the government would be borrowing £450m to invest but spend more than this (around £490m under our low interest rate scenario) to service current and past levels of borrowing.

### *'Revenue financed' capital investment*

Revenue financed capital investment involves the private sector funding capital projects with the public sector committing to pay fees to cover capital costs, interest repayments and (sometimes) maintenance and service charges (usually for 25-30 years).

Revenue financed projects are forms of Public Private Partnerships (PPPs). Scotland's first PPPs were under the Public Finance Initiative (PFI). Since 2010, revenue financed schemes have been delivered through the Non-Profit Distributing (NPD) and hub models. The main difference is that, under NPD and hub, private sector profits are limited, with surplus profit returned to the public sector.

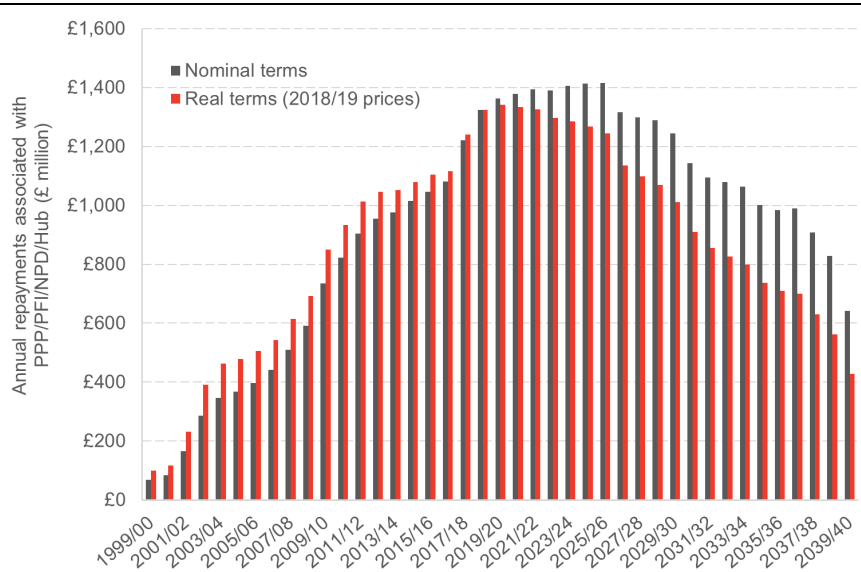
Many schools, hospitals and health facilities, and road infrastructure schemes have been funded through revenue financing – £8.9bn worth of projects in total since the 1990s. In recent years, between £400m - £800m of investment annually has been enabled through the NPD and hub programme.

One implication of revenue financed schemes is of course the constraint of future repayment. In 2017/18, unitary charges totalled £1.22bn, of which £1bn was associated with the former PFI programme<sup>50</sup>. Of this, around £500m was associated with schools, £300m with health projects, £170m investment with waste infrastructure, and £160m with transport projects.

Repayments are expected to reach £1.3bn by 2019/20 and peak at £1.4bn by 2023/24 in cash terms (Chart 5.4).

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<sup>50</sup> See GERS 2018 Box 3.3. In the figures mentioned above, we deduct £25m of annual unitary payments associated with Ministry of Defence procured schemes in Scotland.

**Chart 5.4:** Past and projected annual repayments associated with PPP/PFI/NPD/Hub programmes (£ million)

Source: Government Expenditure and Revenue Scotland (2018), supplementary tables

The relative merits of revenue financed schemes are debated.

In theory, lifetime costs to the public sector are more certain than traditionally funded investments, and may turn out to be lower if the private sector is better placed to manage risks and innovate in project design and management.

On the other hand, the private sector faces higher borrowing costs. Complex procurement processes may add to these, and long-term contracts may limit the flexibility to evolve the use of assets to reflect changing needs.

There have also been some concerns raised about the ultimate bearer of risk in certain projects. More generally, assessing value for money of NPD/hub schemes is difficult because the special purpose vehicles that deliver them are not subject to public sector requirements of accountability and transparency. NPD projects are not covered by Freedom of Information legislation, or to the scrutiny of Audit Scotland.

The significant level of repayment that these schemes expose the government to is clearly a risk. The government has set itself a self-imposed target that repayments associated with revenue-funded investment, capital borrowing, and the RAB schemes, discussed below, do not exceed 5% of its DEL budget. This is discussed further in Box 5.3.

At the UK Budget in 2018, the Chancellor announced that the UK Government will no longer use PFI projects, or the successor projects in England known as PF2, judging these projects to be 'inflexible', 'overly complex' and 'a source of significant fiscal risk to government'. It

remains to be seen whether this will trigger any re-think of the use of revenue financed methods in Scotland.

### *Regulated Asset Base (RAB)*

This is a form of financing used specifically for rail projects and is similar in principle to the PPP schemes discussed above. Network Rail pays for the up-front infrastructure costs by borrowing against the value of its asset base. In exchange, Transport Scotland pays an annual charge to Network Rail over the lifetime of the asset (usually around 30 years).

As such, RAB financing shares several of the advantages/disadvantages of the more general revenue financed methods discussed above, although financing costs do tend to be lower (given the ability of Network Rail to borrow competitively against the value of its assets).

All major rail investment projects in Scotland are currently funded through RAB.

However, following the reclassification of National Rail from a private to a public sector organisation, funding for rail projects will become completely grant-funded from 2019/20 (although annual repayments will still be due in respect of historic RAB-funded projects).

Indeed, the 2018 UK Budget included capital grant allocations for Network Rail in Scotland of £201m in 2019/20 and £388m in 2020/21.

### *Leverage*

The government also seeks to secure capital investment by leveraging in funding from the private sector or other funders.

City Region Deals have become a key channel for this to happen in recent years. The Glasgow City Region Deal contains a promise to lever in an additional £3.3 billion of private sector investment, the Inverness Deal hopes to unlock an additional £800m of private sector investment and the Aberdeen City Region Deal anticipates around a further £500m of leverage from the private sector and other economic partners.

That being said, how likely such funds will ever materialise is open to question. Some of the jobs and output boosts associated with some of the deals – in particular, Glasgow – seem to be highly optimistic.

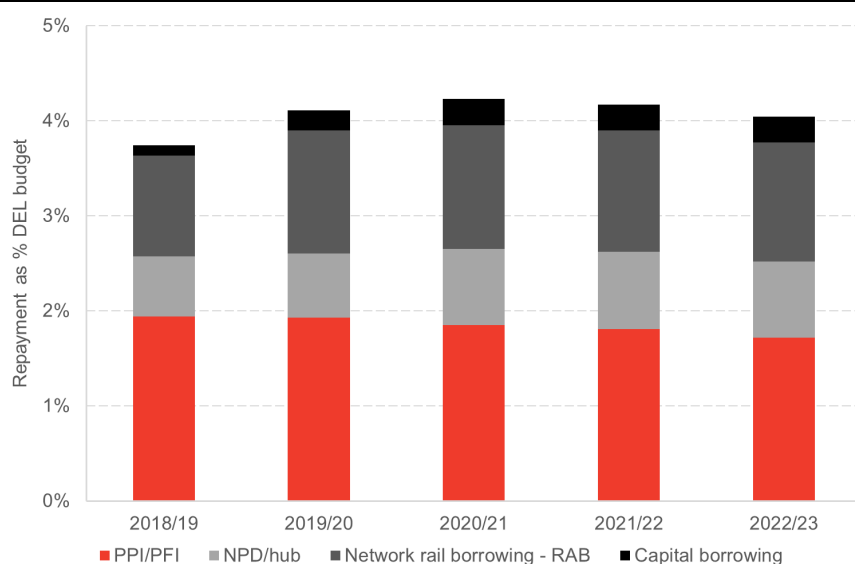
**Box 5.3: The affordability of the government's capital investment**

It will have become clear by now that a large proportion of the Scottish Government's capital programme is funded either by borrowing or through revenue-financed NPD and hub projects. These investments commit public bodies to annual repayments for many years into the future.

In order to ensure that these commitments are sustainable, the Scottish Government has adopted a self-imposed limit on revenue funded investment. This ensures that repayments do not exceed 5% of the government's expected future total annual budget for resource and capital spending.

According to analysis in Scotland's Fiscal Outlook, revenue commitments from current and planned projects will reach 3.74% of the government's DEL budget in 2018/19 (around £1.2bn), and peak at 4.23% in 2020/21 (around £1.4bn) (Chart 5.5).

**Chart 5.5:** Repayment of committed and planned revenue-funded projects and capital borrowing as a percentage of DEL budget



Source: Scotland's Fiscal Outlook (Table 3.3) <https://beta.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-five-year-financial-strategy/>

It is important to note however that this does not cover the value of revenue-financed repayments owed by all Scottish institutions. Whilst the Scottish Government pays the unitary charge for a large proportion of local government revenue financed investments, some schemes are the responsibility of local authorities only; moreover, Scottish Water also faces some unitary charges which do not fall under the government's 5% target. The total value of all revenue financed repayments will be closer to £1.8bn in 2020/21 (including the £1.3bn of total PFI/NPD/hub projects, around £500m of RAB repayments and repayment on capital borrowing of £60m.)



## 5.5 Capital spending by local government

A proportion of the Scottish Government's capital grant is passed to local authorities.

In 2018/19, the Scottish Government allocated £876m in capital grants, including £600m in general (non ring-fenced) grants, £19m for Strathclyde Partnership for Transport and £259m in specific capital grants (£150m of which relates to the expansion of early years facilities).

But total capital spending by local government is substantially higher than what would be possible through the capital funding from government alone. This is because local government capital spending is supported by grants from other organisations and institutions, through borrowing by local authorities themselves, revenue to capital transfers, and through receipts from asset sales.

In 2014/15, the capital grant from the Scottish Government accounted for 43% of local authorities capital spending. Of the remainder, borrowing accounted for 33% and other sources the remaining 26%<sup>51</sup>.

Total capital spending by local government in 2017/18 was around £2.4bn<sup>52</sup>. Of this, the largest elements of spend were education (£700m), roads and transport (£550m), planning and economic development (£375m), cultural services (£195m), and environmental services (£145m).

Local authorities also rely on the NPD/hub programme, largely through schools investment. They face unitary charges of £547m in 2017/18 from revenue financed investments<sup>53</sup>.

In conjunction with the Scottish Government, local authorities are also piloting various 'innovative' approaches to capital funding, described in Box 5.4.

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<sup>51</sup> Major capital investment in Scotland, Accounts Commission (2016)

<sup>52</sup> Scottish Budget 2018/19, Table 10.16

<sup>53</sup> GERS 2018/19

#### Box 5.4: 'Innovative' approaches to investment funding

Experiments with two 'innovative' forms of capital investment funding are underway, Tax Increment Financing (TIF) and the Growth Accelerator Model (GA).

**Tax Incremental Financing** uses future anticipated revenue gains from local taxes (Non-Domestic Rates) to finance the borrowing required to fund public infrastructure improvements. The aim is to enable local authorities to borrow against the increase in tax revenues that is expected to be generated by the infrastructure investment that the borrowing allows.

The Scottish Government has approved 6 pilot projects.

A risk with TIF is that the investment does not result in the revenue uplift anticipated. But even if there is an uplift which covers the borrowing, there is likely to be a limit to how many projects can be approved – if every local authority in Scotland used TIF to develop a business park, it seems unlikely that the gains to each individual authority would be as great as if only one or two business parks were developed! For this reason, the number of TIF projects is limited, and assessments of displacement have to be agreed before TIF projects are signed off.

More generally, whilst TIF might be useful in supporting investment around business development, it is harder to see how the initiative could be applied to health or education projects.

Under the **Growth Accelerator Model, the Scottish Government agrees to make a payment to local authorities for a period of time, following completion of a project which is anticipated to deliver particular outcomes.** These outcomes can include, but are not limited to, uplift in Non Domestic Rates Income and other indicators of increased economic activity such as number of jobs created, employment from more deprived areas, training places etc. The Growth Accelerator Model operates over a wider spatial scale than TIF.

The first GA project was signed in October 2016 with City of Edinburgh Council, for the St James Quarter, with up to £60 million of public sector investment seeking to unlock around £1 billion of new retail, leisure, hotel and residential development in the city centre. A second project has been agreed at Dundee Waterfront.

With both schemes – as per City Deals – there is an incentive to be as positive as possible about the potential gains and uplift. There is a clearly an incentive on the part of local authorities to emphasise the benefits to private contractors as the pay-offs are immediate and to downplay and risks given that they will occur so far into the future. It remains to be seen if the impact is as great as is hoped, particularly for projects that rely heavily on areas like retail and leisure to 'generate' the gains.

## 5.6 Financial transactions

In addition to its main capital grant, the Scottish Government has also – particularly in recent years – been allocated a share of ‘Financial Transactions’. Financial Transactions (FTs) are a particular form of capital spending, which can be used to make loans to, or equity investments in, private sector entities, including universities, or individuals.

The Scottish Government has been strongly critical of the nature of FTs, likening them to ‘funny money’. In part this relates to what the money can be spent on but also that FTs need to be repaid to HM Treasury (see discussion below about the proportion of loans that is expected to be repaid).

That being said, FTs do lead to genuine investment in key parts of the Scottish economy. And many other aspects of what the Scottish Government is doing itself to boost capital investment – e.g. capital borrowing, NPD etc. – themselves require money to be repaid. The Scottish Government is also not shy in showcasing activities – e.g. Help to Buy - that have used FTs for once the money is available.

Indeed, by 31<sup>st</sup> March 2018 the government had disbursed a total of £1.8 billion in FTs with a further £1.5 billion available over the period 2018-19 to 2020-21, excluding recycling of any repayments.

In 2018/19, FTs are being used to support a number of housing initiatives, including Help to Buy, alongside various energy efficiency and low carbon programmes.

The government plans to use FTs to capitalise the new Scottish National Investment Bank (SNIB). Under current plans, the SNIB will make its first investments in 2020. The aim of the SNIB is to provide finance and catalyse private investment to support growth and innovation. It will have a particular focus on providing ‘patient finance’, providing lending where the risks are higher or returns are longer than would be amenable to commercial lenders<sup>54</sup>.

Repayments of FTs to HM Treasury will commence in 2020 and continue until at least 2043. At the moment, the Scottish Government has agreed with HM Treasury that it will repay 80% of FTs, but detail is awaited on how the repayment profile will look in practice.

There is some risk here for the Scottish Government, in that if less than 80% of FTs is recovered, the shortfall may need to be recovered from within the more general capital budget.

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<sup>54</sup> Scottish National Investment Bank Implementation Plan (February 2018)

## 5.7 Conclusions

The Scottish Government has set out an ambitious programme of capital investment. Its programme for government in 2018 sets out a mission to ensure that capital investment is £1.5bn higher by the end of the next parliament compared to 2019/20. This is £1.3bn in today's prices, and represents a real terms increase of around a third.

How will these ambitions be funded?

The Scottish Government's block grant has increased substantially in recent years. In 2019/20 it will be 28% higher than in 2013/14 although this comes off the back of significant cuts since 2009/10 – the block grant remains below its pre-austerity peak. It remains unclear whether the government's ambitions can be met through the block grant alone.

Given that capital investment benefits future generations of taxpayers, a case can be made for transferring some of the costs of capital investment onto future generations, rather than funding the costs from the revenues of today's taxpayers.

The Scottish Government can now borrow to fund capital investment relatively cheaply. But its borrowing rules means that these powers are likely to be more effective for funding temporary rather than permanent increases in investment.

The government can increase capital investment further through revenue funded methods. But there remain ongoing questions over the value for money of these schemes.

Whilst there are strong arguments for increasing levels of capital investment – given the pipeline of projects and the ambition to achieve a step change in investment levels - there are risks of relying too heavily on borrowing and revenue financed methods. The government has set itself a cap for the annual costs of revenue funded investment. But the cap is somewhat arbitrary, and the current level of repayments, at over £1.2bn annually, has a significant opportunity cost.

Indeed, in recent years Scotland has made greater use of revenue borrowing techniques than other parts of the UK. It is also proposing significant use of its new borrowing powers, potentially constraining the use of those powers by future governments, as well as committing future generations to repay this borrowing.

In summary then, there is a strong case for maximising capital investment. There is a good case for using revenue financed methods. But a clearer strategy is needed to establish the principles underpinning the government's approach to investment, including the opportunity costs, to current and future generations of taxpayers, of the choices made.

# Options for reforming taxes

- Taxes (and charges) serve a range of purposes, including revenue raising and influencing behaviours. Recent times have seen a range of proposals put forward for reform of existing taxes, or the creation of new taxes, to serve either or both of these objectives.
- At a local level, proposals include a levy on visitors staying in short-term accommodation, a levy on employer provided parking spaces, and a tax on vacant land. None of these policies is likely to raise significant revenue in their own right, but they could provide local authorities with useful additional tools to meet their own particular funding and broader policy objectives.
- In terms of local taxation, there remains a strong case for reform of council tax. As has often been highlighted, the lack of recent revaluation and the structure of the banding system contrive to create an unfair tax. Reform could achieve a fairer tax structure in such a way to be revenue neutral, or to raise additional revenue with minimal distortion.
- Political momentum for reform appears to be growing, and the enthusiasm for reform held by the Scottish Green Party – who have supported the minority government's budget proposals in the last two years – will push this issue further up the agenda. One option could be a further change to the ratios between bands, similar to the one in 2017/18. Whilst this would raise just over £100m in 2019/20, and be broadly progressive across the distribution, it would not address the underlying weaknesses with council tax.
- If it wanted to raise revenues from income tax, the Scottish Government could consider any number of policies. Putting a penny on the basic, intermediate or higher rates could raise around £170m, £130m or £60m respectively.
- Much political debate will focus on the government's choices for the higher rate threshold. Compared to a policy to increase the threshold in line with inflation, freezing it in cash terms would raise around £60m, increasing it to £46,850 would cost £130m, and increasing it to £50,000 – to match rUK – would cost £280m.
- Of course, bolder tax policy measures are possible. The Welsh Government has been exploring the possibility of establishing a social security fund, where capped, income linked contributions are used to establish a fund that could be invested to yield a flow of revenues to support growing demand for social care. There are many practical obstacles to such a fund. It is perhaps the sort of radical thinking that is required in Scotland but is not yet being debated.

*There is growing interest in the scope to establish 'new' taxes in Scotland – or reform existing ones. Proposals range from taxes on visitors, parking, vacant land and disposable plastic cups. More broadly there have long been calls for reform of property taxation, with some evidence that such calls are gaining political traction. The government also has options to evolve income tax (and the other devolved taxes) to a greater or lesser extent. More fundamentally, with rising pressures on public services, it may wish to consider how it raises revenues particularly with an ageing population. This chapter reviews the case for and against a number of ideas for new or reformed taxes.*

## **6.1 Introduction**

As we saw in preceding chapters, the resource budgets of the Scottish Government and local authorities have faced eight years of constraint. At the same time, the spending pressures of a growing and ageing population have been increasing.

There is, therefore, greater interest in the scope for raising additional revenues at both national and local level. Proposals have been put forward for the establishment of various 'new' taxes. But there are also proposals to reform existing taxes, ranging from relatively minor tweaks through to more fundamental reforms.

Of course taxes (and charges) serve purposes other than revenue raising. They can help achieve distributional objectives and influence behaviours. The case for tax reform has to be considered on the basis of these wider objectives too.

In recent years for example, income tax changes have been introduced to raise revenues to support government spending objectives; changes to LBTT, including the First Time Buyers Relief and the Levy on Second Homes, aim to broaden homeownership by making home-buying more affordable for some groups; whilst the carrier bag charge drove a substantial reduction in use of disposable plastic bags.

This chapter considers a number of ideas for new taxes or reform of existing one. It considers how such reforms might support objectives for revenue raising, but also how they might help achieve wider policy objectives alongside the potential for the policy to have unintended or undesirable effects on behavioural change. We also highlight some practical issues associated with tax design and revenue collection.

It is clearly not possible to cover all possibilities or options, but we aim to cover several of the ideas that have been at the forefront of public debate in recent times. These include: a

Transient Visitor Levy (sometimes known as a tourist tax); a Workplace Parking Levy; tax on vacant land; and more general reform of property taxation. At national level, the ideas considered include: potential reforms of income tax, a levy on the use of disposable coffee cups; and the introduction of a social care levy.

Section 2 considers the advantages and disadvantages of several taxes that have been mooted for introduction at a local level, as well as scope for more fundamental reform of the taxation of (residential and commercial) property. Section 3 considers various tax options that could be introduced at a Scotland-wide level. Section 4 concludes.

## 6.2 Options for new or reformed taxes at local level

When is a tax most suited to implementation at local level? Where there is little scope for a tax base to relocate, or where a tax is intended partly to internalise the social costs on local communities of locally based activities, then taxes lend themselves to being set at a local level.

One issue that arises with any local tax is the equitability of funding across areas where a tax base is unevenly distributed. Grant from central to local government can offset some of these differences, but complete pooling and sharing arguably undermines the incentive for local authorities to introduce new taxes in the first place. As ever, issues of taxation cannot be separated from the operation of local government funding – and local government responsibilities – more generally.

This section considers the advantages and disadvantages of three taxes that have been mooted for introduction: a transient visitor levy, a workplace charging levy, and a vacant land tax. It also considers the case for broader reform of local property tax, including council tax and non-domestic rates.

### *Transient Visitor Levy (Tourist Tax)*

The City of Edinburgh has been exploring the idea of a Transient Visitor Levy (TVL) for some years now, with the current administration seemingly in favour of the concept. Several other authorities have or are considering introducing similar levies. COSLA has argued that all local authorities should have the discretion to introduce such a levy<sup>55</sup>.

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<sup>55</sup> COSLA press release (June, 2018) [www.cosla.gov.uk/news/2018/06/cosla-calls-more-financial-power-councils-starting-transient-visitor-tax](http://www.cosla.gov.uk/news/2018/06/cosla-calls-more-financial-power-councils-starting-transient-visitor-tax)

A Transient Visitor Levy is a charge paid on short-term accommodation. It would most obviously include hotel rooms but could also include B&Bs, serviced apartments, short-term lets such as Airbnb, and campsites.

In Edinburgh's case, the rationale is to raise revenue from visitors to help contribute to the costs that the local authority faces in accommodating them. The aim is not (explicitly) to reduce visitor numbers or to change behaviours in any significant way. Instead, the rationale recognises that visitors do impose costs on the city, but do not directly contribute to the council's revenues. Those in favour argue that it is justifiable to recoup some of these costs so that they do not fall on local residents and Scottish taxpayers more generally.

There are various options for the design of a TVL. It can be levied as a flat fee per room per night or per person per night. Or it can be levied as a percentage of the room price<sup>56</sup>.

A per room flat fee is likely to be the most straightforward, although it may bias occupation provision in favour of multiple occupancy rooms; in this respect per person rates would more effectively target the number of visitors.

The argument for a flat rate rather than a percentage of cost relates both to administrative simplicity and transparency. From a fairness point of view, it could also be argued that occupants of more expensive rentals do not impose greater costs on local infrastructure than do occupants of less expensive rentals. However, a flat rate will clearly represent a higher proportion of the bill of inexpensive rentals compared to more expensive ones. This may distort the market over time.

Whichever structure is advocated, most agree that children would be exempt. Furthermore, the fee would be capped after a certain number of nights.

Research for City of Edinburgh Council has indicated that a TVL could raise:

- Around £7m if it were levied at £1 per room per night (£14m if the charge was £2);
- Around £12m if levied at £1 per person per night (£23m if levied at £2 per person);
- Between £9m (1.5% of room rate) to £17m (3% of room rate) or £29m (5% of room rate)

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<sup>56</sup> Another option is to charge accommodation providers an annual levy per room (regardless of occupancy). This is administratively the simplest way, but it is unlikely to be an efficient way of designing the tax (rooms with low annual occupancy would face the same charge as those with higher occupancy).



Elsewhere, Glasgow City Council has estimated that a charge of £1 per room per night would generate around £3m each year for the local area.

One of the arguments against a TVL is that it may reduce visitor numbers. This may have a negative impact on local jobs and growth.

The extent to which visitor numbers change depends on the elasticity of demand for overnight accommodation<sup>57</sup>. Relatively little research exists into what this might be for UK cities, but the studies that do exist suggest that the response could range from almost no impact through to a like-for-like change (i.e. - a 1% increase in price leads to a 1% fall in demand).

It could be argued that Edinburgh's relatively unique tourism offering means that demand for overnight accommodation is likely to be fairly unresponsive to price changes. Furthermore, with many visitors to Edinburgh travelling from relatively further afield, a levy of £1-3 per person per room will in most cases make little difference to their overall costs. Domestic visitors may be more responsive.

On balance, the policy is unlikely to have significant impacts on the demand for overnight accommodation in Edinburgh, given the relatively small fee and low elasticity of demand.

A second argument against the TVL is that it targets one part of the visitor economy – the accommodation sector – but not others. But a levy charged on the visitor economy more generally, such as bars and restaurants, would be more complex to administer, and be far 'blunter' in the sense that it would not distinguish between visitors to Edinburgh and locals.

Administratively, accommodation providers would need to be registered and provide returns to the council. The scheme would entail costs for accommodation providers in setting up systems to collect and deposit the taxes. It may be that where bookings are made via websites, the levy could be collected by these agents and remitted directly to the levy-administering body<sup>58</sup>.

Changes to legislation would be required to enable local authorities to introduce a TVL. This could be in the form of primary legislation. Alternatively, it could be in the form of secondary legislation to repeal and amend the Local Government (Scotland) Act 2003 around the limit on local authorities to raise money by a levy.

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<sup>57</sup> Elasticity of demand is the degree to which consumers are responsive to price changes.

<sup>58</sup> In Amsterdam, Airbnb collects and remits the city's visitor levy to authorities on behalf of hosts.

In summary, a TVL would arguably provide a relatively simple mechanism to raise modest additional funds at the local level to support tourism infrastructure. As a concept, it will clearly appeal most to those local authorities who have large numbers of visitors.

### *Workplace Parking Levy (and other mechanisms for managing congestion)*

A Workplace Parking Levy (WPL) is a levy on employers who offer free parking to employees, students/pupils, and visitors. The aim of a WPL is two-fold: to reduce congestion, and to raise revenue (which could be hypothecated for transport improvements).

WPLs remain a relatively unusual fiscal instrument. Nottingham is one of few cities worldwide and the only one in the UK to have introduced a WPL<sup>59</sup>.

The Nottingham scheme is generally perceived as a success. Introduced in April 2012, the levy is an annual charge per parking place for employers with 11 or more spaces. Every workplace parking space is licensed, and employers with 10 or fewer spaces receive an exemption. The charge per parking space was £387 in 2017/18, and is linked to inflation.

The levy raises £9m a year and costs around £0.5m to administer<sup>60</sup> (for context, revenue expenditure by the council totalled £472m in 2017/18<sup>61</sup>). Revenue is hypothecated to local transport improvements. Grants are also provided to employers to support the uptake of cycling to work.

Research has found that the levy itself (as distinct from the transport improvements) has been associated with a reduction in congestion<sup>62</sup>. Some major employers introduced charging for staff parking, whilst others introduced other forms of parking management restrictions.

Local authorities in Scotland do not currently have the legislative competence to introduce a WPL. A recent report by Transform Scotland<sup>63</sup> argued that the Transport Bill should put in

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<sup>59</sup> The Australian cities of Perth, Melbourne and Sydney also run WPL schemes.

<sup>60</sup> Centre for Cities (2017) Funding and financing inclusive growth in cities. [www.centreforcities.org/publication/funding-and-financing-inclusive-growth-in-cities/](http://www.centreforcities.org/publication/funding-and-financing-inclusive-growth-in-cities/)

<sup>61</sup> National Statistics: Local Authority Revenue Expenditure and Financing 2017/18.

<sup>62</sup> Dale et al. (2017) Evaluating the impact of a workplace parking levy on local traffic congestion: The case of Nottingham UK. Transport Policy 59, 153 - 164

<sup>63</sup> Transform Scotland (2018) Getting the Bill Right <http://transformscotland.org.uk/wp/wp-content/uploads/2018/05/Transform-Scotland-Getting-The-Bill-Right.pdf>

place enabling legislation to allow local authorities to introduce a WPL, although the Bill (which was introduced in June 2018) does not currently contain such a provision.

Preliminary work for Glasgow City Council has found that there are around 18,000 private workplace parking spaces in Glasgow<sup>64</sup>. Based on a charge similar to the one operated in Nottingham, a WPL scheme could generate around £7m per year. However, if exemptions similar to those in Nottingham were to apply, the revenue generated may be closer to £4m<sup>65</sup>.

The case in favour of a WPL rests on the observation that congestion is one major external cost of driving (the other is emissions), particularly in cities. Individually, drivers tend not to take into account the full social costs of their commute – raising the price of the commute is one way to 'internalise' these costs.

But a WPL is clearly a fairly blunt tool to tackle congestion. Congestion varies both in time and in space<sup>66</sup>. In other words, it occurs at particular times and in particular locations. A WPL may not dis-incentivise driving through a congested area en route to somewhere else. At the same time, a WPL applied on an annual basis may impact on some people who do not contribute to congestion (e.g. they work unusual hours).

In the case of Nottingham, exempting employers offering fewer than eleven parking spaces seems somewhat arbitrary – implicitly implying that the congestion caused by smaller businesses is less socially costly than that caused by those working for larger businesses. It creates a risk that whilst the levy might cause larger employers to reduce the supply of workplace parking, smaller employers may increase provision.

Indeed, if the objective is to target congestion, then a policy based on London's congestion zone is likely to be more efficient. Here the levy applies to all drivers who enter the congested area at specific times. When a referendum was held on the possibility of such a scheme for Edinburgh, voters were overwhelmingly opposed.

In summary, a WPL may reduce congestion, raise modest revenue sums and be relatively easy to administer. By its nature, the policy is only likely to appeal to those authorities which have a major congestion problem.

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<sup>64</sup> Glasgow City Council (2016) Report of the local taxes working group, 15 November 2016

<sup>65</sup> Revenues may be smaller still if there is a change in the number of workplace spaces following its introduction. Research in Nottingham found that the number of spaces fell from 33,000 to 25,000 during the period of implementation – see Dale et al. (2017) op cit

<sup>66</sup> See Chapter 12 of the Mirlees Review of Taxation "Taxes on Motoring", for further discussion

Just as in the case of a tourist tax, it may also raise questions about the equity of the government's rules for distributing grant to local authorities if only some authorities are seen to benefit.

### *Reforming council tax*

The limitations of council tax have been extensively documented. In 2015, the Commission on Local Tax Reform highlighted a fundamental unfairness inherent in the system: that council tax liability is not at all well related to property value.

There are three key reasons for this. Firstly, the spread of ratios between council tax bands is not nearly as broad as the spread of property values (so that council tax is charged at a much lower percentage of property value for high-value properties than for low-value properties).

Secondly, there has been no revaluation of properties since 1991 - with the result that many properties are now in the 'wrong' band.

Thirdly, and indirectly, council tax liability is not well related to household income, (although one could debate the extent to which it should be).

The Commission on Local Tax Reform recommended that council tax be replaced by a 'fairer' tax, with options considered including a local property or land tax, a local income tax, and a reformed council tax based on up-to-date property valuations and revised banding structure.

In response, the Scottish Government took forward some modest reforms for the 2017/18 financial year. These amounted to a relative increase in liability for properties in bands E, F, G and H – a reform that was expected to raise around £110m. At the same time, the council tax freeze, in place since 2007, was relaxed. However, the Scottish Government stopped short of further reform, expressing no desire to undertake a property revaluation or to introduce a tax on land or property values at this time.

An equivalent increase in tax rates for bands E, F, G and H in 2019/20 would likely raise around £108m for local authorities (Box 6.1). This would not in itself be a particularly sensible policy as it would not address any of the fundamental problems with council tax (the fact that bands are not proportional to value, and many properties are in the wrong band). Nonetheless, it is the sort of reform that might be considered as part of a political imperative to be seen to do something.

**Box 6.1: A more progressive form of council tax?**

In 2017/18, the ratio of bands E, F, G and H were increased relative to band D. Table 6.1 shows that these changes cost households £106, £223, £340, and £528 on average in bands E, F, G and H respectively. The government introduced rules so that households who had income less than the Scottish median household income were not liable to these increases.

**Table 6.1:** 2017/18 reform to council tax

	Ratio to band D			
	Pre April 2017	April 2017 onwards	Difference in liability (cash)	Difference in liability (%)
Band E	1.22	1.31	£106	7%
Band F	1.44	1.63	£223	13%
Band G	1.67	1.96	£340	17%
Band H	2	2.45	£528	23%

If the government introduced similar proportionate increases to bands E, F, G and H in 2019/20, then this would increase tax liabilities in each band by £117, £260, £411 and £600 respectively (based on the Band D average in 2018/19 of £1208) – see Table 6.2.

**Table 6.2:** Potential future reform to council tax in 2019/20

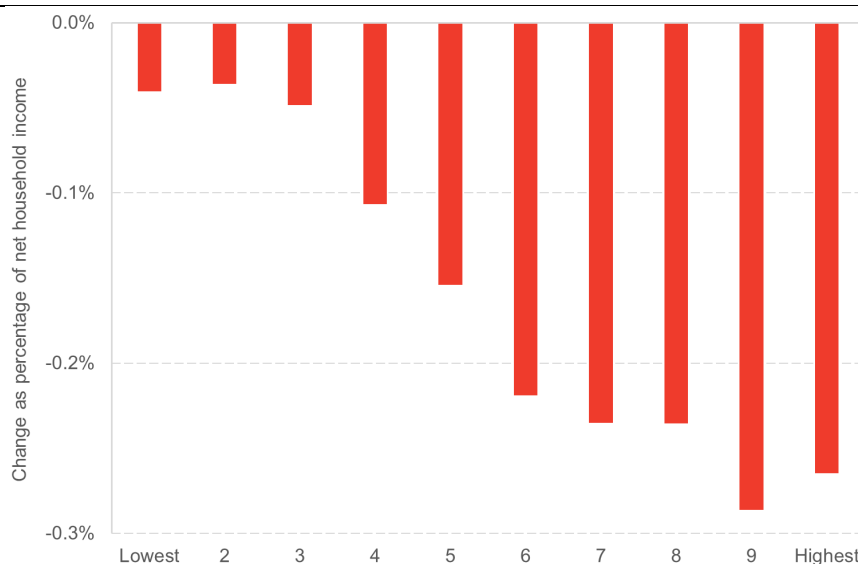
	Ratio to band D			
	Current	Reformed	Difference in liability (cash)	Difference in liability (%)
Band E	1.31	1.41	£117	7%
Band F	1.63	1.85	£260	13%
Band G	1.96	2.30	£411	17%
Band H	2.45	3.00	£666	23%

This reform would make the council tax system more proportionate to property value. The ratio of band A to band H tax would be 4.5:1, compared to 3:1 under the pre-April 2017 system.

But without a property revaluation, the relationship between property value and tax would remain weak.

The reform would be broadly progressive in relation to income (Chart 6.1).

**Chart 6.1:** Distributional effects of an increase in the ratio of council tax in bands E-H relative to band D



Source: FAI distributional model. The chart models the effects of the policy set out in Table 6.2. It is assumed that the policy is introduced alongside a relief so that households with income below the Scottish median are protected from increases. Nonetheless, the income definition used for the relief, combined with the fact that Chart 6.1 is based on equivalised income, means that some households in the bottom half of the income distribution do see small declines in net income as a result of the policy.

Political nervousness around reform of council tax is not new. In 2006, the Burt Review, recommended the replacement of council tax with a tax of 1% of property value. But this was rejected by the incumbent labour-liberal coalition. In 2009, the SNP minority government was unable to deliver a manifesto commitment to replace council tax with a 3% local income tax.

Is momentum for reform growing? Scottish Labour proposed a replacement of the council tax with forms of property value taxation in their 2016 manifesto. The Liberal Democrats have recently proposed the replacement of business rates with a levy on the value of commercial land<sup>67</sup>. Perhaps most significantly given their role in the budget process, the Scottish Greens – long-term proponents of reform – have indicated that progress on a more fundamental reform of council tax will be a prerequisite of their support for the 2019/20 budget<sup>68</sup>.

<sup>67</sup> Corlett et al (2018) Replacing business rates: taxing land, not investment. Report for the Liberal Democrats, September 2018

<sup>68</sup> See letter from Patrick Harvie to Nicola Sturgeon, February 2018  
<https://greens.scot/sites/default/files/Letter%20to%20FM%20re%20local%20tax%20reform.pdf>

### Box 6.2: Taxing land or property?

There are strong arguments in favour of taxing land (rather than the buildings on it). Because land has a fixed supply, taxing it does not result in a reduction in the supply of land. A land tax does not affect the demand for land and hence the rental rates for the land, but merely diverts a proportion of those rents to government rather than landowners. At the same time, it does not dis-incentivise individuals from making improvements to the value of properties on the land.

In contrast the existing system of land and property taxation as a whole is far from efficient<sup>69</sup>:

- The council tax system is poorly related to property or land value; moreover it often includes reductions or exemptions for properties that are unoccupied.
- Non-Domestic Rates are a tax on business premises that are an intermediate input to the production process. Taxing the value of these premises might put off firms from making improvements to premises in a way that a land tax would not.
- The Land and Buildings Transactions Tax (LBTT) is explicitly a tax on transactions. By driving a wedge between the price paid by buyers and that received by sellers, it limits the number of transactions that would otherwise be mutually beneficial for buyers and sellers alike.

To the extent that council tax, business rates and LBTT are arguably unfair and/or distortionary in various ways, a case could be made to replace all these taxes with a land value tax.

This, however, would clearly represent a major departure and require a programme of work to estimate land value. It is also likely to have significant distributional effects (which would require some form of response)<sup>70</sup>.

Consequently, the focus in the shorter term is likely to be on the scope for the introduction of a tax on property values as opposed to land values.

Taxes on property values, unfortunately, do not have the same efficiency benefits as a tax on land. A tax on property values reflects the values of buildings and structures as well as the land; given that these structures are reproducible, a tax can distort their supply. Nonetheless, to the extent that land makes up a large proportion of property values, a property tax would have some merit relative to the existing system of council tax.

<sup>69</sup> See Chapter 16 of 'Tax by Design', the Mirlees Review of Taxation, for further discussion

<sup>70</sup> Given the nature of the tax, it would also likely raise questions about the extent to which revenues from the tax should be shared between local and central government.

Research undertaken as part of the Commission on Local Tax Reform indicates that a recurrent annual property tax of around 0.6% - 0.65% would be 'revenue neutral'<sup>71</sup>. These estimates are in line with estimates for England<sup>72</sup>.

A case could, of course, be made for going beyond a revenue neutral tax rate, particularly if this included the abolition of residential LBTT.

Of course, a property tax would not need to be a flat tax – it could include a tax free allowance and progressive rate structure, similar to income tax. But there would clearly be significant distributional implications, and some form of transition is likely to be required. In particular, those in higher value properties are likely to see significant increases in their tax liability. Some of these households may have relatively low incomes and compensating policies may need to be introduced.

A change in the nature of council tax would also have implications for the revenues raised by individual local authorities. Some authorities are likely to see substantial increases in revenues, whilst others would see declines. Careful consideration would need to be given as to how to accommodate such changes within the grant allocation formula.

In summary, a strong economic case can be made to introduce a form of tax that is proportional to land or property value. As with any reform, there are likely to be challenges around the need for property valuation, and for some form of transitional arrangement to protect those who face large changes in their tax liabilities. Ultimately, the biggest challenge will be political and the fear that 'losers' from the policy will punish the government at future elections.

### *Vacant land tax*

Consideration has been given to the introduction of a tax on vacant or derelict land<sup>73</sup>. Such land could potentially be put to more productive use, benefiting communities and the wider economy. Land remains vacant for many reasons. But, as we have already discussed, the tax system actually discourages such land from being brought into use. Non-Domestic Rates

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<sup>71</sup> Leishman (2015) and Comerford (2015) in Annexes to the Commission on Local Tax Reform <https://localtaxcommission.scot/>

<sup>72</sup> Tax by Design, the Mirlees Review (2011) [www.ifs.org.uk/publications/5353](http://www.ifs.org.uk/publications/5353)

<sup>73</sup> The Scottish Vacant and Derelict Land Survey defines vacant land as 'land which is unused for the purposes for which it is held and is viewed as an appropriate site for development'. Derelict land is defined as 'so damaged by development that it is incapable of development for beneficial use without rehabilitation'.



are not charged on vacant or unused sites, but once they are developed they become liable<sup>74</sup>.

In the absence of a more fundamental reform of non-domestic rates, the introduction of a vacant land tax could help redress the tax incentives against bringing vacant land into use.

In principle the case for a vacant land tax appears sound, but there may be several practical obstacles to its implementation.

- First, there are issues around site ownership. A relatively large proportion of sites are likely to be publicly owned. Glasgow City Council estimates that it owns almost half of the vacant sites in the city. The net revenues from any vacant land tax may therefore not be as significant as would seem. For some sites, ownership may be unclear or disputed, making the basis of liability unclear;
- Second, legal challenges can be expected over the definition of vacant land, and over the valuation of such land for tax purposes; and,
- Thirdly, vacant and derelict land is concentrated in relatively few local authorities. Of the 12,800 hectares of vacant and derelict land in Scotland, almost half is located in four local authority areas (East Ayrshire, North Ayrshire, Glasgow, and North Lanarkshire). The political impetus for pursuing a vacant land tax may therefore be relatively limited in relation to some of the other ideas mentioned here.

### **6.3 Options for new or reformed taxes at national level**

This section considers options for revenue raising and other tax reforms by the Scottish Government. It primarily considers options for changes to income tax, and the arguments for and against introducing some form of social care fund.

Additionally, Box 6.3 considers the case for a very different type of levy – a charge for the use of disposable drinking cups.

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<sup>74</sup> The Barclay Review of Non-Domestic Rates recommended that relief on empty property should be curtailed; but NDR is not charged on vacant land.

### Box 6.3: A charge on disposable coffee cups

There is growing interest in the extent to which a charge on single use disposable hot drinks cups would discourage their use and favour reusable cups.

Interest in such a charge is motivated by the success of the charge on single use carrier bags, introduced in 2014. Between 2010 and 2014, the number of single-use plastic bags in Scotland increased from 760 million to 800 million. In the year following the introduction of the charge, plastic bag use had fallen to 160 million – a reduction of 80%<sup>75</sup>.

The carrier bag charge does not raise money for government. For each bag used by customers, retailers must charge 5p, and are encouraged to pass this on to charities. The charge is estimated to have raised around £6.7m for charity in its first year of operation from major grocery retailers alone (the total raised is likely to be around £8m).

The carrier bag charge is a good example of a successful 'nudge' – the trivial value of the charge itself is unlikely to deter shoppers from accepting a disposable bag from the retailer. But the fact of being explicitly asked whether one wants a bag is enough of a nudge to remind us that (most of the time) we have no need for more bags.

So what about single-use drink cups? Zero Waste Scotland estimates that around 208 million disposable coffee cups (DCCs) are thrown away each year in Scotland, resulting in approximately 3,000 tonnes of waste<sup>76</sup>. It follows that a 5p charge would generate £10m, or a 10p charge would generate £21m, if consumers did not respond. But of course the motivation for the charge is to induce a response from consumers, and the experience of the carrier bag charge suggests that the response is likely to be significant.

A significant reduction in use of disposable cups could therefore be expected following the introduction of a nominal charge. Consequently, a charge on disposable coffee cups would raise very little revenue for government (less than £10m).

But the policy is likely to be an effective way to reduce the use of disposable coffee cups and thus waste to landfill. And the charge could make a meaningful difference to local charities if retailers were encouraged to pass the charge on in this way.

<sup>75</sup> Zero Waste Scotland (2015) Carrier bag charge: one year on [www.zerowastescotland.org.uk/sites/default/files/SUCB%20Charge%20One%20Year%20On%20Report.pdf](http://www.zerowastescotland.org.uk/sites/default/files/SUCB%20Charge%20One%20Year%20On%20Report.pdf)

<sup>76</sup> Zero Waste Scotland (2017) Submission to Scottish Parliament (April 2017) [www.parliament.scot/S5\\_PublicPetitionsCommittee/Submissions%202017/PE1636A\\_Zero\\_Waste\\_Scotland.pdf](http://www.parliament.scot/S5_PublicPetitionsCommittee/Submissions%202017/PE1636A_Zero_Waste_Scotland.pdf)

*Income tax*

In Chapter 3 we outlined the likely revenue effects of various changes to the income tax schedule in Scotland, including adding a penny to various bands, and varying the thresholds between particular bands. These policies and their effects are summarised again in Table 6.3. Substantial revenue is only generated by broad based tax increases that are paid by a majority of income taxpayers. It is possible to argue a case for taxing additional rate taxpayers more highly from an equity perspective, but as a policy this is unlikely to raise significant revenue given the relatively small number of taxpayers affected.

**Table 6.3:** Indicative revenue effects of various income tax policies

	Static effect (no behavioural response)	Dynamic effect (including behavioural response)
1p on Basic Rate	£174m	£167m
1p on Intermediate Rate	£133m	£128m
1p on Higher Rate	£83m	£64m
1p on Additional Rate	£22m	£2m
Freeze Intermediate Rate threshold rather than increasing in line with inflation	£7m	£6m
Freeze Higher Rate threshold rather than increasing in line with inflation	£70m	£64m
Increase Higher Rate threshold to £46,850	-£145m	-£132m
Increase higher rate threshold to £50,000	-£306m	-£280m

*Source: FAI income tax model. The behavioural effects are subject to particular uncertainty; they are estimated using broadly similar assumptions to those adopted by the SFC*

But as well as tweaking the existing five band structure of income tax, there is also scope to consider tax reform more broadly. Box 6.4 illustrates one potential reform to demonstrate the scope for change.

#### Box 6.4: a potential reform to Scottish income tax

One of the features of the UK income tax system is that there are 'jumps' in marginal tax rates at particular tax thresholds. The fact that income from employment is subject to income tax and National Insurance Contributions (NICs) creates some particularly pronounced cliff edges in Scotland at the Scottish Higher Rate threshold.

In particular, the marginal rate of tax on earnings increases from 33% (21% income tax plus 12% NICs) to 53% at the Scottish higher rate threshold (41% income tax plus 12% NICs), before then falling to 43% (41% income tax plus 2% NICs) at incomes above the UK Upper Earnings Limit for NICs.

These cliff edges in the marginal tax rate schedule may act as a particular disincentive to earn more. One way to mitigate their effects is to introduce a 'formula-based' system of determining taxpayers' marginal rate, where each individuals' marginal rate is calculated as a function of income<sup>77</sup>.

Would it be possible to reform Scottish income tax to remove these cliff edges in marginal tax rates in a way that is broadly progressive but does not increase the marginal tax rate faced by 'top rate' income taxpayers?

In principle, it would be possible to introduce an income tax schedule for Scotland that was designed to 'work around' the UK-determined NICs thresholds to create a 'smoother' schedule of marginal rates. For example, starting at a Personal Allowance of £11,850 (which the Scottish Government does not have the ability to vary), the Scottish income tax schedule could:

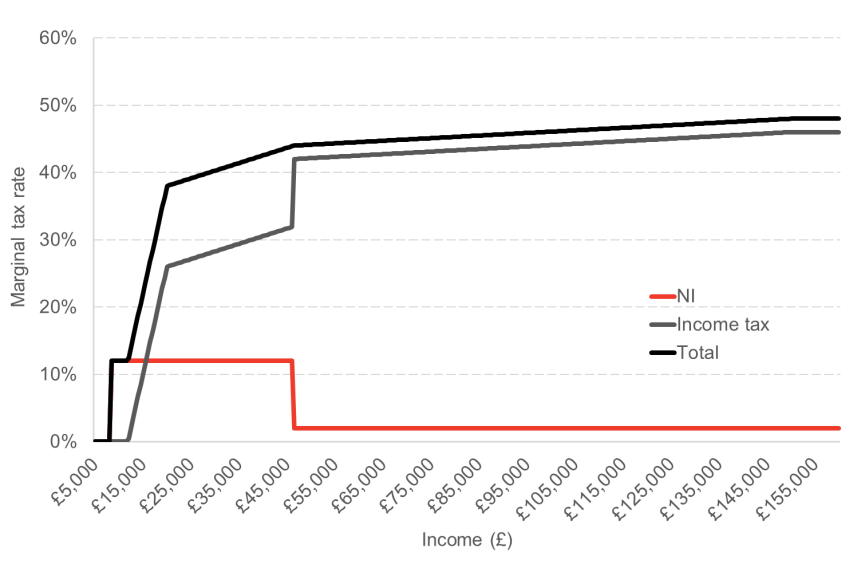
- Increase incrementally from 0% to 26% at an income of £26,000;
- Increase incrementally from 26% to 32% at the UEL threshold for NICs;
- Increase in a step to 42% at the NICs UEL threshold to offset the fall in marginal NICs rate from 12% to 2%;
- Increase incrementally to a peak of 46% at income of £150,000.

This schedule would be broadly revenue neutral with respect to the current 2018/19 income tax schedule in Scotland.

<sup>77</sup> For a detailed exposition of this policy, see Stirling (2018) Tapering over the tax: reforming taxation of income in the UK, IPPR, March 2018

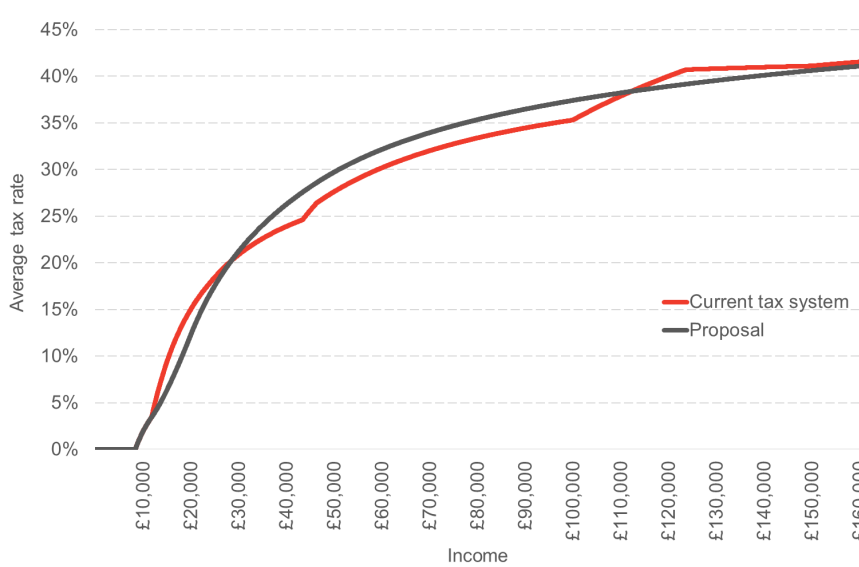
The effects of this schedule on the combined NICs and income tax marginal tax rate are shown in Chart 6.2. The effects on the average rate of tax are shown in Chart 6.3. By replacing the 19% 'starter rate' of income tax with a rate that increases gradually from 0%, Scottish taxpayers earning less than £28,000 (just over half) would be 'better off' under these proposals.

**Chart 6.2:** Marginal tax rates on earnings under an alternative proposal



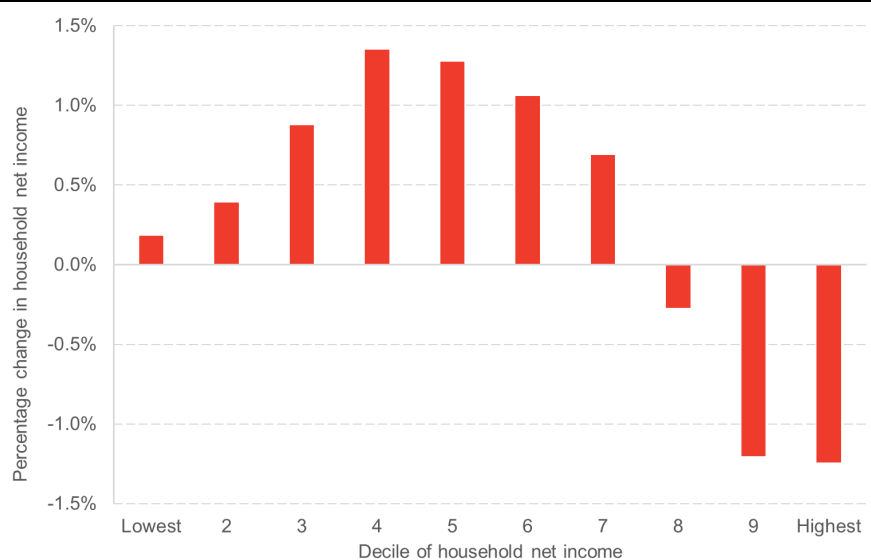
Source: FAI analysis

**Chart 6.3:** Differences in average tax rate between existing and proposed tax schedule



Source: FAI analysis

**Chart 6.4:** Distributional effects of proposed income tax reform by income decile



Source: FAI analysis

There are clearly practical difficulties with a proposal such as this. HMRC would be required to operate such a system.

The formula based nature of the income tax schedule may limit transparency and understanding of the system. And whilst this particular reform would eliminate the jump in marginal rate of earnings taxation at the Higher Rate Threshold (for those who pay income tax and NICs), it would not eliminate the threshold for those who pay income tax only (e.g. the over-65s), or those who face a different NICs rate (the self-employed).

We do not claim that this illustrative system is necessarily superior, all things considered, than the current system, but simply to make the point that discussion of income tax reform can (and should) go beyond a simple discussion of varying rates by 1p or freezing thresholds.

### *A social care fund for Scotland?*

Expenditure on social care for those aged 65+ in Scotland was £1.4bn in 2016/17 and is projected to grow at 3.9% per annum over the period to 2023/24<sup>78</sup>.

As discussed in Chapter 4, the government has not set explicit funding targets for social care, and its 'non-protected' budget is on course to face significant real terms declines over

<sup>78</sup> Scottish Government Medium Term Health and Social Care Financial Framework (October 2018)

the course of this parliament and beyond. The question of how increasing demand for older age social care will be funded is thus becoming particularly acute.

The Scottish Government has a number of options. It could shift more of the burden of social care onto individuals themselves, by introducing a tougher means testing regime. This would be unpopular however, and counter to the notion that the state should insure individuals against the risks of requiring care in older age. Thus, there is likely to remain strong public support for a heavy element of public funding for social care.

It could assume (or hope) that, faced with a similar challenge in England, the UK Government will announce spending increases which will generate consequentials. There have been debates about whether a UK-wide supplement to national insurance should be introduced for the purposes of funding an increase on social care spending.

Alternatively, it could use its income tax powers to support the social care funding requirement. One of the arguments against this, however, is that an income tax rise today would largely be paid for by today's generation of workers for the benefit of today's old age population, yet without providing any guarantee that today's generation of workers will receive an equivalent level of protection in their old age.

Recognising these issues, the Welsh Government has considered the scope to introduce a form of social care fund in Wales<sup>79</sup>. The thought-provoking report argues that individual contributions should be linked to income but capped to insure that individuals do not end up paying-in more to the scheme than they could ever hope to get back, given the premise of the scheme is to provide insurance against the risks of requiring social care in old age. It considers issues such as:

- Should a social care fund for Wales be contributory where benefits are linked to past history of contributions? The report argues that it probably should be, given the propensity of people to retire to Wales from other parts of the UK, but recognises administrative barriers
- Should contributions be related to age-cohort, so that today's young (who will pay into the scheme for 40 years) pay in at a lower rate than today's old (who may only pay-in for a few years)? The report again argues that this feature would be desirable but administratively difficult.

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<sup>79</sup> Holtham (2018) Paying for Social Care, an independent report for the Welsh Government.  
<https://gov.wales/about/cabinet/cabinetstatements/2018/payingforsocialcareholthamreport/?lang=en>

- Should any revenues raised be spent immediately (so-called 'pay as you go') or invested in a fund that can yield a flow of benefits into the future? The report points out that an invested fund would be fairer inter-generationally, as tax rates could be smoothed over time – a pay-as-you-go scheme could start with lower rates but these would have to increase over time to reflect need.

The fact that Wales is having such a discussion, but Scotland is not, suggests that we need to up our game in Scotland with regards to the level and quality of debate.

There are of course many practical difficulties in operationalising proposals such as these. In many ways it feels as though these types of funding discussions should be discussed and considered at a UK level, given both the administrative complexities of having devolved systems, and the fact that National Insurance remains a UK tax.

On the other hand, the funding of adult social care – including the scope of means testing and rules around what proportion of an individual's wealth and assets should be taken into account – are determined at a devolved level. Given these interactions, it would certainly be hoped for that the UK Government would involve the devolved governments in any policy reforms that it was developing.

## 6.4 Conclusions

The 'tax debate' at Holyrood in the run-up to and aftermath of the Scottish Budget being presented is likely to focus on income tax. There will be debate about the extent to which the rates and bands of the existing five band structure should be tweaked for the purposes of revenue raising, and how far the Scottish tax schedule should deviate from the UK's.

But there is a strong case for thinking more broadly. In terms of meeting longer term revenue needs, the Welsh Government has actively considered the scope for a Welsh social care fund. There are undoubtedly many practical issues associated with such a scheme, but it is sensible to consider options. The ability of the Scottish Government to introduce 'new' taxes following the Scotland Act 2012 may well create further opportunities that could and should be considered.

Of course, all of this needs to balance wider objectives on the economy and tackling inequalities.



Many of the recent proposals for the introduction of 'new taxes' have been proposed for introduction at a local level. On the whole, these proposals are unlikely to raise much by way of revenue – and most of them focus on a tax base that only some areas would benefit from.

But in the interests of promoting local revenue responsibility and autonomy, there is a good case for enabling local government to introduce new taxes where there is demand.

One existing tax for which there is a strong reform case is council tax. There is scope to make this tax fairer, and this reform can be done so as to be revenue neutral or revenue raising.

Such a reform would require a commitment to revaluation and some bold policy-making. But in terms of reforms that enhance the fairness and coherence of the tax system and have scope to raise revenue in relatively less distortionary ways, there is a stronger case for focussing efforts here than on income tax.

This point has been made before of course. A danger is that reforms are made which scratch the surface of the problem but do not address the fundamental issues. It will be interesting to see how far the government moves towards reforms in the remaining years of this parliament, given the Green Party's enthusiasm for reform and the minority government's need to secure the passage of the budget bill through parliament.

# Financing Higher Education in Scotland

- The Scottish Government has adopted a different position to HE funding compared to England.
- Higher education in England is increasingly funded through tuition fees which most students pay by taking out a fee loan. This policy is not costless for the taxpayer however given that loans repayments are income contingent and outstanding loan is written off after 30 years.
- In Scotland, the costs of tuition for fulltime, first time Scottish domiciled students remain wholly funded by the Scottish Government, although most students are expected to fund their own maintenance costs, and a majority take out maintenance loans to do so.
- Where the Scottish Government chooses to fund HE through grants – whether these are grants to students to pay fees or support living costs, or allocations directly to universities via the Scottish Funding Council – this is funded from the Scottish Government's total resource allocation.
- The provision of student loans has no impact on the Scottish Government's resource budget. Instead, loans issued score as 'Annually Managed Expenditure' (AME), whilst the estimated value of the impairment associated with student loans is scored as 'ring-fenced non-cash', with both elements being provided to the Scottish budget by the UK Government. The limits of the government's AME and ring-fenced non-cash budgets are not determined by fiscal rules as such, but are subject to negotiation with the UK Government in the event that the Scottish Government wants to change its loan policy.
- In principle HM Treasury would countenance any Scottish Government loans policy that could be interpreted as broadly equitable – in relation to the loan amount and repayment conditions – to what was available in other parts of the UK. But these limits have not to date been tested, given the much lower reliance on loans in the Scottish system.
- In 2018 the Scottish Government announced changes to the loan repayment conditions that will apply to maintenance loans offered to Scottish domiciled students. The loan repayment term will fall from 35 years to 30 years and the repayment threshold (the income above which repayments are due) will increase from £18,300 to £25,000, aligning Scottish loan repayment policy with England. However, the interest rate on Scottish loans will

remain significantly lower than is charged on English loans. These changes will reduce the repayments of Scottish graduates in the lower half of the distribution of lifetime income.

- On average, the tuition costs associated with a full-time, first time, Scottish domiciled undergraduate are £7,000 per annum, or £28,000 for a typical four year degree. These costs are met from the Scottish Government's resource budget, and are channelled to universities partly through the Student Awards Agency for Scotland, and partly through the Scottish Funding Council.
- The Scottish Government could if it wished introduce an element of tuition fee payable by students with the support of loan. Some proportion of the resource budget freed up could be used to provide funding or bursaries for students from less advantaged backgrounds. The burden of funding HE would shift to students themselves (through loan repayments) and the UK government (through loan default).
- Replacing the publicly funded element of the £7,000 tuition cost entirely by a tuition fee could save the government around £800 million per year once it was rolled out across cohorts. However, a fee at this level would imply substantial loan write-off, and would probably not be countenanced by the UK Government (at least without more stringent loan conditions being put in place). It would also impose a substantial debt burden on students, and even though loan repayment conditions would ensure that the profile of lifetime repayments was proportionate to lifetime income, there would be fears about the implications of such levels of debt for participation rates. In contrast, a loan of £1,000 per annum would reduce the Scottish Government's resource allocation to HE by just over £100m.
- The ONS is currently undertaking a review of the treatment of student loans in the public finances, and will report in December 2018. Its recommendations are quite likely to influence the capacity of the Scottish Government to provide loans. The impairment element of loans may be treated more like grant - if so, this may provide the Scottish Government with additional budget flexibility to provide its current (no fee) policy.

The authors acknowledge the advice during the drafting of this chapter from staff at the Scottish Government, Scottish Fiscal Commission, Lucy-Hunter Blackburn at the University of Edinburgh and Suzi MacPherson at the Scottish Parliament. Any errors or omissions are the responsibility of the authors.

## 7.1 Introduction

In each of our Scotland's Budget reports, alongside a discussion of the immediate tax and spending choices facing the Scottish Government we also discuss some longer-term issues of interest.

The approach to the funding of Higher Education (HE) in Scotland, Wales and Northern Ireland is a matter for the devolved administrations; the UK Government determines higher education policy for England.

The Scottish Government has adopted a different position to HE funding compared to England<sup>80</sup>. In England, successive reforms have shifted the financing of HE away from grants (provided both to universities and students) towards tuition fees. Since fees were introduced at £1,000 per year in 1998, the cap now stands at £9,250 (with most charging at or close to this cap).

However, this does not mean that HE in England is costless to the taxpayer. Nearly all undergraduates take out a loan from government. Repayment is contingent on graduates' future income, with any outstanding debt written off after 30 years. Loans are also made available to support living costs, and again the repayment of these is income contingent and subject to write-off after 30 years.

The level of debt now incurred by a typical English student, combined with the repayment terms, implies that almost 50% of lending issued to the 2018/19 cohort will not be repaid, with the default ultimately met by the taxpayer.

In Scotland, the SNP administration has retained its flagship policy of free tuition for Scottish domiciled students (which also applies to eligible EU students)<sup>81</sup>. It funds the costs of HE study from its resource budget, but relies largely on loans to fund maintenance grants. As a result, Scottish students graduate with significantly less debt than English students. But the opportunity cost of this policy is lower resource spending on other public services than would be the case were Scotland to follow the English policy.

Scottish domiciled students do not graduate debt-free however, as loans are still provided to support living costs. As in England, repayment is income-contingent and subject to write-off

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<sup>80</sup> This report looks specifically at funding arrangements for full-time degree level study. 'Higher education' strictly speaking is broader than this, encompassing sub-degree level study and part-time study.

<sup>81</sup> The previous Labour/Liberal Democrat coalition introduced a Graduate Endowment, a levy of £2,000 charged on graduation.

after 30 years. However, the lower level of loan issued in Scotland (and some differences in repayment conditions) means that the proportion of loans written off tends to be much less.

Public debate about the most appropriate way to fund HE tuition is influenced by a number of overlapping arguments.

At the heart of the debate is the question of the extent to which the costs of HE study should be shared between the beneficiaries (graduates) and the state. On the one hand, HE provides social benefits (society needs teachers, doctors, engineers, etc.), and these skills may be under-provided if left to the market. On the other hand, most graduates earn a premium, implying that there are private benefits to HE which individuals are likely to be prepared to contribute to.

Perspectives on how the costs of HE should be balanced across the public and private domains depend also on debates about access and equity. For the Scottish Government, publicly funded HE tuition is seen as part of a social contract which aims to widen participation. Others see it as a subsidy to the mainly better-off individuals, and challenge whether it is particularly helpful in supporting participation from students from low income backgrounds (Riddell et al. 2015).

The extent to which the costs of HE tuition should be met by students is also influenced by a range of interrelated questions and debates. Does the introduction of tuition fees create a 'market' for HE, helping more informed decisions about what and where to study, ultimately raising quality? Does the public funding requirements of HE policy that requires the capping of domiciled student numbers create a socially sub-optimal level of provision; or would a privately financed fees system with no cap result in an over-supply of graduates at the expense of more technical or vocational skills?

The funding of HE is such a contentious issue that new consultations are announced on a regular basis. In early 2018, Theresa May announced the latest review of HE funding in England (coming on the back of recent reports by the House of Commons Treasury Committee and the House of Lords Economic Affairs Committee), whilst the most recent review of Student Support in Scotland was published in autumn 2017.

Nonetheless, whilst there has been a substantive body of research about the costs and implications of HE funding arrangements and proposals in England, there has been a relative lack of comparative analysis for Scotland. This is no doubt partly because of the apparent political consensus in favour of the status quo. Nonetheless, there is a general lack of clarity about issues such as: the way in which HE funding decisions by the UK Government for England influence the choices and constraints facing the Scottish

Government; the extent to which the Scottish Government has 'room for manoeuvre' within its budgets to change the repayment conditions associated with student support; and the opportunity costs associated with a free tuition policy for the devolved Scottish budget.

This chapter aims to contribute to filling this gap. After describing the context and relevant public financing rules, it describes some of the policy options and opportunities available to the Scottish Parliament. It does not aim to be prescriptive in any way – it makes no recommendations, and does not restrict its analysis to policies that are likely to receive political backing in the short-term. But its rationale is based on the belief that there is merit in being transparent about the full range of options available and their implications.

Section 2 describes the public finance implications of the approach to HE tuition funding in England, and the extent to which the Scottish Government's options are influenced by these funding rules. It introduces the critical concept of the 'RAB charge', the proportion of student loans that are expected not to be repaid. Section 3 sets out the arrangements for funding HE that have been adopted in England and Scotland in recent years.

Sections 4 and 5 consider the implications of recently announced and potential policy reforms in Scotland. First, Section 4 considers the implications of recent changes in conditions attached to maintenance loans. Second, Section 5 asks what the effects on the Scottish budget would be of a hypothetical shift in the balance from grant to loan in the funding of HE in Scotland. Section 6 concludes.

## 7.2 Public finance implications of HE funding

### *Public finance implications of HE funding: the UK dimension*

Where the UK Government spends money directly on higher education – for example through the provision of ‘teaching grants’ to universities, or of grants to students to fund tuition or maintenance – those resources form part of the government’s resource spending.

Loans to students are treated differently. The accounting treatment of such loans has to recognise that many people in receipt of them will not repay them in full. This is partly because repayments are contingent on income, and partly because outstanding loans are written off after a defined period of time. The fact that a significant proportion of loans are written off is not a flaw in the system, but a deliberate feature, in effect ensuring that an individuals’ contribution to their tuition fee costs is proportionate to future income.

Loans issued to students that are eventually repaid in later life do not represent a cost to the taxpayer. But every pound of student loan debt that is not repaid does. The accounting treatment of student loans in the Department for Education’s accounts recognises that a proportion of the value of loans issued will be written off, or ‘impaired’.

The impairment on the initial outlay of loans is known as the Resource Accounting and Budgeting (RAB) Charge. The RAB charge defines what proportion of student loan debt the government expects to write off, and is given by:

$$RAB = 1 - \frac{\textit{Total net present value of graduate repayments}}{\textit{Total issues in government loans}}$$

The higher the RAB charge, the larger the proportion of student loan debt written off. For example, a RAB charge of 30% would imply that 30% of lending will not be repaid, and thus be incurred by the taxpayer.

As the financing of HE in England has shifted away from grants to loans, assessments of the long-run taxpayer cost of HE in England has become increasingly contingent on the estimated RAB charge.

The RAB charge is influenced on the one hand by policy decisions regarding loan repayment conditions, i.e. the value of loans issued, the interest rate, repayment threshold & rate, and write-off period. A higher repayment rate will increase the proportion of loans repaid, whilst a higher repayment threshold (i.e. income below which no repayments are made) will increase the RAB charge. Increasing tuition fees does not necessarily reduce the long-run cost to the taxpayer, if it simply means that a greater proportion of loans go unpaid.

But the RAB charge is also influenced by more uncertain factors, including projections of future trends in graduate employment and earnings (the higher future graduate earnings, the lower the RAB charge). It is also influenced by the discount rate, i.e. the value that the government places on repayments in the future (the lower the discount rate the lower the RAB charge).

The estimated RAB charge for full-time undergraduates studying in England is 45% in 2017/18<sup>82</sup>. The increase in the repayment threshold to £25,000 in 2018/19 is expected to raise the RAB charge to 48% according to a recent House of Lords report<sup>83</sup>.

When income contingent loans make up a large proportion of HE funding, the RAB charge has a substantial implication for estimates of the long-run taxpayer subsidy of HE. The IFS estimate that total upfront government spending on HE for the 2017/18 cohort of English domiciled students studying in England is £17bn, of which only £745m is in the form of teaching grant (to support certain high-cost subjects), with the remainder of just over £16bn provided in the form of loans<sup>84</sup>. For a RAB charge of 40% the impairment (i.e. long-run taxpayer cost) associated with these loans is £6.5bn, but for a RAB charge of 45% it would be £7.3bn.

Note that our description of how loans are accounted for via the RAB-charge reflects the Department for Education's accounts. Their treatment of loans is the relevant one from a devolved context, because it is this approach which (indirectly) determines the capacity of the Scottish Government to also issue loans. However, student loans are accounted for differently by the ONS in the UK Government National Accounts – see Box 7.1.

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<sup>82</sup> Department for Education, Student Loan Forecasts 2017/18

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/719817/Student\\_loan\\_forecasts\\_2017-18.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/719817/Student_loan_forecasts_2017-18.pdf)

<sup>83</sup> House of Lords Economic Affairs Committee (2018) Treating students fairly: the economics of post-school education. Second report of session 2017-19.

<https://publications.parliament.uk/pa/ld201719/ldselect/ldeconaf/139/139.pdf>

<sup>84</sup> Institute for Fiscal Studies (2017) Higher Education funding in England: past, present and options for the future. IFS Briefing Note 211. Institute for Fiscal Studies, London. <https://www.ifs.org.uk/uploads/BN211.pdf>



**Box 7.1: Accounting for student loans in the UK National Accounts**

Whereas future loan impairments are explicitly recognised in the Department for Education's accounts, loan impairments are not explicitly recognised in the national accounts. In the national accounts, loans are not a government expenditure. Loan write-offs are counted as expenditure however, but only when the write-off actually occurs. In the case of student loans issued in 2018, losses on these loans will only be recognised in the national accounts in 2049/50. Compared to the funding of HE through grants – where spending does add to the fiscal deficit – funding HE study through loans does not add to the deficit (until that point in future when loans are written off).

This 'fiscal illusion' of student loan accounting is exacerbated by the fact that interest on student loans is recorded as income to the government as it accrues. This further flatters the deficit today, but it ignores the fact that much of the accrued interest will eventually be written off rather than repaid.

On top of this, the UK Government has sold several tranches of the student loan book (i.e. outstanding student loans) at around half face value. Outstanding student loans do add to the government's debt, so selling them is a way of reducing the debt. The sale of loans effectively means that the government has brought forward the write-offs on these loans and recognised them today. But the sale of the loans means that the write-offs are not recognised at all in the deficit, even at the end of the loan term.

The OBR<sup>85</sup>, the Treasury Select Committee of the House of Commons<sup>86</sup>, and the House of Lords Economic Affairs Committee<sup>87</sup> have all criticised the 'distorting effect' of the accounting treatment of student loans, which the OBR itself calls a 'fiscal illusion'. The House of Lords Economic Affairs Committee suggests that the accounting treatment of student loans was likely to be a factor influencing the shift from grant to loan funding, and the choice of the high interest rate in the English loan system.

The OBR has been investigating alternative ways to account for student loans, in order to remove, or reduce, this fiscal illusion<sup>88</sup>. The ONS has also been working with other international statistics agencies to develop a new approach and aims to report later in 2018. It remains to be seen how any changes to the approach in the UK accounts will affect the accounting of loans at a Scottish Government level.

<sup>85</sup> OBR (2018) Student loans and fiscal illusions. Working paper No.12. <http://cdn.obr.uk/WorkingPaperNo12.pdf>

<sup>86</sup> House of Commons Treasury Select Committee (2018) Student Loans. Seventh report of session 2017-19. House of Commons, London. <https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/478/478.pdf>

<sup>87</sup> House of Lords Economic Affairs Committee (2018), op. cit.

<sup>88</sup> OBR (2018) Working Paper No. 12: Student loans and fiscal illusions, op. cit.

### *Public finance implications of HE funding: Scotland*

Higher Education is a devolved matter, and the Scottish Government is effectively free to set its own policy with regard to HE funding, including the balance between grant and loan for tuition, and the conditions attached to students loans. However, the size of the Scottish budget available to provide different types of funding is effectively constrained by the policy decisions of the UK Government.

Where the Scottish Government chooses to fund HE through grants – whether these are grants to students to pay fees or support living costs, or allocations directly to universities via the Scottish Funding Council – this funding forms part of the Scottish Government's total resource allocation. The more that the Scottish Government allocates to HE, the less it has available to allocate to other areas of public spending.

When it comes to providing student loans, there are two elements to the Scottish Government's capacity to provide loans:

- The cash value of net loans issued in any given year (where the net loan is total loans issued minus repayments) counts against the Scottish Government's Annually Managed Expenditure (AME) budget.
- The estimated value of the impairment associated with student loans is scored as 'ring-fenced non-cash'.

What determines the level of AME and ring-fenced non-cash budget that the Scottish Government has available to it?

AME is used to fund 'demand-led' expenditure that can fluctuate from year-to-year (notably spending on public sector pensions and social security). The Scottish Government does not have a set AME allocation, but provides HM Treasury with forecasts of its AME requirement each year. There is a general presumption that HM Treasury will provide sufficient AME in order for it to provide 'comparable' public sector services across the UK.

The Scottish Government's 'ring-fenced non-cash budget' for student loans is a measure of the impairment associated with loans issued in Scotland. As its name suggests, it is not 'real' spendable cash, but an accounting term that is a function of the value of loans issued in Scotland and the RAB-charge associated with those loans.

In principle, the amount of ring-fenced non-cash budget available to the Scottish Government is determined by the Barnett Formula. In practice, the Scottish Government provides a forecast of its non-cash budget requirement to the UK Government, and it is this forecast that appears in each budget. The Scottish Government clearly does not use the full

extent of its hypothetical Barnett allocation of non-cash budget, given the far lower level of total loans issued in Scotland.

But even a hypothetical allocation of non-cash budget would understate Scotland's equitable share of English loan impairment. This is because the costs of writing down student loans in England has become so substantial that much of the impairment is funded through large annual reserve claims that do not generate Barnett consequentials. This is all a slightly technical way of saying that the impairment associated with Scottish loans is far smaller than either its hypothetical allocation of non-cash budget, and far smaller than what a proportionate share of the English non-cash budget would be.

To what extent might the Scottish Government have capacity to either offer higher loans to students, or to make the repayment terms on loans for Scottish domiciled students more generous?

The answer to this question does not depend on specific rules or quantitative allocations. Instead, the answer would depend on the outcome of negotiations between the Scottish and UK governments over whether a particular Scottish policy was broadly equitable in relation to England.

To date, the boundaries to the question of 'what is comparatively equitable' has not been tested, as the Scottish Government has issued far fewer loans than in England, and the repayment conditions on those loans have, until recently, not been particularly generous to students<sup>89</sup>.

It remains unclear however quite how much further the Scottish Government might be able to increase the generosity of terms on Scottish maintenance loans relative to English loans – bearing in mind that the costs of such moves would not have a detrimental effect on the Scottish resource budget.

Moreover, if the Scottish Government did want to issue more loans (or loans of higher value), hypothetically for example following a decision to introduce tuition fees, the question of how much loan could be offered and on what terms would have to be resolved through negotiation<sup>90</sup>.

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<sup>89</sup> As we will see in the subsequent section, the Scottish Government has recently announced a reduction in loan term and an increase in the repayment threshold. These changes both make the loan repayment rules more generous to Scottish students and increase the RAB charge.

<sup>90</sup> In practice, if the Scottish Government wanted to introduce tuition fees on the same terms as in England it is difficult to see how HM Treasury could object, although the prevalence of 4-year rather than 3-year degrees in Scotland could challenge discussions around what is equitable in funding terms

### 7.3 Financing higher education in England and Scotland: an overview

To provide context for the remainder of the chapter, we next set out the arrangements for HE funding in England in Scotland, how these arrangements have evolved and the current debates around funding options.

#### *Higher education funding arrangements in England*

Until 1997, the UK Government funded the full tuition cost for undergraduate students, providing teaching grants to universities. Loans to support student living costs during study were available. Tuition fees of £1,000 per year were first introduced in 1998. No tuition fee loans were available but fee waivers were provided to those from poorer households.

In 2006, tuition fees were increased to £3,000 per annum and income-contingent tuition fee loans were introduced. The rise in fees again acted to boost university income, as there was no reduction in teaching grants.

In 2012, the tuition fee was increased to a 'basic amount' of £6,000, with institutions able to charge up to £9,000 per annum if certain conditions on widening participation were met. In reality, most courses at most institutions set the maximum fee within a couple of years. Fee loans increased in line with the increase in fees. The reform reduced the UK government's costs of funding HE. But at the same time, the resources available to universities increased, as the increase in fee income from students was more than enough to offset the reduction in the teaching grant.

Having been frozen since 2012, the tuition fee cap was raised to £9,250 in 2017<sup>91</sup>.

In 2016 maintenance grants, to support the living costs of students from poorer backgrounds, were abolished. The maximum maintenance loan was increased to £8,200 (from £5,740) for students living away from home (£10,700 for those studying in London).

Much of the recent debate in England has been about the conditions of loans, as these have important implications for the distribution of repayments and perceived issues of fairness. The relatively high repayment threshold (the income level above which loan repayments are due), combined with a positive real interest rate that increases with income (RPI + 0–3% depending on income) means that the loan repayment system is progressive. Whilst some graduates will repay little or even nothing, some of the highest earning graduates actually repay more than they borrowed. The system of loan repayments thus shares many of the

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<sup>91</sup> Although the results of the Teaching Excellence Framework are being used to determine which universities can increase fees.

characteristics of a graduate tax (with the exception that repayments cease after 30 years or when the loan plus any interest is repaid).

The justification for the relatively high interest rate on loans is hotly debated. RPI is currently around 3.6%, so some graduates are potentially paying an interest rate of over 6%.

Moreover RPI is recognised as being a flawed measure of prices that consistently overestimates 'true' inflation. A recent report of the House of Lords Economic Affairs Committee recommended that the interest rate on student loans should be reduced to the level of the 10-year gilt rate (currently around 1.3%)<sup>92</sup>. A report by the House of Commons Economic Affairs Committee argued that the interest rate charged should be based on (lower) CPI rather than RPI, and that interest should not be charged during the period of study<sup>93</sup>.

There has also been debate about the level of the tuition fee cap. There are criticisms that some of the fees levied do not represent value for money. This claim is contested by universities who argue that the fees reflect costs, including the requirement on universities to support 'widening access'. Moreover, analysis suggests that reducing the level of tuition fee would benefit the highest earning graduates, as they are the only ones to repay their loans in full<sup>94</sup>.

Of course although students can take out loans to finance both their tuition fee and their maintenance costs, there is concern that this may put off those from poorer backgrounds. There is some evidence that students from such backgrounds may be more debt-averse than students from better off backgrounds<sup>95</sup>.

Other fee debates in England include the extent to which the system should be adapted to encourage provision or demand for particular subjects/professions. For example, should higher grant provision be made available for nursing or teaching degrees? England is piloting a system whereby loan repayments are forgiven for teachers for as long as they remain in the profession.

The cap on undergraduate numbers in England was removed in 2015. Critics argue that its removal incentivises universities to recruit an increasing number of undergraduates, potentially at considerable long-run expense to taxpayers.

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<sup>92</sup> House of Lords Economic Affairs Committee (2018), *op. cit.*

<sup>93</sup> House of Commons Treasury Committee (2018), *op. cit.*

<sup>94</sup> Institute for Fiscal Studies (2017), *op. cit.*

<sup>95</sup> Callender and Mason (2017) Does Student Loan Debt Deter Higher Education Participation? New Evidence from England *The Annals of the American Academy of Political and Social Science*, 671 (1)

A further objective of the introduction of tuition fees was to create a 'market' in higher education, incentivising quality and innovation. But a recent House of Lords report argues that the introduction of higher tuition fees in 2012 has not achieved an effective market amongst universities, and may instead have had perverse outcomes, such as grade inflation<sup>96</sup>.

### *Higher education funding arrangements in Scotland*

The costs of HE tuition for Scottish domiciled students in Scotland are funded by the Scottish Government, for those undertaking a first undergraduate degree<sup>97</sup>.

The average cost is £7,000 per student per annum.

In allocating teaching grants to Universities, the Scottish Funding Council groups undergraduate subjects into one of six 'price groups'. Each university's teaching grant is essentially a function of the number of funded places in these six subject groups.

The groups are shown in Table 7.1, which shows for example that each funded place in a 'group 1' course attracts funding of £16,454 per student per year.

**Table 7.1:** Funding and FTEs by price group, 2017/18

	Cost group					
	1	2	3	4	5	6
2017/18 gross price	£16,454	£9,336	£8,274	£7,203	£6,367	£5,190
Number of FTEs	2,481	5,647	33,757	16,218	18,029	40,951

Source: SFC, Final Allocations for 2017/18

However, the SFC does not allocate the full amount of the subject gross price to each university as a teaching grant. Each undergraduate degree programme in Scotland is associated with a nominal annual fee of £1,820. The costs of this fee are provided by the Scottish Government to the Students Awards Agency for Scotland (SAAS), who in turn pay it to Scottish Universities on behalf of students. The tuition fee is in turn deducted from the 'gross price' in the allocation made by the SFC to universities.

<sup>96</sup> House of Lords Economic Affairs Committee (2018), op. cit.

<sup>97</sup> Between 2001 and 2006, first time, full time HE students were liable to pay the graduate endowment, a single payment of £2,000 at 2001/01 prices, after graduating. The income from the Graduate Endowment was ring-fenced for student bursaries. Graduates could either pay it in cash or add the liability to an existing or new student loan. The Graduate Endowment was abolished in 2007, and tuition has remained 'free' ever since.

In summary, the average annual cost of HE tuition for Scottish domiciled undergraduates in 2017/18 was £7,000, of which £1,820 was channelled through SAAS and £5,200 was allocated by the SFC. The cost per degree depends on degree length. For a typical four year degree, the public sector teaching cost is £28,000. However, the HE sector in Scotland is relatively heterogeneous, and thus the average cost across the whole HE population is likely to be less than this.

Scottish students are nonetheless liable to fund their living costs and maintenance. Maintenance loans are available, although the maximum annual loan is contingent on household income (and is somewhat higher for those from poorer households). Repayment of a maintenance loan is contingent on income, and is written off after 30 years.

The maximum amount that Scottish students can borrow ranges from £4,750 to £6,750 per annum depending on the income of their household and whether they are classed as dependent or independent. The average maintenance loan in 2016/17 was £5,300<sup>98</sup>. Around 70% of eligible full-time undergraduates take out maintenance loans.

Means tested living cost grants for young students from lower income households were substantially reduced in 2013/14 (from £2,640 to £1,750), and only partially increased to £1,875 in 2017/18. Table 7.2 summarises the support available to full-time students in Scotland. Maintenance grants to English students were abolished completely in 2016, and thus grant availability is now higher in Scotland than in England (although English universities are expected to offer some support as a quid pro quo for tuition fees).

**Table 7.2:** Maintenance support in Scotland, 2017/18

Household income (£)	Young		Independent (i.e. mature)	
	Grant	Loan	Grant	Loan
0-18,999	1,875	5,750	875	6,750
19,000-23,999	1,125	5,750		6,750
24,000-33,999	500	5,750		6,250
34,000 plus	–	4,750		4,750

Source: FAI analysis

<sup>98</sup> Table A11 of SAAS 'Higher Education Student Support in Scotland 2016/17'

Until recently, the repayment conditions associated with maintenance loans in Scotland were quite different to England (Table 7.3). Scottish students faced a lower repayment threshold, a longer repayment term and a lower rate of interest than English students.

**Table 7.3:** Loan repayment conditions, Scotland and England compared

	<b>Scotland, pre-2018 policy</b>	<b>Scotland, current policy</b>	<b>England</b>
Repayment term	35 years after graduation	30 years (from April 2018)	30 years after graduation
Interest rate during study	The lower of RPI (currently 3.6%) and the bank base rate + 1%(currently 1.75%)		RPI+3% (currently 6.6%)
Interest rate after graduation	The lower of RPI and the bank base rate +1%		RPI + 0-3% depending on income
Repayment threshold	£18,330 (rising each year with inflation)	£25,000 in April 2021	£21,000 (increasing to £25,000 in 2018)
Repayment rate	9%		9%

Source: FAI analysis

However, following the independent review of student funding in November 2017<sup>99</sup>, the Scottish Government announced changes to the conditions associated with maintenance loan repayment.

The review recommended a reduction in the loan term, from 35 to 30 years, and the Scottish Government has indicated that this recommendation will be implemented in 2018.

Furthermore, the loan repayment threshold in Scotland will increase from its existing rate of £18,330 to £25,000 (going beyond the review's recommendation of £22,000 by the end of this parliament)<sup>100</sup>. However, the increase in the repayment threshold will not take effect until April 2021 (with the existing threshold increasing in line with inflation in the interim)<sup>101</sup>.

<sup>99</sup> Independent Report for Scotland (2017) <https://www.gov.scot/Resource/0052/00527875.pdf>

<sup>100</sup> Letter from Minister for Further Education, Higher Education and Science to Scottish Parliament Employment and Skills Committee, 9 June 2018

<sup>101</sup> The repayment threshold in England increased to from £21,000 to £25,000 in 2018.



In response to the review, the government also announced an increase of £125 in the annual grant available to support the maintenance costs of poorer students. The income threshold for maximum support will also rise from £19,000 to £21,000.

## 7.4 Implications of recent changes to maintenance loan conditions in Scotland

As noted previously, the Scottish Government recently announced two changes to the repayment conditions attached to maintenance loans:

- From 2018, the length of loan term will reduce from 35 to 30 years.
- From 2021, the repayment threshold will increase to £25,000 (from £18,330 although it will increase in line with inflation until 2021).

This section considers the implications of these changes for Scottish undergraduates<sup>102</sup>. The analysis assumes that students undertake a 4-year degree, and borrow £5,300 per annum for maintenance<sup>103</sup>.

Under the previous loan repayment system (which operated until 2017), with a loan repayment threshold of £18,330 and a 35-year loan term, the majority of Scottish student borrowers would repay their loan in full. Given interest accumulated on their loans, the majority would pay back somewhat more than they had borrowed (in today's prices).

Chart 7.1 shows how these repayments would be distributed by decile of graduates' lifetime earnings. Over the first four deciles of the lifetime earnings distribution, repayments increase with income, reflecting the tendency of loans to be written off before they are repaid. Total loan repayments (in real terms) actually fall slightly through deciles 4 to 10 – this is because those with higher lifetime earnings tend to repay their loans somewhat earlier, incurring less interest.

What will be the effects of replacing the 35-year loan term with a 30-year loan term? From a distributional perspective, the shorter loan term does not affect repayments in deciles 5-10 of lifetime incomes (as these graduates tend to pay off their loans before 30 years anyway).

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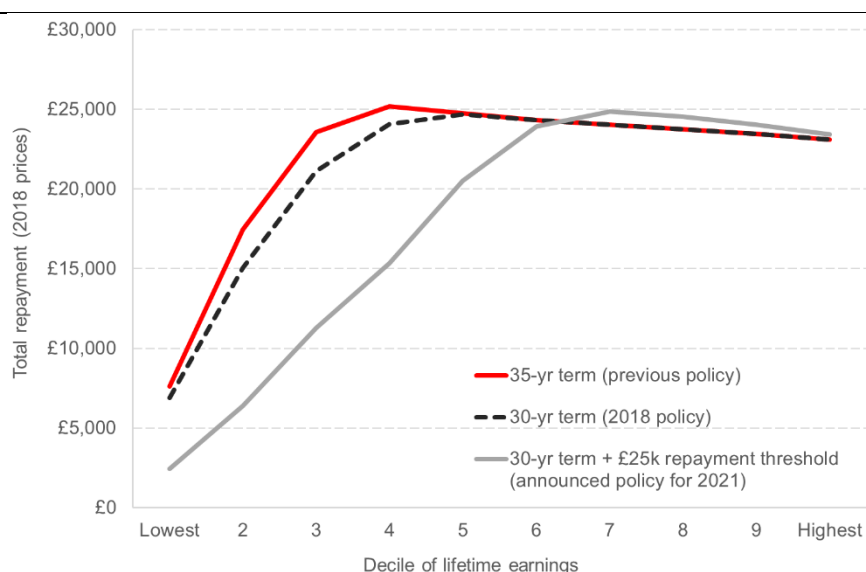
<sup>102</sup> Our estimates of the RAB-charge, and the proportion of lifetime income that students with different lifetime incomes will repay, is based on the FAI's student loan repayment model. This makes assumptions about graduates' earnings paths, and combines this with information about loan amounts and loan repayment conditions, to estimate the path of future repayments for 10,000 representative graduates. Contact the report authors for further details.

<sup>103</sup> The average maintenance loan of borrowers in 2016/17. Source: Table A11 of SAAS 'Higher Education Student Support in Scotland 2016/17'

But it does slightly reduce the repayments of graduates in deciles 1-4, as their loans are written off earlier.

The rise in the repayment threshold – pencilled in to happen in 2021 – makes a more significant difference to the repayment profile. The overall RAB charge increases to 38.8%. Graduates in the bottom half of the distribution of lifetime earnings will repay less than they do currently (and those in deciles 1-4 will repay substantially less). Those in the top-half will end up repaying slightly more (the higher threshold means it takes longer to repay, resulting in a greater accumulation of interest).

**Chart 7.1:** Loan repayments by decile of lifetime income under different policy arrangements



Source: FAI Loan Repayments Model. Notes: Loan per graduate of £21,000. Graduate repayments are expressed in 2018 prices deflated by CPI, but no government discount rate is applied.

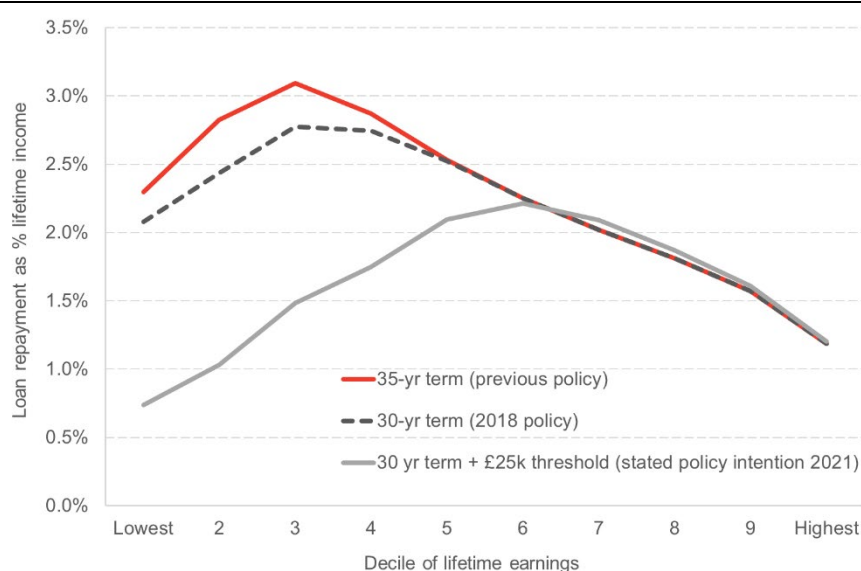
Chart 7.2 shows this same repayment information, but from a slightly different perspective. Rather than considering the real terms value of repayments, it considers graduates' loan repayments as a percentage of lifetime income.

Under the previous 35-year loan term, loan repayments increase as a function of lifetime income over the first three deciles while from deciles 4-10, repayments fall. This reflects the fact that graduates in deciles 4-10 repay their loans in full, but these repayments represent a larger share of the lifetime earnings for those in the middle of the lifetime incomes distribution compared to those at the top.

The introduction of the 30-year term reduces the proportion of lifetime income that those in the bottom 4 deciles spend on loan repayment.

The increase in the repayment threshold to £25,000 arguably gives the repayment profile a more progressive shape, in the sense that loan repayments are increasing as a function of income across the first six deciles. As a percentage of lifetime income, repayments fall from deciles 7-10, reflecting the fact that graduates in these deciles repay their loans in full.

**Chart 7.2:** Loan repayments by decile of lifetime income under different policy arrangements



Source: FAI Loan Repayments Model. Notes: Loan per graduate of £21,000. Graduate repayments are expressed in 2018 prices deflated by CPI, but no government discount rate is applied.

The changes announced by the Scottish Government (the move to a 30-year term and the increase in the repayment threshold) 'make sense' both from the point of view that these are progressive reforms, benefitting students in the lower half of the lifetime earnings distribution, and effectively costing the Scottish Government nothing.

The increased cost of loan write-off is effectively met by the UK Government. The policy change means that the Scottish Government will use up more of its effective allocation for non-cash resource (reflecting higher levels of loan impairment). But the policy makes no difference to the Scottish Government's day-to-day resource budget, or its AME or non-cash budgets for other purposes. One question this analysis raises is why these changes have only been committed to now, and why the repayment threshold increase does not take effect sooner than 2021.

Another question to consider is, in reforming conditions attached to maintenance loans, could the Scottish Government have implemented alternative reforms? An alternative policy would be to reduce the repayment rate from 9% to 4.5% as a percentage of income (while

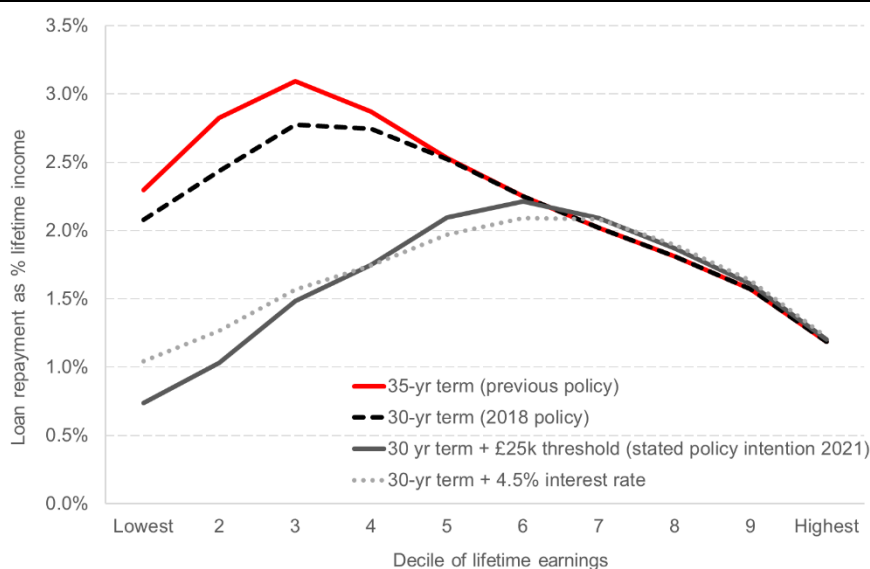
keeping the repayment threshold unchanged at £18,330). This policy would have the same impact on the RAB-charge (39%), so would be equally as 'affordable'. Distributionally, its effect is very similar to the threshold increase (Chart 7.3).

If the policies to increase the threshold to £25,000 and to reduce the repayment rate have similar effects on loan repayments and their distribution, is one superior to the other?

One argument potentially in favour reducing the repayment rate rather than increasing the threshold is in relation to its interaction with earnings taxation. A student loan repayment acts very much like a tax. Under the current system, graduates who have taken out a loan and earn above the repayment threshold pay a marginal rate of tax that is 9% higher than an equivalent non-graduate (or graduate who has no loan to repay). There is an argument that a lower effective marginal rate of taxation could improve incentives to work or earn more.

Ultimately, whether you believe a policy where borrowers repay 4.5% of income above £18,000 is superior to one where borrowers repay 9% of income above £25,000 depends on how significant you think marginal rates of taxation are in influencing work incentives, and how important you think it is that graduates should be protected from repaying their loans until they have income that is broadly in line with the median taxpayer income (currently £26,000 in Scotland).

**Chart 7.3:** Loan repayments by decile of lifetime income under different policy arrangements



Source: FAI Loan Repayments Model. Notes: Loan per graduate of £21,000. Graduate repayments are expressed in 2018 prices deflated by CPI, but no government discount rate is applied.

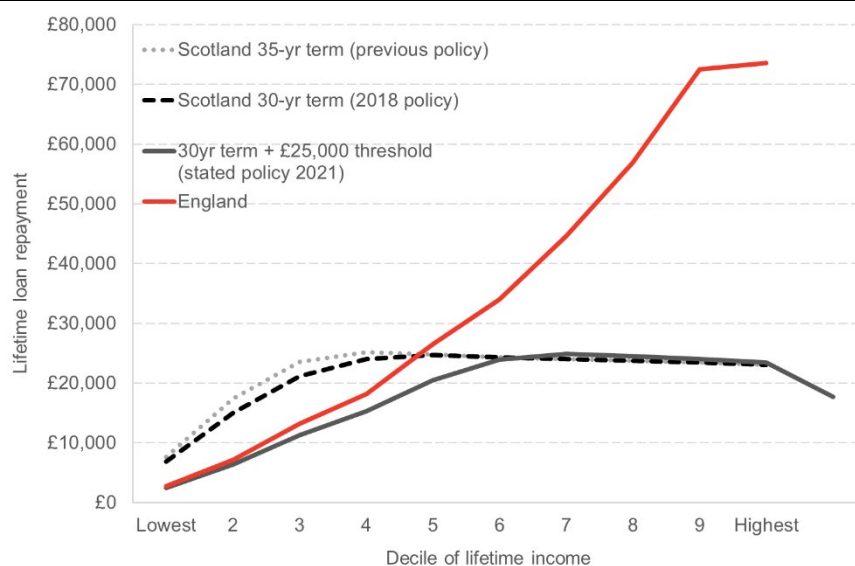
It is also instructive to consider how loan repayment differs in Scotland compared to England (Chart 7.4). Clearly, English students graduate with significantly more debt on average than

do Scottish students – three years of tuition fee loan (at an average of £9,188 per year) plus an average maintenance loan of £6,200 per year per student<sup>104</sup>).

However, the high repayment threshold in England means that English graduates in the bottom four deciles of the distribution of lifetime earnings pay less than Scottish students, under current policy. This situation will change in 2021 when the higher repayment threshold is implemented in Scotland too.

For deciles 5-10, English graduates repay increasingly large amounts. This is largely because the interest rate is both high, and itself linked to earnings (the interest rate charged on English loans is RPI plus 0-3% depending on earnings). As a result of this high rate of interest and the large loan amounts, relatively few graduates repay their loans in full.

**Chart 7.4:** Loan repayments (£) by decile of lifetime income: Scottish and English systems compared



Source: FAI Loan Repayments Model. Notes: Loan per graduate of £21,000 for Scottish students and £46,164 for English students. Graduate repayments are expressed in 2018 prices deflated by CPI, but no government discount rate is applied.

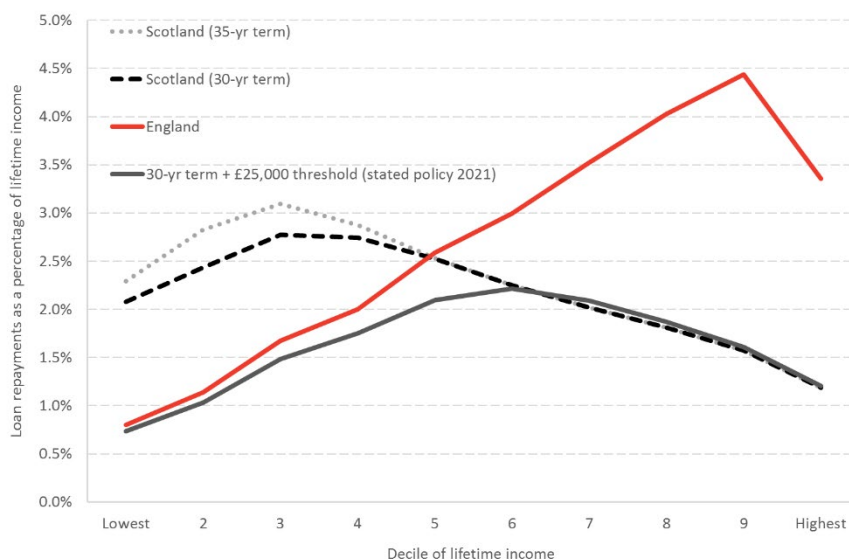
Chart 7.5 compares lifetime loan repayments by decile under the Scottish and English systems as a percentage of lifetime income. The English system is progressive in the sense that those with higher income tend to pay a higher proportion of income as loan (until decile 10, where individuals tend to pay off their loans before the end of the term).

The Scottish system to be in place by 2021 is less obviously 'progressive' in the sense that those from deciles 6-10 pay progressively less of their lifetime income in loan repayments.

<sup>104</sup> Table 4A(ii) and Table 6.5 of Student Support for Higher Education in England 2017

But this is of course the result of the fact that Scottish students borrow less than those in England. Given that all those in deciles 6-10 repay their loans in full, this is bound to result in repayment *as a proportion of income* decreasing as income rises.

**Chart 7.5:** Loan repayments as a percentage of lifetime income by decile of lifetime income: Scottish and English systems compared



Source: FAI Loan Repayments Model. Notes: Loan per graduate of £21,000 for Scottish students and £46,164 for English students. Graduate repayments are expressed in 2018 prices deflated by CPI, but no government discount rate is applied.

Although the structure of future loan repayments in England is more progressive, this in itself does not necessarily make the English system 'better'. It could be argued that a system whereby the majority of graduates repay their living cost loans and the State funds tuition costs, is superior to one where students fund all tuition and living costs through loans, a large proportion of which will never be repaid.

An important caveat to bear in mind is that the analysis here considers loan repayments as a proportion of *future* lifetime earnings of a student. The analysis says nothing about the students' existing household income. It is possible that a student from a poorer household goes on to have high earnings over their lifetime, or vice versa.

There is some evidence that the prospect of high levels of debt may put-off students from lower income households going to university. This effect is not reflected in Chart 7.5 which may exaggerate the apparent progressivity of the English over the Scottish systems. Moreover, those from better off backgrounds are less likely to take out loans in the first place, and to the extent that there is a correlation between parents' income and one's own

income as an adult, this may serve to further erode progressivity of the system as a whole<sup>105</sup> in both systems.

Finally, the analysis takes no account of early repayment – if higher earners are more likely to repay their loans early, then repayment will not increase so significantly as a percentage of income (early repayment is likely to effect the English system in particular, given the higher rates of interest charged).

## **7.5 Changing the balance between public and private contributions to tuition**

Publicly funded higher education tuition is a flagship policy of the Scottish Government. This reflects the belief that higher education tuition should be based on the ability to learn, rather than the ability to pay. Nonetheless, it is important to consider the implications of relaxing this commitment, not least so that the public finance implications can be fully understood.

It is important to note that any introduction of tuition fees in Scotland would no doubt coincide with the provision of a more generous grant regime for those students from relatively less well-off backgrounds. In fact, ensuring an adequate system of grant support is likely to be a prerequisite for introducing any form of fees. In what follows however, we focus purely on the implications of tuition fees, and abstract from the policy question about grants.

At one extreme, the Scottish Government could introduce a tuition fee of £7,000 per annum, offsetting the £7,000 per annum expenditure that it currently provides from its resource budget<sup>106</sup>.

As a result of the policy, the transfer of funding from grant to loan would – in principle – ‘free-up’ resources from the Scottish Government’s resource budget. Across a cohort of some 29,000 full-time, Scottish domiciled HE students<sup>107</sup>, this policy would reduce the government’s departmental spending on HE by just over £200m<sup>108</sup> in year one. In fact the cost-saving would be somewhat higher than that, for two reasons. First, EU students – who under EU rules must be treated in the same way as Scottish domiciled students – would also

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<sup>105</sup> Table A13 of SAAS (2017) shows that average loan size is a decreasing function of the deprivation quintile of students’ familial home, whilst Table A6 of SAAS (2017) shows that average loan size is a decreasing function of students’ familial household income.

<sup>106</sup> We model this as a flat rate fee across all degree programmes at all Scottish universities. There are arguments for and against allowing fees to vary to reflect the costs of course provision.

<sup>107</sup> According to Table 8 of HESA’s ‘Higher Education Student Statistics’ 2016/17, 29,000 Scottish domiciled students enrolled at Scottish universities in for full-time study in 2016/17. This number will exclude those studying HE and FE institutions, and exclude those study HNC and HND.

<sup>108</sup> £203m, derived by multiplying the Scottish Government’s current allocation of £7,000 per student per annum by the cohort size of 29,000



be liable to the fee. There are around 14,000 EU domiciled, full-time students studying for a first degree at Scottish universities<sup>109</sup>. Second, our estimate of student numbers from HESA explicitly excludes students studying higher education qualifications at FE institutions, and those doing HNC/HND courses.

The cost saving across the cohort would depend on the average length of HE degree programmes in Scotland. The Scottish HE sector is significantly more heterogeneous than the English system. However, the vast majority of the 29,000 first year full time students recorded by HESA will be undertaking four year degrees.

On this basis, the total cost saving to the Scottish Government's resource budget, following the introduction of tuition fees at £7,000 per annum would be £812m per annum once rolled out to all cohorts (this is the cost saving relating to Scottish domiciled students only).

At one level this is likely to be an overestimate of actual savings given that some element of targeted grant funding would be introduced alongside the fees policy. On the other hand however, this may be an overestimate in that the analysis here does not include all HE students in Scotland (it excludes part-time students, EU students, and those studying for higher education qualifications at FE institutions).

Of course, replacing the existing £7,000 per annum publicly funded support for an undergraduate degree entirely by fee (albeit one funded through an income contingent loan) is a radical departure from existing Scottish policy.

Table 7.4 below compares the outcomes of four different tuition fee policies that the Scottish Government could introduce. For each policy, we assume that the Scottish Government aims to continue to ensure universities receive £7,000 per student per annum on average, but that the Scottish Government allows universities to charge an annual fee up to the maximum indicated, and provides the difference between the fee and £7,000 from its resource budget. For example, for an annual tuition fee of £1,000 we assume that the government provides £6,000 in grant to universities, whilst for a tuition fee of £2,000 we assume the government provides an annual teaching grant of £5,000.

An annual tuition fee of £1,000 would free-up £29m from the Scottish Government's resource budget per annum and per cohort. This would represent an annual saving of around £116m once rolled out across all cohorts.

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<sup>109</sup> Students Award Agency Scotland, 'Higher Education Student Support in Scotland 2016/17'



**Table 7.4:** Implications for the Scottish resource budget of varying levels of tuition fee for Scottish domiciled students

	Tuition fee per annum				
	£0	£1,000	£2,000	£3,500	£7,000
A: Annual tuition fee	£0	£1,000	£2,000	£3,500	£7,000
B: Scottish Government resource cost per degree (£7,000 x 4) - (4 x A)	£28,000	£24,000	£20,000	£14,000	£0
C: Annual saving to SG resource budget (per cohort) (29,000 x A)	£0m	£29m	£58m	£102m	£203m
D: Annual saving once fully rolled out	£0m	£116m	£232m	£406m	£812m

Source: FAI analysis. Assumptions and sources described in text. Tuition fee is assumed applied to Scottish domiciled students, but analysis excludes effects of fees on other applicable student groups (e.g. EU students). Analysis also excludes budget effects of introduction of offsetting grant support for students from lower income backgrounds

Under the proposals outlined here, Scottish universities are no better or worse off than currently, as the only thing that changes for them is the source of funding. However, as the tuition fee increases, the costs of a degree are transferred from the Scottish resource budget to graduates (through loan repayments) and future UK taxpayers (through loan default).

Whether the UK Government would provide sufficient AME and non-cash resource to enable the Scottish Government to implement the £7,000 tuition fee policy would be a matter for negotiation. On the basis of what might be considered an equitable share of English loan policy, it might in principle seem difficult for HM Treasury not to enable this policy. But the UK Government may well insist that Scottish loan terms were no more generous than those in England – this may imply increasing the interest rate on Scottish loans.

Indeed, our analysis suggests that, if a tuition fee of £7,000 per annum were introduced in Scotland, and the loan repayment conditions were as proposed currently for maintenance loans (i.e. a 30-year loan term, a £25,000 repayment threshold, and a lower interest rate than applies in England), the RAB charge associated with Scottish loans would be around 59% for a cohort beginning studies in 2018/19 - this is significantly higher than the RAB charge of around 46% in England<sup>110</sup>. An annual fee of £3,500 would produce a RAB charge of 50% in Scotland, on the basis of existing proposed loan conditions.

Table 7.5 shows how different levels of tuition fee might influence the public sector cost of HE tuition in Scotland, and how this cost would be distributed. (We assume there are 29,000 Scottish domiciled students per cohort, and that all of these students take out the maximum loan available, which is equal to the tuition fee, in addition to a maintenance loan of £5,000).

<sup>110</sup> This calculated RAB charge includes the existing borrowing associated with maintenance loans

Any reduction in Scottish Government resource cost as a result of introducing a fee is offset by a corresponding increase in loan provision (funded through an increase in AME). As the tuition fee increases, the RAB charge also increases – increasing the long-run taxpayer cost of loan default.

So whilst the public sector costs of HE tuition do fall as fees are increased, the long run costs to the taxpayer do not decrease proportionately.

These cost estimates are clearly highly indicative. The net costs of introducing tuition fees will depend on more precise estimates of student numbers, and the proportion of students taking out loans. And, as noted, there is uncertainty around the magnitude of the RAB charge. The net costs will also depend on how any resource budget 'freed up' from the introduction of tuition fees would be used to provide greater grant support for students from less well-off backgrounds (which may in turn displace loan take-up), or to support the HE sector more generally. Nonetheless, it is useful to consider in broad terms the possible public sector funding implications of the introduction of student loans.

**Table 7.5:** Public sector costs of HE tuition under different tuition fee policies

	Tuition fee per annum				
	£0	£1,000	£2,000	£3,500	£7,000
A: Annual tuition fee	£0	£1,000	£2,000	£3,500	£7,000
B: Scottish Government resource cost per degree (£7,000 x 4) - (4 x A)	£28,000	£24,000	£20,000	£14,000	£0
C: Number of applicable undergraduates	29,000	29,000	29,000	29,000	29,000
D: Annual resource saving to SG (A x 4 x C)	£0	£116m	£232m	£406m	£812m
E: Upfront cost of loan (A x 4 x C x 0.9)	£0	£104m	£209m	£365m	£731m
F: Estimated RAB charge	0.39	0.42	0.45	0.50	0.59
G: Longrun taxpayer cost of loan (E x F)	£0	£44m	£95m	£182m	£428m
H: Total public sector cost of HE tuition (B x C) + G	£812m	£740m	£675m	£588m	£428m

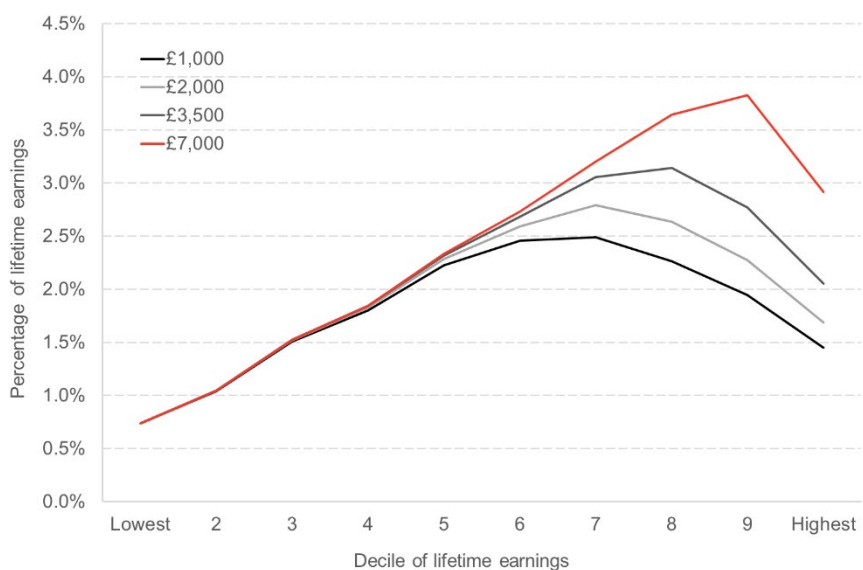
Source: FAI analysis

Graduates themselves would of course have to fund the costs of the tuition fee themselves, either by paying through their own income or savings, or by taking out a tuition fee loan. For a graduate undertaking a four-year degree, the total tuition fee could vary from £4,000 (if the fee was charged at £1,000 per annum) to £28,000 (if the fee was charged at £7,000 per annum). This would clearly represent a significant level of debt (in addition to any living cost debt accumulated), which could have disincentive effects as alluded to earlier.

Chart 7.6 shows how loan repayments would be distributed by decile of lifetime income under each of the tuition fee regimes discussed above. These repayment profiles are for graduates studying for a four year degree who take out a maintenance loan for £5,100 and the maximum tuition fee loan permissible.

As the tuition fee increases, the burden falls increasingly on those with higher lifetime incomes. This is because those on lower incomes do not pay off their loans in full, even when fees are relatively low.

**Chart 7.6:** Lifetime loan repayments as a proportion of lifetime income under four policy scenarios for tuition fees



Source: FAI analysis

## 7.6 Conclusions

The funding of higher education is a matter fully devolved to the Scottish Government. But it is materially and indirectly influenced by the HE funding mechanism for support in England.

The Scottish Government determines the balance between grant and loan for both tuition costs and maintenance support, the levels and repayment conditions for loans, and the way in which the grant is allocated. Grants to students or universities score against the government's resource budget. The Scottish Government's capacity to issue loans – and the terms of those loans – depends on its AME and 'non-cash resource' budgets. These in turn are influenced by the UK Government's policy on student loans in England.

Higher education in England is funded increasingly through loans to students. This policy is not costless for the taxpayer however given that a proportion of loans will not be repaid.

In Scotland, the costs of tuition for Scottish domiciled students remain wholly funded by the Scottish Government, although most are expected to fund maintenance costs.

The Scottish Government has recently announced a reduction in the loan term on maintenance loans, from 35 to 30 years and a large increase in the repayment threshold to £25,000 (by 2021). Both of these policies will make the Scottish loan system more progressive, reducing the repayments of those in the lower part of the earnings distribution.

In principle, the Scottish Government could ask Scottish students to make a contribution to the costs of their tuition through the introduction of fees, backed by income contingent loans. The introduction of a fee policy would free up some resources. At the extreme, if fees were introduced to cover in full the typical cost of an undergraduate degree, this could free-up around £690m once rolled out across all cohorts. If upfront tuition costs were shared 50:50, around £350m could be saved annually. These estimates are indicative rather than precise – actual budgetary effects would depend on a variety of assumptions about student numbers across different types of degree course, and how any resource savings from the introduction of fees were used to enhance grant support.

Tuition fee policies such as these do not have strong political support in Scotland currently, but it is useful nonetheless to understand their budgetary implications.

Higher education funding policy is likely to remain in a state of flux in England. There may be pressure to reduce the interest rate on student loans, or to introduce loan repayment waivers or fee waivers for certain subjects. These kind of changes may have further implications for the capacity of the Scottish Government to provide grant and loan funding.

Perhaps more importantly, it is possible, indeed probable, that there will be changes to the way in which student loans are accounted for. It remains unclear how the accounting might change, and what the implications might be for the Scottish Government. A revised accounting treatment may reclassify at least part of loan outlay as grant, rather than loan. If so, this may provide the Scottish Government with additional budget flexibility to provide its current (no fee) policy.

The debates around how higher education should be funded will undoubtedly continue. There seems little doubt that the fees experiment in England has not 'solved' all the issues it was hoped it would – there is no effective market for HE, and skills shortages continue in many areas. Moreover, there remains little conclusive evidence about how the prospect of significant debt on graduation influences who participates in HE, what they study, and their work choices.

On the other hand, spending pressures across the public sector will continue to intensify, and the Scottish electorate's desire to protect health and local public services may lead to some to question the merits of a fully-funded higher education tuition policy at least relative to other priorities that may go unfunded.

There are no easy answers to these trade-offs, but it is our hope that reports like this one can help inform the debate.



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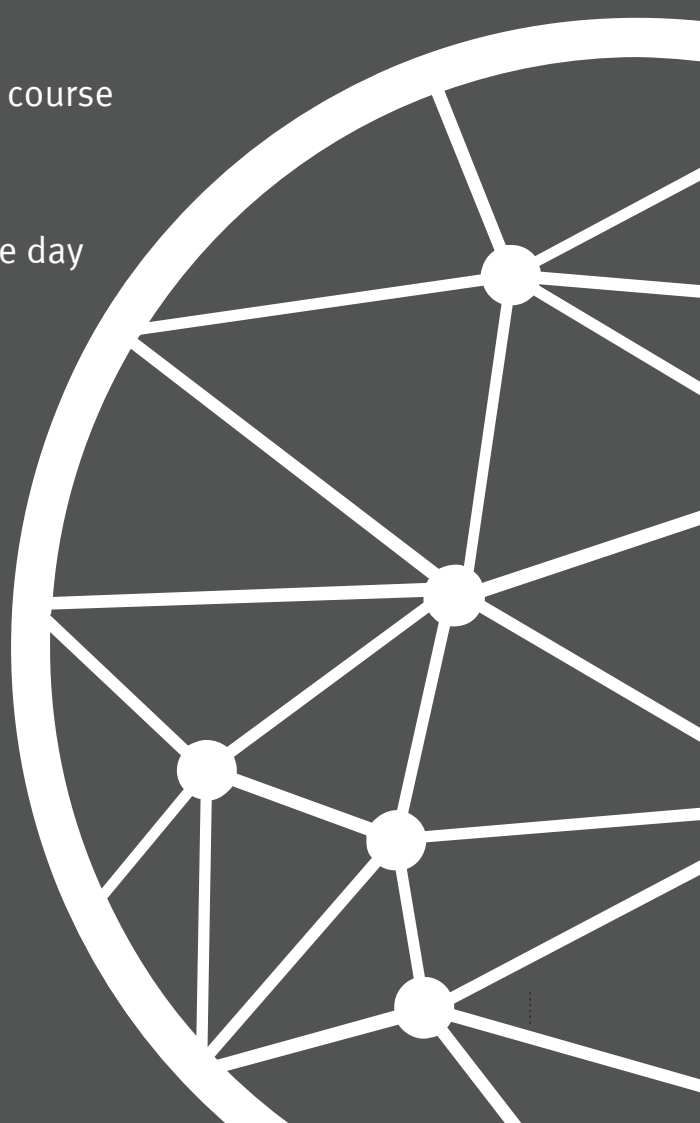
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## Fraser of Allander Institute

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

Telephone: 0141 548 3958

Email: [fraser@strath.ac.uk](mailto:fraser@strath.ac.uk)

Website: [www.strath.ac.uk/fraser](http://www.strath.ac.uk/fraser)

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