

SCOTLAND'S FISCAL FRAMEWORK
WRITTEN SUBMISSION FROM PROFESSOR DAVID BELL

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1. Introduction

Having been a contributor towards its drafting, I fully endorse the Royal Society of Edinburgh's Advice Paper 15-04, "Scotland's Fiscal Framework" and will be happy to answer questions on its content.

I would just like to make a few additional, perhaps more technical, comments. Some of these refer back to an earlier paper which I wrote for the Finance Committee (Bell 2011)¹ and to another paper which is not yet published. These remarks are associated with:

- a) Forecasting
- b) Data
- c) Reporting by the Independent Fiscal Body
- d) Revenue maximisation

I deal with these in turn. Throughout I assume that part of Scotland's fiscal framework will be the establishment of an independent fiscal body. My comments on these issues relate largely to the role of that body.

2. Forecasting

Accurate forecasting of tax receipts and welfare benefit costs will become more important if the Smith Commission proposals are put in place. The issues of *process*, *timing* and *methodology* will acquire greater significance because the cost of forecast errors will become proportionately greater. The remit of the independent fiscal body will extend beyond income tax, stamp duty land tax and landfill tax to also include

¹ Bell, Professor David (2011). "The Scotland Bill: Proposals for Forecasting and Reconciling Income Tax Receipts.", Scottish Parliament

Available at - http://s3.amazonaws.com/zanran_storage/www.scottish-parliament.tv/ContentPages/2472494430.pdf

VAT, air passenger duty and those welfare benefits which may come under the control of the Scottish Parliament.

In relation to process, there would seem to be a case for some joint agreement encompassing HM Treasury, the Office of Budget Responsibility, the Scottish Government and the independent fiscal body in Scotland as to the process for forming independent forecasts in Scotland.

In relation to timing, the Scottish parliament will have to review whether the timing of the various stages of the existing budget process remain fit for purpose, given that certain parts of the process will be contingent on the production of forecast of tax revenues and of welfare benefits.

In relation to methodology, there is a case for ensuring that the independent fiscal body in Scotland takes a different approach to forecasting from, say, the Scottish Government. This might include, for example, placing more weight on business assessments of future prospects. The dangers of “groupthink” in relation to economic forecasting are illustrated by the tendency towards mean reversion in forecasts of productivity growth by the Treasury and OBR. Thus, there is a tendency to assume that productivity will revert to its traditional annual rate of increase of around 2%, when the experience of the last seven years indicates that such growth is increasingly unlikely.

Another issue that will become, perhaps unexpectedly, important for Scotland is the forecasting of tax revenues in the rest of the UK. The reason is that the block grant adjustment, which will have an important influence on Scotland’s funding allocation from Westminster will in part be determined by tax revenue growth in rUK. The need for forecasts from rUK clearly suggests a need for coordination between Scotland’s fiscal body and the OBR.

Forecasting tax revenues inevitably implies taking a broader perspective on economic performance. Economic growth will be one of the principal drivers of increased tax receipts. To give an idea of the importance of this issue, I reproduce below a figure taken from an as yet unpublished paper which simulates the effects of

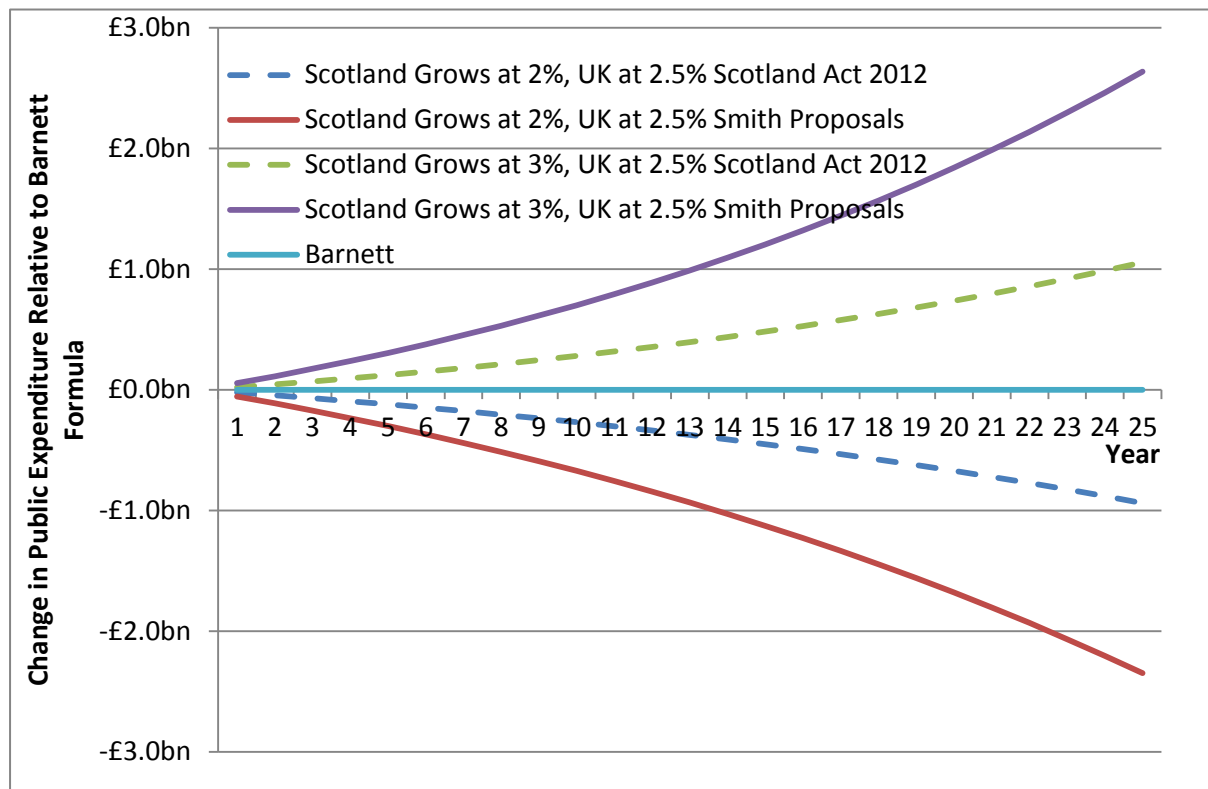
differences in the growth of tax receipts north and south of the border on the Scottish budget under the Barnett Formula, the Scotland Act 2012 and the Smith Commission proposals.

The upward sloping lines show the effect on Scotland's budget in 2013-14 prices of the Smith Commission (purple) and Scotland Act 2012 (green-dashed) proposals assuming that Scotland's tax receipts grow at 3 per cent while rUK tax receipts grow at only 2.5 per cent. The outcomes are measured relative to the Barnett Formula where rates of growth of tax receipts have no bearing.

The downward sloping lines show the effect on Scotland's budget in 2013-14 prices of the Scotland Act 2012 (blue dashed) and Smith Commission (red) brackets proposals assuming that Scotland's tax receipts grow at 2%, while rUK tax receipts grow more rapidly at 2.5%. Again the outcomes are measured relative to the Barnett Formula outcome.

Clearly the downside risks to the Scottish budget are greater the more extensive are the tax powers; conversely, the returns are greater with more tax powers when Scotland's tax returns are growing more rapidly than those in rUK. Again, outcomes are measured relative to the Barnett formula. No assumption is made about changes in tax rates since it is tax receipts that drive the block grant adjustment which in turn is the main cause of divergences from the Barnett Formula.

Figure 1: Changes in Scotland’s Budget As a Result of the Extension of Tax Powers



3. Data

I discussed the need to improve Scotland's capacity in relation to the collection of economic data in my previous paper. The proposals for increased powers are now much more extensive than was the case when that paper was written. The need for improved data is therefore more acute.

Not only do data have to be accurate, they also have to be produced at a time that they are still useful.

The Scottish Government has made considerable effort to provide a set of comprehensive national accounts statistics through the SNAP project. However, it might be appropriate now to open channels of communication with the Office of National Statistics to review the range of statistics that would be a necessary adjunct to the effective forecasting of Scotland’s tax revenues and welfare benefits with a view to identifying where improvements might be made in both accuracy and timing.

4. Reporting by the Independent Fiscal Body

The independent fiscal body should be tasked not only with the production of forecasts for Scotland's tax revenues, it should produce regular reports on:

- The accuracy of its forecasts and an explanation of where these have gone away. The OBR carries out this exercise on an annual basis for the UK as a whole².
- A fiscal sustainability report which looks at longer term pressures on the Scottish budget such as demographic change, skills development and public sector liabilities broadly defined etc.
- Scottish government borrowing - the increase in tax powers will inevitably lead to an increase in the magnitude of forecasting errors, which in turn will have to be matched by borrowing facilities. The arrangements for borrowing are likely to be tightly constrained, but the independent fiscal body should be able to take an oversight of these arrangements and comment on whether they are appropriate and sustainable.

The purpose of these reports would be to provide a more considered medium to long term perspective on Scotland's finances so that adjustments can be made gradually and taken, to some extent out, of the political fray.

5. Revenue Maximisation

Tax revenues are affected by actions taken by governments and tax authorities. Changes in exceedingly complex tax structures can lead to unintended consequences that affect revenues. The fiscal body should therefore perhaps be asked to monitor Scotland's income tax "gap". A tax gap is the difference between tax collected and that, which in HMRC's view should be collected. In my previous paper, based on HMRC estimates for the UK as a whole, I suggested that in 2007-08 Scotland would have a potential shortfall on its self-assessment returns of around

² Office for Budget Responsibility Forecast Evaluation Report-October 2014, Accessed at - <http://budgetresponsibility.org.uk/forecast-evaluation-report-october-2014-published/>

£550m – a significant share of its overall budget. The fiscal body may have a role in monitoring this gap, but it is also important to establish an understanding with HMRC about actions that might help reduce its size.