Cabinet Secretary for Finance and the Constitution
Derek Mackay MSP

Scottish Government
Riaghaltas na h-Alba
gov.scot

T: 0300 244 4000
E: scottish.ministers@gov.scot

Clerk to the Committee
Finance Committee
Scottish Parliament
Edinburgh
EH99 1SP

1 September 2016

Dear Clerk,

BUDGET 2017-18 AND RELATED ISSUES

Thank you for the letter the Convener sent to me on 25 August on behalf of the Committee. I welcomed the opportunity to meet the Committee on 23 August and would be pleased to meet again, in addition to formal evidence sessions such as that scheduled for 7 September, if that would be helpful.

The Convener indicated in his letter that it would be useful for the Committee to be kept updated as agreement is reached between the Scottish and UK Governments on the details of the operation of the revised Fiscal Framework, rather than awaiting the publication of the Draft Budget. I would be happy to provide the Committee with an update and I would suggest doing so at the end of September.

I also agree that the budget process review group should consider how to reflect in the budget cycle the process of reconciling block grant adjustments to tax receipts. Clearly from 2017-18 this becomes a more material exercise, as more of the Scottish Government's budget will be funded by devolved tax receipts. Figures in the most recent GERS publication[1] suggest that following the introduction of the new powers in the Scotland Act 2016, around 40% of estimated devolved expenditure (excluding Housing Benefit) will be funded from devolved tax receipts. A technical briefing for the Joint Working Group by SG officials may be helpful and I would be very happy for this to be arranged.

The focus of the Convener's letter and the enclosed Committee papers was on the process and timetable for this year's Draft Budget. I am grateful to the Committee for considering the points and proposals set out in my letter of 23 June, which we discussed when we met on 29

[1] http://www.gov.scot/Publications/2016/08/2132/331649 (Table 4.9)

June. I attach as an Annex to this letter responses to the questions enclosed with the Convener's letter.

It may also be helpful for me to draw together some overarching observations, having further reflected on the context and on the views the Committee has expressed.

Firstly, the level of potential economic and financial change presented by the EU Referendum outcome, and what that could mean for the UK and Scottish economy and public finances, is unprecedented and therefore uncertain, but likely to be substantial. Clearly the economic implications are still emerging and the Scottish Government and other agencies are taking a range of mitigating steps based on fostering stability and growth. However, the Committee will be familiar with the range of economic forecasts that have emerged since the Referendum. For example, in its August 2016 Inflation Report, the Bank of England has revised down its forecasts of GDP growth in 2017-18 from 2.3% to 0.8%[2], the largest downward revision in forecasts since the Monetary Policy Committee was established. On 23 August 2016, the Scottish Government also published analysis[3] setting out the potentially very challenging medium-term implications of different post-Referendum scenarios for the economy and the public finances.

The Committee paper illustrates the potential scale of the revisions to income tax forecasts between March/July and November/December, based on previous fiscal events. These demonstrate the likelihood of volatility in forecasts even at points of relative stability in the economy. It is worth noting that volatility has been much greater at times of economic uncertainty. For example, prior to the onset of the 2008 financial crisis, the UK Spring Budget forecast from March 2008 was for income tax receipts to grow by 6.8% in 2009-10, whereas the pre-budget report published in November 2008 forecast a fall in income tax receipts of 3.5% over the same period. Such a 10.3 percentage point swing in the growth rate would result in much larger revisions to the Block Grant Adjustment (BGA) for income tax, as set out in detail in the Annex to this letter.

As we discussed on 23 August, the Office for Budget Responsibility (OBR) will forecast later this Autumn (at the time of the Autumn Statement), movements in future revenues available to support public expenditure. If revenue forecasts are revised down materially, the Chancellor of the Exchequer will have to choose among delivering further reductions in spending plans, investing to stimulate growth, adjusting tax policies to manage receipts, reviewing forecasts of demand-led social security spending, and revisiting the UK Government's borrowing strategy. The UK Government has already confirmed that, in responding to the considerable shock to the economy, it is moving away from the key borrowing rule underpinning its fiscal strategy, and the Chancellor has commented that he is looking to reset UK fiscal policy. Depending on the balance the Chancellor chooses to strike, the Autumn Statement could therefore bring significant changes to the Scottish Budget for 2017-18 and beyond. This would occur not only through decisions to reduce spending which would impact on our block grant directly via Barnett, but also (for the first time) through changes to taxes in the rest of the UK that are devolved to Scotland, via the Fiscal Framework.

---

[2] http://www.bankofengland.co.uk/publications/Documents/inflationreport/2016/aug.pdf
[3] http://www.gov.scot/Resource/0050/00504615.pdf

Significant budget reductions would take the Scottish Government, Scottish Parliament and stakeholders into very challenging territory during the budget process. The task of removing what could be several hundred million pounds from a carefully balanced set of budget proposals would be complex and time consuming. Such a process is likely to require a large proportion of the budget to be revisited – it is not simply about adjusting a small number of budget lines.

As a result, a pre-Autumn Statement Draft Budget would not carry the necessary credibility. Spending allocations set out in that budget could not be relied on by public bodies as a basis for planning and decision-making - as they might be substantially revised. It would be particularly difficult to manage a situation where expectations raised by provisional allocations had to be revised downwards later.

I also recognise the time and information required by the Scottish Fiscal Commission to robustly assess the forecasts of around £16 billion of tax revenues (based on 2015-16 figures provided in GERS 2015-16[4]), where the Autumn Statement is a material data source for their work.

For these reasons, I believe it would not be an effective use of the time and resources of the Parliament and of the Scottish Government to develop and publish a Draft Budget ahead of the Autumn Statement - comprising a balanced package of spending, tax and borrowing plans, supported by a range of forecasts of receipts and estimates of future block grant adjustments - given the strong likelihood that we would have to revisit all of these components a matter of weeks later.

The Committee has understandably been keen to obtain figures for the level of volatility and risk that would exist should the Draft Budget be published before the Autumn Statement, and require amendments thereafter. As I have indicated above and elsewhere, the fact that we are dealing with such a wide range of economic, financial, political and forecasting uncertainties means that it is difficult to quantify the scale of individual risks or overall risk. Volatility in previous years is not going to be an accurate indicator of what might take place at the next Autumn Statement. Even the impact of a c.£200 million reduction – less than 1% of Scotland's RDEL budget - as a consequence of these risks crystallising in the Autumn Statement, would require significant revision to the Draft Budget in order to produce a revised set of balanced and sustainable budget proposals.

It is the accumulation of risk and uncertainty for the Scottish budget which will not be resolved until this year's Autumn Statement is published that leads me to propose holding back the Draft Budget. I would reiterate my offer to work with the Committee to consider what steps could be taken before the Autumn Statement to support scrutiny, and also to make myself and officials available to support your work following publication.

I hope this is helpful and look forward to meeting the Committee on 7 September.

Yours

DEREK MACKAY

[4] http://www.gov.scot/Publications/2016/08/2132/331649 (Table 4.9)

ANNEX

FINANCE COMMITTEE QUESTIONS

To what extent has the Scottish Parliament process been taken into account in taking forward the negotiations on the Fiscal Framework with the UK Government?

The Fiscal Framework agreement reached between the Governments in February supporting the powers in the then Scotland Bill was subject to a Parliamentary debate in which key elements of the framework were explored. The Parliament approved a Legislative Consent Motion for the Scotland Bill on 16 March 2016. The detailed arrangements set out in the technical annex which was agreed in March were reported to the Parliament. In reaching these agreements, Ministers were very aware of the need to provide information to the Parliament about the arrangements.

It was always the case that the new powers proposed by Smith and the supporting arrangements to be agreed in the Fiscal Framework would have some implications for when latest Scottish funding forecasts would be available for the following year. UK economic and fiscal forecasts are produced by the Office for Budget Responsibility (OBR) for each fiscal event – the Spring Budget and Autumn Statement. Using the latest of these provides the most accurate picture of funding available for Scotland in the year ahead, as it will have a direct impact on the block grant adjustments (which are calculated using forecast growth in corresponding tax receipts elsewhere in the UK) and the Barnett consequentials flowing to Scotland. The alternative to using the most recent OBR forecasts produced for the Autumn Statement would be to use forecasts published for the Budget the previous March, which will be less accurate. Basing a draft Budget on March forecasts creates the unsatisfactory situation of drawing up spending plans based on figures that we know will shortly be superseded.

The Joint Working Group which has been set up between the Finance Committee and the Scottish Government will help to address these issues. There are trade-offs to be discussed and agreed in deciding on any future changes to processes and timetables.

What priority has been given to securing data sharing arrangements specifically on tax outturn data as set out in the Fiscal Framework?

We have established the principle of reciprocal data sharing in the Fiscal Framework and this will be underpinned by MoUs. Paragraph 77 of the Fiscal Framework technical annex makes clear that both governments and independent forecasters will work together to ensure that the Scottish Government and Scottish Fiscal Commission will *"have access to the necessary data, information and models held by the UK government to support policy development and produce forecasts of a comparable quality to those produced by the OBR."*

Officials are currently discussing and agreeing with HMRC and others the details of the information to be shared. The existing MoU between the Scottish Government and HMRC governing Scottish income tax includes a provision for data sharing and good progress has already been made, where HMRC is making additional information available for the Scottish Government to support preparation of its 2017-18 income tax forecasts. If for any reason difficulties arise in agreeing data sharing arrangements between officials, Ministers have the option of discussing and agreeing issues at the Joint Exchequer Committee. The Finance

Committee could also ask the Chief Secretary to the Treasury to give evidence on this or any other topic. We would be happy to include progress with data sharing in the proposed update to the Committee referred to in the covering letter.

How does the Minister intend to ensure that there is transparency in relation to the on-going negotiations in relation to the Fiscal Framework?

Many of the key issues have been settled in the Fiscal Framework agreement and the technical annex, both published earlier in the year. Some remaining details, including the precise contents of some calculations, which datasets to use, which data items are to be shared, and the profile of financial transfers relating to implementation and administration costs, are still under discussion because further work has been necessary to get to the level of detail required.

As indicated in the covering letter, we would be happy to keep the Committee updated on progress between the Scottish and UK governments on these issues, and we have suggested doing so at the end of September. Scottish Ministers or Scottish Government officials would be happy to provide oral updates to the Committee at any time. Final agreements will be signed off by the Joint Exchequer Committee and we have also committed to full transparency regarding the block grant adjustment calculations and comprehensive figures will be included in the Draft Budget.

Who will produce the in-year forecast for 2016-17 (the baseline adjustment) for income tax?

Estimated Scottish income tax receipts for 2016-17 will be produced by the OBR. The block grant adjustment for 2017-18 will be derived by indexing the 2016-17 baseline to OBR forecasts of growth in income tax receipts per head in the rest of the UK.

Responsibility for producing Scottish income tax forecasts for 2017-18 will lie with the Scottish Government subject to scrutiny by the Scottish Fiscal Commission (SFC). For 2018-19 and future years SFC will be responsible for preparing forecasts. It is expected that the OBR and the SFC will work together on these forecasting arrangements.

All forecasts, whether of baselines, Scottish growth per head, or growth per head in the rest of the UK, will in future be reconciled back to actual receipts once relevant data is available, and any adjustment to the block grant needed in the light of the reconciliation will be applied in the following year.

Forecasting errors, whether relating to Scottish tax receipts or to the block grant adjustment, will thus be corrected. Forecast errors in relation to income tax in respect of 2017-18 should be reconciled by the summer of 2019, and any necessary adjustments applied to the block grant in respect of 2020-21. For the wholly-devolved taxes, reconciliation would be completed by autumn 2018, with any adjustments applied to the block grant in respect of 2019-20.

What account has been given to the timing of Draft Budget 2017-18 regarding the timing of that in-year forecast?

The baseline forecast for Scottish income tax receipts in 2016-17 will be produced by OBR and supplied to the Scottish Government in advance of the publication of the Draft Budget 2017-18. If the Scottish Government's Draft Budget were to be published before the Autumn

Statement, OBR's forecast would be based on a provisional estimate drawn from forecasts published with the UK Budget in March 2016. The forecast will be revised at the Autumn Statement in the light of updated UK economic and fiscal forecasts.

To what extent has the Scottish Government assessed the scale of the risk to the Scottish budget arising from the reliance on forecasts produced in March relative to forecasts produced in November?

Tax forecasts are dependent on the economic conditions when the forecasts are made. Economic conditions will change over time, and so will change between UK Budgets and Autumn Statements. Therefore the scale of errors (compared to outturn data) in forecasts for the following year will tend to reduce when made using the most up to date economic data. This is achieved by basing tax forecasts on latest available OBR forecasts of UK economic determinants based on current data, which are published alongside the Autumn Statement. This is also likely to reduce the scale of the reconciliation adjustments required once outturn data for income tax and the fully devolved taxes become available.

In respect of 2017-18, revisions to the income tax forecasts between the March 2016 Budget and this year's Autumn Statement may be higher because of the unpredictable effect of the Brexit vote and the increased uncertainty over the UK Government's future fiscal plans, as explained in the covering letter.

The Committee paper that you enclosed with the Convener's letter shared comments on revisions to tax forecasts and how these have changed between OBR's Budget figures and Autumn Statement figures. However, it is important to note that the time period covered by the paper (2013-2015) reflects a relatively stable economic period. During the 2008 financial crisis, variances were much larger, as shown in the amended Table 1 below.

Table 1: Change in UK income tax forecasts at Autumn Statement, relative to March Budget (or July Budget for AS 2015)

	In year forecast		**Forecast for following financial year**	
	£bn	**As % total UK income tax forecast**	**£bn**	**As % total UK income tax forecast**
Nov - 08[5]	**-3.5**	**-2.2%**	**-19.9**	**-11.6%**
Dec -13	0.8	0.5%	1.8	1.1%
Dec -14	-3.6	-2.2%	-6.1	-3.6%
Dec - 15	1.6	0.9%	2.1	1.1%

Between the March Budget 2008 and the Pre-Budget Report published in November 2008, the forecast increase in UK income tax revenues between 2008-09 and 2009-10 was revised down by more than £16 billion. Moreover, the 2008 UK Budget forecast was for income tax receipts to grow by 6.8% in 2009-10, whereas the following pre-budget report forecast was for a fall of 3.5% in the same year. This gives a 10.3 percentage point swing.

As an illustration, assuming a Scottish income tax receipts baseline of £12 billion in 2016-17, a 10.3 percentage point swing could result in a revision of Scotland's BGA of more than £1

[5] See Pre-Budget Report 2008, page 203. It should be noted that these forecasts predate the OBR which was created in 2010. Moreover, changes in how the public finances figures are measured mean that the 2008 figures are not directly comparable to the figures presented in later Budgets.

billion. Clearly the net impact on the SG budget of a repetition of such an event would depend on the difference between the revisions to the Scottish and rUK forecasts. However, it illustrates that revisions have in the past been substantially larger than over the last three years and the economic impact of the Brexit vote is still emerging.

The Committee paper quotes a 0.2 percentage point change, comparing income tax forecasts produced in the additional Budget of July 2015 and those accompanying the Autumn Statement 2015. However the change in the growth rate of income tax receipts between the March 2015 Budget and the Autumn Statement 2015 would have been larger at 2.0 percentage points. This would have resulted in a larger revision to the Scottish income tax BGA of around £240 million.

If the Draft Budget is published after the Autumn Statement, does the Minister anticipate that there would be another forecast published at the time of the Budget Bill?

For the 2017-18 Budget the Scottish Government will produce the forecasts of Scottish tax receipts and the SFC will provide independent scrutiny and assurance of the reasonableness of these. Based on the proposal to publish the Draft Budget this year after the Autumn Statement, we do not expect another Scottish tax receipt forecast between the Draft Budget and the Budget Bill, since the lag time would be short – probably less than 2 months. Neither do we expect the OBR to publish revised forecasts for UK economic and tax growth between the Autumn Statement and the Scottish Budget Bill. In relation to the 2017-18 financial year, forecast figures would next be revisited once outturn data was available, unless there was a material change in economic circumstances.

Can the Minister clarify whether it will be the Draft Budget forecast or the Budget Bill forecast which will unlock the resources available to the Scottish Government, in respect of income tax?

The forecast to be used in the 2017-18 Draft Budget (which will be subject to scrutiny and reporting by the SFC) will be notified to the UK Government and used as part of the calculation of what will be paid over by HMT to the Scottish Government in funding during the year. Funding will ultimately depend on the net amount of forecast tax receipts (on the one hand) and the block grant adjustment (on the other). The BGA will depend on OBR forecasts of growth in tax receipts per head in the rest of the UK.

For 2018-19 onwards the SFC will produce independent forecasts of Scottish Government tax receipts, social security expenditure and onshore GDP. The precise timing of the SFC's forecasts will be considered and agreed in the light of the Joint Working Group's proposals.

What assessment has the Scottish Government made of the likelihood that revisions to the forecast for Scottish income tax made at the time of the Autumn Statement would be offset by the forecast to the BGA for income tax?

Page 6 of the Committee paper includes the following statement:

> *"neither the OBR nor Scottish Government/SFC has access to tools, models and data that allow them to estimate Scottish income tax revenues with much greater accuracy than assuming that Scottish revenues are a particular share of UK revenues…. [and therefore that]…..revisions to the UK forecasts at the Autumn Statement will also tend to imply equivalent revisions to Scottish forecasts."*

The Scottish Government has developed, and is now discussing with Scottish Fiscal Commission, modelling approaches that use Scotland-specific determinants (as well as UK economic determinants) and build up income tax receipt forecasts on the basis of these Scottish determinants. Taking into account these Scottish determinants will result in forecasts that should be more accurate than the "constant share" approach described in the paper and which are driven by UK determinants. Therefore there is scope for revisions to Scottish income tax revenue being different to revisions to the corresponding BGA. Since outturn data for Scottish devolved receipts is not available yet, we cannot say with certainty whether and to what extent forecast errors for Scottish receipts (produced by the SG/SFC) and for receipts in the rest of the UK (produced by the OBR) are correlated.

Under some scenarios forecast errors may cancel each other out, but in other scenarios they may not – an example of this would be where an economic shock may have a disproportionately larger, or smaller, impact on the Scottish economy than the rUK economy.

The Scottish Government will monitor outturn data as it becomes available in order to gain a better understanding of the relative accuracy of the SG/SFC forecasts compared to those produced by the OBR, and therefore the impact on the Scottish budget of revisions to income tax forecasts and the block grant adjustment.