ANNEX – CORRESPONDENCE BETWEEN SCOTTISH GOVERNMENT AND FRASER OF ALLANDER ON SEPTEMBER 2017 ECONOMIC COMMENTARY OR SCOTLAND'S BUDGET 2017

EMAIL 1

From: NAME REDACTED
Sent: 05 September 2017 11:57
To: 'Graeme Roy'
Subject: RE:

Hi Graeme,

On the implied deflator, it can be volatile from quarter to quarter (depending on which industries are contributing most to growth, and what is happening with prices (implied or otherwise) of their output) but is running at 2.5% over the year which looks fairly sensible.

However, there is also something else going on. We still publish more detail on the implied deflator in Supplementary Table 5, where you can see that the GVA at basic prices implied deflator increased by 0.7% over the quarter, compared to 0.2% for the GDP at market prices deflator. A similar differential exists in the UK statistics (1.1 and 0.5), which is driven in both cases by a nominal decrease in the basic price adjustment (taxes less subsidies). In real terms, movements in GDP at market prices are assumed to equal GVA at basic prices, as there isn't a clear concept for the volume of taxes less subsidies (especially in the short term), meaning that this shakes out as an implied price effect… Over the year the differential in the implied deflator more or less disappears, indicating that at least part of the issue is timing in the measurements, perhaps offset by changes in inventories, etc…

However, it does make me think I should consider adding the GVA implied deflator back into the summary table if that makes it easier to interpret these things.

Thanks

NAME REDACTED

NAME REDACTED

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 05 September 2017 07:38
To: NAME REDACTED
Subject: RE: Scottish Output Gap.xlsx

Hi NAME REDACTED

Sorry, one other thing – just following on from this.

I was looking at the national accounts data again and there was 0% net growth in domestic final expenditure. So all the growth was coming through exports. And total nominal growth in GDP was only 0.8% when real GDP growth was 0.7%.....so the deflator must be very small this time around?? Table A says 0.2%....that seems very low.

Thanks,

Graeme

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 02 September 2017 17:55
To: NAME REDACTED
Cc: NAME REDACTED
Subject: FW: Scottish Output Gap.xlsx

Hi NAME REDACTED,

I was wondering if I could run a couple of things past you.

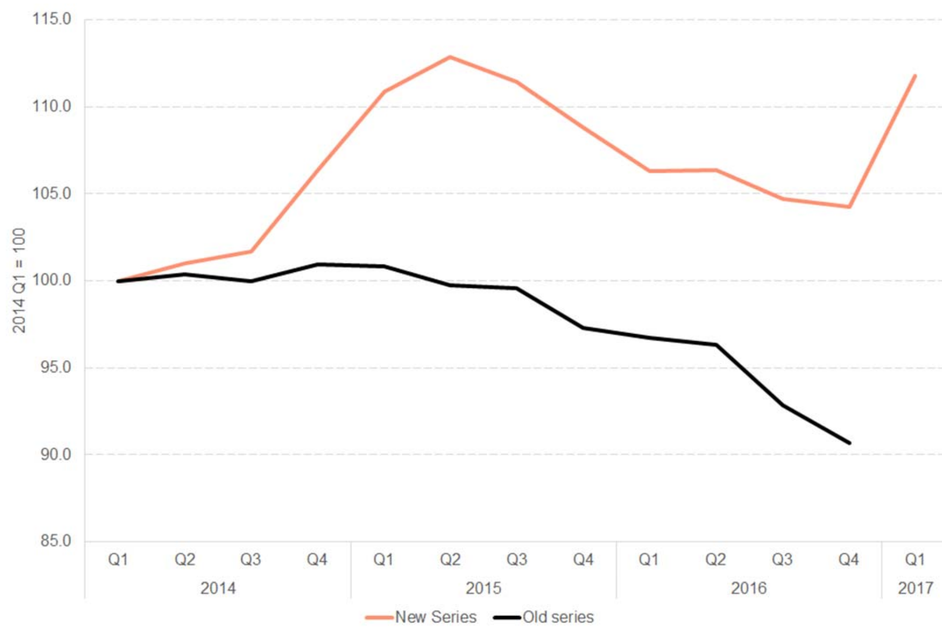
I'm drafting up the next fraser commentary and trying to weave in a narrative about the strong growth in Q1. Part of that – you may have seen from one of our earlier blogs – was to talk about the sector splits and the fact that there was really strong growth in a few areas.

From the national accounts, in terms of cash GDP I notice that net trade made quite a difference this time around. Both exports to the UK and exports internationally.

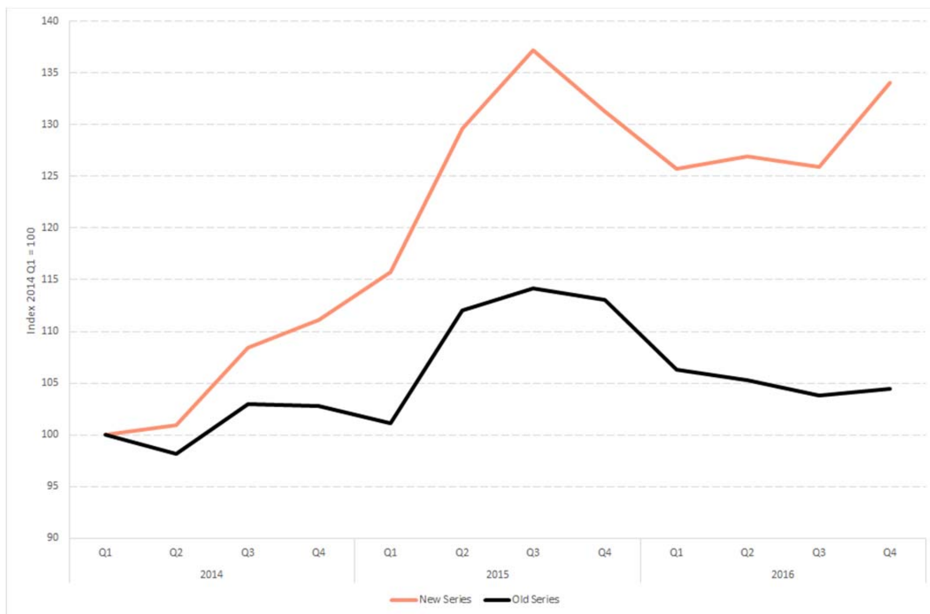
- Is the UK export growth driven by offshore activity? And is there any way of checking from public data?

- And I think I'm right in saying that there have been quite big revisions to IME? I've pasted a couple of charts. First one is IME indexed to 2014Q1 and then 2nd one is petroleum and pharma. From what I can see this changes the narrative quite a bit about Scottish export performance in recent times….so just wanted to double check.

Ps. I think that there might be a minor typo in the stats release – you say that this is the first quarterly rise in 7. But actually Q2 2016 is up 0.1% on the new figures.



Petroleum etc.



Thanks for your help!

Graeme

EMAIL 2

From: NAME REDACTED
Sent: 08 September 2017 15:55
To: 'Graeme Roy'
Cc: NAMES REDACTED
Subject: RE:

Hi Graeme,

Sorry it's taken so long to get back to you on this.

Exports in QNAS are benchmarked to the I-O tables to 2014, and additionally for IME (but not Services ROW exports or RUK exports) we bring in data at this time from ESS for 2015. This is the main reason for revisions being introduced up to and including 2015. In theory the results now should be closer to next year's balanced benchmark for 2015 (and reduce the need to further revisions next year – although potentially introducing revisions for 2016…) than using simply the Monthly Business Survey based estimates. In more recent periods, IME is revised due to a combination of the reweighting of elementary series and routine data cleaning updates. The results in the IME are subject to a higher degree of uncertainty that the equivalent turnover estimates for GDP, despite using mostly the same data source, because exporting propensity tends to be much more heterogeneous within each industry. But yes, this does introduce a few quarters of quite strong growth into a period that was previously estimated to be fairly consistently tanking.

In terms of exports to the RUK, the short term (post-2014) trends in this are estimated using changes in the domestic output of each industry/product. This means that when domestic output is strong, RUK exports are estimated to be correspondingly strong – so I don't think this could be attributed to demand from offshore activity in particular.

I hope that helps

Thanks

NAME REDACTED

NAME REDACTED

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 02 September 2017 17:55
To: NAME REDACTED
Cc: NAME REDACTED
Subject: FW: Scottish Output Gap.xlsx

Hi NAME REDACTED,

I was wondering if I could run a couple of things past you.

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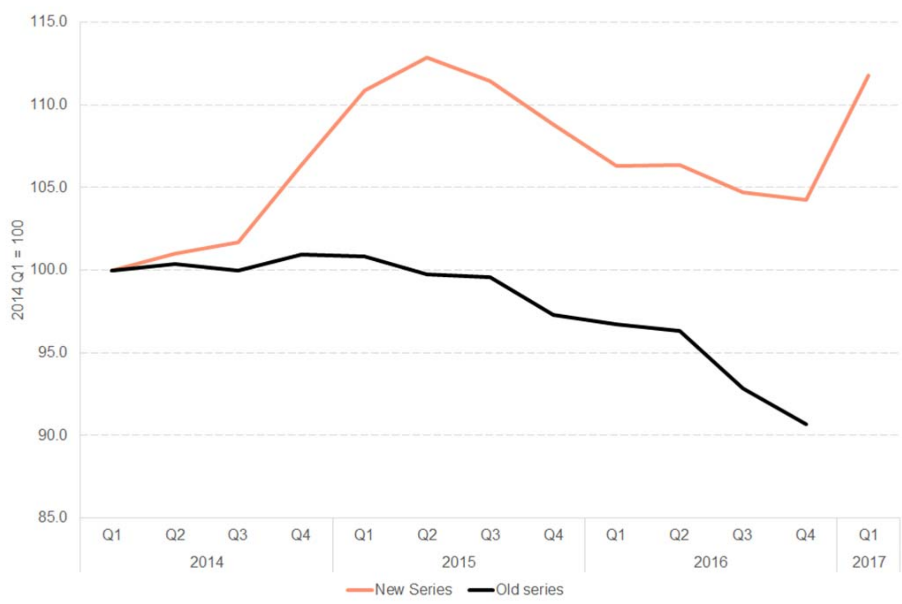

Petroleum etc.

Thanks for your help!

Graeme

EMAIL 3

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 05 September 2017 09:41
To: Nicholson J (John); Grisewood A (Aidan)
Subject: Private: Draft Chapters
Importance: High

John/Aidan

It was good to catch-up.

As discussed, I've attached the first three chapters of our budget report in draft form. There are gaps and the formatting/text will be tidied up ok.

It would be good if you could provide any comments. In particular, we'd be keen to ensure that you were content that you recognised the various budget numbers we are using etc. so that we avoid confusion.

We'd also be more than happy to take on board any suggestions. Or feedback on bits that you don't think we have worded accurately or fairly.

I appreciate that you will be busy with the budget and the PfG. But if you were able to get us any comments by the end of the week that would be much appreciated.

Happy to discuss.

Best wishes,

Graeme

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Chapter 1: Economic Outlook

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly with major new powers over taxation and welfare.
- Around 40% of devolved expenditure are now funded by tax revenues generated in Scotland – a figure that will rise to 50% once VAT revenues are assigned.
- As a result, Scotland's economic performance – or more accurately, Scotland's economic performance *relative* to the UK – now has a much greater bearing on the outlook for the Scottish budget than ever before.
- This autumn, for the first time, the Scottish Fiscal Commission (SFC) will provide detailed forecasts for Scottish devolved taxes, income tax and GDP. The Office for Budget Responsibility (OBR) will be preparing forecasts for the relevant Block Grant Adjustments.
- Both of these will be shaped by their assessments of the outlook for the Scottish and UK economies respectively and the outlook for the key determinants of changes in the revenues collected from each individual devolved tax.
- Despite showing signs of resilience in the immediate aftermath of the EU referendum, UK growth has slowed markedly in the first half of 2017. The strong growth in consumption that propped up the economy in 2016 has tailed off. Business investment remains flat, whilst the boost to trade hoped for following the sharp fall in Sterling has yet to materialise.
- Whilst Scottish growth data for the first quarter of 2017 was more positive than we could have hoped for, the Scottish economy has been weaker than the UK economy over the last two years – in part, driven by challenges in the North Sea.
- Indeed, refreshed figures published last month show that the Scottish economy *contracted* slightly in 2016. But employment is now at a record high with one of the lowest unemployment rates in the UK.
- Over time, what matters most for the Scottish Budget is how Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.
- But in looking ahead to this year's Scottish Budget, what will also be crucial will be the actual forecasts made by both the SFC and OBR. It is the combination of these two forecasts that will determine, at the margin, how much more or less money the Cabinet Secretary for Finance will actually have this year to spend.
- Given recent data, we believe that the Scottish Fiscal Commission is likely to be cautious in their forecasts for growth and Scottish taxation over the next few years.

Whilst the Scottish economy made a welcome return to growth during the first three months of 2017, this was on the back of output actually contracting

during 2016. Employment is at a record high and there are some signs of confidence returning to the North Sea. But with Brexit and weak confidence, we expect the Scottish Fiscal Commission to be cautious in their forecasts for Scottish tax revenues and economic growth in this year's Budget.

1.1 Introduction

The Scottish budget is in the process of significant reform.

As a result of the Scotland Acts 2012 and 2016, substantial new fiscal powers are being transferred to Holyrood, including the devolution and assignment of tax revenues and the devolution of some social security powers.

The Scottish Parliament will soon oversee annual public spending of around £XX billion, control all land and property taxation, and have significant responsibilities over income taxation in Scotland.

The outlook for Scotland's budget now depends upon three key elements –

- What remains of the Westminster block grant – as determined by the Barnett Formula;
- Future tax policy choices of the Scottish Government; and,
- The relative performance of Scottish devolved tax revenues.

UK economic performance and spending decisions taken at Westminster will continue to set the overall envelope for Scottish public spending through the Barnett formula.

But with Scotland's block grant now being adjusted (i.e. reduced) to take account of the new devolved tax revenues, how Scottish tax revenues perform relative to the rest of the UK now have a much greater bearing on the outlook for the Scottish budget than ever before.

In time, it is this relative economic performance that will determine whether or not the Scottish Budget is better or worse off relative to what it would have been prior to devolution.

But for the immediate outlook of next year's Budget and the trajectory to the end of the Parliament, it will be the forecasts made for Scottish tax revenues and the equivalent taxes in the rest of the UK by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) that will be crucial.

This chapter is structured as follows.

Section 1.2 summarises the key elements of this new fiscal framework and explains how Scotland's relative economic performance will now feed through to budget outcomes.

Section 1.3 summarises the recent performance of the Scottish and UK economies. Section 1.4 discusses the outlook.

Section 1.5 highlights some of the key issues facing the Scottish Fiscal Commission in the compiling of economic and tax forecasts for Scotland than will face the Scottish Fiscal Commission.

Section 1.7 concludes.

1.2 Scotland's fiscal framework

The new powers

The Scottish Parliament's new tax and welfare powers are being phased in gradually over the next few years. With these new powers has come fundamental changes to the way that the Scottish budget is calculated and administered.

New arrangements for fiscal forecasting have been put in place with the Scottish Fiscal Commission achieving statutory status in April this year.

The Scottish Government has secured more extensive borrowing and cash management tools to manage budget volatility and uncertainty.

At the same time, implementing the new powers is requiring substantial technical and administrative work, much of which is ongoing. The way in which Scottish budgets are presented to and scrutinised by the Scottish Parliament is also changing.

Table XX provides a summary of the new responsibilities for taxation – including the taxes devolved as part of the 2012 Scotland Act.

Table X: Devolved, shared and assigned tax revenues in Scotland

Tax	Date of transfer/ devolution	Revenues raised 2015/16 (£m)	Degree of control by Scottish Parliament	Responsibility for collection
Land and Business Transactions Tax (LBTT)	2015	£416	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	£147	Fully devolved; complete autonomy.	Revenue Scotland
Income tax	2017	£11,214	The Scottish Government can set the rates and bands. But the UK Government defines the tax base and sets allowances.	HMRC
Air Passenger Duty	2018	£275	Fully devolved; complete autonomy	Revenue Scotland
VAT	2019	£5,000	Assigned revenues; no autonomy	HMRC
Aggregates Levy	tbc	£53	Fully devolved; complete autonomy	Revenue Scotland

Source: Government Expenditure and Revenue Scotland (GERS)

A new Scottish tax agency, Revenue Scotland, has been established to collect revenues for the fully devolved Scottish taxes (LBTT, Scottish Landfill Tax, Aggregates Levy, and Air Passenger Duty, which the Scottish Government has announced will be renamed 'Air Departure Tax').

Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC.

Alongside taxation, some devolution of social security benefits is also taking place.

In particular, a number of UK-administered benefits, mainly related to ill-health, disability and carers are being devolved. The benefits associated with the regulated social fund – such as winter fuel payments – are also being devolved.

Spending on these benefits in Scotland by the UK Government in 2015/16 totalled around £3bn – see Table XXX.

[insert table on the new social security powers]

The Scottish Government is currently working to establish a new social security system in Scotland, with implementation dates for the new powers to be agreed by the Joint Ministerial Group on Welfare.

Additionally, the Scottish Government has already gained the power to:

- create new benefits (except pensions) in areas not otherwise connected with reserved matters
- top up reserved benefits
- make discretionary payments or provide discretionary assistance to meet certain needs
- amend some employment support schemes
- make changes to the amount of Universal Credit (UC) for the costs of rented accommodation, and the timing and recipients of payments.

Since 1 April 2017, Discretionary Housing Payments have been devolved.

The calculation of the Scottish budget

The Scottish Government's block grant from Westminster will continue to be determined by the Barnett Formula.

Therefore, decisions on public spending at Whitehall will still set the overall envelope for Scottish public spending through the decisions that they take on comparable funding for England-only departments where spending is devolved to Scotland.

However, the block grant will be adjusted (i.e. reduced) to take account of the fact that some taxes are now devolved to the Scottish Parliament.

How does this happen?

For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) is calculated. The BGA is effectively a measure of the tax revenues that the UK Government has foregone as a result of transferring the tax in question to the Scottish Parliament.

Box XX explains the operation of the BGAs in a bit more detail.

Box 1.1: The Block Grant Adjustments

The Block Grant Adjustments (BGA) are a key component of the new framework for the Scottish Budget. It is the combination of Scottish tax revenues *and* the BGAs that will ultimately determine whether or not the Scottish budget is better or worse off relative to the old settlement.

Under the new approach, a BGA will be calculated for each tax and will consist of two elements: an *initial deduction* and an *indexation mechanism.*

The initial deduction is equal to the tax revenues collected in Scotland in the year prior to devolution of the new power. For example, income tax was devolved for 2017-18. So the initial deduction was equal to income tax receipts in Scotland in 2016-17. The net effect was that the Scottish Budget was no better or worse off.

But what is the BGA for 2017-18 and thereafter?

This is where the indexation mechanism comes in. Its purpose is to provide a measure of the rate at which 'comparable revenues' have grown (or declined) in the rest of the UK (rUK) between 2016-17 and 2017-18 (or any subsequent year).

The basic idea is that the BGA should grow at the same rate as the growth in comparable revenues in rUK.

So how is the indexation mechanism actually calculated?[1]

Until 2020-21, the BGA for Scotland will effectively grow in line with the growth in per capita tax receipts for the equivalent devolved taxes in rUK. For income tax for example, the BGA will increase in line with the growth in NSND income tax growth per head in the rest of the UK.

A similar mechanism has been established for the new welfare powers. But instead, the BGA for social security powers involves a 'baseline addition' to the budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism.

The final indexation mechanism is still to be agreed but could ultimately be based on the 'Barnett Formula', so that the BGAs will be increased by a population share of 'comparable' benefits in rUK. But for the transitional period to 2021, they will grow in line with the percentage

[1] During the development of the Fiscal Framework, there was disagreement between the Scottish and UK Governments over the indexation mechanism. In the end, a temporary mechanism was agreed for review in 2021.

change in per capita spending on these ‘comparable’ benefits in rUK (and the change in Scotland’s population[2]).

So each year the BGAs for each tax will take money out of the Scottish Government’s block grant. What is added back in are the revenues that are raised from each tax in Scotland.

[insert diagram]

The key implication of how all this works is quite straightforward (even if the process underpinning it is not). In short, if the sum of the revenues raised from the devolved/ assigned taxes is greater than the sum of the BGAs, then the Scottish budget will be better off than it would have been without tax devolution[3].

It is this mechanism that builds in ‘risk and reward’ to the Scottish budget process, with how the economy performs now crucial to the future outlook for public spending in Scotland.

Scotland’s Budget could be better off under the new system for two reasons:

- the tax base grows relatively more quickly in Scotland than in rUK; or
- tax policies in Scotland that seek to raise revenues relative to those in rUK.

Of course the reverse could happen – Scottish revenues may grow relatively more slowly than those in rUK, in which case the Scottish budget will be worse off than it would have been without tax devolution.

Under this new framework, the Scottish budget bears in full the effects of any differential growth in Scottish revenues relative to rUK revenues, even if the causes of any differential growth are beyond the control of the Scottish Government.

Operational issues with the implementation of the new powers

As highlighted above, the determination of the Scottish budget is now significantly more complex than in the past. It is no surprise therefore that the institutional framework that underpins this new arrangement has been reformed significantly.

Box 1.2 summarises some of the major new changes.

Box 1.2: The Fiscal Framework

The fiscal framework is the term used to cover the new budget arrangements for the Scottish Parliament’s tax and welfare powers.

In addition to setting out the mechanism for how the block grant adjustment (BGA) will operate

[2] Given that Scotland has a higher proportion of people claiming these benefits than a population share, applying a Barnett uplift will – over time – effectively be a relative squeeze on welfare spending in Scotland.

[3] Similarly, for social security, if Scottish spending increases faster than in the rest of the UK, then this will have to come at the expense of lower spending in other parts of the budget or increased taxation.

– see Box 1.1 – there are a number of other important features of the new framework:

- The Scottish Government's capital borrowing powers have increased. The overall limit on borrowing has risen to £3 billion, with an annual limit of 15% of the overall borrowing cap (equivalent to £XXX million for 2018/19).
- The Scottish Government now has increased revenue borrowing powers of up to £600 million per annum, subject to a combined overall limit of £1.75 billion, for in-year cash management, forecast error and Scottish-specific economic shocks.
- The Scottish Fiscal Commission has been established with responsibility for forecasting economic growth and devolved tax revenues and welfare payments.
- The processes for managing cash flow and variations in tax revenues between years have changed significantly. Gone is the old Budget Exchange Mechanism for transferring 'underspends' from one year to the next, with a new Scotland Reserve established in its place. In this Reserve, the Scottish Government is able to deposit up to £700 million and draw down monies – subject to limits of £250 million for resource and £100 million for capital – should they need to[4].
- Following the recommendations of the Budget Review Group, new procedures are being put in place for how the budget will be presented to and scrutinised by Parliament. A greater focus on 'year round' scrutiny is likely.
- Finally, the inter-governmental relations between the Scottish and UK Governments have been reformed with new dispute resolution mechanisms, and new arrangements for information sharing. These have already been tested in the light of the deal by the new UK Government to secure support from the Democratic Unionist Party in June.

One of the biggest institutional changes – particularly from an economic perspective – has been the establishment of the Scottish Fiscal Commission.

From now on, twice each year, the SFC will make a 5-year forecast for each of the Scottish revenues, and for spending on the social security benefits being transferred to Scotland. They will also make a forecast for growth in Scottish onshore GDP.

The SFC will produce its first official forecast this year alongside the Scottish Budget. But in order to set its budget, the Scottish Government will not only need forecasts for Scottish revenues but forecasts for the BGAs. The BGA forecasts will be determined by the UK Office of Budget Responsibility's (OBR's) tax forecasts for rUK, and DWP expenditure forecasts for social security benefits.

[4] At the end of 2016-17, the Scottish Government had around £75 million in the Scotland Reserve and an underspend of XX.

The UK Government will transfer to the Scottish Government the SFC's forecast for income tax revenues; these will be drawn down throughout the financial year, whilst the UK Government will deduct from the block grant the forecast of the income tax BGA.

Therefore in looking ahead to this year's Scottish Budget, the outlook that the SFC and OBR have for the Scottish and UK economies (and tax revenues) will be crucial for determining the exact amount of money the Scottish Government will have at its disposal for the coming financial year[5].

1.3 Recent Scottish and UK economic performance

Economic Growth

All of this above discussion makes the outlook for the economy vitally important.

Over the last 12 months, the Scottish economy grew by 0.6% (and by 0.4% on a 4Q-on4Q basis). This is well below its long-term average and the equivalent growth rate for the UK as a whole (which grew by 2.0%).

Table XX: Scottish growth (%) by sector Q1 2016 to Q1 2017 (Quarter on Quarter growth)

	GDP	Agriculture	Production	Construction	Services	*GDP per head*
Scotland	+0.6	+0.8	-0.1	-4.0	+1.2	*+0.3*
UK	+2.0	-0.2	+2.3	+2.8	+2.3	*+1.3*

Source: Scottish Government

It is also below the forecast made by the Scottish Government for growth of 1.0% in 2016-17 in December's Draft Budget.

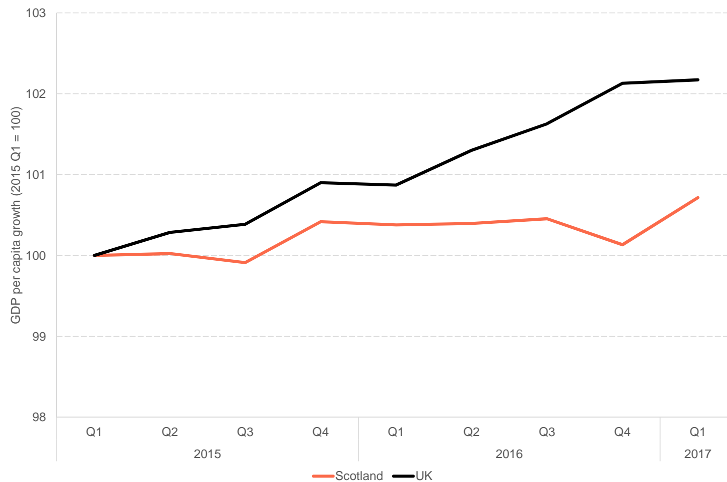
It is also sufficiently weak to trigger the emergency borrowing powers in the Fiscal Framework to cope with an asymmetric shock. This is defined as when Scottish growth is less than 1% and more than 1 percentage point smaller than the UK as a whole.

When measured in terms of output per head – arguably the more relevant indicator of performance given the focus of the new framework on tax receipts per capita – a similar story emerges.

Scotland grew strongly in 2014 but since then the UK has grown more quickly (Chart XX) – with growth in GDP per capita in Scotland of just 0.2% compared to the UK's 1.3% over the past year.

[5] Once outturn data on the taxes are available, the forecasts of both Scottish tax revenues and the income tax BGA will be reconciled to that outturn. For the fully devolved taxes these will happen on a monthly basis. But for income tax, outturn data will not be known until 15 months after the end of the financial year – so outturn data for 2017/18 for example will not be available until June 2019.

Chart XX: Scottish & UK GDP per head: 2014Q1 to 2016Q1



Source: Scottish Government

The Scottish economy recorded strong growth during the first three months of 2017. Whilst welcome, some caution needs to be exercised at this stage when interpreting these figures.

- Firstly, the growth of +0.7% comes on the back of a fall in output of 0.2% in the final three months of 2016.
- Secondly, the latest figures now show that the Scottish economy actually contracted during 2016 as a whole – falling by 0.1%.
- Thirdly, much of the growth during Q1 2017 was driven by a 'bounce-back' in sectors which have been hit quite badly due to the downturn in oil and gas. Even with the strong growth in Q1, these sectors are still well below where they were just two years ago – see Box 1.3.

All things considered, it is our expectation that the Scottish Fiscal Commission will view the recent GDP data with some caution. Much will depend upon the figures for Q2 to be published in October and the extent to which growth is shared more evenly across the economy.

Box 1.3: Recent Scottish Growth Figures - how sustainable?

In July, the Scottish Government published GDP figures for Q1 2017 showing quarterly growth in Scotland of 0.8%. This was well above expectations. Figures published in August revised this growth down to 0.7%. But this was still much higher than the equivalent UK figure of 0.2% for the same period.

Examining what was behind these figures is important, particularly in terms of assessing the outlook for the next few months and the coming year.

Table XX shows the contribution of growth made by each sector to the Q1 figures.

Table XX: Scottish growth (%) by sector Q1 2017

	GDP	Agriculture	Production	Construction	Services
Scotland	+0.7	+0.3	+2.7	-0.6	+0.4
UK	+0.2	+0.1	+0.1	+1.1	+0.1

Source: Scottish Government

For services and construction, which together make up over 80% of the economy, performance was much less spectacular than the headline rate. Services grew 0.4% (marginally below trend) whilst construction output actually fell 0.6%. What drove upswing was the strong growth in production of 2.7%.

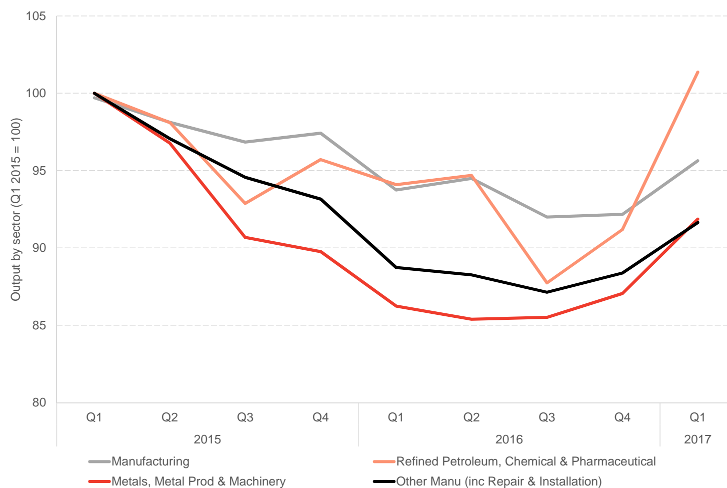
An analysis of the industry make-up of this growth shows that three sectors – 'metals & machinery', 'refined petroleum, chemicals and pharmaceuticals' and 'other manufacturing, repair and installation' contributed over half the net growth recorded in Q1. What is particularly remarkable is that, taken together, these sectors account for just 6% of the Scottish economy

Chart XX: Contribution to Scottish GDP Q1 2017

Source: Scottish Government

Chart XX shows how these sectors have been performing since 2015. All three of them have had a challenging recent history.

Chart XX: Performance by Sector Q1 2015 to Q1 2016

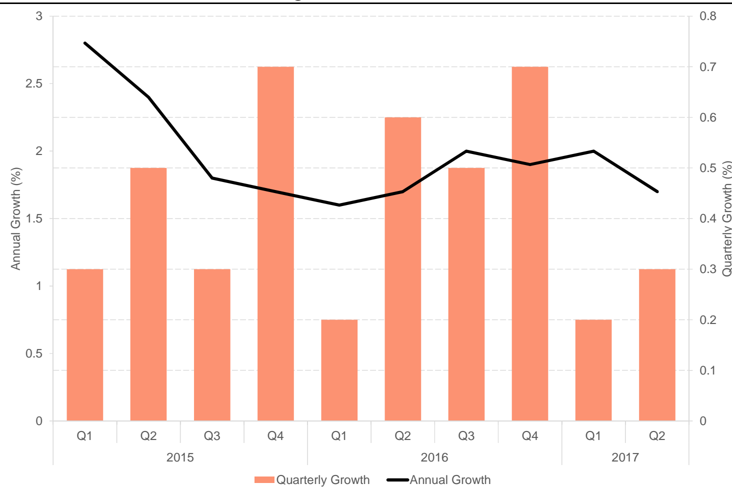


Source: Scottish Government

Whilst positive, it is entirely possible that a number of these factors will only have a (large) temporary impact on the results for Q1 2017. A degree of success will be maintaining these gains. We should therefore be careful in setting expectations too high that such growth will continue at the same pace for the remainder of 2017.

The UK economy initially appeared to hold up much better than expected in the immediate aftermath of the EU referendum. In fact, growth picked up through the second half of the year. But conditions have weakened markedly in the first half of this year.

Chart 1.XX: Slowdown in UK economic growth



Source: ONS

As expected, household consumption – which had been the principal driver of growth in recent times – has slowed to just 0.1% in the three months up to June. In 2016, consumption grew by

2.8%, in part fuelled by increased borrowing. But household consumption, particularly discretionary spending is being scaled back as inflation continues to bite. The Consumer Price Index is expected to peak at close to 3% this year.

Business investment remains subdued with little growth over the last two years. Some indicators from the Bank of England suggest that investment intentions may have *"strengthened a little further"* in recent months, but they also find that heightened uncertainty is playing a part in some firms' unwillingness to invest[6].

The UK's net trade position is broadly similar to that back in 2015 (at a deficit of around £8 to £9 billion) even with the help of a sharp depreciation in Sterling.

Against that however, tax receipts have been relatively healthy. The ONS' latest estimates of public sector borrowing for the year to March 2017 put the deficit at £45.1 billion, a reduction of £27 billion on the previous year. Borrowing is forecast to increase however, through the remainder of 2017.

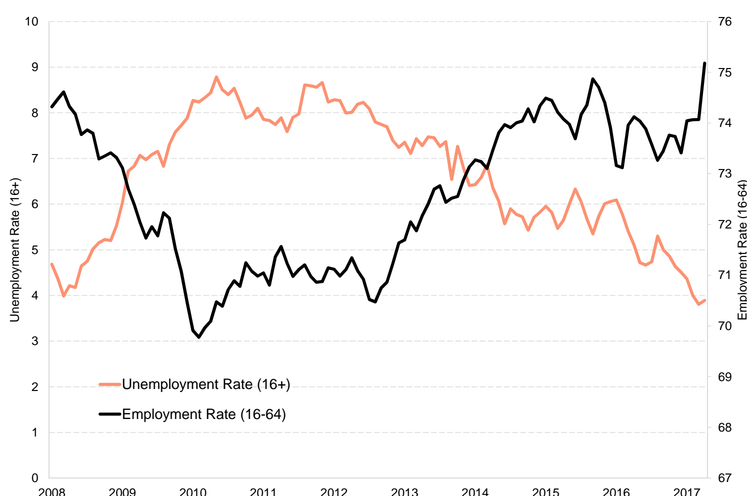
Scottish Labour market

In contrast to the wider economy, Scotland's labour market continues – at least in terms of the headline figures – to hold up remarkably well.

This is important given the focus of the new fiscal framework on income tax and VAT where employment and earnings will be key determinants of future revenue growth.

The employment rate in Scotland now stands at 75.2% up 1.1 percentage points on a year ago. Meanwhile the unemployment rate has fallen to 3.9% down 1.2 percentage points since last year.

Chart XX: Scottish employment rate and unemployment rate best since records began



Source: ONS, Labour Force Statistics, August 2017

[6] See www.bankofengland.co.uk/publications/Documents/agentssummary/2017/q2.pdf

Compared to the UK, Scotland now has a marginally higher employment rate and a lower unemployment rate.

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.2%	3.9%	21.8%
Quarterly Change	+1.1	-0.5	-0.7
Annual Change	+1.1	-1.2	+0.0
UK	*75.1%*	*4.4%*	*21.3%*
Quarterly Change	*+0.3*	*-0.2*	*-0.2*
Annual Change	*+0.7*	*-0.5*	*-0.3*

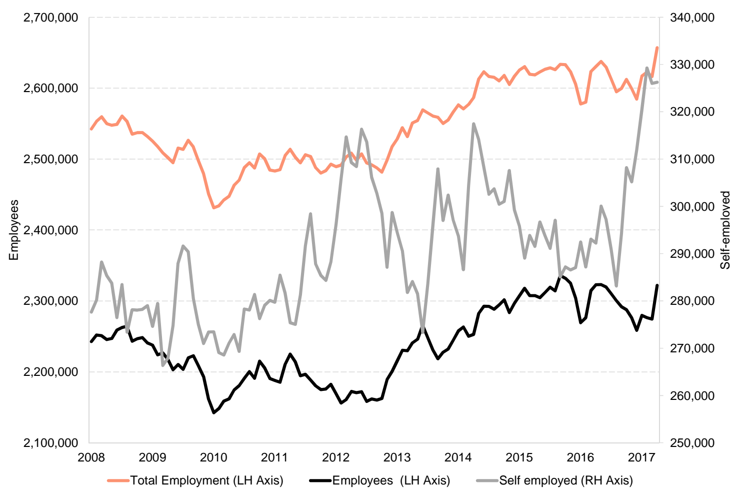
Source: ONS, Labour Force Statistics, August 2017

However as we have discussed in our Scottish Labour Market Trends reports, the headline figures do hide some challenges.

Firstly, there is an ongoing concern about the nature and type of work being undertaken by those in employment. For example since the financial crisis, there has been a rise in part-time employment (up around 10% over the past 10 years). The number of people working part-time because they cannot find a full-time job is up nearly 60% on the last decade.

Secondly, while employment has grown over the past year, this has almost all been driven by increases in self-employment.

Chart XX: Sharp rise in self-employment in Scotland over last year



Source: ONS, Labour Force Statistics, August 2017

Not only do we await to see what the long-term economic consequences of both effects, we do not yet know how such trends will feed through to the tax figures for Scotland (and the position of Scotland vis-à-vis the UK). On the one hand, by paying less in National Insurance contributions, a self-employed person who earns more than the personal allowance will pay more in income tax

than a traditional employee. But against that, those in self-employment have arguably greater scope to alter their tax affairs such as taking more in un-earned income (e.g. dividends) from their 'company' than employees.

Thirdly, real earnings remain under pressure.

Unfortunately, the most recent data we have for Scotland covers to the end of March 2016.

Over that year, wage growth has been slower in Scotland than in the UK. One explanation is the downturn in the offshore economy. Indeed, median wages declined by 5% in Aberdeen and 4% in Aberdeenshire between 2015 and 2016.

Table 4: Median Gross Weekly Earnings, Scotland

	Median Earnings	% change	FT Median Earnings	% change	CPI
2014	£414.70	1.5%	£519.60	2.1%	1.8
2015	£422.60	1.9%	£527.00	1.4%	-0.1
2016	£432.00	2.2%	£535.00	1.5%	0.3

Source: ASHE

More up to date data is available for the UK. It shows that after a short return to real earnings growth in the first part of 2016, average real wages are falling once again and remain XX% below their 2008 levels.

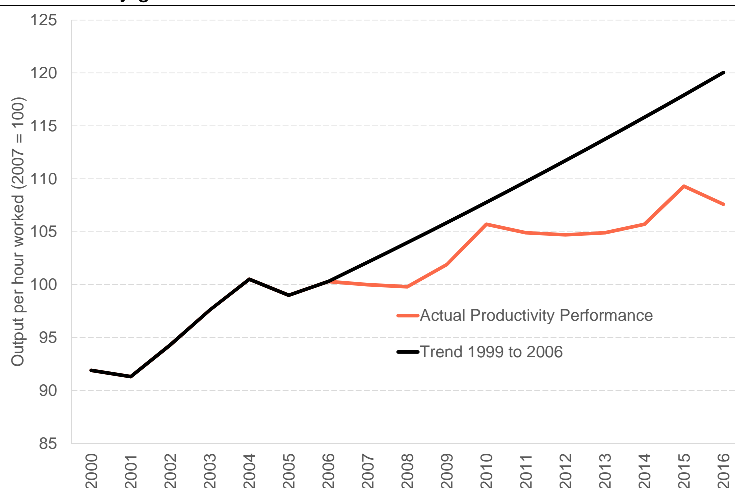
Productivity growth

The strong performance in the labour market belies weak productivity growth. In the UK, productivity growth averaged 2% per year until the mid-2000s, but has slowed significantly since.

Scotland has seen a similar slowing trend – Chart XX – although Scotland has fared better than the UK as a whole with the Sco-UK gap narrowing in recent years. Productivity fell in Scotland in 2016.

As we discuss below, the view of the Scottish Fiscal Commission on the outlook for productivity growth in Scotland compared to the UK as a whole will have a significant bearing on their forecasts for Scottish tax revenues.

Chart 1.XX: Productivity growth in Scotland



Source: Scottish Government productivity statistics[7]

1.4 The economic outlook

The economic outlook for both Scotland and the UK is highly uncertain.

Most forecasters predict that the UK economy will grow by around 1.6% this year, before falling back slightly further in 2018. This is below trend growth of around 2%.

Table XX: Latest economic growth forecasts for the UK economy

	2017	2018
CBI	1.6	1.4
Item Club	1.5	1.3
NIESR	1.7	1.9
British Chambers of Commerce	1.7	1.3
European Commission	1.8	1.3
OECD	1.6	1.0
IMF	1.7	1.5
Average of forecasts	*1.6*	*1.4*

Source: HM Treasury

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

The UK outlook will have three key implications for the Scottish Budget.

- Firstly, we await details of how the new UK Government will respond in their Autumn Budget to emerging evidence of a weakening in UK growth. Any changes to public

[7] http://www.gov.scot/Topics/Statistics/Browse/Economy/PROD16Q4

spending – e.g. to support a greater than planned pay increase for public sector workers – could have a direct bearing on the Sottish Budget via Barnett consequentials.

- Secondly, with around £11bn worth of exports destined for the rest of the UK every three months, the UK economy's performance will have an important bearing on the outlook for Scottish growth.

- Thirdly, as highlighted above, what matters most for the net position of the Scottish Budget now is how Scottish tax revenues perform *relative* to equivalent taxes in the rest of the UK.

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

Box XX: The global economic environment

The fundamentals of the global economy are stronger than they have been for many years.

Global economic activity is picking up with a long awaited recovery in investment and trade. The IMF forecast global growth to rise from around 3% in 2016 to nearer 3½% this year and next – not too distant from the long-term average growth rate.

Encouragingly, growth in international trade is expected to move ahead – once again – of overall growth in the global economy.

Financial markets have also held on to gains made in early 2017 and levels of business and consumer confidence – on the whole – are positive. The keenly watched 'OECD Leading Indicator' points to advanced economies remaining in positive territory in the near term with momentum building.

In terms of Scotland's two main international export markets, the outlook is positive.

Firstly, whilst the US economy has posted relatively modest results so far this year, strong jobs market data and an anticipated fiscal stimulus should lead to faster growth going forward.

Secondly, the recovery in Europe continues to build momentum and has now reached all Euro Area countries. But whilst unemployment continues its downward trend, it remains high with painful structural adjustments still needed. Even by 2018, Euro Area unemployment is still projected to be close to 8%.

Overall, policy uncertainty – from President Trump through to Brexit – remains high and is the biggest risk facing the global economy. There are also still a number of imbalances and vulnerabilities in financial markets – not least in China where the government is seeking to establish a more balanced and less debt-fuelled growth model.

Table XX: Outlook for global growth: 2017-2018

Year on Year			*Projections*	
	2015	2016	*2017*	*2018*

World Output	3.4	3.2	*3.5*	*3.6*
Advanced Economies	2.1	1.7	*2.0*	*1.9*
US	2.6	1.6	*2.1*	*2.1*
Euro Area	2.0	1.8	*1.9*	*1.7*
Emerging Market and Developing Economies	4.3	4.3	*4.6*	*4.8*

Source: IMF World Economic Outlook, July 2017

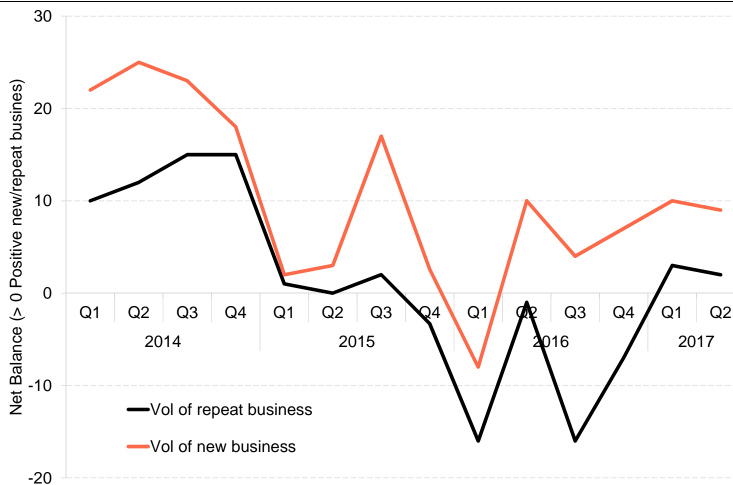
All of this takes us to the outlook for Scotland.

As highlighted above, the latest growth figures for Scotland showed strong growth in the first three months of 2017, but on the back of much weaker growth over the last two years.

Up-to-date survey and confidence indicators suggest that the economy is continuing to grow, albeit at a relatively slow pace.

For example, the FAI-RBS Business Monitor for Q2 2017 shows that the total volume of business activity in Scotland increased with the both repeat business and new business positive for the 2nd quarter in a row. That being said, the rate of growth remains relatively weak.

Chart 1.XX: FAI-RBS Business Monitor for Q2 2017

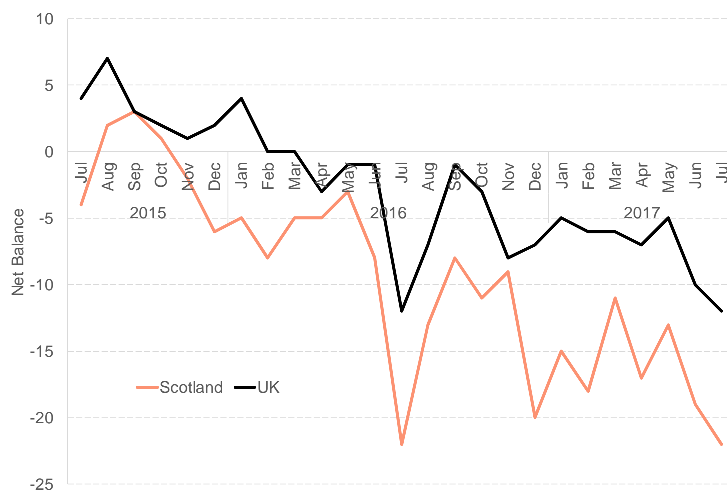


Source: Fraser of Allander Institute-Royal Bank of Scotland

The latest Lloyds Banking Group PMI for Scotland is perhaps more encouraging. It is at a 33 month high, although Scotland is still tracking behind the UK average – something that it has been doing for over two years now.

Overall levels of consumer confidence in Scotland remain relatively weak. The GfK indicator shows consumer confidence much weaker in Scotland than the UK as a whole, with the optimism becoming more pessimistic over the summer.

Chart 1.XX: Consumer Confidence remains negative in Scotland and gap with UK remains



Source: GfK

The Scottish Government's own measure of consumer confidence has been negative during the first quarter of 2017[8].

To provide an up to date assessment of economic activity in Scotland, the FAI produces monthly 'nowcasts' of Scottish growth – www.fraserofallander.org. The advantage of a 'nowcast' is that it provides an indication of economic performance far in advance of official data. Our latest nowcast estimates growth of XX% in Q2 and XX% in Q3.

The Institute's latest forecast for Scotland is for growth of around XX% in 2017 – fragile growth but clearly better than the outturn for 2016 – picking up to XX% in 2018.

Table XX: FAI forecast Scottish economic growth (%) by sector: 2017-2019

	2017	2018	2019
GVA			
Production			
Construction			
Services			

Source: Fraser of Allander Institute, September 2017

These forecasts suggest that whilst growth will be faster than last year, it is likely to remain below trend. Quarterly growth is also likely to remain volatile, with further negative quarters of growth or strong positive quarters (like Q1) entirely possible. We continue to recommend that the focus of attention is centred upon the medium to long-term trend as opposed to sharp movements in one quarter or another.

On balance, we believe that over the next couple of years Scotland will do well to match UK growth. A number of factors will determine whether this is the case or not –

[8] https://beta.gov.scot/publications/state-of-the-economy-june-2017/

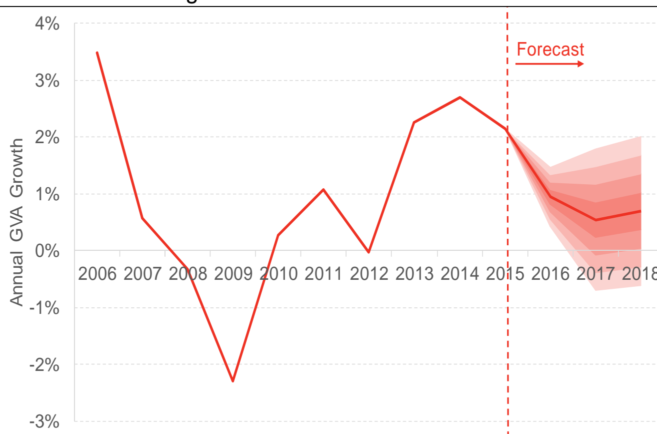
1. Much will depend upon the outlook for the North Sea and the recent pick-up in confidence. Our judgement is that the outlook is more positive than 12 months ago, but that it is fragile.

2. The Brexit process will add its own unique dynamics to the pattern of Scottish and UK growth over the coming months. We continue to hold the view that Brexit will act as a significant headwind to growth over the next few months – particularly in terms of investment and business uncertainty. Whether Scotland will fare better or worse is uncertain.

3. There is no doubt that Scotland has been stuck in a relatively weak growth cycle for over two years now. Economies go through cycles all the time – sometimes operating above potential and other times below potential. To the extent that at least some of the recent weak performance is cyclical and the Scottish economy is currently operating below potential, we could see faster growth in Scotland over the short-term as growth catches up with its trend.

We therefore continue to recommend that just as much focus is made upon the range of our forecasts as the central estimate.

Chart XX: FAI forecasts for GVA growth: 2017-2019



Source: Fraser of Allander Institute, September 2017

* Actual data up to 2016, central forecast with forecast error for 2017 – 2019

1.5 The forecasting choices facing the Scottish Fiscal Commission

So the outlook for the Scottish and UK economies remains relatively fragile and there remains a high degree of uncertainty about the outlook.

As we set out in Section 1.2, under this new Fiscal Framework, what ultimately matters over time will be how devolved Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.

If Scottish devolved revenues per head grow more quickly than the equivalent taxes in the rest of the UK then Scotland will be better off relative to the position prior to tax devolution; if Scottish devolved tax revenues grow more slowly, then the Scottish Budget will be worse off.

But in looking ahead to this year's Scottish Budget and the next few years, we will not have actual data on tax revenues in advance.

So what the SFC forecast for devolved taxes – and how they compare to the forecasts made by the OBR for the relevant BGAs – will be what determines the relative size of the Scottish Budget at the margin.

In making these forecasts, the SFC face a number of important judgement calls.

The size of the output gap in Scotland

One of the most important decisions that the Commissioners will need to take a view on, is the underlying economic potential of the Scottish economy – and crucially where they believe Scotland's economy is at the current time relative to that potential.

In the short-run, growth in an economy is largely determined by show-term factors such as the demand for Scottish exports or the level of government consumption. How these all add up creates an overall rate of growth in aggregate demand. In the short-run, growth in demand tends to dominate all other factors.

But in order to forecast how the Scottish economy – and by implication devolved taxes – may evolve over the forecast horizon, a much more subjective view of Scotland's potential level of output is required. Ultimately, it is the outlook for potential output and its determinants – the growth in Scotland's population, changes in labour market participation and hours worked, and the rate of productivity growth – that will drive forecasts for tax revenues.

The assumptions that the SFC places on each of these will have a significant impact on the forecasts that they make for Scotland's economy and tax revenues in 2018-19 and beyond.

Ultimately these are significant judgement calls. We highlight two key issues –

One area for careful consideration will be the outlook for Scotland's population. In 2016, the Scottish Government's forecasts were based upon a projection based upon the ONS's principal population projection for Scotland. Should the SFC take a different view – perhaps in the light of recent trends in EU migration and the possibility of a hard Brexit limiting migration – then the forecasts for Scottish tax revenues will look quite different (and potentially be materially weaker than for the rest of the UK).

Another crucial area is the rate of productivity growth (i.e. potential output per hour worked). The OBR has been persistently overly optimistic when forecasting UK productivity growth. Despite this, the OBR still assume that UK productivity will return to its long-term rate over the course of the forecast horizon. The SFC is not bound by this assumption, and many economists believe that such an optimistic forecast for productivity is not appropriate. Should the SFC take a different view, then the outlook for Scottish tax revenues could be much smaller than the BGAs put forward by the OBR.

Modelling tax forecasts

The SFC will be considering carefully how their new models and methods will stack-up vis-à-vis other forecasters and the OBR.

Forecasting future tax revenues or wider economic variables are, by their nature, subject to margins of error. Assumptions that are built into forecasts - based on the best available information at the time - often prove to be too optimistic or pessimistic as new economic events continuously unfold.

None of this will be straightforward and the Scottish Fiscal Commission will be doing this for the first time, with data that lags the UK as a whole, has fewer observations and is more susceptible to revision.

Note also that the Scottish budget bears the risk of forecast errors made by the OBR for rUK income tax. For example, consider the case where the SFC's forecast for Scottish revenues corresponds exactly to outturn, but where the OBR forecast for rUK income tax revenue substantially underestimates subsequent rUK outturn figures. In this case, the BGA will be smaller than it otherwise should have been so a future Scottish budget will be cut to reconcile actual rUK receipts with forecast.

Determinants of individual tax revenues

Finally, whilst the overall pattern of growth in an economy is strongly correlated with tax revenue growth in the long-run, from one year to the next it is not perfect.

For example, it is possible for GDP growth to be relatively tax rich or tax poor, particularly from one year to the next. Public sector wages for example, may not be strongly correlated with GDP in the short run (public sector employment makes up almost 30% of employment in Scotland).

Property prices and transactions are strongly pro-cyclical, meaning that they often grow more strongly than GDP during upswings, but fall more quickly than GDP during downswings. And GDP growth in any year may be accounted for in part by higher profits repatriated overseas, which have no bearing on Scottish tax revenues.

Therefore, the Fiscal Commission will – in addition to taking a view about the overall health of the Scottish economy – be monitoring and modelling important individual determinants of each devolved tax revenue.

For NSND income tax for example, their focus is likely to concentrate on their assessment of the outlook for employment growth, earnings growth and the relative distribution of any improvement in this wage growth by decile. As we will discuss in the next chapter, they will also have to consider potential behavioural responses if tax policies were to change in Scotland vis-à-vis the rest of the UK.

Property prices in Scotland will clearly be a key factor for Land and Buildings Transaction tax, with factors such as the number of transactions and tax band of sales important.

1.6 Conclusions

The new fiscal framework for Scotland will mean that developments in the Scottish economy will now have a much greater impact on future budgets than ever before.

Ultimately, how the Scottish economy performs relative to the rest of the UK will have a much greater impact on the Scottish budget than before.

The potential paths for the economies of both Scotland and the UK – and the implications for fiscal policy – are highly uncertain.

Growth in the UK economy has undoubtedly weakened in recent months. That being said, the economy is still expected to grow over the coming months although the degree of uncertainty around the outlook remains high. The Chancellor faces a careful balancing act between continuing to reduce the deficit and protecting the real economy.

On balance, the immediate outlook for the Scottish economy appears to be just as – if not more challenging – and Scotland will do well to match UK economic performance in the near-term.

Of course, we will not know how Scotland has fared until tax revenues are collected and this will not happen – in the case of income tax – for a good few months after the financial year in question. Therefore in assessing the outlook for the Scottish Budget for next year and the remainder of the Parliament, what will be crucial will be the forecasts that the Scottish Fiscal Commission and the Office for Budget Responsibility make for Scottish devolved taxes and the BGAs respectively.

On balance, given recent data we believe that the Scottish Fiscal Commission are likely to be relatively cautious in their forecasts for Scottish growth and tax revenues.

Chapter 2: outlook for the Scottish budget

2.1 Introduction

Between the establishment of the Scottish Parliament in 1999 and April 2015, the resource budget of the Scottish Government essentially depended on one thing only: the block grant from Westminster.

Under the new arrangements, the block grant will continue to be determined by the Barnett Formula. And will continue to shape the overall envelope the Scottish Government faces.

However, the block grant will be now adjusted by a block grant adjustment (BGA) to take account of the new taxes being devolved.

As was discussed in Chapter 1, in this respect the critical question is the extent to which the revenues raised in Scotland exceed or underperform the BGA.

If less is raised in Scotland from tax than is deducted from the block grant, the Scottish budget will be worse off than it would have been without tax devolution. But if the revenues raised exceed the BGA, the Scottish budget will be better off.

For any given tax, the revenues raised in Scotland may differ from the BGA for two reasons:

- If the tax base grows differently in Scotland relative to the rUK (for example, if wages grow more quickly then Scottish income tax revenues per capita are likely to increase more quickly); or

- If tax policy is varied in Scotland in such a way as to raise relatively more or less revenues in Scotland relative to the BGA.

In this chapter, we examine the outlook for the Scottish budget over the period to 2021/22.

We consider first in section 2.2 the outlook for the block grant from Westminster. It is important to remember that this remains the dominant driver of changes in the Scottish budget.

We then consider in section 2.3 the outlook for the devolved and assigned taxes, taking into account both the outlook for Scottish revenues and the equivalent BGA. Given the recent performance of the Scottish economy, the Scottish Fiscal Commission (SFC) may take a cautious approach to its forecasts for Sottish revenues. It would not be surprising therefore if – short of any specific policy announcements to raise income in Scotland – the tax forecasts turn out to be slightly smaller than the BGA.

That being said, ultimately what matters is how outturn Scottish revenues *actually* compare to rUK revenues. As the purpose of this chapter is to examine the profile of the budget over the lifetime of the parliament we set out a range of possible scenarios for how taxes and the BGA may evolve rather than specific point forecasts.

Section 2.4 brings together the material in sections 2.2 and 2.3 to consider the overall outlook for the Scottish Government's resource budget.

In Section 2.5 we consider the outlook for capital spending. This is most straightforward in that the outlook only on the block grant for capital spending and capital borrowing. Section 2.6 concludes.

2.2 Outlook for the block grant

Based upon the latest plans from the UK Government, having grown slightly in 2017/18, the RDEL block grant, before any adjustments for new tax and social security powers, is expected to decline by 3% in real terms by 2021/22 (Table X).

Table X: Outlook for the Scottish Government's resource block grant

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Change 16/17 - 21/22
Cash terms	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656	£1,569
2017/18 prices	£26,512	£26,627	£26,230	£25,871	£25,879	£25,796	-£716
Real terms annual change		*0.4%*	*-1.5%*	*-1.4%*	*0.0%*	*-0.3%*	*-2.7%*

Notes: figures for 2016/17 – 2019/20 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget.

Figures for 2020/21 and 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total RDEL spending but does not allocate this total between spending departments.

Of course there is a possibility that the block grant may turn out to be somewhat higher or lower than the Chanellor set out in March.

The downside risks arguably seem fairly small. Under current forecasts, the Chancellor is on course to meet his new fiscal target to get structural borrowing below 2% of GDP by 2020/21 with around £26bn 'headroom'.

So even if revenue growth is slower than forecast, there is some insurance against the need to immediately cut spending. But even if growth is faster than forecast, the Chancellor may choose to 'bank' the proceeds of additional revenue growth, given that the UK Government still retains the ambition of returning the public finances to balance in the 'next parliament'.

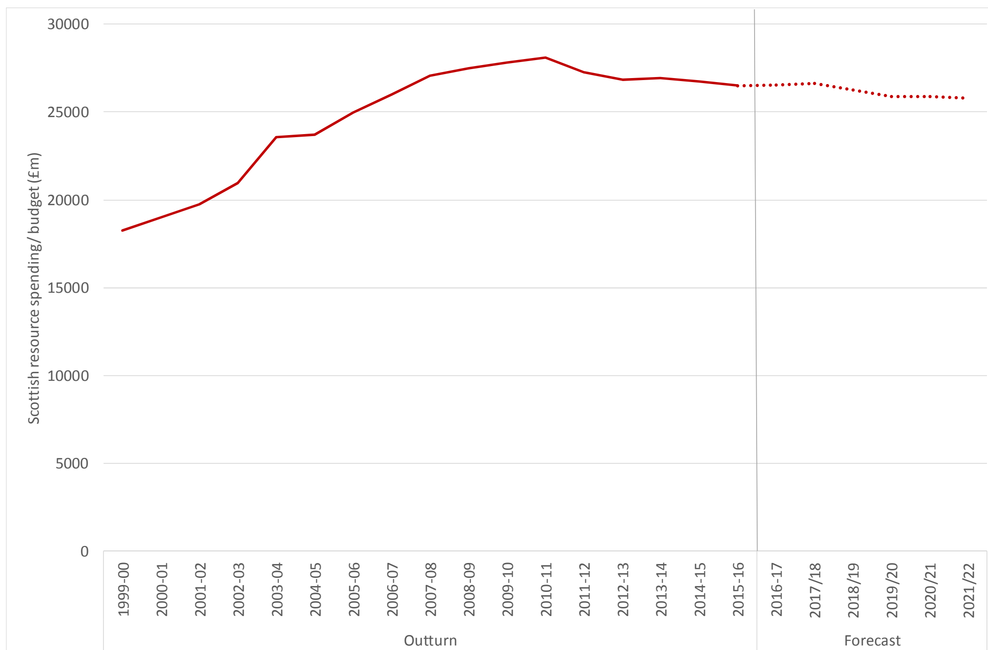
These are uncertain times politically and economically, and the possibility of significant change in the outlook for the block grant should not be ruled out.

Figure X places the future outlook in a longer term context.

By 2021/22, the Scottish Government's resource block grant is expected to be 8% lower in real terms (before any adjustments for new devolved powers) compared to the level of resource spending in 2010/11[9].

Figure X: Scottish Government resource spending £m (2017/18 prices)

[9] On a like-for-like basis, the actual funding reduction has been slightly greater than indicated by this headline figure. The Scottish Government's funding responsibilities have increased during this time, notably as a result of the transfer of Council Tax Reduction to the Scottish budget in 2013/14.



Source: Outturn from Public Expenditure Statistical Analyses, various years. Forecast derived from UK Government Spring Budget 2017

2.3 The outlook for revenues and block grant adjustments

In this section we consider the outlook for revenues and the BGA for each of the taxes currently – or soon to be – devolved or assigned to Scotland. In doing so, we draw on recent revenue forecasts for Scottish and comparable UK taxes, as well as on recent data on comparative performance of the Scottish and rUK tax bases. For simplicity, we calculate the BGAs based on the Indexed Per Capita method[10].

Ultimately what is important is whether outturn Scottish revenues are higher or lower than the outturn BGAs. When the Budget is published however, outturn data will not be available. The Budget itself must therefore be based on forecasts: forecasts for Scottish revenues, and forecasts for the BGAs.

Tax forecasts are subject to significant uncertainty. They will evolve over time in light of new data. But they will always be subject to error, and will always turn out to be 'wrong' if they are perceived as being something they do not claim to be, i.e. an exact prediction (Box X).

A further technical complication is that the latest rUK revenue forecasts – which determine the calculation of the BGAs – were published in March 2017; but the latest Scottish revenue forecasts were published four months earlier in December. The emergence of more recent data in the period between the two forecasts means that they are not quite made on a comparable

[10] The Fiscal Framework identifies two methods for calculating the BGAs: Indexed Per Capita (IPC) and the Comparable Method (CM). Over the period up to 2021/22, the BGAs will be calculated according to the IPC method (although the results of the Comparable Method will also be published). The Scottish and UK Governments will need to agree a methodology for 2022/23 and beyond.

basis. Throughout this section therefore, whilst making reference to these forecasts, we focus on what is ultimately the key question:

How likely is it that Scottish revenues will match or exceed the relevant BGA, taking account what we know of current trends in tax base growth, and proposals for tax policy in Scotland and rUK?

Box X: Forecasting and uncertainty

The Scottish Fiscal Commission and the OBR are both obliged to produce 'point estimate' forecasts for revenues (for Scotland and the UK respectively) for up to five years.

Both institutions are tasked with simply providing their best estimates of either devolved Scottish taxes or the Block Grant Adjustments. They will not – and are not allowed – to coordinate their forecasts or methodologies.

Point estimates are necessary for budgeting purposes. But they belie significant uncertainty and margins of error. What might happen in future is of course unknowable with complete certainty.

Uncertainty is present in all forecasts. But economic forecasts are arguably associated with particularly high levels of uncertainty. We only have an imperfect notion of how the economy works, we only have partial information about the state of the economy at any point in time, and the economy is constantly hit by unanticipated shocks. Forecast uncertainty will never be eliminated.

The SFC's 'point estimate' forecasts will, like the OBR's, implicitly be probabilistic. The actual forecast is effectively a 'central' or 'median' forecast. This means that, the risks are perceived to be balanced, in the sense that the actual outcome is just as likely to be above expectations as below.

In this context, the forecasts for Scottish revenues and block grant adjustments should be taken for what they are – not (perhaps despite appearances) precise predictions, but the best estimate of what a future outcome is likely to be.

From a Scottish budget point of view, what is ultimately critical is how Scottish revenues perform relative to the comparable revenues in rUK. In the sense, what is just as important as the error associated with the Scottish forecasts, is the extent to which error associated with the Scottish forecasts is correlated with error in the rUK forecasts.

For example, outturn revenues in Scotland could turn out to be 10% lower than forecast. But if rUK revenue outturn for the comparable tax is also 10% down on forecast, the Scottish budget will be no worse off. The two forecast errors effectively cancel out.

Income tax

When the Scottish Government published its 2017/18 Budget in December 2016, it was forecasting income tax revenues of £11.8bn in 2017/18, rising to £14.6bn in 2021/22.

This forecast for Scottish revenues exceeded the forecast for the BGA by £79m in 2017/18, rising to a difference of +£661m by 2021/22. The difference between the forecast for Scottish revenues and the BGA forecast is partly due to the fact that the Scottish Government had

announced an intention to set a lower threshold for the Higher Rate of income tax throughout this parliament[11].

At the time of the UK Spring budget in March 2017, the OBR published updated forecasts – based on new data – for rUK income tax revenues over the period to 2021/22. The implication was that the forecast for the income tax BGA was reduced, relative to the figure available at the time of the Scottish Government's Budget.

The implication is that the gap between the Scottish Government's latest revenue forecast and the latest BGA forecast has widened. On paper, this looks good news for the Scottish budget!

But it should be remembered that both the forecasts for the BGA and the Scottish revenues will be revised again before the Scottish Government publishes its 2018/19 Budget later this year. It seems almost inevitable that the forecast for Scottish revenues will also be revised downwards, given that the Scottish forecasts will also take into account the more recent income tax data.

Table X: Income tax revenue and GBA forecasts (£m)

	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)	11,750	12,159	12,672	13,233	13,898
BGA forecast (March 2017)	11,636	11,924	12,326	12,833	13,460
Scottish forecast (Dec 2017)	11,829	12,290	12,912	13,647	14,559
Difference between revenue forecast and BGA (Dec 2016)	79	131	240	414	661
Difference between revenue forecast and BGA (Mar 2017)	193	366	586	814	1,099

Source: Fraser of Allander calculations

How likely is it that Scottish income tax revenues will match or better the BGA in 2017/18 and beyond?

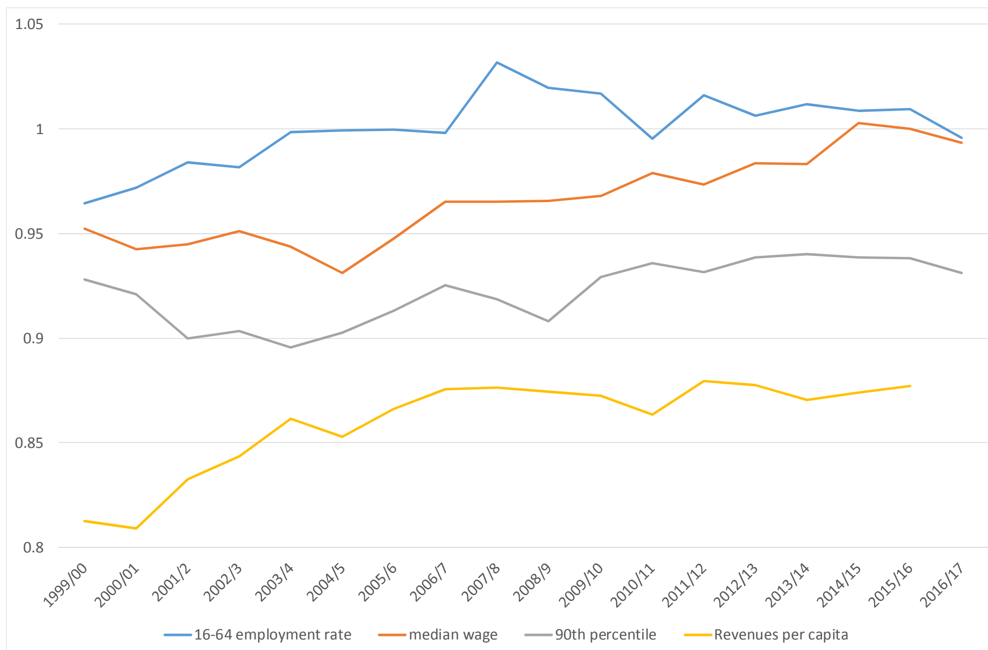
To answer this, it is necessary to consider how trends in the major determinants of the income tax base (wages and employment) are likely to evolve in Scotland relative to rUK, and how tax policy may change.

Recent trends in tax revenues and the tax base

Between 2007/8 and 2015/16, income tax revenues per capita have grown at the same rate in Scotland as the UK (Figure x). On the one hand, the employment rate in Scotland has declined relative to UK rate. But over the same period, wages in Scotland have performed slightly better than in the UK (more accurately, Scottish wages have not declined quite as much).

Figure X: Trends in employment, wages and income tax revenues per capita, Scotland as a percentage of UK

[11] It was not clear from the analysis presented in the 2017/18 Budget whether other factors (e.g. differences in modelling approaches or assumptions for underlying tax base growth) also contributed to differences between the revenue and BGA forecasts.



Source: Employment rate from Labour Force Survey; Wage data from Annual Survey of Hours and Earnings, various years; income tax data from HMRC tax outturn statistics

But changes in income tax policy have played a role in influencing relative revenue growth too. Two key changes are worth noting.

Since 2007/8 the Personal Allowance has increased in real terms. Between 2007/8 and 2015/17 it increased by 65% in real terms. Alongside the real terms increase in the Personal Allowance, tax rates on the highest earners have increased. During the last parliament, the Higher Rate threshold was reduced in real terms by around 13%[12]. Furthermore an Additional Rate of tax was introduced in 2010/11, initially at 50% before being reduced to 45% in 2013/14.

The increases in Personal Allowance, lower Higher Rate threshold and introduction of the Additional Rate have together resulted in tax liabilities becoming more concentrated on higher earners. As a result, tax revenues per capita have grown more quickly in parts of the UK (i.e. London and the South East) which have the highest proportion of high earners.

These trends in relative employment and wages combine with trends in income tax policy to influence the outcome observed in Figure X.

Whether Scotland continues to match UK growth in per capita income tax revenues will depend on how these determinants evolve in coming years. Note from Figure X however that the omens for 2016/17 specifically are not particularly positive. Employment and wages in Scotland declined relative to those in the UK, which in itself would suggest that Scotland's relative income tax revenues per capita may also decline[13]. The extent to which 2016/17 was a one-off 'blip' or the

[12] A reduction in the higher rate threshold means that the level of income that people pay the higher rate of tax is lower – hence a tax rise.

[13] The Scottish budget is not directly affected by income tax revenue performance in 2016/17, as tax devolution does not occur until 2017/18. Lower Scottish revenues in 2016/17 simply mean a lower 'initial deduction' and thus a lower block grant adjustment in 2017/18.

start of a longer-term trend is not yet clear (comprehensive data for 2017 will be released this October).

The FAI's income tax simulation model can be used to assess the risks to the Scottish budget arising from relatively faster or slower wage growth in Scotland.

Table X shows how different Scottish income tax revenues would be if average wages in Scotland grew 0.3 percentage points faster or slower than wages in rUK, and if wages grew 0.8 percentage points faster or slower than wages in rUK.

A difference in revenue performance of just 0.3 percentage points equates to a revenue difference of just over £200m after one year, whilst a revenue difference of 0.8 percentage points equates to a revenue difference of over half a billion pounds in one year.

Clearly, the effects of differential growth will become magnified over time[14].

Table X: Effect on Scottish income tax revenues (£m) of faster or slower wage growth in Scotland compared to rUK

	2017/18	2018/19	2019/20	2020/21	2021/22
0.3 pp slower growth	-£212	-£278	-£347	-£424	-£510
0.3 pp faster growth	£215	£283	£356	£437	£526
0.8 pp slower growth	-£558	-£729	-£907	-£1,105	-£1,322
0.8 pp faster growth	£581	£769	£967	£1,193	£1,442

Source: FAI tax microsimulation model. Notes: 'pp' stands for 'percentage point'.

Income Tax policy

The Scottish Government can from now on vary its budget directly, by varying income tax policy.

This is exactly what it chose to do in 2017/18.

Freezing the Higher Rate threshold at £43,000 is likely to have raised an additional £135m for the Scottish budget this year, compared to what would have been the case if the Scottish Government had followed the UK Government in setting the rate at £45,000 (Box X discusses difficulties in determining when a policy change can be thought of as revenue raising under Scotland's new Fiscal Framework).

Box X: Determining the policy 'baseline' against which policy proposals are assessed

Under the new framework, determining the policy 'baseline' against which the revenue effects of alternative policies can be assessed is not straightforward.

For income tax, the Scottish Parliament must set rates and bands each year through a 'Rate Resolution'. If a Resolution cannot be agreed, the Budget cannot be passed, and the previous year's budget would apply until agreement was reached.

[14] During the past ten years, average weekly earnings have grown more quickly in Scotland than UK in six years, and in these years Scottish wages have grown on average 0.8 percentage points more quickly; average weekly earnings have grown less quickly in Scotland than in UK in four years, and in these years Scottish wages have grown on average 0.3 percentage points more slowly. The 0.3 and 0.8 figures are chosen pragmatically as an indication of the potential magnitude of differential growth in one year, but based on the recent past, it would be unlikely that such differential growth is observed over consecutive years.

It could be argued that the decision to freeze the Higher Rate threshold in cash terms effectively represents a policy of 'no change' (in the same way that the Additional Rate remained unchanged at £150,000).

Instead, the effect on the Scottish budget comes about through the UK Government's decision to raise the Higher Rate threshold to £45,000 in rUK. This can be characterised as a tax cut, and effectively reduces the Scottish BGA.

Thus although the tax thresholds set in Scotland are legislatively independent of those set in rUK, the Scottish budget is ultimately influenced by policy in Scotland relative to policy in rUK. It is in this sense that a freeze in the Higher Rate threshold can be thought of as a revenue raising policy in 2017/18.

If, over the remainder of the period to 2021/22, the Scottish and UK Governments increase the Higher Rate threshold in line with CPI inflation, the difference between the two rates will grow somewhat in cash terms – boosting Scottish revenues by £183m by the end of the forecast period.

The lower threshold in Scotland at which taxpayers pay the Higher Rate may have some behavioural effects. Taxpayers with income between £43,000 and £45,000 will pay a higher marginal rate of tax in Scotland than in rUK, whilst those with income above £45,000 will face a higher average tax rate. These higher average and marginal tax rates may instigate some offsetting reductions in taxable income, and as a result, the revenue effects of the policy may not be as large as the direct estimates reported above. However, any behavioural effects are likely to be small. The OBR estimates that the behavioural effects of the lower threshold in Scotland are to reduce revenues by just £9m per annum in 2017/18 and beyond.

The estimates of the income tax BGA in Table X are based on an assumption that the UK Government increases the Higher Rate threshold in line with CPI inflation in future years. However, the UK Government has committed to increase the threshold above the rate inflation to reach £50,000 by the end of the parliament. If it were to do so, the effect on the Scottish budget would be via an even smaller BGA.

We estimate that, compared to a baseline where the Scottish and UK Governments increase their respective Higher Rate thresholds in line with inflation, a UK Government decision to increase the threshold to £50,000 by 2020/21 (and indexed to CPI thereafter) would result in the Scottish budget being £274m better off by 2020/21.

Table X: Effects on Scottish budget of various Higher Rate threshold policy parameters

Policy		2017/18	2018/19	2019/20	2020/21	2021/22
Baseline	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	45,000	46,200	47,270	48,210	49,260
	Revenue effect (£m)	*0*	*0*	*0*	*0*	*0*
Freeze Higher Rate in Scotland 17/18, then CPI	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*143*	*153*	*165*	*183*

Increase UK threshold to £50,000 by 2020/21	UK threshold	45,000	46667	48333	50000	51089
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*170*	*216*	*274*	*301*

A number of other revenue raising options for the Scottish Government in relation to income tax are discussed in Box X.

Box X: Revenue raising options from income tax

Additional rate increase

One policy option that is often mooted is to raise the Additional Rate (AR) – payable on income above £150,000 – from 45p to 50p. The policy is often motivated by a sense that higher earners should contribute more to revenue generation, and is sometimes justified by references either to top tax rates in various other European countries, or by references to past UK income tax rates (the top marginal rate of income tax exceeded 75% in the late 1970s).

In direct terms (i.e. assuming no behavioural effect), an increase to 50p would raise some £126m per annum. This represents around 1% of Scottish NSND income.

There is sometimes a preconception that the policy would raise more than this, but it raises relatively little because there are few (around 17,000), AR taxpayers in Scotland and the policy asks these individuals just to pay an additional 5% tax only on income over £150,000.

The policy is always subject to claims that it could raise significantly less than this in practice, as the propensity of AR taxpayers to vary their income is high.

However, there remains little in the way of hard evidence of any behavioural response to an increase in the AR. This is partly because there is no counterfactual against which the impacts can be evaluated. In reflecting upon the introduction of the Additional Rate at 50p at UK level, the Treasury estimates that possibility that the policy either raised revenue or cost revenue is unclear within reasonable confidence limits.

Incomes respond to tax changes in a variety of ways. People might vary the amount they work, take advantage of tax reliefs (e.g. put more money into a pension), or convert earned income into dividend income. But some of these options will be more viable for some taxpayers than others.

It seems unlikely that a higher AR in Scotland would cause individuals to relocate, especially when one considers the uncertainty around future tax rates in Scotland and rUK. It is possible however, that higher top tax rates may discourage in-migration of high-earning individuals from other countries more than they incentivise existing residents to leave.

Note finally that, if the UK Government did increase the Additional Rate in rUK to 50p, this would represent a double-edged sword. On the one hand, the risk of behavioural effects from Scottish taxpayers diminishes if the policy is implemented UK-wide. On the other hand, the additional revenues raised in rUK would increase the Scottish BGA, negating any positive revenue effects for the Scottish Government (other than those accruing through additional UK Government spending and resulting Barnett consequentials).

The Scottish Government has tasked the Council of Economic Advisers to consider the implications of an increase in the Additional Rate to 50p.

1p on each rate

A number of political parties in Scotland have proposed raising revenue by adding 1p to each of the basic, higher and additional rates of income tax (so the rates become 21p, 41p and 46p respectively).

According to FAI's income tax model, this policy would raise some £471m, excluding behavioural effects, in 2018/19.

Apply standard TIEs to derive estimate of behavioural effect.

LBTT

At the time of the publication of the Scottish Government's Budget in December 2016, revenues from LBTT were forecast to be somewhat higher in 2016/17 than the BGA (Table X).

Provisional LBTT outturn data has since been published for 2016/17. This indicates that £493m was raised from LBTT in 2016/17. Provisional outturn data has also been published for the 'equivalent' Stamp Duty Land Tax revenues in rUK (these raised £11.7bn). This indicates that the BGA for LBTT in 2016/17 will be £522m (Table X).

The implication is that the BGA for LBTT was some £29m higher than Scottish revenues in 2016/17 (based on provisional outturn statistics for both Scottish and rUK revenues, and is liable to some revision once audited figures are published).

Note that this does not mean the Scottish Government now faces a bill of £29m; the difference has already been factored into the Scottish budget by virtue of the fact that less revenue has been raised in Scotland by LBTT than has been deducted from the block grant.

Table X: LBTT revenues and BGA – outturn and forecasts (£ million)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		504	545	585	634	689	741
BGA outturn/ forecast (March 2017)		*£522*	£580	£619	£656	£700	£747
Scottish outturn/ forecast (Dec 2017)	*£425*	*£493*	507	543	571	597	624
Difference between revenue forecast and BGA (Dec 2016)		*34*	*-38*	*-42*	*-63*	*-92*	*-117*
Difference between revenue forecast and BGA (Mar 2017)		*-29*	*-73*	*-76*	*-85*	*-103*	*-123*

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (June 2017) and OBR forecasts for rUK Stamp Duty (March 2017). Notes: Data in red italics relate to provisional outturn data. Table X does not show a BGA for LBTT in 2015/16, the first year of devolution. This is because for 2015/16, the Scottish and UK Governments agreed a one-year BGA for LBTT and SLfT combined of £494m, which is independent of outturn rUK data. Outturn data for Scotland suggests that in 2015/16, £425m was raised from LBTT and £147m was raised from Scottish Landfill Tax. This total, £572m, is clearly greater than the BGA by £78m. In 2015/16 the Scottish Budget was thus £78m better off as a result of the devolution of LBTT and SLfT, given the BGA agreed with the UK Government.

What about the outlook?

The OBR's latest (March 2017) forecasts for Stamp Duty in the UK have been revised up very marginally from those available at the end of 2016. They imply that the Scottish block grant

adjustment will increase to £579m in 2017/18, and then by 6-7% each year until 2021/22. This is a faster rate than the Scottish Government was forecasting for LBTT revenues in December 2016. The difference implies a net cost to the Scottish Budget of around £100m per year by the end of the parliament.

The difference between the Scottish Government's forecast for LBTT and the OBR's forecast for Stamp Duty revenues for rUK (from which the BGA is derived) are due to different assumptions about the likely growth rate of house prices and residential transactions in Scotland and rUK (assumptions about non-domestic property price and transaction growth and broadly similar). In particular, the OBR assumes price growth in excess of 4% per year over the forecast period, whereas the Scottish Government's forecast is less than half this. The OBR also assumes somewhat faster growth in transactions in rUK than the Scottish Government does.

There are some grounds for assuming that property prices will grow relatively more slowly in Scotland than in rUK over the next few years – and continue recent trends. In the two years since LBTT was devolved, house prices have grown of 2.5% per annum in Scotland compared to 6.5% in the UK[15]. Against this however, and counter to perception, residential property transactions have grown at least as strongly in Scotland in recent years as in rUK. In 2015/16, the number of transactions grew by about 10% in Scotland and in rUK, whilst in 2016/17 transactions declined by 13% in rUK compared to a decline of 7% in Scotland.

On balance therefore, there are not strong a priori grounds for believing that Scottish LBTT revenues will drastically over or underperform rUK revenues either way.

The forecasts for both Scottish LBTT revenues and the BGA should be treated with caution, as revenues from property transactions are particularly difficult to forecast (see Box X). For these reasons, monthly outturn data is likely to be monitored closely.

In our central scenario, we assume that LBTT revenues underperform the BGA by 6%, reflecting a continuation of the relative performance observed in 2016/17.

Need to say something about non-resi.

Box X: Forecasting property transactions taxes

In its latest Forecast Evaluation Report, the OBR states:

'Stamp duty land tax (SDLT) is one of the more volatile sources of receipts – the standard deviation of annual growth over the past five years has been 11.9 per cent, compared to just 1 per cent for overall receipts. In recent years, SDLT receipts have been a large source of fiscal forecasting errors. In line with that, we have revised our SDLT forecasts proportionally more than for any other major tax (bar the even-more-volatile CGT and North Sea oil and gas revenues).'

There are many reasons why forecasting receipts from property transactions taxes can be challenging, including:

- It is difficult to map economic determinants to the true tax base (i.e. relatively few properties are transacted in any one year);
- The tax schedule is progressive meaning a large proportion of tax revenues are derived from very few transactions
- The tax regime has been subject to large policy changes in recent years (e.g. the introduction of the Additional Dwelling Supplement, and changes in tax rates)
- The growth of prices and transactions can be quite volatile from year-to-year, and is difficult to predict based on economic determinants (owing much to other factors

[15] Comparing prices in May 2017 with May 2015 according to ONS House Price Index.

including consumer sentiment and expectations).

As an example of this forecasting difficulties, note that between November 2015 and November 2016, the OBR revised its SDLT forecast for 2017/18 downwards by £2bn (14%).

LBTT tax policy

The current structure of LBTT, introduced in April 2015, marks a significant improvement on the previous UK-wide system of Stamp Duty. This is because, whereas Stamp Duty operated a 'slab' structure (whereby tax rates were levied over the entire value of a property), under LBTT, each additional tax rate is applied only to the part of property value above that threshold.

Some concerns have been raised that the structure of LBTT – which implies a higher average tax rate on all properties worth over £350,000 – has reduced housing market activity in the mid to higher end of the market. This view results in part from the fact that the LBTT forecasts in the Scottish Government's 2015/16 Budget for the 2015/16 financial year overestimated revenues in the £325,000 - £750,000 bracket by some 37%[16].

The dampened activity in 2015/16 may turn out to be temporary. Indeed between 2015/16 and 2016/17, property revenues and transactions in the £325,000 - £700,000 tax band increased more quickly than those in the lower tax bands.

Nonetheless, concern remains about the effect of the 10% tax rate on this segment of the market.

A number of organisations have called for a reduction in the rate for properties in the £325,000 plus range[17]. Our modelling suggests that an extension of the 5% tax rate to properties worth £500,000 would cost around £45m assuming no behavioural response, whilst extending the 5% tax rate to £700,000 would cost around a further £15m, again assuming no behavioural response.

Of course the motivation for such a policy would be to stimulate additional market activity. We estimate that, to offset a reduction in revenues of £60m from extending the 5% band to £750,000, the number of transactions in that band would need to increase by around 3,750 per annum[18]. This represents roughly a doubling in transactions in this band relative to current rates.

Landfill Tax

According to provisional outturn data, £147m was raised from Landfill Tax in Scotland in 2016/17. Based on provisional data on comparable revenues in rUK, Scottish revenues are likely to be around £15m higher than the Landfill Tax BGA (Table X).

In future years, revenues from landfill tax are forecast to decline, reflecting lower levels of waste sent to landfill as alternative waste infrastructure (e.g. incinerators) comes on stream, and increased rates of recycling. Under the latest (December 2016) forecasts, Scottish landfill tax revenues are expected to bring in somewhat more revenue than the BGA for Landfill Tax (based

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[16] Scottish Fiscal Commission Outturn Report, Sep 2016

[17] See Finance and Constitution Committee's Report on the First Year of Operation of the Land and Buildings Transactions Tax http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/102523.aspx#e

[18] Revenue Scotland data indicate that the average revenue from transactions in the £325k-£750k band was £16,000 in 2007/8.

on the OBR's March 2017 forecasts). This partly reflects an expectation that capacity for alternative waste infrastructure may come on stream somewhat more slowly in Scotland.

The Scottish Government has announced an aspiration to reduce waste to landfill at a quicker rate than in England. It has not yet introduced explicit policy to achieve this aspiration, but were the aspiration achieved, it would likely affect the budgetary position, if Scottish revenues were to decline relative to those in rUK.

Table X: Landfill Tax revenues and Landfill Tax BGA – outturn and forecasts

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		137	119	104	97	92	90
BGA outturn/ forecast (March 2017)		*£132*	£107	£99	£92	£89	£88
Scottish outturn/ forecast (Dec 2016)	*147*	*147.4*	149	118	109	112	106
Difference between revenue forecast and BGA (Dec 2016)		-4	30	14	12	20	16
Difference between revenue forecast and BGA (Mar 2017)		*15*	42	19	17	23	18

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (May 2017) and OBR forecasts for rUK Landfill Tax (March 2017). Notes: Data in red italics relates to outturn. For 2015/16, a combined BGA for LBTT and Landfill Tax was agreed, see text for further details.

Air Departure Tax

In April 2018, Air Passenger Duty (APD) will cease to operate in Scotland. In its place, the government has announced plans to establish an Air Departure Tax (ADT).

ADT is expected to be similar in scope and structure to APD. Additionally however the Scottish Government has a commitment to reducing the overall tax burden of ADT by 50% by the end of this parliament[19]. The aim of the policy is to 'generate sustainable growth by boosting Scotland's international air connectivity'[20].

Based on the OBR's latest (March 2017) forecasts, the BGA for ADT is expected to be £327m in the first year of devolution, rising by about 4.5% a year to £373m in 2021/22. If the structure and rates of ADT were to remain the same in Scotland as in rUK, the OBR forecasts[21] that Scottish revenues would grow at the same rate as revenues in rUK. Implicitly, this implies that Scottish revenues would match the BGA.

If the Scottish Government were to reduce the burden of ADT by 50%, this would likely lead to a reduction in revenues, at least over the short-term. If the policy were to have behavioural effects (i.e. additional passenger travel from Scottish airports), a reduction in the burden of ADT by 50% may not imply a reduction in revenues of 50%, relative to the base-case.

However, estimating the extent to which a reduction in ADT rates may stimulate increased passenger travel is difficult, not least because of a lack of data or evidence on the effects of similar policy changes in the UK or elsewhere. Furthermore there has not yet been a formal

[19] Policy Memorandum to the Air Departure Tax Bill

[20] Programme for Government, 2016

[21] The Scottish Government did not produce a forecast for ADT in its 2017/18 Budget, and the Scottish Fiscal Commission is not due to produce its first official forecasts until later in 2017.

assessment of the likely behavioural effects of the policy (although a report is due by end 2017). Critical questions include the extent to which an ADT reduction is likely to be passed through to ticket prices, and the sensitivity of customers to changes in prices.

In the absence of any evidence on the scale of behavioural effects, we assume that a 50% reduction in the burden of ADT – phased over the period to 2021/22, is associated with a 50% reduction in revenues. The policy, whilst not yet legislated for, thus represents a source of budgetary risk.

Table X: Forecasts for Air Departure Tax revenues and the BGA

	2018-19	2019-20	2020-21	2021-22
BGA forecast	£327	£340	£356	£373
Scottish revenue forecast (no policy change)	£327	£340	£356	£373
Difference between revenues and BGA	*£0*	*£0*	*£0*	*£0*
Scottish revenue forecast (50% reduction in burden)	£327	£284	£238	£187
Difference between revenues and BGA	*£0*	*-£57*	*-£119*	*-£187*

Notes: Revenue and BGA forecasts derived from OBR March 2017 Economic and Fiscal Outlook.

VAT

From 2019/20, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced VAT rate will be assigned to the Scottish budget. A number of technical issues around how Scottish VAT revenues will be estimated are being investigated by a VAT Assignment Working Group, which is due to report in September 2017.

No official forecasts for the assigned element of Scottish VAT have yet been published. At the UK level the OBR forecasts VAT revenues to grow at an average of 4% per year to 2021/22. Between 2010/11 – 2015/16 Scotland's share of UK VAT has remained stable around 8.5% to 8.6%.

Assuming that this share remains stable, then based on the UK's OBR forecast and the estimate of assigned Scottish VAT in 2015/16 provided in the 2015/16 GERS report, our estimate of Scottish VAT revenues is shown in Table X.

With VAT assignment some 18 months away, it is currently too early to say whether VAT assignment is likely to have net fiscal costs or benefits for the Scottish budget. As already noted, the Scottish share of UK VAT has remained robust in recent years, and there is little evidence in existing data to suggest this trend may change. Our working assumption is thus that the BGA for assigned VAT will match the Scottish revenues in the later years of the forecast period.

Table X: Forecasts of assigned Scottish VAT and the BGA

	2019-20	2020-21	2021-22
BGA forecast	£6,568	£6,826	£7,075
Scottish revenue forecast	£6,568	£6,826	£7,075
Difference between revenue and BGA	*£0*	*£0*	*£0*

Source: FAI analysis of OBR Economic and Fiscal Outlook (March 2017) and Government Expenditure and Revenue Scotland (GERS) 2016.

Aggregates Levy

No date has yet been agreed for the devolution of Aggregates Levy, a tax on the importing or extraction of sand, gravel and rock. The OBR forecasts revenues to remain broadly unchanged in cash terms at UK and Scottish levels after 2017/18. We assume that Aggregates Levy is

devolved in 2020/21, with Scottish revenues of £54m offsetting an equivalent block grant adjustment.

2.4 Bringing it together

Table X brings together the outlook for the Scottish budget, taking account of the block grant, together with the BGAs and revenues for each tax.

This central scenario assumes that

- Scottish income tax revenues grow at the same per capita rate as those in rUK, and that the Scottish Government increases the income tax Higher Rate threshold in line with inflation, but that the UK Government increases it to £50,000 by 2020/21. A risk to the budget is that the UK Government does not implement its commitment on the Higher Rate, which would result in a somewhat higher BGA.

- LBTT revenues slightly underperform the BGA – to the same extent as was the case in 2016/17 – throughout the forecast period. In other words, LBTT revenues are 6% lower than the BGA each year

- Landfill Tax revenues grow in line with the Scottish Government's December 2016 forecasts, whilst the BGA grows in line with the latest OBR forecasts for the comparable rUK taxes.

- For ADT, we assume the Scottish Government implements a 50% reduction in the burden of the tax by 2021/22, but the central scenario makes no allowance for any behavioural response to the tax reduction.

- Finally, for both Aggregates Levy and assigned VAT, we assume that revenues per capita in Scotland grow in line with those in rUK.

Under this central scenario, the Scottish Government's budget outlook is only slightly different from the outlook for the block grant. Additional revenues from income tax (resulting from the Scottish Government's decision to set a lower Higher Rate threshold, combined with the UK Government's assumed decision to increase the rUK Higher Rate threshold to £50,000 in 2020/21) are offset by forecast relatively lower growth in LBTT revenues, and, from 2019/20, the reduction in the ADT burden.

Table X: Outlook for Scottish Government revenue budget, £m (cash terms)

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Block grant	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656
		£11,636	£11,924	£12,326	£12,833	£13,460
Income tax		£11,771	£12,094	£12,543	£13,108	£13,761
		£135	£170	£216	£274	£301
	£522	£580	£619	£656	£700	£747
LBTT	£493	£548	£585	£619	£661	£705
	-£29	-£33	-£35	-£37	-£39	-£42
	£132	£107	£99	£92	£89	£88
LfT	£147	£149	£118	£109	£112	£106
	£15	£42	£19	£17	£23	£18
			£327	£340	£356	£373
ADT			£327	£284	£238	£187
			£0	-£57	-£119	-£187
				£6,568	£6,826	£7,075
VAT				£6,568	£6,826	£7,075
				£0	£0	£0
					£54	£55
Aggregates Levy					£54	£55
					£0	£0
Total	£26,073	£26,772	£26,794	£26,851	£27,362	£27,747

Source: FAI analysis

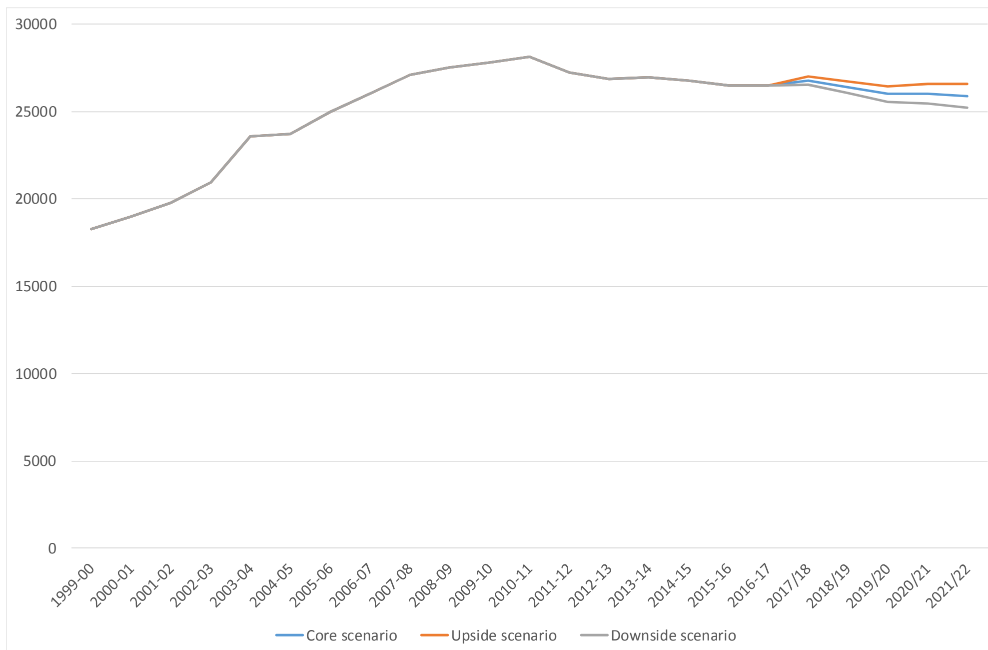
There is clearly uncertainty around the exact outlook for Scottish revenues and the BGAs.

Figure X sets out the outlook for the Scottish resource budget in real terms based on our 'central scenario' set out above, and under two scenarios designed to capture both upside and downside risk.

- Relative to the central scenario, the upside risk scenario assumes that Scottish wages grow 0.3 percentage points faster than rUK wages over the forecast period, that LBTT revenues match the BGA, and that the Scottish Government chooses not to implement the cut to Air Departure Tax.

- Relative to the central scenario, the downside risk scenario assumes that Scottish wages grow 0.3 percentage points less quickly than in rUK; that the UK Government chooses to increase the Higher Rate by inflation (and does not increase it to £50,000), and that outturn LBTT revenues match the Scottish Government's December 2016 forecast (which in turn implies that revenues are around 13-15% lower than the BGA in each year of the forecast period).

Figure X shows the implications of the inclusion of the tax and BGA forecasts into the long-term profile of Scottish Government resource budget. Between 2017/18 and 2021/22, the resource budget is forecast to decline 3.3% in the central scenario, by 1.6% in the upside scenario, and by 4.9% in the downside scenario.



2.5 The outlook for capital expenditure

The Scottish Government's block grant for capital expenditure increased by 5.5% in real terms between 2016/17 and 2017/18. Relatively strong real terms growth is also expected in 2018/19 and 2019/20, following the £23bn increase in capital spending announced by Chancellor Phillip Hammond in the November 2016 Autumn Statement.

From April 2017, the Scottish Government is able to borrow up to £450m in any year for capital investment, within an overall limit of £3bn. The 2017/18 Budget indicates that the Scottish Government plans to utilise its £450m capital borrowing powers in full in 2017/18.

To date no borrowing has been drawn down in 2017/18, although this is consistent with prudent budget management, in the sense that borrowing should only occur once the full CDEL allocation has been used up.

At the same time however, it is likely that the Scottish Government may not be able to utilise its borrowing powers in full in 2017/18. This is because some of its borrowing powers are likely to be required to provide 'cover' for schemes that are re-classified from the Non Profit Distributing (NPD) programme (Box X).

Box X: Implications of NPD reclassification for the Scottish Government's capital borrowing

The NPD programme involves the private sector funding the upfront capital costs of particular building projects (schools, hospitals etc.) and the Scottish Government committing to pay fees to cover capital costs, increased interest repayments and maintenance/ service charges (usually for 25-30 years).

In 2015/16, the ONS reclassified various NPD projects as being on the public balance sheet

(rather than being private sector funded). In consequence, the Scottish Government came to an accounting agreement with UK Treasury to use its capital borrowing allocation for 2015/16 to provide budget 'cover' for the reclassified schemes. This does not mean that the Scottish Government borrowed in this year (and thus there will be no interest rate charges); but the full value of the capital project will score on the balance sheet, and count as part of the Scottish Government's borrowing limit.

In 2015/16, £280m of reclassified NPD schemes were scored against the Scottish Government's borrowing limit; in 2016/17, £398m of reclassified NPD schemes were scored against the borrowing limit[22]. Although this imposes an opportunity cost (in terms of reduced ability to borrow), it does also reduce the future repayments associated with the NPD schemes by an equivalent amount.

A proportion of the Scottish Government's 2017/18 borrowing limit is also likely to be required to provide budget cover for reclassified NPD projects, although it is not yet clear how much.

Table X: Outlook for Scottish Government capital budget

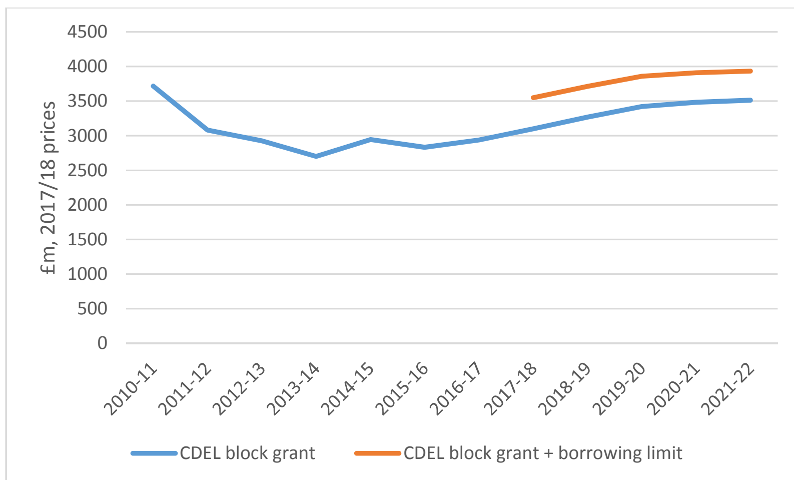
	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Cash terms	2,892	3,100	3,320	3,533	3,663	3,767
2017/18 prices	2,939	3,100	3,269	3,422	3,482	3,513
Real terms annual change		*5.5%*	*5.4%*	*4.7%*	*1.8%*	*0.9%*
Borrowing limit		450	450	450	450	450

Notes: figures for 2016/17 – 2020/21 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget. Figures for 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total CDEL spending but does not allocate this total between spending departments.

The outlook for capital spending is placed in a longer term context in Figure X. Following declines from a historic high level in 2010/11, the Scottish Government's capital allocation is forecast to approach its historic high of £3.5bn by 2019/20. If the Scottish Government's borrowing powers are utilised in full, capital investment could reach £4bn per year by 2021/22.

Figure X: Outlook for Scottish Government capital spending

[22] Source: Letter from Cabinet Secretary to Convenor of Finance and Constitution Committee, January 2017. http://www.parliament.scot/S5_Finance/General%20Documents/Cab_Sec_FC_to_FinConvenor_-_05Jan17.pdf



2.6 Conclusions

As we set out in Chapter 1, under the Fiscal Framework, the performance of the Scottish economy – and by implication of devolved Scottish revenues – relative to the performance of the rUK economy and comparable rUK tax revenues is critical in determining the size of the Scottish budget in future.

That said, the block grant remains the key component in determining the size of the Scottish Government's spending envelope. The block grant actually increased slightly in real terms in 2017/18. But, based on the UK Government's spending plans, cuts to the resource block grant of 1.5% and 1.4% are expected in 2018/19 and 2019/20.

The outlook implies that the block grant (before any adjustments for new tax and social security powers) will be around 8% lower in 2020/21 than it was ten years earlier.

There is clearly some uncertainty around the extent to which the Scottish revenues are likely to be higher or lower than the respective BGAs in any given future year. Recent slower growth in Scottish wages, house prices and the wider economy than in rUK may result in the Scottish Fiscal Commission adopting a relatively cautious approach to its forecasts – although the recent past is not necessarily a good guide to the medium term future.

Relatively small differences in wage growth between Scotland and rUK can make significant differences to income tax growth over time.

Setting a lower threshold at which the Higher Rate of income tax is paid will raise between £140m and £170m in 2018/19, depending on where the UK Government sets the Higher Rate threshold in rUK. On the other hand, a commitment to reduce the burden of APD is likely to reduce revenues by over £119m by the end of this parliament.

We have set out a range of possible scenarios. Under a central scenario – where the Scottish Government continues to set a somewhat lower threshold for the Higher Rate than in rUK; where the income tax base per capita grows at the same rate in Scotland as rUK; where LBTT revenues marginally underperform the BGA; and where cuts to APD go ahead – the Scottish Government's resource budget is forecast to fall by 3.3% in real terms between 2017/18 and 2021/22.

Under an upside scenario – where LBTT revenues match the BGA, cuts to APD are not made, and Scottish wages grow more quickly than in rUK – the resource budget is forecast to fall 1.6% over the period. Under a more challenging scenario, where Scottish wages grow relatively slowly and LBTT revenues substantially underperform the BGA – the resource budget could fall by 4.9% in real terms.

These scenarios are of course only indicative, and the government's outturn budget could prove higher or lower than this. But the scenarios illustrate, on the balance of probability, further real terms cuts are more likely than increases over coming years.

As we outline in the next chapter, this outlook will mean that the government will have to prioritise carefully its commitments over the remainder of this parliament.

The outlook for the capital budget is more positive. The government's capital allocation increased by 5.5% in 2017/18 in real terms, and will increase by almost as much again in 2018/19 and 2019/20. The government is now also able to borrow up to £450m annually to fund capital investment, although its ability to do so remains somewhat constrained in 2018/19 as a result of the reclassification of various NPD schemes.

Chapter 3: Spending Commitments and Constraints

- In 2016, the Scottish Government set key budget priorities for the next few years.
- A number of these carry price tags. On health, the government has committed to increase spending by £500 million more than inflation by the end of the parliament. It has also pledged to maintain real terms spending on policing and to double free childcare provision.
- Delivering these plans will continue to require a prioritisation of spend from other areas. As outlined in Chapter XX, the total resource that the Scottish Government has at its disposal is likely to fall in real terms over the course of this parliament (and possibly beyond).
- Some unprotected areas could therefore face cuts of between 4% to 12% (1% to 3% annually) over the period from 2016/17 to 2020/21.
- Added to that, the government is likely to be reluctant to give up on commitments that have been at the centre of their narrative, including free higher education tuition, protecting college places, concessionary travel and free prescriptions.
- In looking forward, new spending pressures are also emerging.
- The government has committed to investing an additional £750 million over the course of the parliament to tackle the attainment gap. In June, the Cabinet Secretary announced his intention to move to a more generous pay settlement.
- Prudent financial management is also likely to mean that the government will wish to build up the new Scotland Reserve in case tax forecasts undershoot, the economy takes a turn for the worse or spending pressures arise in the future.
- In the medium term, the new social security powers carry significant opportunities to do things differently but also costs –
    - Initial estimates for set-up costs point to a gap of over £100m over 2017 to 2021 between monies provided by the UK Government and actual costs;
    - Initial estimates also point to a gap of over £80m per annum for administration.
    - The Scottish Government will be under pressure to use these powers – either to offer more generous benefits or to maximise uptake. Under the fiscal framework, this will carry costs.
- All of this leaves local government as the largest element which could be categorised as "unprotected". This is likely to re-ignite the debate about the future for local government finance and delivery of local services.

The government has set out a number of spending commitments to the end of the parliament. In a time of tight resources, this will continue to require a tough re-prioritisation of spend across – and within – portfolios. With the overall budget likely to decline in real terms, commitments to increase or maintain spending mean other portfolios have to pick up the burden. These unprotected portfolios could face average cuts of between 8% and 12% by 2020-21.

3.1 Introduction

Chapter XX considered how the spending envelope the Scottish Government could have at its disposal might evolve over the coming years.

How might it decide to distribute this budget across policy priorities? This is the question we consider in this chapter.

Given that it was the first year of the new income tax powers, it was perhaps not surprising that last year's budget debates – both in parliament and Scotland at large – focussed on issues of taxation. But in the end, the tax changes were marginal both in revenues raised an in the context of the budgetary challenges faced[23].

How portfolios fare with ongoing tight settlements is likely to return to the agenda this year.

As Chapter X made clear, the balance of probability is that the Scottish budget is likely to remain highly constrained to the end of – at least – this parliamentary term.

The Scottish Government will need to decide how to allocate these resources to meet their immediate policy commitments and their aspirations set out in the National Performance Framework[24].

A number of spending pledges have been clearly set out and costed. We know, for example, that the health budget will continue to increase in real terms.

Added to that, the government is likely to be reluctant to move away from particular high profile pledges that have been at the centre of their narrative – such as, free higher education tuition, protecting college places, subsidised concessionary travel and free prescriptions.

But new spending pressures are also now emerging.

One of the most significant of these is the delivery of the Parliament's new social security powers. The government will also wish to build up some resource in the new Scotland Reserve in case tax forecasts undershoot, the economy takes a turn for the worse or spending pressures arise in the future.

All this means that the pressure on unprotected areas is likely to remain acute. Many of these areas have already borne the brunt of cutbacks to date.

This chapter is structured as follows.

In Section 3.2, we outline some of the core spending pledges committed to by the government and the costs associated with them.

In Section 3.3, we discuss the outlook for non-protected areas.

When looking at the potential implications for 'unprotected areas', it is important to view such a discussion in the round. Resource spending on health accounts for around 48% of the Scottish Budget, so any prioritisation of health spend will undoubtedly have implications for other

[23] The Scottish Government estimated that freezing the higher rate threshold at £43,000 would generate an additional £29m in revenues from Scottish taxpayers.

[24] http://www.gov.scot/About/Performance/scotPerforms

portfolios. Critics of cuts elsewhere will need to set out where money should be saved or what taxes should rise.

In Section 3.4, we discuss some of the wider spending pressures the government is likely to face over the next few years. The outlook for social security will undoubtedly be a key area of focus on the government's financial risk register.

Section 3.5 focusses on the outlook for capital spending.

In Section 3.6, we close with a discussion of the outlook for local government. Based upon the analysis set out in this report, the scale of the financial challenge facing local authorities is likely to once again spark a debate about the future of local government finance and how best to deliver local services.

Section 3.7 concludes.

3.2 Explicit spending commitments

Next year, the Scottish Government will spend around £26 billion on public services.

At first glance, this sounds as though Ministers have significant resources at play in order to change spending priorities and find savings.

But in reality, through a combination of different factors, much of this spend is difficult to alter – at least in the short-term.

Some of these stem from the largely fixed costs of running government. These includes things like pay and pension costs, NHS drug costs, heating costs for public buildings, infrastructure payments, maintenance obligations and the costs associated with meeting minimum legal commitments in certain areas.

On top of that, political commitments can build in their own frictions – for example, totemic commitments on free personal care, concessionary travel, free higher education tuition and free prescriptions.

All this has knock-on effects in other areas which, faced with tight budget settlements, will feel any squeeze that much more.

To illustrate how this will have an impact on the budgets for 2018-19 and up to 2020-21, we focus upon the three major policy commitments that the Scottish Government has set out:

- Health
- Police
- Childcare

It should be noted that the Scottish Government clearly has other priorities, some of which could be argued are just – if not even more – politically important to them.

Improving standards in education and closing the attainment gap is the most obvious area. So we explore education a little further below.

Health spending

Health has been the clear budgetary priority of the devolution years. As a proportion of total resource spending, spending on health has increased from 38% in 1999-2000 to 45% in 2017-18.

Spending on health has increased 81% in real terms over this period.

There are a number of explanations for this trend. The Scottish population has been growing (up 7% between 1999-2000 and 2017-18) and is getting older (aged 65+ has increased by 25%). Costs have also been rising as a result of new treatments and new technologies, together with ambitious service delivery commitments. Despite this, we have seen issues emerge in waiting times and other areas of service delivery.

However, despite the significant increases in spending – both in real terms and as a proportion of the Scottish budget – the increase since 2010 has been much slower than in the earlier years of devolution. And although public spending on health in Scotland is higher (as a percentage of national income) than it is in the UK as a whole, it is slightly lower than in several major European countries, including Germany, France and Sweden[25].

Chapter 4 discusses long-term trends in health spend in more detail, and considers the effect of future demographic and cost trends.

The Scottish Government has pledged to increase the NHS revenue budget by £500m more than inflation by the end of the parliament.[26] Based on the latest inflation figures, this commitment now implies an increase in the health resource budget from £12.3bn in 2016-17 £13.9bn by 2021-22, equivalent to a 3.7% real terms funding increase.

For the 2017-18 Scottish Budget, the Scottish Government allocated £12.7bn spending to health. This implies that spending has to rise by a further £1.2bn over the remainder of the Parliament to meet the commitment.

As the exact profile has yet to be set out, for simplicity, we assume that increase is phased equally over the forecast period.

Police spending

The Scottish Government has committed to protect the police resource budget in real terms over the course of this parliament.

This implies an increase in funding for the Scottish Police Authority from £1.07bn in 2016-17 to £1.17bn in 2021-22. This is expected to enable Police Scotland deliver on a commitment to maintain the number of Police Offices at 17,234.

The transition to Police Scotland has continued to remain a challenging one.

Audit Scotland has been critical of the apparent weak financial leadership and lack of a long-term financial strategy within the organisation.

The most recent report by Audit Scotland concluded that “even with the Scottish Government’s commitment to maintain a real terms increase in the policing budget for the duration of the current parliamentary session” – Police Scotland - “could face a cumulative funding gap of almost £190m by 2020-21.”[27]

This suggests that a commitment to ensuring sufficient resources are in place for the police in Scotland is likely to remain a key priority in upcoming budgets. It is also likely to mean further reform, including the distinct possibility that the commitment to supporting 1,000 extra police officers will be reviewed.

Childcare

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[25] Public expenditure on health is 8.3% of (onshore) GDP in Scotland in 2016/17 compared to 9.5% in Germany, 8.7% in France and 9.2% in Sweden. Source: https://data.oecd.org/healthres/health-spending.htm

[26] The commitment ‘by the end of this parliament’ in our view means 2021-22, which is the last Budget to be set in this parliamentary session (with elections in May 2021). By NHS we mean all health spending and not just territorial and Special NHS Boards. This commitment results in additional health spending of £1.8 billion by 2021-22, which is broadly consistent with the Scottish Government’s figure ‘of around £2 billion.’

[27] Audit Scotland identified that, even after the commitments given by the Scottish Government to maintain funding in real terms, financial pressures are likely to see the Scottish Police Authority face deficits of between £18m and £60m each year from 2016/17 to 2020/21. See: http://audit-scotland.gov.uk/uploads/docs/report/2016/s22_161222_spa.pdf

The Scottish Government has committed to doubling the number of hours of free early years education and childcare to 30 hours a week for vulnerable 2 year olds and all 3 and 4 year olds by 2021.

In March 2017, the government published a Blueprint and Action Plan[28] for its Childcare Strategy. But there has yet to be any detailed costings of delivering the childcare commitment.

The only available figure is from the 2016 SNP Holyrood Manifesto which highlighted a cost of an additional £500m per annum by the end of the Parliament (effectively an increase from £439m in 2015-16 to £939m in 2020-21).

The expansion is being delivered by local authorities. As such the transfer of funds will be subject to a negotiation with COSLA about how to deliver the increased service.

The transfer of such funds – and how they have been used by local authorities – has not been without controversy.

Protecting these 3 areas has implications for other non-protected budgets…..

These three commitments represent a significant financial investment by the Scottish Government.

Table XX shows the financial implications for spending on health, police and childcare by 2020-21.

We have followed Scottish Government practice of expressing spending plans and commitments at a portfolio level to include 'non-cash' DEL[29].

Total spend in these priority areas will total just under £15bn (or 55% of Resource DEL) in the final financial year of this Parliament (2020-21). This is a real terms increase on 2016-17 of 5.2%.

Table x: Spending commitments and implications for the Scottish Government resource budget, 2017-18 prices

Commitments	Allocation 2017/18	Expenditure in 2020-21 (£m)	% Change 16-17 to 20-21	Annualised % change 16-17 to 20-21
NHS – spend £500m more than inflation by end of Parliament	12,660	13,020	3.24%	0.80%
Police Scotland – protect in real terms	1,092	1,087	0.00%	0.00%
Childcare – double provision	660	893	59.99%	12.47%
Total spend on committed areas	**14,412**	**14,941**	**5.23%**	**1.28%**

Source: Fraser of Allander calculations

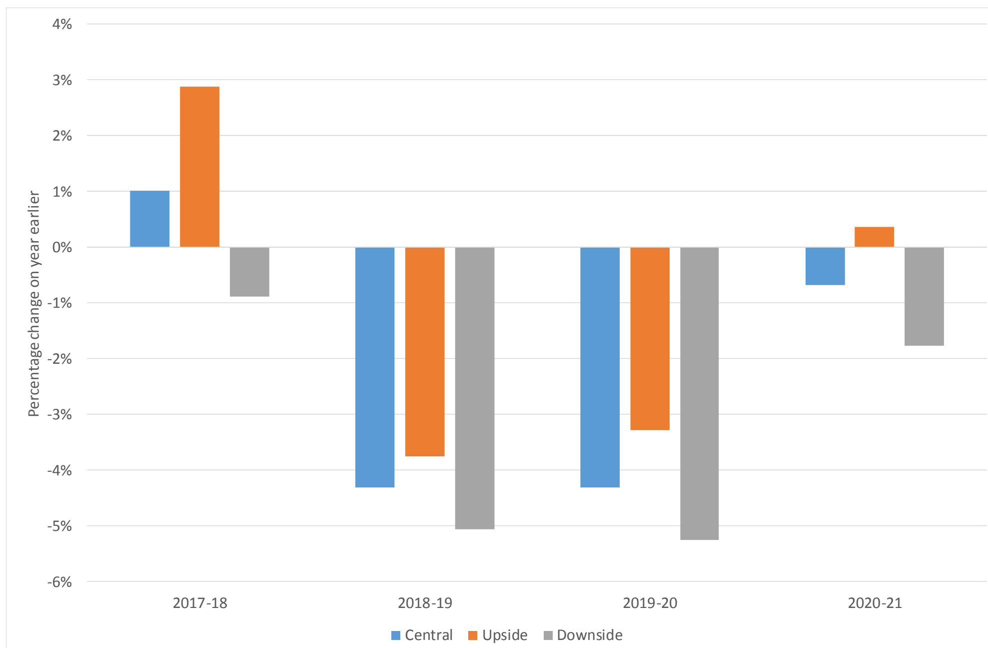
As we outlined above, delivering these commitments will require substantial re-prioritisation within other portfolios.

Therefore, Chart XX sets out the implications of these commitments for unprotected portfolios, under a variety of budget scenarios – as set out in Chapter 2.

Chart X: Budget implications for unprotected portfolios under a variety of budget scenarios

[28] http://www.gov.scot/Resource/0051/00515637.pdf

[29] Non-cash DEL is an accounting adjustment to cover depreciation and impairments and does not represent actual spending power. Non-cash DEL accounts for just over £1bn in 2017/18, rising to £1,1bn in 2019/20.



Under the Central Scenario – where Scottish income tax base grows at the same per capita rate as that in rUK, where the Scottish Government continues to set a lower threshold for the Higher Rate than in rUK, and where the Scottish Government implements its commitment to halve the burden of Air Departure Tax – the implication for unprotected portfolios is that they will see real terms cuts of around 8% by the end of the parliament – an annualised rate of -2.1%. The cuts are concentrated in two years in particular – 2018/19 and 2019/20.

Under a more 'upside' scenario – defined as where Scottish wages grow slightly faster than UK wages, LBTT revenues match the BGA, and the Scottish Government chooses not to implement its ADT cut – unprotected portfolios would see average real terms cuts of 3.9%.

But under a more 'downside' scenario – where Scottish wages grow less quickly than UK wages, the UK Government decides not to raise the Higher Rate threshold above the rate of inflation, and Scottish LBTT revenues underperform the BGA to the same extent as in 2016/17 – unprotected portfolios could face cuts of almost 12%.

The exact point estimates of each scenario are not that important. What can be seen from this however, is the scale of change facing particular areas. An 8% reduction in spending on unprotected portfolios is equivalent to just over £1bn in today's prices. A cut of £1bn is equivalent to the government's entire spend on the portfolios 'economy jobs and fair work', 'environment, climate change and land reform', and 'culture, tourism and external affairs'.

Clearly any savings will not be distributed evenly across unprotected areas, but the average cut is clearly substantial. Indeed, this is just a snapshot of the Scottish Government's headline commitments. As we discuss below, within this remaining group of unprotected areas are major components of spending that carry their own priorities.

3.3 Other policy commitments

Alongside these high level spending commitments set out above, the Scottish Government has other important priorities they seek to deliver.

Here we highlight two – the pressure to increase public sector pay awards following several years of a pay cap; and the continuing goal to improve educational standards and reduce the attainment gap.

Pay pressures

In last year's report, we highlighted the risk from higher inflation following the sharp fall in Sterling. Indeed, whereas in March 2016 the OBR was forecasting inflation of 1.6% and 2.0% in 2017 and 2018 respectively, by March 2017 it had increased these forecasts to 2.4% and 2.3%. Higher inflation reduces the real terms value of a given level of cash spending; costs go up meaning spending goes less far. It also means that the cost of "protecting" certain budgets in "real terms", like Police and Health, become more expensive.[30]

One of the ways in which higher inflation is likely to manifest itself as a cost is in terms of the pressure on public sector pay.

Public sector pay is one of the largest day-to-day elements within the Scottish budget. The latest available estimate suggests that pay equated to approximately £15bn in 2016-17[31] - or over 55% of the government's entire resource budget.

The Scottish Government has adopted a twin-track approach to pay in recent years.

The first strand has been a policy of no-compulsory redundancies, maintenance of 'progression', and pay awards targeted at those on the lowest incomes (including delivering the Living Wage). These are not without cost. Progression for example is estimated to cost around £120 million across the devolved public sector.

The second strand has been pay restraint with modest (below inflation) pay awards. Mirroring UK-wide policy, public sector pay awards in Scotland have largely been capped at 1% since 2013, following two years of freeze following the financial crisis.

However in June 2017 the Scottish Government committed to unilaterally lift the 1% cap on public sector pay. In a parliamentary debate on 29 June, Cabinet Secretary for Finance Derek Mackay said *'We will take a reasonable approach that absolutely recognises that the time is up for the 1% pay cap. Not only will the SNP commit to that, but we will do it.'*

Increasing public sector pay above the 1% pay cap will have significant budgetary implications. A 1% uplift adds £150m to the pay-bill.

Additional expenditure on pay represents both a constraint on the resources available for other areas of spending but at the same time a key part of any strategy to maintain the quality of public service delivery.

Education – the "defining mission"

The First Minister has made improving Scotland's attainment record in education – both in terms of overall performance and closing the gap between those from the poorest and most affluent backgrounds "the defining mission of this government.[32]"

Recent results from the Programme for International Student Assessment (PISA) showed that the performance of Scottish students had tended to decline somewhat compared to those in

[30] "Real terms" budget calculations are made using the GDP deflator. This is a different measure of inflation to CPI which is what most households are interested in. Economy wide measures of inflation may not be wholly accurate for individual portfolios where local inflation rates may look quite different – e.g. the NHS.

[31] http://www.gov.scot/Resource/0051/00515144.xlsx

[32] See https://beta.gov.scot/publications/first-minister-speech-priorities-for-government/

comparator countries[33]. This has served to increase the level of scrutiny around this commitment.

To help deliver on their objectives, the government has earmarked a total of £750 million through the Scottish Attainment Fund over the course of this parliament. In 2016-17, £120m was allocated according to how many children in primary school and the first three years of secondary school were entitled to free school meals. Schools have significant autonomy to determine how to use this funding, with the government providing information to headteachers about successful approaches and interventions.

The use of free school meal entitlement as an indicator of educational disadvantage mirrors the approach to allocating 'pupil premium' funding in England. In 2016-17, the pupil premium allocation in England was £1,320 for each pupil eligible for Free School Meals in years 1-6, and £935 for pupils in years 7-11[34]. In Scotland the £120m Attainment Fund allocation in 2017-18 is equivalent to around £1,200 per eligible pupil[35].

It seems highly unlikely that the Scottish Government will move away from this commitment to fund improvements in attainment, if anything the figure is likely to increase.

In addition, it seems likely that the government will seek to find some mechanism to maintain – at least in some form – the overall level of investment in school education outside the attainment commitments (e.g. to maintain teacher numbers). As part of the 2017/18 local government settlement, councils agreed to maintain the pupil:teacher ratios at the same level as in 2016/17, and to secure teacher placements for all probationers who required one. These were supported by of £51 million to maintain teacher numbers and £37 million to support the teacher induction scheme.

Whilst the Scottish Government has indicated a preference for focussing new educational investments on schools, it has also made commitments relating to further and higher education. It has committed to maintaining the number of college FTE places at 116,000 per annum. The Scottish Government's net college funding increased by 2.3% in real terms between 2016/17 to 2017/18, although it is likely to be difficult to maintain a similar pace of increase over the next two years.

On university funding, the outlook is more uncertain. In 2017-18, the resource allocation to the Higher Education sector was 2.9% lower in real terms than in 2016/17. This does not however include the costs of funding the Government's flagship free tuition commitment, which costs just over £217m per year.

If it is assumed that the commitment to maintain college places will require the college budget to be maintained at least in cash terms (at £550m), that the commitment to free university tuition will require an allocation of at least £220m per annum, and that at least £120m per annum will be invested in the Attainment Fund annually, these commitments tie-up a further £890m of spending.

Taking these education spending commitments together with those already discussed in relation to health, police and childcare implies that 57% of the government's resource budget could already be committed in 2018/19. It also implies that unprotected portfolios will face cuts of between 3.9% and 5.3% between 2017/18 and 2018/19, under the 'upside' and 'downside' scenarios respectively.

[33] See http://www.gov.scot/Publications/2016/12/7252

[34] https://www.gov.uk/guidance/pupil-premium-information-for-schools-and-alternative-provision-settings

[35] https://news.gov.scot/news/pupil-equity-funding

Another way to look at this is to examine how much of the Scottish budget is being absorbed by 'fixed' input commitments – either in terms of a budget commitment or a commitment to a particular target in terms of staff numbers etc. Taking the 'fixed input' commitments to include:

- The funding commitment on health;
- The commitment to double childcare provision;
- The commitment to maintain police spending (in order to retain the same number of police officers);
- The commitment to maintain college places;
- The commitment to free university provision;

These 'fixed input' commitments account for 55% of the government's resource budget in 2017/18, increasing to 58% in 2020/21. This analysis does not include the costs associated with maintaining the pupil-teacher ratio, and it assumes the costs associated with HE tuition fees and college places will remain fixed in cash terms going forward. Nor does this assessment include the cost constraints imposed by the NPD programme, discussed below.

3.4 Additional financial constraints

The Scottish Government will face two additional technical constraints over the short to medium term. The first of these relates to the costs of financing capital projects that have been funded through the Non-Profit Distributing (NPD) programme and its predecessor PFI programme.
The second relates to the pressing need to build some resource in the Scotland Reserve in order to provide capacity to deal with in-year cash management issues and forecast errors associated with the new tax and social security powers.

Revenue financing of capital investment

The government faces funding obligations arising from ongoing public private partnership (PPP) projects which have been used to fund infrastructure investment in Scotland.
The Scottish Government's non-profit distributing (NPD) model is a form of PPP with the rates capped on the more controversial PFI schemes of the past. Under such projects, the private sector finances the upfront capital costs associated with a project and, on completion, continues to maintain and, in some cases, operate, the asset. Once operational, the public sector makes annual payments ("unitary charges") to the private sector contractor to cover the capital costs, interest costs and maintenance/service charges. Such payments typically continue for 25-30 years.
Estimated payments under past PFI and NPD contracts are expected to be around £1.1bn in the current financial year (2017-18).

Table X: Estimated payments under PPP Contracts

£m	2016-17	2017-18
Health and Sport	244.1	248.9
Finance and the Constitution	-	-
Education and Skills	351.0	357.7
Justice	51.5	51.5
Communities, Social Security and Equalities	148.0	149.9
Rural Economy and Connectivity	94.0	96.4
Culture, Tourism and External Affairs	-	-
Economy, Jobs and Fair Work	-	-
Environment, Climate Change and Land Reform	151.3	154.8
Administration	-	-

Total	1,039.9	1,059.2

Source: Scottish Government Draft Budget 2017/18, Annex H

Annual repayments resulting from these projects come from the Scottish Government's revenue budget.
The Scottish Government has committed to spending no more than 5% of its total DEL budget on repayments resulting from revenue financing (which includes NPD, previous PFI contracts, regulatory asset base (RAB) rail investment) and any repayments resulting from borrowing. Based on current plans, the Scottish Government will spend just over 4% of its total DEL budget on such payments in 2017-18, rising to a peak of just under 4.5% in 2020-21.

Strategic budget management and the importance of establishing reserves

As we discussed in Chapters 1 and 2, the devolution of tax and social security powers to the Scottish Parliament will mean that the Scottish budget is now much more dependent on forecasts of tax revenues and social security spending.
Not only are revenues and demand-led social security spending inherently more volatile from one year to the next than a relatively stable block grant, but there will also be a degree of error associated with any given set of forecasts.
For example, and as we set out more explicitly in Box X below, a forecast made at the time of a budget that spending on social security spending would be £3bn in a given year could quite feasibly turn out to represent an underestimate of actual spend by £100m or £200m. Similarly, an estimate that income tax revenues would bring in £12bn in a given year could easily turn out to be an overestimate of one or two hundred million.
And as well as being exposed to error in the Scottish forecasts, the Scottish budget will also be exposed to error in calculating the BGAs, as we explain in Box X below.
Managing these financial risks will become a key element of the Scottish budget process.
As highlighted in Chapter 1, the Scottish Government now has access to a number of cash management tools to enable it to smooth the budgetary effects of forecast errors and other in-year cash management issues. These include some ability to borrow, and provision for a cash management reserve – the Scotland Reserve.
On resource borrowing, within the statutory cap on total borrowing (£1.75bn), there is –

- an annual limit of £500 million for in-year cash management to cover the fact that the timing of when devolved revenues are collected and spending commitments need to be allocated may differ); and,
- an annual limit of £300 million to account for forecast errors for devolved taxes, social security spending and the BGAs.

The Fiscal Framework also makes provisions for a cash reserve – the Scotland Reserve –which can be used to smooth spending, manage revenue volatility and ensure that the government is not always in the process of borrowing money (which carries a charge). The government is able to build up reserves of £700 million and draw these down at a rate of up to £250 million a year for resource spending, and £100 million a year for capital spending.
Use of either the borrowing powers or the Scotland Reserve will have implications for the Scottish Government's remaining budget. Borrowing in any given year will incur repayment costs in future years, whilst building up resources in the Scotland Reserve implies an opportunity cost (in terms of reduced expenditure) in the current year.
There may be a temptation to assume that the Scotland Reserve will build up naturally as a result of underspends. However, a more strategic and prudent approach is likely to now be necessary.

Management of budgetary risks will constrain the Scottish budget at the margin, but is necessary as part of a prudential approach to the budget.

3.5 Social Security

As highlighted in Chapter 1, a number of social security powers are being devolved. Spending on these benefits in Scotland by the UK Government in 2015-16 totalled around £3bn[36]. Additionally, the Scottish Government will gain the power to 'top-up' benefits reserved to Westminster, and to create new benefits.

These new powers offer an opportunity to take forward a different 'type' of social security system in Scotland.

But this will bring with it new spending risks and pressures. We highlight four here.

First, the Scottish budget will bear the risk that expenditure per capita on any of the benefits being devolved increases more quickly than expenditure on equivalent benefits in rUK.

Just as the block grant adjustments for tax are designed to represent the 'revenues foregone' by the UK Government, the block grant adjustments for social security are designed to represent the 'spending foregone' as a result of transferring the powers to the Scottish Parliament.

The implication is that the Scottish budget bears the risk that spending per capita on any benefit increases more rapidly in Scotland than in rUK. This could arise if demand rises relatively more rapidly (e.g. because of an ageing population. Higher uptake, perhaps as a result of improved awareness of eligibility (which the Scottish Government is keen to encourage) or an approach to deliver that is perceived as being more caring, could also result in higher costs.

Secondly, the Scottish Budget will bear the costs (or savings) of any policy differentiation. The costs of a higher benefit rate, or wider eligibility, for example relative to rUK will be borne by the Scottish budget.

Ministers have committed to a number of social security policies:

- Increasing the annual value of Carers Allowance to match Jobseekers Allowance; and
- Replacing the Sure Start Maternity Grant with an enhanced Best Start Grant.

The Financial Memorandum to the Social Security Bill sets out indicative cost estimates of around £34m per year for Carers Allowance and around £17m per year for the Best Start Grant. These commitments come on top of the existing policy to mitigate the effects of the 'bedroom tax', which costs around £35m annually.

Similarly rUK policy changes will also have budgetary implications via the block grant. The introduction of means testing for the Winter Fuel Payment, to take a hypothetical example, would result in a reduction to rUK spending and a cut to the Scottish Government's grant.

Thirdly, the Scottish Government will bear any additional costs (beyond those already agreed with the UK Government) associated with the establishment and operation of the new Scottish social security system. This includes not just the Social Security Agency itself, but also arrangements for the benefit assessment process, forecasting, policy design, and so on.

The Financial Memorandum to the Social Security Bill estimates the costs of setting up the Social Security Agency at £308m over the four year period to 2020-21 (£104m on staffing and £190m on IT). Running costs, once fully operational, are estimated at between £144m - £156m per annum. This is around 5% of the value of benefits being devolved.

Under the agreement reached between the Scottish and UK governments to do a deal, the UK Government will transfer up to £66m each year to cover these ongoing administration costs. They are also making a one-off transfer of £200m to cover implementation costs (of which

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[36] Source GERS 2016-17 http://www.gov.scot/Topics/Statistics/Browse/Economy/GERS

£100m has been transferred so far). Note that these transfers are to cover all costs associated with the newly devolved powers, not just social security.
Any additional costs will need to be funded by the Scottish Government. Clearly the costs put forward by the Scottish Government exceed the transfer from the UK Government – set-up costs of £308m vs. £200m and running costs of around £150m vs. £66m.
Finally, the devolution of the social security powers, together with the process for adjusting the Scottish block grant and the difficulties inherent in forecasting social security expenditure, also poses a unique in-year cash management risk. This is explained in Box X, and emphasises the importance of establishing a contingency fund in the Scotland Reserve.

Box X: Forecasting expenditure on devolved social security benefits and the implications for in-year cash management

The Scottish Fiscal Commission (SFC) will be responsible for making the official forecasts for spending on the devolved social security benefits in Scotland.

The Block Grant Adjustments (BGAs) for the social security benefits will initially be based on forecasts made by the UK Government (DWP), based on the their forecasts for spending on 'equivalent' social security benefits in rUK. The forecast BGA will be added to the Scottish Government's block grant.

Once outturn expenditure on the benefits is known (in September following the end of the financial year), the forecast BGA will be 'reconciled' with the outturn BGA.

This process creates a cash management risk for the Scottish budget. This is accentuated by the fact that in recent years the UK Government has tended to overestimate the savings it will make from various welfare reforms; as a result, expenditure has been greater than forecast.

A practical example of the implications of this for is as follows:

- Imagine that the Personal Independence Payment (PIP) has been devolved, and that on the basis of rUK expenditure forecasts, a BGA of £1.5bn is transferred to the Scottish block grant. The SFC forecasts Scottish spending at £1.5bn, so the budget is in balance.

- However, imagine that higher than anticipated demand results in expenditure in rUK on PIP being 7% higher than forecast, and for the same reasons, expenditure is also 7% higher than forecast in Scotland.

- This means that, despite having a BGA of £1.5bn, the Scottish Government spends £1.6bn on PIP. The £100m difference between actual spending and the BGA must come from borrowing, savings elsewhere, or use of the Scotland Reserve.

- Subsequently, once it emerges that rUK spending was higher than forecast, the BGA will be reconciled upwards by £100m, leaving the Scottish budget no worse off in aggregate over time. But what has been created is a major in-year cash management headache because of the forecast error.

On average, UK forecasts for the benefits being devolved have been affected by systematic downward bias of 6.9% per year since 2014/15. In the context of total spend on the devolved

benefits in Scotland of around £3bn, a 7% error equates to £210 million.

Under the Fiscal Framework, the maximum that the Scottish Government can draw down from the Scotland Reserve in any year is £250m (for all purposes, including revenue shortfalls), whilst the maximum it can borrow for forecast error (again including revenue forecasts errors too) is £300m annually.

Thus even a fairly 'average' error in the estimation of the BGAs for social security powers would wipe out the majority of its in-year cash management borrowing capacity.

3.5 Capital Spending

The Scottish Government's capital budget allocation by portfolio is shown in Table x below. The Communities, Social Security and Equalities portfolio has the largest capital budget of any portfolio in the current financial year at just under £1.5bn. Around half of this portfolio's capital allocation goes to Local Government (£756.5m) with nearly £700m going to Housing, principally the construction of affordable homes.

Table X: Scottish capital budget allocation, £m

	2016-17	2017-18	£m change 16-17 to 17-18	% change 16-17 to 17-18
	£ million			%
Health and Sport	524.5	408.1	-116.4	-22.2%
Finance and Constitution	3.5	2.0	-1.5	-42.9%
Education and Skills	99.5	171.4	71.9	72.3%
Justice	74.8	91.5	16.7	22.3%
Economy, Jobs and Fair Work	138.5	137.7	-0.8	-0.6%
Communities, Social Security and Equalities	1,319.5	1,485.1	165.6	12.6%
Of which Local Govt	*606.9*	*756.5*	*149.6*	*24.6%*
Environment, Climate Change and Land Reform	20.2	142.8	122.6	606.9%
Rural Economy and Connectivity	1,294.7	1,407.8	113.1	8.7%
Culture, Tourism and External Affairs	32.4	32.0	-0.4	-1.2%
Administration	13.1	13.1	0.0	0.0%
Crown Office and Procurator Fiscal	3.6	3.6	0.0	0.0%
Total	**3526.0**	**3,895.1**	**369.1**	**10.5%**

Source: Scottish Draft Budget 2017/18. Notes: figures include Financial Transactions and assume that the Scottish Government's borrowing powers are utilised.

The Rural Economy and Connectivity portfolio has an allocation of £1.4bn, with motorways and trunk roads (£627m) and Rail Services (£462m) the largest elements.

As set out in the previous Chapter, the outlook for capital spending is reasonably positive, with the capital grant from Westminster increasing by almost 5% in real terms in 2018/19 and 2019/20. The Scottish Government can augment its block grant allocation through additional borrowing, as set out in the previous chapter.

3.6 Local Government

Our report last year highlighted that, given budgetary constraints and the commitments made to various other portfolios, the settlement for local government in 2017-18 was likely to be particularly constrained.
In the end, the 2017-18 local government settlement was indeed the subject of both significant scrutiny and a degree of contention – see Box X.

The financing arrangements for local government are complex. Local government revenue is derived from a number of sources:

- The General Resource Grant from Scottish Government
- Specific Revenue Grants from Scottish Government
- Non-Domestic Rates Income
- Council Tax revenues
- Income for a variety of other service fees and charges (ranging from parking fees to income from social care services).

The revenue funding provided by the Scottish Government consists of the General Resource Grant, Specific Revenue Grants, and Non-Domestic Rates Income (NDRI).
The General Resource Grant and ring-fenced Specific Revenue Grants are paid by the Scottish Government to local authorities from the Scottish Government's resource budget. Non-Domestic Rates on the other hand are collected by local authorities, paid into a central pool and then re-distributed.
The Scottish Government guarantees to provide to local authorities the total of General Revenue Grant and NDRI – in other words the Scottish Government bears the risk that NDRI revenues come in below forecast. Council Tax revenues raised by each local authority are retained.

Box X: The local government settlement in 2017/18

In presenting its Draft Budget 2017/18, the Scottish Government stated that spending to support local authority services would increase by over £200m between 2016/17 and 2017/18.

The core settlement for local government however, included a reduction of around £100m in the General Resource Grant, and a reduction of around £100m in the level of redistributable Non-Domestic Rates[37].

The amount of funding that local government received from the Scottish Government to fund discretionary spending thus declined. But against this, the settlement included –

- An additional £120m in specific, ring-fenced grants to support school attainment; and
- An increase in funding of £107m for Health and Social Care Integration (mainly for paying the Living Wage to social care workers), albeit this had already been included in the Government's health spending line.

Whilst these two items do result in additional funding for local government, they do not add to local government's discretionary spending power.

[37] These figures reflect those at Stage 2 of the Budget Bill, after the Government had reached agreement with the Green Party to increase local government funding.

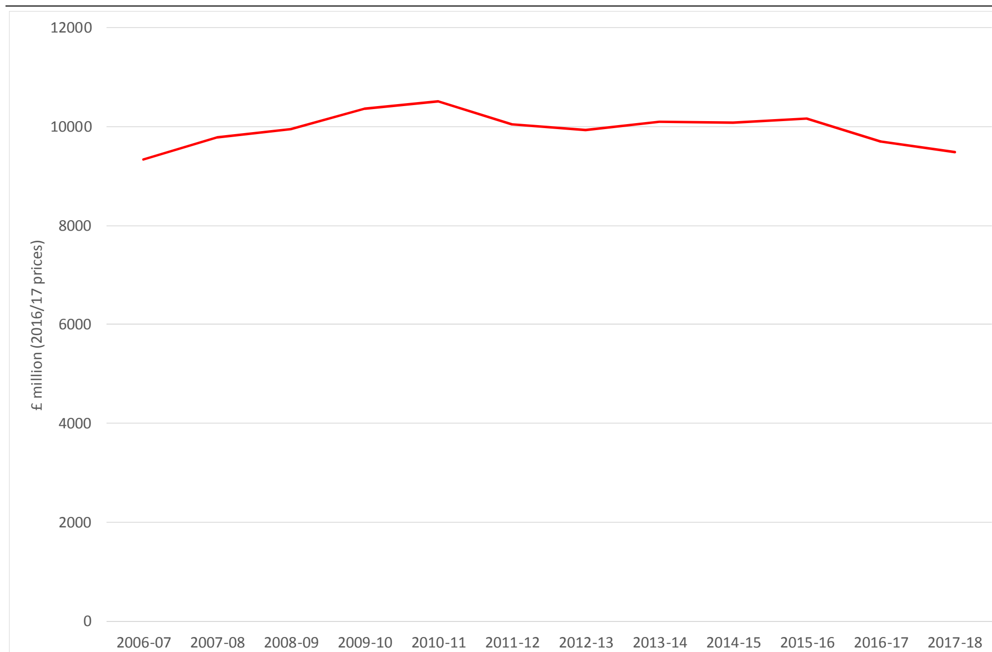
Additionally, the Government included in its definition of 'local authority services' the revenue that local government would raise collectively as a result of increases to the Council Tax charge for properties in Bands E-H (£111m), as well as the potential £70m of revenues that could be raised if all Scottish local authorities raised Council Tax by 3% (the maximum they are entitled to in 2017/18). The extent to which Council Tax should be thought of as a local or nationally controlled tax is unclear.

In summary, the presentation of local government vis-à-vis funding for local services is likely to remain a source of much debate. With tight resources, it is desirable that funding pools are shared and work together to either maintain or improve outcomes. But too often this gets lost in political point-scoring on all sides. A much more open and transparent approach would be a step forward.

Chart X shows the evolution of the local government revenue settlement over the last decade. The Chart controls for the fact that police and fire services were removed from local authority control in 2013/14. It thus shows the evolution of local authority settlement on a broadly like-for-like basis.

The local government settlement has declined by around 9.5% since 2010/11, equivalent to around £1bn in real terms (this analysis includes the additional £120m allocated in 2017/18 for the Attainment Fund).

Chart X: Total revenue funding to local government (including Non-Domestic Rates and specific grants), 2006/07 – 2017/18



Source: Fraser of Allander Calculations

Has the local government settlement fallen disproportionately in the context of the Scottish Government's overall budget? Perhaps, but not as much as might be expected. Local government's revenue funding (general resource grant, specific grant and Non-Domestic Rates) as a share of the Scottish Government's RDEL grant plus Non-Domestic Rates revenues, has fallen from 35% to 33% between 2010/11 and 2017/18.

Maintaining the local government share would have boosted local budgets by around £570m in 2017/18. Of course, such increases if they had materialised would have led to reduced spending in other areas of spending.

The reason the local government settlement has not declined more is that Non Domestic Rates Income – which is collected by local authorities, pooled with Government and then redistributed, and hence counts as part of the local government 'settlement' – has proved relatively buoyant.

Redistributable Non-Domestic Rates grew by an average of 3.5% per year in real terms between 2010/11 and 2016/17. This was partly due to 'buoyancy' of the tax base (i.e. growth in the number of premises subject to tax) and inflationary increase in the 'poundage' (i.e. the tax rate).

What is the outlook for local government general funding from the Scottish Government?

There are two elements to this question – the outlook for the General Resource Grant (funded from the Government's resource budget), and the outlook for Non-Domestic Rates income.

Local government is the largest element within the 'non-protected' part of the Scottish budget. Earlier in this chapter we set out a central scenario which would see cuts to unprotected portfolios of 10.1% in real terms between 2016/17 and 2020-21. Our upside scenario sees cuts of 5% whereas a downside scenario sees cuts of 14.7% to unprotected portfolios.

Offsetting this, some buoyancy in Non-Domestic Rates Income is expected. The Scottish Government has forecast that the Non-Domestic Rates tax base will grow by 1.8% in 2018/19, 1.1% in 2019/20 and 0.9% in 2020/21[38]. With the poundage set to increase in line with inflation, these forecasts assume that Non-Domestic Rates revenues will continue to be buoyant, although less so than in the past.

When it comes to Non-Domestic Rates however, a further complication is that what is 'collected' in any given year is not quite the same as what is available to be 'redistributed' to local government. The somewhat complicated arrangements underpinning the NDRI pool are described in Box X.

Box X: The NDRI Pool

The non-domestic rate income (NDRI) pool came to prominence during passage of the 2017-18 Budget Bill when, at stage 2 of parliamentary proceedings, the Scottish Government transferred £60m from the NDRI pool to help fund a boost of £220m over and above the money allocated in the Draft Budget.

Each year the Scottish Government makes a forecast for non-domestic rates (NDR) and guarantees the revenues implied by that forecast to local government as part of its overall settlement. This acts like a withdrawal from the pool.

[38] Draft Budget 2017/18 Devolved Taxes Forecast Methodology

The Scottish Government then receives the NDR revenue as the year progresses, which acts as a payment into the pool.

Over time the withdrawals from and income to the pool are expected to balance out. This acts as a discipline on forecasts which, consequently should be neither consistently over optimistic or over pessimistic.

But the most recent year for which we have audited information on the balance of the NDRI pool is 2015-16. In the financial year 2015-16 there was a deficit of £215m for the year, and a net deficit in the NDRI pool as at 31 March 2016 of £289m, which would be carried into 2016-17.

What matters with the NDRI pool is not the pool in any one year, but the profile of the pool going forward and – if in deficit – how the Scottish Government plans to manage it back to balance.

When announcing use of the NDRI pool to fund budget amendments, Mr Mackay stated that the Scottish Government were "continuing to update the profile of the Scottish Government contribution required to bring the non-domestic rates pool into balance. This process has allowed us to meet the estimated cost of the additional support package announced today."

We currently do not have NDRI pool data beyond 2015-16 (2016-17 returns are due in October), but given the statement above, one would expect that government believe the balance in 2016-17 to have been relatively healthy and/or have a projected profile for the future that supports a return to balance. Of course, the Scottish Government bears the financial risk of any NDRI funding shortfalls. And the Scottish Fiscal Commission may take a less generous forecast of future revenues which may make closing any gap in the pool more difficult.

The NDRI pool has come to prominence as a mechanism to fund Budget Bill amendments in a similar way to the use of underspends to boost the 2017-18 budget. Consequently, opposition policymakers are likely to press the government much more in the future over whether the Budget initially introduced to parliament is indeed the complete picture of resource available. Some may ask whether or not more resources can be found from other sources – such as re-profiling the NDRI pool – to meet additional commitments during any negotiations.

Combining these two elements – the outlook for the general resource grant from Holyrood and the outlook for NDRI – provides a picture about the outlook for the local government settlement in general.

As shown in Table X, the outlook for the local government core settlement is for real terms falls of around 10% between 2016/17 and 2020/21.

Funding to local authorities may differ from this outlook if additional monies are allocated to local government to help deliver on any of the government's broader commitments or objectives. For example, additional funding may help support delivery of the childcare commitment or aspects of the new social security powers.

Table X: Outlook for local government general revenue budget (Resource grant + NDRI), 2017/18 prices

	2016/17	2017/18	**2018-19**	**2019-20**	**2020-21**	**Change, 2016/17 - 2020/21**
	£ million					
Central scenario	9,770	9,416	9,131	8,838	8,770	-10%

upside scenario	9,770	9,416	9,169	8,940	8,938	-9%
downside scenario	9,770	9,416	9,080	8,729	8,596	-12%

What about Council Tax?

The nine-year Council Tax freeze ended in 2017/18 and local authorities have been able to decide whether or not to increase (or, theoretically to reduce) Council Tax rates by up to 3%.

21 of Scotland's 32 Councils chose to increase rates by the maximum 3%, whilst eight froze their rates for a tenth year (the remaining councils increased their rates by less than 3%).

Whilst the decision not to increase rates might seem surprising, with council tax accounting for only around 15% of local government revenue a percentage increase in the tax rate (which is very visible to local residents) results in a proportionately small increase in council budget.

As well as the end of the freeze, 2017/18 also marked a change to council tax bands. Properties pay tax based on which of eight bands they are in, with the amount paid in each band defined as a ratio relative to a band D property.

The Scottish Government increased the multipliers applied to bands E-H, with no change for band A-D. The changes to the ratios means that higher banded properties pay a somewhat higher tax rate relative to property value than previously. This is forecast to have raised an additional £111m for local government in 2017/18.

It remains to be seen whether councils will be able to increase tax rates further in 2018/19, although this seems likely. Further reform to the banding structure is likely at some point, but may be seen as politically inexpedient in the near term, coming so soon on the back of the changes in 2017/18.

Local Government - Summary

Given priorities in other areas, it is no surprise that local government budgets have been under pressure from relatively above average cuts to central government grants. The cuts would have been worse had it not been for the relative strong performance of Non-Domestic Rates.

Local government has responded by making changes to back office functions, implementing pay restraint, evolving their use of assets, and raising more income from services.

At the same time, the balance of spending has been shifting with some responsibilities increased (e.g. childcare and early years) and some taken away (e.g. police and fire services).

So the last few years have seen changes in both overall funding, the responsibilities of local government, and the way in which money has been spent. Yet partly because these changes are happening relatively gradually, there has been little public debate around the changing nature of local government service delivery, or how these services are funded.

Looking forward, local government will face major spending pressures. Some of these reflect demand pressures (particularly in relation to social care), whilst others reflect cost pressures (pay awards etc.).

These challenges highlight why many are now calling for a debate about local government's role in service delivery, and how these services are funded in the future.

3.7 Conclusions

The Scottish Government has committed to increase real terms spending on health, continuing a trend that has been observed since the establishment of the parliament in 1999. Nonetheless, as we will see in Chapter X, the forecast spending increases are arguably towards the lower end of what might be required when one considers demographic trends and broader cost increases.

The Scottish Government has also made flagship commitments to increase provision of childcare and maintain real terms spending on police. These three commitments alone account for over half of the Scottish Government's resource budget.

There is clearly some uncertainty around exactly what level of resource the Scottish Government will have available for each of the remaining years of this parliament.

But the projections suggest that these three commitments will imply that the resources available for unprotected portfolios will fall by 8-12% between 2016/17 and 2020/21.

These unprotected portfolios include education (where the government has pledged to maintain the number of college places, and to close the education attainment gap), and local government. The local government settlement was one of the key areas for debate in 2017, and is likely to prove so again in 2018.

Of course, with a tight settlement those who argue against such cuts need to put forward where money will be saved elsewhere – including not following through with these commitments on health, childcare and policing – or to outline where taxes will rise.

The government will also face a number of other spending pressures and constraints. It has pledged to remove the 1% public sector pay cap – arguably necessary to protect quality in public service delivery, but with clear budgetary implications. And as part of prudent financial management it will probably want to build some resource in the new Scotland Reserve – effectively providing some insurance against the risk of forecast error associated with the new tax and social security powers.

Looking slightly beyond 2018/19, the new social security powers will provide another significant resource constraint. Although the Scottish budget will be increased to reflect the costs of delivering the social security benefits in Scotland at the point of devolution, the Scottish budget will bear the costs of policy variation, any costs associated with faster growth in benefit take-up, and the costs of administering the new powers.

The outlook for capital spending is more positive. The government's block grant from Westminster is forecast to increase by XX. Additionally, the government can borrow up to £450m per year to fund capital investment, although its ability to do so will remain somewhat constrained in 2018/19 as a result of the reclassification of various NPD schemes.

EMAIL 4

From: Grisewood A (Aidan)
Sent: 12 September 2017 10:20
To: Graeme Roy (graeme.roy@strath.ac.uk)
Subject: FW: Private: Draft Chapters

Graeme, apologies for the delay. I thought these were being co-ordinated elsewhere and sent on, but turns out they weren't, so sending you direct. Did you get comments separately from John on spending side? If not I can chase separately here.

You'll see nothing major in comments here, and as a general comment I thought it was a good read and a good fist at explaining BGAs to a lay audience too (if such an audience reads FoA publications!)

All the best

Aidan

Chapter 1: Economic Outlook

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly with major new powers over taxation and welfare.
- Around 40% of devolved expenditure are now funded by tax revenues generated in Scotland – a figure that will rise to 50% once VAT revenues are assigned.
- As a result, Scotland's economic performance – or more accurately, Scotland's economic performance *relative* to the UK – now has a much greater bearing on the outlook for the Scottish budget than ever before.
- This autumn, for the first time, the Scottish Fiscal Commission (SFC) will provide detailed forecasts for Scottish devolved taxes, income tax and GDP. The Office for Budget Responsibility (OBR) will be preparing forecasts for the relevant Block Grant Adjustments.
- Both of these will be shaped by their assessments of the outlook for the Scottish and UK economies respectively and the outlook for the key determinants of changes in the revenues collected from each individual devolved tax.
- Despite showing signs of resilience in the immediate aftermath of the EU referendum, UK growth has slowed markedly in the first half of 2017. The strong growth in consumption that propped up the economy in 2016 has tailed off. Business investment remains flat, whilst the boost to trade hoped for following the sharp fall in Sterling has yet to materialise.
- Whilst Scottish growth data for the first quarter of 2017 was more positive than we could have hoped for, the Scottish economy has been weaker than the UK economy over the last two years – in part, driven by challenges in the North Sea.
- Indeed, refreshed figures published last month show that the Scottish economy *contracted* slightly in 2016. But employment is now at a record high with one of the lowest unemployment rates in the UK.
- Over time, what matters most for the Scottish Budget is how Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.
- But in looking ahead to this year's Scottish Budget, what will also be crucial will be the actual forecasts made by both the SFC and OBR. It is the combination of these two forecasts that will determine, at the margin, how much more or less money the Cabinet Secretary for Finance will actually have this year to spend.
- Given recent data, we believe that the Scottish Fiscal Commission is likely to be cautious in their forecasts for growth and Scottish taxation over the next few years.

Whilst the Scottish economy made a welcome return to growth during the first three months of 2017, this was on the back of output actually contracting

during 2016. Employment is at a record high and there are some signs of confidence returning to the North Sea. But with Brexit and weak confidence, we expect the Scottish Fiscal Commission to be cautious in their forecasts for Scottish tax revenues and economic growth in this year's Budget.

1.7 Introduction

The Scottish budget is in the process of significant reform.

As a result of the Scotland Acts 2012 and 2016, substantial new fiscal powers are being transferred to Holyrood, including the devolution and assignment of tax revenues and the devolution of some social security powers.

The Scottish Parliament will soon oversee annual public spending of around £XX billion, control all land and property taxation, and have significant responsibilities over income taxation in Scotland.

The outlook for Scotland's budget now depends upon three key elements –

- What remains of the Westminster block grant – as determined by the Barnett Formula;
- Future tax policy choices of the Scottish Government; and,
- The ~~relative~~ performance of Scottish devolved tax revenues relative to their rUK counterparts.

UK economic performance and spending decisions taken at Westminster will continue to set the overall envelope for Scottish public spending through the Barnett formula.

But with Scotland's block grant now being adjusted (i.e. reduced) to take account of the new devolved tax revenues, how Scottish tax revenues perform relative to the rest of the UK will ~~now~~ have a much greater bearing on the outlook for the Scottish budget than ever before.

In time, it is this relative economic performance that will determine whether or not the Scottish Budget is better or worse off relative to what it would have been prior to devolution.

But for the immediate outlook of next year's Budget and the trajectory to the end of the Parliament, it will be the forecasts made for Scottish tax revenues and the equivalent taxes in the rest of the UK by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) that will be crucial.

This chapter is structured as follows.

Section 1.2 summarises the key elements of this new fiscal framework and explains how Scotland's relative economic performance will now feed through to budget outcomes.

Section 1.3 summarises the recent performance of the Scottish and UK economies. Section 1.4 discusses the outlook.

Section 1.5 highlights some of the key issues facing the Scottish Fiscal Commission in the compiling of economic and tax forecasts for Scotland than will face the Scottish Fiscal Commission.

Section 1.7 concludes.

1.8 Scotland's fiscal framework

The new powers

The Scottish Parliament's new tax and welfare powers are being phased in gradually over the next few years. With these new powers has come fundamental changes to the way that the Scottish budget is calculated and administered.

New arrangements for fiscal forecasting have been put in place with the Scottish Fiscal Commission achieving statutory status in April this year.

The Scottish Government has secured more extensive borrowing and cash management tools to manage budget volatility and uncertainty.

At the same time, implementing the new powers is requiring substantial technical and administrative work, much of which is ongoing. The way in which Scottish budgets are presented to and scrutinised by the Scottish Parliament is also changing.

Table XX provides a summary of the new responsibilities for taxation – including the taxes devolved as part of the 2012 Scotland Act.

Table X: Devolved, shared and assigned tax revenues in Scotland

Tax	Date of transfer/ devolution	Revenues raised 2015/16 (£m)	Degree of control by Scottish Parliament	Responsibility for collection
Land and Business Transactions Tax (LBTT)	2015	£425 RS accounts~~16~~	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	£147	Fully devolved; complete autonomy.	Revenue Scotland
Income tax	2017	£11,214	The Scottish Government can set the rates and bands. But the UK Government defines the tax base and sets allowances.	HMRC
Air Passenger Duty	2018	£247 GERS 2016-17~~75~~	Fully devolved; complete autonomy	Revenue Scotland
VAT	2019	£5,000	Assigned revenues; no autonomy	HMRC
Aggregates Levy	tbc	£53	Fully devolved; complete autonomy	Revenue Scotland

Source: Government Expenditure and Revenue Scotland (GERS)

A new Scottish tax agency, Revenue Scotland, has been established to collect revenues for the fully devolved Scottish taxes (LBTT, Scottish Landfill Tax, Aggregates Levy, and Air Passenger Duty, which the Scottish Government has announced will be renamed 'Air Departure Tax').

Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC.

Alongside taxation, some devolution of social security benefits is also taking place.

In particular, a number of UK-administered benefits, mainly related to ill-health, disability and carers are being devolved. The benefits associated with the regulated social fund – such as winter fuel payments – are also being devolved.

Spending on these benefits in Scotland by the UK Government in 2015/16 totalled around £3bn – see Table XXX.

[insert table on the new social security powers]

The Scottish Government is currently working to establish a new social security system in Scotland, with implementation dates for the new powers to be agreed by the Joint Ministerial Group on Welfare.

Additionally, the Scottish Government has already gained the power to:

- create new benefits (except pensions) in areas not otherwise connected with reserved matters
- top up reserved benefits
- make discretionary payments or provide discretionary assistance to meet certain needs
- amend some employment support schemes
- make changes to the amount of Universal Credit (UC) for the costs of rented accommodation, and the timing and recipients of payments.

Since 1 April 2017, Discretionary Housing Payments have been devolved.

The calculation of the Scottish budget

The Scottish Government's block grant from Westminster will continue to be determined by the Barnett Formula.

Therefore, decisions on public spending at Whitehall will still set the overall envelope for Scottish public spending through the decisions that they take on comparable funding for England-only departments where spending is devolved to Scotland.

However, the block grant will be adjusted (i.e. reduced) to take account of the fact that some taxes are now devolved to the Scottish Parliament.

How does this happen?

For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) is calculated. The BGA is effectively a measure of the tax revenues that the UK Government has foregone as a result of transferring the tax in question to the Scottish Parliament.

Box XX explains the operation of the BGAs in a bit more detail.

Box 1.1: The Block Grant Adjustments

The Block Grant Adjustments (BGA) are a key component of the new framework for the Scottish Budget. It is the combination of Scottish tax revenues ***and*** the BGAs that will ultimately determine whether or not the Scottish budget is better or worse off relative to the old settlement.

Under the new approach, a BGA will be calculated for each tax and will consist of two elements: an *initial deduction* and an *indexation mechanism*.

The initial deduction is equal to the tax revenues collected in Scotland in the year prior to devolution of the new power. For example, income tax was devolved for 2017-18. So the initial deduction was equal to income tax receipts in Scotland in 2016-17. The net effect was that the Scottish Budget was no better or worse off.

But what is the BGA for 2017-18 and thereafter?

This is where the indexation mechanism comes in. Its purpose is to provide a measure of the rate at which 'comparable revenues' have grown (or declined) in the rest of the UK (rUK) between 2016-17 and 2017-18 (or any subsequent year).

The basic idea is that the BGA should grow at the same rate as the growth in comparable revenues in rUK.

So how is the indexation mechanism actually calculated?[39]

Until 2020-21, the BGA for Scotland will effectively grow in line with the growth in per capita tax receipts for the equivalent devolved taxes in rUK. For income tax for example, the BGA will increase in line with the growth in NSND income tax growth per head in the rest of the UK.

A similar mechanism has been established for the new welfare powers. But instead, the BGA for social security powers involves a 'baseline addition' to the budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism.

The final indexation mechanism is still to be agreed but could ultimately be based on the 'Barnett Formula', so that the BGAs will be increased by a population share of 'comparable' benefits in rUK. But for the transitional period to 2021, they will grow in line with the percentage

[39] During the development of the Fiscal Framework, there was disagreement between the Scottish and UK Governments over the indexation mechanism. In the end, a temporary mechanism was agreed for review in 2021.

change in per capita spending on these 'comparable' benefits in rUK (and the change in Scotland's population[40]).

So each year the BGAs for each tax will take money out of the Scottish Government's block grant. What is added back in are the revenues that are raised from each tax in Scotland.

[insert diagram]

The key implication of how all this works is quite straightforward (even if the process underpinning it is not). In short, if the sum of the revenues raised from the devolved/ assigned taxes is greater than the sum of the BGAs, then the Scottish budget will be better off than it would have been without tax devolution[41].

It is this mechanism that builds in 'risk and reward' to the Scottish budget process, with how the economy performs now crucial to the future outlook for public spending in Scotland.

Scotland's Budget could be better off under the new system iffor two reasons:

- the tax base grows relatively more quickly in Scotland than in rUK; or
- tax policies in Scotland that seek to raise revenues relative to those in rUK.

Of course the reverse could happen – Scottish revenues may grow relatively more slowly than those in rUK, in which case the Scottish budget will be worse off than it would have been without tax devolution.

Under this new framework, the Scottish budget bears in full the effects of any differential growth in Scottish revenues relative to rUK revenues, even if the causes of any differential growth are beyond the control of the Scottish Government.

Operational issues with the implementation of the new powers

As highlighted above, the determination of the Scottish budget is now significantly more complex than in the past. It is no surprise therefore that the institutional framework that underpins this new arrangement has been reformed significantly.

Box 1.2 summarises some of the major new changes.

Box 1.2: The Fiscal Framework

The fiscal framework is the term used to cover the new budget arrangements for the Scottish Parliament's tax and welfare powers.

In addition to setting out the mechanism for how the block grant adjustment (BGA) will operate

[40] Given that Scotland has a higher proportion of people claiming these benefits than a population share, applying a Barnett uplift will – over time – effectively be a relative squeeze on welfare spending in Scotland.

[41] Similarly, for social security, if Scottish spending increases faster than in the rest of the UK, then this will have to come at the expense of lower spending in other parts of the budget or increased taxation.

– see Box 1.1 – there are a number of other important features of the new framework:

- The Scottish Government's capital borrowing powers have increased. The overall limit on borrowing has risen to £3 billion, with an annual limit of 15% of the overall borrowing cap (equivalent to £XXX million for 2018/19).
- The Scottish Government now has increased revenue borrowing powers of up to £600 million per annum, subject to a combined overall limit of £1.75 billion, for in-year cash management, forecast error and Scottish-specific economic shocks.
- The Scottish Fiscal Commission has been established with responsibility for forecasting economic growth and devolved tax revenues and welfare payments.
- The processes for managing cash flow and variations in tax revenues between years have changed significantly. Gone is the old Budget Exchange Mechanism for transferring 'underspends' from one year to the next, with a new Scotland Reserve established in its place. In this Reserve, the Scottish Government is able to deposit up to £700 million and draw down monies – subject to limits of £250 million for resource and £100 million for capital – should they need to[42].
- Following the recommendations of the Budget Review Group, new procedures are being put in place for how the budget will be presented to and scrutinised by Parliament. A greater focus on 'year round' scrutiny is likely.
- Finally, the inter-governmental relations between the Scottish and UK Governments have been reformed with new dispute resolution mechanisms, and new arrangements for information sharing. These have already been tested in the light of the deal by the new UK Government to secure support from the Democratic Unionist Party in June.

One of the biggest institutional changes – particularly from an economic perspective – has been the establishment of the Scottish Fiscal Commission.

From now on, twice each year, the SFC will make a 5-year forecast for each of the Scottish revenues, and for spending on the social security benefits being transferred to Scotland. They will also make a forecast for growth in Scottish onshore GDP.

The SFC will produce its first official forecast this year alongside the Scottish Budget. But in order to set its budget, the Scottish Government will not only need forecasts for Scottish revenues but forecasts for the BGAs. The BGA forecasts will be determined by the UK Office of Budget Responsibility's (OBR's) tax forecasts for rUK, and DWP expenditure forecasts for social security benefits.

[42] At the end of 2016-17, the Scottish Government had around £75 million in the Scotland Reserve and an underspend of XX.

The UK Government will transfer to the Scottish Government the SFC's forecast for income tax revenues; these will be drawn down throughout the financial year, whilst the UK Government will deduct from the block grant the forecast of the income tax BGA.

Therefore in looking ahead to this year's Scottish Budget, the outlook that the SFC and OBR have for the Scottish and UK economies (and tax revenues) will be crucial for determining the exact amount of money the Scottish Government will have at its disposal for the coming financial year[43].

1.9 Recent Scottish and UK economic performance

Economic Growth

All of this above discussion makes the outlook for the economy vitally important.

Over the last 12 months, the Scottish economy grew by 0.6% (and by 0.4% on a 4Q-on4Q basis). This is well below its long-term average and the equivalent growth rate for the UK as a whole (which grew by 2.0%).

Table XX: Scottish growth (%) by sector Q1 2016 to Q1 2017 (Quarter on Quarter growth)

	GDP	Agriculture	Production	Construction	Services	*GDP per head*
Scotland	+0.6	+0.8	-0.1	-4.0	+1.2	*+0.3*
UK	+2.0	-0.2	+2.3	+2.8	+2.3	*+1.3*

Source: Scottish Government

It is also below the forecast made by the Scottish Government for growth of 1.0% in 2016-17 in December's Draft Budget.

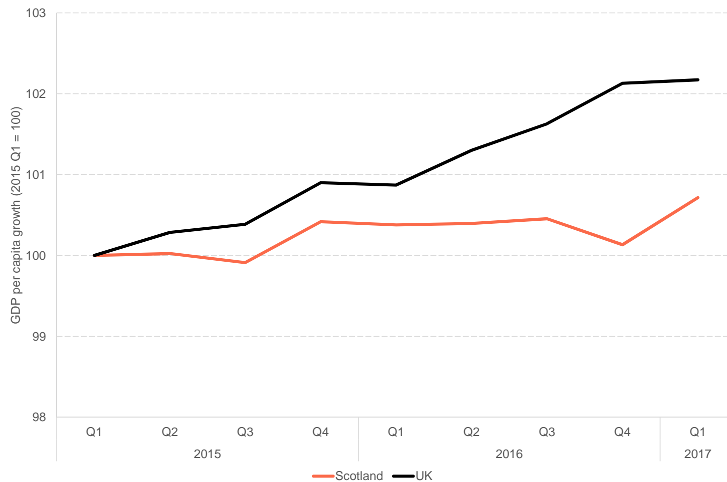
It is also sufficiently weak to trigger the emergency borrowing powers in the Fiscal Framework to cope with an asymmetric shock. This is defined as when Scottish growth is less than 1% and more than 1 percentage point smaller than the UK as a whole.

When measured in terms of output per head – arguably the more relevant indicator of performance given the focus of the new framework on tax receipts per capita – a similar story emerges.

Scotland grew strongly in 2014 but since then the UK has grown more quickly (Chart XX) – with growth in GDP per capita in Scotland of just 0.2% compared to the UK's 1.3% over the past year.

[43] Once outturn data on the taxes are available, the forecasts of both Scottish tax revenues and the income tax BGA will be reconciled to that outturn. For the fully devolved taxes these will happen on a monthly basis. But for income tax, outturn data will not be known until 15 months after the end of the financial year – so outturn data for 2017/18 for example will not be available until June 2019.

Chart XX: Scottish & UK GDP per head: 2014Q1 to 2016Q1



Source: Scottish Government

The Scottish economy recorded strong growth during the first three months of 2017. Whilst welcome, some caution needs to be exercised at this stage when interpreting these figures.

- Firstly, the growth of +0.7% comes on the back of a fall in output of 0.2% in the final three months of 2016.
- Secondly, the latest figures now show that the Scottish economy actually contracted during 2016 as a whole – falling by 0.1%.
- Thirdly, much of the growth during Q1 2017 was driven by a 'bounce-back' in sectors which have been hit quite badly due to the downturn in oil and gas. Even with the strong growth in Q1, these sectors are still well below where they were just two years ago – see Box 1.3.

All things considered, it is our expectation that the Scottish Fiscal Commission will view the recent GDP data with some caution. Much will depend upon the figures for Q2 to be published in October and the extent to which growth is shared more evenly across the economy.

Box 1.3: Recent Scottish Growth Figures - how sustainable?

In July, the Scottish Government published GDP figures for Q1 2017 showing quarterly growth in Scotland of 0.8%. This was well above expectations. Figures published in August revised this growth down to 0.7%. But this was still much higher than the equivalent UK figure of 0.2% for the same period.

Examining what was behind these figures is important, particularly in terms of assessing the outlook for the next few months and the coming year.

Table XX shows the contribution of growth made by each sector to the Q1 figures.

Table XX: Scottish growth (%) by sector Q1 2017

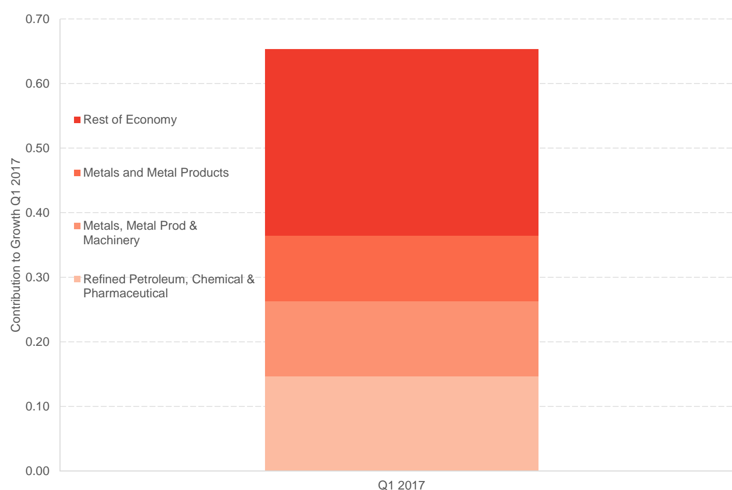
	GDP	Agriculture	Production	Construction	Services
Scotland	+0.7	+0.3	+2.7	-0.6	+0.4
UK	+0.2	+0.1	+0.1	+1.1	+0.1

Source: Scottish Government

For services and construction, which together make up over 80% of the economy, performance was much less spectacular than the headline rate. Services grew 0.4% (marginally below trend) whilst construction output actually fell 0.6%. What drove upswing was the strong growth in production of 2.7%.

An analysis of the industry make-up of this growth shows that three sectors – 'metals & machinery', 'refined petroleum, chemicals and pharmaceuticals' and 'other manufacturing, repair and installation' contributed over half the net growth recorded in Q1. What is particularly remarkable is that, taken together, these sectors account for just 6% of the Scottish economy

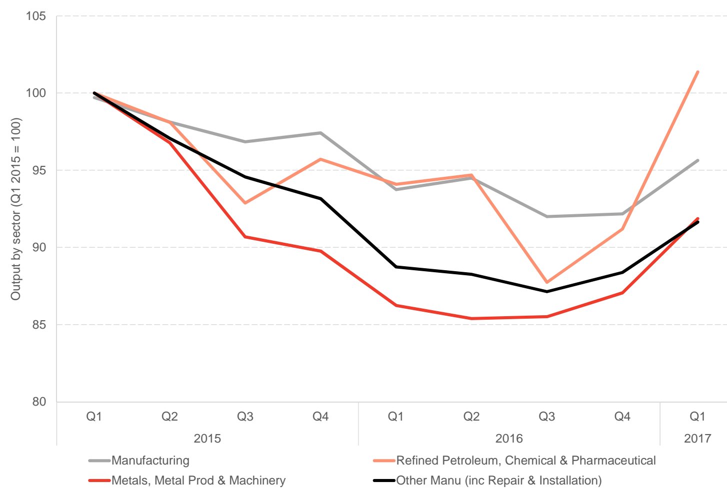
Chart XX: Contribution to Scottish GDP Q1 2017



Source: Scottish Government

Chart XX shows how these sectors have been performing since 2015. All three of them have had a challenging recent history.

Chart XX: Performance by Sector Q1 2015 to Q1 2016

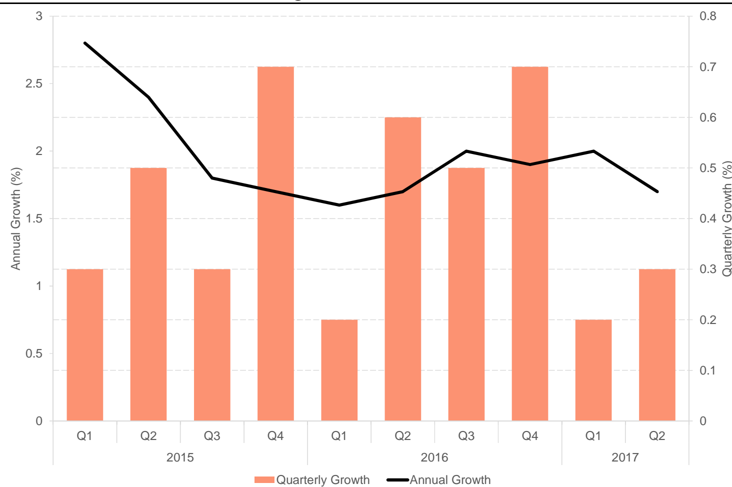


Source: Scottish Government

Whilst positive, it is entirely possible that a number of these factors will only have a (large) temporary impact on the results for Q1 2017. A degree of success will be maintaining these gains. We should therefore be careful in setting expectations too high that such growth will continue at the same pace for the remainder of 2017.

The UK economy initially appeared to hold up much better than expected in the immediate aftermath of the EU referendum. In fact, growth picked up through the second half of the year. But conditions have weakened markedly in the first half of this year.

Chart 1.XX: Slowdown in UK economic growth



Source: ONS

As expected, household consumption – which had been the principal driver of growth in recent times – has slowed to just 0.1% in the three months up to June. In 2016, consumption grew by

2.8%, in part fuelled by increased borrowing. But household consumption, particularly discretionary spending is being scaled back as inflation continues to bite. The Consumer Price Index is expected to peak at close to 3% this year.

Business investment remains subdued with little growth over the last two years. Some indicators from the Bank of England suggest that investment intentions may have *"strengthened a little further"* in recent months, but they also find that heightened uncertainty is playing a part in some firms' unwillingness to invest[44].

The UK's net trade position is broadly similar to that back in 2015 (at a deficit of around £8 to £9 billion) even with the help of a sharp depreciation in Sterling.

Against that however, tax receipts have been relatively healthy. The ONS' latest estimates of public sector borrowing for the year to March 2017 put the deficit at £45.1 billion, a reduction of £27 billion on the previous year. Borrowing is forecast to increase however, through the remainder of 2017.

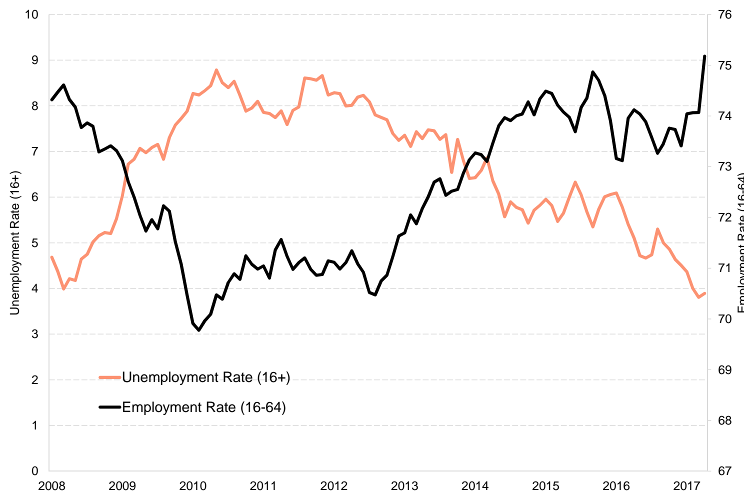
Scottish Labour market

In contrast to the wider economy, Scotland's labour market continues – at least in terms of the headline figures – to hold up remarkably well.

This is important given the focus of the new fiscal framework on income tax and VAT where employment and earnings will be key determinants of future revenue growth.

The employment rate in Scotland now stands at 75.2% up 1.1 percentage points on a year ago. Meanwhile the unemployment rate has fallen to 3.9% down 1.2 percentage points since last year.

Chart XX: Scottish employment rate and unemployment rate best since records began



Source: ONS, Labour Force Statistics, August 2017

[44] See www.bankofengland.co.uk/publications/Documents/agentssummary/2017/q2.pdf

Compared to the UK, Scotland now has a marginally higher employment rate and a lower unemployment rate.

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.2%	3.9%	21.8%
Quarterly Change	+1.1	-0.5	-0.7
Annual Change	+1.1	-1.2	+0.0
UK	*75.1%*	*4.4%*	*21.3%*
Quarterly Change	*+0.3*	*-0.2*	*-0.2*
Annual Change	*+0.7*	*-0.5*	*-0.3*

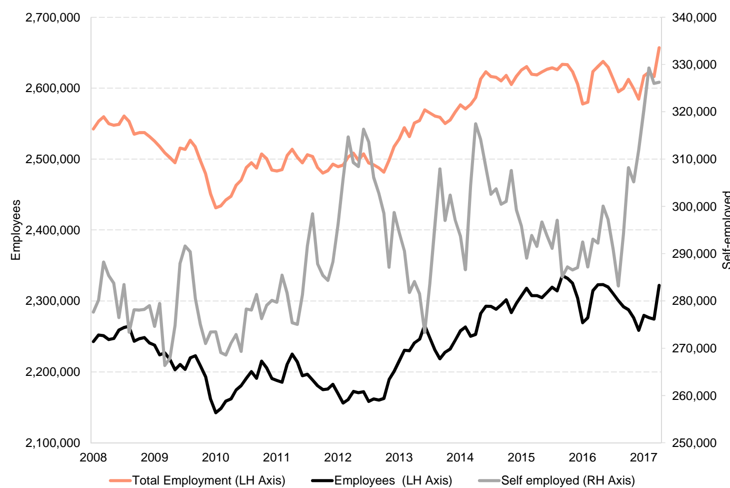
Source: ONS, Labour Force Statistics, August 2017

However as we have discussed in our Scottish Labour Market Trends reports, the headline figures do hide some challenges.

Firstly, there is an ongoing concern about the nature and type of work being undertaken by those in employment. For example since the financial crisis, there has been a rise in part-time employment (up around 10% over the past 10 years). The number of people working part-time because they cannot find a full-time job is up nearly 60% on the last decade.

Secondly, while employment has grown over the past year, this has almost all been driven by increases in self-employment.

Chart XX: Sharp rise in self-employment in Scotland over last year



Source: ONS, Labour Force Statistics, August 2017

Not only do we await to see what the long-term economic consequences of both effects, we do not yet know how such trends will feed through to the tax figures for Scotland (and the position of Scotland vis-à-vis the UK). On the one hand, by paying less in National Insurance contributions, a self-employed person who earns more than the personal allowance will pay more in income tax

than a traditional employee. But against that, those in self-employment have arguably greater scope to alter their tax affairs such as taking more in un-earned income (e.g. dividends) from their 'company' than employees.

Thirdly, real earnings remain under pressure.

Unfortunately, the most recent data we have for Scotland covers to the end of March 2016.

Over that year, wage growth has been slower in Scotland than in the UK. One explanation is the downturn in the offshore economy. Indeed, median wages declined by 5% in Aberdeen and 4% in Aberdeenshire between 2015 and 2016.

Table 4: Median Gross Weekly Earnings, Scotland

	Median Earnings	% change	FT Median Earnings	% change	CPI
2014	£414.70	1.5%	£519.60	2.1%	1.8
2015	£422.60	1.9%	£527.00	1.4%	-0.1
2016	£432.00	2.2%	£535.00	1.5%	0.3

Source: ASHE

More up to date data is available for the UK. It shows that after a short return to real earnings growth in the first part of 2016, average real wages are falling once again and remain XX% below their 2008 levels.

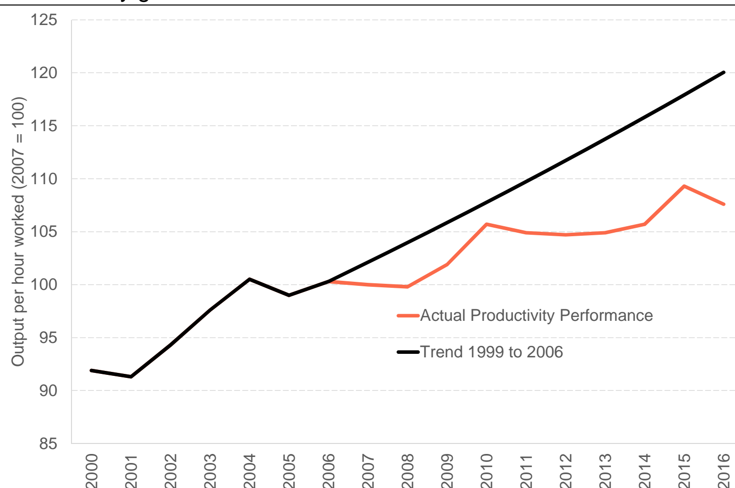
Productivity growth

The strong performance in the labour market belies weak productivity growth. In the UK, productivity growth averaged 2% per year until the mid-2000s, but has slowed significantly since.

Scotland has seen a similar slowing trend – Chart XX – although Scotland has fared better than the UK as a whole with the Sco-UK gap narrowing in recent years. Productivity fell in Scotland in 2016.

As we discuss below, the view of the Scottish Fiscal Commission on the outlook for productivity growth in Scotland compared to the UK as a whole will have a significant bearing on their forecasts for Scottish tax revenues.

Chart 1.XX: Productivity growth in Scotland



Source: Scottish Government productivity statistics[45]

1.10 The economic outlook

The economic outlook for both Scotland and the UK is highly uncertain.

Most forecasters predict that the UK economy will grow by around 1.6% this year, before falling back slightly further in 2018. This is below trend growth of around 2%.

Table XX: Latest economic growth forecasts for the UK economy

	2017	2018
CBI	1.6	1.4
Item Club	1.5	1.3
NIESR	1.7	1.9
British Chambers of Commerce	1.7	1.3
European Commission	1.8	1.3
OECD	1.6	1.0
IMF	1.7	1.5
Average of forecasts	*1.6*	*1.4*

Source: HM Treasury

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

The UK outlook will have three key implications for the Scottish Budget.

- Firstly, we await details of how the new UK Government will respond in their Autumn Budget to emerging evidence of a weakening in UK growth. Any changes to public

[45] http://www.gov.scot/Topics/Statistics/Browse/Economy/PROD16Q4

spending – e.g. to support a greater than planned pay increase for public sector workers – could have a direct bearing on the Sottish Budget via Barnett consequentials.

- Secondly, with around £11bn worth of exports destined for the rest of the UK every three months, the UK economy's performance will have an important bearing on the outlook for Scottish growth.

- Thirdly, as highlighted above, what matters most for the net position of the Scottish Budget now is how Scottish tax revenues perform *relative* to equivalent taxes in the rest of the UK.

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

Box XX: The global economic environment

The fundamentals of the global economy are stronger than they have been for many years.

Global economic activity is picking up with a long awaited recovery in investment and trade. The IMF forecast global growth to rise from around 3% in 2016 to nearer 3½% this year and next – not too distant from the long-term average growth rate.

Encouragingly, growth in international trade is expected to move ahead – once again – of overall growth in the global economy.

Financial markets have also held on to gains made in early 2017 and levels of business and consumer confidence – on the whole – are positive. The keenly watched 'OECD Leading Indicator' points to advanced economies remaining in positive territory in the near term with momentum building.

In terms of Scotland's two main international export markets, the outlook is positive.

Firstly, whilst the US economy has posted relatively modest results so far this year, strong jobs market data and an anticipated fiscal stimulus should lead to faster growth going forward.

Secondly, the recovery in Europe continues to build momentum and has now reached all Euro Area countries. But whilst unemployment continues its downward trend, it remains high with painful structural adjustments still needed. Even by 2018, Euro Area unemployment is still projected to be close to 8%.

Overall, policy uncertainty – from President Trump through to Brexit – remains high and is the biggest risk facing the global economy. There are also still a number of imbalances and vulnerabilities in financial markets – not least in China where the government is seeking to establish a more balanced and less debt-fuelled growth model.

Table XX: Outlook for global growth: 2017-2018

Year on Year	2015	2016	*Projections* *2017*	*2018*

World Output	3.4	3.2	*3.5*	*3.6*
Advanced Economies	2.1	1.7	*2.0*	*1.9*
US	2.6	1.6	*2.1*	*2.1*
Euro Area	2.0	1.8	*1.9*	*1.7*
Emerging Market and Developing Economies	4.3	4.3	*4.6*	*4.8*

Source: IMF World Economic Outlook, July 2017

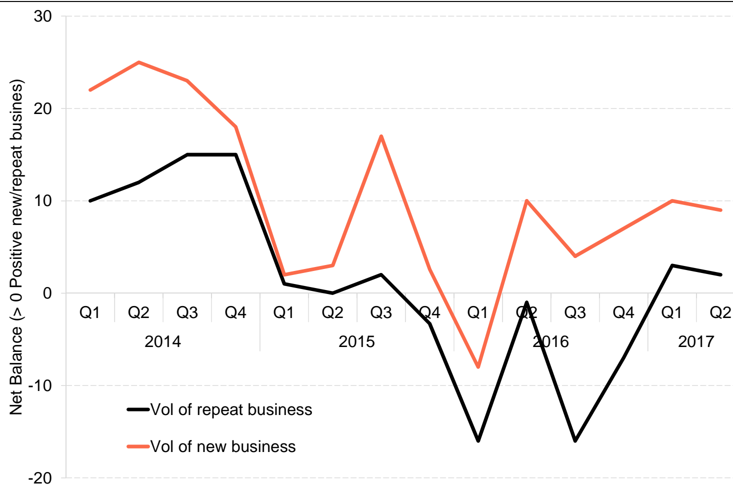
All of this takes us to the outlook for Scotland.

As highlighted above, the latest growth figures for Scotland showed strong growth in the first three months of 2017, but on the back of much weaker growth over the last two years.

Up-to-date survey and confidence indicators suggest that the economy is continuing to grow, albeit at a relatively slow pace.

For example, the FAI-RBS Business Monitor for Q2 2017 shows that the total volume of business activity in Scotland increased with the both repeat business and new business positive for the 2nd quarter in a row. That being said, the rate of growth remains relatively weak.

Chart 1.XX: FAI-RBS Business Monitor for Q2 2017

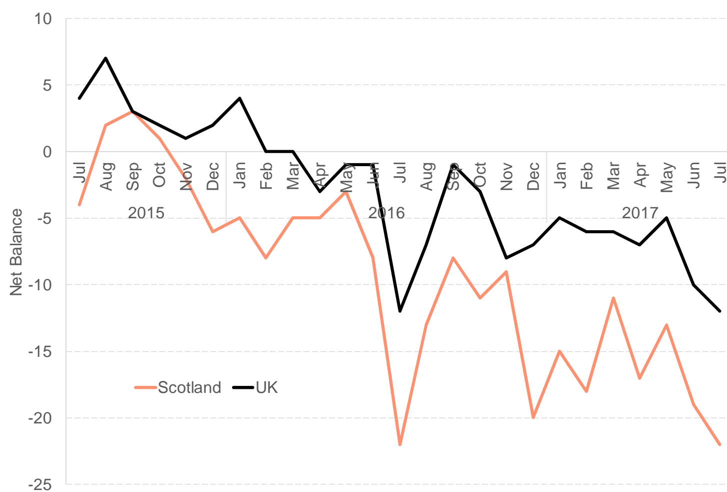


Source: Fraser of Allander Institute-Royal Bank of Scotland

The latest Lloyds Banking Group PMI for Scotland is perhaps more encouraging. It is at a 33 month high, although Scotland is still tracking behind the UK average – something that it has been doing for over two years now.

Overall levels of consumer confidence in Scotland remain relatively weak. The GfK indicator shows consumer confidence much weaker in Scotland than the UK as a whole, with the optimism becoming more pessimistic over the summer.

Chart 1.XX: Consumer Confidence remains negative in Scotland and gap with UK remains



Source: GfK

The Scottish Government's own measure of consumer confidence has been negative during the first quarter of 2017[46].

To provide an up to date assessment of economic activity in Scotland, the FAI produces monthly 'nowcasts' of Scottish growth – www.fraserofallander.org. The advantage of a 'nowcast' is that it provides an indication of economic performance far in advance of official data. Our latest nowcast estimates growth of XX% in Q2 and XX% in Q3.

The Institute's latest forecast for Scotland is for growth of around XX% in 2017 – fragile growth but clearly better than the outturn for 2016 – picking up to XX% in 2018.

Table XX: FAI forecast Scottish economic growth (%) by sector: 2017-2019

	2017	2018	2019
GVA			
Production			
Construction			
Services			

Source: Fraser of Allander Institute, September 2017

These forecasts suggest that whilst growth will be faster than last year, it is likely to remain below trend. Quarterly growth is also likely to remain volatile, with further negative quarters of growth or strong positive quarters (like Q1) entirely possible. We continue to recommend that the focus of attention is centred upon the medium to long-term trend as opposed to sharp movements in one quarter or another.

On balance, we believe that over the next couple of years Scotland will do well to match UK growth. A number of factors will determine whether this is the case or not –

[46] https://beta.gov.scot/publications/state-of-the-economy-june-2017/

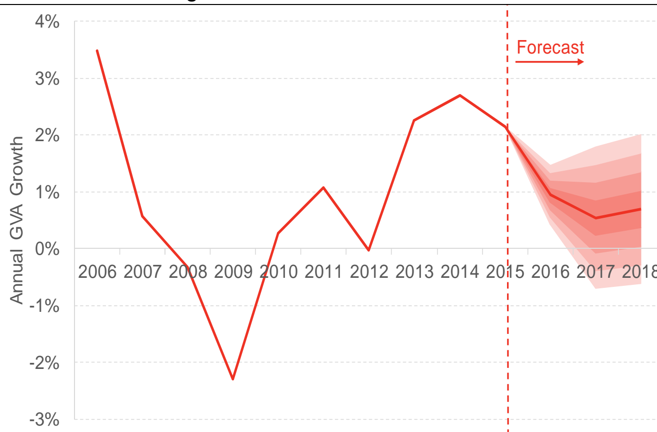
4. Much will depend upon the outlook for the North Sea and the recent pick-up in confidence. Our judgement is that the outlook is more positive than 12 months ago, but that it is fragile.

5. The Brexit process will add its own unique dynamics to the pattern of Scottish and UK growth over the coming months. We continue to hold the view that Brexit will act as a significant headwind to growth over the next few months – particularly in terms of investment and business uncertainty. Whether Scotland will fare better or worse is uncertain.

6. There is no doubt that Scotland has been stuck in a relatively weak growth cycle for over two years now. Economies go through cycles all the time – sometimes operating above potential and other times below potential. To the extent that at least some of the recent weak performance is cyclical and the Scottish economy is currently operating below potential, we could see faster growth in Scotland over the short-term as growth catches up with its trend.

We therefore continue to recommend that just as much focus is made upon the range of our forecasts as the central estimate.

Chart XX: FAI forecasts for GVA growth: 2017-2019



Source: Fraser of Allander Institute, September 2017

* Actual data up to 2016, central forecast with forecast error for 2017 – 2019

1.11 The forecasting choices facing the Scottish Fiscal Commission

So the outlook for the Scottish and UK economies remains relatively fragile and there remains a high degree of uncertainty about the outlook.

As we set out in Section 1.2, under this new Fiscal Framework, what ultimately matters over time will be how devolved Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.

If Scottish devolved revenues per head grow more quickly than the equivalent taxes in the rest of the UK then Scotland will be better off relative to the position prior to tax devolution; if Scottish devolved tax revenues grow more slowly, then the Scottish Budget will be worse off.

But in looking ahead to this year's Scottish Budget and the next few years, we will not have actual data on tax revenues in advance.

So what the SFC forecast for devolved taxes – and how they compare to the forecasts made by the OBR for the relevant BGAs – will be what determines the relative size of the Scottish Budget at the margin.

In making these forecasts, the SFC face a number of important judgement calls.

The size of the output gap in Scotland

One of the most important decisions that the Commissioners will need to take a view on, is the underlying economic potential of the Scottish economy – and crucially where they believe Scotland's economy is at the current time relative to that potential.

In the short-run, growth in an economy is largely determined by show-term factors such as the demand for Scottish exports or the level of government consumption. How these all add up creates an overall rate of growth in aggregate demand. In the short-run, growth in demand tends to dominate all other factors.

But in order to forecast how the Scottish economy – and by implication devolved taxes – may evolve over the forecast horizon, a much more subjective view of Scotland's potential level of output is required. Ultimately, it is the outlook for potential output and its determinants – the growth in Scotland's population, changes in labour market participation and hours worked, and the rate of productivity growth – that will drive forecasts for tax revenues.

The assumptions that the SFC places on each of these will have a significant impact on the forecasts that they make for Scotland's economy and tax revenues in 2018-19 and beyond.

Ultimately these are significant judgement calls. We highlight two key issues –

One area for careful consideration will be the outlook for Scotland's population. In 2016, the Scottish Government's forecasts were based upon a projection based upon the ONS's principal population projection for Scotland. Should the SFC take a different view – perhaps in the light of recent trends in EU migration and the possibility of a hard Brexit limiting migration – then the forecasts for Scottish tax revenues will look quite different (and potentially be materially weaker than for the rest of the UK).

Another crucial area is the rate of productivity growth (i.e. potential output per hour worked). The OBR has been persistently overly optimistic when forecasting UK productivity growth. Despite this, the OBR still assume that UK productivity will return to its long-term rate over the course of the forecast horizon. The SFC is not bound by this assumption, and many economists believe that such an optimistic forecast for productivity is not appropriate. Should the SFC take a different view, then the outlook for Scottish tax revenues could be much smaller than the BGAs put forward by the OBR.

Modelling tax forecasts

The SFC will be considering carefully how their new models and methods will stack-up vis-à-vis other forecasters and the OBR.

Forecasting future tax revenues or wider economic variables are, by their nature, subject to margins of error. Assumptions that are built into forecasts - based on the best available information at the time - often prove to be too optimistic or pessimistic as new economic events continuously unfold.

None of this will be straightforward and the Scottish Fiscal Commission will be doing this for the first time, with data that lags the UK as a whole, has fewer observations and is more susceptible to revision.

Comment [A1]: Though they have been challenging/assessing SG forecasts for 3 years.

Comment [A2]: They also have 2.5 years of outturn data for LBTT and SLfT which is likely to help them however.

Note also that the Scottish budget bears the risk of forecast errors made by the OBR for rUK income tax. For example, consider the case where the SFC's forecast for Scottish revenues corresponds exactly to outturn, but where the OBR forecast for rUK income tax revenue substantially underestimates subsequent rUK outturn figures. In this case, the BGA will be smaller than it otherwise should have been so a future Scottish budget will be cut to reconcile actual rUK receipts with forecast.

Determinants of individual tax revenues

Finally, whilst the overall pattern of growth in an economy is strongly correlated with tax revenue growth in the long-run, from one year to the next it is not perfect.

For example, it is possible for GDP growth to be relatively tax rich or tax poor, particularly from one year to the next. Public sector wages for example, may not be strongly correlated with GDP in the short run (public sector employment makes up almost 30% of employment in Scotland).

Property prices and transactions are strongly pro-cyclical, meaning that they often grow more strongly than GDP during upswings, but fall more quickly than GDP during downswings. And GDP growth in any year may be accounted for in part by higher profits repatriated overseas, which have no bearing on Scottish tax revenues.

Therefore, the Fiscal Commission will – in addition to taking a view about the overall health of the Scottish economy – be monitoring and modelling important individual determinants of each devolved tax revenue.

For NSND income tax for example, their focus is likely to concentrate on their assessment of the outlook for employment growth, earnings growth and the relative distribution of any improvement in this wage growth by decile. As we will discuss in the next chapter, they will also have to consider potential behavioural responses if tax policies were to change in Scotland vis-à-vis the rest of the UK.

Property prices in Scotland will clearly be a key factor for Land and Buildings Transaction tax, with factors such as the number of transactions and tax band of sales important.

1.12 Conclusions

The new fiscal framework for Scotland will mean that developments in the Scottish economy will now have a much greater impact on future budgets than ever before.

Ultimately, how the Scottish economy performs relative to the rest of the UK will have a much greater impact on the Scottish budget than before.

The potential paths for the economies of both Scotland and the UK – and the implications for fiscal policy – are highly uncertain.

Growth in the UK economy has undoubtedly weakened in recent months. That being said, the economy is still expected to grow over the coming months although the degree of uncertainty around the outlook remains high. The Chancellor faces a careful balancing act between continuing to reduce the deficit and protecting the real economy.

On balance, the immediate outlook for the Scottish economy appears to be just as – if not more challenging – and Scotland will do well to match UK economic performance in the near-term.

Of course, we will not know how Scotland has fared until tax revenues are collected and this will not happen – in the case of income tax – for a good few months after the financial year in question. Therefore in assessing the outlook for the Scottish Budget for next year and the remainder of the Parliament, what will be crucial will be the forecasts that the Scottish Fiscal Commission and the Office for Budget Responsibility make for Scottish devolved taxes and the BGAs respectively.

On balance, given recent data we believe that the Scottish Fiscal Commission are likely to be relatively cautious in their forecasts for Scottish growth and tax revenues.

Chapter 2: outlook for the Scottish budget

2.1 Introduction

Between the establishment of the Scottish Parliament in 1999 and April 2015, the resource budget of the Scottish Government essentially depended on one thing only: the block grant from Westminster.
Under the new arrangements, the block grant will continue to be determined by the Barnett Formula. And will continue to shape the overall envelope the Scottish Government faces. However, the block grant will be now adjusted by a block grant adjustment (BGA) to take account of the new taxes being devolved.
As was discussed in Chapter 1, in this respect the critical question is the extent to which the revenues raised in Scotland exceed or underperform the BGA.
If less is raised in Scotland from tax than is deducted from the block grant, the Scottish budget will be worse off than it would have been without tax devolution. But if the revenues raised exceed the BGA, the Scottish budget will be better off.
For any given tax, the revenues raised in Scotland may differ from the BGA for two reasons:

- If the tax base grows differently in Scotland relative to the rUK (for example, if wages grow more quickly then Scottish income tax revenues per capita are likely to increase more quickly); or

- If tax policy is varied in Scotland in such a way as to raise relatively more or less revenues in Scotland relative to the BGA.

In this chapter, we examine the outlook for the Scottish budget over the period to 2021/22.
We consider first in section 2.2 the outlook for the block grant from Westminster. It is important to remember that this remains the dominant driver of changes in the Scottish budget.
We then consider in section 2.3 the outlook for the devolved and assigned taxes, taking into account both the outlook for Scottish revenues and the equivalent BGA. Given the recent performance of the Scottish economy, the Scottish Fiscal Commission (SFC) may take a cautious approach to its forecasts for Sottish revenues. It would not be surprising therefore if – short of any specific policy announcements to raise income in Scotland – the tax forecasts turn out to be slightly smaller than the BGA.
That being said, ultimately what matters is how outturn Scottish revenues *actually* compare to rUK revenues. As the purpose of this chapter is to examine the profile of the budget over the lifetime of the parliament we set out a range of possible scenarios for how taxes and the BGA may evolve rather than specific point forecasts.
Section 2.4 brings together the material in sections 2.2 and 2.3 to consider the overall outlook for the Scottish Government's resource budget.
In Section 2.5 we consider the outlook for capital spending. This is most straightforward in that the outlook only on the block grant for capital spending and capital borrowing. Section 2.6 concludes.

Comment [A3]: Do you mean across all taxes or some individual ones e.g. Income Tax. Not sure necessarily applies across the piece – depends on individual markets.

2.2 Outlook for the block grant

Based upon the latest plans from the UK Government, having grown slightly in 2017/18, the RDEL block grant, before any adjustments for new tax and social security powers, is expected to decline by 3% in real terms by 2021/22 (Table X).
Table X: Outlook for the Scottish Government's resource block grant

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Change 16/17 - 21/22
Cash terms	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656	£1,569
2017/18 prices	£26,512	£26,627	£26,230	£25,871	£25,879	£25,796	-£716
Real terms annual change	*0.4%*	*-1.5%*	*-1.4%*	*0.0%*	*-0.3%*	*-2.7%*	

Notes: figures for 2016/17 – 2019/20 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget.

Figures for 2020/21 and 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total RDEL spending but does not allocate this total between spending departments.

Of course there is a possibility that the block grant may turn out to be somewhat higher or lower than the Chanellor set out in March.

The downside risks arguably seem fairly small. Under current forecasts, the Chancellor is on course to meet his new fiscal target to get structural borrowing below 2% of GDP by 2020/21 with around £26bn 'headroom'.

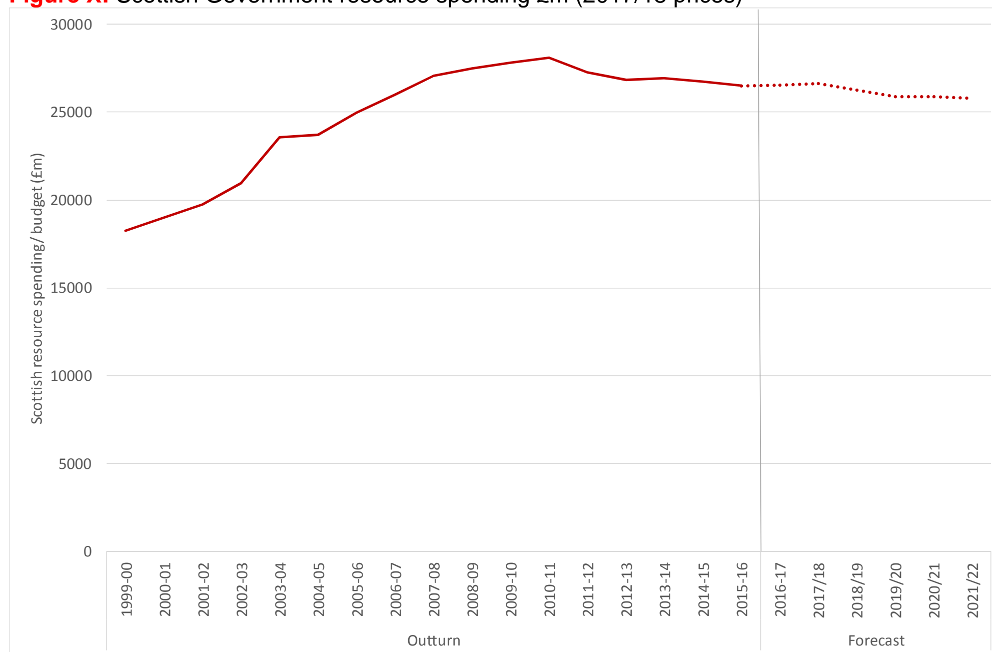
So even if revenue growth is slower than forecast, there is some insurance against the need to immediately cut spending. But even if growth is faster than forecast, the Chancellor may choose to 'bank' the proceeds of additional revenue growth, given that the UK Government still retains the ambition of returning the public finances to balance in the 'next parliament'.

These are uncertain times politically and economically, and the possibility of significant change in the outlook for the block grant should not be ruled out.

Figure X places the future outlook in a longer term context.

By 2021/22, the Scottish Government's resource block grant is expected to be 8% lower in real terms (before any adjustments for new devolved powers) compared to the level of resource spending in 2010/11[47].

Figure X: Scottish Government resource spending £m (2017/18 prices)



[47] On a like-for-like basis, the actual funding reduction has been slightly greater than indicated by this headline figure. The Scottish Government's funding responsibilities have increased during this time, notably as a result of the transfer of Council Tax Reduction to the Scottish budget in 2013/14.

Source: Outturn from Public Expenditure Statistical Analyses, various years. Forecast derived from UK Government Spring Budget 2017

2.3 The outlook for revenues and block grant adjustments

In this section we consider the outlook for revenues and the BGA for each of the taxes currently – or soon to be – devolved or assigned to Scotland. In doing so, we draw on recent revenue forecasts for Scottish and comparable UK taxes, as well as on recent data on comparative performance of the Scottish and rUK tax bases. For simplicity, we calculate the BGAs based on the Indexed Per Capita method[48].

Ultimately what is important is whether outturn Scottish revenues are higher or lower than the outturn BGAs. When the Budget is published however, outturn data will not be available. The Budget itself must therefore be based on forecasts: forecasts for Scottish revenues, and forecasts for the BGAs.

Tax forecasts are subject to significant uncertainty. They will evolve over time in light of new data. But they will always be subject to error, and will always turn out to be 'wrong' if they are perceived as being something they do not claim to be, i.e. an exact prediction (Box X).

A further technical complication is that the latest rUK revenue forecasts – which determine the calculation of the BGAs – were published in March 2017; but the latest Scottish revenue forecasts were published four months earlier in December. The emergence of more recent data in the period between the two forecasts means that they are not quite made on a comparable basis. Throughout this section therefore, whilst making reference to these forecasts, we focus on what is ultimately the key question:

How likely is it that Scottish revenues will match or exceed the relevant BGA, taking account what we know of current trends in tax base growth, and proposals for tax policy in Scotland and rUK?

Box X: Forecasting and uncertainty

The Scottish Fiscal Commission and the OBR are both obliged to produce 'point estimate' forecasts for revenues (for Scotland and the UK respectively) for up to five years.

Both institutions are tasked with simply providing their best estimates of either devolved Scottish taxes or the Block Grant Adjustments. They will not – and are not allowed – to coordinate their forecasts or methodologies.

Point estimates are necessary for budgeting purposes. But they belie significant uncertainty and margins of error. What might happen in future is of course unknowable with complete certainty.

Uncertainty is present in all forecasts. But economic forecasts are arguably associated with particularly high levels of uncertainty. We only have an imperfect notion of how the economy works, we only have partial information about the state of the economy at any point in time, and the economy is constantly hit by unanticipated shocks. Forecast uncertainty will never be eliminated.

The SFC's 'point estimate' forecasts will, like the OBR's, implicitly be probabilistic. The actual forecast is effectively a 'central' or 'median' forecast. This means that, the risks are perceived to be balanced, in the sense that the actual outcome is just as likely to be above expectations as below.

In this context, the forecasts for Scottish revenues and block grant adjustments should be

[48] The Fiscal Framework identifies two methods for calculating the BGAs: Indexed Per Capita (IPC) and the Comparable Method (CM). Over the period up to 2021/22, the BGAs will be calculated according to the IPC method (although the results of the Comparable Method will also be published). The Scottish and UK Governments will need to agree a methodology for 2022/23 and beyond.

taken for what they are – not (perhaps despite appearances) precise predictions, but the best estimate of what a future outcome is likely to be.

From a Scottish budget point of view, what is ultimately critical is how Scottish revenues perform relative to the comparable revenues in rUK. In the sense, what is just as important as the error associated with the Scottish forecasts, is the extent to which error associated with the Scottish forecasts is correlated with error in the rUK forecasts.

For example, outturn revenues in Scotland could turn out to be 10% lower than forecast. But if rUK revenue outturn for the comparable tax is also 10% down on forecast, the Scottish budget will be no worse off. The two forecast errors effectively cancel out.

Income tax

When the Scottish Government published its 2017/18 Budget in December 2016, it was forecasting income tax revenues of £11.8bn in 2017/18, rising to £14.6bn in 2021/22.

This forecast for Scottish revenues exceeded the forecast for the BGA by £79m in 2017/18, rising to a difference of +£661m by 2021/22. The difference between the forecast for Scottish revenues and the BGA forecast is partly due to the fact that the Scottish Government had announced an intention to set a lower threshold for the Higher Rate of income tax throughout this parliament[49].

At the time of the UK Spring budget in March 2017, the OBR published updated forecasts – based on new data – for rUK income tax revenues over the period to 2021/22. The implication was that the forecast for the income tax BGA was reduced, relative to the figure available at the time of the Scottish Government's Budget.

The implication is that the gap between the Scottish Government's latest revenue forecast and the latest BGA forecast has widened. On paper, this looks good news for the Scottish budget! But it should be remembered that both the forecasts for the BGA and the Scottish revenues will be revised again before the Scottish Government publishes its 2018/19 Budget later this year. It seems almost inevitable that the forecast for Scottish revenues will also be revised downwards, given that the Scottish forecasts will also take into account the more recent income tax data.

Table X: Income tax revenue and GBA forecasts (£m)

	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)	11,750	12,159	12,672	13,233	13,898
BGA forecast (March 2017)	11,636	11,924	12,326	12,833	13,460
Scottish forecast (Dec 2017)	11,829	12,290	12,912	13,647	14,559
Difference between revenue forecast and BGA (Dec 2016)	79	131	240	414	661
Difference between revenue forecast and BGA (Mar 2017)	193	366	586	814	1,099

Source: Fraser of Allander calculations

How likely is it that Scottish income tax revenues will match or better the BGA in 2017/18 and beyond?

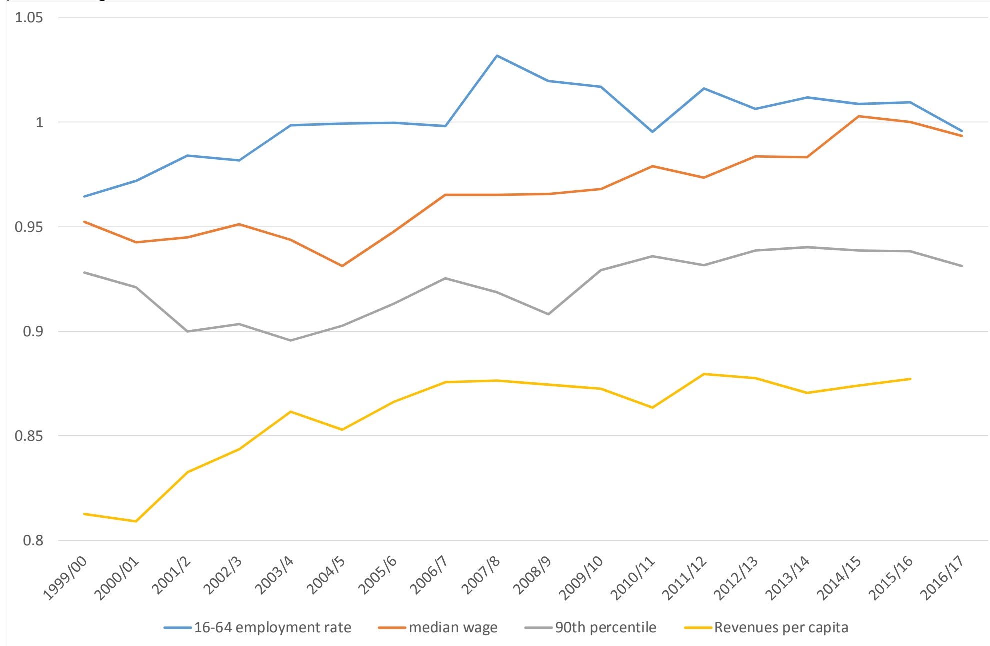
To answer this, it is necessary to consider how trends in the major determinants of the income tax base (wages and employment) are likely to evolve in Scotland relative to rUK, and how tax policy may change.

Recent trends in tax revenues and the tax base

Between 2007/8 and 2015/16, income tax revenues per capita have grown at the same rate in Scotland as the UK (Figure x). On the one hand, the employment rate in Scotland has declined relative to UK rate. But over the same period, wages in Scotland have performed slightly better than in the UK (more accurately, Scottish wages have not declined quite as much).

[49] It was not clear from the analysis presented in the 2017/18 Budget whether other factors (e.g. differences in modelling approaches or assumptions for underlying tax base growth) also contributed to differences between the revenue and BGA forecasts.

Figure X: Trends in employment, wages and income tax revenues per capita, Scotland as a percentage of UK



Source: Employment rate from Labour Force Survey; Wage data from Annual Survey of Hours and Earnings, various years; income tax data from HMRC tax outturn statistics

But changes in income tax policy have played a role in influencing relative revenue growth too. Two key changes are worth noting.

Since 2007/8 the Personal Allowance has increased in real terms. Between 2007/8 and 2015/17 it increased by 65% in real terms. Alongside the real terms increase in the Personal Allowance, tax rates on the highest earners have increased. During the last parliament, the Higher Rate threshold was reduced in real terms by around 13%[50]. Furthermore an Additional Rate of tax was introduced in 2010/11, initially at 50% before being reduced to 45% in 2013/14.

The increases in Personal Allowance, lower Higher Rate threshold and introduction of the Additional Rate have together resulted in tax liabilities becoming more concentrated on higher earners. As a result, tax revenues per capita have grown more quickly in parts of the UK (i.e. London and the South East) which have the highest proportion of high earners.

These trends in relative employment and wages combine with trends in income tax policy to influence the outcome observed in Figure X.

Whether Scotland continues to match UK growth in per capita income tax revenues will depend on how these determinants evolve in coming years. Note from Figure X however that the omens for 2016/17 specifically are not particularly positive. Employment and wages in Scotland declined relative to those in the UK, which in itself would suggest that Scotland's relative income tax revenues per capita may also decline[51]. The extent to which 2016/17 was a one-off 'blip' or the start of a longer-term trend is not yet clear (comprehensive data for 2017 will be released this October).

The FAI's income tax simulation model can be used to assess the risks to the Scottish budget arising from relatively faster or slower wage growth in Scotland.

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[50] A reduction in the higher rate threshold means that the level of income that people pay the higher rate of tax is lower – hence a tax rise.

[51] The Scottish budget is not directly affected by income tax revenue performance in 2016/17, as tax devolution does not occur until 2017/18. Lower Scottish revenues in 2016/17 simply mean a lower 'initial deduction' and thus a lower block grant adjustment in 2017/18.

Table X shows how different Scottish income tax revenues would be if average wages in Scotland grew 0.3 percentage points faster or slower than wages in rUK, and if wages grew 0.8 percentage points faster or slower than wages in rUK.

A difference in revenue performance of just 0.3 percentage points equates to a revenue difference of just over £200m after one year, whilst a revenue difference of 0.8 percentage points equates to a revenue difference of over half a billion pounds in one year.

Clearly, the effects of differential growth will become magnified over time[52].

Table X: Effect on Scottish income tax revenues (£m) of faster or slower wage growth in Scotland compared to rUK

	2017/18	2018/19	2019/20	2020/21	2021/22
0.3 pp slower growth	-£212	-£278	-£347	-£424	-£510
0.3 pp faster growth	£215	£283	£356	£437	£526
0.8 pp slower growth	-£558	-£729	-£907	-£1,105	-£1,322
0.8 pp faster growth	£581	£769	£967	£1,193	£1,442

Source: FAI tax microsimulation model. Notes: 'pp' stands for 'percentage point'.

Income Tax policy

The Scottish Government can from now on vary its budget directly, by varying income tax policy. This is exactly what it chose to do in 2017/18.

Freezing the Higher Rate threshold at £43,000 is likely to have raised an additional £135m for the Scottish budget this year, compared to what would have been the case if the Scottish Government had followed the UK Government in setting the rate at £45,000 (Box X discusses difficulties in determining when a policy change can be thought of as revenue raising under Scotland's new Fiscal Framework).

Box X: Determining the policy 'baseline' against which policy proposals are assessed

Under the new framework, determining the policy 'baseline' against which the revenue effects of alternative policies can be assessed is not straightforward.

For income tax, the Scottish Parliament must set rates and bands each year through a 'Rate Resolution'. If a Resolution cannot be agreed, the Budget cannot be passed, and the previous year's budget would apply until agreement was reached.

It could be argued that the decision to freeze the Higher Rate threshold in cash terms effectively represents a policy of 'no change' (in the same way that the Additional Rate remained unchanged at £150,000).

Instead, the effect on the Scottish budget comes about through the UK Government's decision to raise the Higher Rate threshold to £45,000 in rUK. This can be characterised as a tax cut, and effectively reduces the Scottish BGA.

Thus although the tax thresholds set in Scotland are legislatively independent of those set in rUK, the Scottish budget is ultimately influenced by policy in Scotland relative to policy in rUK. It is in this sense that a freeze in the Higher Rate threshold can be thought of as a revenue raising policy in 2017/18.

[52] During the past ten years, average weekly earnings have grown more quickly in Scotland than UK in six years, and in these years Scottish wages have grown on average 0.8 percentage points more quickly; average weekly earnings have grown less quickly in Scotland than in UK in four years, and in these years Scottish wages have grown on average 0.3 percentage points more slowly. The 0.3 and 0.8 figures are chosen pragmatically as an indication of the potential magnitude of differential growth in one year, but based on the recent past, it would be unlikely that such differential growth is observed over consecutive years.

If, over the remainder of the period to 2021/22, the Scottish and UK Governments increase the Higher Rate threshold in line with CPI inflation, the difference between the two rates will grow somewhat in cash terms – boosting Scottish revenues by £183m by the end of the forecast period.

The lower threshold in Scotland at which taxpayers pay the Higher Rate may have some behavioural effects. Taxpayers with income between £43,000 and £45,000 will pay a higher marginal rate of tax in Scotland than in rUK, whilst those with income above £45,000 will face a higher average tax rate. These higher average and marginal tax rates may instigate some offsetting reductions in taxable income, and as a result, the revenue effects of the policy may not be as large as the direct estimates reported above. However, any behavioural effects are likely to be small. The OBR estimates that the behavioural effects of the lower threshold in Scotland are to reduce revenues by just £9m per annum in 2017/18 and beyond.

The estimates of the income tax BGA in Table X are based on an assumption that the UK Government increases the Higher Rate threshold in line with CPI inflation in future years. However, the UK Government has committed to increase the threshold above the rate of inflation to reach £50,000 by the end of the parliament. If it were to do so, the effect on the Scottish budget would be via an even smaller BGA.

We estimate that, compared to a baseline where the Scottish and UK Governments increase their respective Higher Rate thresholds in line with inflation, a UK Government decision to increase the threshold to £50,000 by 2020/21 (and indexed to CPI thereafter) would result in the Scottish budget being £274m better off by 2020/21.

Table X: Effects on Scottish budget of various Higher Rate threshold policy parameters

Policy		2017/18	2018/19	2019/20	2020/21	2021/22
Baseline	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	45,000	46,200	47,270	48,210	49,260
	Revenue effect (£m)	*0*	*0*	*0*	*0*	*0*
Freeze Higher Rate in Scotland 17/18, then CPI	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*143*	*153*	*165*	*183*
Increase UK threshold to £50,000 by 2020/21	UK threshold	45,000	46667	48333	50000	51089
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*170*	*216*	*274*	*301*

A number of other revenue raising options for the Scottish Government in relation to income tax are discussed in Box X.

Box X: Revenue raising options from income tax

Additional rate increase

One policy option that is often mooted is to raise the Additional Rate (AR) – payable on income above £150,000 – from 45p to 50p. The policy is often motivated by a sense that higher earners should contribute more to revenue generation, and is sometimes justified by references either to top tax rates in various other European countries, or by references to past UK income tax rates (the top marginal rate of income tax exceeded 75% in the late 1970s).

In direct terms (i.e. assuming no behavioural effect), an increase to 50p would raise some

£126m per annum. This represents around 1% of Scottish NSND income.

There is sometimes a preconception that the policy would raise more than this, but it raises relatively little because there are few (around 17,000), AR taxpayers in Scotland and the policy asks these individuals just to pay an additional 5% tax only on income over £150,000.

The policy is always subject to claims that it could raise significantly less than this in practice, as the propensity of AR taxpayers to vary their income is high.

However, there remains little in the way of hard evidence of any behavioural response to an increase in the AR. This is partly because there is no counterfactual against which the impacts can be evaluated. In reflecting upon the introduction of the Additional Rate at 50p at UK level, the Treasury estimates that possibility that the policy either raised revenue or cost revenue is unclear within reasonable confidence limits.

Incomes respond to tax changes in a variety of ways. People might vary the amount they work, take advantage of tax reliefs (e.g. put more money into a pension), or convert earned income into dividend income. But some of these options will be more viable for some taxpayers than others.

It seems unlikely that a higher AR in Scotland would cause individuals to relocate, especially when one considers the uncertainty around future tax rates in Scotland and rUK. It is possible however, that higher top tax rates may discourage in-migration of high-earning individuals from other countries more than they incentivise existing residents to leave.

Note finally that, if the UK Government did increase the Additional Rate in rUK to 50p, this would represent a double-edged sword. On the one hand, the risk of behavioural effects from Scottish taxpayers diminishes if the policy is implemented UK-wide. On the other hand, the additional revenues raised in rUK would increase the Scottish BGA, negating any positive revenue effects for the Scottish Government (other than those accruing through additional UK Government spending and resulting Barnett consequentials).

The Scottish Government has tasked the Council of Economic Advisers to consider the implications of an increase in the Additional Rate to 50p.

1p on each rate

A number of political parties in Scotland have proposed raising revenue by adding 1p to each of the basic, higher and additional rates of income tax (so the rates become 21p, 41p and 46p respectively).

According to FAI's income tax model, this policy would raise some £471m, excluding behavioural effects, in 2018/19.

Apply standard TIEs to derive estimate of behavioural effect.

LBTT

At the time of the publication of the Scottish Government's Budget in December 2016, revenues from LBTT were forecast to be somewhat higher in 2016/17 than the BGA (Table X). Provisional LBTT outturn data has since been published for 2016/17. This indicates that £493m was raised from LBTT in 2016/17. Provisional outturn data has also been published for the 'equivalent' Stamp Duty Land Tax revenues in rUK (these raised £11.7bn). This indicates that the BGA for LBTT in 2016/17 will be £522m (Table X).

Comment [A4]: £484m is provisional outturn statement and likely to be the figure in RS accounts published end Sept. Difference is accruals.

Comment [A5]: £11.8 bn but sources on this may vary

The implication is that the BGA for LBTT was some £29m higher than Scottish revenues in 2016/17 (based on provisional outturn statistics for both Scottish and rUK revenues, and is liable to some revision once audited figures are published).

Note that this does not mean the Scottish Government now faces a bill of £29m; the difference has already been factored into the Scottish budget by virtue of the fact that less revenue has been raised in Scotland by LBTT than has been deducted from the block grant.

Table X: LBTT revenues and BGA – outturn and forecasts (£ million)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		504	545	585	634	689	741
BGA outturn/ forecast (March 2017)		*£522*	£580	£619	£656	£700	£747
Scottish outturn/ forecast (Dec 2016~~7~~)	*£425*	*£493*	507	543	571	597	624
Difference between revenue forecast and BGA (Dec 2016)		*34*	*-38*	*-42*	*-63*	*-92*	*-117*
Difference between revenue forecast and BGA (Mar 2017)		*-29*	*-73*	*-76*	*-85*	*-103*	*-123*

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (June 2017) and OBR forecasts for rUK Stamp Duty (March 2017). Notes: Data in red italics relate to provisional outturn data. Table X does not show a BGA for LBTT in 2015/16, the first year of devolution. This is because for 2015/16, the Scottish and UK Governments agreed a one-year BGA for LBTT and SLfT combined of £494m, which is independent of outturn rUK data. Outturn data for Scotland suggests that in 2015/16, £425m was raised from LBTT and £147m was raised from Scottish Landfill Tax. This total, £572m, is clearly greater than the BGA by £78m. In 2015/16 the Scottish Budget was thus £78m better off as a result of the devolution of LBTT and SLfT, given the BGA agreed with the UK Government.

What about the outlook?

The OBR's latest (March 2017) forecasts for Stamp Duty in the UK have been revised up very marginally from those available at the end of 2016. They imply that the Scottish block grant adjustment will increase to £579m in 2017/18, and then by 6-7% each year until 2021/22. This is a faster rate than the Scottish Government was forecasting for LBTT revenues in December 2016. The difference implies a net cost to the Scottish Budget of around £100m per year by the end of the parliament.

The difference between the Scottish Government's forecast for LBTT and the OBR's forecast for Stamp Duty revenues for rUK (from which the BGA is derived) are largely due to different assumptions about the likely growth rate of house prices and residential transactions in Scotland and rUK (assumptions about non-domestic property price and transaction growth and broadly similar). In particular, the OBR assumes price growth in excess of 4% per year over the forecast period, whereas the Scottish Government's forecast is less than half this. The OBR also assumes somewhat faster growth in transactions in rUK than the Scottish Government does.

There are some grounds for assuming that property prices will grow relatively more slowly in Scotland than in rUK over the next few years – and continue recent trends. In the two years since LBTT was devolved, house prices have grown of 2.5% per annum in Scotland compared to 6.5% in the UK[53]. Against this however, and counter to perception, residential property transactions have grown at least as strongly in Scotland in recent years as in rUK. In 2015/16, the number of transactions grew by about 10% in Scotland and in rUK, whilst in 2016/17 transactions declined by 13% in rUK compared to a decline of 7% in Scotland.

On balance therefore, there are not strong a priori grounds for believing that Scottish LBTT revenues will drastically over or underperform rUK revenues either way.

The forecasts for both Scottish LBTT revenues and the BGA should be treated with caution, as revenues from property transactions are particularly difficult to forecast (see Box X). For these reasons, monthly outturn data is likely to be monitored closely.

In our central scenario, we assume that LBTT revenues underperform the BGA by 6%, reflecting a continuation of the relative performance observed in 2016/17.

Need to say something about non-resi.

Comment [A6]: Also, some modelling differences i.e. they use different approaches.

Comment [A7]: Would say have held up better in Scotland – now falling in RUK depending on the measure (HMRC transactions over £40,000)

Comment [A8]: Plus adjustments at either end of year for accruals. Forecasts are accrual based as SFC's forecast evaluation report. (5/9)

[53] Comparing prices in May 2017 with May 2015 according to ONS House Price Index.

Box X: Forecasting property transactions taxes

In its latest Forecast Evaluation Report, the OBR states:

'Stamp duty land tax (SDLT) is one of the more volatile sources of receipts – the standard deviation of annual growth over the past five years has been 11.9 per cent, compared to just 1 per cent for overall receipts. In recent years, SDLT receipts have been a large source of fiscal forecasting errors. In line with that, we have revised our SDLT forecasts proportionally more than for any other major tax (bar the even-more-volatile CGT and North Sea oil and gas revenues).'

There are many reasons why forecasting receipts from property transactions taxes can be challenging, including:

- It is difficult to map economic determinants to the true tax base (i.e. relatively few properties are transacted in any one year);
- The tax schedule is progressive meaning a large proportion of tax revenues are derived from very few transactions
- The tax regime has been subject to large policy changes in recent years (e.g. the introduction of the Additional Dwelling Supplement, and changes in tax rates)
- The growth of prices and transactions can be quite volatile from year-to-year, and is difficult to predict based on economic determinants (owing much to other factors including consumer sentiment and expectations).

As an example of this forecasting difficulties, note that between November 2015 and November 2016, the OBR revised its SDLT forecast for 2017/18 downwards by £2bn (14%).

LBTT tax policy

The current structure of LBTT, introduced in April 2015, marks a significant improvement on the previous UK-wide system of Stamp Duty. This is because, whereas Stamp Duty operated a 'slab' structure (whereby tax rates were levied over the entire value of a property), under LBTT, each additional tax rate is applied only to the part of property value above that threshold.
Some concerns have been raised that the structure of LBTT – which implies a higher average tax rate on all properties worth over £325~~50~~,000 – has reduced housing market activity in the mid to higher end of the market. This view results in part from the fact that the LBTT forecasts in the Scottish Government's 2015/16 Budget for the 2015/16 financial year overestimated revenues in the £325,000 - £750,000 bracket by some 37%[54].
The dampened activity in 2015/16 may turn out to be temporary. Indeed between 2015/16 and 2016/17, property revenues and transactions in the £325,000 - £700,000 tax band increased more quickly than those in the lower tax bands.
Nonetheless, concern remains about the effect of the 10% tax rate on this segment of the market.
A number of organisations have called for a reduction in the rate for properties in the £325,000 plus range[55]. Our modelling suggests that an extension of the 5% tax rate to properties worth £500,000 would cost around £45m assuming no behavioural response, whilst extending the 5% tax rate to £700,000 would cost around a further £15m, again assuming no behavioural response.
Of course the motivation for such a policy would be to stimulate additional market activity. We estimate that, to offset a reduction in revenues of £60m from extending the 5% band to

Comment [A9]: Precise crossover point is £333,000.

Comment [A10]: Need to be careful about effect of forestalling on residential LBTT which was concentrated in the £325k+ brackets. Are you sure you mean underestimation and not overestimation?

Comment [A11]: Again, two periods of forestalling to contend with here – pre April 15 and pre-April 16 (ADS introduction). Very tricky comparisons.

Comment [A12]: SG published in various places that £325k+ share of overall market transactions is steady/rising so challenges stakeholders' views.

Comment [A13]: Broadly consistent with our own analysis (published)

[54] Scottish Fiscal Commission Outturn Report, Sep 2016

[55] See Finance and Constitution Committee's Report on the First Year of Operation of the Land and Buildings Transactions Tax http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/102523.aspx#e

£750,000, the number of transactions in that band would need to increase by around 3,750 per annum[56]. This represents roughly a doubling in transactions in this band relative to current rates.

Landfill Tax

According to provisional outturn data, £147m was raised from Landfill Tax in Scotland in 2016/17. Based on provisional data on comparable revenues in rUK, Scottish revenues are likely to be around £15m higher than the Landfill Tax BGA (Table X).

In future years, revenues from landfill tax are forecast to decline, reflecting lower levels of waste sent to landfill as alternative waste infrastructure (e.g. incinerators) comes on stream, and increased rates of recycling. Under the latest (December 2016) forecasts, Scottish landfill tax revenues are expected to bring in somewhat more revenue than the BGA for Landfill Tax (based on the OBR's March 2017 forecasts). This partly reflects an expectation that capacity for alternative waste infrastructure may come on stream somewhat more slowly in Scotland.

The Scottish Government has announced an aspiration to reduce waste to landfill at a quicker rate than in England. It has not yet introduced explicit policy to achieve this aspiration, but were the aspiration achieved, it would likely affect the budgetary position, if Scottish revenues were to decline relative to those in rUK.

Table X: Landfill Tax revenues and Landfill Tax BGA – outturn and forecasts

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		137	119	104	97	92	90
BGA outturn/ forecast (March 2017)		*£132*	£107	£99	£92	£89	£88
Scottish outturn/ forecast (Dec 2016)	*147*	*1497.4*	149	118	109	112	106
Difference between revenue forecast and BGA (Dec 2016)		-4	30	14	12	20	16
Difference between revenue forecast and BGA (Mar 2017)		*15*	42	19	17	23	18

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (May 2017) and OBR forecasts for rUK Landfill Tax (March 2017). Notes: Data in red italics relates to outturn. For 2015/16, a combined BGA for LBTT and Landfill Tax was agreed, see text for further details.

Air Departure Tax

In April 2018, Air Passenger Duty (APD) will cease to operate in Scotland. In its place, the government has announced plans to establish an Air Departure Tax (ADT).

ADT is expected to be similar in scope and structure to APD. Additionally however the Scottish Government has a commitment to reducing the overall tax burden of ADT by 50% by the end of this parliament[57]. The aim of the policy is to 'generate sustainable growth by boosting Scotland's international air connectivity'[58].

Based on the OBR's latest (March 2017) forecasts, the BGA for ADT is expected to be £327m in the first year of devolution, rising by about 4.5% a year to £373m in 2021/22. If the structure and rates of ADT were to remain the same in Scotland as in rUK, the OBR forecasts[59] that Scottish revenues would grow at the same rate as revenues in rUK. Implicitly, this implies that Scottish revenues would match the BGA.

If the Scottish Government were to reduce the burden of ADT by 50%, this would likely lead to a reduction in revenues, at least over the short-term. If the policy were to have behavioural effects

[56] Revenue Scotland data indicate that the average revenue from transactions in the £325k-£750k band was £16,000 in 2007/8.?????

[57] Policy Memorandum to the Air Departure Tax Bill

[58] Programme for Government, 2016

[59] The Scottish Government did not produce a forecast for ADT in its 2017/18 Budget, and the Scottish Fiscal Commission is not due to produce its first official forecasts until later in 2017.

Comment [A14]: Broadly, consistent with our own analysis excluding behavioural effects. Have to calculate for very narrow individual prices bands to get good figures.

Comment [A15]: Provisional outturn statement was £149m. RS accounts will confirm data at the end of Sept.

Comment [A16]: We have a policy to end all biodegradable waste to landfill by beginning of 2020 unlike RUK. This will help to some extent.

(i.e. additional passenger travel from Scottish airports), a reduction in the burden of ADT by 50% may not imply a reduction in revenues of 50%, relative to the base-case.

However, estimating the extent to which a reduction in ADT rates may stimulate increased passenger travel is difficult, not least because of a lack of data or evidence on the effects of similar policy changes in the UK or elsewhere. Furthermore there has not yet been a formal assessment of the likely behavioural effects of the policy (although a report is due by Autumn ~~end~~ 2017). Critical questions include the extent to which an ADT reduction is likely to be passed through to ticket prices, and the sensitivity of customers to changes in prices.

In the absence of any evidence on the scale of behavioural effects, we assume that a 50% reduction in the burden of ADT – phased over the period to 2021/22, is associated with a 50% reduction in revenues. The policy, whilst not yet legislated for, thus represents a source of budgetary risk.

Table X: Forecasts for Air Departure Tax revenues and the BGA

	2018-19	2019-20	2020-21	2021-22
BGA forecast	£327	£340	£356	£373
Scottish revenue forecast (no policy change)	£327	£340	£356	£373
Difference between revenues and BGA	*£0*	*£0*	*£0*	*£0*
Scottish revenue forecast (50% reduction in burden)	£327	£284	£238	£187
Difference between revenues and BGA	*£0*	*-£57*	*-£119*	*-£187*

Notes: Revenue and BGA forecasts derived from OBR March 2017 Economic and Fiscal Outlook.

Comment [A17]: GERS 2016-17 have revised down baseline outturn for APD in Acotland to £264m. Likely to impact on SFC forecasts at least.
Details here:
http://www.gov.scot/Resource/0052/00523683.pdf

VAT

From 2019/20, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced VAT rate will be assigned to the Scottish budget. A number of technical issues around how Scottish VAT revenues will be estimated are being investigated by a VAT Assignment Working Group, which is due to report in September 2017.

No official forecasts for the assigned element of Scottish VAT have yet been published. At the UK level the OBR forecasts VAT revenues to grow at an average of 4% per year to 2021/22. Between 2010/11 – 2015/16 Scotland's share of UK VAT has remained stable around 8.5% to 8.6%.

Assuming that this share remains stable, then based on the UK's OBR forecast and the estimate of assigned Scottish VAT in 2015/16 provided in the 2015/16 GERS report, our estimate of Scottish VAT revenues is shown in Table X.

With VAT assignment some 18 months away, it is currently too early to say whether VAT assignment is likely to have net fiscal costs or benefits for the Scottish budget. As already noted, the Scottish share of UK VAT has remained robust in recent years, and there is little evidence in existing data to suggest this trend may change. Our working assumption is thus that the BGA for assigned VAT will match the Scottish revenues in the later years of the forecast period.

Table X: Forecasts of assigned Scottish VAT and the BGA

	2019-20	2020-21	2021-22
BGA forecast	£6,568	£6,826	£7,075
Scottish revenue forecast	£6,568	£6,826	£7,075
Difference between revenue and BGA	*£0*	*£0*	*£0*

Source: FAI analysis of OBR Economic and Fiscal Outlook (March 2017) and Government Expenditure and Revenue Scotland (GERS) 2016.

Aggregates Levy

No date has yet been agreed for the devolution of Aggregates Levy, a tax on the importing or extraction of sand, gravel and rock. The OBR forecasts revenues to remain broadly unchanged in cash terms at UK and Scottish levels after 2017/18. We assume that Aggregates Levy is devolved in 2020/21, with Scottish revenues of £54m offsetting an equivalent block grant adjustment.

2.4 Bringing it together

Table X brings together the outlook for the Scottish budget, taking account of the block grant, together with the BGAs and revenues for each tax.
This central scenario assumes that

- Scottish income tax revenues grow at the same per capita rate as those in rUK, and that the Scottish Government increases the income tax Higher Rate threshold in line with inflation, but that the UK Government increases it to £50,000 by 2020/21. A risk to the budget is that the UK Government does not implement its commitment on the Higher Rate, which would result in a somewhat higher BGA.

- LBTT revenues slightly underperform the BGA – to the same extent as was the case in 2016/17 – throughout the forecast period. In other words, LBTT revenues are 6% lower than the BGA each year

- Landfill Tax revenues grow in line with the Scottish Government's December 2016 forecasts, whilst the BGA grows in line with the latest OBR forecasts for the comparable rUK taxes.

- For ADT, we assume the Scottish Government implements a 50% reduction in the burden of the tax by 2021/22, but the central scenario makes no allowance for any behavioural response to the tax reduction.

- Finally, for both Aggregates Levy and assigned VAT, we assume that revenues per capita in Scotland grow in line with those in rUK.

Under this central scenario, the Scottish Government's budget outlook is only slightly different from the outlook for the block grant. Additional revenues from income tax (resulting from the Scottish Government's decision to set a lower Higher Rate threshold, combined with the UK Government's assumed decision to increase the rUK Higher Rate threshold to £50,000 in 2020/21) are offset by forecast relatively lower growth in LBTT revenues, and, from 2019/20, the reduction in the ADT burden.

Table X: Outlook for Scottish Government revenue budget, £m (cash terms)

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Block grant	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656
		£11,636	£11,924	£12,326	£12,833	£13,460
Income tax		£11,771	£12,094	£12,543	£13,108	£13,761
		£135	£170	£216	£274	£301
	£522	£580	£619	£656	£700	£747
LBTT	£493	£548	£585	£619	£661	£705
	-£29	-£33	-£35	-£37	-£39	-£42
	£132	£107	£99	£92	£89	£88
LfT	£147	£149	£118	£109	£112	£106
	£15	£42	£19	£17	£23	£18
			£327	£340	£356	£373
ADT			£327	£284	£238	£187
			£0	-£57	-£119	-£187
				£6,568	£6,826	£7,075
VAT				£6,568	£6,826	£7,075
				£0	£0	£0
					£54	£55
Aggregates Levy					£54	£55
					£0	£0
Total	£26,073	£26,772	£26,794	£26,851	£27,362	£27,747

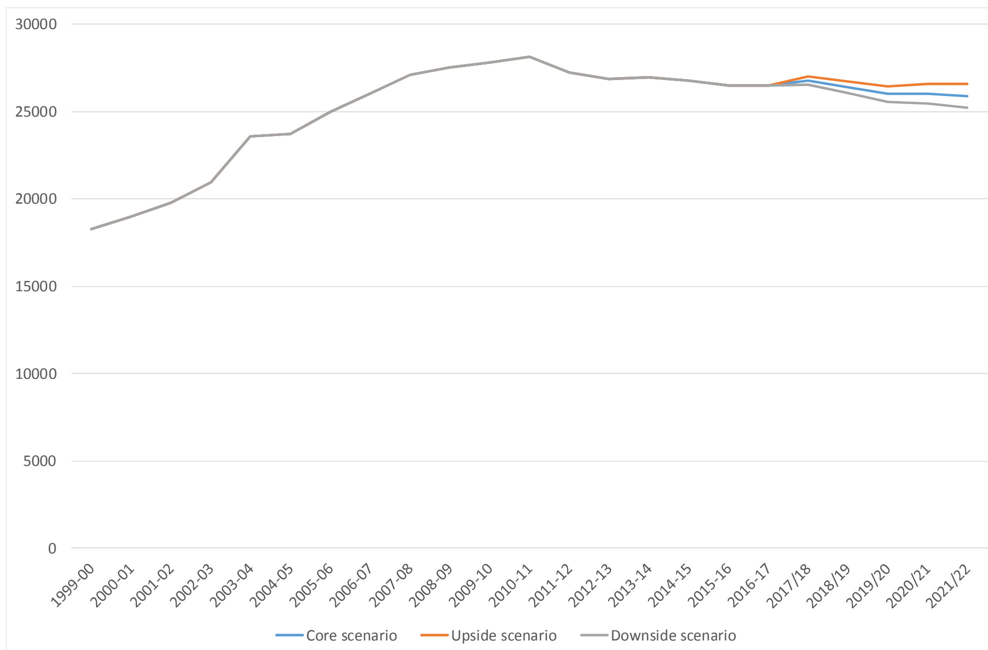
Source: FAI analysis

There is clearly uncertainty around the exact outlook for Scottish revenues and the BGAs. Figure X sets out the outlook for the Scottish resource budget in real terms based on our 'central scenario' set out above, and under two scenarios designed to capture both upside and downside risk.

- Relative to the central scenario, the upside risk scenario assumes that Scottish wages grow 0.3 percentage points faster than rUK wages over the forecast period, that LBTT revenues match the BGA, and that the Scottish Government chooses not to implement the cut to Air Departure Tax.

- Relative to the central scenario, the downside risk scenario assumes that Scottish wages grow 0.3 percentage points less quickly than in rUK; that the UK Government chooses to increase the Higher Rate by inflation (and does not increase it to £50,000), and that outturn LBTT revenues match the Scottish Government's December 2016 forecast (which in turn implies that revenues are around 13-15% lower than the BGA in each year of the forecast period).

Figure X shows the implications of the inclusion of the tax and BGA forecasts into the long-term profile of Scottish Government resource budget. Between 2017/18 and 2021/22, the resource budget is forecast to decline 3.3% in the central scenario, by 1.6% in the upside scenario, and by 4.9% in the downside scenario.



2.5 The outlook for capital expenditure

The Scottish Government's block grant for capital expenditure increased by 5.5% in real terms between 2016/17 and 2017/18. Relatively strong real terms growth is also expected in 2018/19 and 2019/20, following the £23bn increase in capital spending announced by Chancellor Phillip Hammond in the November 2016 Autumn Statement.
From April 2017, the Scottish Government is able to borrow up to £450m in any year for capital investment, within an overall limit of £3bn. The 2017/18 Budget indicates that the Scottish Government plans to utilise its £450m capital borrowing powers in full in 2017/18.
To date no borrowing has been drawn down in 2017/18, although this is consistent with prudent budget management, in the sense that borrowing should only occur once the full CDEL allocation has been used up.
At the same time however, it is likely that the Scottish Government may not be able to utilise its borrowing powers in full in 2017/18. This is because some of its borrowing powers are likely to be required to provide 'cover' for schemes that are re-classified from the Non Profit Distributing (NPD) programme (Box X).

Box X: Implications of NPD reclassification for the Scottish Government's capital borrowing

The NPD programme involves the private sector funding the upfront capital costs of particular building projects (schools, hospitals etc.) and the Scottish Government committing to pay fees to cover capital costs, increased interest repayments and maintenance/ service charges (usually for 25-30 years).

In 2015/16, the ONS reclassified various NPD projects as being on the public balance sheet (rather than being private sector funded). In consequence, the Scottish Government came to an accounting agreement with UK Treasury to use its capital borrowing allocation for 2015/16 to provide budget 'cover' for the reclassified schemes. This does not mean that the Scottish Government borrowed in this year (and thus there will be no interest rate charges); but the full value of the capital project will score on the balance sheet, and count as part of the Scottish

Government's borrowing limit.

In 2015/16, £280m of reclassified NPD schemes were scored against the Scottish Government's borrowing limit; in 2016/17, £398m of reclassified NPD schemes were scored against the borrowing limit60. Although this imposes an opportunity cost (in terms of reduced ability to borrow), it does also reduce the future repayments associated with the NPD schemes by an equivalent amount.

A proportion of the Scottish Government's 2017/18 borrowing limit is also likely to be required to provide budget cover for reclassified NPD projects, although it is not yet clear how much.

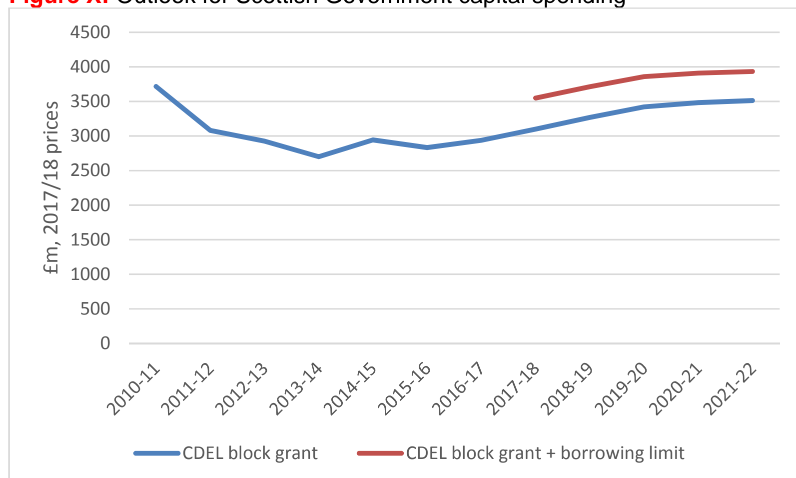
Table X: Outlook for Scottish Government capital budget

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Cash terms	2,892	3,100	3,320	3,533	3,663	3,767
2017/18 prices	2,939	3,100	3,269	3,422	3,482	3,513
Real terms annual change		*5.5%*	*5.4%*	*4.7%*	*1.8%*	*0.9%*
Borrowing limit		450	450	450	450	450

Notes: figures for 2016/17 – 2020/21 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget. Figures for 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total CDEL spending but does not allocate this total between spending departments.

The outlook for capital spending is placed in a longer term context in Figure X. Following declines from a historic high level in 2010/11, the Scottish Government's capital allocation is forecast to approach its historic high of £3.5bn by 2019/20. If the Scottish Government's borrowing powers are utilised in full, capital investment could reach £4bn per year by 2021/22.

Figure X: Outlook for Scottish Government capital spending



2.6 Conclusions

As we set out in Chapter 1, under the Fiscal Framework, the performance of the Scottish economy – and by implication of devolved Scottish revenues – relative to the performance of the

[60] Source: Letter from Cabinet Secretary to Convenor of Finance and Constitution Committee, January 2017. http://www.parliament.scot/S5_Finance/General%20Documents/Cab_Sec_FC_to_FinConvenor_-_05Jan17.pdf

rUK economy and comparable rUK tax revenues is critical in determining the size of the Scottish budget in future.

That said, the block grant remains the key component in determining the size of the Scottish Government's spending envelope. The block grant actually increased slightly in real terms in 2017/18. But, based on the UK Government's spending plans, cuts to the resource block grant of 1.5% and 1.4% are expected in 2018/19 and 2019/20.

The outlook implies that the block grant (before any adjustments for new tax and social security powers) will be around 8% lower in 2020/21 than it was ten years earlier.

There is clearly some uncertainty around the extent to which the Scottish revenues are likely to be higher or lower than the respective BGAs in any given future year. Recent slower growth in Scottish wages, house prices and the wider economy than in rUK may result in the Scottish Fiscal Commission adopting a relatively cautious approach to its forecasts – although the recent past is not necessarily a good guide to the medium term future.

Relatively small differences in wage growth between Scotland and rUK can make significant differences to income tax growth over time.

Setting a lower threshold at which the Higher Rate of income tax is paid will raise between £140m and £170m in 2018/19, depending on where the UK Government sets the Higher Rate threshold in rUK. On the other hand, a commitment to reduce the burden of APD is likely to reduce revenues by over £119m by the end of this parliament.

We have set out a range of possible scenarios. Under a central scenario – where the Scottish Government continues to set a somewhat lower threshold for the Higher Rate than in rUK; where the income tax base per capita grows at the same rate in Scotland as rUK; where LBTT revenues marginally underperform the BGA; and where cuts to APD go ahead – the Scottish Government's resource budget is forecast to fall by 3.3% in real terms between 2017/18 and 2021/22.

Under an upside scenario – where LBTT revenues match the BGA, cuts to APD are not made, and Scottish wages grow more quickly than in rUK – the resource budget is forecast to fall 1.6% over the period. Under a more challenging scenario, where Scottish wages grow relatively slowly and LBTT revenues substantially underperform the BGA – the resource budget could fall by 4.9% in real terms.

These scenarios are of course only indicative, and the government's outturn budget could prove higher or lower than this. But the scenarios illustrate, on the balance of probability, further real terms cuts are more likely than increases over coming years.

As we outline in the next chapter, this outlook will mean that the government will have to prioritise carefully its commitments over the remainder of this parliament.

The outlook for the capital budget is more positive. The government's capital allocation increased by 5.5% in 2017/18 in real terms, and will increase by almost as much again in 2018/19 and 2019/20. The government is now also able to borrow up to £450m annually to fund capital investment, although its ability to do so remains somewhat constrained in 2018/19 as a result of the reclassification of various NPD schemes.

Comment [A18]: Revised GERS estimate for 2016-17 may change this and depending on whether OBR take on board the estimate.

EMAIL 5

From: Anna Murray [mailto:anna.murray@strath.ac.uk]
Sent: 12 September 2017 10:38
To: NAME REDACTED
Subject: RE: Scotland's Budget Report

NAME REDACTED,

Thanks for getting in touch.

Apologies that the material has not been passed to you. Graeme sent a draft version on to a couple of people in SG last week – one of whom was Simon, so I presumed that it would have been passed on!

Here are the latest versions of the relevant chapters.

They are very much in draft stage at the moment so excuse any missing X's, etc.

Happy to hear any comments you might have,

Anna

Anna Murray | Fraser of Allander Institute Research Assistant | Department of Economics
University of Strathclyde Business School | Duncan Wing, Rm 539 | 199 Cathedral Street | Glasgow G4 0QU

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From: NAME REDACTED
Sent: 11 September 2017 13:54
To: Anna Murray <anna.murray@strath.ac.uk>
Subject: Scotland's Budget Report

Hi Anna,

I hope all is well with you and things are not too stressful in the lead up to the FAI's publication on Scotland's budget.

I just wanted to drop you a quick email to follow up on our meeting from last month.

I believe you were happy to share the material on income tax ahead of the publication for QA purposes? Is this still something that you are intending to do?

Best wishes,
NAME REDACTED

Chapter 1: Economic Outlook

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly with major new powers over taxation and welfare.
- Around 40% of devolved expenditure are now funded by tax revenues generated in Scotland – a figure that will rise to 50% once VAT revenues are assigned.
- As a result, Scotland's economic performance – or more accurately, Scotland's economic performance *relative* to the UK – now has a much greater bearing on the outlook for the Scottish budget than ever before.
- This autumn, for the first time, the Scottish Fiscal Commission (SFC) will provide detailed forecasts for Scottish devolved taxes, income tax and GDP. The Office for Budget Responsibility (OBR) will be preparing forecasts for the relevant Block Grant Adjustments.
- Both of these will be shaped by their assessments of the outlook for the Scottish and UK economies respectively and the outlook for the key determinants of changes in the revenues collected from each individual devolved tax.
- Despite showing signs of resilience in the immediate aftermath of the EU referendum, UK growth has slowed markedly in the first half of 2017. The strong growth in consumption that propped up the economy in 2016 has tailed off. Business investment remains flat, whilst the boost to trade hoped for following the sharp fall in Sterling has yet to materialise.
- The Scottish economy grew strongly in the first quarter of 2017 but growth in Scotland has been weaker than for the UK economy as a whole over the last two years.
- Indeed, refreshed figures published last month show that the Scottish economy *contracted* slightly in 2016.
- Over time, what matters most for the Scottish Budget is how Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.
- But in looking ahead to this year's Scottish Budget, what will be crucial will be the actual forecasts made by both the SFC and OBR. It is the combination of these two forecasts that will determine, at the margin, how much more or less money the Cabinet Secretary for Finance will actually have to spend next year.
- Given recent data, we believe that the Scottish Fiscal Commission is likely to be relatively cautious in their forecasts for growth and Scottish taxation over the next few years.

Whilst the Scottish economy made a welcome return to growth during the first three months of 2017, this comes on the back of weak economic data over the

past couple of years. Employment is at a record high and there are some signs of confidence returning to the North Sea. But with Brexit and weak confidence, we expect the Scottish Fiscal Commission to be cautious in their forecasts for Scottish tax revenues and economic growth in this year's Budget.

1.13 Introduction

The Scottish budget is in the process of significant reform.

As a result of the Scotland Acts 2012 and 2016, substantial new fiscal powers are being transferred to Holyrood, including the devolution and assignment of tax revenues and the devolution of some social security powers.

The Scottish Parliament will soon oversee annual public spending of around £XX billion, control all land and property taxation, and have significant responsibilities over income taxation in Scotland.

The outlook for Scotland's budget now depends upon three key elements –

- What remains of the Westminster block grant – as determined by the Barnett Formula;
- Future tax policy choices of the Scottish Government; and,
- The relative performance of Scottish devolved tax revenues.

UK economic performance and spending decisions taken at Westminster will continue to set the overall envelope for Scottish public spending through the Barnett formula.

But with Scotland's block grant now being adjusted (i.e. reduced) to take account of the new devolved tax revenues, how Scottish tax revenues perform relative to the rest of the UK now have a much greater bearing on the outlook for the Scottish budget than ever before.

In time, it is this relative economic performance that will determine whether or not the Scottish Budget is better or worse off relative to what it would have been prior to devolution.

But for the immediate outlook of next year's Budget and the trajectory to the end of the Parliament, it will be the forecasts made for Scottish tax revenues and the equivalent taxes in the rest of the UK by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR) that will be crucial.

This chapter is structured as follows.

Section 1.2 summarises the key elements of this new fiscal framework and explains how Scotland's relative economic performance will now feed through to budget outcomes.

Section 1.3 summarises the recent performance of the Scottish and UK economies. Section 1.4 discusses the outlook.

Section 1.5 highlights some of the key issues facing the Scottish Fiscal Commission in the compiling of economic and tax forecasts for Scotland.

Section 1.7 concludes.

1.14 Scotland's fiscal framework

The new powers

The Scottish Parliament's new tax and welfare powers are being phased in gradually over the next few years. With these new powers has come fundamental changes to the way that the Scottish budget is calculated and administered.

New arrangements for fiscal forecasting have been put in place with the Scottish Fiscal Commission achieving statutory status in April this year.

The Scottish Government has secured more extensive borrowing and cash management tools to manage budget volatility and uncertainty.

At the same time, implementing the new powers is requiring substantial technical and administrative work, much of which is ongoing. The way in which Scottish budgets are presented to and scrutinised by the Scottish Parliament is also changing.

Table XX provides a summary of the new responsibilities for taxation – including the taxes devolved as part of the 2012 Scotland Act.

Table X: Devolved, shared and assigned tax revenues in Scotland

Tax	Date of transfer/ devolution	Revenues raised 2015/16 (£m)	Degree of control by Scottish Parliament	Responsibility for collection
Land and Business Transactions Tax (LBTT)	2015	£416	Fully devolved; complete autonomy.	Revenue Scotland
Landfill Tax	2015	£147	Fully devolved; complete autonomy.	Revenue Scotland
Income tax	2017	£11,214	The Scottish Government can set the rates and bands. But the UK Government defines the tax base and sets allowances.	HMRC
Air Passenger Duty	2018	£275	Fully devolved; complete autonomy	Revenue Scotland
VAT	2019	£5,000	Assigned revenues; no autonomy	HMRC
Aggregates Levy	tbc	£53	Fully devolved; complete autonomy	Revenue Scotland

Source: Government Expenditure and Revenue Scotland (GERS)

A new Scottish tax agency, Revenue Scotland, has been established to collect revenues for the fully devolved Scottish taxes (LBTT, Scottish Landfill Tax, Aggregates Levy, and Air Passenger Duty, which the Scottish Government has announced will be renamed 'Air Departure Tax').

Revenues from the partially devolved income tax and the assigned VAT in Scotland will continue to be collected by HMRC.

Alongside taxation, some devolution of social security benefits is also taking place.

In particular, a number of UK-administered benefits, mainly related to ill-health, disability and carers are being devolved. The benefits associated with the regulated social fund – such as winter fuel payments – are also being devolved.

Spending on these benefits in Scotland by the UK Government in 2015/16 totalled around £3bn – see Table XXX.

[insert table on the new social security powers]

The Scottish Government is currently working to establish a new social security system in Scotland, with implementation dates for the new powers to be agreed by the Joint Ministerial Group on Welfare.

Additionally, the Scottish Government has already gained the power to:

- create new benefits (except pensions) in areas not otherwise connected with reserved matters
- top up reserved benefits
- make discretionary payments or provide discretionary assistance to meet certain needs
- amend some employment support schemes
- make changes to the amount of Universal Credit (UC) for the costs of rented accommodation, and the timing and recipients of payments.

Since 1 April 2017, Discretionary Housing Payments have been devolved.

The calculation of the Scottish budget

The Scottish Government's block grant from Westminster will continue to be determined by the Barnett Formula.

Therefore, decisions on public spending by the UK Government will still set the overall envelope for Scottish public spending through the decisions that they take on comparable funding for Whitehall departments where spending is devolved to Scotland.

However, the block grant will be adjusted (i.e. reduced) to take account of the fact that some taxes are now devolved to the Scottish Parliament.

How does this happen?

For each of the devolved (and assigned) taxes, a ‘block grant adjustment’ (BGA) is calculated. The BGA is effectively a measure of the tax revenues that the UK Government has foregone as a result of transferring the tax in question to the Scottish Parliament.

Box XX explains the operation of the BGAs in a bit more detail.

Box 1.1: The Block Grant Adjustments

The Block Grant Adjustments (BGA) are a key component of the new framework for the Scottish Budget. It is the combination of Scottish tax revenues *and* the BGAs that will ultimately determine whether or not the Scottish budget is better or worse off relative to the old settlement.

Under the new approach, a BGA will be calculated for each tax and will consist of two elements: an *initial deduction* and an *indexation mechanism*.

The initial deduction is equal to the tax revenues collected in Scotland in the year prior to devolution of the new power. For example, income tax was devolved for 2017-18. So the initial deduction was equal to income tax receipts in Scotland in 2016-17. The net effect was that the Scottish Budget was no better or worse off.

But what is the BGA for 2017-18 and thereafter?

This is where the indexation mechanism comes in. Its purpose is to provide a measure of the rate at which ‘comparable revenues’ have grown (or declined) in the rest of the UK (rUK) between 2016-17 and 2017-18 (or any subsequent year).

The basic idea is that the BGA should grow at the same rate as the growth in comparable revenues in rUK.

So how is the indexation mechanism actually calculated?[61]

Until 2020-21, the BGA for Scotland will effectively grow in line with the growth in per capita tax receipts for the equivalent devolved taxes in rUK. For income tax for example, the BGA will increase in line with the growth in NSND income tax growth per head in the rest of the UK.

A similar mechanism has been established for the new welfare powers. But instead, the BGA for social security powers involves a ‘baseline addition’ to the budget (which is equal to UK Government spending on the benefits to be devolved in the year prior to devolution), and an indexation mechanism.

The final indexation mechanism is still to be agreed but could ultimately be based on the ‘Barnett Formula’, so that the BGAs will be increased by a population share of ‘comparable’ benefits in rUK. But for the transitional period to 2021, they will grow in line with the percentage

[61] During the development of the Fiscal Framework, there was disagreement between the Scottish and UK Governments over the indexation mechanism. In the end, a temporary mechanism was agreed for review in 2021.

change in per capita spending on these 'comparable' benefits in rUK (and the change in Scotland's population[62]).

So each year the BGAs for each tax will take money out of the Scottish Government's block grant. What is added back in are the revenues that are raised from each tax in Scotland.

[insert diagram]

The key implication of how all this works is quite straightforward (even if the process underpinning it is not). In short, if the sum of the revenues raised from the devolved/ assigned taxes is greater than the sum of the BGAs, then the Scottish budget will be better off than it would have been without tax devolution[63].

It is this mechanism that builds in 'risk and reward' to the Scottish budget process, with how the economy performs now crucial to the future outlook for public spending.

Scotland's Budget could be better off under the new system for two reasons:

- the tax base grows relatively more quickly in Scotland than in rUK; or
- tax policies in Scotland that seek to raise revenues relative to those in rUK.

Of course the reverse could happen – Scottish revenues may grow relatively more slowly than those in rUK, in which case the Scottish budget will be worse off than it would have been without tax devolution.

Under this new framework, the Scottish budget bears in full the effects of any differential growth in Scottish revenues relative to rUK revenues, even if the causes of any differential growth are beyond the control of the Scottish Government.

Operational issues with the implementation of the new powers

As highlighted above, the determination of the Scottish budget is now significantly more complex than in the past. It is no surprise therefore that the institutional framework that underpins this new arrangement has been reformed significantly.

Box 1.2 summarises some of the major new changes.

Box 1.2: The Fiscal Framework

The fiscal framework is the term used to cover the new budget arrangements for the Scottish Parliament's tax and welfare powers.

In addition to setting out the mechanism for how the block grant adjustment (BGA) will operate

[62] Given that Scotland has a higher proportion of people claiming these benefits than a population share, applying a Barnett uplift will – over time – effectively be a relative squeeze on welfare spending in Scotland.

[63] Similarly, for social security, if Scottish spending increases faster than in the rest of the UK, then this will have to come at the expense of lower spending in other parts of the budget or increased taxation.

– see Box 1.1 – there are a number of other important features of the new framework:

- The Scottish Government's capital borrowing powers have increased. The overall limit on borrowing has risen to £3 billion, with an annual limit of 15% of the overall borrowing cap (equivalent to £XXX million for 2018/19).
- The Scottish Government now has increased revenue borrowing powers of up to £600 million per annum, subject to a combined overall limit of £1.75 billion, for in-year cash management, forecast error and Scottish-specific economic shocks.
- The Scottish Fiscal Commission has been established with responsibility for forecasting economic growth and devolved tax revenues and welfare payments.
- The processes for managing cash flow and variations in tax revenues between years have changed significantly. Gone is the old Budget Exchange Mechanism for transferring 'underspends' from one year to the next, with a new Scotland Reserve established in its place. In this Reserve, the Scottish Government is able to deposit up to £700 million and draw down monies – subject to limits of £250 million for resource and £100 million for capital – should they need to[64].
- Following the recommendations of the Budget Review Group, new procedures are being put in place for how the budget will be presented to and scrutinised by Parliament. A greater focus on 'year round' scrutiny is likely.
- Finally, the inter-governmental relations between the Scottish and UK Governments have been reformed with new dispute resolution mechanisms, and new arrangements for information sharing. These have already been tested in the light of the deal by the new UK Government to secure support from the Democratic Unionist Party in June.

One of the biggest institutional changes has been the establishment of the Scottish Fiscal Commission.

From now on, twice each year, the SFC will make a 5-year forecast for each of the Scottish revenues, and for spending on the social security benefits being transferred to Scotland. They will also make a forecast for growth in Scottish onshore GDP.

The SFC will produce its first official forecast this year alongside the Scottish Budget. But in order to set its budget, the Scottish Government will not only need forecasts for Scottish revenues but forecasts for the BGAs. The BGA forecasts will be determined by the UK Office of Budget Responsibility's (OBR's) tax forecasts for rUK, and DWP expenditure forecasts for social security benefits.

[64] At the end of 2016-17, the Scottish Government had around £75 million in the Scotland Reserve and an underspend of XX.

The UK Government will transfer to the Scottish Government the SFC's forecast for income tax revenues; these will be drawn down throughout the financial year, whilst the UK Government will deduct from the block grant the forecast of the income tax BGA.

Therefore in looking ahead to this year's Scottish Budget, the outlook that the SFC and OBR have for the Scottish and UK economies (and tax revenues) will be crucial for determining the exact amount of money the Scottish Government will have at its disposal for the coming financial year[65].

1.15 Recent Scottish and UK economic performance

Economic Growth

All of this above discussion makes the outlook for the economy vitally important.

Over the last 12 months, the Scottish economy grew by 0.6% (and by 0.4% on a 4Q-on4Q basis). This is below its long-term average and the equivalent growth rate for the UK as a whole (which grew by 2.0%).

Table XX: Scottish growth (%) by sector Q1 2016 to Q1 2017 (Quarter on Quarter growth)

	GDP	Agriculture	Production	Construction	Services	*GDP per head*
Scotland	+0.6	+0.8	-0.1	-4.0	+1.2	*+0.3*
UK	+2.0	-0.2	+2.3	+2.8	+2.3	*+1.3*

Source: Scottish Government

It is also below the forecast made by the Scottish Government for growth of 1.0% in 2016-17 in December's Draft Budget.

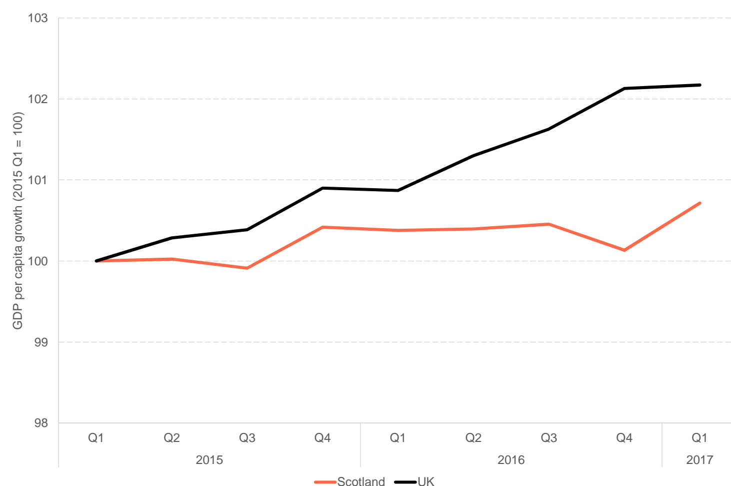
It is also sufficiently weak to trigger the emergency borrowing powers in the Fiscal Framework to cope with an asymmetric shock. This is defined as when Scottish growth is less than 1% and more than 1 percentage point smaller than the UK as a whole.

When measured in terms of output per head – arguably the more relevant indicator of performance given the focus of the new framework on tax receipts per capita – a similar story emerges.

Scotland grew strongly in 2014 but since then the UK has grown more quickly (Chart XX) – with growth in GDP per capita in Scotland of just 0.2% compared to the UK's 1.3% over the past year.

[65] Once outturn data on the taxes are available, the forecasts of both Scottish tax revenues and the income tax BGA will be reconciled to that outturn. For the fully devolved taxes these will happen on a monthly basis. But for income tax, outturn data will not be known until 15 months after the end of the financial year – so outturn data for 2017/18 for example will not be available until June 2019.

Chart XX: Scottish & UK GDP per head: 2014Q1 to 2016Q1



Source: Scottish Government

The Scottish economy recorded strong growth during the first three months of 2017. Whilst welcome, as discussed in our latest Economic Commentary[66], some caution needs to be exercised at this stage when interpreting these figures.

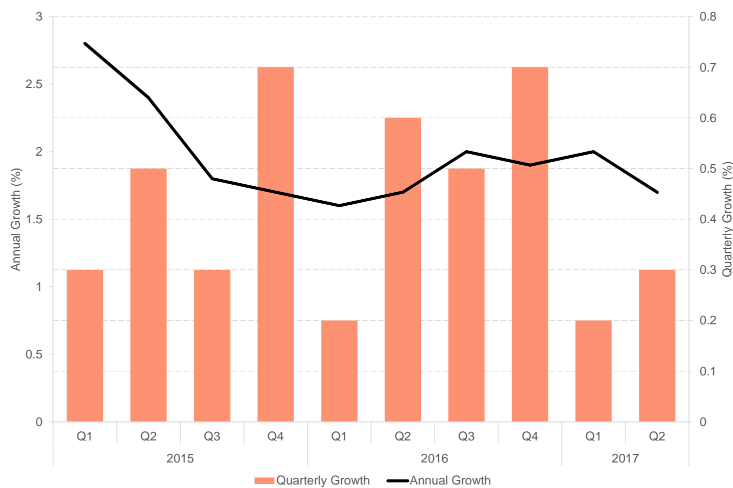
- Firstly, the growth of +0.7% comes on the back of a fall in output of 0.2% in the final three months of 2016.
- Secondly, the latest figures now show that the Scottish economy actually contracted during 2016 as a whole – falling by 0.1%.
- Thirdly, much of the growth during Q1 2017 was driven by a 'bounce-back' in sectors which have been going through a challenging period in recent years. Even with the strong growth in Q1, these sectors are still well below where they were just two years ago – see Box 1.3.
- Finally, domestic demand was flat this quarter, with all the net growth coming from external sources

All things considered, it is our expectation that the Scottish Fiscal Commission will view the recent GDP data with some caution. Much will depend upon the figures for Q2 to be published in October and the extent to which growth is shared more evenly across the economy.

The UK economy initially appeared to hold up much better than expected in the immediate aftermath of the EU referendum. In fact, growth picked up through the second half of the year. But conditions have weakened markedly in the first half of this year.

Chart 1.XX: Slowdown in UK economic growth

[66] [Insert link to latest FEC once published]



Source: ONS

As expected, household consumption – which had been the principal driver of growth in recent times – has slowed to just 0.1% in the three months up to June. In 2016, consumption grew by 2.8%, in part fuelled by increased borrowing. But household consumption, particularly discretionary spending is being scaled back as inflation continues to bite. The Consumer Price Index is expected to peak at close to 3% this year.

Business investment remains subdued with little growth over the last two years. Some indicators from the Bank of England suggest that investment intentions may have *"strengthened a little further"* in recent months, but they also find that heightened uncertainty is playing a part in some firms' unwillingness to invest[67].

The UK's net trade position is broadly similar to that back in 2015 (at a deficit of around £8 to £9 billion) even with the help of a sharp depreciation in Sterling.

Against that however, tax receipts have been relatively healthy. The ONS' latest estimates of public sector borrowing for the year to March 2017 put the deficit at £45.1 billion, a reduction of £27 billion on the previous year. Borrowing is forecast to increase however, through the remainder of 2017.

Scottish Labour market

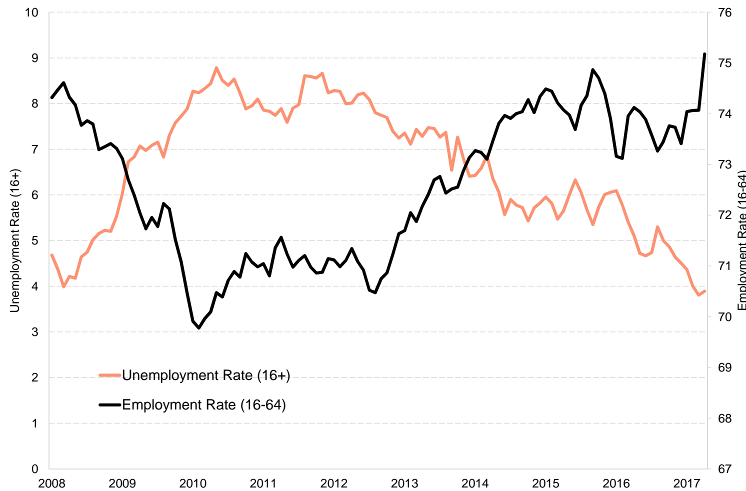
In contrast to the wider economy, Scotland's labour market continues – at least in terms of the headline figures – to hold up remarkably well.

This is important given the focus of the new fiscal framework on income tax and VAT where employment and earnings will be key determinants of future revenue growth.

The employment rate in Scotland now stands at 75.2% up 1.1 percentage points on a year ago. Meanwhile the unemployment rate has fallen to 3.9% down 1.2 percentage points since last year.

[67] See www.bankofengland.co.uk/publications/Documents/agentssummary/2017/q2.pdf

Chart XX: Scottish employment rate and unemployment rate best since records began



Source: ONS, Labour Force Statistics, August 2017

Compared to the UK, Scotland now has a marginally higher employment rate and a lower unemployment rate.

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	75.2%	3.9%	21.8%
Quarterly Change	+1.1	-0.5	-0.7
Annual Change	+1.1	-1.2	+0.0
UK	*75.1%*	*4.4%*	*21.3%*
Quarterly Change	*+0.3*	*-0.2*	*-0.2*
Annual Change	*+0.7*	*-0.5*	*-0.3*

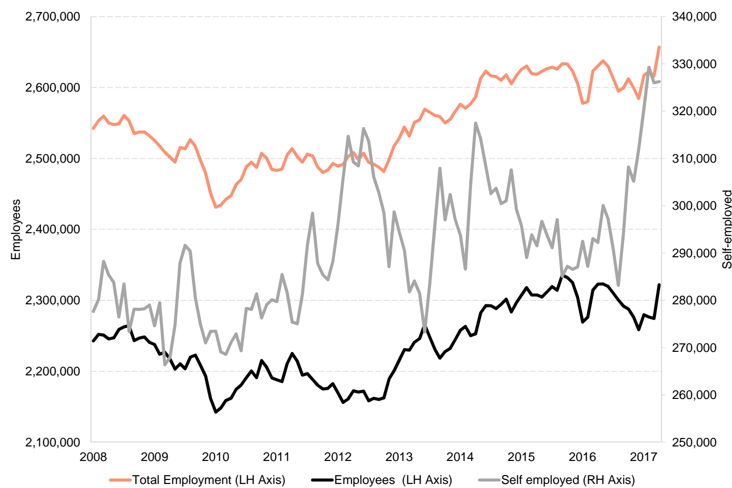
Source: ONS, Labour Force Statistics, August 2017

However as we have discussed in our Scottish Labour Market Trends reports, the headline figures do hide some challenges.

Firstly, there is an ongoing concern about the nature and type of work being undertaken by those in employment. For example since the financial crisis, there has been a rise in part-time employment (up around 10% over the past 10 years). The number of people working part-time because they cannot find a full-time job is up nearly 60% on the last decade.

Secondly, while employment has grown over the past year, this has almost all been driven by increases in self-employment.

Chart XX: Sharp rise in self-employment in Scotland over last year



Source: ONS, Labour Force Statistics, August 2017

Not only do we await to see what the long-term economic consequences of both effects, we do not yet know how such trends will feed through to the tax figures for Scotland (and the position of Scotland vis-à-vis the UK). On the one hand, by paying less in National Insurance contributions, a self-employed person who earns more than the personal allowance will pay more in income tax than a traditional employee. But against that, those in self-employment have arguably greater scope to alter their tax affairs such as taking more in un-earned income (e.g. dividends) from their 'company' than employees.

Thirdly, real earnings remain under pressure.

Unfortunately, the most recent data we have for Scotland covers to the end of March 2016.

Over that year, wage growth has been slower in Scotland than in the UK. One explanation is the downturn in the offshore economy. Indeed, median wages declined by 5% in Aberdeen and 4% in Aberdeenshire between 2015 and 2016.

Table 4: Median Gross Weekly Earnings, Scotland

	Median Earnings	% change	FT Median Earnings	% change	CPI
2014	£414.70	1.5%	£519.60	2.1%	1.8
2015	£422.60	1.9%	£527.00	1.4%	-0.1
2016	£432.00	2.2%	£535.00	1.5%	0.3

Source: ASHE

More up to date data is available for the UK. It shows that after a short return to real earnings growth in the first part of 2016, average real wages are falling once again and remain XX% below their 2008 levels.

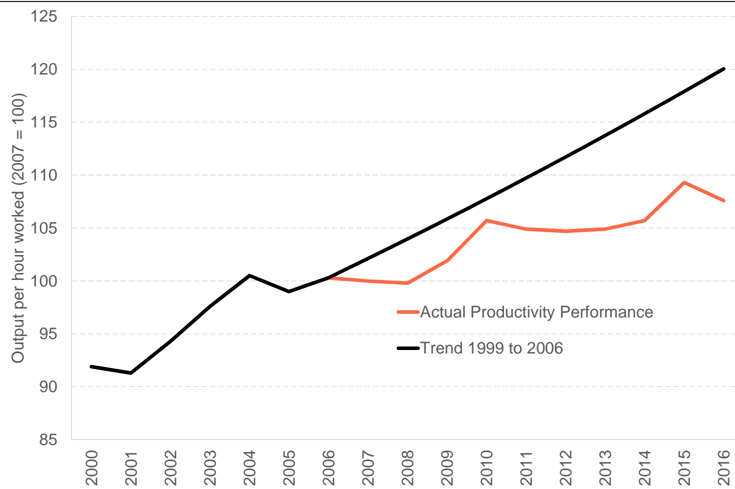
Productivity growth

The strong performance in the labour market belies weak productivity growth. In the UK, productivity growth averaged 2% per year until the mid-2000s, but has slowed significantly since.

Scotland has seen a similar slowing trend – Chart XX – although Scotland has fared better than the UK as a whole with the Sco-UK gap narrowing in recent years. Productivity fell in Scotland in 2016.

As we discuss below, the view of the Scottish Fiscal Commission on the outlook for productivity growth in Scotland compared to the UK as a whole will have a significant bearing on their forecasts for Scottish tax revenues.

Chart 1.XX: Productivity growth in Scotland



Source: Scottish Government productivity statistics[68]

1.16 The economic outlook

The economic outlook for both Scotland and the UK is highly uncertain.

Most forecasters predict that the UK economy will grow by around 1.6% this year, before falling back slightly further in 2018. This is below trend growth of around 2%.

Table XX: Latest economic growth forecasts for the UK economy

	2017	2018
CBI	1.6	1.4
Item Club	1.5	1.3
NIESR	1.7	1.9
British Chambers of Commerce	1.7	1.3
European Commission	1.8	1.3
OECD	1.6	1.0

[68] http://www.gov.scot/Topics/Statistics/Browse/Economy/PROD16Q4

IMF	1.7	1.5
Average of forecasts	*1.6*	*1.4*

Source: HM Treasury

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

The UK outlook will have three key implications for the Scottish Budget.

- Firstly, we await details of how the new UK Government will respond in their Autumn Budget to emerging evidence of a weakening in UK growth. Any changes to public spending – e.g. to support a greater than planned pay increase for public sector workers – could have a direct bearing on the Sottish Budget via Barnett consequentials.

- Secondly, with around £11bn worth of exports destined for the rest of the UK every three months, the UK economy's performance will have an important bearing on the outlook for Scottish growth.

- Thirdly, as highlighted above, what matters most for the net position of the Scottish Budget now is how Scottish tax revenues perform *relative* to equivalent taxes in the rest of the UK.

One thing that should help prop up the UK economy is a relatively positive global trading environment – see Box XX.

Box XX: The global economic environment

The fundamentals of the global economy are stronger than they have been for many years.

Global economic activity is picking up with a long awaited recovery in investment and trade. The IMF forecast global growth to rise from around 3% in 2016 to nearer 3½% this year and next – not too distant from the long-term average growth rate.

Encouragingly, growth in international trade is expected to move ahead – once again – of overall growth in the global economy.

Financial markets have also held on to gains made in early 2017 and levels of business and consumer confidence – on the whole – are positive. The keenly watched 'OECD Leading Indicator' points to advanced economies remaining in positive territory in the near term with momentum building.

In terms of Scotland's two main international export markets, the outlook is positive.

Firstly, whilst the US economy has posted relatively modest results so far this year, strong jobs market data and an anticipated fiscal stimulus should lead to faster growth going forward.

Secondly, the recovery in Europe continues to build momentum and has now reached all Euro Area countries. But whilst unemployment continues its downward trend, it remains high with painful structural adjustments still needed. Even by 2018, Euro Area unemployment is still

projected to be close to 8%.

Overall, policy uncertainty – from President Trump through to Brexit – remains high and is the biggest risk facing the global economy. There are also still a number of imbalances and vulnerabilities in financial markets – not least in China where the government is seeking to establish a more balanced and less debt-fuelled growth model.

Table XX: Outlook for global growth: 2017-2018

Year on Year	2015	2016	*Projections* 2017	2018
World Output	3.4	3.2	*3.5*	*3.6*
Advanced Economies	2.1	1.7	*2.0*	*1.9*
US	2.6	1.6	*2.1*	*2.1*
Euro Area	2.0	1.8	*1.9*	*1.7*
Emerging Market and Developing Economies	4.3	4.3	*4.6*	*4.8*

Source: IMF World Economic Outlook, July 2017

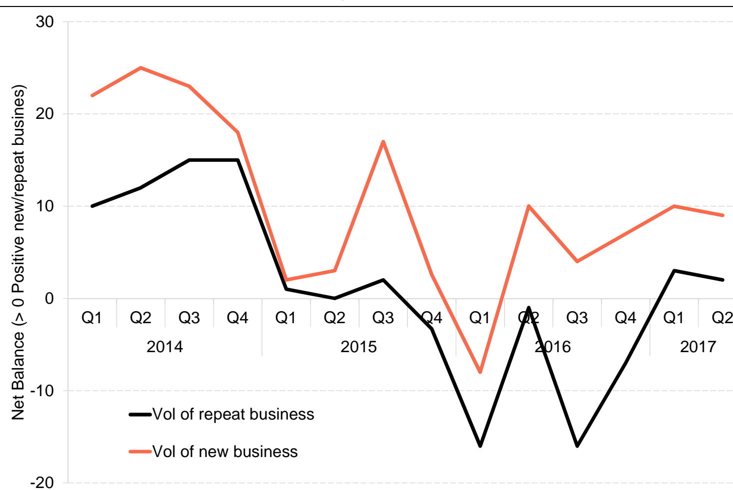
All of this takes us to the outlook for Scotland.

As highlighted above, the latest growth figures for Scotland showed strong growth in the first three months of 2017, but on the back of much weaker growth over the last two years.

Up-to-date survey and confidence indicators suggest that the economy is continuing to grow, albeit at a relatively slow pace.

For example, the FAI-RBS Business Monitor for Q2 2017 shows that the total volume of business activity in Scotland increased with the both repeat business and new business positive for the 2nd quarter in a row. That being said, the rate of growth remains relatively weak.

Chart 1.XX: FAI-RBS Business Monitor for Q2 2017

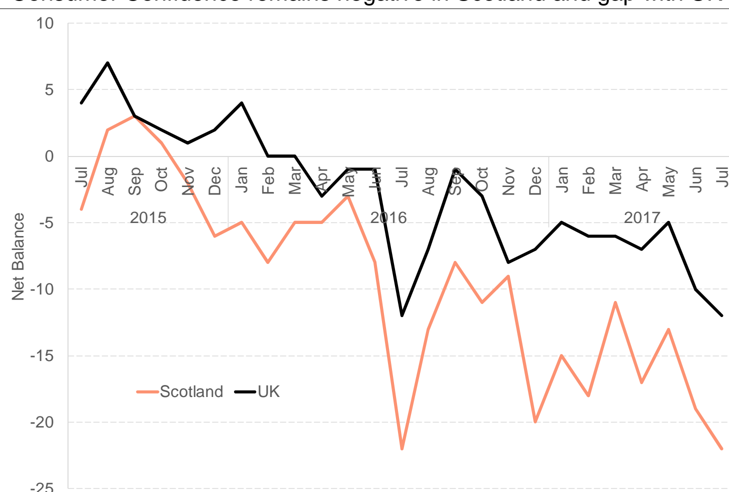


Source: Fraser of Allander Institute-Royal Bank of Scotland

The latest Lloyds Banking Group PMI for Scotland is perhaps more encouraging. It is at a 33 month high, although Scotland is still tracking behind the UK average – something that it has been doing for over two years now.

Overall levels of consumer confidence in Scotland remain relatively weak. The GfK indicator shows consumer confidence much weaker in Scotland than the UK as a whole, with the optimism becoming more pessimistic over the summer.

Chart 1.XX: Consumer Confidence remains negative in Scotland and gap with UK remains



Source: GfK

The Scottish Government's own measure of consumer confidence has been negative during the first quarter of 2017[69].

To provide an up to date assessment of economic activity in Scotland, the FAI produces monthly 'nowcasts' of Scottish growth – www.fraserofallander.org. The advantage of a 'nowcast' is that it provides an indication of economic performance far in advance of official data. Our latest nowcast estimates growth of XX% in Q2 and XX% in Q3.

The Institute's latest forecast for Scotland is for growth of around XX% in 2017 – fragile growth but clearly better than the outturn for 2016 – picking up to XX% in 2018.

Table XX: FAI forecast Scottish economic growth (%) by sector: 2017-2019

	2017	2018	2019
GVA			
Production			
Construction			
Services			

[69] https://beta.gov.scot/publications/state-of-the-economy-june-2017/

Source: Fraser of Allander Institute, September 2017

These forecasts suggest that whilst growth will be faster than last year, it is likely to remain below trend. Quarterly growth is also likely to remain volatile, with further negative quarters of growth or strong positive quarters (like Q1) entirely possible. We continue to recommend that the focus of attention is centred upon the medium to long-term trend as opposed to sharp movements in one quarter or another.

On balance, we believe that over the next couple of years Scotland will do well to match UK growth. A number of factors will determine whether this is the case or not –

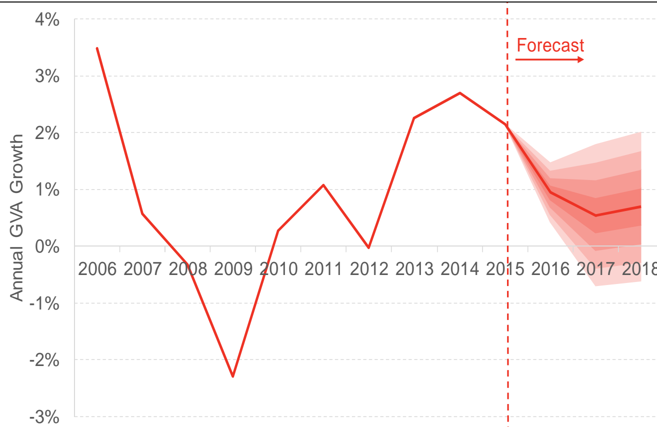
7. Much will depend upon the outlook for the North Sea and the recent pick-up in confidence. Our judgement is that the outlook is more positive than 12 months ago, but that it is fragile.

8. The Brexit process will add its own unique dynamics to the pattern of Scottish and UK growth over the coming months. We continue to hold the view that Brexit will act as a significant headwind to growth over the next few months – particularly in terms of investment and business uncertainty. Whether Scotland will fare better or worse is uncertain.

9. There is no doubt that Scotland has been stuck in a relatively weak growth cycle for over two years now. Economies go through cycles all the time – sometimes operating above potential and other times below potential. To the extent that at least some of the recent weak performance is cyclical and the Scottish economy is currently operating below potential, we could see faster growth in Scotland over the short-term as growth catches up with its trend.

We therefore continue to recommend that just as much focus is made upon the range of our forecasts as the central estimate.

Chart XX: FAI forecasts for GVA growth: 2017-2019



Source: Fraser of Allander Institute, September 2017

* Actual data up to 2016, central forecast with forecast error for 2017 – 2019

1.17 The forecasting choices facing the Scottish Fiscal Commission

So the outlook for the Scottish and UK economies remains relatively fragile and there remains a high degree of uncertainty about the outlook.

As we set out in Section 1.2, under this new Fiscal Framework, what ultimately matters over time will be how devolved Scottish tax revenues grow (per head) relative to the equivalent taxes in the rest of the UK.

If Scottish devolved revenues per head grow more quickly than the equivalent taxes in the rest of the UK then Scotland will be better off relative to the position prior to tax devolution; if Scottish devolved tax revenues grow more slowly, then the Scottish Budget will be worse off.

But in looking ahead to this year's Scottish Budget and the next few years, we will not have actual data on tax revenues in advance.

So what the SFC forecast for devolved taxes – and how they compare to the forecasts made by the OBR for the relevant BGAs – will be what determines the relative size of the Scottish Budget at the margin.

In making these forecasts, the SFC face a number of important judgement calls.

The size of the output gap in Scotland

One of the most important decisions that the Commissioners will need to take a view on, is the underlying economic potential of the Scottish economy – and crucially where they believe Scotland's economy is at the current time relative to that potential.

In the short-run, growth in an economy is largely determined by show-term factors such as the demand for Scottish exports or the level of government consumption. How these all add up creates an overall rate of growth in aggregate demand. In the short-run, growth in demand tends to dominate all other factors.

But in order to forecast how the Scottish economy – and by implication devolved taxes – may evolve over the forecast horizon, a much more subjective view of Scotland's potential level of output is required. Ultimately, it is the outlook for potential output and its determinants – the growth in Scotland's population, changes in labour market participation and hours worked, and the rate of productivity growth – that will drive forecasts for tax revenues.

The assumptions that the SFC places on each of these will have a significant impact on the forecasts that they make for Scotland's economy and tax revenues in 2018-19 and beyond.

Ultimately these are significant judgement calls. We highlight two key issues –

One area for careful consideration will be the outlook for Scotland's population. In 2016, the Scottish Government's forecasts were based upon a projection based upon the ONS's principal population projection for Scotland. Should the SFC take a different view – perhaps in the light of recent trends in EU migration and the possibility of a hard Brexit limiting migration – then the forecasts for Scottish tax revenues will look quite different (and potentially be materially weaker than for the rest of the UK).

Another crucial area is the rate of productivity growth (i.e. potential output per hour worked). The OBR has been persistently overly optimistic when forecasting UK productivity growth. Despite this, the OBR still assume that UK productivity will return to its long-term rate over the course of the forecast horizon. The SFC is not bound by this assumption, and many economists believe that such an optimistic forecast for productivity is not appropriate. Should the SFC take a different view, then the outlook for Scottish tax revenues could be much smaller than the BGAs put forward by the OBR.

Modelling tax forecasts

The SFC will be considering carefully how their new models and methods will stack-up vis-à-vis other forecasters and the OBR.

Forecasting future tax revenues or wider economic variables are, by their nature, subject to margins of error. Assumptions that are built into forecasts - based on the best available information at the time - often prove to be too optimistic or pessimistic as new economic events continuously unfold.

None of this will be straightforward and the Scottish Fiscal Commission will be doing this for the first time, with data that lags the UK as a whole, has fewer observations and is more susceptible to revision.

Note also that the Scottish budget bears the risk of forecast errors made by the OBR for rUK income tax. For example, consider the case where the SFC's forecast for Scottish revenues corresponds exactly to outturn, but where the OBR forecast for rUK income tax revenue substantially underestimates subsequent rUK outturn figures. In this case, the BGA will be smaller than it otherwise should have been so a future Scottish budget will be cut to reconcile actual rUK receipts with forecast.

Determinants of individual tax revenues

Finally, whilst the overall pattern of growth in an economy is strongly correlated with tax revenue growth in the long-run, from one year to the next it is not perfect.

For example, it is possible for GDP growth to be relatively tax rich or tax poor, particularly from one year to the next. Public sector wages for example, may not be strongly correlated with GDP in the short run (public sector employment makes up almost 30% of employment in Scotland).

Property prices and transactions are strongly pro-cyclical, meaning that they often grow more strongly than GDP during upswings, but fall more quickly than GDP during downswings. And GDP growth in any year may be accounted for in part by higher profits repatriated overseas, which have no bearing on Scottish tax revenues.

Therefore, the Fiscal Commission will – in addition to taking a view about the overall health of the Scottish economy – be monitoring and modelling important individual determinants of each devolved tax revenue.

For NSND income tax for example, their focus is likely to concentrate on their assessment of the outlook for employment growth, earnings growth and the relative distribution of any improvement in this wage growth by decile. As we will discuss in the next chapter, they will also have to

consider potential behavioural responses if tax policies were to change in Scotland vis-à-vis the rest of the UK.

Property prices in Scotland will clearly be a key factor for Land and Buildings Transaction tax, with factors such as the number of transactions and tax band of sales important.

1.18 Conclusions

The new fiscal framework for Scotland will mean that developments in the Scottish economy will now have a much greater impact on future budgets than ever before.

Ultimately, how the Scottish economy performs relative to the rest of the UK will have a much greater impact on the Scottish budget than before.

The potential paths for the economies of both Scotland and the UK – and the implications for fiscal policy – are highly uncertain.

Growth in the UK economy has undoubtedly weakened in recent months. That being said, the economy is still expected to grow over the coming months although the degree of uncertainty around the outlook remains high. The Chancellor faces a careful balancing act between continuing to reduce the deficit and protecting the real economy.

On balance, the immediate outlook for the Scottish economy appears to be just as – if not more challenging – and Scotland will do well to match UK economic performance in the near-term.

Of course, we will not know how Scotland has fared until tax revenues are collected and this will not happen – in the case of income tax – for a good few months after the financial year in question. Therefore in assessing the outlook for the Scottish Budget for next year and the remainder of the Parliament, what will be crucial will be the forecasts that the Scottish Fiscal Commission and the Office for Budget Responsibility make for Scottish devolved taxes and the BGAs respectively.

On balance, given recent data we believe that the Scottish Fiscal Commission are likely to be relatively cautious in their forecasts for Scottish growth and tax revenues.

Chapter 2: outlook for the Scottish budget

2.1 Introduction

Between the establishment of the Scottish Parliament in 1999 and March 2015, the resource budget of the Scottish Government essentially depended on one thing only: the block grant from Westminster.

Under the new arrangements, the block grant will continue to be determined by the Barnett Formula. And will continue to shape the overall envelope the Scottish Government faces. However, the block grant will be now adjusted by a block grant adjustment (BGA) to take account of the new taxes being devolved.

As was discussed in Chapter 1, in this respect the critical question is the extent to which the revenues raised in Scotland exceed or underperform the BGA.

If less is raised in Scotland from tax than is deducted from the block grant, the Scottish budget will be worse off than it would have been without tax devolution. But if the revenues raised exceed the BGA, the Scottish budget will be better off.

For any given tax, the revenues raised in Scotland may differ from the BGA for two reasons:

- If the tax base grows differently in Scotland relative to the rUK (for example, if wages grow more quickly then Scottish income tax revenues per capita are likely to increase more quickly); or

- If tax policy is varied in Scotland in such a way as to raise relatively more or less revenues in Scotland relative to the BGA.

In this chapter, we examine the outlook for the Scottish budget over the period to 2021/22.

We consider first in section 2.2 the outlook for the block grant from Westminster.

We then consider in section 2.3 the outlook for the devolved and assigned taxes, taking into account both the outlook for Scottish revenues and the equivalent BGA. As discussed in Chapter 1, given the recent performance of the Scottish economy, the Scottish Fiscal Commission (SFC) may take a cautious approach to its forecasts for Sottish revenues. It would not be surprising therefore if – short of any specific policy announcements to raise income in Scotland – the tax forecasts turn out to be slightly smaller than the BGA.

That being said, ultimately what matters is how outturn Scottish revenues *actually* compare to rUK revenues. As the purpose of this chapter is to examine the profile of the budget over the lifetime of the parliament we set out a range of possible scenarios for how taxes and the BGA may evolve rather than specific point forecasts.

Section 2.4 brings together the material in sections 2.2 and 2.3 to consider the overall outlook for the Scottish Government's resource budget.

In Section 2.5 we consider the outlook for capital spending. This is most straightforward in that the outlook only on the block grant for capital spending and capital borrowing. Section 2.6 concludes.

2.2 Outlook for the block grant

Based upon the latest plans from the UK Government, having grown slightly in 2017/18, the RDEL block grant, before any adjustments for new tax and social security powers, is expected to decline by 3% in real terms by 2021/22 (Table X).

Table X: Outlook for the Scottish Government's resource block grant – 2016/17 to 2021/22

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Change

							16/17 - 21/22
Cash terms	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656	£1,569
2017/18 prices	£26,512	£26,627	£26,230	£25,871	£25,879	£25,796	-£716
Real terms annual change		*0.4%*	*-1.5%*	*-1.4%*	*0.0%*	*-0.3%*	*-2.7%*

Notes: figures for 2016/17 – 2019/20 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget.

Figures for 2020/21 and 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total RDEL spending but does not allocate this total between spending departments.

Of course there is a possibility that the block grant may turn out to be somewhat higher or lower than the Chanellor set out in March.

The risks from further cuts – on the whole – seem fairly small. Under current forecasts, the Chancellor is on course to meet his new fiscal target to get structural borrowing below 2% of GDP by 2020/21 with around £26bn 'headroom'.

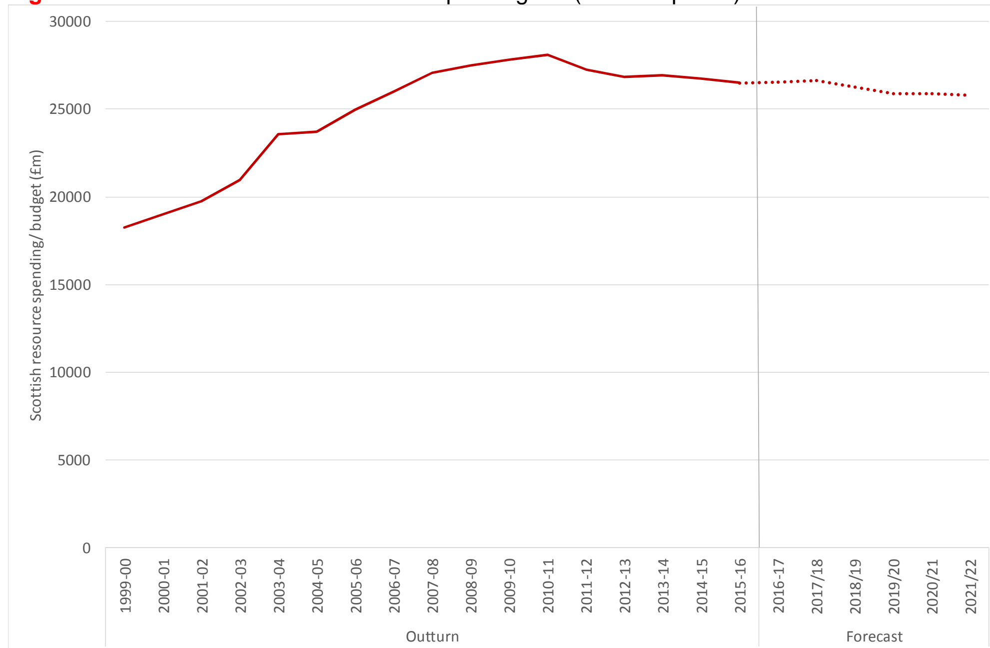
So even if revenue growth is slower than forecast, there is some insurance against the need to immediately cut spending. But even if growth is faster than forecast, the Chancellor may choose to 'bank' the proceeds of additional revenue growth, given that the UK Government still retains the ambition of returning the public finances to balance in the 'next parliament'.

These are uncertain times politically and economically, and the possibility of significant change in the outlook for the block grant should not be ruled out.

Figure X places the future outlook in a longer term context.

By 2021/22, the Scottish Government's resource block grant is expected to be 8% lower in real terms (before any adjustments for new devolved powers) compared to the peak of resource spending in 2010/11[70].

Figure X: Scottish Government resource spending £m (2017/18 prices)



Source: Outturn from Public Expenditure Statistical Analyses, various years. Forecast derived from UK Government Spring Budget 2017

[70] On a like-for-like basis, the actual funding reduction has been slightly greater than indicated by this headline figure. The Scottish Government's funding responsibilities have increased during this time, notably as a result of the transfer of Council Tax Reduction to the Scottish budget in 2013/14.

2.3 The outlook for revenues and block grant adjustments

In this section we consider the outlook for revenues and the BGA for each of the taxes currently – or soon to be – devolved or assigned to Scotland. In doing so, we draw on recent revenue forecasts for Scottish and comparable UK taxes, as well as on recent data on comparative performance of the Scottish and rUK tax bases. For simplicity, we calculate the BGAs based on the Indexed Per Capita method[71].

Ultimately what is important is whether outturn Scottish revenues are higher or lower than the outturn BGAs. When the Budget is published however, outturn data will not be available. The Budget itself must therefore be based on forecasts: forecasts for Scottish revenues, and forecasts for the BGAs.

Such tax forecasts are subject to significant uncertainty. They will evolve over time in light of new data. But they will always be subject to error, and will always turn out to be 'wrong' if they are perceived as being something they do not claim to be, i.e. an exact prediction (Box X).

A further technical complication is that the latest rUK revenue forecasts – which determine the calculation of the BGAs – were published in March 2017; but the latest Scottish revenue forecasts were published four months earlier in December. The emergence of more recent data in the period between means that they are not quite made on a comparable basis. Throughout this section therefore, whilst making reference to these forecasts, we focus on what is ultimately the key question:

How likely is it that Scottish revenues will match or exceed the relevant BGA, taking account what we know of current trends in tax base growth, and proposals for tax policy in Scotland and rUK?

Box X: Forecasting and uncertainty

The Scottish Fiscal Commission and the OBR are both obliged to produce 'point estimate' forecasts for revenues (for Scotland and the UK respectively) for up to five years.

Both institutions are tasked with simply providing their best estimates of either devolved Scottish taxes or the Block Grant Adjustments. They will not – and are not allowed – to coordinate their forecasts.

Point estimates are necessary for budgeting purposes. But they hide significant uncertainty and margins of error. What might happen in future is of course unknowable with complete certainty.

Uncertainty is present in all forecasts. But economic forecasts are arguably associated with particularly high levels of uncertainty. We only have an imperfect notion of how the economy works, we only have partial information about the state of the economy at any point in time, and the economy is constantly hit by unanticipated shocks.

The SFC's 'point estimate' forecasts will, like the OBR's, implicitly be probabilistic. The actual forecast is effectively a 'central' or 'median' forecast. This means that, the risks are perceived to be balanced in the sense that the actual outcome is as likely to be above expectations as below.

From a Scottish budget point of view, what is ultimately critical is how Scottish revenues perform relative to the comparable revenues in rUK. In the sense, what is just as important as the error associated with the Scottish forecasts, is the extent to which error associated with the

[71] The Fiscal Framework identifies two methods for calculating the BGAs: Indexed Per Capita (IPC) and the Comparable Method (CM). Over the period up to 2021/22, the BGAs will be calculated according to the IPC method (although the results of the Comparable Method will also be published). The Scottish and UK Governments will need to agree a methodology for 2022/23 and beyond.

Scottish forecasts is correlated with error in the rUK forecasts.

For example, outturn revenues in Scotland could turn out to be 10% lower than forecast. But if rUK revenue outturn for the comparable tax is also 10% down on forecast, the Scottish budget will be no worse off. The two forecast errors effectively cancel out.

Income tax

When the Scottish Government published its 2017/18 Budget in December 2016, it was forecasting income tax revenues of £11.8bn in 2017/18, rising to £14.6bn by 2021/22.

This forecast for Scottish revenues exceeded the forecast for the BGA by £79m in 2017/18, rising to a difference of +£661m by 2021/22. The difference between the forecast for Scottish revenues and the BGA forecast is partly due to the fact that the Scottish Government had announced an intention to set a lower threshold for the Higher Rate of income tax throughout this parliament[72].

At the time of the UK Spring budget in March 2017, the OBR published updated forecasts – based on new data – for rUK income tax revenues over the period to 2021/22. The implication was that the forecast for the income tax BGA was reduced, relative to the figure available at the time of the Scottish Government's Budget.

As a result, the gap between the Scottish Government's latest revenue forecast (December 2016) and the latest BGA forecast (March) has widened. On paper, this looks good news!

But it should be remembered that the forecasts for Scottish revenues (and the BGA) will be revised again before the Scottish Government publishes its 2018/19 Budget later this year. It seems almost inevitable that the forecast for Scottish revenues will also be revised downwards, once they take into account the more income tax data.

Table X: Income tax revenue and BGA forecasts (£m) – 2017/18 to 2021/22

	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)	11,750	12,159	12,672	13,233	13,898
BGA forecast (March 2017)	11,636	11,924	12,326	12,833	13,460
Scottish forecast (Dec 2017)	11,829	12,290	12,912	13,647	14,559
Difference between revenue forecast and BGA (Dec 2016)	79	131	240	414	661
Difference between revenue forecast and BGA (Mar 2017)	193	366	586	814	1,099

Source: Fraser of Allander calculations

How likely is it that Scottish income tax revenues will match or better the BGA in 2017/18 and beyond?

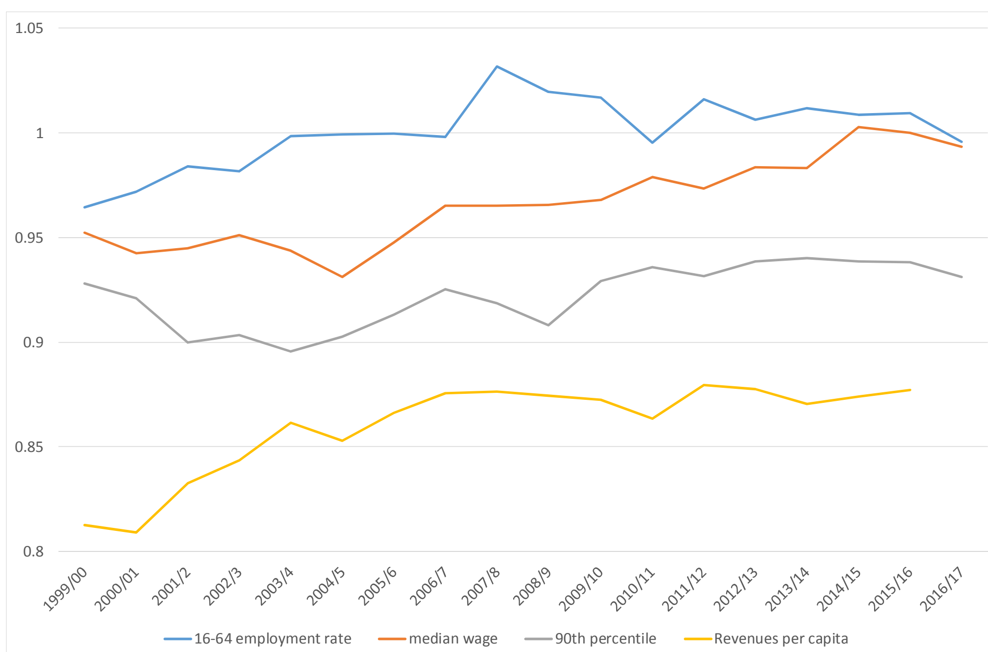
Chapter 1 discussed the overall outlook for the economy. But as we mentioned, to answer this question a more in-depth analysis of the major determinants of the income tax base (wages and employment) are likely to evolve in Scotland relative to rUK, and how tax policy may change.

Recent trends in tax revenues and the tax base

Between 2007/8 and 2015/16, income tax revenues per capita have grown at the same rate in Scotland as the UK (Figure x). On the one hand, the employment rate in Scotland has declined relative to the UK rate. But over the same period, wages in Scotland have performed slightly better than in the UK (more accurately, Scottish wages have not declined quite as much).

Figure X: Trends in employment, wages and income tax revenues per capita, Scotland as a percentage of UK

[72] It was not clear from the analysis presented in the 2017/18 Budget whether other factors (e.g. differences in modelling approaches or assumptions for underlying tax base growth) also contributed to differences between the revenue and BGA forecasts.



Source: Employment rate from Labour Force Survey; Wage data from Annual Survey of Hours and Earnings, various years; income tax data from HMRC tax outturn statistics

But changes in income tax policy have played a role in influencing relative revenue growth too. Two key changes are worth noting.

1. Since 2007/8 the Personal Allowance has increased in real terms. Between 2007/8 and 2015/17 it increased by 65% in real terms.

2. Tax rates on the highest earners have also increased. During the last parliament, the Higher Rate threshold was reduced in real terms by around 13%[73]. Furthermore an Additional Rate of tax was introduced in 2010/11, initially at 50% before being reduced to 45% in 2013/14.

The increases in Personal Allowance, lower Higher Rate threshold and introduction of the Additional Rate have together resulted in tax liabilities becoming more concentrated on higher earners. As a result, tax revenues per capita have grown more quickly in parts of the UK (i.e. London and the South East) which have the highest proportion of high earners.

These trends in relative employment and wages combine with trends in income tax policy to influence the outcome observed in Figure X.

Whether Scotland continues to match UK growth in per capita income tax revenues will depend on how these determinants evolve. Note from Figure X however that the omens for 2016/17 specifically are not particularly positive. Employment and wages in Scotland declined relative to those in the UK, which in itself would suggest that Scotland's relative income tax revenues per capita may also decline[74]. The extent to which 2016/17 was a one-off 'blip' or the start of a longer-term trend is not yet clear (comprehensive data for 2017 will be released this October). The FAI's income tax simulation model can be used to assess the risks to the Scottish budget arising from relatively faster or slower wage growth in Scotland.

[73] A reduction in the higher rate threshold means that the level of income that people pay the higher rate of tax is lower – hence a tax rise.

[74] The Scottish budget is not directly affected by income tax revenue performance in 2016/17, as tax devolution does not occur until 2017/18. Lower Scottish revenues in 2016/17 simply mean a lower 'initial deduction' and thus a lower block grant adjustment in 2017/18.

Table X shows how different Scottish income tax revenues would be if average wages in Scotland grew 0.3 percentage points faster or slower than wages in rUK, and if wages grew 0.8 percentage points faster or slower than wages in rUK.

A difference in revenue performance of just 0.3 percentage points equates to a revenue difference of just over £200m after one year, whilst a revenue difference of 0.8 percentage points equates to a revenue difference of over half a billion pounds in one year.

Clearly, the effects of differential growth will become magnified over time[75].

Table X: Effect on Scottish income tax revenues (£m) of faster or slower wage growth in Scotland compared to rUK

	2017/18	2018/19	2019/20	2020/21	2021/22
0.3 pp slower growth	-£212	-£278	-£347	-£424	-£510
0.3 pp faster growth	£215	£283	£356	£437	£526
0.8 pp slower growth	-£558	-£729	-£907	-£1,105	-£1,322
0.8 pp faster growth	£581	£769	£967	£1,193	£1,442

Source: FAI tax microsimulation model. Notes: 'pp' stands for 'percentage point'.

Income Tax policy

The Scottish Government can from now on vary its budget directly through income tax policy. This is exactly what it chose to do in 2017/18 by freezing the Higher Rate threshold.

Freezing the threshold at £43,000 is likely to have raised an additional £135m for the Scottish budget this year, compared to what would have been the case if the Scottish Government had followed UK policy of a rate of £45,000 (Box X discusses difficulties in determining when a policy change can be thought of as revenue raising under Scotland's new Fiscal Framework).

Box X: Determining the policy 'baseline' against which policy proposals are assessed

Under the new framework, determining the policy 'baseline' against which the revenue effects of alternative policies can be assessed is not straightforward.

For income tax, the Scottish Parliament must set rates and bands each year through a 'Rate Resolution'. If a Resolution cannot be agreed, the Budget cannot be passed, and the previous year's budget would apply until agreement was reached.

It could be argued that the decision to freeze the Higher Rate threshold in cash terms effectively represents a policy of 'no change' (in the same way that the Additional Rate remained unchanged at £150,000).

Instead, the effect on the Scottish budget comes about through the UK Government's decision to raise the Higher Rate threshold to £45,000 in rUK. This can be characterised as a tax cut, and effectively reduces the Scottish BGA.

Thus although the tax thresholds set in Scotland are legislatively independent of those set in rUK, the Scottish budget is ultimately influenced by policy in Scotland relative to policy in rUK. It is in this sense that a freeze in the Higher Rate threshold can be thought of as a revenue raising policy in 2017/18.

[75] During the past ten years, average weekly earnings have grown more quickly in Scotland than UK in six years, and in these years Scottish wages have grown on average 0.8 percentage points more quickly; average weekly earnings have grown less quickly in Scotland than in UK in four years, and in these years Scottish wages have grown on average 0.3 percentage points more slowly. The 0.3 and 0.8 figures are chosen pragmatically as an indication of the potential magnitude of differential growth in one year, but based on the recent past, it would be unlikely that such differential growth is observed over consecutive years.

If, over the remainder of the period to 2021/22, the Scottish and UK Governments increase the Higher Rate threshold in line with CPI inflation, the difference between the two rates will grow in cash terms – boosting Scottish revenues by £183m by the end of the forecast period.
As discussed in Chapter X, the lower threshold in Scotland at which taxpayers pay the Higher Rate may have some behavioural effects. Taxpayers with income between £43,000 and £45,000 will pay a higher marginal rate of tax in Scotland than in rUK, whilst those with income above £45,000 facing a higher average tax rate. These higher average and marginal tax rates may instigate some offsetting reductions in taxable income if behaviours change. As a result, the revenue effects of the policy may not be as large as the direct estimates reported above. However on balance, any behavioural effects are likely to be small. The OBR estimates that the behavioural effects of the lower threshold in Scotland are to reduce revenues by just £9m per annum in 2017/18 and beyond.
The estimates of the income tax BGA in Table X are based on an assumption that the UK Government increases the Higher Rate threshold in line with CPI inflation in future years. However, the UK Government has committed to increase the threshold above the rate of inflation to reach £50,000 by the end of the parliament. If it were to do so, the effect on the Scottish budget would be via an even smaller BGA.
We estimate that, compared to a baseline where the higher Rate thresholds increase in line with inflation, a UK Government decision to increase the threshold to £50,000 by 2020/21 (and indexed to CPI thereafter) would result in the Scottish budget being £274m better off by 2020/21.

Table X: Effects on Scottish budget of various Higher Rate threshold policy parameters

Policy		2017/18	2018/19	2019/20	2020/21	2021/22
Baseline	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	45,000	46,200	47,270	48,210	49,260
	Revenue effect (£m)	*0*	*0*	*0*	*0*	*0*
Freeze Higher Rate in Scotland 17/18, then CPI	UK threshold	45,000	46,200	47,270	48,210	49,260
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*143*	*153*	*165*	*183*
Increase UK threshold to £50,000 by 2020/21	UK threshold	45,000	46667	48333	50000	51089
	Scottish threshold	43,000	44,115	45,105	45,995	46,915
	Revenue effect (£m)	*135*	*170*	*216*	*274*	*301*

A number of other revenue raising options for the Scottish Government in relation to income tax are discussed in Box X.

Box X: Revenue raising options from income tax

Additional rate increase

One policy option that is often mooted is to raise the Additional Rate (AR) – payable on income above £150,000 – from 45p to 50p. The policy is often motivated by a sense that higher earners should contribute more, and is sometimes justified by references either to top tax rates in various other European countries, or by references to past UK tax rates (the top marginal rate of income tax exceeded 75% in the late 1970s).

In direct terms (i.e. assuming no behavioural effect), an increase to 50p would raise some £126m per annum. This represents around 1% of Scottish NSND income.

There is sometimes a preconception that the policy would raise more than this, but it raises

relatively little because there are few (around 17,000), AR taxpayers in Scotland and the policy asks these individuals just to pay an additional 5% tax only on income over £150,000.

The policy is also subject to claims that it could raise significantly less than this in practice, as the propensity of AR taxpayers to vary their income is high.

People might vary the amount they work, take advantage of tax reliefs (e.g. put more money into a pension), or convert earned income into dividend income. Some of these options will be more viable for some taxpayers than others.

It seems unlikely that a higher AR in Scotland would cause many individuals to relocate, especially when one considers the tax differentials being discussed and the costs of re-location. It is possible however, that higher top tax rates may discourage in-migration of high-earning individuals from other countries more than they incentivise existing residents to leave.

Overall, there remains little in the way of hard evidence of any behavioural response to an increase in the AR. In reflecting upon the introduction of the Additional Rate at 50p at UK level, the Treasury estimates that possibility that the policy either raised revenue or cost revenue is unclear within reasonable confidence limits.

Note finally that, if the UK Government did increase the Additional Rate in rUK to 50p, this would represent a double-edged sword. On the one hand, the risk of behavioural effects from Scottish taxpayers diminishes if the policy is implemented UK-wide. On the other hand, the additional revenues raised in rUK would increase the Scottish BGA, negating any positive revenue effects for the Scottish Government.

The Scottish Government has tasked the Council of Economic Advisers to consider the implications of an increase in the Additional Rate to 50p.

1p on each rate

A number of political parties in Scotland have proposed raising revenue by adding 1p to each of the basic, higher and additional rates of income tax (so the rates become 21p, 41p and 46p respectively).

According to FAI's income tax model, this policy would raise some £471m, excluding behavioural effects, in 2018/19.

LBTT

At the time of the publication of the Scottish Government's Budget in December 2016, revenues from LBTT were forecast to be somewhat higher in 2016/17 than the BGA (Table X).
Provisional LBTT outturn data has since been published for 2016/17 – with £493m being raised from LBTT in 2016/17. Provisional outturn data has also been published for the 'equivalent' Stamp Duty Land Tax revenues in rUK (these raised £11.7bn). This suggests that the BGA for LBTT in 2016/17 will be £522m (Table X).
The implication is that the BGA for LBTT was some £29m higher than Scottish revenues in 2016/17 (based on provisional outturn statistics for both Scottish and rUK revenues, and is liable to some revision once audited figures are published).
Note that this does not mean the Scottish Government now faces a bill of £29m; the difference has already been factored into the Scottish budget by virtue of the fact that less revenue has been raised in Scotland by LBTT than has been deducted from the block grant.

Table X: LBTT revenues and BGA – outturn and forecasts (£ million)

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		504	545	585	634	689	741

BGA outturn/ forecast (March 2017)		*£522*	£580	£619	£656	£700	£747
Scottish outturn/ forecast (Dec 2017)	*£425*	*£493*	507	543	571	597	624
Difference between revenue forecast and BGA (Dec 2016)		*34*	*-38*	*-42*	*-63*	*-92*	*-117*
Difference between revenue forecast and BGA (Mar 2017)		*-29*	*-73*	*-76*	*-85*	*-103*	*-123*

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (June 2017) and OBR forecasts for rUK Stamp Duty (March 2017). Notes: Data in red italics relate to provisional outturn data. Table X does not show a BGA for LBTT in 2015/16, the first year of devolution. This is because for 2015/16, the Scottish and UK Governments agreed a one-year BGA for LBTT and SLfT combined of £494m, which is independent of outturn rUK data. Outturn data for Scotland suggests that in 2015/16, £425m was raised from LBTT and £147m was raised from Scottish Landfill Tax. This total, £572m, is greater than the BGA by £78m. In 2015/16 the Scottish Budget was thus £78m better off than it would have been a strictly 'no-detriment' policy been applied.

What about the outlook?

The OBR's latest (March 2017) forecasts for Stamp Duty in the UK have been revised up marginally from those available at the end of 2016. They imply that the Scottish block grant adjustment will increase to £579m in 2017/18, and then by 6-7% each year until 2021/22. This is a faster rate than the Scottish Government was forecasting for LBTT revenues in December 2016. The difference implies a net cost to the Scottish Budget of around £100m per year by the end of the parliament.

The difference between the Scottish Government's forecast for LBTT and the OBR's forecast for Stamp Duty revenues for rUK (from which the BGA is derived) are due to different assumptions about the likely growth rate of house prices and residential transactions in Scotland and rUK (assumptions about non-domestic property price and transaction growth are broadly similar). In particular, the OBR assumes price growth in excess of 4% per year, whereas the Scottish Government's forecast is less than half this. The OBR also assumes somewhat faster growth in transactions in rUK.

There are some grounds for assuming that property prices could grow relatively more slowly in Scotland than in rUK over the next few years – and continue recent trends. In the two years since LBTT was devolved, house prices have grown of 2.5% per annum in Scotland compared to 6.5% in the UK[76]. Against this however, and counter to perception, residential property transactions have grown at least as strongly in Scotland in recent years as in rUK. In 2015/16, the number of transactions grew by about 10% in Scotland and in rUK, whilst in 2016/17 transactions declined by 13% in rUK compared to a decline of 7% in Scotland.

On balance therefore, there are not strong a priori grounds for believing that Scottish LBTT revenues will drastically over or underperform rUK revenues either way.

The forecasts for both Scottish LBTT revenues and the BGA should be treated with caution, as revenues from property transactions are particularly difficult to forecast (see Box X). For these reasons, monthly outturn data is likely to be monitored closely.

In our central scenario, we assume that LBTT revenues underperform the BGA by 6%, reflecting a continuation of the relative performance observed in 2016/17.

Need to say something about non-resi.

Box X: Forecasting property transactions taxes

In its latest Forecast Evaluation Report, the OBR states:

'Stamp duty land tax (SDLT) is one of the more volatile sources of receipts – the standard deviation of annual growth over the past five years has been 11.9 per cent, compared to just 1 per cent for overall receipts..'

There are many reasons why forecasting receipts from property transactions taxes can be challenging, including:

[76] Comparing prices in May 2017 with May 2015 according to ONS House Price Index.

- It is difficult to map economic determinants to the true tax base (i.e. relatively few properties are transacted in any one year);
- The tax schedule is progressive meaning a large proportion of tax revenues are derived from very few transactions
- The tax regime has been subject to large policy changes in recent years (e.g. the introduction of the Additional Dwelling Supplement, and changes in tax rates)
- The growth of prices and transactions can be volatile from year-to-year, and is difficult to predict based on economic determinants (owing much to other factors including consumer sentiment and expectations).

As an example of the forecasting difficulties, between November 2015 and November 2016, the OBR revised its SDLT forecast for 2017/18 downwards by £2bn (14%).

LBTT tax policy

The current structure of LBTT, introduced in April 2015, marks a significant improvement on the previous system of Stamp Duty. This is because, whereas Stamp Duty operated a 'slab' structure (whereby tax rates were levied over the entire value of a property), under LBTT, each additional tax rate is applied only to the part of property value above that threshold.

Some concerns however, have been raised that the structure of LBTT – which implies a higher average tax rate on all properties worth over £350,000 – has reduced housing market activity in the mid to higher end of the market. This view stems in part from the fact that the LBTT forecasts in the Scottish Government's 2015/16 Budget for the 2015/16 financial year overestimated revenues in the £325,000 - £750,000 bracket by some 37%[77].

The dampened activity in 2015/16 may turn out to be temporary. Indeed between 2015/16 and 2016/17, property revenues and transactions in the £325,000 - £700,000 tax band increased more quickly than those in the lower tax bands.

Nonetheless, concern remains about the effect of the 10% tax rate on this segment of the market.

A number of organisations have called for a review of the tax rate for properties in the £325,000 plus range[78]. Our modelling suggests that an extension of the 5% tax rate to properties worth £500,000 would cost around £45m assuming no behavioural response, whilst extending the 5% tax rate to £700,000 would cost around a further £15m.

We estimate that, to offset a reduction in revenues of £60m from extending the 5% band to £750,000, the number of transactions in that band would need to increase by around 3,750 per annum[79]. This represents roughly a doubling in transactions in this band relative.

Landfill Tax

According to provisional outturn data, £147m was raised from Landfill Tax in Scotland in 2016/17. Based on provisional data on comparable revenues in rUK, Scottish revenues are likely to be around £15m higher than the Landfill Tax BGA (Table X).

In future years, revenues from landfill tax are forecast to decline, reflecting lower levels of waste sent to landfill as alternative infrastructure (e.g. incinerators) comes on stream, and rates of recycling increase. Under the latest (December 2016) forecasts, Scottish landfill tax revenues are expected to bring in somewhat more revenue than the BGA for Landfill Tax (based on the OBR's March 2017 forecasts).

The Scottish Government has announced an aspiration to reduce waste to landfill at a quicker rate than in England. It has not yet introduced explicit policy to achieve this aspiration, but were

[77] Scottish Fiscal Commission Outturn Report, Sep 2016

[78] See Finance and Constitution Committee's Report on the First Year of Operation of the Land and Buildings Transactions Tax http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/102523.aspx#e

[79] Revenue Scotland data indicate that the average revenue from transactions in the £325k-£750k band was £16,000 in 2007/8.

the aspiration achieved, it would likely affect the budgetary position, if Scottish revenues were to decline relative to those in rUK.

Table X: Landfill Tax revenues and Landfill Tax BGA – outturn and forecasts

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
BGA forecast (Nov 2016)		137	119	104	97	92	90
BGA outturn/ forecast (March 2017)		*£132*	£107	£99	£92	£89	£88
Scottish outturn/ forecast (Dec 2016)	*147*	*147.4*	149	118	109	112	106
Difference between revenue forecast and BGA (Dec 2016)		-4	30	14	12	20	16
Difference between revenue forecast and BGA (Mar 2017)		*15*	42	19	17	23	18

Source: Scottish outturn from Revenue Scotland; Scottish forecasts from Scottish Budget 2017/18; BGAs derived from HMRC outturn statistics (May 2017) and OBR forecasts for rUK Landfill Tax (March 2017). Notes: Data in red italics relates to outturn. For 2015/16, a combined BGA for LBTT and Landfill Tax was agreed, see text for further details.

Air Departure Tax

In April 2018, Air Passenger Duty (APD) will cease to operate in Scotland. In its place, the government has announced plans to establish an Air Departure Tax (ADT).

ADT is expected to be similar in scope and structure to APD. Additionally however the Scottish Government has set out a commitment to reduce the tax burden of ADT by 50% by the end of this parliament[80]. The aim is to 'generate sustainable growth by boosting Scotland's international air connectivity'[81].

Based on the OBR's latest (March 2017) forecasts, the BGA for ADT is expected to be £327m in the first year of devolution, rising by about 4.5% a year to £373m in 2021/22. If the structure and rates of ADT were to remain the same in Scotland as in rUK, the OBR forecasts[82] that Scottish revenues would grow at the same rate as revenues in rUK. Implicitly, this implies that Scottish revenues would match the BGA.

If the Scottish Government were to reduce the burden of ADT by 50%, this would likely lead to a reduction in revenues, at least over the short-term. Of course, if the policy were to have behavioural effects (i.e. additional passenger travel from Scottish airports), a reduction in the burden of ADT by 50% may not imply a reduction in revenues of 50%, relative to the base-case. However, estimating the extent to which a reduction in ADT rates may stimulate increased passenger travel is difficult, not least because of a lack of data or evidence on the effects of similar policy changes in the UK or internationally. Critical questions include the extent to which an ADT reduction is likely to be passed through to ticket prices, and the sensitivity of customers to changes in prices.

In the absence of any evidence on the scale of behavioural effects, we assume that a 50% reduction in the burden of ADT – phased over the period to 2021/22, is associated with a 50% reduction in revenues. The policy, whilst not yet legislated for, thus represents a source of budgetary risk.

Table X: Forecasts for Air Departure Tax revenues and the BGA

	2018-19	2019-20	2020-21	2021-22
BGA forecast	£327	£340	£356	£373
Scottish revenue forecast (no policy change)	£327	£340	£356	£373
Difference between revenues and BGA	*£0*	*£0*	*£0*	*£0*

[80] Policy Memorandum to the Air Departure Tax Bill

[81] Programme for Government, 2016

[82] The Scottish Government did not produce a forecast for ADT in its 2017/18 Budget, and the Scottish Fiscal Commission is not due to produce its first official forecasts until later in 2017.

Scottish revenue forecast (50% reduction in burden)	£327	£284	£238	£187
Difference between revenues and BGA	*£0*	*-£57*	*-£119*	*-£187*

Notes: Revenue and BGA forecasts derived from OBR March 2017 Economic and Fiscal Outlook.

VAT

From 2019/20, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced VAT rate will be assigned to the Scottish budget. A number of technical issues around how Scottish VAT revenues will be estimated are being investigated by a VAT Assignment Working Group, which is due to report in September 2017.

No official forecasts for the assigned element of Scottish VAT have yet been published. At the UK level, the OBR forecasts VAT revenues to grow at an average of 4% per year to 2021/22. Between 2010/11 – 2015/16 Scotland's share of UK VAT has remained stable around 8.5% to 8.6%.

Assuming that this share remains stable, then based on the UK's OBR forecast and the estimate of assigned Scottish VAT in 2015/16, our estimate of Scottish VAT revenues is shown in Table X. With VAT assignment some 18 months away, it is currently too early to say whether VAT assignment is likely to have net fiscal costs or benefits. As already noted, the Scottish share of UK VAT has remained robust in recent years, and other than the general economic outlook there is little evidence in existing data to suggest this trend may change. Our working assumption is thus that the BGA for assigned VAT will match the Scottish revenues in the later years of the forecast period.

Table X: Forecasts of assigned Scottish VAT and the BGA

	2019-20	2020-21	2021-22
BGA forecast	£6,568	£6,826	£7,075
Scottish revenue forecast	£6,568	£6,826	£7,075
Difference between revenue and BGA	*£0*	*£0*	*£0*

Source: FAI analysis of OBR Economic and Fiscal Outlook (March 2017) and Government Expenditure and Revenue Scotland (GERS) 2016.

Aggregates Levy

No date has yet been agreed for the devolution of Aggregates Levy[83]. The OBR forecasts revenues to remain broadly unchanged in cash terms at UK and Scottish levels after 2017/18. We assume that Aggregates Levy is devolved in 2020/21, with Scottish revenues of £54m offsetting an equivalent block grant adjustment.

The net impact on the budget is therefore zero.

2.4 Bringing it together

Table X brings together the outlook for the Scottish budget, taking account of the block grant, the BGAs and revenues for each tax.

This central scenario assumes that -

- Scottish income tax revenues grow at the same per capita rate as those in rUK, and that the Scottish Government increases the income tax Higher Rate threshold in line with inflation, but that the UK Government increases it to £50,000 by 2020/21.
- LBTT revenues slightly underperform the BGA – to the same extent as was the case in 2016/17 – throughout the forecast period. In other words, LBTT revenues are 6% lower than the BGA each year
- Landfill Tax revenues grow in line with the Scottish Government's December 2016 forecasts, whilst the BGA grows in line with the latest OBR forecasts for the comparable rUK taxes.

[83] Agrregates levy isa tax on the importing or extraction of sand, gravel and rock

- For ADT, we assume the Scottish Government implements a 50% reduction in the burden of the tax by 2021/22, with an equivalent reduction in tax revenues.

- Finally, for both Aggregates Levy and assigned VAT, we assume that revenues per capita in Scotland grow in line with those in rUK.

Under this central scenario, the Scottish Government's budget outlook is only slightly different from the outlook for the block grant. Additional revenues from income tax (resulting from the Scottish Government's decision to set a lower Higher Rate threshold than the UK are offset by forecast relatively lower growth in LBTT revenues, and, from 2019/20, the reduction in the ADT burden.

Table X: Outlook for Scottish Government revenue budget, £m (cash terms)

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Block grant	£26,088	£26,627	£26,640	£26,711	£27,223	£27,656
		£11,636	£11,924	£12,326	£12,833	£13,460
Income tax		£11,771	£12,094	£12,543	£13,108	£13,761
		£135	£170	£216	£274	£301
	£522	£580	£619	£656	£700	£747
LBTT	£493	£548	£585	£619	£661	£705
	-£29	-£33	-£35	-£37	-£39	-£42
	£132	£107	£99	£92	£89	£88
LfT	£147	£149	£118	£109	£112	£106
	£15	£42	£19	£17	£23	£18
			£327	£340	£356	£373
ADT			£327	£284	£238	£187
			£0	-£57	-£119	-£187
				£6,568	£6,826	£7,075
VAT				£6,568	£6,826	£7,075
				£0	£0	£0
					£54	£55
Aggregates Levy					£54	£55
					£0	£0
Total	£26,073	£26,772	£26,794	£26,851	£27,362	£27,747

Source: FAI analysis

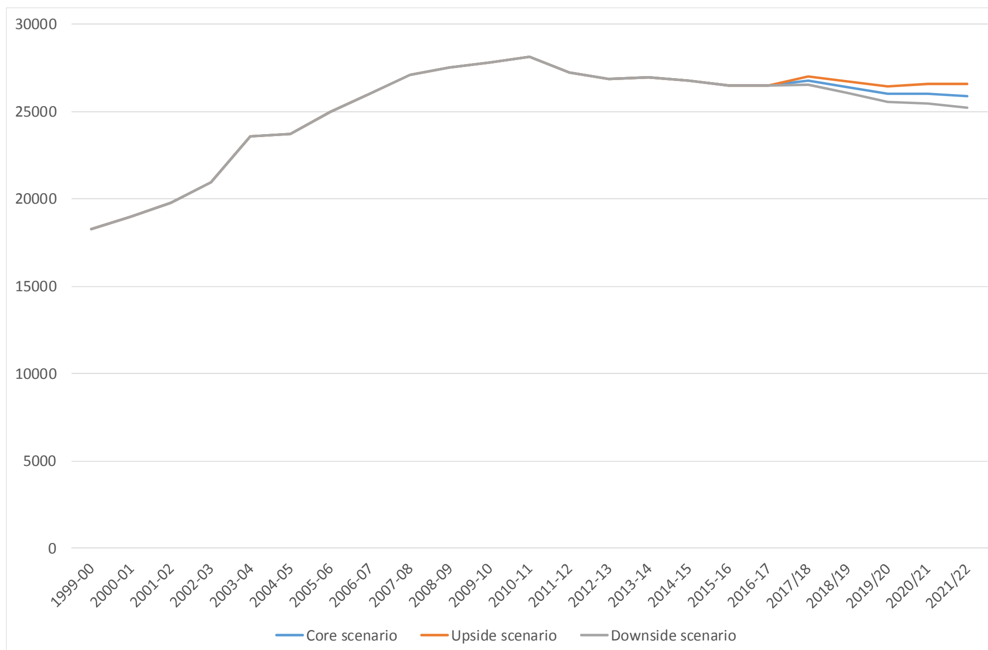
There is clearly uncertainty around the exact outlook for Scottish revenues and the BGAs. Figure X sets out the outlook for the Scottish resource budget in real terms based on our 'central scenario' set out above, and under two scenarios designed to capture both upside and downside risk.

- Relative to the central scenario, the upside risk scenario assumes that Scottish wages grow 0.3 percentage points faster than rUK wages over the forecast period, that LBTT revenues match the BGA, and that the Scottish Government chooses not to implement the cut to Air Departure Tax.

- Relative to the central scenario, the downside risk scenario assumes that Scottish wages grow 0.3 percentage points less quickly than in rUK; that the UK Government chooses to increase the Higher Rate by inflation (and does not increase it to £50,000), and that outturn LBTT revenues match the Scottish Government's December 2016 forecast (which in turn implies that revenues are around 13-15% lower than the BGA in each year of the forecast period).

Between 2017/18 and 2021/22, the resource budget is forecast to decline 3.3% in the central scenario, by 1.6% in the upside scenario, and by 4.9% in the downside scenario. [84]

[84] It is important to note that these are not detailed forecasts but instead scenarios to illustrate how the budget could evolve under certain outcomes and policy choices.



2.5 The outlook for capital expenditure

The Scottish Government's block grant for capital expenditure increased by 5.5% in real terms between 2016/17 and 2017/18. Relatively strong real terms growth is also expected in 2018/19 and 2019/20, following the £23bn increase in capital spending announced in the November 2016 Autumn Statement.

From April 2017, the Scottish Government has been able to borrow up to £450m in any year for capital investment, within an overall limit of £3bn. The 2017/18 Budget indicates that the Scottish Government plans to utilise its £450m capital borrowing powers in full in 2017/18.

To date no borrowing has been drawn down in 2017/18, although this is consistent with prudent budget management, in the sense that borrowing should only occur once the full CDEL allocation has been used up.

At the same time however, it is likely that the Scottish Government may not be able to utilise its borrowing powers in full in 2017/18. This is because some of its borrowing powers are still likely to be required to provide 'cover' for schemes that are re-classified from the Non Profit Distributing (NPD) programme (Box X).

Box X: Implications of NPD reclassification for the Scottish Government's capital borrowing

The NPD programme involves the private sector funding the upfront capital costs of particular building projects (schools, hospitals etc.) and the Scottish Government committing to pay fees to cover capital costs, increased interest repayments and maintenance/ service charges (usually for 25-30 years).

In 2015/16, the ONS reclassified various NPD projects as being on the public balance sheet (rather than being private sector funded). In consequence, the Scottish Government came to an accounting agreement with UK Treasury to use its capital borrowing allocation for 2015/16 to provide budget 'cover' for the reclassified schemes. This does not mean that the Scottish Government borrowed in this year (and thus there will be no interest rate charges); but the full value of the capital project will score on the balance sheet, and count as part of the Scottish

Government's borrowing limit.

In 2015/16, £280m of reclassified NPD schemes were scored against the Scottish Government's borrowing limit; in 2016/17, £398m of reclassified NPD schemes were scored against the borrowing limit[85]. Although this imposes an opportunity cost (in terms of reduced ability to borrow), it does also reduce the future repayments associated with the NPD schemes by an equivalent amount.

A proportion of the Scottish Government's 2017/18 borrowing limit is also likely to be required to provide budget cover for reclassified NPD projects, although it is not yet clear how much.

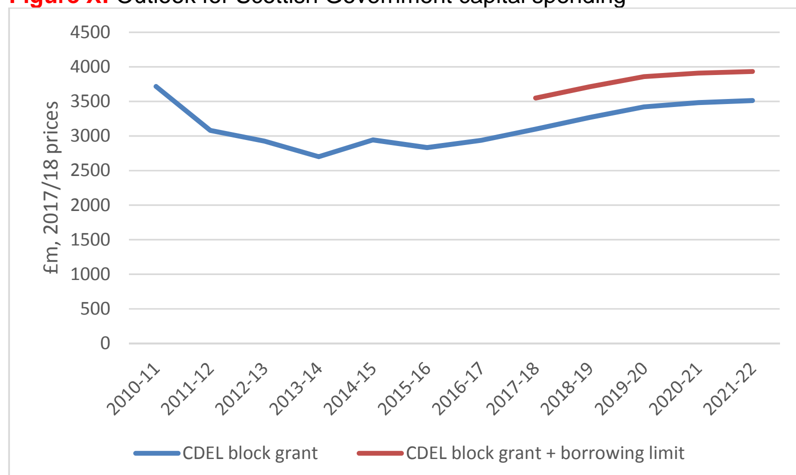
Table X: Outlook for Scottish Government capital budget

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Cash terms	2,892	3,100	3,320	3,533	3,663	3,767
2017/18 prices	2,939	3,100	3,269	3,422	3,482	3,513
Real terms annual change		*5.5%*	*5.4%*	*4.7%*	*1.8%*	*0.9%*
Borrowing limit		450	450	450	450	450

Notes: figures for 2016/17 – 2020/21 are derived from HMT estimates of the allocation to the Scottish Government published in the Spring 2017 Budget. Figures for 2021/22 are derived by FAI from the UK Government's Spring Budget, which sets out plans for total CDEL spending but does not allocate this total between spending departments.

The outlook for capital spending is placed in a longer term context in Figure X. Following declines from a historic high level in 2010/11, the Scottish Government's capital allocation is forecast to approach its historic high of £3.5bn by 2019/20. If the Scottish Government's borrowing powers are utilised in full, capital investment could reach £4bn per year by 2021/22.

Figure X: Outlook for Scottish Government capital spending



2.6 Conclusions

As we set out in Chapter 1, under the new Fiscal Framework, the performance of the Scottish economy – and by implication of devolved Scottish revenues – relative to the performance of the

[85] Source: Letter from Cabinet Secretary to Convenor of Finance and Constitution Committee, January 2017. http://www.parliament.scot/S5_Finance/General%20Documents/Cab_Sec_FC_to_FinConvenor_-_05Jan17.pdf

rUK economy and comparable rUK tax revenues is critical in shaping the size of the Scottish budget.
That said, the block grant remains the key component in determining the size of the Scottish Government's spending envelope. The block grant actually increased slightly in real terms in 2017/18. But, based on the UK Government's spending plans, cuts to the resource block grant of 1.5% and 1.4% are expected in 2018/19 and 2019/20.
The outlook implies that the block grant (before any adjustments for new tax and social security powers) will be around 8% lower in 2020/21 than it was ten years earlier.
There is clearly some uncertainty around the extent to which the Scottish revenues are likely to be higher or lower than the respective BGAs in any given future year. Recent slower growth in Scottish wages, house prices and the wider economy than in rUK may result in the Scottish Fiscal Commission adopting a relatively cautious approach to its forecasts – although the recent past is not necessarily a good guide to the medium term future.
Relatively small differences in economic outcomes between Scotland and rUK can make significant differences to income tax growth over time.
Setting a lower threshold at which the Higher Rate of income tax is paid will raise between £140m and £170m in 2018/19, depending on where the UK Government sets the Higher Rate threshold in rUK. On the other hand, a commitment to reduce the burden of APD is likely to reduce revenues by over £119m by the end of this parliament.
We have set out a range of possible scenarios. Under a central scenario – where the Scottish Government continues to set a somewhat lower threshold for the Higher Rate than in rUK; where the income tax base per capita grows at the same rate in Scotland as rUK; where LBTT revenues marginally underperform the BGA; and where cuts to APD go ahead – the Scottish Government's resource budget is forecast to fall by 3.3% in real terms between 2017/18 and 2021/22.
Under an upside scenario – where LBTT revenues match the BGA, cuts to APD are not made, and Scottish wages grow more quickly than in rUK – the resource budget is forecast to fall 1.6% over the period. Under a more challenging scenario, where Scottish wages grow relatively slowly and LBTT revenues substantially underperform the BGA – the resource budget could fall by 4.9% in real terms.
These scenarios are of course indicative, and the government's outturn budget could prove higher or lower than this. But the scenarios illustrate, on the balance of probability, further real terms cuts are more likely than increases over coming years.
As we outline in the next chapter, this outlook will mean that the government will have to prioritise its commitments over the remainder of this parliament.
The outlook for the capital budget is more positive. The government's capital allocation increased by 5.5% in 2017/18 in real terms, and will increase by almost as much again in 2018/19 and 2019/20. The government is now also able to borrow up to £450m annually to fund capital investment, although its ability to do so remains somewhat constrained in 2018/19 as a result of the reclassification of various NPD schemes.

EMAIL 6

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 13 September 2017 11:06
To: Nicholson J (John)
Cc: Grisewood A (Aidan); NAMES REDACTED
Subject: RE: Private: Draft Chapters

John,

This is great – thanks for taking the time to go through it. I will let you know if we have any questions on any comments. We'll aim to have the final draft next week and send it to you in advance of publication on the 26th.

Thanks again,

Graeme

From: John.Nicholson@gov.scot [mailto:John.Nicholson@gov.scot]
Sent: 12 September 2017 20:42
To: Graeme Roy <graeme.roy@strath.ac.uk>
Cc: Aidan.Grisewood@gov.scot; NAMES REDACTED
Subject: RE: Private: Draft Chapters

Graeme

Many thanks for the opportunity to offer comments on your draft report. I understand that Aidan has replied separately for his interests.

Chapter 1

- **Budget Process Review Group** - we wondered whether the language in this section should be more future tense, talking about the budget process "will be changing" as by the time the report publishes the Finance Committee will only just have considered the BPRG report and we won't really be seeing any immediate significant changes.

- Would it be helpful to explain what NSND is somewhere up front as you refer it in a few places without any explanation/definition first.

- **Page 4 –** should we say that the legislation that created ADT was the way in which its name was established rather than via an SG announcement?

- **Page 4** –The report says that DHPs have been devolved since 1 April 2017. That's technically correct but it misses the context that we have had DHPs for years and were topping them up. There's also a later reference to the cost of mitigating the bedroom tax at £35m which looks like an out of date figure. In the Draft Budget last year we quoted the value of this as £47m.

- **Page 8** - mentions a Draft Budget assumption of 1% for growth. The 1% was in the supporting paper published alongside not the Draft Budget itself – it may be worth clarifying in case readers want more detail and hunt through the DB and can't find it.

Chapter 2

- **Page 2** – (Table X) The table is clear that the figures are 'derived' and that our budget numbers evolve throughout the year but we don't recognise the numbers presented. As a minimum the table needs to be clear that it's Fiscal RDEL. The 2016-17 figures are right but following the Spring Budget our HMT Fiscal RDEL Control Total (cash) for 2017-18 is £26,647m, for 2018-19 is £26,664m and for 2019-20 is £26,746m. We obviously don't have the figures for later years yet. Our suspicion is that it is something to do with in-year machinery of government changes that aren't being picked up.

- **Page 2** - Following that, we also don't recognise the 8% lower figure in the final paragraph. While we don't have figures beyond 2019-20, Table X suggests 2020-21 and 2021-22 are 0% and -0.3% and our Fiscal RDEL 10 year total a 9.4% real terms reduction between 2010-11 and 2019-20. We'd therefore expect the 12 year total to be larger than 9.4%.

Chapter 3

- You may want to reflect some of the PfG content in this section as it is now published.

- **Page 12** - there is a paragraph linking the Scotland Reserve to Underspends. As drafted, I think it misrepresents how underspends are deployed. It implies there is some sort of constant flow of underspends which would build up as opposed to recognising that underspends are deployed to support specific spending in the subsequent year (and not simply accumulate in the reserve).

I or one of the team would be very happy to discuss any of this in more detail.

Thanks,

John

John Nicholson
Deputy Director
Financial Scrutiny & Outcomes
Scottish Government

Tel: 0131 244 2873
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E-mail: john.nicholson@gov.scot

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 05 September 2017 09:41
To: Nicholson J (John); Grisewood A (Aidan)
Subject: Private: Draft Chapters
Importance: High

John/Aidan

It was good to catch-up.

As discussed, I've attached the first three chapters of our budget report in draft form. There are gaps and the formatting/text will be tidied up ok.

It would be good if you could provide any comments. In particular, we'd be keen to ensure that you were content that you recognised the various budget numbers we are using etc. so that we avoid confusion.

We'd also be more than happy to take on board any suggestions. Or feedback on bits that you don't think we have worded accurately or fairly.

I appreciate that you will be busy with the budget and the PfG. But if you were able to get us any comments by the end of the week that would be much appreciated.

Happy to discuss.

Best wishes,

Graeme

Graeme Roy | Director | Fraser of Allander Institute | Department of Economics
University of Strathclyde | Duncan Wing | 130 Rottenrow | Glasgow G4 0GE

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EMAIL 7

From: NAME REDACTED
Sent: 12 September 2017 18:42
To: david.eiser@strath.ac.uk
Cc: Grisewood A (Aidan)
Subject: RE: LBTT analysis

David

Aidan has asked me to reply on this.

Yes, I mentioned in the comments to your paper that our (static) modelling was 'broadly consistent' with what you had suggested in their paper. The figure I had in mind was our internal (now public, see below) estimate which was £32m (to lift the 10% threshold to £500k) with no behavioural response included. This estimate is getting on for a year old and will have risen since making it even more 'broadly consistent' with your figure though I said that more for your general reassurance rather than for it to be directly compared.

Here's my comments to FAI:

In terms of a link to a publication, there isn't one – though our figure is in the public domain. That came about, when Aidan and Mr Mackay were at the Finance Committee on 26 October last year when Mr Mackay referred to our (static) modelling estimates in his exchanges with Willie Coffey, MSP. The link to the official report is here:

http://www.parliament.scot/parliamentarybusiness/report.aspx?r=10583&i=97386&c=1940750

And the text itself is here given this is a long document:

- Derek Mackay:
  There will always be differential impacts on different parts of the country because of the economy and more localised issues. The headline for LBTT is that it has been delivered effectively and responsibly. We have inherited the powers, and we have a sound policy approach and efficient management. The committee has heard from Revenue Scotland, which I think everyone appreciates runs a slick and efficient operation.

  I remember the debates around this tax policy and how it should be implemented and who should operate it. Modelling was done on how best to do that, and the creation of Revenue Scotland has been vindicated. It was suggested that HM Revenue and Customs or somebody else could operate the tax, but we considered that setting up Revenue Scotland would be the most efficient way to do it, and that has turned out to be true.

  With regard to the overall headline for Scotland, I have highlighted that the tax has resulted in higher than expected revenue performance in the first year, in addition to the policy benefits. The exact figure is 93 per cent of house buyers paying less tax than under stamp duty land tax. That includes those who pay no tax at all under LBTT, which I am sure is welcome.

  I have listened carefully to some of the commentary and the anecdotes around the upper end of the market, and I have explained that the evidence suggests that there is not an issue as has been suggested.

I have also seen alternative suggestions, and it is maybe helpful to make the committee aware of them. The Scottish Property Federation and Homes for Scotland have suggested changing the bands and the thresholds. It is reasonable for people to suggest how things could work differently. However, preliminary modelling—which cannot truly judge behaviours—tells me that raised thresholds could lead to losses. The figures from the Scottish Property Federation modelling suggest an estimated loss of £32 million, and those from the Homes for Scotland modelling show an estimated loss of £44 million. Unless we got those amounts from elsewhere in the tax system, it would mean cuts somewhere. Given that modelling of the alternatives suggests that they would result in losses, I think that our balance is the right one. However, I will be happy to engage with stakeholders at the round-table meeting to which I referred.

I hope that what I have said covers the benefits of LBTT and shows that I have looked at alternative models. It would be wrong for the Government just to rule out other people's suggestions, but our study of them shows that they carry a significant risk of potential loss of income as we enter what might be a more difficult economic period.

So, there isn't a link I can provide apart from Mr Mackay's comments at Committee. We didn't publish any static modelling analysis in our methodology report which Aidan referred to below as that concentrated on explaining the 17-18 revenue forecast rather than costing policy changes.

Though we haven't published any figures, we would also 'broadly reassure' you that upper market transactions, in our estimation, would need to rise 'substantially' to make up for this loss of revenue following a shift in the threshold to £500k but we cannot currently find any evidence to show that anything like this might actually happen. When moving from the 'slab' SDLT system to the 'slice' LBTT system in April 2015, transactions certainly didn't double (in the lower market) or halve (in the upper market) as a result of the tax change. That would be the nearest property tax change we have as a comparison. There is not much alternative evidence either (currently) to suggest what the behavioural impact might be but, if you have any thoughts on this, we'd be very glad to hear them. This is exactly what we have said to stakeholders recently and what Mr Mackay has said separately to those seeking the tax change at a recent event in Edinburgh.

Hope that helps. Please let me know if you need further.

NAME REDACTED

NAME REDACTED

From: David Eiser [mailto:david.eiser@strath.ac.uk]
Sent: 12 September 2017 10:37
To: Grisewood A (Aidan)
Cc: Graeme Roy
Subject: LBTT analysis

Hi Aidan

Thanks for comments on our report. The comments mention some government published work on revenue effects of changes to LBTT rates; please can you send a link?

Thanks
David

David Eiser | Fraser of Allander Institute | Department of Economics
University of Strathclyde Business School | 199 Cathedral Street | Glasgow G4 0QU
Tel: 0141 548 3962
Email: david.eiser@strath.ac.uk

EMAIL 8

From: NAME REDACTED
Sent: 15 September 2017 11:27
To: Anna Murray
Subject: Re: Scotland's Budget Report

Hi Anna,

Many thanks for sending over the material on income tax - much appreciated.

As you say, Graeme did provide a draft version to Simon, however, Simon was on leave so the chapter did not get circulated until after I had already dropped you an email - so simply a delay on our side!

I believe Simon collated all our comments and sent them back to you earlier this week. In case my material dropped out of the final version, the income tax section looked fine and I didn't have any substantive comments. I only had a couple of minor comments which I've summarised below:

- Your estimates of the policy impact of the HRT cash freeze in 2017-18 are slightly different from the OBR's published ones, in particular towards the end of the forecast period. This is just something to be aware of but it is not surprising that estimates differ as we all use slightly different models.
- As you note, different policy baselines are possible. When looking at 2018-19, it could be argued that reverting to the rUK's HRT would actually cost the Scottish Budget revenues, as the HRT would have to be increased from a lower level. Under your baseline, the table suggests that matching the rUK's threshold would be costless. I can see that this approach makes sense for 2017-18 and for making a theoretical point about the operation of the BGA. However, looking ahead to the 2018-19 budget, this might lead to confusion. Just a thought - not saying that there is a right or wrong approach!

Any questions, please let me know.

Best wishes,
NAME REDACTED

From: Anna Murray
Sent: Tuesday, 12 September 2017 10:39 AM
To: NAME REDACTED
Subject: RE: Scotland's Budget Report

NAME REDACTED,

Thanks for getting in touch.

Apologies that the material has not been passed to you. Graeme sent a draft version on to a couple of people in SG last week – one of whom was Simon, so I presumed that it would have been passed on!

Here are the latest versions of the relevant chapters.

They are very much in draft stage at the moment so excuse any missing X's, etc.

Happy to hear any comments you might have,

Anna

Anna Murray | Fraser of Allander Institute Research Assistant | Department of Economics
University of Strathclyde Business School | Duncan Wing, Rm 539 | 199 Cathedral Street | Glasgow G4 0QU

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From: NAME REDACTED
Sent: 11 September 2017 13:54
To: Anna Murray <anna.murray@strath.ac.uk>
Subject: Scotland's Budget Report

Hi Anna,

I hope all is well with you and things are not too stressful in the lead up to the FAI's publication on Scotland's budget.

I just wanted to drop you a quick email to follow up on our meeting from last month.

I believe you were happy to share the material on income tax ahead of the publication for QA purposes? Is this still something that you are intending to do?

Best wishes,
NAME REDACTED

EMAIL 9

From: Anna Murray [mailto:anna.murray@strath.ac.uk]
Sent: 20 September 2017 14:02
To: NAME REDACTED
Subject: RE: Scotland's Budget Report

Thanks NAME REDACTED – have passed those on. Cheers,

Anna

From: NAME REDACTED
Sent: 11 September 2017 13:54
To: Anna Murray <anna.murray@strath.ac.uk>
Subject: Scotland's Budget Report

Hi Anna,

I hope all is well with you and things are not too stressful in the lead up to the FAI's publication on Scotland's budget.

I just wanted to drop you a quick email to follow up on our meeting from last month.

I believe you were happy to share the material on income tax ahead of the publication for QA purposes? Is this still something that you are intending to do?

Best wishes,
NAME REDACTED

EMAIL 10

From: Graeme Roy [mailto:graeme.roy@strath.ac.uk]
Sent: 25 September 2017 10:09
To: Nicholson J (John); Grisewood A (Aidan)
Subject: Report

Hi both,

Please find attached a copy of our budget report for tomorrow.

We're not sending it to media in advance – so the report along with the press release will come out at 9am tomorrow.

Thanks,

Graeme

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Graeme Roy | Director | Fraser of Allander Institute | Department of Economics
University of Strathclyde | Duncan Wing | 130 Rottenrow | Glasgow G4 0GE

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Twitter: @strath_fai

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THE ABOVE E-MAIL HAD ONE ATTACHMENTS – AN EMBARGOED COPY OF SCOTLAND'S BUDGET 2017 REPORT WHICH IS AVAILABLE AT https://www.sbs.strath.ac.uk/economics/fraser/20170926/Scotlands-Budget-2017.pdf