Written evidence submitted by the Royal Society of Edinburgh (FSG0010)

Scottish Affairs Committee Inquiry – The financing of the Scottish Government

Royal Society of Edinburgh consultation response

1. The Royal Society of Edinburgh welcomes the invitation to provide evidence on financing Scotland's budget and a working group of Fellows with expertise in economic analysis has been established to do so. We would welcome the opportunity to develop some of these arguments in an oral evidence session.

2. The devolved funding system is complex and made more so by tax devolution. The Committee's inquiry can help communicate how the funding system works to elected members and citizens. Transparency is essential but on its own does not resolve the problem of limited understanding.

Q1. How effective is the Barnett formula in calculating the amount of money made available to Scotland for providing essential public services?

3. The Barnett formula is the UK's unique way of allocating central government resources to devolved government. It emerged from more than 100 years of population-based allocations to the government departments which preceded them. The full detail is set out in the HM Treasury "Statement of Funding Policy".[1] Barnett adds to the devolved budget each year a population share of the change in comparable spending (e.g. on health, education, transport) in England. This approach provides a high degree of certainty for the devolved administration, as the "baseline" is not reviewed, but simply adjusted. The funding is split between resource and capital spending. Switches can be made from resource into capital but not the other way. Importantly, there is no other constraint on how the Scottish Government might spend the allocated funding. This contrasts with other systems internationally where funding often comes with strings attached, as it does for UK local government: there is no "ring-fencing" with Barnett. The RSE believes that Barnett fits well with the UK Government's internal budgeting systems, and it simplifies and largely depoliticises what might otherwise be a difficult annual negotiation. In practice, it has sustained significantly higher levels of per capita public spending in Scotland before and since devolution.

4. The RSE notes that aside from the use of relative population, Barnett is not needs-based. One might argue that factors such as rurality and higher levels of deprivation provide a case for higher spending in the devolved nations, but the UK does not use a needs-based mechanism. The only recent exercise that seriously assessed relative need within the UK was the Holtham commission,[2] set up in 2008 by the Welsh Government. It argued that Wales was underfunded, basing its assessment on indicators of population, health, incomes, and geography. In response to these concerns, the UK Government adjusted the formula so that the increase in Wales' budget is 5% more than its population share.[3] A similar change has been made for Northern Ireland but not for Scotland.[4]

[1] See HM Treasury, 2024, Autumn budget 2024, available at: www.gov.uk/government/publications/autumn-budget-2024

[2] House of Commons Library, 2012, Holtham Commission, available at: https://commonslibrary.parliament.uk/research-briefings/sn06288/

5. Because the annual addition to the budget is population-based, it might be expected that over a long period of time and other things being equal, relative spending would converge towards the same per capita amount. This concern underlaid the adjustment to the formula for Wales and Northern Ireland. This has not transpired in Scotland because of the relative population decline of Scotland compared to England. As a result, the baseline is spread over relatively fewer people which tends to drive spending to relatively higher per capita levels. This issue emerges again in discussing the Block Grant Adjustments (BGA) considered below.
6. Not all public spending in Scotland is covered by Barnett, with examples such as City Deals and post-Brexit replacements for EU funding. Reserved UK government spending, including spending by the Department for Work and Pensions (DWP) across a range of benefits, such as the old-age pension, is driven by the numbers eligible for the relevant benefits, and so, in one sense, more responsive to "need." Now that some welfare benefits are devolved, the Scottish Government's budget for them is not determined by Barnett. There was a "no detriment" adjustment made in year 1 of social security devolution for each payment, then the Block Grant Adjustment (see paragraphs 19-20 below) grows in line with spending per head in England and Wales.
7. The RSE contends that Barnett supports high levels of public spending in Scotland. So-called identifiable expenditure per head of population (excluding expenditure like defence, foreign representation and debt interest which cannot be allocated to a particular geographical location) for each part of the UK is given in the table below.[5] Scottish spending is £2,124 per head, or 14%, higher than the equivalent spending in England.

Figure 1: Public spending £/head in 2023/24

England	12,635
Scotland	14,759
Wales	14,424
Northern Ireland	15,371
UK	12,549

Source: HM Treasury, Country and regional analysis: 2024, 20 November 2024

8. Much of this extra spending in Scotland is concentrated in the budget of the Scottish Parliament. Holyrood is responsible for 60% of the total public expenditure for Scotland.[6] The remaining 40% is split roughly equally between UK Government-provided services in Scotland and non-identifiable expenditure (defence, debt interest etc). UK Government spending per head on the identifiable reserved spending is only slightly higher than the UK average, and as a result, the

[3] House of Commons Library, 2024, The Barnett formula and fiscal devolution, available at: https://commonslibrary.parliament.uk/research-briefings/cbp-7386/

[4] UK Government, 2024, Deal reached on interim Fiscal Framework for Northern Ireland https://www.gov.uk/government/news/deal-reached-on-interim-fiscal-framework-for-northern-ireland#:~:text=It%20is%20headlined%20by%20a,its%20relative%20need%20per%20head

[5] House of Commons Library, 2024, Public spending by country and region, available at: https://commonslibrary.parliament.uk/research-briefings/sn04033/ based on HM Treasury data released for November 2024

[6] See for instance Cabinet Office, 2015, Scotland in the United Kingdom: An enduring settlement, available at: https://assets.publishing.service.gov.uk/media/5a7dd7aced915d2ac884de15/Scotland_EnduringSettlement_acc.pdf

Scottish parliament's budget in total is around 30% per head higher than comparable spending in England.[7]

9. Due to the operation of the Barnett formula, Scottish spending, particularly in local authorities, suffered less from austerity than England's.[8] Without its protection, it is likely that the Treasury would have imposed harsher cuts on Scotland during the period of peak austerity.

10. The RSE contends that this is an important piece of context when looking at the challenges the Scottish Government faces in managing its budget. Since it is responsible for the same range of services as the UK Government is in England, it should be possible to produce markedly better outcomes, and this has not happened.

11. The additional spending is allocated across a range of public services, often to provide services free which in England attract some degree of charging, but perhaps surprisingly, not to higher expenditure on school education or significantly higher spending on the NHS. Figure 2[9] shows comparable spending levels per head on different public services.

Figure 2: UK identifiable expenditure on services by function, £ per head, 2023-24 by country and region

	1. General public services	*of which: public and*	*of which: international*	2. Defence	3. Public order and safety	4. Economic affairs	*of which: enterprise and*	*of which: science and*	*of which: employment*	*of which: agriculture,*	*of which: transport*	5. Environment protection	6. Housing and community	7. Health	8. Recreation, culture and religion	9. Education	10. Social protection	Total Expenditure on Services
2023-24																		
North East	163	*162*	*1*	4	759	1,118	*263*	*134*	*80*	*100*	*541*	169	262	3,454	149	1,667	5,848	13,593
North West	128	*127*	*1*	0	623	1,261	*278*	*97*	*88*	*69*	*729*	451	202	3,438	132	1,589	5,471	13,297
Yorkshire and The Humber	122	*121*	*1*	1	555	1,025	*255*	*106*	*75*	*94*	*495*	155	219	3,118	132	1,624	5,234	12,185
East Midlands	128	*127*	*1*	1	558	881	*239*	*101*	*67*	*105*	*368*	163	203	2,953	99	1,599	5,018	11,603
West Midlands	112	*111*	*1*	1	569	1,249	*280*	*119*	*70*	*73*	*706*	136	231	3,236	98	1,672	5,222	12,527
East	145	*144*	*1*	1	505	1,252	*344*	*148*	*59*	*102*	*599*	205	227	2,899	100	1,580	4,817	11,730
London	146	*145*	*1*	1	942	2,139	*510*	*189*	*99*	*28*	*1,313*	210	575	3,975	150	1,808	4,897	14,842
South East	138	*137*	*1*	2	477	1,300	*344*	*179*	*54*	*94*	*628*	197	220	2,902	99	1,539	4,740	11,613
South West	134	*133*	*1*	2	482	991	*258*	*98*	*55*	*151*	*429*	221	200	3,081	102	1,493	5,230	11,936
England	134	*133*	*1*	1	610	1,311	*324*	*136*	*72*	*86*	*693*	221	273	3,243	117	1,621	5,093	12,625
Scotland	394	*392*	*1*	1	654	1,597	*468*	*149*	*65*	*152*	*763*	277	533	3,310	223	1,943	5,828	14,759
Wales	226	*225*	*1*	1	644	1,231	*295*	*100*	*71*	*200*	*566*	278	448	3,466	186	1,757	6,187	14,424
Northern Ireland	273	*272*	*1*	-	792	1,363	*345*	*131*	*40*	*363*	*484*	193	648	3,550	260	1,942	6,349	15,371
UK identifiable expenditure	163	*162*	*1*	1	620	1,332	*335*	*135*	*71*	*105*	*687*	227	313	3,268	133	1,662	5,239	12,958

Source: Country and Regional Analysis 2024, HM Treasury, Table A15.

[7] Institute for Fiscal Studies, 2021, Scottish Government funding per person is over 30% higher than equivalent English funding, available at: https://ifs.org.uk/news/scottish-government-funding-person-over-30-higher-equivalent-english-funding-it-has-still

[8] Philips, David, 2014, "Flaw" in Barnett formula protects Scotland and Northern Ireland from hundreds of millions of cuts, https://ifs.org.uk/news/flaw-barnett-formula-protects-scotland-and-northern-ireland-hundreds-millions-cuts

[9] HM Treasury, 2024, Country and Regional Analysis 2024, available at: https://www.gov.uk/government/statistics/country-and-regional-analysis-2024

12. The RSE contends that several points are worth noting here. First, the additional level of spending on health has declined markedly over the last 15 years. When the present administration in Edinburgh took office in 2007, Scotland spent 14% per head more on health than England,[10] now this is 2% per head higher.[11] This is partially offset by additional expenditure on providing social care and free personal care, which is included in the figures for social protection. The higher level of spending on education reflects policy on student funding (free tuition for HE&FE), rather than on school education. The high levels of social protection spending reflect higher spending on social care, and the Scottish Government's choices to spend more on devolved benefits.

Q2. Following its review in 2023, to what extent does the current Fiscal Framework effectively govern the mechanisms for Block Grant Adjustments and fiscal flexibilities of the Scottish Government?

13. The Scotland Act 2016 transferred substantial tax and social security powers to Scotland, thereby increasing its "fiscal autonomy." These tax powers most notably include almost all revenue from income tax. Devolved income tax will raise just less than £20 billion in 2025-26,[12] by far the largest part of the forecast total tax revenue of £24.6 billion.
14. These new tax and social security powers mean Scotland is less directly dependent on the block grant than at any time since the introduction of the Barnett formula. However, additional fiscal autonomy brings risk. In those countries which take needs-based approaches to subnational funding, additional money is provided for essential public services to areas that suffer economic decline. The Barnett formula is not needs-based and therefore does not provide Scotland with insurance against the risk of long-term structural decline.
15. Since Scotland's new fiscal powers imply reduced reliance on Westminster, Scotland will gain relative to the rest of the UK when the Scottish economy performs relatively well but cannot expect to be bailed out if the Scottish economy underperforms the rest of the UK. Additional risks associated with the new fiscal powers are set out in the 2023 Fiscal Framework,[13] which draws on the principles set out by the Smith Commission[14] in 2014.
16. The same legislation devolved some social security powers, which are not funded through Barnett. For payments such as the Adult Disability Payment, which has a DWP equivalent, Scotland benefits from a higher baseline at devolution where take-up is higher than in England ("no detriment"), but the Scottish budget is at risk if such benefits become more generous than in England or there is an above-England increase in take-up. There is no adjustment to the block grant for newly created Scottish benefits such as the Scottish Child Payment that have no DWP

[10] Calculated from Treasury, *Public Expenditure: Statistical Analysis*, April 2008, HC 489, Table 9.11, available at: https://assets.publishing.service.gov.uk/media/5a7c7f88ed915d48c2410259/0489.pdf
[11] Calculated from the Health column in Figure 2.
[12] Scottish Government, 2024, Scottish Income Tax 2025 to 2026: factsheet, available at: https://www.gov.scot/publications/scottish-income-tax-2025-2026-factsheet/pages/2/
[13] Scottish Government, 2023, Fiscal Framework: Agreement between the Scottish and UK Governments, available at: https://www.gov.scot/publications/fiscal-framework-agreement-between-scottish-uk-governments/
[14] UK Parliament, 2014, The Smith Commission: Proposals for Further Devolution Scotland, available at: https://committees.parliament.uk/work/4733/the-smith-commission-proposals-for-further-devolution-to-scotland/

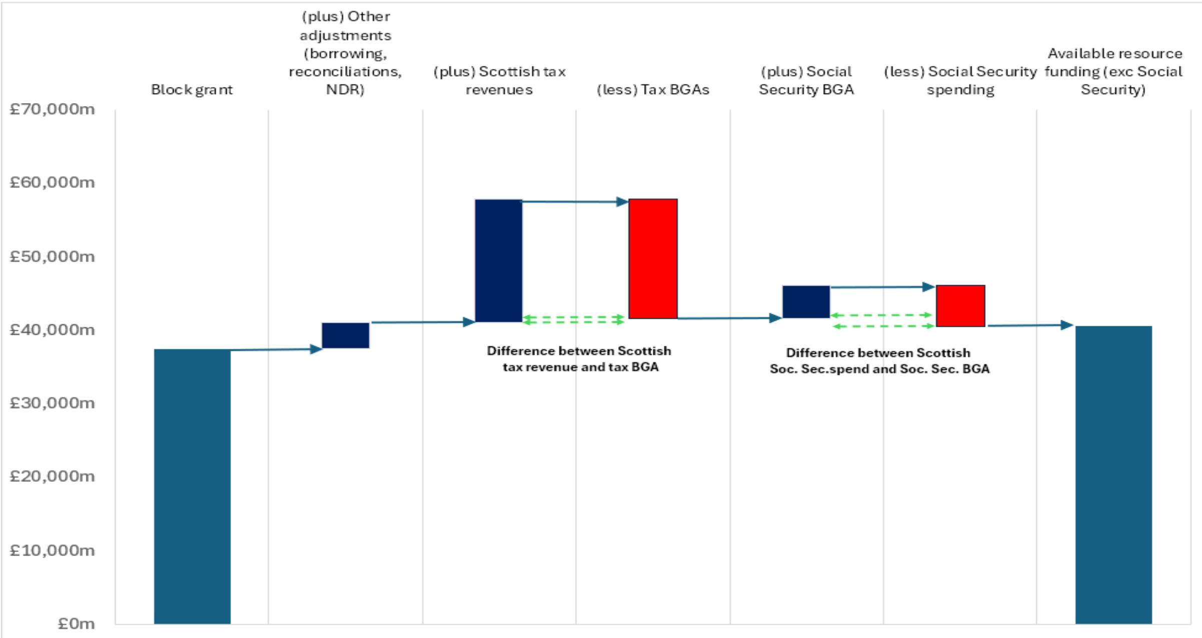
equivalent; the funding for such benefits must come directly from other Scottish Government programs.

17. The RSE notes that the choice made by Scottish ministers to spend markedly more on devolved social security benefits is one of the most significant issues for the Scottish budget. There are four broad categories:
    - The Scottish Child Payment, which costs around half a billion pounds a year.
    - The Scottish Adult Disability Payment is considerably more generous in terms of access to, and remaining on, than the UK benefit, the Personal Independence Payment, that it replaces.
    - Additional administration costs for a free-standing Scottish Social Security Agency and spending from any benefits becoming more generous or achieving higher take-up rates than their UK counterparts.
    - Moreover, the Scottish Budget 2024 contained future proposals for re-introducing Winter Fuel Allowance and removing the two-child benefit cap. Unless the UK Government makes parallel policy changes, there will be no UK funding.
18. Spending on social security benefits beyond what is provided by the UK Government means that expenditure on public services must be cut by an equivalent amount, or the money found from tax increases. The reduction in public service spending might disproportionately affect lower-income groups, who are more likely to be dependent on public services and have less access to private substitutes.

19. Under the Fiscal Framework, the amounts provided by the UK Government to offset Scotland's new spending on social security benefits are known as Block Grant Adjustments (BGAs). Similarly, there are BGAs which *reduce* the block grant to take account of Scotland's new tax-raising powers. The income tax BGA compensates the UK Government for its lost revenues because the Scottish income tax is now allocated to the Scottish Government.

20. How the tax and social security BGAs are calculated is complex and poorly understood, but they are a critical determinant of the ability of the Scottish Government to fund essential public services. They determine which risks are borne by the UK Government and which by the Scottish Government. For income tax, the BGA is indexed to the growth of per capita income tax revenues in England, adjusted for the change in Scotland's population share. If Scotland's share of the UK population is constant and Scottish income tax per head grows faster than that in England, the Scottish Government benefits since the income tax added to its budget is greater than the amount withdrawn from the block grant. Scotland also benefits if its share of the UK population falls, which has the effect of reducing the BGA and therefore leaving more of block grant with the Scottish Government. For social security, the block grant is increased by Scotland's population share of any increase in the equivalent benefits in England (or England and Wales). This mechanism is the same as the Barnett Formula.

Figure 3: Components of Scottish Budget 2024-25



Source: Fiscal Update August 2024, Scottish Fiscal Commission

21. The Scottish Budget 2024-25 incorporating the BGAs is illustrated to scale (£bn) in Figure 3. The left-most column comprises (1) the block grant from the UK Government; (2) the next column shows the net amount that the Scottish Government receives from other sources, such as non-domestic rates and borrowing; (3) the third column shows the addition to the Scottish budget from all of the taxes that the Scottish Government levies, such as income tax and Land and Buildings Transaction Tax; (4) the next column shows the sum of all of the tax BGAs which is effectively a withdrawal from Scotland's budget. Therefore, the difference between the sizes of these blocks gives the net effect of Scotland's tax powers on its budget; (5) the following two columns go through the same calculation for social security spending. The first shows the sum of the social security BGAs which the UK Government provides to Scotland to compensate for the social security spending that it no longer needs to make, while the second shows actual spending by the Scottish Government on its social security powers. The difference between these two columns shows the net effect of Scotland's social security policies on the remaining Scottish budget (excluding social security); (7) the final column therefore shows what remains for the Scottish Government to spend on programmes other than social security.

22. Figure 4,[15] drawn from the Scottish Fiscal Commission's most recent report, crystallises the substantial fiscal effects of the Scottish Government's social security choices on its budget as portrayed in Figure 3. It shows that in 2024-25 the Scottish budget will have to find spending reductions or tax rises of £1,042 million, rising to £1,453 million in 2026-27 from other programmes to pay for the increased social security. Payments of this kind always risk consuming resources from other Scottish Government programmes to meet the demand which emerges. Such oversight and commentary on current and projected spending decisions, such as

[15] Scottish Fiscal Commission, 2024, Scotland's Economic and Fiscal Forecasts – December 2024, available at: https://fiscalcommission.scot/publications/scotlands-economic-and-fiscal-forecasts-december-2024/

the example provided above, shows why the work of an independent actor such as the Scottish Fiscal Commission should be key in informing budgetary processes.

Figure 4: Effect of social security spending on the Budget

£ million	2023-24 outturn	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30
Social security net position	-198	-263	-529	-619	-616	-601	-568
Spending on payment without a BGA, of which:	blank	blank	blank	blank	blank	blank	blank
Payments unique to Scotland	-569	-618	-644	-674	-697	-713	-732
Other social security spending	-132	-162	-161	-160	-161	-162	-163
Effect on the Budget	-899	-1,042	-1,334	-1,453	-1,475	-1,476	-1,463

Source: Scotland's Economic and Fiscal Forecasts – December 2024, Scottish Fiscal Commission

23. The Fiscal Framework also created two sets of borrowing limits:
    - The first addresses forecast errors in devolved tax revenues and social security expenditure. The annual limit for 2023-24 was set at £600 million with a cumulative cap of £1.75 billion, with both limits being adjusted for inflation going forward;
    - The second addresses large-scale infrastructure and capital investments with a limit of £450 million in 2023-24 and a cumulative cap of £3 billion, again with an inflation adjustment.
24. Although a considerable increase on previous borrowing limits, these are still relatively small by international standards. HM Treasury has tended to oppose significant extension of Scotland's borrowing powers.

Q3. Within the existing devolution settlement, what steps could the UK Government take to offer Scotland more financial certainty?

25. The RSE suggests that there are number of ways of increasing Scotland's financial certainty. These include:

Providing multi-year funding settlements

26. In recent years UK Government spending decisions have been taken for one year only, rather than for a three-year spending review period. The most recent example of this was the present UK Government's budget on 30 October 2024, though there is to be a three-year UK spending review in the summer of 2025. Annual settlements are inimical to planning public services and have been part cause of the U.K.'s low-level of government capital spending. Taking a longer view of government funding would benefit all parts of the UK, including Scotland. That does not entirely rule out change in spending during the review period, so there is still some uncertainty to contend with. During the Covid period, arrangements were put in place to give the Scottish Government some certainty over future consequentials (foreseen but not yet determined), though it is unlikely that this would be sustainable in normal circumstances. With a pattern of

regular positive Barnett consequentials from spending reviews, it is unlikely that a fixed model that eliminates uncertainty completely would be preferred by the Scottish Government.

27. Such short-term planning is difficult for any organisation which is seeking to manage public expenditure, particularly if the assumption is that later years' provision may well be supplemented in subsequent spending rounds. The Scottish Government takes a similar approach, with the budget taking into consideration additional UK contributions during that year, such as the most recent budget, leaving its long-term stability in question.

28. Short-term planning has further unintended consequences. In response to in-year spending cuts in the last three financial years, organisations have sought to spend early to avoid reductions. However, such practices can also increase the centralisation of decision-making at the Scottish Government level, to the detriment of local authorities, public bodies and third-sector organisations. Any three-year planning arrangement thus should be reflected at different levels of government in Scotland.

Enhanced borrowing powers

29. Extending the Scottish Government's existing borrowing powers would enhance the ability to manage short-term volatility or large-scale infrastructure projects. HM Treasury would, however, likely resist this, especially as these were reset at the 2023 Fiscal Framework Review.[16]

Tax Revenue Insurance

30. Scotland could self-insure against volatility in tax revenues by establishing a stabilisation fund that it contributes to when revenues are strong and depletes during recessions. Or it could seek such insurance from a third party such as the Treasury, again paying premiums when revenues are high and receiving payments during economic downturns.

31. Moreover, given the above-mentioned instability of the system, as outlined in recent economic forecasts such as those produced by the Scottish Fiscal Commission[17] which show a growing deficit in the next years, adjustments to spending or tax are needed, and the development of a dedicated tax strategy at the Scottish Government level would be useful to address such negative trends.

Increased transparency on fiscal matters from the UK Government

32. Increased communication on fiscal matters between the Scottish and UK Governments would reduce the element of surprise. Efficient communication can support a more streamlined Scottish budgetary process.

Frequent reviews of the operation of the fiscal framework

33. Regular reviews of the framework reduce the possibility of problematic issues only being resolved through radical and politically contentious change.

[16] More details available at:https://www.gov.uk/government/publications/the-updated-agreement-on-the-scottish-governments-fiscal-framework#:~:text=In%20line%20with%20the%202016,a%20parliament's%20worth%20of%20experience

[17] Scottish Fiscal Commission, 2024, Scotland's Economic and Fiscal Forecasts – December 2024, available at: https://fiscalcommission.scot/publications/scotlands-economic-and-fiscal-forecasts-december-2024/

Q4. Are there any comparative perspectives that should be considered when assessing the effectiveness of fiscal devolution in Scotland?

34. The RSE notes some general observations (outlined below) which might be useful for the Committee's inquiry. However, the RSE advises that drawing comparisons with overseas can be problematic due to the asymmetric pattern of devolution conferred by the UK Parliament. There are many models of fiscal devolution worldwide. These map to different levels of fiscal autonomy for subnational governments.

35. The historical evolution of fiscal arrangements can be a powerful differentiator: for example, whether the federation has been created by hitherto independent states, or an existing unitary state has been federalised. The geographical size of the nation matters, as larger size tends to reduce the behavioural effects of tax differentials at internal borders. The level of tolerance for territorial divergence of living standards and public services is another aspect.

36. Thus, states in the US have extensive fiscal independence, including the ability to set income, sales and property taxes. But they bear the full responsibility for balancing their budgets. Australia is a geographically large country with low tolerance for divergence, hence Australian states have an extensive federal redistribution mechanism that is operated by the Commonwealth Grants Commission which carries out periodic needs assessments of the states and territories. Canada combines significant tax devolution with a strong commitment to extensive but incomplete territorial equalisation. In Sweden, local governments deliver most public services, but equalisation payments are used to reduce regional disparities. A complicated scheme for territorial fiscal redistribution is in place in Germany, with extensive territorial redistribution on the expenditure side but tax revenues are formula-assigned and mostly not subject to variation at the Länder level, the system being overseen by the Bundesrat (upper house with representation from the Länder).

37. Some general lessons to be drawn:
    - Greater fiscal autonomy is often associated with higher risks,[18] including greater economic divergence between regions which might lead to unanticipated political consequences.
    - Transparency of the mechanisms that generate equalisation payments increases their political acceptability.
    - Reliable and transparent data is a necessary, but not sufficient condition, for stable subnational fiscal mechanisms.
    - There is a balance between incentives and equalisation. Full equalisation reduces the incentive for subnational governments to promote economic development, which may result in areas characterised by long-term economic disadvantage that become dependent on equalisation payments.

38. The RSE notes that all these details suggest that there are no ready answers, yet the United Kingdom could benefit from a better understanding of how other countries operate their fiscal decentralisation systems. To support such comparisons and to keep up to date with best practices for intergovernmental fiscal relations in other countries, the UK should reconsider its decision not to join the OECD's Network on Fiscal Relations across Levels of Government.[19]

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[18] Mcintyre, S., Mitchell, J. and Roy, G., "Careful What you Wish for? Risk and Reward with Scottish Tax Devolution," *Political Quarterly*, Vol. 93(3), 2022, https://onlinelibrary.wiley.com/doi/full/10.1111/1467-923X.13174

[19] OECD, no date, The network on fiscal relations across levels of government, available at:

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https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/fiscal-federalism-network/about-the-fiscal-network.pdf