Office for
**Budget
Responsibility**

Welsh taxes outlook

March 2022 update

1 Updated tax forecasts

Introduction

1.1 In our December 2021 *Welsh taxes outlook* (*WTO*) we presented five-year tax forecasts alongside the Welsh Government's draft Budget. It covered the Welsh rates of income tax, land transaction tax (LTT) and landfill disposals tax (LDT), as well as the equivalent UK Government taxes that are required to calculate block grant adjustments.[1]

1.2 Those forecasts were based on our October 2021 UK-wide economy and fiscal forecasts, plus new receipts data published since then.[2] The Welsh Government has asked us to publish updated forecasts for LTT and LDT – reflecting the outturn data published since December – alongside its final Budget for 2022-23. They are still underpinned by determinants from our October 2021 economy and fiscal forecasts for the UK as a whole.[3]

1.3 The ONS's *Public sector finances* bulletin published on 22 February identified a £7.7 billion upside surprise in UK-wide self-assessment (SA) receipts relative to the monthly profiles consistent with our October forecast. These payments will largely relate to tax liabilities that accrued in the 2020-21 fiscal year. A detailed split between SA income tax and capital gains tax (which is also paid via SA) from administrative tax data was not available for the ONS's February bulletin. Based on the relative sizes of the two tax streams, roughly two-thirds has been assumed to relate to UK-wide SA income tax, but this could be subject to significant revisions in coming months when it can be replaced with data informed by tax returns. It is also not known at this stage how much of the SA income tax surplus relates to non-savings, non-dividend income tax – the element subject to the Welsh rates. But it is clear that this upside surprise will have implications for the Welsh rates of income tax for 2020-21 once final outturn liabilities have been calculated and published by HMRC later this year.

1.4 We have not updated our forecast for the Welsh rates of income tax in light of this surprise in this *WTO* update pending further information on the composition and future implications of the surplus. To the extent that higher than expected receipts generate an upward revision to 2020-21 liabilities, they may affect the outturn reconciliation adjustment for 2023-24, in line with the fiscal framework. The impact on the reconciliation adjustment will depend on how the revision affects Welsh revenues relative to those in England and Northern Ireland. It is also possible that higher liabilities in 2020-21 would indicate the need for upward revisions to liabilities in future years too. But given the pandemic-affected nature of the

[1] The methodology for the block grant adjustment is set out in *The agreement between the Welsh Government and the United Kingdom Government on the Welsh Government's fiscal framework*, December 2016. The OBR has no direct involvement in these spending decisions or block grant negotiations, but the spending settlements do draw on our tax forecasts.
[2] See our October 2021 *Economic and fiscal outlook*.
[3] Analysts in the Welsh Government produced updated forecasts for LTT and LDT on 21 February 2022. The Budget Responsibility Committee scrutinised and finalised these forecasts on 22 February.

2020-21 tax year, the magnitude of such revisions will not be straightforward to judge. There are several reasons why the strength could reflect an overestimate of how far SA-relevant incomes fell in 2020-21, which would be considered one-off effects with no implications for future tax liabilities.

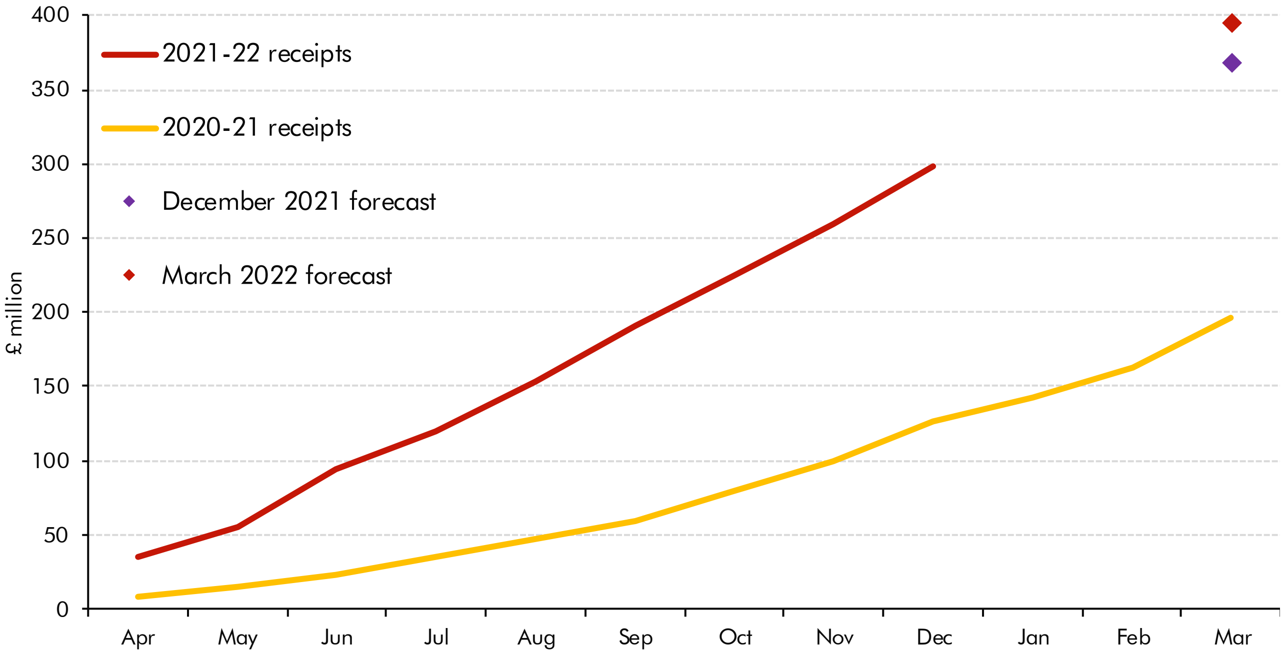
1.5 We will provide an initial view on future UK-wide and Welsh income tax in our next UK-wide *Economic and fiscal outlook* and *Devolved tax and spending forecasts* publications on 23 March. These will also reflect our updated UK-wide economy and fiscal forecasts.

Land transaction tax

Recent developments

1.6 Chart 1.1 shows recent developments in monthly LTT receipts and compares them to our latest forecast for receipts in 2021-22. The coronavirus pandemic supressed receipts in the early part of 2020-21 but they recovered strongly in the latter part of the year. In the ten months of outturn data published for 2021-22 receipts have remained strong, leading us to revise up our forecast for 2021-22 by £28 million since December (see Table 1.1).

Chart 1.1: Recent land transaction tax outturns



Source: WRA, OBR

1.7 Our LTT forecast starts from our UK-wide property market forecasts and an assessment of whether and how far the Welsh property market is deviating from that outlook in the short term. (In the absence of evidence to the contrary, we assume that Welsh property prices and transactions move in line with those across the UK as a whole.) We have revised up the uplift to the forecast for house price inflation underpinning our residential LTT forecasts in 2021-22 from 3.2 to 3.4 percentage points, to reflect the somewhat greater momentum in Welsh house price inflation that is evident in the latest data.

Latest forecasts

1.8 Table 1.1 shows our updated forecasts for LTT and changes since December. Total receipts have been revised up by £18 million (5 per cent) a year on average, reflecting stronger than expected outturn for each component of LTT. Half of this additional strength in receipts is carried forward to future years of the forecast, as we assume that it stems from a combination of pandemic-related changes (such as forced savings flowing into property purchases) that will diminish over time, and more persistent structural changes resulting in a more tax-rich distribution of transactions. Since it is not possible to discern the precise weights to place on these factors, they are given equal weight in the forecast judgement.

1.9 Breaking the overall difference down by component, Table 1.1 shows that:

- **Residential main rates** receipts have been revised up by an average of £3 million a year;
- Receipts from **higher rates on additional residential properties** have been revised up by an average of £2 million a year; and
- **Commercial property** receipts have been revised up by a more material £13 million (13 per cent) a year on average. This reflects continued strength in outturn, with November and December recording the sixth and second highest totals for monthly receipts since the devolution of LTT (with April having recorded the highest total).

Table 1.1: Land transaction tax forecast – March 2022 update

	£ million						
	Outturn	Forecast					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
Total LTT							
December forecast	212	367	366	383	404	432	465
March update	212	395	381	398	420	449	482
Change	**0**	**28**	**15**	**16**	**16**	**17**	**18**
Residential main rates							
December forecast	89	176	185	196	209	229	252
March update	89	180	187	198	212	233	255
Change	**0**	**4**	**3**	**3**	**3**	**3**	**4**
Higher rates on additional properties							
December forecast	66	87	86	87	91	95	100
March update	66	90	87	89	92	97	101
Change	**0**	**3**	**1**	**2**	**2**	**2**	**2**
Commercial							
December forecast	58	104	95	100	104	108	113
March update	58	125	106	111	115	120	126
Change	**0**	**21**	**11**	**11**	**12**	**12**	**13**

Landfill disposals tax

1.10 Table 1.2 shows our updated LDT forecast. The small downward revision reflects the inclusion of outturn data for the third quarter of 2021-22, an effect that we have assumed endures in future years of the forecast. The latest data appear to confirm that the strength recorded in the first half of 2021-22 was largely due to pandemic-related catch-up activity, with receipts falling from an average of £13.1 million a quarter in the first half to £9.6 million in the third quarter. This is still somewhat higher than our LDT forecast model would predict, with indications that the excess could relate to greater volumes of waste being sent to landfill after being rejected from recycling plants.

Table 1.2: Landfill disposals tax forecast – March 2022 update

	£ million						
	Outturn	Forecast					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
December forecast	32	45	36	36	36	35	35
March update	32	44	35	35	35	35	35
Change	**0**	**-1**	**-1**	**-1**	**-1**	**-1**	**-1**
of which:							
Data		-1	-1	-1	-1	-1	-1

2 Evaluating previous forecasts

2.1 As the Welsh Government's official forecaster, we believe it is important to describe our forecasts in detail. We did that for our forecast methodologies too in our first *Welsh taxes outlook* (*WTO*) – which are now available on our website – and in each *WTO* we highlight the areas of uncertainty around our central forecasts. We also believe it is important to examine regularly how these forecasts compare to outturn data once it is available. With the publication of outturn data for Welsh rates of income tax in July 2021, we can now evaluate selected forecasts across all the Welsh taxes that we forecast for the Welsh Government.

2.2 Assessing the performance of our forecasts after the event is important for transparency and accountability, but also helps us identify ways to improve them. We carry out similar assessments of our UK-wide forecasts in a *Forecast evaluation report* each year. In our 2021 *WTO* we presented a high-level analysis of the performance of previous forecasts for the Welsh rates of income tax. In this chapter we deepen that analysis and extend it to land transaction tax (LTT) and landfill disposals tax (LDT) receipts. We have selected forecasts that were used to set the Welsh Government's budget for the most recent years of outturn. This means that we analyse 2019-20 outturn for income tax liabilities (which is published with a long lag) and 2020-21 for LTT and LDT receipts outturns (which are much more timely).

2.3 In this chapter we therefore assess the performance of our:

- November 2018 forecast for 2019-20 Welsh rates of income tax; and
- February 2020 forecasts for 2020-21 land transaction tax and landfill disposals tax.

Welsh rates of income tax

2.4 In our December 2021 *WTO* we showed how our five most recent forecasts for the Welsh rates in 2019-20 compared with the first year of outturn since they were devolved. We concluded that, as one would expect, more recent forecasts were more accurate, in part because they can draw on timely information about PAYE income tax receipts from HMRC's real-time information (RTI) system. It also showed that modelling of the Welsh share of total UK income tax receipts had consistently overestimated outturn, while errors related to forecasting UK-wide income tax liabilities had been both positive and negative over time.

2.5 Building on that high-level analysis, Table 2.1 looks back further at how our November 2018 forecast for the Welsh rates in 2019-20 compared to outturn. This forecast was the basis of the Welsh Government's draft Budget for 2019-20, which was prepared before we took on the formal role as the Welsh Government's independent forecaster. It was based on the Survey of Personal Incomes (SPI) for 2015-16, plus UK-wide tax receipts data up to mid-

2018, which covered PAYE liabilities for all of 2017-18 and some of 2018-19, but provided no information about self-assessment liabilities in 2017-18. At the time, we did not use RTI data in our Welsh share modelling. The only adjustments we made to the SPI-based Welsh share were with respect to relative population growth rates and the asymmetric effects of any policy measures that took effect after the SPI year or would take effect in the future.

2.6 Overall, the Welsh rates of income tax raised less than expected by £18 million (0.9 per cent). This is a small error by historical standards – the average absolute year-ahead forecast error in our UK-wide income tax forecasts is 2.4 per cent.

2.7 The £18 million shortfall compared to our forecast can be attributed to three factors:

- The error associated with **fiscal modelling** generated a shortfall of £31 million (1.5 per cent). As noted above, this forecast did not yet incorporate an RTI adjustment to our Welsh share modelling, as we had not yet tested whether it would provide a good guide to changes in the Welsh share across all income tax. The evidence now shows that changes in RTI earnings shares are a reasonable guide to broader movements. If the forecast had applied an index adjustment based on movements in RTI earnings, it would have been £15 million lower. We now routinely include such adjustments in our forecasts, making use of both the most recent full year of RTI data and also a current year estimate that draws on the latest available year-to-date RTI data.

- The error due to **subsequently announced policies** generated a shortfall of £1 million (0.04 per cent). Policy changes accounted for the smallest error in forecasting and reflect adjustments made to our overall share calculations due to the knock-on effects of the higher rate freeze in Scotland. This reflects a mechanical change to how the share is modelled rather than a real-world response from Welsh income tax payers to changes in tax thresholds that applied in Scotland in 2019-20.

- These two factors were partially offset by stronger than expected growth in **economic determinants of income tax liabilities**, which generated a surplus of £14 million (0.7 per cent) compared to our forecast. This reflects the outperformance of UK-wide wages and salaries growth relative to our October 2018 *Economic and fiscal outlook* (*EFO*) forecast. Overall, growth exceeded our forecast by 0.6 percentage points, with employment growth exceeding our forecast by 0.3 percentage points while average earnings growth outperformed by 0.5 percentage points.[1]

Table 2.1: The Welsh rates of income tax in 2019-20: forecast versus outturn

	£ million					
	Forecast	Outturn	Difference	*of which:*		
				Economic determinants	Fiscal modelling	Policy changes
Welsh rates of income tax	2,059	2,041	-18	14	-31	-1

[1] Differences do not sum due to rounding.

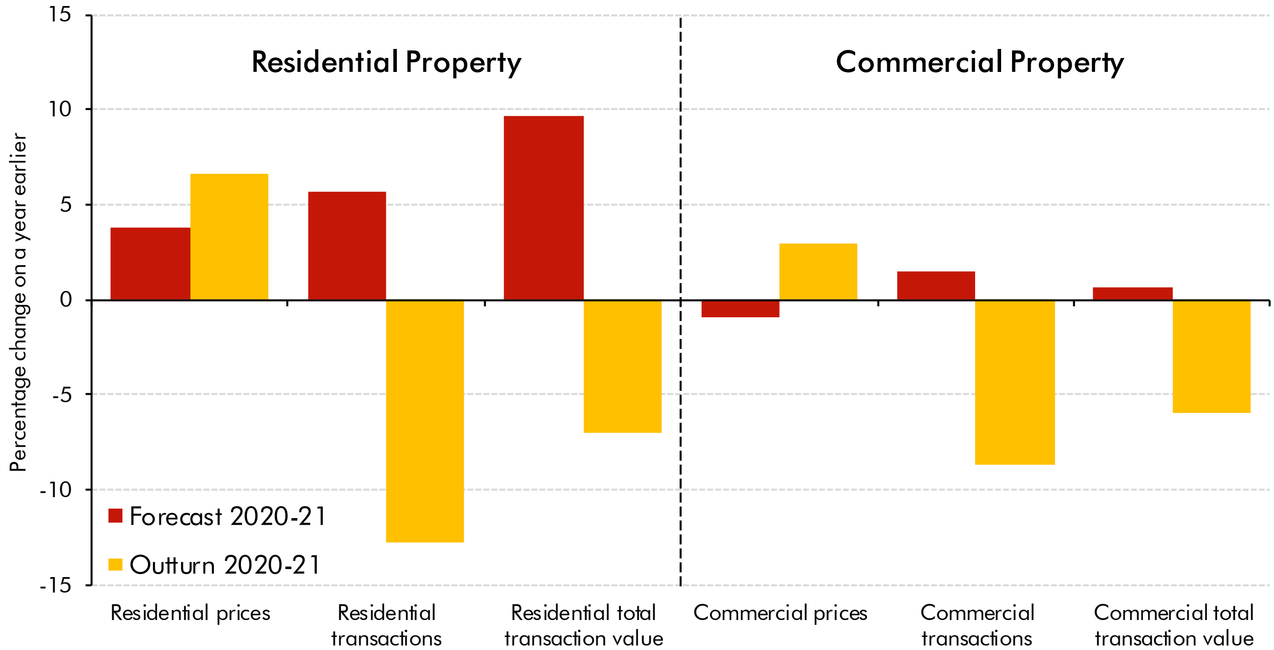
Land transaction tax

2.8 Table 2.2 compares our February 2020 forecasts for LTT receipts in 2020-21 with outturn, showing an overall shortfall of £39 million (16 per cent). In aggregate, a shortfall in the value of transactions in different markets explains around three-quarters of the overall shortfall – labelled 'economic determinants' in the table since they are driven by assumptions about property prices and the volume of transactions. Chart 2.1 shows that:

- **Residential property markets in Wales** saw prices rise significantly in 2020-21, with house price inflation exceeding our forecast by 3 percentage points. This is likely to reflect the combination of pent-up demand being released following the easing of pandemic-related restrictions, plus the 'race for space', sharp falls in interest rates, and some excess savings built up during lockdowns flowing into the housing market. But restrictions meant that transactions fell considerably short of our forecast, falling 12.8 per cent (18.5 percentage points below forecast) despite the support from temporary tax cuts. This combined to produce significantly lower than expected outturn for growth in the total value of residential transactions, which fell 7 per cent – a shortfall of almost 17 percentage points relative to our forecast.

- **Welsh commercial property markets** were significantly weaker than our pre-pandemic forecast assumed. Similarly to residential markets, prices rose but transactions fell, with the total value of transactions falling 6 per cent rather than rising 0.6 per cent as forecast. This reflects pandemic-related disruption during lockdowns, combined with the fact that commercial properties did not benefit from tax holidays or from the other factors that appear to have buoyed the residential market.

Chart 2.1: Property prices and transactions: forecasts versus outturns



Source: OBR

2.9 Looking at receipts performance in the three individual LTT markets:

- **Residential main rates.** £31 million (79 per cent of the overall shortfall) relates to residential LTT. This was more than explained by subsequent policy changes, which are estimated to have cost £33 million in 2020-21 – the largest cost being associated with pandemic-related support measures such as the LTT holiday. The lower than expected growth in the value of residential property transactions described above was responsible for £15 million of the shortfall. Partly offsetting these sources of downside surprise was a £17 million upside surprise related to fiscal modelling. This reflects the stronger performance of higher-priced transactions relative to lower-priced ones during 2020-21, which raised the effective tax rate paid due to the progressive structure of the LTT rates – for example, transactions at prices below £500,000 fell 14 per cent year-on-year in 2020-21, whereas transactions at prices above £500,000 increased by 41 per cent (see Chart 3.3 in our December 2021 *WTO*).

- **Higher rates on additional properties.** Receipts exceeded our forecast by £4 million. While the lower than expected value of property transactions lowered receipts, this effect was outweighed by fiscal modelling (adding £3 million) that is likely to relate to the same compositional effects that boosted residential receipts, and subsequent policy changes (adding £10 million). The latter reflects the exclusion of additional rates charged on second homes and buy-to-let properties from the LTT holiday, which meant that all the tax paid on qualifying transactions was recorded as revenue from the higher rates during the period of the holiday, boosting these receipts.

- **Commercial receipts.** £12 million of the overall shortfall relates to commercial property receipts. This shortfall reflects both the lower than expected value of commercial transactions and fiscal modelling errors, which are also likely to reflect differences between the outturn composition of transactions and that assumed in the forecast model, which at the time was based on transactions in 2018-19.

Table 2.2: Land transaction tax receipts in 2020-21: forecast versus outturn

	£ million					
	Forecast	Outturn	Difference	*of which:*		
				Economic determinants	Fiscal modelling	Policy changes
Total LTT forecast	**250**	**211**	**-39**	**-28**	**13**	**-24**
of which:						
Main rates residential	118	87	-31	-15	17	-33
Higher rates residential	61	65	4	-9	3	10
Non-residential	71	58	-12	-4	-8	0

Landfill disposals tax

2.10 Table 2.3 compares our February 2020 forecast for LDT in 2020-21 with outturn, showing an overall shortfall of £4 million (11 per cent). This is almost entirely attributed to fiscal modelling and was mainly driven by the large impact of the pandemic in the first quarter of the fiscal year when strict lockdowns were in place for much of the time. Receipts averaged £9.3 million a quarter in 2019-20, before dropping to £5.4 million in the first quarter of 2020-21, then recovering to average £8.9 million a quarter in the remainder of the fiscal year. In terms of the categories of waste, the shortfall of £4 million was due to over-forecasting standard-rated waste, which makes up the bulk of receipts.

Table 2.3: Landfill disposals tax receipts in 2020-21: forecast versus outturn

	£ million					
	Forecast	Outturn	Difference	*of which:*		
				Economic determinants	Fiscal modelling	Policy changes
Total LDT forecast	36	32	-4	0	-4	0