Scottish Fiscal Commission

Supplementary Note for Budget 2017-18

February 2017

Summary

1. The Scottish Fiscal Commission (the Commission) was established in June 2014 as a non-statutory body to provide independent scrutiny of Scottish Government forecasts of receipts and economic determinants from taxes devolved to Scotland.

2. From April 2017 the Commission will assume responsibility for the production of independent forecasts; this year is therefore the last year in which the Commission will scrutinise the Scottish Government's forecasts.

3. This note is a supplement to the Commission's Report on the Draft Budget. Since the Draft Budget 2017-18, the government's chosen policy on income tax has changed as discussed below, and this note assesses the reasonableness of the Scottish Government's new forecasts on this basis.

The revised policy

4. The Draft Budget for 2017/18 placed before the Parliament on 15th December 2016 assumed that the Higher Rate Threshold for non-saving, non-dividend income tax would rise in line with inflation in each year of the forecast. The revised forecast now assumes that the Higher Rate Threshold is frozen in nominal terms (at £43,000) for 2017-18, as opposed to the previous real terms freeze.

5. For the final four years of the forecast horizon, the Higher Rate Threshold is assumed to be frozen in real terms, as in the Draft Budget 2017/18. All other rates and thresholds for 2017-18 remain unchanged at the level assumed in the Draft Budget. This revision to the income tax parameters therefore results in an increase in NSND income tax liabilities as a result of a one-off temporary change in policy, relative to the original Draft Budget proposals. However, because this freeze in the HRT is assumed never to be reversed in the forecast period, it will have an impact on income tax liabilities throughout the whole forecast period.

6. The proposed change in policy results, as noted, in an increase in NSND tax liabilities. However, that increase is small, amounting to £28million in 2017/18 and rising, in cash terms, to around £36million by the final year of the forecast period. Relative to the original forecast of liabilities in each year, these figures represent substantially less than a one percent increase on the original forecast tax take. Relative to the inherent uncertainties in the headline income tax forecast, this does not amount to a statistically significant change in the forecast outturn.

7. In response to a request from the SFC, Scottish analysts re-ran the forecast assuming that behavioural responses (as reflected in the so-called Taxable Income Elasticities - TIEs) were twice as large as in the base forecast. This made a very

small impact in the forecast increase in liabilities. That reflects the fact, discussed in the SFCs Report on the Draft Budget 2017/18, that TIEs applied to changes in average tax rates (as opposed to marginal tax rates) are typically very small.

8. The revised forecast scenario assumes that the policy change only applies in 2017/18 before returning to the previous assumption of full indexation to inflation of the Higher Rate Threshold. If taxpayers come to believe temporary changes in policy are actually likely to be more persistent, perhaps because the factors lying behind the temporary change in policy are also likely to be present in the future, then larger behavioural responses may occur. As noted by Scottish Government analysts: "The published proposal in March is to increase Higher Rate Threshold by a maximum of inflation post 2017-18. We have assumed the upper limit of this proposal from 2018-19 onwards."

Macroeconomic Forecast

9. The proposed change in policy is small and the Scottish Government believes it will have no material impact on their macroeconomic forecasts. Given the forecast magnitudes outlined above, that judgment is reasonable. As noted above, however, if more material policy changes to income tax were to be proposed following the publication of future Draft Budgets, the SFC may need to re-visit the macroeconomic forecast and perhaps other forecast tax revenues (such as VAT).

Assessment

10. Overall, the Commission finds the Scottish Government's revised income tax revenue forecast to be reasonable.

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