FINANCIAL SECRETARY TO THE TREASURY
HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Kenneth Gibson
Convener, Scottish Parliament Finance Committee
Room T3.60
The Scottish Parliament
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Dear Mr Gibson

Block grant adjustment for SDLT and landfill tax

Following my appearance at your Committee in June, I committed to write in August to provide you with an update on progress in relation to the stamp duty land tax (SDLT) and landfill tax (LT) block grant adjustment.

As I explained in June, the aim of the block grant adjustment is to reflect not only the tax revenues that are being forfeited by the UK Government in year 1, but also the tax revenues that are being forfeited in subsequent years.

The UK Government has therefore been consistently clear (starting in the Scotland Bill Command Paper in Nov-10) that the block grant adjustment should be equitable to both governments and parliaments. I.e. there should be no systematic gain or loss to either government simply as a result of the block grant adjustment mechanism.

Such an approach is consistent with the UK Government's aim of increasing the accountability of the Scottish Government. The Scotland Act 2012 provides the Scottish Government with new tax and borrowing powers, but it also transfers the responsibility for managing these powers. In particular, the Scottish Government will need to manage the risks and rewards associated with tax devolution.

For example, consider the scenario where the Scottish Government decides to retain exactly the same taxes following devolution. In this case, as people in Scotland would be paying the same taxes as now, it is surely right that the Scottish Government's budget should be broadly unchanged. This is what an equitable adjustment would deliver - the Scottish Government would then need to increase tax rates in order to increase its spending, or decrease its spending if it wanted to set lower rates of tax. This is fair and increases the accountability of the Scottish Government.

As you are aware, in December 2013 the UK Government proposed a one-off adjustment based on the approach that was taken when business rates were devolved to the Scottish Government (and which is also consistent with the approach taken when areas of spending are devolved). This proposal would comprise two elements:

- reduce the Scottish Government's baseline block grant (to reflect the taxes currently[1] generated by the taxes); and
- implement a Barnett abatement to make future Barnett consequentials slightly smaller (to reflect the future prospects of the taxes).

As this mechanism can reflect the current and future prospects of the taxes being devolved, it is a relatively flexible solution that could be sustainably applied if further taxes are devolved to Scotland (and/or to other parts of the UK).

As I explained in June, this is not a change to the Barnett formula – similar to the devolution of business rates (and the devolution of spending areas, such as railways) this simply aims to maintain comparability between the size of the block grant and what it is funding. The only difference on this occasion (compared with the approach to business rates devolution) is that there aren't specific comparability factors for SDLT and LT that can be updated to make future Barnett consequentials smaller – hence the proposal for all

[1] This doesn't necessarily mean the taxes that would have been generated in 2015-16, given the volatility of tax revenues and the significance of where we are in the economic cycle. Instead, the baseline deduction should work alongside the Barnett abatement to deliver an equitable outcome in the longer-term.

consequentials to be abated. There is already a Barnett abatement in operation to determine the Northern Ireland Executive's budget, so this is an existing feature of devolved funding arrangements that we know can work efficiently and effectively.

The Scottish Government has proposed an adjustment that would be fixed in real terms. While this is a less flexible mechanism, the UK Government has been clear throughout this process that we are willing to consider options. The annex to this letter therefore sets out a summary of our work to date with the Scottish Government to consider both proposals (and we remain willing to consider further options).

A meeting of the Intergovernmental Assurance Board enabled senior officials to discuss progress on 31st July. The Chief Secretary to the Treasury has since discussed this analysis with the Cabinet Secretary for Finance, Employment and Sustainable Growth.

Further Ministerial discussions will take place as this analysis develops, but it has already provided us with a far greater understanding of the likely impact of each proposal, and we remain confident that we will be able to reach agreement shortly.

Finally, as I said in my evidence in June, the UK Government has no plans to impose an adjustment. Both sides remain committed to agreeing a timely and equitable solution. Further, to manage the small risk of not reaching agreement on a permanent mechanism in

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advance of the Scottish Government's draft budget for 2015-16, officials have started to discuss what an interim adjustment could look like. While we don't expect such an eventuality given the progress we have made, such an interim solution could use the OBR's forecasts for 2015-16, for example, but would be revisited once a permanent arrangement has been agreed.

Yours sincerely

David Gauke MP

Annex: Summary of analysis

UK and Scottish Government officials have produced initial assessments of the mechanisms proposed by both governments. These assessments consider how each proposal could perform against forecasts for SDLT/LT up to 2029-30 and beyond.

While officials have worked closely on this analysis, some elements have developed separately. In particular, the UK Government has identified the size of the adjustments that would be expected to deliver an equitable solution, whereas the Scottish Government calculated adjustments based on historic tax revenues and then determined what impact these would have. Officials are now working to refine this analysis (particularly in relation to the longer-term prospects for the two taxes) and ensure that we have a shared view of the potential outcomes.

Given the uncertainty of forecasting over such a long period, we have considered a range of forecasts. The top of the range is based on the OBR's forecasts up to 2018-19, which the UK Government accepts as a central forecast for Scottish taxes. The bottom of the range reflects Scottish Government concerns that the OBR overestimates Scotland's future share of UK revenues. While the UK Government does not agree with this view, we have agreed to consider a range of forecasts in an attempt to make progress. Significantly, both forecasts conclude that combined SDLT/LT revenues would grow in real terms (if they weren't devolved).

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The table below shows the adjustments that are forecast to be equitable during the period 2015-16 to 2029-30. I.e. these are the adjustments that would be expected to produce no gain or loss to either the UK or Scottish Governments over this period. Results are shown for both the Barnett Abatement (BA) and Fixed Real (FR) proposals, and for both the upper and lower forecasts. As the upper forecast is more closely based on the OBR's Scottish forecasts, the UK Government believes that this is a more reliable central forecast. For context, the OBR forecasts that (if the taxes were not devolved) SDLT/LT would together provide the UK Government with £610m in 2015-16, increasing to £720m by 2018-19.

	Lower SDLT/LT forecast		**Upper SDLT/LT forecast**	
	Baseline deduction	Abatement or Growth	Baseline deduction	Abatement or Growth
BA	£580m	1.9% abatement	£660m	2.2% abatement
FR	£630m	Fixed in real terms	£710m	Fixed in real terms

The Government's ongoing concerns with a Fixed Real adjustment are twofold:

- while equitable over the period between 15-16 and 29-30 as a whole, the larger baseline deduction required by this mechanism would adversely affect the Scottish Government's budget in the early years; and

- it would have a built-in long-term bias towards the Scottish Government as combined SDLT/LT revenues are expected to grow in real terms. I.e. however large you make the initial deduction, it will eventually be overtaken by expected real terms growth in SDLT/LT. So while a Fixed Real adjustment could be equitable from 15-16 to 29-30, beyond this point the Scottish Government would be expected to make substantial gains while the UK Government would make corresponding losses. Not only would this not be fair to taxpayers in the rest of the UK, but it wouldn't be consistent with the UK Government's aim of increasing the Scottish Government's accountability.

The Barnett Abatement mechanism, on the other hand, could be broadly equitable beyond 2029-30 (as well as being equitable during the period from 2015-16 to 2029-30). For example, while an abatement of 1.9% or 2.2% (for the lower and upper forecast respectively) produces a small UK Government gain over the 20 years beyond 2029-30, an abatement of 1.8% or 2.1% produces a small Scottish Government gain over the same period.

Finally, in addition to trying to identify equitable solutions under both proposals, it is also worth noting that officials have considered the impact of using a baseline deduction based only on actuals. This produces a real terms average of £470m (over the last 5 years) or £455m (since devolution). Scottish Government officials estimate that this approach would see an expected Scottish Government gain of at least £1.8bn over the period to 29-30, with further gains expected thereafter (and corresponding losses for the UK Government). This acts as a useful reminder that the block grant adjustment is trying to deal with future tax revenues, which aren't always reliably predicted by looking at the past.