1. The Scotland Bill will provide the Scottish Parliament with greater tax raising powers. To create the “tax-room” for the new Scottish rate of income tax, a 10p reduction will be made to UK income tax levied in Scotland at both the basic, higher and additional rate. A value representing this amount will then be deducted from the block grant to reflect devolved taxation revenues.

2. The intention of the Government’s reforms is not to change the funding settlement for Scotland, but rather to increase the Scottish Parliament’s financial powers and to link the Scottish budget more closely with receipts raised in Scotland.

3. The new tax-based funding model is likely to result in a different budget for Scotland than the amount provided for by the existing funding model in any given year. This is because in future the Scottish budget will be made up partly of tax receipts rather than entirely through a block grant from the UK Government. The growth in the Scottish budget will therefore depend on two sources: growth in the Scottish block grant, which is determined by the Barnett formula and depends on growth in public spending on devolved functions in the rest of the UK; and growth in Scottish tax receipts.

4. The extent to which the Scottish budget will vary in future from what it would have been without the devolution of tax powers depends on the relative growth rates of public spending and tax receipts. Where tax receipts grow faster than public spending, the Scottish budget will be larger. Where public spending grows faster than tax receipts, the Scottish budget will be lower. In this way, the Scottish budget will be linked to decisions made by the Scottish Parliament and the performance of its economy.

5. Committee members asked what the impact of the changes will be on the Scottish budget. It is not possible at this stage to estimate what the impact of the changes on the Scottish budget will be when the system is introduced:

   - The permanent adjustment to the block grant will not be made until April 2018 or 2019 (following the initial transitional period during which the Scottish budget will be no different than it would have been under the existing funding model). This is beyond the current forecast period so data on forecast tax receipts or forecast public spending is not available.

   - Given this lack of data, the exact mechanism for making the initial adjustment to the block grant has not yet been determined.

   - The amount of tax receipts available to Scotland will ultimately depend on Scottish economic growth, the Scottish Government’s tax policy decisions and wider economic policies.

6. Committee members also asked whether the UK Government had estimated the impact of the new tax-linked funding system if it had been introduced from devolution in 1999, referencing modelling done by the Scottish Government. Again, given that the mechanism for adjusting the block grant has not been determined, and will be decided in consultation with the Scottish Government, it is not possible to estimate what the impact on the Scottish budget would have been.
7. However, using two examples it is possible to show how sensitive the block grant adjustment is to a number of factors, and therefore why the figures put forward by the Scottish Government are both partial and misleading. It is worth noting at this stage that the numbers set out below do not represent official UK Government estimates of the impact of the block grant adjustment – those will be determined later once the adjustment mechanism has been determined.

8. There are a number of ways of calculating the value of the initial adjustment to the block grant, and it is very sensitive to a number of factors:
   - the year in which that adjustment is made;
   - whether the adjustment is based on a single year or an average of years; and
   - the period of time over which the value of the reduction is calculated

9. Between 1999-00 and 2014-15, the Treasury estimates that Scottish income tax receipts may have amounted to between 14.6 per cent of the Scottish budget and 20.2 per cent of the Scottish budget in a single year. If the value of the adjustment is based on tax receipts in a single year, the Scottish budget will vary significantly depending on the point in the economic cycle at which the initial adjustment is made.

10. For example, the UK economy has gone through a significant recession during which there was an exceptional fall in income tax receipts. Estimating what the impact of the new funding model would have been in recent years will provide a partial picture. If the adjustment had been made on the basis of receipts immediately prior to the recession, for example in 2007-08, then the Scottish budget would appear to reduce.

11. Similarly, the UK is entering the largest period of fiscal consolidation since World War Two. As shown in chart 1, if the adjustment were made in 2011-12 on the basis of receipts in each year, the Scottish budget could be up to £2.2bn larger than it would otherwise have been by 2014-15.

12. As the Command Paper sets out, the value of the adjustment to the block grant would not be priced on the basis of receipts in a single year, rather an average of receipts over a number of years.

13. From the Calman Commission’s final report, it can be inferred that the Commission intended for the value of the adjustment to be a percentage based on the average worth of the devolved tax receipts over a number of years, not a single year. This approach poses the question of which years to base the percentage adjustment upon.
14. For the purposes of illustration, charts 2 and 3 below show the effect of taking an average of Scottish income tax receipts as a percentage of the Scottish budget during the period 1999-00 and 2010-11 (which equates to 17.25 per cent). 17.25 per cent is then taken off the block grant in each year from 1999-00 to 2014-15.

15. As the charts demonstrate the impact on the Scotland budget starts in the year in which the adjustment is made then varies over time depending on the growth rates of public spending and tax receipts. For example, the charts show a total reduction to the Scottish budget of £691m in the period to 2010-11, but by 2014-15, there is a cumulative gain to the Scottish budget of £397m over the entire period.

16. The methodology and data behind these models is set out in the attached annex to this note.

17. These models can only be illustrative to show the sensitivities of the block grant adjustment methodology. As set out above, the intention of the reforms is not a transfer of funds, but a transfer of power. Therefore, the Command Paper published alongside the Scotland Bill confirms that:

- The Government will consult with the Scottish Government on the methodology for adjusting the block grant.
- The Government will review the system to ensure that the relative levels of public expenditure going forward remain consistent with what the Commission described as the social and economic unions between Scotland and the rest of the United Kingdom. This approach is intended to serve as a safeguard to both the Scottish and UK Parliaments once the new arrangements are implemented, for example by limiting the risk of an unintended transfer of resources one way or the other.
ANNEX – SOURCE DATA

The charts above use the following data sources:


Scottish share of income tax receipts: figures up to 2007-08 are HMRC estimates of the Scottish share of income tax accounted for by a 10% rate of tax. From 2008-09 onwards, an average percentage share (2.8 per cent) is applied to overall UK receipts.

HMRC estimates of Scottish share of income tax

The table below shows the estimates of that part of income tax liabilities for those who would pay the new Scottish rate accounted for by a 10% rate of tax on non-savings and non-dividends income across all income tax bands Scottish and UK Income tax liabilities are estimated using HMRC’s Personal Tax Model (PTM), a microsimulation model of the UK income tax system, using data from HMRC’s annual Survey of Personal Incomes (SPI).

PTM computes total income tax liabilities across the SPI sample of individuals for a given tax year, taking account of the main features and parameters of the income tax system, including allowances, rates, thresholds and the main tax reliefs and tax credits. Estimated Scottish liabilities are calculated as an appropriate proportion of modeled total liabilities on non-savings and non-dividends income, based on the income tax rates that applied each year.¹

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated Scottish Liabilities £m</th>
<th>as % total UK liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999-00</td>
<td>2,600</td>
<td>2.8</td>
</tr>
<tr>
<td>2000-01</td>
<td>2,980</td>
<td>2.8</td>
</tr>
<tr>
<td>2001-02</td>
<td>3,130</td>
<td>2.9</td>
</tr>
<tr>
<td>2002-03</td>
<td>3,210</td>
<td>3.0</td>
</tr>
<tr>
<td>2003-04</td>
<td>3,310</td>
<td>3.0</td>
</tr>
<tr>
<td>2004-05</td>
<td>3,570</td>
<td>2.9</td>
</tr>
<tr>
<td>2005-06</td>
<td>3,930</td>
<td>2.8</td>
</tr>
<tr>
<td>2006-07</td>
<td>4,260</td>
<td>2.8</td>
</tr>
<tr>
<td>2007-08</td>
<td>4,570</td>
<td>2.8</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>2.8</td>
</tr>
</tbody>
</table>

¹ For example, Scottish liabilities in 2007-08 are calculated as 10/10, 10/22 and 10/40 respectively of total modelled liabilities on non-savings and non-dividends income for Scottish residents across the then starting, basic and higher rate tax bands.

The SPI is an annual sample survey of persons who could be liable to income tax, drawn from HMRC’s PAYE, Self Assessment and Claims systems. Some components of investment income (e.g. interest and dividends) must be estimated for the SPI sample cases drawn from PAYE because the information is not held by HMRC, and this inevitably contributes to uncertainty in the estimates.

The SPI sample size has risen from approximately 150,000 in 1999-00 to 600,000 in 2007-08, the latest available SPI data. The 2007-08 SPI sample is stratified by income level and other variables, but not by country or region; estimated Scottish shares in liabilities are therefore subject to sampling variation.

Beyond sampling variation and potential errors arising from simplifications in the PTM modelling process, the following specific caveats should be noted. Scottish liabilities are estimated on the basis of residential...
postcode of individuals within the SPI sample. In addition, the method described implicitly allocates some proportion of the costs of reliefs and tax credits in UK income tax to Scotland. These are modelling assumptions only.

Variations in Scottish liabilities as a percentage of the UK total may arise due to different economic trends in Scotland and the rest of the UK or through variations in the share of non-savings and non-dividends income in total taxable income (as tax on savings and dividends income do not contribute to Scottish liabilities under the new proposals). Both factors are likely to have played a part, however those living in Scotland’s share in total UK income tax liabilities have been more stable than the estimates shown in Table 1 suggesting that variations in the estimated make-up of taxable incomes may have been more important.

Further information about the SPI and a range of SPI-based analyses of incomes and tax liabilities are published on the HMRC website.2 Projections of tax liabilities beyond the latest base SPI year are not published on a regional or country basis, as the projections take account only of expected changes in determinants of tax at the United Kingdom level, e.g changes in employment and earnings.

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2 See [http://www.hmrc.gov.uk/stats/income_distribution/menu.htm](http://www.hmrc.gov.uk/stats/income_distribution/menu.htm)