Scottish Fiscal Commission

Bruce Crawford MSP
Convener
Finance and Constitution Committee
The Scottish Parliament

By Email

19 February 2018

Dear Convener,

The Scottish Fiscal Commission (SFC) has reviewed the Committee's report on the Draft Budget 2018-19. We are responding to those recommendations specifically addressed to the SFC.

40: "…the more significant issue for the size of the Scottish budget is comparing the SFC forecasts with the OBR forecasts for growth in the equivalent taxes in the rest of the UK."

The Commission has previously included comparisons of OBR forecasts of Scottish receipts as the most direct comparator to our forecasts. Our report in December explained how the OBR's Scottish forecasts have no impact on the Scottish budget (see Box 1.2). We recognise that for the purposes of determining the Scottish Government's Budget the most informative companion to our forecasts is the Block Grant Adjustment (BGA) for each tax/benefit. However, the calculation of the BGA is a matter for the Scottish and UK Governments.

The BGAs are determined by growth in equivalent UK Government tax receipts, population growth and by the previous values of the BGA, thus a simple comparison to the OBR forecasts for growth in equivalent taxes in the rest of the UK alone would not provide sufficient information to directly infer the impact on the Scottish budget. Nevertheless, the Commission can include the OBR forecasts of growth in the UK Government equivalent receipts or payments in our future publications if the Committee would find that helpful.

We note that the BGA figures were not published as separate figures at the time of the UK fiscal event; the Scottish Government subsequently published separate BGAs for each tax as part of the Draft Budget document. If the Commission were provided with information on the individual BGAs for the five-year forecast horizon by the Scottish Government sufficiently in advance of each fiscal event we would be happy to reference them in our publication.

63: "…..While it is not clear what the impact will be on income tax revenues there is nevertheless some risk to the public finances which will require close monitoring by both the Scottish Government and the SFC."

The Commission will continue to monitor closely the Scottish macro-economy and income tax revenues. The Committee will receive at least two forecasts a year from the Commission and an annual evaluation, all of which will contain analysis of the latest data and how these affect our view of economic growth and income tax revenues.

The Commission will monitor income tax data from a range of sources. The Survey of Personal Incomes (SPI) is currently the primary source of data on income tax. It is published once a year around two years after the end of the tax year for which data are being published. The Commission is currently using the 2014-15 SPI as a basis for its forecasts and the 2015-16 SPI will be available shortly.

HMRC have started to publish Real Time Information (RTI) income tax statistics, though these are currently described as experimental. These statistics will provide a more timely but less detailed view of incomes and taxpayers in Scotland. RTI data is currently available up to the July to September quarter of financial year 2017-18. RTI has a number of limitations but the Commission will continue to consider its use in forecasting.

HMRC will also publish final estimates of Scottish NSND income tax liabilities outturn data. Figures for tax year 2016-17 are expected to be available in summer 2018.

The Commission will continue to monitor these sources of data to inform future income tax forecasts.

117: "…The Committee asks the SFC to explain …. why despite lower economic growth forecasts per capita relative to rUK, they forecast that income tax revenues per capita will grow at the same rate in Scotland as in rUK. In particular, why its judgements about earnings growth do not appear to be influenced by its growth and productivity assumptions."

The key driver of income tax liabilities in the Commission's forecast is nominal earnings growth. An important driver of real earnings growth is productivity. However, whilst strongly related, these variables do not move perfectly in line with each other. The Commission has detailed and disaggregated models of both the Scottish economy and Scottish income tax. This means that there are a broad range of factors that also influence growth in nominal earnings and therefore income tax liabilities from one year to the next.

In the Commission's forecasts, particularly from 2019-20 onwards, real wages grow with productivity as shown in Table 1. However, there are a number of other factors that will influence growth in real wages, particularly in the short term. These are inflation, growth in employment and unemployment, broader demand conditions in the economy and demographics. In addition, the recent performance of wage growth compared to the UK may influence wage growth in the short-medium term (for example, if as recently there was a weak period in real wage growth compared to the rest of the UK, one may expect some catch-up in the medium term). These factors are taken account of in the Commission's economy forecasts.

Table 1: Growth rate of real wages and productivity (%)

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Real wages	-0.4	0.2	0.5	0.6	0.9	1.2
Trend productivity	0.3	0.5	0.6	0.7	0.9	1.0

Source: Scottish Fiscal Commission

The Committee report notes that, despite the Commission's forecast of slightly slower GDP per capita growth in Scotland than the OBR forecasts for the UK, the Commission forecasts higher growth in income tax liabilities per capita than the OBR forecasts for the UK. Broadly, this is due to modelling differences between the Commission and the OBR, differences in the economic factors described in the paragraph above, and most importantly, different policy choices in the UK and Scotland.

Particular policies which have an impact on the growth per capita of income tax liabilities, relative to the UK:

- The impact of higher public sector pay growth in Scotland than in the UK
- Policies to raise additional revenues in Scotland (such as the income tax policy announced for 2018-19)
- Policies to cut taxes in the UK, for example faster than inflation growth in the higher rate threshold (such as for 2017-18, when the UK threshold was raised to £45,000 when the Scottish threshold was frozen at £43,000)

These three factors have a significant impact on growth in income tax revenues, particularly in 2018-19, where there is a jump in revenues because of the new income tax policy. In our published forecasts, we forecast growth in income tax liabilities per capita of 4.7 per cent in Scotland in 2018-19, compared to 1.6 per cent forecast by the OBR for the UK. However, an illustrative calculation shows that, stripping out the effects of income tax policies introduced in Scotland in 2018-19 and the impact of higher public sector pay in Scotland, the growth rate of income tax liabilities per capita in 2018-19 would be 2.2 per cent in Scotland. This comparison does not take account of further differential policies in the UK, such as increasing the higher rate threshold faster than inflation in some years.

132: The Committee asks the SFC what evidence it examined of behavioural responses to relatively small changes to marginal tax rates including a 1p change and how this informed its forecast.

135: The Committee asks the SFC why it views small differences in tax rates as having little impact on forestalling behaviour yet a relatively high impact on other behavioural responses.

The Commission will be publishing a detailed paper on its behavioural response modelling on 7 March 2018.

The Commission uses evidence from HMRC, the OBR and the academic literature, based on analysis of historic tax changes, to model the impact of behavioural change. However, this provides a range of the scale of behavioural responses, and is not specific to Scotland. Behavioural change will depend on the detail of the policy and on the context. The available evidence, which is based on a range of different changes in policy, is used to estimate how behavioural responses may change depending on the size of the tax change.

Based on this evidence and the judgement of the Commission, we use a broad brush approach to model the impact of behavioural change. We cannot know with precision what the behavioural response will be to any particular policy change.

Our behavioural responses scale with the size of the change in taxes, and smaller changes in tax rates will lead to smaller changes in behaviour. This is particularly the case with our forestalling analysis.

Whilst it is possible that some taxpayers will choose not to respond to incremental changes in tax rates, we also need to take account of perceptions and the broader picture of tax changes.

Our general approach to modelling behavioural change through our Taxable Income Elasticities (TIEs) captures a broad range of possible behavioural responses. The broad range of responses captured means that some of these responses will be applicable even for smaller changes in tax rates. These TIEs capture behavioural responses over our full five year forecast.

Forestalling is a particular and one-off behavioural response that requires immediate action on the part of taxpayers to shift their income. Because of the short-term and one-off nature of forestalling, we use a different modelling approach to capture its impact based on evidence from HMRC and the OBR. There are limited incentives provided for this kind of behavioural response to the policy changes announced at Budget 2018-19, so we expect forestalling behaviour to have a negligible impact on income tax liabilities. We set out in our December report how we would expect forestalling effects to scale with changes in tax rates.

We do not see our TIE behavioural response as particularly high. Our elasticities are similar to estimates used by HMRC. Although we have greater disaggregation in our TIEs, we have a weighted average TIE of 0.51 for taxpayers earning over £150,000. This compares to an elasticity of 0.48 estimated based on the change in the additional rate of tax published by HMRC in 2012. This slightly higher average TIE reflects the Commission's judgement on the ease with which some individuals with very high earnings may choose to relocate as a result of changes in the additional rate of tax, and the flexibility of location decisions within the UK in general, as a result of changes in the additional rate of tax.

144: The Committee asks the SFC to explain whether it believes that the number of incorporations in Scotland is likely to increase relative to the rest of the UK as a consequence of the proposed income tax policy changes.

We model the impact of increasing incorporations in our baseline income tax forecast. Even without a change in policy, we would therefore be modelling an increasing number of incorporations in Scotland.

Whilst relatively higher tax rates will have some impact on the incentive to incorporate, we did not include a specific adjustment to our behavioural modelling for this. Our TIEs capture a range of behavioural responses including incorporations. We felt that, due to the particular risk of incorporations, as well as the relatively higher risk of migration, we were right to assume slightly higher TIEs for Scotland than for the UK as a whole.

Higher tax rates in Scotland may provide a slightly greater incentive to incorporate, but we believe this is captured in our overall approach to behavioural modelling.

157: The Committee asks the SFC whether it considered the impact of the Aberdeen housing market on its LBTT revenue forecasts in its most recent report.

The Commission continually monitors developments across Scotland and may occasionally single out an area for discussion, as with Aberdeen last year. Our Forecast Evaluation Report published in September 2017 discussed the impact of lower house price growth in the Aberdeen housing market on LBTT receipts. Our latest forecast incorporates data from the whole of Scotland, and therefore implicitly captures the effect of Aberdeen within the projection for Scotland as a whole. We will continue to monitor developments in the housing market, and may revisit our analysis of the Aberdeen housing market in future Forecast Evaluation Reports.

160: The Committee asks the SFC whether it considered the possibility of longer term behavioural responses to residential LBTT other than in relation to fiscal drag.

The Commission added an adjustment to the forecast model for LBTT to account for the behavioural response to fiscal drag, which occurs as house prices rise so increasing the tax payable. Our forecast does not make additional adjustments beyond those encapsulated in existing trends. This approach is in line with existing practice, for example in the forecasts for Stamp Duty Land Tax, Land Transactions Tax and Land and Buildings Transactions Tax produced by the OBR.

166: The Committee asks the SFC why its forecasts for ADS for 2017-18 and 2018-19 are the same as the outturn figure for 2018-19 when it is forecasting higher average house prices and a higher number of transactions.

The forecast for ADS receipts is based on two components: gross revenues and repayments. Gross revenues counts the total ADS revenue paid. Repayments, which occur should the purchaser transfer their main residence within 18 months of the purchase. The two combine to produce the net ADS forecast.

As Table 2 shows, gross ADS receipts increase each year in line with the forecasts for house price and transactions growth. A particularly large increase occurs in 2017-18 as this is the year with the largest price and transactions growth forecasts. The increase to 2018-19 is lower as average house price growth slows from 4.3 per cent to 1.9 per cent in 2018-19.

<u>Table 2: Summary of the Additional Dwelling Supplement forecasts for 2016-17 to 2018-19 (£ million)</u>

	Gross	Repayments	Net (pre-measures)	Net (post-measures)
2016-17	107.1	14.3	92.8	92.8
2017-18	128.8	36.2	92.6	92.6
2018-19	133.5	40.0	93.5	93.3

Source: Scottish Fiscal Commission

Table 2 shows that the principal reason for the £93 million forecasts for 2016-17 and 2017-18 is the large increase in repayments expected in 2018-19. This is primarily due to repayments being accounted for within the quarter that they are paid out. Taxpayers can reclaim the ADS paid provided they transfer their main residence within 18 months. As the tax was introduced at the start of 2016-17, repayments are only due on transfers that took place during that year, reaching a maximum of 12 months of repayments in the final month of 2016-17. The first full 18-month window is only reached in the middle of 2017-18. As price and transactions grow throughout the period, repayments are significantly boosted in 2017-18 relative to 2016-17 and then to a lesser extent in 2018-19 over 2017-18.

2018-19 also includes a downward adjustment of £0.3 million to the pre-measures forecast, due to the introduction of the First Time Buyers relief.

We report the full unrounded final pre and post-measures forecasts that are set out in Table 3.26 in the spreadsheets that accompanied Scotland's Economic and Fiscal Forecasts in December 2017. The figures in the main report are rounded to the nearest million, so the figures for 2016-17 and for 2017-18 are rounded up to £93 million, while 2018-19 is rounded down to £93 million.

A final factor relates to the accounting basis for the figures. Revenue Scotland's Annual Report publishes figures on an accruals basis and accounts for tax receipts on an annual basis. In addition, Revenue Scotland provides the Commission with data on tax declared by year and month of the effective date of transaction.

For residential, non-residential and gross ADS receipts, this difference is small – typically less than £500,000 for a financial year. For repayments, the difference is somewhat larger, leading to a £2 million difference in repayments in 2016-17 as reported in the Annual Report compared to data on an effective date basis as at 31 May.

This difference reflects the financial year in which the date of sale of the previous main residence takes place. ADS repayments claimed in April and May 2017 are only included in the accounts for 2016-17 if the date of sale of the previous main residence occurred in the financial year 2016-17.

My colleagues on the Scottish Fiscal Commission and I trust that this letter responds satisfactorily to the recommendations in your report. Please let us know, however, if any additional information is required by the Committee.

I have copied this letter to the Cabinet Secretary for Finance and the Constitution and DG Scottish Exchequer.

Sincerely,

Susan Rice

Susan Rice DBE