Scottish Fiscal Commission

# Approach to Policy Costings
September 2019

This publication is available at www.fiscalcommission.scot

Any enquiries regarding this publication should be sent to us at: Scottish Fiscal Commission, Governor's House, Regent Road, Edinburgh EH1 3DE

Published by the Scottish Fiscal Commission, September 2019

ISBN: 2019-978-1-911637-08-0

# Contents

# Chapter 1 Overview

1.1 The Scottish Fiscal Commission is the independent fiscal institution for Scotland. Our role includes forecasting revenues from the Scottish Government's tax policies and the spending on the Scottish Government's social security policies. In producing these forecasts we sometimes produce **policy costings** – our best estimates of the change in revenue or spending from Scottish Government policy changes.

1.2 We consider a **policy change** to be anything the Scottish Government alters that affects the amount of tax raised or the amount spent on social security. We only produce costings for Scottish Government policy and cannot cost other proposals (for example from political parties). Tax policy covers the tax rates applied, the thresholds at which the different rates apply and any factor which determines who or what pays the tax such as any reliefs or exemptions. Social security policy determines the level at which a benefit is paid, how an individual or household qualifies for a benefit and how the benefit is delivered and received. We do not produce separate costings of UK policies which affect Scottish taxes and benefits but we do incorporate these effects into our pre-measures forecasts.

1.3 To provide our best estimates of tax revenues and social security spending, we first consider the scenario where the Scottish Government does not change policy; on this basis we produce a **pre-measures forecast**. This requires us to consider how aspects of the existing policy may change without the Scottish Government making an explicit policy change. For example the different thresholds or rates at which a tax or benefit is paid may increase with inflation each year. We then apply this pre-measures policy to our forecast of the determinants of the tax or benefit.

1.4 When the Scottish Government makes a policy change to an existing tax or benefit, we produce a policy costing. The first step in the policy costing is to produce a costing based on no one changing their behaviour as a result of the change. We then assess whether people or firms may change their behaviour in response to the change. For example, we may assume that higher income tax rates can affect the number of hours an individual chooses to work.

Similarly the level at which a benefit is paid may affect how many people or households apply for it, the ‘take-up rate’. We then incorporate the behavioural change to produce our post-measures forecast.

1.5 Our final **post-measures forecast** adds together the pre-measures forecast and the policy costing.

1.6 At the time of the Scottish Budget and the Government’s Medium Term Financial Strategy, known as **fiscal events**, we publish Scotland’s Economic and Fiscal Forecasts (SEFF). The SEFF sets out our policy costings for all tax and social security spending policies announced at the time. We incorporate these policy costings into our forecasts. By incorporating the effects of announced policy decisions, we are producing the best and most transparent forecasts that we can of tax revenue and social security spending.

1.7 The Commission may also produce supplementary costings at any time the Scottish Government introduces legislation to Parliament with changes to a tax or a benefit.

1.8 This paper describes our role in policy costings. It explains what a policy is, how we approach costing policies and how we evaluate our policy costings once data are available. The paper also covers the process with the Scottish Government and how our role differs from that of the Office for Budget Responsibility (OBR). Policy costing comes with its own terminology and jargon. Throughout the paper, we define what the various terms are and what they mean. Where we define them, the terms are highlighted in bold. A glossary is provided at the end of the paper.

1.9 With this paper we want to improve the transparency of our work on policy costings and the approaches we take. We also aim to explain the challenges in forecasting the effects of policy changes and retrospectively evaluating those forecasts. This occasional paper is part of a series setting out aspects of the Commission’s work in further detail.

# Chapter 2
# Our role in policy costings

2.1 This chapter sets out when we produce policy costings and the process for producing those costings, including how we work with the Scottish Government.

2.2 In the ten weeks running up to the publication of the Scottish Budget or of the Medium Term Financial Strategy (which we often refer to as **fiscal events**) we proceed as follows:

- We begin by preparing our first-round economic forecasts. These draw on data releases since the previous forecast and preliminary judgements on economic developments. Once we have finalised our first-round economic forecasts, we use some of the outputs (which we call **economic determinants**) to produce our first-round tax and social security forecasts (or **fiscal forecasts**). Examples include wage growth and employment, which we use in our income tax forecast. At this point, our forecasts are **pre-measures forecasts** – they assume no changes to policy.

- The first-round economic and fiscal forecasts are sent to the Scottish Government, so that they may scrutinise them and use them in their preparations for the fiscal event.

- We then follow with further iterations of forecast rounds – typically one or two rounds. Each round incorporates any new data and any changes to judgements in both economic and fiscal forecasts. The Scottish Government can provide indicative details of possible policy measures to the Commission at any stage in the process and the Commission will aim to provide indicative costings at the next forecast round.

- Roughly three weeks in advance of the fiscal event there is a deadline for the Scottish Government to share any significant policy changes (referred to as **policy measures**) that may affect our economy forecasts. Only those policy changes relating to devolved taxes and benefits will have a policy costing, other economy-moving measures are incorporated in our forecasts but we do not produce a separate policy costing.

- Roughly two weeks in advance of the fiscal event is the deadline for the Scottish Government to share final policy for tax and social security spending. Policy changes at this stage are more incremental. We use this information to produce three things: the final pre-measures forecast; the policy costing; and the final forecast that includes both our pre-measures forecast and the policy costing (what we call the **post-measures forecast**).

- The Commission provides final pre- and post-measures forecasts to the Scottish Government, typically seven days ahead of the fiscal event.

- The Scotland's Economic and Fiscal Forecasts publication includes an Annex A with details of how we have costed all the Scottish Government's policy changes. As well as setting out the fiscal effect of the policy change, we explain how we have estimated the effect of the policy change and the uncertainties associated with it.

2.3 This process is set out in detail in the protocol between the Commission and the Scottish Government.[1] Some deviation from these timings can occur, for example to allow the incorporation of data releases or to account for the timing of the UK Government's fiscal event.

2.4 We do not provide policy advice to Scottish Ministers. Instead the Commission provides analysts in the Scottish Government with copies of all our forecasting models and judgements to help them to provide policy advice to Ministers. Running these models will not always result in the same costing as those produced by the Commission. We may choose to revise judgements or assumptions to better reflect the latest evidence and context. These assumptions and judgements are important in determining the effect of any policy change.

## When we produce policy costings

2.5 Our overall objective is to ensure the Scottish Parliament has an independent estimate of the policy costing associated with any proposed legislation relating to taxes or benefits. As a result we only cost policies announced at fiscal events or which accompany legislative changes introduced in the Scottish Parliament.

[1] Protocol for engagement between the Scottish Fiscal Commission and the Scottish Government Version 2.0 published March 2018 (link). An updated version of the protocol is due to be published in the autumn 2019 although the process for policy costings will remain as set out.

2.6 The text above explained the process we follow to cost policies during a fiscal event. The Scottish Government also announces policy changes at other times in the year. In the remaining sections of this chapter we outline our approach for the following:

- policies announced during the Scottish Budget Bill process
- policies announced outside fiscal events

## Policies announced during the Scottish Budget Bill process

2.7 The budget process was reformed in 2018 to reflect the recommendations of the Budget Process Review Group.[2] The Scottish Government introduces the Scottish Budget to Parliament in December, and the Commission publishes its forecasts and associated policy costings at the same time. Following the introduction of the Scottish Budget, the Budget Bill must progress through the Scottish Parliament. Further policy changes can occur during this process.

2.8 The stage 1 debate in the main Chamber is when Members of the Scottish Parliament (MSPs) can put forward alternative proposals and usually takes place in January. At stage 2, the Finance and Constitution Committee examines the Budget Bill and any proposed amendments or changes. The stage 3 debate then takes place in the Chamber and is followed by a vote on whether to pass the bill. Only the Scottish Government can propose amendments at stages 2 and 3.

2.9 As the Budget Bill progresses through Parliament there is the possibility of further changes to tax and benefit policies. When the Scottish Government formally changes its policy, the Commission produces amended forecasts and policy costings to ensure Parliament has access to independent forecasts of the final policies. We do not produce policy costings for alternative proposals, unless these are formally adopted by the Scottish Government.

2.10 Once the Commission has been informed of the policy change and decided to cost the policy, we produce amended forecasts and costings which are shared with Scottish Government analysts for comment ahead of publication. The Commission aims to publish the forecasts as soon as possible once the formal policy is announced, but the exact timing of publication will depend on the amount of notice given and the complexities of the policies being costed.

[2] Budget Process Review Group (link)

**Box 2.1: Income tax policy change at stage 1**

In the 2018-19 Budget published in December 2017, the Government announced a new five band income tax system. This system introduced two new bands – a start rate and an intermediate rate, and applied a one percentage point increase to the higher rate and top rate.

As part of our December 2017 forecast, the Commission provided a costing of the policy of £164 million for 2018-19. The costing assumed that the higher rate threshold would increase by inflation to £44,273.

During stage 1 of the Budget Bill debate on 31 January 2018 the Cabinet Secretary for Finance and the Constitution announced a number of changes to the Budget that had been published in December 2017. These included a decision to freeze the higher rate threshold at £43,000, instead of increasing it by inflation.

Using the existing Commission income tax models and judgements, the Scottish Government provisionally estimated that this higher rate policy freeze would raise an additional £55 million on top of the £164 million previously estimated by the Commission. On 6 February, we provided an updated costing of the final policy. We estimated that the policy change at stage 1 would raise an additional £55 million, consistent with the Scottish Government estimate.

2.11 The Commission can only produce policy costings based on Scottish Government policy. Further information on what is considered a policy is covered in Chapter 3. The Scottish Government must inform the Commission as early as possible of likely policy changes. The Commission must make a judgement on whether different forms of announcement constitute a formal change in Government policy. Likely ways that policy changes are announced include Ministerial statements, the Scottish Government lodging formal amendments to the Budget Bill or the Scottish Government agreeing to support an opposition amendment.

## Policies announced outside fiscal events

2.12 The Scottish Government may announce or introduce new policies which had not been announced at the last fiscal event. The Commission only produces **supplementary costings** of new policies where the Scottish Government introduces legislation to Parliament affecting taxes or benefits in our remit and which we have not previously costed.

2.13 The Scottish Government can introduce changes through **primary or secondary legislation.**[3] In both cases it must inform the Commission it

[3] A definition of what constitutes Primary legislation can be found in the Scotland Act 1998 (link) and for Secondary legislation on the Scottish Parliament website (link)

intends to introduce legislation and provide the Commission with details of the planned policies. The Commission will consider whether it wishes to produce a supplementary policy costing.

2.14 If the Commission produces a costing, the Scottish Government will provide final policy information ten days before the legislation is laid. We provide officials in the Scottish Government with draft forecasts and costings a few days later for any comments before the final numbers are provided to the Government shortly before publication. The Commission will publish the supplementary costing at the same time as the legislation is published.

**Box 2.2: LBTT supplementary costings**

In early May 2018 the Scottish Government introduced a change to Group Relief for Land and Buildings Transaction Tax (LBTT). This policy had not been announced in December 2017 when we had last produced forecasts. Neither was it a policy that was being introduced as part of the Medium Term Financial Strategy. We therefore published a supplementary costing on Group Relief which set out our estimate of the effect of the policy change.[4]

At the same time, the Scottish Government introduced secondary legislation for a residential LBTT relief for first time buyers. This is an example of a situation in which we did not produce a supplementary costing. The reason is that First time buyer relief was announced in the December 2017 Budget and we provided a costing of the policy in our report. The December 2017 costing was used to accompany the relevant secondary legislation when it was introduced to the Scottish Parliament in May 2018 and no supplementary costing was needed.

## Comparison to the Office for Budget Responsibility (OBR)

2.15 The OBR's role in relation to policy costings is different to that of the Commission and also distinct from its role in producing the official economic and fiscal forecasts for the UK Government.

2.16 The OBR's economic forecast is produced in-house, with the OBR owning and operating the forecast models, including taking on the judgements of its Budget Responsibility Committee (BRC).

2.17 The production of the fiscal forecasts is largely outsourced to the relevant UK departments, where the underlying data are held. The forecast models are operated on OBR's behalf by analysts within those departments (including HMRC for taxes and DWP for social security spending) rather than within the

[4] Scottish Fiscal Commission (2018) Supplementary Costings: Non-Residential Land and Buildings Transaction Tax Group Relief (link)

OBR itself. But the assumptions and judgements that are fed into those models are still those of the BRC.

2.18 The OBR's role in policy costings is set out in the Charter for Budget Responsibility.[5] The Charter states that "*the [UK] government is responsible for all policy decisions and for policy costings"* and that "*the OBR will provide independent scrutiny and certification of the [UK] government's policy costings. The OBR will state whether it agrees or disagrees with the [UK] government's costings, or whether it has been given insufficient time or information to reach a judgement. The OBR will also determine any resultant impact of the policy on its economic forecast ahead of publication.*"

2.19 While the UK Treasury manages the policy costings process, most of the discussions that take place as part of the OBR's scrutiny role are with the analysts and operational staff in the relevant departments. These discussions are usually by correspondence, and centred around the detailed costing note that departments must submit for each tax or spending measure that the UK Government wishes the OBR to consider. In practice, the OBR asks questions about every costing – often clarificatory rather than challenging judgements – but for more complicated or contentious costings there can be many rounds of questions and responses before it is certified as reasonable and central.

2.20 The UK Treasury produces a list of tax and spending decisions known as a **scorecard,** containing an estimate of how much each policy will cost or raise. If all policy costings have been certified then the OBR includes these scorecard costings into its post-measures forecast. If the OBR disagrees with the UK Treasury's scorecard costing, then it can use its preferred alternative, though this is not something that has been required thus far.

2.21 In some cases where information on a policy measure is either insufficient or provided late the OBR may choose not certify the measure at a fiscal event. To date, for the handful of costings that have not been certified, the OBR has decided to include the UK Treasury's scorecard costing in its forecast at the time but request a full recosting for the subsequent forecast. This occurred at Budget 2018 when the UK Government announced a complicated package of changes to Universal Credit without providing the OBR with sufficient time or information to deem the costings as reasonable and central. The costings were not certified but were revisited in the OBR's March 2019 forecast. In both instances the OBR's reports included detailed explanations, including the reasons for the non-certification and the information uncovered within the

[5] HM Treasury (2017) Charter for Budget Responsibility (link)

recosting.[6] Further information on the OBR's approach to policy costings can be found in its briefing paper on policy costings.[7]

## Policy recostings

2.22 Policy costings are produced based on the best available data and information on the policy. As our forecasts of tax revenue or benefit spending are revised over time, our estimates of the effect of a policy may change. Similarly as new data become available or as our understanding of how the policy is implemented changes, our view of the effect of a policy will likely change over time. We refer to this as a **policy recosting**.

2.23 In each of our SEFF publications we review the policy costings previously produced and consider whether we either need to update them, for example to account for new data or changes in judgements. Our recostings are published in Annex B of the SEFF. If the Scottish Government was to alter part of the policy then we would consider this to be a new policy costing not a recosting.

2.24 Typically, we will stop recosting a policy after we have data for one full financial year following the policy change. For most policy changes this will be the year after the policy change is made. We often provide income tax recostings for longer than one year as there is a lag in the outturn data becoming available. For example, the five band income tax system introduced for the 2018-19 tax year will continue to be recosted until our summer 2020 forecast because finalised income tax outturn data for 2018-19 will not be available until July 2020.

## Materiality threshold

2.25 Some policy changes to taxes or benefits announced by the Scottish Government will have a very small fiscal effect in relation to the total size of taxes and benefits devolved. We have an approach to handling policies we do not consider to have material fiscal effects.

2.26 The Commission's **materiality threshold** was first set out in our December 2018 publication.[8] Where a policy is estimated to cost less than £0.5 million per year it is considered negligible and therefore will not be costed. For policies with an estimated cost of £2 million or lower per year, a decision will be made whether to cost the policy or not. These thresholds will be kept under review.

[6] OBR (2018) Economic and Fiscal Outlook – October 2018 (link) and OBR (2019) Economic and Fiscal Outlook – March 2019 (link)

[7] OBR (2014) Briefing Paper No. 6: Policy costings and our forecast (link)

[8] Scottish Fiscal Commission (2018) Scotland's Economic and Fiscal Forecasts – December 2018 (link)

2.27 Our decision to not cost a policy requires some, or all, of the following criteria to be met:

- High degree of confidence that the cost of the policy is low, even if there is a high degree of uncertainty as to the precise cost.
- The cumulative changes being made do not push the policy costing above the materiality threshold.
- Limited risk of significant behavioural response of taxpayers to a change in the tax or social security recipients to changes in social security.

2.28 Details of any policies the Commission has decided not to cost are included in Annex C of our SEFF publication. Box 2.3 explains the first policy we considered below the materiality threshold and therefore did not cost.

**Box 2.3: Young Carer's Grant**

At the time of our December 2018 forecasts, the Scottish Government was consulting on the development of a Young Carer's Grant (YCG). The YCG provides a £300 one-off payment, which can be applied for annually for young carers aged 16-17 or 18 and still at school, who meet certain qualifying criteria. The Government has committed to make YCG payments by autumn 2019.

Based on the available information we considered that the YCG would cost less than £0.5 million in each year of the forecast. Therefore we decided we would not produce forecasts of expenditure on YCG.

# Chapter 3
# What is a policy?

3.1 As taxes and social security benefits have been devolved to the Scottish Government, the design of these taxes and benefits has been changed as well as some operational aspects of delivery.

## What counts as a policy change?

3.2 A **policy change** is any change to an existing devolved tax or social security policy.

3.3 Policy changes that affect tax bases and tax rates are usually announced in the Budget and are included in our policy costings, unless they are deemed immaterial. These can include changes to tax rates, changes to thresholds at which different tax rates apply and changes to reliefs, exemptions or supplements to a tax.

3.4 Policy announcements relating to social security are also often made at other points through the year. These changes can relate to benefit rates, eligibility criteria, benefit design and delivery of the benefits. We would typically cost these changes at fiscal events or when the secondary legislation is laid in parliament. When and whether we cost them will depend on the information available such as the start date of the policy change or operational decisions that may affect spend.

3.5 We only provide policy costings for changes made by the Scottish Government to the taxes and benefits which we forecast. Changes made by the Scottish Government in other areas which affect tax revenue and benefit spending are incorporated in our pre-measures forecasts but are not modelled as separate policy costings. For example we would consider the effect of a change in the Scottish Government's policy on Help to Buy on house price and transactions forecasts, but we would not explicitly produce a separate policy costing for this.

3.6 Similarly we do not produce separate costings of UK Government policies which affect Scottish taxes and benefits but we do incorporate these effects in our pre-measures forecasts. For example we include an adjustment in our

Carer's Allowance forecast to account for the effect of changes to Universal Credit on Carer's Allowance entitlement but this is not a separate policy costing. Similarly in our income tax forecast, we include an adjustment for the auto-enrolment pension policy. As more people are contributing to pensions tax-free, this subsequently reduces the amount of income tax collected.

3.7 Our legislation requires us to cost only Scottish Government policy and not to consider alternative policy options. We include firm Government policy in our forecasts where there is sufficient information for us to produce a costing.

3.8 We do not consider policy aspirations. In these cases we will ask the Government to confirm whether a policy is a firm policy with the required level of detail of the policy available to cost or whether it is a policy aspiration. Policy aspirations are noted as a risk to our forecast.

## What information is needed to produce a policy costing?

3.9 The Commission considers each potential policy on a case-by-case basis. For policy changes made to a tax or benefit we forecast, we need detailed information of the Scottish Government's policy change. Normally the minimum information required to cost a policy includes: a date of implementation; a full description of the nature of the policy change; evidence that the proposed policy change can be implemented as described.

3.10 In some cases the Scottish Government may announce broad plans for a policy change but will not announce the details until much nearer the time of implementation. Where the detailed information required to produce a policy costing is not all available, and the change is planned to take more than one financial year in the future, we will note the potential for future policy change as a risk to our forecast rather than produce a costing.

3.11 Once a policy change is due to come into effect in the next financial year, we will produce a policy costing at the Budget even if we do not have all the information we would usually require. Where detailed information on the policy is still not available our policy costing will highlight the uncertainties. For example the Scottish Government did not announce a start date for the three benefits launched in 2019-20 in the 2019-20 Budget. Based on the Scottish Government's commitment to deliver the benefits 'by summer 2019' we assumed a start date of 1 June 2019 in order to produce a costing. This commitment always to cost policies coming into effect in the next financial year ensures the Scottish Budget is set based on the inclusion of all relevant policy changes, even if the costings will be uncertain.

3.12 The Scottish Government does from time to time announce policies which are not directly related to the taxes and benefits we forecast, but which may affect revenues, spending or the economy. For these broader changes we will only take them into account in our forecasts once there is clear information on how these policies will affect the economy as well as the taxes and benefits we're forecasting.

## Deciding not to cost a policy

3.13 There may be occasions when we would choose not to produce a policy costing. For example, if the Scottish Government inform us of a significant and complex policy change very close to the deadline for providing final forecasts there may not be sufficient time for us to cost the policy. In this case we would make it clear that the policy had not been costed and the reasons why.

3.14 There are also other cases where a policy change may not be costed. The recent introduction of the Non-Domestic Rates (Scotland) Bill in March 2019 provides some examples of decision criteria we have applied when considering whether or not to cost a policy change.[9]

**Table 3.1: Criteria used to decide whether to cost a policy**

| Criteria | Non-Domestic Rates (NDR) Example |
|---|---|
| The policy change is categorised as enabling, that is to say, if it grants the relevant authority, public body or agency the power to carry out a certain action, without requiring them to do so and the details of how the policy change will be implemented are not yet available. | The proposal in the NDR Bill to allow a Local Authority to serve a notice on a ratepayer receiving a relief other than empty property relief where the authority considers the property not to be in use or underused. |
| The policy change concerns the administration of a tax or benefit with no effect on revenue or spending. | Enabling local authorities to initiate debt-recovery procedures for non-payment of NDR sooner in the financial year. We would not consider any associated administrative costs for example IT system updates, changes to documentation, staff training, ratepayer awareness campaigns etc. |

[9] Non-Domestic Rates (Scotland) Bill (link)

| | |
|---|---|
| There is insufficient information contained either in the proposed legislation or in the Scottish Government's statement of policy intent provided to the Commission. | The move to a three-yearly revaluation for non-domestic properties combined with a new process for carrying out appeals. Only part of the new appeals process is included in the NDR Bill, with the rest to be detailed in subsequent legislation, as yet unwritten. |
| For a small policy announced through legislation rather than a fiscal event, a costing already exists and we judge that we are unable to provide an alternative based on superior data or method. | An example is the costing for the removal of eligibility to claim charity relief from non-domestic rates for mainstream independent schools. |

# Chapter 4
# How we produce policy costings

4.1 The Commission produces our forecasts in-house. Staff in the Commission develop and run the forecast models under the guidance of the Commissioners. Similarly we produce all policy costings in-house. The Commissioners take direct responsibility for forecast and policy costing judgements.

## Creating a pre-measures or baseline forecast

4.2 Before we produce a policy costing, we need to understand and cost the scenario where there is no policy change for the relevant tax or social security spending item. This is often referred to as the **baseline** and is used to create the **pre-measures forecast**. This is the starting point from which a policy change by the Government can be considered. We include all aspects of the policy controlled by the Government that can affect tax revenues or social security expenditure over the next five years. This includes tax rates and thresholds, allowances, benefit eligibility criteria, start dates etc.

4.3 There are no fixed rules for creating a baseline. Normally, our starting point is the policy as set by the Government in the previous Budget. We then consider a number of questions, the most important of which are:

- Is there a legislative basis for changes in **policy parameters** (for example tax rates and bands) over time? For example, is it in legislation that thresholds will rise with inflation?
- Has the Government previously given a clear indication of what it sees as a reasonable policy baseline?
- What is the historical precedent for the policy parameter? What expectation do taxpayers or benefit receivers have?

4.4 If there is no clear legislative basis for baseline policy assumptions, and the Government has not provided a clear indication of a policy baseline, then we will use our judgement to form a baseline based on our interpretation of historical precedent and public expectations.

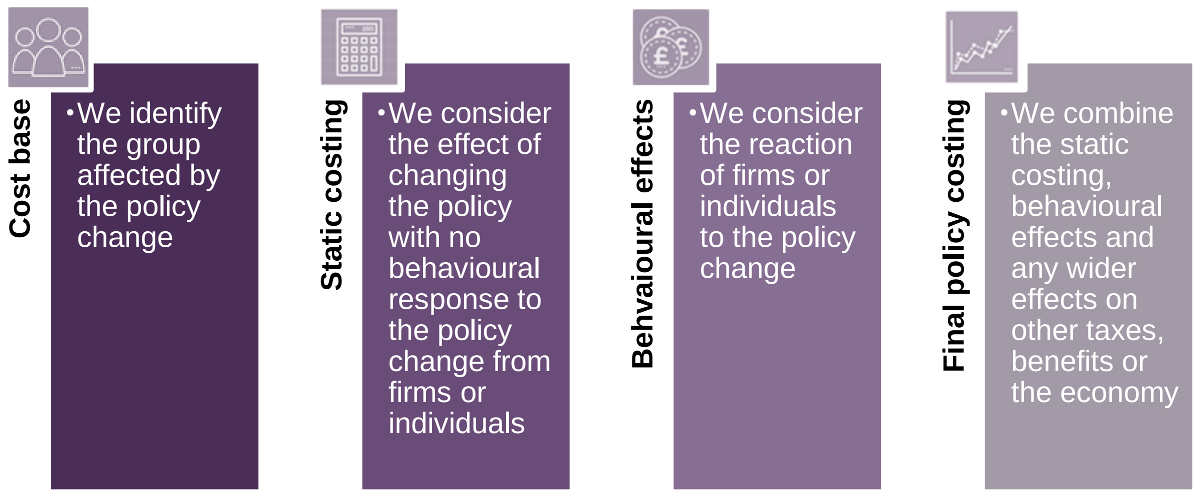
4.5 As the Scottish tax and social security system develops, we may change some of our baseline assumptions.

4.6 We will make clear to the Government our selected baseline at the first round of the forecasting process. We are open to discussing our assumptions with the Government. To maintain transparency we will also publish our assumptions together with our forecasts.

## Steps to creating a policy costing

4.7 Once we have a baseline and a pre-measures forecast we can start to consider the policy change and produce a costing. The detail of how each policy is modelled varies significantly, and the Commission keeps the approach to modelling policy costings under review. The broad approach for producing policy costings is consistent across the Commission and has the following steps:

**Figure 4.1: Steps to creating a policy costing**




### Cost base

4.8 The cost base is our estimate of the population that will be affected by the policy change. For example, for the LBTT first time buyers relief, the cost base was our estimate of the number of first time buyer transactions occurring in a given year in Scotland and their value. For the removal of eligibility to claim charitable rate relief from NDR for mainstream independent schools, the cost base is mainstream independent schools that are on the valuation roll and are currently claiming charitable rate relief.

## Static costing

4.9 A static costing involves calculating the immediate fiscal effect of a policy change without considering any behavioural responses from those affected by the change or any knock-on effects to the wider economy.

4.10 In the simplest form this would involve calculating tax revenue based purely on the number of people affected using the new tax rate and comparing this to the revenue raised under the previous tax rate.

4.11 When the cost base can be easily and accurately identified, we can have relative confidence in the static costing reflecting the effect of the policy change without any behavioural effects. The challenge is when there are uncertainties about the cost base or any uncertainties in the pre-measures forecast.

## Behavioural effects

4.12 Policy changes can affect the incentives and decisions made by people and by firms. We need to consider potential responses to both tax and social security policy changes. Policy makers may also change policy in order to achieve certain behavioural responses – for example Scottish Landfill Tax is designed to incentivise the redirection of waste away from landfill through alternatives like reuse or recycling.

4.13 There are typically three stages to estimating **behavioural effects**. First is to consider any behaviour by firms or individuals in anticipation of a policy change, what is referred to as **forestalling**. Second, is to consider what the longer-term changes in behaviour by individuals or firms might be. For example how might a change in income tax in Scotland affect the choice of where to work. Third is to consider whether there are any behavioural changes associated with the policy that are of sufficient scale to affect our economy forecast. Box 4.1 details the example of the introduction of the Additional Dwelling Supplement in 2016.

**Box 4.1: Additional Dwelling Supplement (ADS)**

The introduction of the Additional Dwelling Supplement on 1 April 2016 set a 3 per cent flat tax charge on any transaction above £40,000 where the buyer already owned a property.[10] The first and most noticeable response was from property buyers whose purchases would be affected by the tax bringing forward their

[10] The policy costing for the introduction of the ADS was produced by the Scottish Government in December 2015. The approach taken illustrates the principles we follow in producing policy costings.

transactions that would have completed in April or May 2016 into March – the forestalling behaviour.

The second response to consider was the extent to which the introduction of ADS would affect the number of properties purchased by those who already owned a property. The effect on the overall housing market was made more complicated by the fact that some second home buyers falling out of the market would be replaced by others, such as first time buyers.

The third response was the extent to which the introduction of the tax would be reflected in the purchase prices of the house. For example some home buyers with a fixed budget may simply have bid a lower amount for the property to accommodate the extra tax. Finally, there was the consideration about whether these changes would be sufficiently large to have a material effect on the economy forecast.

4.14 Similar challenges exist for social security costings, in particular when considering the proportion of the eligible population which applies for and successfully receives a benefit, known as the **take-up rate**. Taking up social security support is a choice and this behaviour can be influenced by Scottish Government policy decisions such as the ease of the application process.

4.15 Behavioural change is uncertain and challenging to quantify, even when good historic data are available. However behavioural change can often be material and we will always aim to consider the potential effect of behavioural change on our forecasts where possible.

4.16 As discussed in paragraph 4.13, as part of our consideration of behavioural responses we consider any wider potential economic effects as a result of the policy which could then feedback into our tax and social security forecasts. For example, if a policy has an effect on decisions on labour market participation or migration then this may affect our economic forecast and in turn our tax and social security forecasts. We incorporate these changes into our post-measures forecasts.

### Final policy costing

4.17 Finally we calculate the total effect on the tax revenues or benefit spending we are forecasting by comparing our pre-measures and post-measures forecasts. We also calculate the total effect on other areas. The two are combined to estimate the **final policy costing**.

4.18 When a tax or benefit is changed this can have effects on other areas the Commission forecasts. For example in our December 2018 LBTT forecasts we considered the effect of a change in the Additional Dwelling Supplement (ADS) rate from 3 per cent to 4 per cent. As the housing market is made up of a variety of buyer types such as first time buyers, home movers and buy-to-let landlords, we formed a judgement on the extent to which discouraged additional property buyers would be replaced by other groups, in particular first time buyers. This is because the tax change only directly affected one sub-group transacting in the Scottish housing market.

4.19 Some policy changes could be of sufficient magnitude to have an effect on Scotland's economy, which could then feed back into our tax and social security forecasts. For example, policies that affect decisions on labour market participation or migration. The effect of policies on the economy are hard to judge so we only include such effects where we judge them to have a significant effect, and to date, we have not included any in any of our forecasts.

## Uncertainties in policy costings

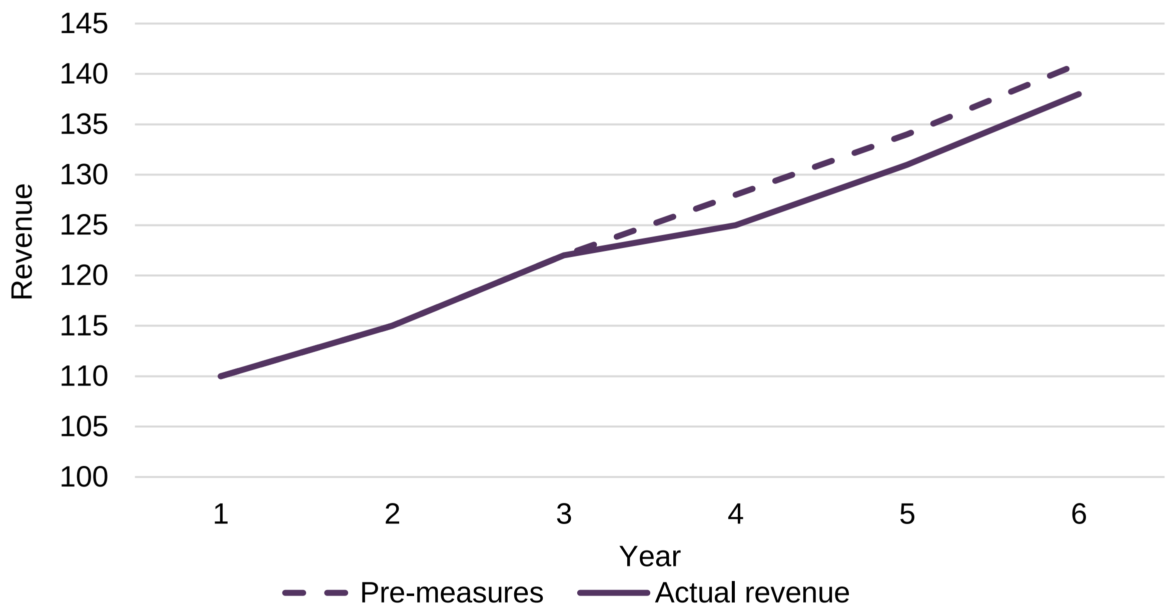
4.20 Policy costings are often subject to considerable uncertainties, ranging from whether it is possible to identify the affected population to what the response of individuals or firms affected will be. We will always publish our assessment of where these uncertainties lie and the extent to which we think they might affect our policy costing. These can be found in Annex A of our SEFF publications.

# Chapter 5 Evaluation of policy costings

## Alternative realities

5.1 In any policy costing we are trying to estimate the total cost or saving compared to a world in which there had been no policy change, which we earlier described as the **baseline**. When we come to evaluate policy costings, we can only observe what actually happened, and we cannot know with certainty what would have happened had a policy change not been implemented. This problem of alternative realities is illustrated in Figure 5.1.

**Figure 5.1: Pre-measures forecast compared to revenue under policy change**




Source: Scottish Fiscal Commission

5.2 In Figure 5.1, a policy change was introduced in year four that reduces revenues. The cost of the policy is the difference between the dashed line, representing the pre-measures forecast, and the solid line, representing actual revenues. Once outturn data are available, we know with certainty what actual total revenues were. However, we can never know with complete confidence what the no-policy-change alternative would have been, given the myriad factors that can affect the path of tax revenues or social security spending.

5.3 Even with outturn data available, we can still only approximate the effect of a policy change. This means that, when it comes to evaluating a policy costing, we can only compare our initial policy costings to what is hopefully a better estimate of the policy costing based on additional outturn data. And knowing one of the lines in Figure 5.1 does not necessarily give greater certainty about the difference between the two lines.

## Evaluating a policy costing

5.4 From the point where a policy change is first announced and we provide our first forecast, we update our policy costings as new information is received. This will likely include updates to our pre-measures forecasts, our policy costings or both. We can compare these updated policy costings to our original forecasts.

5.5 Once outturn data are available, we at least know for certain one component of the policy costing. Outturn data may also give us new insight into aspects of the policy costing, allowing us to improve our estimates. A few examples of this are provided in the following paragraphs.

### Take-up

5.6 For some policies the rate of take-up or compliance can be highly uncertain when the policy is first costed, particularly when individuals or firms have to apply. Outturn data in this case might improve estimates considerably. Even though the problem of not knowing what would have happened absent the policy change remains, we can have more confidence in attributing changes in take-up rates or compliance to a response to a policy change in some areas than others.

5.7 For example, in our social security forecasts if a benefit is made more generous or easier to access, and there follows a significant increase in spending, we might attribute some or all of this to the change in policy. This new information can help us to improve our future policy costings significantly. It can be more difficult to disentangle the effect of a policy change if several changes are made at once, for example if the number of eligible people increases at the same time the benefit is made more generous.

### Forestalling

5.8 Depending on the availability of data, forestalling responses can be relatively simple to observe. If daily or monthly data are available, it might be possible to observe a clear peak and trough in the data around the introduction of a policy change. If this is different to the more regular patterns in the data, we might be able to attribute this to forestalling. There will always be an element of uncertainty as to the exact scale of forestalling, as we cannot observe the scenario when the tax change was not introduced.[11]

5.9 By observing and estimating forestalling in the outturn data, we can create a better policy costing estimate.

5.10 Clearly observing a forestalling effect is not always possible. For example, a lot of income tax data are only available at an annual frequency, and this is unlikely to provide much clear information on forestalling effects.

## When will we evaluate policy costings?

5.11 We may choose to evaluate a particular policy costing and we would typically do this as part of our Forecast Evaluation Report that we publish each year. We may do this if:

- We believe the policy costing has had a material effect on our forecast error.
- The policy costing has changed significantly since our first forecast.
- There are good data available to evaluate the policy costing.
- There is significant public interest in the policy costing.

[11] Further information on estimating forestalling can be found in our September 2019 Forecast Evaluation Report in the discussion on forestalling ahead of the increase in the Additional Dwelling Supplement in January 2019. Scottish Fiscal Commission (2019) Forecast Evaluation Report (link)

# Abbreviations and Glossary

| | |
|---|---|
| **ADS** | Additional Dwelling Supplement |
| **DWP** | Department for Work and Pensions |
| **HMRC** | Her Majesty's Revenue and Customs |
| **LBTT** | Land and Buildings Transaction Tax |
| **NDR** | Non-Domestic Rates |
| **OBR** | Office for Budget Responsibility |
| **SEFF** | Scotland's Economic and Fiscal Forecasts |
| **YCG** | Young Carer's Grant |

**Baseline:** The scenario for the relevant tax or social security benefit where there is assumed to be no policy change. The baseline is used to create the pre-measures forecast.

**Behavioural effects:** Refers to how individuals or firms respond to a change in policy, which may increase or reduce the cost base.

**Cost base:** The population, money or transactions that will be affected by proposed changes to policy.

**Economic Determinants:** Factors that capture developments in the Scottish economy that may have a direct effect on our tax and social security forecasts, for example inflation or gross domestic product (GDP).

**Fiscal event:** A time when the Cabinet Secretary for Finance, Economy and Fair Work presents to Parliament the Scottish Government's Budget statement or Medium Term Financial Strategy. At a fiscal event, the Cabinet Secretary outlines the state of the Scottish economy and the Government's proposals for changes to fiscal policy.

**Fiscal forecasts:** Forecasts of revenue from taxes and spending on social security.

**Forestalling:** A particular kind of behavioural effect where individuals shift activity over time in response to a change in policy.

**Materiality threshold:** Materiality refers to relative significance of fiscal effects of policy changes compared to the overall size of devolved taxes and benefits. The materiality threshold is a set amount below which, the fiscal effect of a policy change is deemed very small.

**Policy change:** Any change to aspects of an existing devolved tax or social security policy.

**Policy costing:** An estimate of the change in revenue or spending resulting from a change in an existing Scottish Government fiscal policy or introduction of a new policy.

**Policy measures:** These are a set of proposed actions introduced to implement a tax or benefit spending policy.

**Policy recostings:** Refers to re-estimation of the effects of policy changes resulting from availability of new data or better understanding of the implementation of the policy changes.

**Post-measures forecast:** Final forecast that includes pre-measures forecast and policy costing of policy measures.

**Pre-measures forecast:** Estimates of tax revenues and social security spending in a scenario where aspects of existing policy may change without the Scottish Government making explicit changes to the policy. For example inflation may alter policy thresholds, tax rates or benefit rates.

**Primary legislation:** A primary legislation, also known as an Act of the Scottish Parliament, is a law made in the Scottish Parliament and receives Royal assent.

**Scorecard:** List of tax and spending decisions provided by the UK Treasury to the Office of Budget Responsibility (OBR) prior to UK fiscal events

**Secondary legislation:** Also known as subordinate legislation – made by executive bodies or individuals, for example Ministers, under powers granted to them by primary legislation. Secondary legislation often provides further details on its primary legislation.

**Static costing:** An estimate of the increase or reduction in revenues or spending after changes to fiscal policy without taking into account potential behavioural effects

**Supplementary costing:** An estimate of the effects of a new policy when Scottish Government introduces legislation to Parliament affecting taxes or benefits in our remit and which we have not previously costed at a fiscal event.

**Take-up rate:** The proportion of people eligible for a social security benefit, who apply for and successfully receive the benefit. Take-up rates also apply to the proportion of people eligible for a tax relief who apply for and successfully receive the relief.

**Voluntary compliance with the Code of Practice for Official Statistics**

The Commission seeks to adhere to the highest standards for analysis possible. While we do not produce Official Statistics (we produce forecasts), the Commission and our work voluntarily comply as much 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.

**Correspondence and enquiries**


Press enquiries should be sent to press@fiscalcommission.scot or call Caroline Rham 0131 244 0929; Mob: 07974227021

For technical enquiries about the analysis and data presented in this paper please contact:

| | | |
|---|---|---|
| **Economy** | Silvia Palombi | Silvia.Palombi@fiscalcommission.scot |
| **Income tax and VAT** | Chris Dunlop | Chris.Dunlop@fiscalcommission.scot |
| **Fully devolved taxes** | Rupert Seggins | Rupert.Seggins@fiscalcommission.scot |
| **Social security** | Claire Mellor | Claire.Mellor@fiscalcommission.scot |

For general enquiries about the commission and how we work please contact info@fiscalcommission.scot





This publication is available at www.fiscalcommission.scot

ISBN: 2019-978-1-911637-08-0

Published by the Scottish Fiscal Commission, September 2019