Scottish Fiscal Commission tax and economy forecasts, May 2019

This note covers the key implications of the SFC's latest forecast document.

GDP forecast

The forecast for GDP growth in 2019 has been revised down from 1.2% to 0.8% since December (Table 1). This is despite a slightly improved outlook for earnings and longrun unemployment. The reason for the reduction in GDP is the continued uncertainty created by the Brexit negotiation process together with evidence from various business sentiment indicators. Consequently, GDP growth is anticipated to be slower in 2019 than in 2018 (when it was 1.3%), and to return only slowly to 1.3% by 2023.

Table 1: GDP growth forecasts, Dec 2018 and May 2019

	2018	2019	2020	2021	2022	2023	2024
Dec-18	1.4	1.2	1.0	1.0	1.1	1.2	
May-19	1.3	0.8	0.9	1.1	1.2	1.3	1.3

Source: SFC forecast report, table 2.8

The SFC is forecasting that Scottish GDP growth will be somewhat slower than the OBR is forecasting for the UK. But this is largely because of slower projected population growth in Scotland. On a per capita basis, growth in Scotland is forecast to be only slightly slower than in the UK, largely reflecting a more pessimistic outlook for productivity growth in Scotland (Table 2).

Table 2: Comparison of OBR and SFC GDP growth forecasts

		2018	2019	2020	2021	2022	2023	2024
GDP	OBR Mar-2019	1.4	1.2	1.4	1.6	1.6	1.6	
	SFC May-2019	1.3	0.8	0.9	1.1	1.2	1.3	1.3
GDP per person	OBR Mar-2019	0.8	0.6	0.9	1.1	1.1	1.1	
	SFC May-2019	0.9	0.5	0.6	0.9	1.0	1.0	1.1

Source: SFC forecast report, table 2.9

Income tax – the overall narrative

The next few pages provide some detailed analysis about why income tax reconciliations have come about, and the factors that explain this. In an attempt to provide clarity, this section summarises the key points without using charts or tables.

As the Committee has discussed previously, the fiscal framework brings two types of risk to the Scottish budget:

- First, there is the risk that the Scottish tax base grows more slowly than the equivalent rUK tax base. If this happens, the Scottish budget may end up being smaller than it would have been without tax devolution.
- Second is the risk of forecast error. A Scottish budget may be set based on an assumption that more resources are available to spend than turns out to be the case.

In theory, these two risks are completely independent of one another. For example:

- It is perfectly possible that the Scottish tax base could grow more quickly than the rUK tax base, so that outturn revenues are higher than outturn BGA. But there could still be a

negative tax reconciliation if the initial forecasts had suggested that the Scottish tax base would grow even more quickly (relative to the rUK) than is ultimately observed.
- Equally, it is possible that outturn revenues could be lower than the BGA but there was a positive reconciliation in Scotland's favour. This could arise if the initial forecasts had suggested that Scottish revenues would perform worse than was ultimately observed.

So what has happened to generate the negative income tax reconciliations, and the particularly large reconciliation in 2018/19?

When the SFC published its forecasts to inform the 2018/19 Budget, it expected the Scottish tax base to grow at about the same rate as the rUK tax base. This meant that the full effect of the Scottish income tax policy impacted the Scottish budget – witnessed by revenues being higher than the BGA.

Since then, the SFC has revised down its forecast for Scottish tax base growth (although in reality not by a huge amount). But at the same time, the OBR has revised up its forecast for rUK tax base growth, quite substantially.

The latest forecasts thus suggest that the Scottish tax base will grow a bit more slowly than the rUK tax base. According to the latest forecasts, Scottish revenues will be smaller than the BGA, despite the Scottish income tax policy.

If the forecasts at the time of the 2018/19 Budget had been 'correct', there would be no need for a reconciliation in 2021/22. But the 2018/19 Budget would have been £608m smaller than it was (and we would clearly have had a different debate at that time).

Another way to look at this is to say that the Scottish tax base has grown slightly more slowly than the rUK tax base, but because this differential was not foreseen, it has to be dealt with after the event, through reconciliation, rather than at the time.

But it is important to remember that the reconciliation does not reflect a substantial downgrade to the performance of the Scottish economy (or Scottish tax base) relative to what the SFC had forecast at the end of 2017. Instead, it largely reflects unexpectedly buoyant performance of rUK income tax revenues, which the OBR did not foresee at the time.

Income tax forecast

How has the income tax forecast changed since December? As is always the case, some factors act to increase the forecast, whilst others act to reduce it.

- The upward revision is due to an improved outlook for earnings growth following better-than-anticipated outturn figures on earnings published since December.
- However, most of the improvement in the forecast as a result of improved earnings growth is offset by a downward reduction to the forecast as a result of an improvement in the way that the effects of pensions auto-enrolment is accounted for (auto-enrolment reduces revenues because pension contributions are not taxed).
- The forecast is also revised down (very slightly) to account for new taxpayer survey data

On balance however, the effect of the improved outlook for earnings outweighs the downward adjustment associated with the other two factors. The SFC's income tax forecast has been revised up (very slightly) since December, for each year of the forecast period.

'Net tax' position for income tax

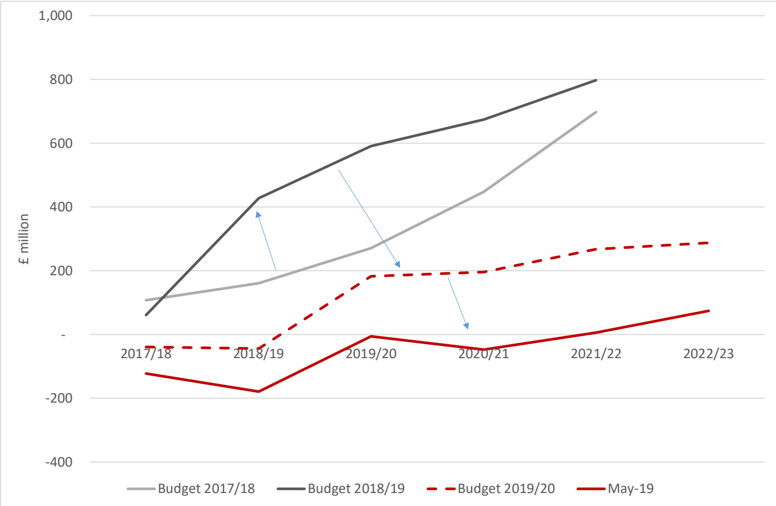
What matters for the Scottish budget is not simply the outlook for Scottish revenues, but the outlook for the 'net tax' position – the difference between Scottish revenues and the Block Grant Adjustment (BGA). The BGA is the estimate of the revenues foregone by the UK Government as a result of transferring a tax to Scotland. It is calculated by assuming that, if it had not been devolved, revenues from the tax in Scotland would have grown at the same per capita rate as they have done in the rest of the UK.

The 'net tax' position has deteriorated since December. Although the Scottish revenue forecast has improved by £20 million in 2019/20, the forecast of the BGA has increased by £208m. Thus the 'net tax' position for 2019/20 has in fact worsened by £188m since December.

Chart 1 shows the evolution of the net tax position across successive fiscal events. It can be interpreted as follows:

- When the 2017/18 budget was set, revenues were forecast to outperform the BGA by £100m, largely as a result of the Scottish Government's decision to freeze the higher rate threshold. In years beyond 2017/18, the net tax position was forecast to continue to improve, as a result of a slightly stronger earnings outlook in Scotland than rUK.
- When the 2018/19 budget was set, the net tax position improved substantially, largely because of the Scottish Government's tax policy announcements.
- By the time of the 2019/20 budget however the net tax position had deteriorated substantially. This was due to a combination of a downward revision to the SFC forecast with an upward revision to the OBR forecast for rUK.
- In the latest analysis things have deteriorated again. In 2019/20, Scottish revenues are forecast to be equal to the BGA. But this is despite the fact that Scottish taxpayers are paying £500m more in tax revenues than they would be if the UK Government policy applied. Slower growth in the Scottish tax base relative to rUK tax base since 2016/17 has cost the Scottish Government £500m in 2019/20, wiping out any dividend of higher revenues from increased tax rates.

Chart 1: Income tax 'net tax' position at successive fiscal events



Income tax reconciliations

Budgets are set based on forecasts of Scottish revenues and the BGA. Once outturn data is available (approximately 16 months after the end of the financial year), reconciliations are applied to the following year's budget.

Income tax outturn data is not yet available for any year since income tax devolution has taken place. Outturn for 17/18 will be published this summer, with reconciliation applying to the 2020/21 budget.

In the meantime, the latest forecasts give the most up-to-date picture as to the likely scale of reconciliations. The indicative reconciliations are shown in Table 3. This shows for example that, when the 2017/18 Budget was set, revenues were forecast to be £107m higher than the BGA, and the budget was planned on that basis. Latest forecasts for 2017/18 however suggest that revenues will be £122m less than the BGA. The difference between £107 and minus £122m, minus £229m, will be 'reconciled' in Budget 2020/21.

Table 3: Indicative reconciliations (£ million)

	Budget forecast			Latest forecast			Indicative reconciliation
	Revenues	BGA	Net	Revenues	BGA	Net	
Budget 17/18	11,857	11,750	107	11,005	11,127	-122	-229
Budget 18/19	12,177	11,749	428	11,486	11,665	-179	-607
Budget 19/20	11,684	11,501	183	11,703	11,709	-5	-188

Why has the net tax position deteriorated since budget forecasts were made? Is it due more to error on the part of the Scottish forecasts, or more due to error on the part of the rUK forecasts?

At first glance it is not easy to answer this question. This is because the forecasts for both Scottish revenues and the BGA declined substantially following the publication of 2016/17 outturn data in summer 2018. We need to strip this effect out, and instead look at how forecasts of *annual growth*, of both Scottish revenues and the BGA, have changed[1]. This is done in Table 4 below. This shows that:

- When the 2017/18 budget was set (row 1), the Scottish Government forecast that Scottish revenues would grow 2.9% in 2017/18; latest data (row 4) suggest growth of 2.7%, so the original Scottish Government forecast appears to have been only marginally too optimistic. In contrast, the 2017/18 Budget forecast the BGA to grow 2%; latest data indicate it will grow by 3.8%. **A larger part of the 2017/18 reconciliation is thus due to upward revisions to the OBR forecast as opposed to downward revisions to the Scottish forecast**.
- When the 2018/19 budget was set, the SFC forecast growth in Scottish revenues of 3.3% and 5.1% in 2017/18 and 2018/19 respectively (*cumulative growth of 8.6%).* The latest data suggests somewhat weaker growth in both years (*cumulative 7.2%*). The OBR initially forecast growth in the BGA of 2.8% and 2% in 2017/18 and 2019/20 (*cumulative growth of 4.8%*). Under its latest forecasts, the implied growth is 3.8% and 4.8% (*cumulative growth of*

[1] Looking at the annual forecast growth in the BGA is a proxy for annual forecast growth in rUK income tax revenues. In practice the growth of the BGA mirrors growth in the rUK income tax forecast.

8.8%). **A majority of the 2018/19 reconciliation is thus again due to upward revisions to the BGA, rather than downward revisions to the Scottish forecasts**.

- The emerging picture for 2019 is again, of larger proportionate revisions to the BGA (and implicitly to the OBR's forecasts for rUK) than to the Scottish forecasts.

Table 4: Forecast growth on previous year, successive budget events

		2017/18	2018/19	2019/20
Scottish revenues	Budget 2017/18	2.9%	3.9%	5.1%
	Budget 2018/19	3.3%	5.1%	3.9%
	Budget 2019/20	2.7%	4.0%	2.0%
	May-19	2.7%	4.4%	1.9%
BGA	Budget 2017/18	2.0%	3.5%	4.2%
	Budget 2018/19	2.8%	2.0%	2.6%
	Budget 2019/20	3.1%	4.1%	0.1%
	May-19	3.8%	4.8%	0.4%

What has caused the downward adjustments to Scottish forecasts (in particular between December 2017 and more recently) and the upward adjustment to rUK forecasts?

The explanation relates in large part to adjustments to forecasts for average earnings. The Committee has previously discussed the downward revisions to the forecast for Scottish earnings made by the SFC from its December 2017 to May 2018 budgets. This was due to an 'evolution of judgement' about the outlook for Scottish earnings – although by December 2018 the SFC had revised its earnings forecast back up again.

At the same time as the SFC has been revising down the forecast for Scottish earnings, the OBR has been revising up the forecast for UK earnings. These revisions have tended to reflect stronger than anticipated outturn data on earnings growth.

Table 5: Forecasts for average earnings growth

	2017	2018	2019	2020	2021	2022	2023
SFC							
Dec-17	2.0	2.2	2.4	2.6	2.8	3.1	
Dec-18	1.5	2.0	2.3	2.5	2.8	3.0	3.1
May-19	1.5	2.6	2.6	2.7	2.9	3.1	3.3
OBR							
Nov-17	2.3	2.3	2.3	2.6	3.0	3.1	
Oct-18	2.7	2.6	2.5	2.8	3.0	3.1	3.2
Mar-19	2.8	3.0	3.1	3.0	3.1	3.1	3.3

Income tax reconciliations – summary

This discussion can be summarised as follows:

- Income tax reconciliations for 2017/18 and 2018/19 can be explained by two factors: the forecasts made for Scottish income tax by the SFC when budgets were set now appear to have been too optimistic; at the same time, the forecasts made by the OBR for rUK income tax now appear to have been too pessimistic.

- However, the OBR's forecasts for rUK have been revised up by proportionately more than the SFC's have been revised down.
- It is important that this is not seen as an exercise in blame. To some extent it is in the nature of forecasting, and it cannot be seen as evidence that one forecasters is superior to the other.
- The explanation for the revisions to forecasts largely relates to the difficulties in forecasting earnings growth. When the 2018/19 budgets were set, both forecasters had very similar assumptions about future earnings growth. Subsequently, the SFC has revised its earnings forecast down whilst the OBR has revised its up.
- These revisions have largely been driven by emerging outturn data. 2017 appears to have been a particularly 'bad year' for Scottish earnings growth relative to rUK. The difference in forecast earnings growth between the SFC and OBR is around half a percentage point in 2018 and 2019 and then narrows in subsequent years.

LBTT

The forecast for residential and non-residential LBTT has been revised down slightly since December as a result of slower than anticipated price growth and weaker outturn data in the residential and non-residential markets respectively.

Under current forecasts, LBTT revenues are forecast to be slightly higher than the BGA in 2018/19, and then around £80m per annum higher in 2019/20 – 2021/22 (Table 6). The Committee asked the SFC about the explanation for this strong net tax position in its Budget 2019/20 report. The SFC's explanation was that it reflected the more progressive tax rates in Scotland, the lower price distribution of Scottish properties which increase the effects of 'fiscal drag', and the higher rate of Additional Dwelling Supplement (see page six).

Table 6: LBTT Revenues and BGA

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Revenues	557	553	616	655	691	724	759
BGA	584	547	535	568	611	651	705
Difference	-27	6	81	88	80	73	54

Landfill Tax

The forecast for landfill tax has been very slightly revised up since December. There is forecast to be a large reduction in revenues in 2020/21. This results (mainly) from the planned ban on Biodegradeable Municipal Waste that is due to come into force in 2021, (combined to a lesser extent with new waste incineration capacity coming on stream).

As a result of the forecast drop in revenues in 2020/21 – due to the ban on Biodegradable Municipal Waste – revenues are forecast to be substantially lower than the BGA in that year (offsetting the forecast positive position for LBTT) – Table 7.

Table 7: Landfill Tax revenues and BGA

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Revenues	148	143	109	87	12	14	15
BGA	113	105	92	86	92	84	72
Difference	35	38	17	1	-80	-71	-57

Non-Domestic Rates

There have been only small changes to the NDR forecast since December, and these are largely due to updated data on appeal losses. Policy changes are forecast to raise £9m in 2020/21 (withdrawing independent schools from charitable relief is forecast to raise £7m, whilst withdrawing NDR exemptions for certain types of buildings, such as cafes in local authority parks is forecast to raise £2m).

The balance of the NDR pool is currently projected at minus £100m in 2019/20 (this is the difference between the distributable amount in 2019/20 and the projected contributions for 2019/20 plus adjustments from previous years).

Social security

The detail of social security policy is the concern of the Social Security Committee, but spending on the new social security powers is significant, and forecast error in relation to social security spending could have implications for other areas of the budget.

Social security spending informing the 2019/20 Budget is forecast at £467m (Table 3.3 of the SFC report). Most of this (£323m) is accounted for by the Carer's Allowance and Carer's Allowance Supplement. Several of the social security benefits currently forecast by the SFC are small in monetary terms (e.g. Best Start Grant, Best Start Foods, Funeral Support Payment cost £31m in total, and spending on employability services is around £16m), although there is significant uncertainty about forecast spending on some of these the benefits given the 'new' nature of the benefits and the lack of data). Forecast expenditure on Discretionary Housing Payments (£64m), and the Scottish Welfare Fund (£33m) is somewhat higher.

But more significantly, fiscal responsibility for the remaining benefits to be devolved will transfer to the Scottish Parliament by April 2020 at the latest. This is an important point that has perhaps been overshadowed by media reports about rollout of the Scottish benefits taking place over the period to 2024/25. The point about rollout is correct, but fiscally the Scottish budget takes the risk from spending on social security benefits in full from 2020/21.

Specifically, the SFC will forecast expenditure on devolved social security benefits from 2020/21. The Scottish Government will reimburse DWP for continuing to deliver benefits to Scottish claimants, until claimants are transferred to the Scottish Social Security Agency. Forecast Scottish spending on benefits such as DWP and PIP and their replacements will depend on the way that the replacement benefits are designed, and the pace at which claimants are transferred onto the replacement benefits.

The Scottish Budget for 2020/21 will include spending for all benefits being devolved. In practice this will result in social security spending rising by a further £3bn in the 2020/21 Budget (Table 3.4 of the SFC forecasts). Note however that the SFC has not yet been able to cost in detail the Government's intended policy changes to some of these benefits, as there is not yet sufficient detail on the nature of intended policy change. The SFC thus notes that its illustrative forecasts for the remaining benefits are 'likely to underestimate expenditure'.

In short, there are substantial budgetary risks associated with the new social security powers, and these budgetary risks are transferred to the Scottish budget in 2020/21, despite the fact that most claimants will still be receiving a UK benefit from the DWP at that point.

(It may also be of interest to note that, for 2018/19, Scottish Government expenditure on the Carer's Allowance is forecast to be £5m less than the BGA, whilst in 2019/20 expenditure is forecast to be

£1m less than the BGA. If these forecasts are 'correct' it will mean that Scottish Government expenditure is slightly less than the additions to the block grant for this benefit. Of course the costs of the 'Carer's Allowance Supplement', forecast at £37m in 2019/20, have to be met from elsewhere in the Scottish budget).

VAT

Analysis provided by Ross Burnside, SPICe.

The SFC has revised down its Scottish assigned VAT forecasts due to the emergence of new data since December 2018. The forecasts incorporate small revisions to historic VAT assignment outturn estimates, which were published by HMRC on the same day as the MTFS (and shared with the SFC in advance). In addition, the OBR's March 2019 UK VAT receipts were revised down, and the SFC has assumed that Scottish VAT assignment follows a similar pattern. The downward revision to the economy forecast also impact on the expenditure liable for VAT. The combination of these three effects are presented in Table 8.

Table 8: Changes to SFC VAT forecast since December 2018

£ million	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
December 2018	5,033	5,383	5,631	5,801	5,966	6,122	6,279
Revised outturn	-21	-19	-19	-25	-29	-30	-30
UK determinants	0	-3	-85	-68	-59	-53	-52
Economic determinants	0	-0	-13	-1	1	4	9
May 2019	5,012	5,361	5,514	5,707	5,879	6,043	6,205
Change from December 2018	-21	-23	-117	-94	-87	-79	-73

The SFC report seems to chime with recent analysis from the Scottish Government that there are risks to the Scottish Budget from random fluctuations in data, and there never being actual VAT outturn revenues available. The SFC report states:

"The VAT reconciliation will be based on VAT assignment estimates. Differences between our VAT assignment forecasts and VAT assignment estimates could be because the Scottish economy performed differently to what we expected, or it could be because of unobserved random variation generated by the LCFS sample, or any other changes in the VAT assignment model. This would expose the Scottish Budget to an additional sampling error risk which does not apply for any other taxes or benefits where the actual amount raised or spent is eventually known.

It is difficult to fully understand the sampling error issue when there is limited published information on VAT assignment estimates. We think further data, analysis and discussion is needed to fully understand the risks to the Scottish Budget of VAT assignment and to consider mechanisms for handling sampling error risks."

Members may wish to probe the Commissioners on whether they consider the assignment of VAT to be workable, and how their thinking has evolved since the December 2018 forecast.