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# Consultation on our approach to policy baselines

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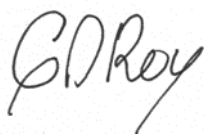
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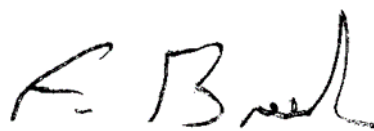
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# Foreword

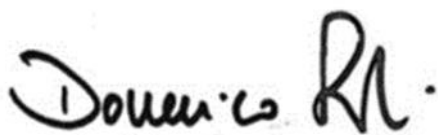
We produce forecasts regularly to support the Scottish Budget process. An important part of our role is also to estimate the effect policy changes introduced by the Scottish Government will have on tax revenues and social security spending in future years. Each time we produce a forecast we have a pre-measures forecast reflecting all previously announced policies, and a post-measures forecast reflecting any new policy announcements. Our pre-measures forecast uses what we call our policy baseline, for example that tax thresholds will be held frozen or increase by inflation each year. How we set our policy baseline has a significant effect on our forecasts and also how government policy changes are framed. We recognise there are a number of approaches we could adopt to setting policy baselines, and we are keen to hear from stakeholders their views on this subject. We look forward to hearing from you and discussing these issues.



Professor Graeme Roy



Professor Francis Breedon



Dr Domenico Lombardi



Professor David Ulph

25 May 2023

# A consultation on policy baselines

- 1 Policy baselines are a critical part of our forecasting process. Our current judgement-based approach is not the only way to set policy baselines; there are a number of possible options and objectives. We now have several years of experience in producing our forecasts and policy costings and feel that now is a good time to review our approach. We're seeking views from anyone with an interest in the Scottish Government's Budget or Scottish public finances on how we approach setting our policy baselines in the future. We'd like views on alternative methodologies for setting baselines to help us improve our approach.
- 2 In general, baselines for our social security forecasts are better defined, with most payments having uprating processes set in legislation. The examples we give in this consultation on policy baselines are therefore focused on taxes, although the same general principles apply to our social security forecasts. If we change our approach to setting policy baselines, this will extend across all our forecasts as appropriate.

## What is a policy baseline?

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- 3 Taking the income tax higher rate threshold as an example, to forecast income tax, we need a value for the higher rate threshold to use in each year of our five-year forecast. We currently assume the higher rate threshold remains fixed at its current level over the next five years. At the start of our forecasting process, the set of values used for the higher rate threshold is our policy baseline.
- 4 This concept extends across all our tax and social security forecasts. We need detailed policy information to produce our five-year forecasts of Scottish taxes and social security spending. Factors which can be considered a policy include tax rates and thresholds, allowances, social security payment eligibility criteria, payment amounts and the timing for implementation of any changes.
- 5 When the Scottish Government has previously made a clear policy decision, or there is a legislative basis for the policy parameter, we include this in our policy baseline. For example, in the UK legislation, it is explicit that many tax thresholds will rise in line with inflation. That is not generally the case in Scottish tax legislation. When there is no government policy decision or legislation in place, for example in later years of the forecast, we need a system in place to create our policy baseline.
- 6 Each time we produce a forecast, the effect of our policy baseline on tax revenues or social security spending is fully factored into what we call our pre-measures forecast – a forecast which does not include any new policy changes. Our policy baseline creates the starting point from which a government policy change can be considered. Only when a policy decision is different to our policy baseline, with a potential difference to our pre-measures forecast of tax revenue or social security spending, would we consider this to be a policy change. Effectively, we compare the policy decision to our no-policy change counterfactual. We only consider Scottish Government policy changes as part of this process. Changes in policy by the UK Government that affect our forecast feature in our pre-measures forecast.
- 7 The public needs to be able to understand how decisions taken by government on tax and spending affect budgets. How we set our policy baseline has important implications for how these decisions are framed and communicated.

# Our current approach

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- 8 We discussed our current approach to policy baselines in our 2019 occasional paper on policy costings.<sup>1</sup> Our starting point is the policy as set by the Scottish Government in the previous Budget or MTFS. We then consider a number of questions, such as:
- Is there any legislation which sets out how policies will change over time? For example, does the legislation say that tax rates and bands will rise with inflation?
  - Has the Scottish Government previously given a clear and public indication of what it sees as a reasonable policy baseline?
  - What is the historical precedent for the policy parameter? What expectation would it be reasonable for taxpayers or recipients of social security payments have?
- 9 If there is no clear legislative basis for baseline policy assumptions, and the Scottish Government has not provided a clear, public indication of a policy baseline, then our current approach is to use our judgement to form a baseline based on our interpretation of historical precedent and public expectations. We consider this to be a pragmatic and judgement driven approach to setting policy baselines. For transparency we publish all our forecast baselines as part of our supplementary tables with each forecast.<sup>2</sup>
- 10 For example, when we first started forecasting Scottish income tax, there was no information on what should form a Scottish policy baseline. For the higher rate threshold, our policy baseline mirrored the UK Government's approach, with the threshold moving in line with inflation unless there was a policy change. Over several years, the higher rate threshold was consistently set to be fixed in cash terms or to rise by less than inflation. Following this, within our pragmatic and judgement driven approach to setting policy baselines, we took the decision in May 2022 to freeze the Scottish higher rate threshold in our policy baseline.<sup>3</sup>

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<sup>1</sup> Scottish Fiscal Commission (2019) Approach to Policy Costings September 2019 ([link](#))

<sup>2</sup> Scottish Fiscal Commission (2023) Scotland's Economic and Fiscal Forecasts – May 2023 ([link](#))

<sup>3</sup> Scottish Fiscal Commission (2018) Scotland's Economic and Fiscal Forecasts – May 2018 ([link](#))

# Objectives to consider in selecting our approach to setting policy baselines

- 11 There are a number of objectives that may be considered in selecting an approach to setting policy baselines. These objectives may conflict with each other under different approaches, and no approach will maximise all objectives simultaneously. Figure 1 lists the objectives we have identified in alphabetical order. The relative importance of objectives will be different for different users.

**Figure 1: Objectives of setting policy baselines**

Objective	
Forecast accuracy	<p>Are there clear expectations about the pattern of policy setting behaviour? If our policy baseline diverges from these expectations, it may introduce a bias to our forecasts and reduce accuracy.</p> <p>For example, we previously assumed the higher rate threshold would rise in line with inflation, and the Scottish Government consistently fixed it to rise by less than inflation. This introduced a source of policy change error to our forecasts.</p>
Forecast independence	<p>Could the approach be influenced by government, political parties or others? Could the approach be perceived as having been influenced by government, political parties or others?</p>
Fiscal neutrality	<p>Does our approach maintain the current policy status quo? How does our baseline affect tax revenues, post-tax incomes and social security spending in nominal and real terms? Varying decisions around tax thresholds in our baseline would mean taxpayers could feature in different tax bands or payments in our forecast, and shift the structure of the system over the longer term.</p> <p>For example, freezing thresholds in cash terms can lead to people going into a higher tax bracket when their real income has not changed – a process known as fiscal drag. To what extent should this be considered in our approach to setting baselines?</p>
Informing public debate	<p>Does our approach help inform public understanding and debate about tax and social security policy options? Does our approach frame the debate in a helpful and transparent way? For example, if we index thresholds, does it make sense to the public that keeping a threshold fixed from one year to the next is effectively a policy change?</p>
Resilience to political change	<p>Will our approach remain robust to changes in the Scottish Government or changes in political objectives? If the current government supports a particular baseline, but this is not in legislation, does it still apply in the next Scottish Parliament?</p>
Transparency and accessibility	<p>Is our approach transparent and easy to understand?</p>

Source: Scottish Fiscal Commission

## Consultation question 1: What should our objectives be in approaching policy baselines?

- Are there are additional objectives we should consider as part of our approach to setting policy baselines?
- Which of these objectives should have the highest priority?
- How might these objectives be brought into conflict?

## Options for setting policy baselines

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- 12 We believe there are two broad options for an approach to setting policy baselines: our current judgement-based approach, or alternatively a rules-based approach. A rules-based approach would dictate consistently how all policy parameters would be set over time in the absence of government policy or legislation. Even with a rules-based approach, there may be exceptions and a different baseline makes sense, for example mirroring a piece of UK legislation. We will always maintain a degree of pragmatism in the way we set policy baselines.
- 13 We believe our current judgement-based approach primarily prioritises the objective of forecast accuracy, though we do also consider other objectives in setting our judgements.
- 14 A rules-based approach might reduce forecast accuracy, but would arguably score better against the objectives of forecast independence, transparency, and would also be more resilient to political change, including changes in policy priorities and changes in administration.
- 15 Focussing primarily on thresholds, within a rules-based approach we see three main options:
- Freeze all thresholds in cash terms
  - Grow all thresholds in line with inflation
  - Grow thresholds in line with the tax base – for example Land and Buildings Transactions Tax (LBTT) thresholds grow in line with house prices
- 16 Freezing all thresholds would be a simple and transparent approach, but would likely to lead to significant fiscal drag over time. Growing all thresholds in line with inflation would reduce fiscal drag, with taxpayers only moving between bands as a result of real earnings growth. Growing thresholds in line with the tax base, for example growing LBTT thresholds in line with house price growth, would do more than the other two options to keep the structure of the tax system constant over time, with the least movement between bands.

## Consultation question 2: Should we adopt a judgement-based or rules-based approach?

- Which broad approach do you think the Commission should adopt? A judgement-based approach or a rules-based approach?
- How does this approach deliver against the objectives you have identified as being the highest priority?

### Consultation question 3: How should the approach be implemented?

- Given the broad approach, how should this be implemented?
- With a judgement-based approach, do you have any comments on how this should be implemented in practice?
- For a rules-based approach, what is your view on what the rules should be? For example, should thresholds be frozen, indexed to inflation, or grown in line with the tax base? If tax thresholds should move in line with inflation, then which measure of inflation?

## Implementing a new approach: timing of changes

- 17 If we implement a new approach or revise our current approach to setting policy baselines, this could introduce a significant change to our forecasts. To smooth the transition, we could put a time-limit on our current policy baseline assumptions, for example implementing a new approach at year three of our forecast horizon.

### Consultation question 4: When should changes be made?

- Do you think any change to our approach should be implemented immediately or only after a pre-announced period of time? How long should this period of time be?
- Do you have any comments on how changes should be communicated?

## The role of the Scottish Government

- 18 We believe there can be a role for the Scottish Government in shaping our policy baselines in a transparent way if it chooses to do so. For example, if the Government made a clear and firm statement in Parliament about a policy direction, we could adopt this as a policy baseline, particularly under a judgement-based approach. As a stricter approach, we might only change our baselines if legislation was introduced to or passed by parliament, for example stating that a certain threshold will go up in line with inflation.

### Consultation question 5: What is the role of the Scottish Government?

- What should the mechanism be for the Scottish Government to shape policy baselines given your preferred approach from Question 2? Should this be limited to only legislation or are there other possible mechanisms?

## How to respond to this consultation

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- 19 Please respond by email to [info@fiscalcommission.scot](mailto:info@fiscalcommission.scot) to share your views on the questions posed in this consultation. Please use the email subject line “Policy baselines consultation response”.
- 20 **The consultation will remain open to responses until 15 September 2023.**

## Next steps

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- 21 We’ll publish a summary of consultation responses by spring 2024. Our approach to setting policy baselines is at the discretion of the Commissioners. Once the consultation is closed, the



Commissioners will consider all the views shared before selecting their preferred approach to setting policy baselines. We'll announce and implement our new approach as part of our May 2024 forecast.

# Additional Information

## Glossary

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Fiscal drag	Many taxes are progressive, with higher tax rates being applied as you move up through the tax base, for example on higher incomes or larger transactions above certain thresholds. Fiscal drag refers to the general increase in revenues over time that comes from the tax base growing relative to tax thresholds and higher tax rates being applied.
Policy baseline	A set of policy parameters used at the start of our forecasting process, forming our pre-measures forecast.
Policy change	When the Scottish Government sets a policy decision which is different to our policy baseline, therefore potentially affecting tax revenue or social security spending as compared to pre-measures forecast.
Policy decision	When the Scottish Government sets a policy parameter. This may or may not be considered a policy change depending on the policy baseline.
Policy parameter	This can include any aspect of tax or social security controlled by the Scottish Government that can have an effect on revenues or spending. The main examples are tax rates and thresholds, allowances, benefit eligibility criteria and the timing for implementation of any changes.
Pre-measures forecast	A forecast which is formed using our policy baseline, and does not include any new policy changes. It will include previously announced policy decisions and changes which now form our policy baseline.
Post-measures forecast	A forecast which includes any new policy changes in addition to our policy baseline.

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A full glossary of terms is available on our website:

<https://www.fiscalcommission.scot/explainers/glossary/>

# Professional Standards

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The Commission is committed to fulfilling our role as an Independent Fiscal Institution, in line with the principles set out by the Organisation for Economic Cooperation and Development (OECD).<sup>4</sup>

The Commission also seeks to adhere to the highest possible standards for analysis. While we do not produce official statistics, we voluntarily comply as far as possible with the UK Statistic Authority's Code of Practice for Statistics. Further details and our statement of voluntary compliance can be found on our website.<sup>5</sup>

## Correspondence and enquiries

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We welcome comments from users about the content and format of our publications. If you have any feedback or general enquiries about this publication or the Commission, please contact [info@fiscalcommission.scot](mailto:info@fiscalcommission.scot). Press enquiries should be sent to [press@fiscalcommission.scot](mailto:press@fiscalcommission.scot).

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<sup>4</sup> OECD (2014) Recommendation on Principles for Independent Fiscal Institutions ([link](#))

<sup>5</sup> Scottish Fiscal Commission (2018) Compliance with the Code of Practice for Official Statistics ([link](#))

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