Bruce Crawford
Convener
Finance and Constitution Committee
The Scottish Parliament
Edinburgh
EH99 1SP

11 April 2019

Dear Convener,

We are writing in response to the Committee's *Report on Scottish Government Budget 2019-20* of 25 January, which requested further information on our recent forecasts. As some of the questions were addressed to both the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR), we felt we could best help the Committee by providing a joint response.

As set out in our recently signed Memorandum of Understanding, the SFC and the OBR have a productive working relationship with regular co-operation and engagement that supports our respective functions. This includes regularly sharing information on forecast methodologies, data and models.

Detailed responses to the questions posed to us in your report are given below.

Sincerely,

Susan Rice

Dame Susan Rice, Chair of the Scottish Fiscal Commission

Robert Chote

Robert Chote, Chairman of the Office for Budget Responsibility

13. The Committee notes the SFC's view that it is not unreasonable to expect an average one-year ahead error in their tax forecasts of around £30 million (sic). While this may not be unreasonable in forecasting terms it presents a substantial risk to the Scottish Government's budget which may or may not be offset by similar forecast error by the OBR. These risks are discussed in more detail below. The Committee recognises that there is an increasing need for effective parliamentary scrutiny and wider understanding and awareness of these opportunities and risks. This report is intended to support that process.

The risks and uncertainties around revenue forecasts can be thought of in two parts – economy-related risks and revenue-specific risks. Economy related risks includes changes to levels of employment, average earnings or reflective of housing market fluctuations affecting the overall value of property transactions. Revenue-specific risks concern the amount of tax raised from a given tax base; even if we knew the size of the tax base with certainty the amount of tax raised from it could vary due to changes in its composition or in compliance rates.

The SFC have looked at typical UK revenue forecast errors over the past three decades. Across all one-year-ahead UK revenue forecasts, there has been an average absolute forecast error of 3.3 per cent. As a purely illustrative example, the SFC are forecasting revenue of £16 billion in 2019-20 from the fully and partially devolved taxes, suggesting that you would expect a forecast error of around £0.53 billion on average.

The one-year ahead forecast error for Scottish NSND income tax for 2016-17 was 5.1 per cent relative to the SFC's May 2018 forecast and 6.3 per cent relative to the OBR's March 2018 forecast. As this is the first year of Scottish outturn, there is no 'normal' level of forecast error to compare it to. The OBR has been monitoring forecast errors across UK income tax since 2010. It finds that the average absolute one-year ahead error has been 1.5 per cent for PAYE income tax and 9.8 per cent for self-assessment income tax. One reason for the higher average error on self-assessment income tax is the lack of any in-year data to inform forecasts (unlike the monthly information available for PAYE income tax). There is also a lack of published in-year data for Scottish income tax, which no doubt helps explain why the size of the forecast error was relatively large despite the fact that the Scottish outturn relates largely to tax collected through the PAYE system.

The OBR discusses the 2016-17 error in its March *Devolved tax and spending forecasts*, including a comparison of the outturn data with information from the equivalent year of HMRC's *Survey of Personal Incomes*. The SFC has also covered the source of the error in its September 2018 *Forecast Evaluation Report* and December 2018 *Scotland's Economic and Fiscal Forecasts.*

We will continue to monitor and report on the level of forecast errors and to explain their underlying causes. It should be said that when we refer to 'errors', this is simply shorthand for the difference between forecast and outturn – it does not necessarily mean that the difference was avoidable given the data available at the time of the forecast.

64. The Committee highlighted this issue in our report on Draft Budget 2018-19. The Committee recommended that the OBR should have responsibility for publishing an independent analysis of the year-on-year changes to the adjustments to the block grant as part of its devolved taxes forecast. The Committee will take this forward with HM Treasury with a view to improving the transparency of the annual adjustments to the block grant. This is vital in ensuring confidence in the operation of the Fiscal Framework.

HM Treasury sets out the changes in devolved administrations' block grant funding in its annual *Block grant transparency* publication. One route to improving transparency would be to enhance this publication.

The OBR is committed to maintaining the transparency of its publications and improving wider understanding of its forecasts. In response to the Committee's recommendation, Chapter 1 of March's *Devolved tax and spending forecasts* included a brief analysis of relative year-on-year growth rates across the tax jurisdictions of the UK (paragraphs 1.17 and 1.18). The OBR does not have a direct role in determining the 'correct' level of funding via the block grant, which is ultimately a policy choice that is determined by political negotiation between the Scottish and UK Governments.

115. The Committee also notes that despite slower earnings and employment rate growth in Scotland compared to the rest of the UK, Scottish income tax revenues are forecast to grow more than the adjustments to the block grant. The Committee invites the OBR and the SFC to provide their views on this seemingly contradictory position.

The forecast of Scottish income tax liabilities is greater than the block grant adjustments (BGAs) over the whole forecast period. These differences primarily reflect policy decisions by the Scottish and UK Governments as well as differences in the underlying growth of tax revenues. Policy differences between Scotland and the rest of the UK explain the apparent contradiction between the outlook for employment and earnings and the income tax forecasts.

The SFC estimates that Scottish Government policy announcements at the three Budgets since 2016-17 – the initial deduction year for the BGA – *raise* an additional £358 million of income tax in 2019-20. In contrast, UK Government policy changes to income tax thresholds are expected to *reduce* income tax liabilities in 2019-20. Most notably, Budget 2018 set the UK higher rate threshold at £50,000 for 2019-20. The Scottish Government has estimated that it would cost £500 million if it was to adopt the income tax rates and bands set by the UK Government.[1]

[1] Scottish Government – Scottish Budget 2019-2020 (link)

127. The Committee invites the SFC to provide a breakdown of the forecast increase in tax revenues from the increased number of additional and higher rate taxpayers over the forecast period.

We have attached a separate paper written by the SFC on how taxpayer numbers are expected to change over time. For ease of reference, the key conclusions from are summarised below.

As a result of increasing employment, the SFC estimates that the total number of taxpayers will increase from 2.52 million in 2016-17 to 2.68 million in 2023-24. In addition, the SFC expects an increase in the number of people who are classified as higher or top rate taxpayers. This arises due to an effect known as 'fiscal drag', which is when earnings rise faster than thresholds, dragging individuals who are currently sitting just below a tax threshold into a higher band.

In 2016-17 there were 13,300 top rate taxpayers (individuals earning over £150,000) and the SFC expect this to increase to 22,000 by 2023-24, primarily due to fiscal drag. Between 2016-17 and 2023-24 the SFC expect nominal average earnings to grow by around 2.5 per cent a year, a cumulative increase of around 18.5 per cent. This cumulative growth in earnings needs to be compared to the £150,000 top rate threshold which remains fixed in cash terms. Someone earning around £127,000 in 2016-17 whose earnings grew in line with the average projected across all employees would see their income grow to £150,000 by 2023-24.

The SFC's analysis estimates that the vast majority of 'new' top rate taxpayers are also due to fiscal drag (around 7,100 taxpayers out of a total of 8,700). Although the number of top rate taxpayers increases by 65 per cent, total tax revenue from those taxpayers is only estimated to grow by 25 per cent. While these taxpayers are now classified as top rate, they will only experience a modest increase in their total tax liability, as the 46 per cent rate is only paid on the portion of their income that is above £150,000.

146. The Committee notes that the SFC has substantially revised down its forecast for tax-motivated incorporations which increases its total income tax forecast. This raises the question of whether the OBR has also revised down its forecast for tax-motivated incorporations to the same extent which would result in zero impact on the net income tax position in the Budget. The Committee will invite the OBR to provide this information.

The adjustment for incorporations in the SFC's forecast is sourced from HMRC's Scottish-specific incorporations model, and has not been substantially revised from the December 2017 forecast when compared on a like-for-like basis.

Differences in the data used in the SFC's December 2017 and December 2018 forecasts mean that adjustments for incorporations in each forecast cannot be directly compared. The forecasts are based on different data starting points. The SFC's December 2017 forecast is based on *Survey of Personal Incomes* data covering 2014-15, while the December 2018 forecast uses 2016-17 income tax outturn data.

For example, when evaluating the incorporations adjustment for 2021-22, the calculation differs depending on the forecast starting point. The December 2017 forecast had to include seven years of incorporations effects (2014-15 to 2021-22), but the December 2018 forecast only required five years of incorporations effects (2016-17 to 2021-22).

Table 1 provides information on the incorporations adjustment from the SFC's December 2017 and December 2018 forecasts and the December 2017 forecast adjustment on a comparable basis to December 2018. For the latter, it is assumed that the December 2017 forecast adjustment has a data start point of 2016-17 rather than 2014-15.

Table 1: Comparison of incorporations adjustment from previous forecasts

£ million	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
1. December 2017 (2014-15 start)	-77	-136	-178	-239	-297	-354	-440	-525	
2. December 2017 (assuming 2016-17 start)		0	-42	-103	-161	-218	-304	-389	
3. December 2018 (2016-17 start)		0	-39	-100	-157	-221	-315	-406	-494
4. Difference between 2 and 3			3	3	4	-3	-11	-17	

Source: Scottish Fiscal Commission

As Table 1 shows, there is a relatively small difference when comparing the incorporations adjustment on a like-for-like basis. The SFC will make this clearer in future reports.

The OBR assumes that the share of tax lost due to incorporations in Scotland is proportional to total NSND income tax revenue. The difference between the two methods is relatively modest and is kept under review.

The base data do not capture the effect on incorporations of recently announced policy changes such as the UK Government's '*Off-payroll working: extend reforms to private sector in 2020-21, excluding small businesses'* from Budget 2018. The effect of such measures is captured at a later stage in the forecast process.

173. The Committee asks the OBR and the SFC to clarify why there is a forecast net benefit of £76m to Budget 2019-20 from LBTT when the underlying drivers of LBTT revenues (prices and transactions) do not appear to be forecast to grow more quickly in Scotland than in rUK. The Committee also asks the SFC to publish its assumptions for non-residential transactions and price growth.

There are many factors to consider when comparing the BGA forecast and the SFC's LBTT forecast (which includes the residential, additional dwellings supplement and non-residential forecasts), including the underlying growth rates of property prices and transactions.

The BGA is estimated by taking the stamp duty land tax (SDLT) revenue generated in Scotland in the year immediately prior to devolution and growing it at the same rate as growth in UK Government SDLT receipts per head and Scottish population growth. Any change in the Scottish and UK tax systems or differences in per capita tax growth since 2014-15 will result in differences between the BGA and the SFC forecast.

Since April 2015, the Scottish residential LBTT system has moved away from the SDLT system that applies in England and Northern Ireland. LBTT is more progressive than SDLT, with higher tax rates on higher value transactions, lower rates on lower value transactions and a higher zero-rate threshold. In 2016-17 around half of Scottish residential transactions were below the lower LBTT threshold of £145,000 and did not pay any tax. This compares to around a quarter of transactions in the rest of the UK being below the £125,000 SDLT tax-free threshold. This means that there is a larger pool of Scottish properties that could start paying LBTT with sufficient price inflation. It also means that for similar growth in house prices and transactions we would expect larger revenue growth in LBTT than SDLT.

Fiscal drag also applies to LBTT and SDLT. As thresholds are frozen in cash terms, rises in property prices drag more transactions into higher bands. The design of the LBTT tax schedule and the relative distribution of property values in Scotland are expected to lead more fiscal drag than in the rest of the UK.

Policy changes have also led to different revenue growth trajectories. At Autumn Budget 2017 the UK Government announced a first-time buyers' tax relief up to £500,000. This reduced SDLT tax receipts per capita, and therefore reduced the BGA. The Scottish Government announced two policy changes in Budget 2019-20 that increased the SFC's LBTT forecasts.

The OBR discussed the relative growth rates of its LBTT and SDLT forecasts in its March *Devolved taxes and spending forecasts*.

The Committee also asks the SFC to publish its assumptions for non-residential transactions and price growth.

The SFC's assumptions for the non-residential property market are published on its website, as part as the *Scotland's Economic and Fiscal Forecasts* (December 2018 – Chapter 3 –Tax – Supplementary Charts and Tables).

Table 2: SFC assumptions for the non-residential property market

(%)	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Transactions Growth	-1.0	-2.4	1.3	1.0	1.1	1.1	1.2
Price Growth	3.6	2.8	1.4	1.9	1.9	1.9	1.9

Source: Scottish Fiscal Commission (link)

190. The Committee is unclear to what extent the SFC can make an assessment of the reasonableness of the Government's borrowing projections without some indication of the level of provisional underspends for 2018-19. The Committee asks the SFC whether it has requested that information from the Scottish Government and if not to explain how it has assessed the reasonableness of Ministers' borrowing projections without it.

The Scottish Government provided the Commission with outturn figures for borrowing and use of the Scotland Reserve in 2017-18, in addition to the planned drawdowns in 2018-19 and 2019-20. These figures were provided by the Scottish Government in advance of the Budget and were reported in our publication.

The Commission also requested information on the level of estimated underspends in 2018-19. The Scottish Government informed us that underspend information for 2018-19 was not available part way through the financial year due to estimates from individual areas still being determined. This meant it was not possible for the Scottish Government to provide an informative estimate of payments into the reserve or of the closing balance for 2018-19.

The Commission expects the Scottish Government to provide an early estimate of underspends for 2018-19 in advance of our May publication, which will allow the SFC to present a more complete picture of the use of the Reserve during 2018-19. The provisional outturn data is then expected to be available in June.

The SFC's assessment of reasonableness considers the level of borrowing and the use of the Scotland Reserve relative to the statutory caps set out in the Scotland Act 2016 and the associated fiscal framework. The projections the Government provided for borrowing and use of the reserve comply with the terms set out in the fiscal framework. The Commission will continue to monitor how these projections compare to outturn use and will comment in future publications as more data becomes available.