Office for
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Economic and fiscal outlook
Scottish tax forecasts

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Introduction

The Office for Budget Responsibility (OBR) was created in 2010 to provide independent and authoritative analysis of the UK's public finances. Twice a year, at the Budget and in the autumn, we produce forecasts for the UK economy and the public finances, which we publish in our *Economic and fiscal outlook* (EFO) publication. In addition, the Government has now asked us to forecast Scottish receipts from a number of taxes, which the Government intends to devolve to the Scottish Parliament from April 2015 onwards. This request arises from the Scotland Bill, which was introduced in Parliament in November 2010 and is expected to receive Royal Assent in Spring 2012.

The Command Paper 'Strengthening Scotland's Future'[1], published alongside the Bill, included proposals to fully devolve stamp duty land tax and landfill tax to Scotland and devolve 10p from each band of income tax in order to increase the financial accountability of the Scottish Parliament. The Command Paper also committed to devolve aggregates levy following the resolution of an ongoing court case.

In agreement with the OBR, the Command Paper set out our role in providing forecasts of Scottish income tax, landfill tax, stamp duty land tax and aggregates levy receipts from April 2012. The Chancellor will also send these forecasts to the First Minister in an open letter. At this stage, HM Treasury will notionally assign these forecast receipts to the Scottish Budget to show how much of what is currently grant funding would be replaced by tax, although the Scottish Budget would not vary until the devolution of these taxes takes place.

This is our first publication of Scottish tax forecasts. In future we will publish our forecasts for these taxes alongside each *Economic and fiscal outlook* (EFO), consistent with the main UK forecast it contains. As with our main UK forecasts these are five-year forecasts to 2016-17. They are based on current Government policy including the policies announced in this Budget.

We published a methodology note[2] on 13 March this year which described how we plan to forecast these Scottish tax receipts. It explained that it is not possible to

[1] http://www.scotlandoffice.gov.uk/scotlandoffice/files/Scotland_Bill_Command_Paper.pdf

[2] http://budgetresponsibility.independent.gov.uk/wordpress/docs/Forecasting-Scottish-taxes.pdf

replicate the methodology we use to produce the UK forecasts. In particular the macroeconomic data that we would need to produce a Scottish macroeconomic forecast and economic determinants is generally not available at a Scottish level or is only available with a long lag. We are therefore not able to produce a Scottish macroeconomic forecast to drive the Scottish tax forecast. Instead the methodologies we intend to use, described in more detail in the methodology document, are generally based on Scotland's historic share of the relevant UK tax stream. We then generally assume that this share will be maintained at the recent average level in the future.

We will consider the case for making ad-hoc adjustments if there is robust evidence of specific factors which may affect the Scottish share of the tax in the future, for example if a newly announced policy can be expected to have a disproportionate impact on the Scottish share.

We have worked closely with analysts at HM Revenue and Customs (HMRC) in developing these methodologies and these first forecasts. We have also discussed the approach and the preliminary forecasts with officials from HM Treasury and the Scottish Government. The methodology and the forecasts represent the collective view of the three independent members of the OBR's Budget Responsibility Committee (BRC). The Committee takes full responsibility for the judgments that underpin them.

We consider these methodologies work-in-progress. The OBR's role in forecasting is starting three years ahead of the initial devolution of the taxes, which will allow us to develop and improve forecasts in the light of experience and the availability of new information sources. The methodologies implicitly assume unchanged policy in both the UK and Scotland. We will work with the Scottish Government to develop forecasting methodologies in light of changes that Scotland may make in the tax regime following the devolution of these taxes.

Producing the forecasts

The process for producing the first Scottish tax forecasts has been as follows:

- In the second half of last year OBR staff had initial discussions with HMRC officials and we formally commissioned HMRC to consider methodological approaches to producing Scottish taxes. In January this year the BRC and OBR staff met with officials from HMRC and the Scottish Government to discuss the methodologies that we would use for these first forecasts;

- OBR staff then worked with HMRC officials to draft the methodological note which we published on March 13, after sharing drafts with officials from the Scottish Government;

- We asked HMRC officials to produce draft Scottish tax forecasts using a near-final pre-measures UK economic forecast. The BRC and OBR staff discussed these forecasts with HMRC and Scottish Government officials on March 9; and

- In the final week before the Budget, HMRC officials provided us with a final set of Scottish forecasts using our final post-measures UK economic forecast and taking into account the effect of Budget policy measures. Due to the confidentiality of Budget measures we were unable to involve the Scottish Government in this stage of the process.

1 Scottish tax forecasts

1.1 In this section we set out forecasts for the following Scottish taxes:

- Income tax
- Stamp duty land tax
- Landfill tax
- Aggregates levy

1.2 The Scottish forecasts for each of these taxes is set out in Table 1.1. These are explained in more detail in the rest of this chapter.

Table 1.1: Summary of Budget 2012 Scottish Forecasts

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Income Tax[1]	4397	4375	4417	4542	4874	5265	5633
Stamp Duty Land Tax	330	319	328	369	426	480	536
Landfill Tax	99	115	123	132	145	151	157
Aggregates Levy	46	43	43	45	47	49	51

[1] Scottish income tax liabilities from Scottish rate

Income tax

1.3 Under the Scotland Bill, the existing basic, higher and additional rates of income taxes levied by the UK government would be reduced by 10 pence in the pound for those individuals defined as Scottish taxpayers from April 2016. The Scottish Parliament will then levy a new Scottish rate of income tax, which will apply equally to all of the main UK rates. The new Scottish income tax rate will need to be set every year by the Scottish Parliament. The block grant from the UK government to Scotland will then be reduced to reflect the fiscal impact of the devolution of these tax-raising powers.

1.4 The Scottish rate of income tax will be paid by Scottish taxpayers, where a Scottish taxpayer is defined as a UK taxpayer either resident in Scotland or whose closest connection is with Scotland. It will be levied on non-savings, non-dividend income (i.e. earnings from employment, self-employment, pension income, taxable benefits and income from property). Tax liabilities for a particular year would include both PAYE (largely paid in the same year as the activity which created the tax liability) and self assessment (which is usually paid in the year after the activity that took place to create the tax liability).

1.5 To produce our Scottish income tax forecast we apply a Scottish share to our forecast of UK tax liabilities on non-savings, non-dividend income. There are four steps in producing this forecast:

- first we produce a UK forecast for tax liabilities on non-savings, non-dividend income;
- we then calculate the 'Scottish share' of this forecast, based on the most recent Scottish taxpayers' share of total UK liabilities which is currently for 2009-10. The Scottish share is for liabilities specifically for the Scottish rate and we have assumed a 10p rate is levied for the basic, higher and additional rates in each year;
- we then adjust this for policies introduced since 2009-10 which may have had an effect on the Scottish share, to produce a pre-Budget measures forecast; and
- finally we adjust for any new Budget measures to produce a post-measures forecast.

1.6 We first build a UK forecast for non-savings, non-dividend income from the projections that are included in our receipts forecasts published in our *EFO*. The key steps in calculating the UK forecast are:

- include all PAYE liabilities – this is the PAYE forecast included in the current receipts table in Chapter 4 of the EFO;
- include self assessment (SA) liabilities on non-savings, non-dividend income. The forecast for SA in the EFO is on a receipts basis (i.e. when the cash is received). This is adjusted to be on a liabilities basis and further adapted to exclude the savings and dividend elements of SA; and
- PAYE, the SA liabilities on non-savings, non-dividend income and a forecast of relevant non-SA repayments are then added together to get a UK forecast for this definition. Table 1.2 shows the UK forecast on this definition.

Table 1.2: UK forecast of tax liabilities on non-savings, non-dividend income (prior to Budget 2012 measures)

£ billion	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
UK forecast	137.9	140.8	144.1	148.2	157.2	168.7	181.6	194.1

1.7 We then apply the Scottish share to this forecast. The methodology note showed that the Scottish share of total UK liabilities was very stable between 2000-01 and 2009-10. On this basis we simply project forward the latest outturn share (2009-10) as our baseline Scottish share.

1.8 With the outturn, currently based on the Survey of Personal Incomes, only available with a long lag, we then allow for income tax measures coming into effect after this outturn to affect the share. For this forecast we assess whether policies introduced in 2010-11 and 2011-12 and already announced policies coming into effect in 2012-13 and 2013-14 affected the Scottish share in those and future years. We then use this adjusted share. We have not adjusted the Scottish share for any Scottish-specific trends in the labour market.

1.9 Since 2009-10, there have been a number of policies such as the introduction of the 50 per cent additional rate of income tax for incomes over £150,000, the withdrawal of personal allowances above £100,000 and a number of reductions in the basic rate limit relative to normal indexation. These policies affect the top end of the income distribution and Scotland has a lower proportion of higher and additional rate taxpayers than the rest of the UK.

1.10 HMRC modelling indicates that these policies are expected to have reduced the Scottish share of income tax from 3.16 per cent in 2009-10 to 2.96 per cent by 2016-17. The contrast between this fall and the stability of the Scottish share between 2000-01 and 2009-10, when it only varied (apart from one year) within a narrow range of 3.13 per cent to 3.16 per cent, can be explained by the different nature of the policy measures. Those announced in Budgets and Pre-Budget Reports over the earlier period primarily affected basic rate taxpayers, and so did not disproportionally affect the Scottish share.

1.11 Table 1.3 provides the projections for the Scottish share and a forecast for Scottish income tax liabilities on non-savings, non-dividend income prior to including the effect of the Budget 2012 income tax measures. As noted earlier, these are income tax liabilities specifically for the Scottish rate. Prior to a decision in the Scottish Parliament on the new Scottish income tax rate for the 2016-17 tax year, the forecast assumes that a 10p Scottish rate would be levied.

Table 1.3: Scottish income tax forecast

£ million	09-10	10-11	11-12	12-13	13-14	14-15	15-16	16-17
Scottish Share (%)	3.16	3.12	3.04	2.99	2.97	2.97	2.97	2.96
Scottish income tax liabilities (pre-measures)	4352	4397	4375	4433	4674	5013	5391	5745
Budget 2012 measures	0	0	0	-16	-131	-139	-125	-112
Scottish income tax liabilities (post-measures)	4352	4397	4375	4417	4542	4874	5265	5633

1.12 We then adjust this forecast for Budget 2012 measures to produce a post-measures forecast. The main measures affecting income tax in Budget 2012 are:

- the £1100 increase in the personal allowance from 2013-14;
- the reduction in the additional rate from 50 per cent to 45 per cent;
- the cap on unlimited tax reliefs;
- the reforms to age-related allowances; and
- changes to company car tax.

1.13 We have not yet had time to repeat the modelling exercise needed to estimate the effect of these measures on the Scottish share and have instead relied on HMRC estimates of the direct effect of the measures on Scottish income tax liabilities. The increase in the personal allowance has the largest negative effect on receipts and more than offsets the tax-raising income tax measures such as those on age-related allowances and company car tax introduced in Budget 2012. The appropriate methodology for incorporating measures into the Scottish forecast is one of the issues that we will consider further for future forecasts.

1.14 Overall, the assumed fall in the Scottish share means that growth in income tax receipts in recent years has been slower in Scotland than for the UK as a whole. As in the rest of the UK, our forecast is that growth in Scottish income tax receipts will only pick up markedly from 2013-14 onwards. While the further increase in the personal allowance announced in this Budget will constrain receipts growth in 2013-14, we expect stronger growth in average earnings and rises in employment as the economy improves. In addition, after 2013-14, the forecast assumes that tax thresholds and allowances are uprated with inflation. With earnings starting to rise faster than inflation, there will be a positive effect on receipts from 'fiscal drag' as people find more of their income taxed at higher rates.

Stamp duty land tax

1.15 The Scotland Bill provides for stamp duty land tax to be entirely devolved to Scotland in 2015.

1.16 As set out in the methodology note we project Scottish stamp-duty land tax (SDLT) using a constant share of overall UK SDLT receipts. For residential SDLT, we use the latest outturn share and project this forwards. For non-residential SDLT (primarily commercial property), we use a three-year average of the Scottish share and project this forward. A three-year average share should lessen the risk of an error resulting from volatility due to changes in the mix of transactions between years. As with Scottish income tax, we use this to generate a pre-measures forecast. We then add on the Scottish element of policy measures.

1.17 Table 1.4 shows the UK forecasts for SDLT prior to including the effect from policy measures announced at Budget 2012. SDLT receipts are expected to grow only modestly in 2012-13. Thereafter, SDLT receipts are expected to grow strongly with receipts growth of over 10 per cent in each year from 2013-14. This mainly reflects the expected recovery in property markets as credit conditions begin to normalise and economic growth picks up. In particular, residential property transactions are expected to recover towards a level consistent with the average historical duration of home ownership. Box 3.4 in the March 2012 EFO notes that the current depressed level of transactions is consistent with owner-occupiers moving every 30 years compared with a long-term average of every 19 years. Forecasts for UK property markets are published in Table 4.3 of the March EFO.

1.18 The methodology note compared trends in Scottish house prices and property transactions in recent years. Given the similarities in credit conditions and the availability of mortgage finance, the trends between Scotland and the UK are highly correlated. We would thus expect the Scottish housing market to also show a similar recovery to that for the UK as a whole.

Table 1.4: UK forecasts of Stamp duty land tax (pre-measures)

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Residential SDLT	4040	4220	4370	5140	6190	7120	8060
Non-residential SDLT	1920	1900	1910	1990	2160	2370	2590
Total SDLT	5960	6120	6280	7130	8350	9490	10650

1.19 Table 1.5 provides forecasts for Scottish SDLT. There were three policy measures that affected SDLT receipts in Budget 2012. These were:

- avoidance on residential properties particularly through enveloping;
- a 7 per cent rate on residential properties over £2 million; and
- abolition of residential disadvantaged area relief

1.20 The effect of these measures on Scotland's overall SDLT yield is likely to be very modest. The enveloping measure and the new 7 per cent rate will only affect expensive properties which are concentrated in London and South-East England. HMRC have estimated that just over 1 per cent of properties over £2 million are in Scotland. On the basis that around 7.6 per cent of residential disadvantaged area relief claims in 2010-11 were from Scotland, we have taken this proportion of the yield for this measure.

1.21 The forecast for the final two years implicitly assumes that the current system of SDLT would remain after the tax is fully devolved in April 2015. We would need to look again at the forecast in the event that the Scottish Parliament changed the tax.

Table 1.5: Forecasts of Scottish Stamp duty land tax

£ million	Scottish Share	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Residential SDLT	4.1%	165	172	178	210	253	291	329
Non-residential SDLT	7.7%	165	146	147	153	167	183	200
Total SDLT (pre-measures)		330	319	326	363	419	474	529
Measures		0	0	2	5	7	7	7
Total SDLT (post-measures)		330	319	328	369	426	480	536

Landfill tax

1.22 The Scotland Bill provides for landfill tax to be entirely devolved to Scotland in 2015.

1.23 To forecast Scottish landfill tax we use an assumption of a constant Scottish share of UK landfill tax based on an average of the last three years, as explained in our methodology note. This gives a Scottish share of 9.2 per cent. We then add on the Scottish element of landfill tax policy measures.

1.24 Table 1.6 shows the UK forecast for landfill tax prior to incorporating the policy measure announced in Budget 2012. Landfill tax is expected to grow over time reflecting trends in the quantity of landfilled waste and higher tax rates. The tax rates are assumed to be uprated in line with inflation in the absence of announced policy.

Table 1.6: UK forecast of landfill tax (pre-measures)

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
UK Forecast	1094	1249	1333	1433	1576	1630	1691

1.25 Table 1.7 provides forecasts for Scottish landfill tax based on the 9.2 per cent share. Budget 2012 announced that the landfill communities fund would be frozen at its current level in 2012-13. This yields a maximum of £10 million for the UK as a whole by the end of the forecast period. Using the same Scottish share as in the pre-measures forecast adds just £1 million to Scottish landfill tax. As with SDLT, the forecast implicitly assumes a unchanged tax regime in the final two years after the tax is fully devolved in April 2015.

Table 1.7: Forecasts of Scottish landfill tax

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Pre-Measures	99	115	123	132	145	150	156
Measures	0	0	0	0	0	1	1
Post-Measures	99	115	123	132	145	151	157

Aggregates levy

1.26 The Command Paper commits to devolve aggregates levy to Scotland following the resolution of an ongoing court case. In the interim, the UK government will assign receipts from the aggregates levy as it relates to Scotland to the Scottish Government. The estimated revenue will be allocated to the Scottish Government, with the equivalent amount deducted from the Scottish Government's block grant each year.

1.27 To forecast Scottish aggregates levy we use a constant Scottish share of UK aggregates levy, based on an average of the last three years. With a sizeable lag in information on Scottish aggregates production, we project forward the share using the average from 2007 to 2009. This gives a Scottish share of 15.7 per cent. We then add on the Scottish element of policy measures.

1.28 Table 1.8 shows the UK aggregates levy forecast prior to Budget 2012 measures. This indicates that the aggregates levy is expected to grow over the forecast period reflecting growth in aggregates extraction as the construction industry benefits from the economic recovery. Tax rates are also assumed to be uprated with inflation in the absence of announced policy.

Table 1.8: UK forecast of aggregates levy (pre-measures)

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
UK forecast	292	276	289	298	307	321	337

1.29 Table 1.9 provides forecasts of the aggregates levy in Scotland. We have incorporated the Budget 2012 decision to freeze the aggregate levy rate in 2012-13. This reduces UK aggregates levy receipts by £15 million in 2012-13 and by £10 million in subsequent years. The Scottish share of this measure is around £2 million.

Table 1.9: Forecasts of Scottish aggregates levy

£ million	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Pre-Measures	46	43	45	47	48	50	53
Measures	0	0	-2	-2	-2	-2	-2
Post-Measures	46	43	43	45	46	48	51

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