HM Government

The Scottish Government
Riaghaltas na h-Alba

The agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework

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THE AGREEMENT

Between the Scottish Government and the United Kingdom government on the Scottish Government's fiscal framework

1. The Smith Commission was convened in September 2014 and charged with reaching a cross-party agreement on the devolution of further powers to the Scottish Parliament. Lord Smith of Kelvin oversaw the process. The Smith Commission published its report detailing Heads of Agreement on 27 November 2014.[1]

2. Both governments are committed to the implementation of the Smith Commission's conclusions including the creation of a new Scottish Government fiscal framework consistent with the overall UK government's fiscal framework.

3. Both the Scottish Government and the UK government are committed to financial responsibility and democratic accountability, incentivising the Scottish Government to increase economic growth while allowing Scotland to contribute to the United Kingdom as a whole.

4. Additionally, the Governments are committed to a sustainable overall fiscal position for public finances both within Scotland and the UK as a whole.

5. The Scottish Government will be able to exercise its fiscal powers fully and flexibly while operating within a sustainable fiscal framework for the whole of the UK.

Principles of the Fiscal Framework

6. The agreed fiscal framework set out in this document is consistent with the principles in the Smith Agreement. Annex A sets out the principles for the Scottish Government's fiscal framework recommended by the Smith Commission and agreed by the Scottish and UK governments.

Funding the Scottish Government's budget

7. As set out in the Smith Agreement, changes in the Scottish Government's block grant will continue to be determined via the operation of the Barnett Formula. Under the Barnett Formula, the Scottish Government's block grant in any given

[1] https://www.smith-commission.scot/

financial year is equal to the block grant baseline plus a population share of changes in UK government spending on areas that are devolved to the Scottish Parliament. This will continue to apply to changes in UK government spending on areas that are devolved to the Scottish Parliament. In future, the Scottish Government will retain all devolved and assigned Scottish tax revenues.

8. For all further spending powers other than welfare (and any other areas explicitly set out in this document) the normal approach to machinery of government changes will determine the initial baseline adjustments, with the full programme costs in and for Scotland being transferred at the point of devolution for the remainder of the Spending Review period. This change will be baselined and the Barnett formula will subsequently apply to changes in UK government spending in these areas. For the employment programmes, the Barnett formula will apply to changes in the entirety of UK government spending, including any elements funded through payment by results.

The block grant adjustments for taxation and welfare

9. The block grant to the Scottish Government will be adjusted to reflect the introduction of devolved and assigned revenues, and the transfer of responsibility for welfare.

10. The adjustments will involve two elements: an initial block grant baseline adjustment (a deduction in relation to tax and an addition in relation to welfare) and an indexation mechanism.

Baseline adjustments to the Block Grant

11. The initial baseline deduction for tax[2] will be equal to the UK government's receipts generated from Scotland in the year immediately prior to the devolution of powers. This agreement is without prejudice to the block grant adjustments agreed in respect of Landfill Tax and Stamp Duty Land Tax for 2015-16, no revisions will be applied to the block grant adjustments for this financial year.

12. The baseline adjustment for Stamp Duty Land Tax will take into account the forestalling that is estimated to have occurred, which will reduce the baseline

[2] Revenues from Scottish courts and tribunals will be treated in the same way as devolved/assigned taxes.

adjustment by £20m. No further forestalling effects in relation to the implementation of new powers will be taken into account.

13. The initial baseline addition to the block grant for devolved welfare payments will be the UK government's spending on these areas in Scotland in the year immediately prior to the devolution of powers, with the exception of the Cold Weather Payment. Reflecting the substantial volatility of the Cold Weather Payment, the initial baseline addition will be an average of the UK government's spending in Scotland on this benefit from 2008-09 to the year prior to devolution.

14. The indexation mechanisms set out below will be operated separately for each tax and welfare power and applied annually.

Indexation mechanisms

15. The block grant to the Scottish Government will be adjusted to reflect the devolution/assignment of the taxes and the devolution of the spending set out in this agreement.

16. For welfare, and all other spending unless stated otherwise in this agreement, the chosen method will be the Barnett formula. The comparability factor will be set at 100% for elements of welfare that are devolved under this agreement.

17. For a transitional period covering the next Scottish Parliament, the Governments have agreed that the block grant adjustment for tax should be effected by using the Comparable Model (Scotland's share), whilst achieving the outcome delivered by the Indexed Per Capita (IPC) method for tax and welfare. This will ensure that the Scottish Government's overall level of funding will be unaffected if Scotland's population grows differently from the rest of the UK.

18. The comparability factors for tax that would be used in the Comparable Model on the basis of Scotland's current share of each tax to be devolved are set out in the table below.

Tax	**Scotland's share (%)**
Income tax	87.7
SDLT	51.5
Landfill tax	108.3
VAT	98.9
APD	117.5
Aggregates	189.1

19. During the transitional period up to and including 2021-22, however, there will be an annual reconciliation process to achieve the Indexed Per Capita outcome. This will ensure that the Scottish Government's overall level of funding will be unaffected if Scotland's population grows differently from the rest of the UK.

Review

20. The Smith Commission report said that, once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation, but that the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

21. Accordingly, the two governments have agreed that these arrangements will be reviewed following the UK and Scottish Parliament elections in 2020 and 2021 respectively, allowing an assessment at that time, and in the light of a Parliament's worth of experience, of the best way of achieving a fair, transparent and effective outcome in line with all of the Smith principles.

22. The review will be informed by an independent report with recommendations presented to both Governments by the end of 2021.

23. The fiscal framework does not include or assume the method for adjusting the block grant beyond the transitional period. The two governments will jointly agree that method as part of the review. The method adopted will deliver results consistent with the Smith Commission's recommendations, including the principles of no detriment, taxpayer fairness and economic responsibility.

Commencement dates and transition periods

24. The Scottish Rate of Income Tax comes into effect from April 2016 and will operate for one transitional year until the full devolution of the Smith Income Tax powers. During this transition year there will be no reconciliation of forecasts to outturn (for the tax revenues or the block grant adjustment) as previously agreed under Scotland Act 2012.

25. Full devolution of income tax rates and thresholds for non-savings and non-dividend income will therefore commence in April 2017.

26. Air Passenger Duty will be devolved in April 2018.

27. The Joint Exchequer Committee (JEC) will agree on a suitable point for the commencement for devolution of the Aggregates Levy once current state aid and other outstanding legal issues have been resolved.

28. Revenues from courts and tribunals in Scotland will be retained by the Scottish Government from April 2017.

29. The implementation dates for welfare will be agreed by the Joint Ministerial Working Group on Welfare. The Joint Exchequer Committee will oversee the transfers of funding.

Administration and implementation costs

30. There are administration and implementation costs associated with the powers being devolved. In line with the Smith Commission recommendations the UK government will transfer funding to support a share of the associated implementation and running costs for the functions being devolved.

31. Both Governments have agreed that the UK government will provide £200m to the Scottish Government to support the implementation of new powers. This will represent a one-off (non-baselined) transfer, supplementing the block grant, to support the functions being transferred. The profile of this transfer is to be agreed by the JEC.

32. The Governments have agreed a baseline transfer of £66m to cover the ongoing administration costs associated with the new powers. This figure includes the marginal savings realised by the UK government as a result of no longer administering the powers in Scotland devolved under the current Scotland Bill, plus a share of the Scottish Government's running costs. This baseline transfer will be indexed through the normal application of the Barnett formula.

33. In line with the Smith Commission report, additional administration and programme costs directly associated with the exercise of the powers in paragraphs 44 to 45 of the Smith Commission Heads of Agreement will be met by the Scottish Government, these relate to the powers to vary elements of Universal Credit.

34. All administration and programme costs incurred by the Scottish Government due to the creation of new welfare benefits or making discretionary payments will be met by the Scottish Government.

35. In line with the approach taken for the Scottish Rate of Income Tax, the Scottish Government will reimburse the UK government for net additional costs wholly and necessarily incurred as a result of the implementation and administration of the Income Tax powers.

36. The Scottish Government will reimburse the UK government for any net additional costs wholly and necessarily incurred in ‘switching off’ APD and Aggregates Levy in Scotland.

37. Both governments have agreed to share equally all costs wholly and necessarily incurred as a result of the implementation and administration of VAT assignment.

38. All other demonstrable and jointly agreed net costs to the UK government wholly and necessarily incurred as a result of the devolution of powers will be met by the Scottish Government.

39. All costs incurred by the UK government where the Scottish Government is expected to meet the costs will be subject to audit.

Value Added Tax (VAT)

40. Receipts from the first 10p of the standard rate of VAT and the first 2.5p of the reduced rate of VAT in Scotland will be assigned to the Scottish Government.

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.

43. The two Governments have agreed that VAT assignment will be implemented in 2019-20.

No detriment due to policy spillovers effects

44. The Smith Commission stated that there should be no detriment as a result of UK government or Scottish Government policy decisions post-devolution.

45. Specifically, where either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving.

46. These financial consequences of policy decisions have been termed policy spillover effects.

47. The main categories of these can be divided into:

- Direct effects – these are the financial effects that will directly and mechanically exist as a result of the policy change (before any associated change in behaviours); and
- Behavioural effects – these are the financial effects that result from people changing behaviour following a policy change.

48. Other indirect or second-round effects may also arise from policy changes, and the Governments have agreed that the financial consequences of these should not be included in the scope of the "no detriment" principle. This is because of the difficulty in demonstrating and agreeing both causality and the scale of any financial impact.

49. The UK and Scottish Governments have agreed to account for all direct effects.

50. Behavioural effects that involve a material and demonstrable welfare cost or saving will be taken into account where these are in exceptional circumstances. Behavioural effects that impact tax revenues can be taken into account where, in exceptional circumstances, they are demonstrated to be material and both governments agree that it is appropriate to do so.

51. Assessment of causality and of the scale of any financial impacts will be based on and supported by a shared understanding of the evidence.

52. Any decision or transfer relating to a spillover effect must be jointly agreed by both Governments. Without a joint agreement, no transfer or decision will be made.

53. Issues relating to spillovers will first be discussed by officials in both Governments. Where officials are unable to reach an agreement this will be discussed by Ministers at the JEC. Where the Governments are unable to reach agreement at

official or ministerial level a dispute can be raised. The arrangements for resolving disputes on spillover effects and the wider fiscal framework are set out below under dispute resolution.

Capital borrowing

54. The Scottish Government's existing capital borrowing limits (set out in the Scotland Act 2012) are being increased. In reaching this conclusion, due consideration was given to the merits of a prudential borrowing regime in line with the Smith Commission's recommendation.

55. The Governments have agreed that the statutory limit on borrowing for capital expenditure will be increased to £3bn. The annual limit on the amount of borrowing for capital expenditure will also be increased. It will now be set at 15% of the overall borrowing cap, which is equivalent to £450 million a year.

56. The Scottish Government will notify the Treasury monthly on its planned capital borrowing, its outstanding debt and repayment profile, but will be able to borrow within the agreed limits as it deems appropriate.

57. These capital borrowing limits are in addition to the Scottish Government's capital block grant, which will continue to be calculated in accordance with the Barnett formula.

58. The UK Government will amend the Scotland Bill accordingly to increase the aggregate borrowing limit with effect from 1 April 2017.

59. The Scottish Government may borrow through the UK Government from the National Loans Fund, by way of a commercial loan (directly from a bank or other lender), or through the issue of bonds. Borrowing for capital expenditure will be in pounds Sterling.

60. The repayment arrangements are to remain consistent with the Scotland Act 2012 and to be finalised in a revised Memorandum of Understanding between the Scottish Government and UK government. Under these arrangements, the term of any loan would normally be for 10 years, but where the lives of the assets being purchased through the loan justify longer or shorter terms, these can be agreed.

Resource borrowing

61. Under the Scotland Act 2012, the Scottish Parliament is responsible for around £9 billion in taxation. Under the Smith Agreement powers, the Scottish Parliament will be responsible for nearly £21 billion in devolved and assigned tax revenue and over £2 billion in demand-led welfare spending. The Governments have agreed a set of fiscal tools to enable the Scottish Government to manage the additional risks and volatility associated with the devolution of these powers.

62. Under current powers, the Scottish Government has a total resource borrowing limit of £500m that may be used in specified circumstances. Scotland Act 1998 first enabled the Scottish Government to borrow up to £500m from the National Loans Fund (NLF) to meet an in-year excess in expenditure over income or to provide a working balance in the Scottish Consolidated Fund.

63. The Scotland Act 2012 extended this facility to enable the Scottish Government to borrow from the NLF across financial years when devolved tax revenues are lower than forecast. This form of borrowing is repayable within four years rather than in-year. An annual limit of £200m was set administratively within a statutory £500m overall limit.

64. Under this agreement, the Scottish Government will have the power to borrow up to £600m each year within a statutory overall limit for resource borrowing of £1.75bn, for the following reasons:

- for in-year cash management, with an annual limit of £500m;
- for forecast error in relation to devolved and assigned taxes and demand-led welfare expenditure arising from forecasts of Scottish receipts/expenditure and corresponding UK forecasts for the Block Grant Adjustments, with an annual limit of £300m; and
- for any observed or forecast shortfall in devolved or assigned tax receipts or demand-led welfare expenditure incurred where there is, or is forecast to be, a Scotland-specific economic shock, with an annual limit of £600m.

65. These enhanced borrowing powers will apply from 2017-18 onwards.

66. A Scotland-specific economic shock is triggered when onshore Scottish GDP is below 1% in absolute terms on a rolling 4 quarter basis, and 1 percentage point below UK GDP growth over the same period. The shock may be triggered from outturn data or forecasts. In the event that forecast data shows an economic shock but outturn data does not, no retrospective revisions will be applied to borrowing powers.

67. Once a shock is triggered, the annual cyclical resource borrowing (of up to £600m) lasts for each financial year in which the trigger applies, plus the following two financial years, as the economy and public finances recover. This is the period during which cyclical borrowing powers may be used.

68. The Governments agreed that the Scottish Government should have the option of refinancing, on the same terms, any debt due to be repaid in a year of a Scotland-specific economic shock.

69. Resource borrowing will continue to be from the National Loans Fund, and the repayment period will be between three and five years, as determined by Scottish Ministers at the time of borrowing. The Scottish Government will provide regular monthly forecasts to the Treasury of the amount of resource borrowing it expects to make, outstanding debt and repayment profiles, but will be able to borrow within the agreed limits as deemed appropriate.

70. Where a Scotland-specific shock will, or is expected to, require a higher level of cyclical borrowing than is set out in this agreement, an escape clause will apply. On request from the Scottish Government, the resource borrowing limits may be temporarily increased. This will provide the Scottish Government with the necessary tools to manage extreme levels of volatility.

Scotland Reserve

71. The Scotland Act 2012 provided the Scottish Government with a cash reserve to build up funds when devolved revenues are higher than forecast and drawdown funds when devolved revenues are lower than forecast. The reserve must be held within the UK government rather than with a commercial bank.

72. For five years from June 2011, the Scottish Government has been able to make discretionary payments into the cash reserve up to a total £125m limit. This is so that the Scottish Government may accumulate a reserve in advance of new powers being devolved. From April 2015, the Scottish Government has been able to pay surplus tax receipts into the reserve.

73. The new Scotland Reserve will now enable the Scottish Government to smooth all types of spending and manage tax volatility and determine the timing of expenditure. The Scotland Reserve will apply from 2017-18 onwards.

74. The Scotland Reserve will be separated between resource and capital. Payments may be made into the resource reserve from the resource budget including tax receipts. Funds in the resource reserve may be drawn down to fund resource or

capital spending. Payments may be made into the capital reserve from the capital budget. Funds in the capital reserve may be drawn down to fund capital spending only.

75. The Scotland Reserve will replace the existing cash reserve. The Budget Exchange Mechanism will no longer apply to the Scottish Government's resource or capital budgets.

76. The Scotland Reserve will be capped in aggregate at £700m. The Governments have agreed that annual drawdowns from the reserve will be limited to £250m for resource and £100m for capital. There are no annual limits for payments into the Scotland Reserve.

77. The Governments have agreed that the total annual drawdown limits will be temporarily waived in the face of a Scotland-specific economic shock, triggered by the same circumstances as for cyclical resource borrowing and described in paragraph 66.

78. The Scotland reserve will be held within the UK government's Exchequer. The detailed arrangements for the operation of the Scotland reserve and access arrangements will be agreed between the Governments.

Fiscal scrutiny

79. Alongside the devolution of further powers to the Scottish Parliament, the Smith Commission recommended that the Scottish Parliament should expand and strengthen independent fiscal scrutiny of Scotland's public finances.

80. The Scottish Fiscal Commission was established on a non-statutory basis in 2014, with a remit to independently scrutinise and report on the Scottish Government's devolved tax revenue forecasts and projections of economic determinants underpinning forecasts of non-domestic rate income (NDRI).

81. In September 2015 the Scottish Fiscal Commission Bill was introduced into the Scottish Parliament.[3] The Bill relates to the tax powers devolved to the Scottish Parliament under the Scotland Acts of 1998 and 2012 as the Scottish Parliament does not yet have competence to legislate for additional functions for the Commission to reflect the new fiscal framework.

[3] http://www.scottish.parliament.uk/parliamentarybusiness/Bills/92309.aspx

82. The Bill provides that Scottish Ministers will have a regulation-making power to expand the Scottish Fiscal Commission's functions to take account of new fiscal powers once the new Scotland Act is in place, subject to the approval of the Scottish Parliament. To reflect additional devolved tax and spending powers devolved by the current Scotland Bill and the associated fiscal framework the remit of the Scottish Fiscal Commission will be expanded. The future effectiveness of the Scottish Fiscal Commission and the OBR in scrutinising Scotland's devolved public finances and the operation of Scotland's new fiscal framework will be dependent on close and constructive working between the two bodies.

83. In order to support these independent bodies in discharging their statutory functions, the Governments have agreed to introduce a reciprocal statutory duty of cooperation between the Scottish Fiscal Commission and the OBR. The practical working arrangements will be set out in a Memorandum of Understanding.

Forecasting

84. Forecasts of tax revenue and demand-led welfare expenditure in Scotland and the corresponding forecasts in the rest of the UK will be required to support the working of the fiscal framework (as the forecasts for the rest of the UK will be used to determine the block grant adjustment forecasts). In addition, forecasts of GDP will be required to support the cyclical borrowing provisions.

85. The Scottish Fiscal Commission will prepare independent forecasts of demand-driven welfare spending, revenues from the fully devolved taxes and income tax, and onshore GDP in Scotland. The founding legislation for the Scottish Fiscal Commission will require the Commission to prepare forecasts of fully devolved taxes and will contain regulation making powers to enable the Commission to prepare forecasts of these other factors once the Scottish Parliament has the relevant competence. The timing of commencement of this responsibility is still to be discussed and agreed with the Scottish Fiscal Commission.

86. The OBR will continue to produce economic and fiscal forecasts for the whole of the UK, as well as all forecasts of UK government tax and spending required for the operation of the fiscal framework.

87. Arrangements for the production of forecasts of VAT revenues will be agreed by the JEC.

88. The UK and Scottish governments have agreed that appropriate and reciprocal information-sharing arrangements will be put in place to enable both governments

(as well as the OBR and the Scottish Fiscal Commission) to undertake their respective responsibilities.

Welfare Benefits

89. The Governments have agreed that any new benefits or discretionary payments introduced by the Scottish Government must provide additional income for a recipient and not result in an automatic offsetting reduction by the UK government in their entitlement elsewhere in the UK benefits system. Any new benefits or discretionary payments introduced by the Scottish Government will not be deemed to be income for tax purposes, unless topping up a benefit which is deemed taxable such as Carer's Allowance.

90. The Governments have also agreed that the UK government's Benefit Cap will be adjusted to accommodate any additional benefit payments introduced by the Scottish Government.

Crown Estate

91. The Governments have agreed that the Scottish Government will take on responsibility for managing the Crown Estate assets in Scotland.

92. The managers of Crown Estate assets in Scotland will continue to receive the same benefits as the Crown Estate Commissioners in terms of exemption from corporation tax, income tax, capital gains tax and other HMT finance rules.

93. Responsibility for the Coastal Communities Fund will be devolved to the Scottish Government.

94. The Governments have agreed that a baseline deduction to the Scottish Government's block grant will be equal to the net revenues[4] generated by the Crown Estate assets in Scotland in the year immediately prior to the transfer. A baseline addition will be made for the funding of the Coastal Communities Fund equal to the UK government spending in the year immediately prior to devolution. Neither baseline adjustment will be subject to indexation.

[4] Gross revenues generated by the Scottish Crown Estate assets in Scotland, net of the costs of managing these assets.

95. The Scottish Government will also assume full responsibility for all associated liabilities relating to the Crown Estate assets in Scotland.

96. The JEC will agree a date for the transfer of the Scottish Crown Estate assets and devolution of the Coastal Communities Fund.

Governance

97. The Joint Exchequer Committee (JEC), operating by consensus, will govern the completion, implementation, operation and review of the fiscal framework. The JEC will also discuss any other issues arising which Ministers from either Government refer to the JEC.

Dispute Resolution

98. The dispute resolution mechanism set out below has the following scope:

- All disputes arising from the consideration of direct and behavioural spillover effects, including both gains and losses.
- It would also apply to the resolution of inter-administration disputes relating to the fiscal framework, including calculation of the Block Grant Adjustment and other aspects of the fiscal framework, but excluding the review arrangements described in paragraphs 20 to 23 of this Agreement.
- It would not apply to any other issues of inter-governmental dispute or disputes between UKG and other devolved administrations and the MoU procedure would continue to apply in these cases.

99. If the difference of view cannot be settled at working level, it would become a disagreement and be referred to senior officials (at Director level or above), including consideration at Joint Exchequer Committee (Official) (JEC(O)). If no resolution can be reached, the matter becomes a formal dispute and would be referred to Ministers to be raised and discussed at a meeting of JEC.

100. If it becomes clear that there is a dispute that cannot be resolved between Ministers, there is an automatic pause placed on the disputed finances, i.e. no decisions or actions can be taken by either government in relation to the disputed amount until the dispute is resolved.

101. Both governments will draw up a statement of fact on the dispute. Technical input on the dispute may be sought from the OBR and the Scottish Fiscal Commission. The findings of any technical input and analysis will be published.

102. The statement of fact and the technical input from the OBR and Scottish Fiscal Commission will be considered by both governments, who commit to using their best endeavours to resolve the dispute.

103. If no agreement can be reached then the dispute falls – there would be no specific outcome from the dispute and so no fiscal transfer between the Governments.

104. If either Government wishes to pursue the dispute further it can be referred to the "Protocol on the Resolution and Avoidance of Disputes" attached to the Memorandum of Understanding between the UK government and the devolved administrations. That MoU is currently subject to review.

Reporting

105. The Smith Commission recommended that both governments provide updates to their respective parliaments, including through the laying of annual update reports [Paragraph 95 (9)]. These reports should set out the changes agreed to the Scottish Government's fiscal framework.

106. Section 33 of the Scotland Act 2012 makes provision for Scottish and UK Ministers to report on the implementation and operation of the finance powers/functions devolved under that Act. These reports are required to set out:

- action taken towards commencement of the provisions;
- an assessment of the operation of provisions which have commenced;
- an assessment of the operation of any other powers to devolve taxes or to change the powers of Scottish Ministers to borrow and any other changes affecting the finance provisions inserted or amended by the Act;
- the effect on payments into Scottish Consolidated Fund; and,
- any other matters concerning sources of revenue for the Scottish Administration which should be brought to the attention of both Parliaments.

107. Both Governments will separately prepare and publish a similar type of report for functions and duties being devolved under the forthcoming Scotland Act 2016. These reports will also be provided to both the UK and Scottish Parliaments.

108. Any annual report provided to either Parliament would sit alongside and be complementary to existing scrutiny by both Parliaments, such as the legislative process, committee inquiries and questions to ministers. It is also open to both Parliaments to request updates from their respective Governments on the operation of the framework.

Implementation and operation

109. The Governments have agreed that the Joint Exchequer Committee – Officials (JEC(O)) will see its remit expanded to include detailed implementation and operation of the financial provisions of any Scotland Act 2016. The remit of the JEC(O) will be expanded to cover the remit of the Intergovernmental Assurance Board established to oversee implementation and operation of the fiscal provisions of the Scotland Act 2012. JEC(O) will oversee, at official level, the delivery of the fiscal framework. Membership will also be expanded to include relevant interests from UK government departments and equivalent officials in the Scottish Government.

110. The Governments have agreed that there will be no in-year updates to the forecasts for income tax and VAT revenues, or the associated block grant adjustments. These forecasts will be used until they can be reconciled to outturn.

Review

111. A review of the operation of the Scottish Government's fiscal framework against the principles agreed by the Smith Commission will be completed, agreed and published after the independent report on the block grant adjustment arrangements is presented to both governments by the end of 2021. The JEC will agree the arrangements for undertaking the review.

112. It will be open to either government to propose changes to the fiscal framework from that point. The fiscal framework does not include or assume the method for adjusting the block grant beyond the transitional period. The two governments will jointly agree that method as part of the review. The method adopted will deliver results consistent with the Smith Commission's recommendations, including the principles of no detriment, taxpayer fairness and economic responsibility. The Joint Exchequer Committee will jointly agree conclusions, recommendations and revisions of the review.

113. In line with the Smith Commission recommendations, the fiscal framework as a whole will be reviewed periodically.

Completion

114. An annex to this agreement covering the operational and governance aspects of the fiscal framework will be published as soon as possible. This annex will set out the detailed arrangements on the fiscal framework including the methodology and data sources for calculating the baseline adjustments and indexing the BGAs and arrangements for sharing information and data. The governance arrangements will cover bilateral engagement, official engagement, Memorandums of Understanding and audit. An updated Terms of Reference for the Joint Exchequer Committee will be set out along with updated terms of reference for Joint Exchequer Committee – Officials (JEC(O)).

ANNEX A: Smith Commission Principles for Scottish Government's Fiscal Framework

95 (1) Barnett Formula: the block grant from the UK government to Scotland will continue to be determined via the operation of the Barnett formula.

95 (2) Economic Responsibility: the revised funding framework should result in the devolved Scottish budget benefiting in full from policy decisions by the Scottish Government that increase revenues or reduce expenditure, and the devolved Scottish budget bearing the full costs of policy decisions that reduce revenues or increase expenditure.

95 (3) No detriment as a result of the decision to devolve further power: the Scottish and UK governments' budgets should be no larger or smaller simply as a result of the initial transfer of tax and/or spending powers, before considering how these are used.

(a) This means that the initial devolution and assignment of tax receipts should be accompanied by a reduction in the block grant equivalent to the revenue forgone by the UK government, and that future growth in the reduction to the block grant should be indexed appropriately.

(b) Likewise, the initial devolution of further spending powers should be accompanied by an increase in the block grant equivalent to the existing level of Scottish expenditure by the UK government, including any identified administrative savings arising to the UK government from no longer delivering the devolved activity, and a share of the associated implementation and running costs in the policy area being devolved, sufficient to support the functions being transferred, at the point of transfer.

95 (4) No detriment as a result of UK government or Scottish Government policy decisions post-devolution:

(a) Where either the UK or the Scottish Governments makes policy decisions that affect the tax receipts or expenditure of the other, the decision-making government will either reimburse the other if there is an additional cost, or receive a transfer from the other if there is a saving. There should be a shared understanding of the evidence to support any adjustments.

(b) Changes to taxes in the rest of the UK, for which responsibility in Scotland has been devolved, should only affect public spending in the rest of the UK. Changes to devolved taxes in Scotland should only affect public spending in Scotland.

95 (5) Borrowing powers: to reflect the additional economic risks, including volatility of tax revenues, that the Scottish Government will have to manage when further financial responsibilities are devolved, Scotland's fiscal framework should provide sufficient, additional borrowing powers to ensure budgetary stability and provide safeguards to smooth Scottish public spending in the event of economic shocks, consistent with a sustainable overall UK fiscal framework. The Scottish Government should also have sufficient borrowing powers to support capital investment, consistent with a sustainable overall UK fiscal framework. The Scottish and UK governments should consider the merits of undertaking such capital borrowing via a prudential borrowing regime consistent with a sustainable overall UK fiscal framework.

(a) The Scottish Government's borrowing powers should be agreed by the Scottish and UK governments, and their operation should be kept under review in conjunction with agreement on the mechanism to adjust the block grant to accommodate the transfer of taxation and spending powers.

(b) Borrowing powers should be set within an overall Scottish fiscal framework and subject to fiscal rules agreed by the Scottish and UK governments based on clear economic principles, supporting evidence and thorough assessment of the relevant economic situation.

95 (6) Implementable and Sustainable: once a revised funding framework has been agreed, its effective operation should not require frequent ongoing negotiation. However, the arrangements should be reviewed periodically to ensure that they continue to be seen as fair, transparent and effective.

95 (7) Independent Fiscal Scrutiny: the Scottish Parliament should seek to expand and strengthen the independent scrutiny of Scotland's public finances in recognition of the additional variability and uncertainty that further tax and spending devolution will introduce into the budgeting process.

95 (8) UK Economic Shocks: the UK government should continue to manage risks and economic shocks that affect the whole of the UK. The fiscal framework should therefore ensure that the UK government retains the levers to do that, and that the automatic stabilisers continue to work across the UK. The UK Parliament would continue to have reserved power to levy an additional UK-wide tax if it was in the UK national interest.

95 (9) Implementation: the Scottish and UK governments should jointly work via the Joint Exchequer Committee to agree a revised fiscal framework for Scotland based on the above principles. The two governments should provide updates to the Scottish and UK Parliaments, including through the laying of annual update reports, setting out the changes agreed to Scotland's fiscal framework.

ANNEX B: Revenue and Expenditure Covered by the Fiscal Framework

115. Following the recommendations of the Smith Commission a number of new tax and spending powers are being devolved to the Scottish Parliament in the current Scotland Bill.

Devolved and Assigned Tax Powers:

- The Scottish Parliament will be given the power to set rates and bands of non-saving non-dividend income tax.
- The first 10p in VAT receipts at the standard rate and the first 2.5p in VAT receipts at the reduced rate will be assigned to the Scottish Parliament.
- Air Passenger Duty and Aggregates Levy are to be fully devolved. Aggregates Levy will be devolved once the European Commission's State Aid investigation is complete.

116. Under the Smith Commission Agreement the Scottish Government will also retain fines, forfeitures and fixed penalties imposed by courts and tribunals in Scotland, as well as sums recovered under Proceeds of Crime.

117. This document also covers fiscal arrangements for the tax powers devolved under the Scotland Act 2012; this covers the Scottish Rate of Income Tax, Stamp Duty Land Tax (now Land and Buildings Transaction Tax) and Landfill Tax (now Scottish Landfill Tax).

Welfare Powers:

118. Powers relating to benefits for carers, disabled people, and those who are ill are being devolved through the Scotland Bill. The Smith Agreement recognises this as referring to the following benefits: Attendance Allowance, Carer's Allowance, Disability Living Allowance, Personal Independence Payment, Industrial Injuries Disablement Allowance, Severe Disablement Allowance, Cold Weather Payment, Funeral Payment, Sure Start Maternity Grant, Winter Fuel Payment and Discretionary Housing Payments. For the purposes of the fiscal framework these benefits are referred to as "devolved welfare".

119. In addition the following powers will be devolved to the Scottish Parliament:

- Powers to vary housing cost elements of Universal Credit.

- Administrative powers to change payment arrangements for Universal Credit.
- Power to top-up reserved benefits.
- Power to create new benefits in areas other than pensions.

Spending Powers:

The fiscal framework also covers the arrangements for “devolved public services” under the Scotland Act 2016.[5]

120. In addition two key areas being devolved are the Crown Estate and the contracted employment programmes on expiry of the current commercial arrangements. These two areas have more complex funding arrangements and are, therefore, covered separately in the fiscal framework.

Administration and Implementation Cost

121. The fiscal framework also sets out the arrangements for administration and implementation costs.

[5] This covers the following spending powers: Equal opportunities, Tribunals, Roads, Policing of railways and railway property, British Transport Police, Onshore petroleum, Consumer advocacy and advice, Betting, gaming and lotteries, Broadcasting, Regulation of telecommunications and postal services, Commissioners of Northern Lighthouses, Maritime and Coastguard Agency, Rail, Fuel poverty, Energy market regulation and renewables, Competition policy, Election and franchise, EU, and Health and social affairs.

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