Scottish Fiscal Commission

Bruce Crawford MSP
Convener
Finance and Constitution Committee
Edinburgh, EH99 1SP

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Sent via email

Dear Convener,

This morning HMRC published updated income tax outturn data for Scotland showing Scottish non-savings non-dividends (NSND) income tax revenues in 2018-19 were £11,556 million.[1] Growth in Scottish NSND tax revenues was greater than growth in NSND income tax revenues in the rest of the UK in 2018-19. The Scottish Government and HM Treasury have now published a final Block Grant Adjustment (BGA) and reconciliation relating to 2018-19 income tax.[2] A negative reconciliation of £309 million will be applied to the Scottish Budget for 2021-22 to adjust for the 2018-19 income tax outturn data.

Income tax reconciliations occur because of errors in the forecasts of Scottish income tax revenues and the income tax BGA. Our budget setting forecast in February 2018 anticipated Scottish income tax revenue growing by 8.6 per cent between 2016-17 and 2018-19, greater than the income tax BGA, which based on OBR forecasts was expected to grow by 4.8 per cent. Faster growth in Scottish income tax revenues compared to the BGA is explained in part by income tax policy changes in Scotland to raise additional revenue. Outturn data show the growth rates were much closer at 7.8 per cent for Scottish income tax revenue and 6.7 per cent for the income tax BGA. Our overestimate of growth in Scottish income tax revenues and the underestimate of growth of the BGA both contributed to the negative reconciliation. We have more detailed explanations of how BGAs and reconciliations work on our website.[3]

We cover three further points in this letter. First, what was our forecast error and how can this be explained. Second, how did our forecast error contribute to the - £309 million reconciliation. Third, what explains the difference between the final - £309 million reconciliation and our February 2020 estimate of -£555 million.

<u>Our February 2018 income tax forecast error</u>

The Scottish Budget for 2018-19 was set using our income tax forecasts published in February 2018 of £12,177 million.[4] Compared to the outturn data of £11,556 million, our February 2018 forecast had a headline forecast error of £621 million, or 5.4 per cent.

When we published our February 2018 income tax forecasts HMRC had not yet developed its outturn data on Scottish income tax. Instead, we based our forecast on historical data

[1] HMRC (2020) Scottish Income Tax Outturn Statistics: 2018 to 2019 (link)
[2] Scottish Government (2020) Scottish income tax outturn 2018 to 2019 (link)
[3] Scottish Fiscal Commission (2020) Explainers – Income Tax Reconciliations (link), Scottish Fiscal Commission (2020) Explainers – Block Grant Adjustments (link)
[4] Scottish Fiscal Commission (2018) Scotland's Economic and Fiscal Forecasts – February 2018 (link)

from a survey estimate of income tax revenues in Scotland, the best information available at the time. Our analysis suggests that, of the £621 million forecast error from our February 2018 forecast, around £538 million is because we did not have access to historical outturn data when we made our forecast. After adjusting for the 2016-17 outturn data, our forecast error was £83 million, or 0.7 per cent.

Importantly for the Scottish budget, the survey data were also incorporated in the baseline BGA used by HM Treasury and the Scottish Government to estimate the funding change. This means that using survey data in the budget setting forecasts had no direct net effect on the Scottish Government's budget. However, it does distort our forecast errors and makes understanding the effect of forecast errors on the reconciliation harder.

How did forecast errors contribute to the reconciliation?

Our headline budget setting income tax forecast error was an overestimate of £621 million, and the income tax BGA had a forecast error of £312 million. The combined effect of these forecast errors is a negative income tax reconciliation of £309 million.

After adjusting the original budget setting forecasts for the 2016-17 outturn data, we find that our forecast error contributed £83 million and BGA forecast errors contributed £207 million to the £309 million reconciliation, with a further £19 million unallocated.

Reconciliations can also be thought of as a result of differences in the net effect on budget between budget setting forecasts and outturn. When the Scottish Budget for 2018-19 was set, our income tax forecast was £428 million greater than the income tax BGA, leading to a £428 million positive net effect on the Scottish Budget. Outturn data now show Scottish income tax revenues were only £119 million greater than the BGA. The difference between these figures is equal to the -£309 million reconciliation.

What explains the difference between the final reconciliation and our February 2020 estimate?

In February 2020 we estimated a reconciliation for 2018-19 of -£555 million based on the latest SFC and BGA forecasts, £246 million below the -£309 million final reconciliation. Errors in our February 2020 estimates of 2018-19 Scottish income tax and the BGA both contributed to this difference. Our February 2020 income tax forecast was £178 million less than outturn, while the estimated BGA in February 2020 was £68 million above the final BGA, contributing to the £246 million difference between our latest estimate of the reconciliation and the final reconciliation figure.

In the Annex to this letter we provide further analysis of all three of these issues.

We'll publish a full evaluation of our income tax forecasts for 2018-19 on 5 October. For now, I wanted to provide an overview of the 2018-19 outturn data and what it means for the Scottish Government's Budget for 2020-21.

Yours sincerely,

Susan Rice

Dame Susan Rice DBE

Annex

Table 1 shows how the outturn data has changed over time, in particular comparing the 2018-19 outturn data to the 2016-17 initial deduction year figure.

Table 1: HMRC Scottish and rUK NSND income tax outturn data

£ million	2016-17	2017-18	2018-19	Total change since 2016-17
Scotland	10,719	10,916	11,556	
Growth (%)		1.8	5.9	7.8
rUK	149,713	154,199	160,750	
Growth (%)		3.0	4.2	7.4

Source: Scottish Fiscal Commission, HMRC (2019) Scottish income tax outturn statistics (link)
Figures may not sum because of rounding.

Scottish NSND income tax revenues grew significantly faster than rUK NSND income tax revenues in 2018-19, a reversal on 2017-18. Overall, since the 2016-17 initial deduction year for Scottish income tax, Scottish NSND income tax revenues have grown slightly faster than in the rest of the UK. Policies to raise additional revenues from income tax in Scotland will have contributed to this higher growth for Scotland.

The BGA is based on rUK growth in NSND tax revenues, and is also adjusted for relative population change between Scotland and the rest of the UK.

Our 2018-19 forecast error

The Scottish Budget for 2018-19 was set using our income tax forecasts published in February 2018 of £12,177.[5] Compared to the outturn data of £11,556 million, our February 2018 forecast had a forecast error of £621 million.

When we created our February 2018 income tax forecasts HMRC Outturn data on Scottish income tax did not yet exist. Instead, we based our forecast on a survey estimate of income tax revenues in Scotland, the best information available at the time. In July 2018 we received outturn income tax data for Scotland for the first time covering 2016-17. Table 2 shows how having access to outturn data would have affected our February 2018 forecast. We compare to 2016-17 as this is the initial deduction year for the purposes of calculating the income tax BGA.

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

Table 2: 2018-19 Scottish income tax forecast error, adjusted for base data issue

£ million	2016-17	2018-19
Original budget setting forecast		
February 2018 Budget setting forecast	11,214	12,177
Growth rate (%)		8.6
2018-19 forecast error		621
Adjusted forecast based on 2016-17 outturn		
2016-17 outturn and adjusted February 2018 forecast	10,719	11,639
Growth rate (%)		8.6
Adjusted 2018-19 forecast error		83
Outturn data		
Outturn	10,719	11,516
Growth between 2016-17 and 2018-19 (%)		7.8

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.

Outturn data shows Scottish NSND income tax revenues grew by 7.8 per cent between 2016-17 and 2018-19. In our February 2018 forecast we slightly overestimated the growth rate of Scottish income tax revenues between 2016-17 and 2018-19, forecasting growth of 8.6 per cent. Applying this growth rate to outturn income tax data for 2016-17 suggests we would have forecast income tax revenues of £11,639 in 2018-19 had outturn income tax data for 2016-17 been available.

On the basis of this adjusted forecast, our forecasting error would have been £83 million, much less than the headline £621 million error.

Of the £621 million forecast error from the February 2018 forecast, around £538 million is because we did not have access to outturn data when we made our forecast.

Importantly for the Scottish budget, survey data was also incorporated in the baseline BGA used by HM Treasury and the Scottish Government to estimate the funding change. This means that the data issue has no direct net effect on the Scottish Government's budget. However, it does distort our forecast errors and makes understanding the reconciliations harder.

How did SFC and OBR forecast errors contribute to the -£309 million reconciliation?

The Scottish Government's Budget is set using SFC forecasts of Scottish income tax revenues and forecasts of the Block Grant Adjustment (BGA) based on OBR forecasts. Scottish income tax revenues add to the budget, while the BGA reduces the budget. We call the combined effect of income tax revenues compared to the income tax BGA the net effect on budget. We have more detailed explanations of how BGAs and reconciliations work on our website.[6]

[6] Scottish Fiscal Commission (2020) Explainers – Income Tax Reconciliations (link), Scottish Fiscal Commission (2020) Explainers – Block Grant Adjustments (link)

Reconciliations are a result of errors in the forecasts of Scottish income tax revenues and the BGA. This is shown in Table 2.

Table 3: 2018-19 Scottish income tax and BGA forecast errors and reconciliation

£ million	Scottish income tax	BGA	Reconciliation
Budget setting forecast	12,177	-11,749	
Final outturn	11,556	-11,437	
Forecast error	-621	312	-309

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.

Table 2 shows that we overestimated Scottish income tax revenues by -£621 million. At the same time, based on OBR forecasts, the income tax BGA was overestimated by £312 million. The net effect of these two forecast errors leads to a reconciliation of -£309 million.

Reconciliations can also be thought of as a result of differences in the net effect on budget between budget setting forecasts and outturn. When the Scottish Budget for 2018-19 was set, our income tax forecast was £428 million greater than the income tax BGA, leading to a £428 million positive net effect on the Scottish Budget. Outturn data now show Scottish income tax revenues were only £119 million greater than the BGA. The difference between these figures is equal to the -£309 million reconciliation.

It is also helpful to look at SFC and BGA forecast errors stripping out the effect of the 2016-17 base data issue. We did this for our Scottish income tax revenue forecasts in Table 2 above. The exercise is repeated in Table 4 for the BGA.

Table 4: 2018-19 BGA, adjusted for base data issue

£ million	2016-17	2018-19
Original budget setting forecast		
February 2018 Budget setting forecast	-11,214	-11,749
Growth rate (%)		4.8
2018-19 forecast error		312
Adjusted forecast based on 2016-17 outturn		
2016-17 outturn and adjusted February 2018 forecast	-10,719	-11,231
Growth rate (%)		4.8
Adjusted 2018-19 forecast error		-207
Outturn data		
Outturn	-10,719	-11,437
Growth between 2016-17 and 2018-19 (%)		6.7

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.

Growth in the BGA, based on OBR forecasts of income tax revenue growth in the rest of the UK, was underestimated between 2016-17 and 2018-19. The BGA was forecast to grow by

4.8 per cent between 2016-17 and 2018-19. With outturn data now available for 2018-19, the BGA is known to have grown by 6.7 per cent. Had 2016-17 income tax outturn data been available, we estimate that a BGA figure of closer to -£11,231 million would have been used to set the Scottish Budget in 2018-19.

Table 5 shows how these adjusted forecasts contributed to the reconciliation.

Table 5: 2018-19 reconciliation, adjusted for base data issue

£ million	Scottish income tax	BGA	Unallocated Reconciliation [1]	Reconciliation
Adjusted budget setting forecasts	11,639	-11,231		
Final outturn	11,556	-11,437		
Forecast error	-83	-207	19	-309

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.
[1] Our methodology of adjusting historic forecasts means there is a small reconciliation value that is unallocated to either the SFC or OBR rUK forecasts.

Our analysis suggests that, had we had access to outturn data for 2016-17 when we made our 2018-19 income tax forecast, we would have overestimated Scottish income tax revenues in 2018-19 by £83 million. The BGA would have been underestimated by around £207 million.

Once the 2016-17 base data issue is accounted for, underestimation of the BGA accounted for more of the reconciliation than our underestimate of Scottish income tax revenues.

Scottish income tax outturn data was published by HMRC for the first time in July 2018. Our December 2018 forecasts, used to set the 2019-20 Scottish Budget, were based on the outturn data. Therefore, this base data issue will not be a factor in the 2019-20 reconciliation.

What explains the difference between the final reconciliation and our February 2020 estimate?

Table 6 shows the change from the February 2020 £555 million reconciliation estimate, compared to the finalised reconciliation. The Scottish income tax component increased by £178 million, with the BGA also reducing by £68 million.

Table 6: February 2020 estimate of £555 million reconciliation

£ million	Scottish income tax	BGA	Reconciliation
Budget setting forecast	12,177	-11,749	
February 2020 forecast [1]	11,378	-11,505	-555
Outturn	11,556	-11,437	-309
February 2020 difference from outturn	178	68	246

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.
[1] Scottish income tax component based on SFC February 2020 forecast. The BGA were provisional and agreed at the time of the Budget between SG and UK Government.