HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Pete Wishart MP
Scottish Affairs Committee
House of Commons
London
SW1H 9NB

Dear Pete,

12th February 2016

REVISING SCOTLAND'S FISCAL FRAMEWORK

I warmly welcome the publication of the Scottish Affairs Committee's report on the Scottish Government's new fiscal framework this week. Thank you for inviting me to give evidence and for taking other views into account in the final Report. This is exactly the kind of scrutiny I hope the final fiscal framework agreement will receive at Westminster.

2. As the Prime Minister has reiterated, we want to reach an agreement that enables the Scottish Government to take on and use the extensive new tax and welfare powers agreed by the Smith Commission. The UK government has been consistently clear that it wants a deal that is fair for Scotland, fair for the rest of the UK and fully meets the principles in the Smith Agreement. I remain optimistic we will be able to achieve this.

3. The UK government agrees with the Committee that the Indexed Per Capita (IDPC) model would *"breach the second no detriment principle, that of taxpayer fairness"*. This model would see Scotland benefitting from an ever-increasing share of income tax from the rest of UK, irrespective of the Scottish Government's policy decisions or relative economic performance.

CHIEF SECRETARY TO THE TREASURY

4. However, while the Committee suggested this model could be refined *"to ensure that Scotland's funding per capita does not increase beyond a certain point relative to rUK"* we believe this would run counter to the aim of devolving tax powers. For example, if the Scottish Government decides to increase taxes in Scotland, then Scottish taxpayers should benefit fully from the extra spending. We also believe that a simple, mechanical approach is preferable to a more complicated system of IDPC plus an extra adjustment formula for taxpayer fairness.

5. The UK Government instead believes that the Levels model is most consistent with both elements of 'no detriment'. This model would have seen no detriment to Scotland or the rest of the UK at the point of devolution (paragraph 95/3); thereafter, taxpayers in Scotland would have benefitted from all changes in devolved Scottish taxes while taxpayers in the rest of the UK would have benefitted from all changes in their equivalent taxes (paragraph 95/4/b). As the Committee's report notes, this model *"would therefore appear to satisfy the taxpayer fairness principle"*.

6. This is simple, logical and fair. It also reflects the fundamental consequence of a tax being devolved, which is that the Scottish Government keeps all revenues from devolved taxes rather than pooling and sharing these with the rest of the UK. Hence the Smith Commission's requirement for symmetric arrangements for corresponding taxes in the rest of the UK. The First Minister's recent letter to the Prime Minister made clear that she also agreed that the arrangements should be fair and symmetric.

7. However, concerns have been raised that this Levels model would not take in to account the fact that Scotland currently generates less than a population share of income tax. While the Indexed model would take this into account (as agreed by the UK and Scottish governments for the first 10p of Scottish income tax under Scotland Act 2012) concerns have now been raised that it would not

take into account changes in Scotland's share of the population, despite the Deputy First Minister stating in evidence to the Scottish Parliament Finance Committee in June 2015 that managing population change *"is another of the wider range of risks that we take on as a consequence of gaining the responsibilities"*.

8. The UK Government has listened carefully to these concerns and has developed a proposal that comprehensively deals with both of them. In the interests of enabling further scrutiny I thought it would be helpful if I set out our proposed model, which essentially extends the Barnett Formula so that it applies to devolved taxes as well as devolved spending.

9. In the same way that Barnett (spending) consequentials are added to the block grant when there are changes in comparable UK Government spending, we would similarly deduct Barnett (tax) consequentials when there are changes in comparable UK Government tax. The table below sets out how Barnett consequentials would be calculated under this proposal:

Change	**x**	**Comparability**	**x**	**Population share**
UK Government spending	x	Y%	x	c10%
UK Government tax	x	X%	x	c10%

Note that the population share would be updated to reflect changes over time.

10. While spending comparability is set so that Barnett adds a population share of changes in comparable UK Government spending, we have proposed that tax comparability takes into account the share of devolved tax that Scotland generates (rather than being a full population share).

11. The general approach to tax comparability would be to take an average of 100% (the existing approach to devolved areas within Barnett) and Scotland's share of the relevant tax at the point of devolution. However, for income tax, the

UK Government has offered to use Scotland's share at the point of devolution (which is currently 89% of a population share) rather than an average.

12. This proposal would also treat population change in exactly the same way for tax as the Barnett Formula does for spending, with Scotland's population share being updated over time. This would mean that the Scottish Government was being treated like all other governments, who have the same population to generate taxes and use public services.

13. So if Scotland's population grows quickly, the Scottish Government will receive more tax revenue but need to provide public services to more people; if Scotland's population grows slowly, the Scottish Government will receive less tax revenue but need to provide public services to fewer people.

14. As a result, our proposal means that the Scottish Government would retain all devolved Scottish taxes and a share of the growth in corresponding taxes in the rest of the UK. Had this proposal been in operation since 1999-00, Scotland would have received more funding than under Barnett. And using the Scottish Government's own forecasts, Scotland would benefit from c£4.5bn of the growth in taxes from the rest of the UK in the next decade alone.

15. While this arguably goes beyond the letter of the Smith Agreement, the UK Government is committed to devolving the further tax and welfare powers that would make the Scottish Parliament one of the most powerful devolved parliaments in the world. We believe that this proposal is therefore fair for taxpayers in Scotland, fair for taxpayers in the rest of the UK, and built to last.

16. We are continuing to discuss all elements of the fiscal framework with the Scottish Government, including your important recommendation that *"There is a clear consensus that forecasting should be done by a body independent of government. We agree with the conclusions of the Finance Committee of the*

Scottish Parliament and recommend that an enhanced Scottish Fiscal Commission be made responsible for forecasting in Scotland", and remain optimistic that we can reach agreement on a deal that is fair for taxpayers across the UK.

17. I am copying this to Lord Hollick (chair of the Lords Economic Affairs Committee) and Andrew Tyrie MP (chair of the Treasury Select Committee) and I am also putting this letter in the public domain.

Yours ever,

GREG HANDS