Finance and Public Administration Committee

21st Meeting, 2023 (Session 6), Tuesday 5 September 2023

Scottish Fiscal Commission: Forecast Evaluation Report and paper on Productivity and Fiscal Sustainability

Purpose

1. The Committee is invited to take evidence from the Scottish Fiscal Commission (SFC) on its Forecast Evaluation Report and Paper on Productivity and Fiscal Sustainability both published on 29 August 2023. Witnesses for this evidence session are:

   - Professor Graeme Roy, Chair,
   - Professor Francis Breedon, Commissioner, and
   - Claire Murdoch, Head of Fiscal Sustainability and Public Funding.

2. This paper, produced by the Financial Scrutiny Unit in SPICe and the Committee's Clerks, provides background information and a summary of key points from the publications to inform the Committee's evidence-taking. Professor Roy's letter to the Committee accompanying the two publications is attached at Annexe A.

Forecast Evaluation Report, August 2023

Background

3. The SFC is required under statute to publish a Forecast Evaluation Report (FER) each year to evaluate how its previous forecasts compare to actual outcomes, according to outturn data. The SFC explains that its aim is to reduce its average forecast error by learning lessons from previous forecasts and notes that forecasts can differ from outturn for many reasons, including data revisions, modelling errors, unexpected events, incorrect judgements, analytical mistakes and human error, or changes in policy.

4. Its August 2023 FER evaluates its December 2021 forecasts for the economy, fully devolved taxes, and social security in 2022-23, and its income tax forecasts for 2021-22 published in January 2021.

Economy, fully devolved taxes, and social security

5. On the economy, the SFC notes that its GDP forecast error for 2022-23 was "relatively small" at -0.2%. Outturn data as at 26 July 2023 was 2.0% compared to the December 2021 forecast of 2.2%. The SFC underestimated employment growth for 2022-23 by 1.0 percentage points, "mainly because of the unexpected resilience of the labour market after the end of the furlough scheme". The SFC also underestimated nominal average earnings growth for 2022-23 by 1.4 percentage points, "due to high inflation[1] following the early 2022 inflation shock as well as ongoing tightness in the labour market".

6. In relation to fully devolved taxes:

    - <u>Non-domestic rates</u> revenues for 2022-23 were £2,792 million based on provisional data from notified returns, which is 1% lower than the SFC's December 2021 forecast of £2,809 million. The main reason for this forecast error, the SFC notes, is that "more revenue than we expected was lost to successful appeals while less revenue than expected was lost to reliefs claimed".
    - The SFC forecast total <u>Land and Buildings Transaction Tax</u> (LBTT) revenues of £749 million for 2022-23. With provisional outturn data from Revenue Scotland at £848 million, the SFC's overall forecast error was 13%. The relative forecast errors for residential LBTT and Additional Dwelling Supplement are 19% and 22%, respectively, and for non-residential revenue is -3%. The largest source of error was residential house prices, which increased much more than the SFC had expected.
    - Provisional <u>Scottish Landfill Tax</u> (SLfT) outturn revenue for 2022-23 was £109 million, 8% higher than the £101 million forecast by the SFC in December 2021. The SFC explains that "the largest component of the error was an overestimation of incineration capacity in 2022-23, which meant more waste entered landfill than we expected".

7. Total spending on devolved social security payments in 2022-23 was £4.2 billion, 3% higher that the SFC's December 2021 forecast of £4.1 billion. The SFC notes that this is a similar scale of error as in the last two years and that "the two biggest factors this year are higher spending on disability payments and in-year decisions by the Scottish Government, both of which are recurring themes from previous years". The SFC indicates that, while it is still too early to make a detailed assessment of the effect of the introduction of the Child Disability Payment or Adult Disability Payment, "the evidence so far is broadly in line with our judgements that they will lead to additional spending over and above what would have been spent on the payments they replace". It goes on to state that it "will continue to work with Social Security Scotland to ensure we have the necessary data and keep these assumptions under review as we work on our next forecasts to support the 2024-25 Scottish Budget".

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[1] This, the SFC explains, reflects workers bargaining for higher wages to compensate for the rising cost of living.

Income tax

8. The SFC's income tax forecast was published in January 2021 for the tax year 2021-22. The FER notes that "this forecast was prepared in a period of exceptional uncertainty related to the Covid-19 pandemic". The effects of the pandemic on the economy, it explains, were "smaller than we had assumed at the time and there was an unexpected increase in inflation". These factors contributed to an underestimate of income tax revenues in 2021-22 of 12% (£1,461 million) compared to HMRC outturn data. The SFC notes that, "as we stated at the time, the exceptional context of Covid-19 meant that a large forecast error was always a possibility" and goes on to explain that—

   "Compared to our assumptions at the time, the lockdown in early 2021 was not as significant as we anticipated. The Scottish economy was more resilient, with growth in GDP of 14.2% compared to our forecast of 7.5%. There was an unexpected increase in inflation in 2021-22, further increasing nominal earnings growth compared to our forecasts. There also appears to have been strong growth in tax revenues from the top end of the income distribution, particularly among those paying tax via Self-Assessment. … Importantly for the Scottish Budget, there was a similar scale and direction of error in the Block Grant Adjustment (BGA) based on forecasts by the Office for Budget Responsibility."

Indicative income tax reconciliations

9. A key point in the FER relates to the indicative income tax reconciliation estimates made in intervening SFC forecasts. The SFC forecast in January 2021 that there would be an income tax net position of £475 million – in other words that, income tax receipts would be £475 million higher than the BGA deducted from the block grant. Funding for the Scottish Budget was based on this value. The SFC notes that—

   "At the time, we cautioned that this high Budget setting net position arose because of the uncertainty around Covid-19 and its effects on the data and judgements used in our and the OBR's forecasts, as well as issues with the timing of the forecasts. We did not expect Scottish tax revenues to perform significantly differently to the UK in 2021-22 and cautioned that a negative reconciliation was likely. We suggested a value of -£300 million if the net position was closer to the lower 2020-21 value.

   Now that we have the outturn data[2] for 2021-22 Scottish income tax revenues and the income tax BGA, we can assess the impact on the Scottish Budget… The provisional net position is now £85 million, less than the £475 million on which the Scottish Budget was set. This leads to a reconciliation of £390 million which is broadly in line with the value we suggested back in January 2021, given the circumstances".

[2] The Scottish Government published the provisional outturn figures in July 2023: [Provisional Outturn – HM Treasury Budgets - Budget - Provisional Outturn 2022-2023: briefing note - gov.scot (www.gov.scot)]

10. However, as Members will be aware, the most recent SFC forecast of May 2023 had an indicative negative reconciliation for Scottish income tax in 2021-22 of -£712 million. The explanation given by the SFC for this error was that (1) Pay As You Earn (PAYE) outturn data was stronger than suggested by the PAYE Real Time Information (RTI) data the SFC had used in its updated estimate, and (2) there were higher than expected Scottish income tax revenues at the top end of the income distribution, particularly through Self-Assessment. Further explanation for the change in figures for this reconciliation are provided in Professor Roy's letter to the Committee of 6 July.

11. Annexe A of the FER discusses how the highest earners in Scotland account for a large share of income tax revenues and "an even larger share of the variation in growth of income tax revenues over time." It states that—

"The accuracy of our forecasts of growth in tax revenues from top rate taxpayers will clearly have a significant effect on our forecast error. However, the tax revenues paid by this group are highly variable and we have limited means to monitor the liabilities of this group until the outturn data are published.

The variation in tax revenue generated by the highest earners is likely to continue to be a source of uncertainty and forecast error. We will continue to work closely with HM Revenue and Customs (HMRC) to improve our understanding of what determines changes in tax revenues of the highest earners."

12. This may be an area for discussion with the SFC. On the one hand, indicative reconciliation figures are helpful in setting out the parameters of the likely reconciliation and allow the Government and Parliament to make indicative plans. However, this may be diminished if there is significant uncertainty around this information.

13. Members will also be aware that the updated Fiscal Framework agreed in August 2023 enables the Scottish Government to borrow up to £600 million each year, within a statutory overall limit for resource borrowing of £1.75 billion. It may borrow within these limits "for in-year cash management, and for forecast error in relation to devolved and assigned taxes and demand-led welfare expenditure arising from forecasts of Scottish receipts/expenditure and corresponding UK forecasts for the BGAs". These borrowing arrangements apply from 2023-24 onwards.

Paper on Productivity and Fiscal Sustainability, August 2023

14. This paper explores the potential effects of a change in productivity growth on the long-term outlook for the devolved Scottish public finances. This follows a related discussion between the Committee and the SFC at an evidence session on 28 March 2023 in relation to the SFC's first Fiscal Sustainability Report published earlier that month.

15. In his letter to the Committee dated 29 August 2023 which accompany the two publications (attached at Annexe A), Professor Roy states “we conclude that even though higher productivity growth leads to a faster economic growth, higher wage growth and likely better public services for the people of Scotland, on its own it does not necessarily translate into a more sustainable fiscal position”. He goes on to explain that “while higher productivity growth has a clear positive effect on the economy, the net effects on the public finances are complicated and to improve fiscal sustainability will require changes in public spending or tax policy”.

16. The paper models higher and lower productivity growth than in the SFC’s fiscal sustainability report published in March 2023. The SFC explains that “historically productivity growth in Scotland and the rest of the UK has been broadly similar and therefore we focus on changes in productivity growth across the UK”. It has also modelled “the effects of higher and lower productivity growth being seen only in Scotland, and those results are discussed in the report to illustrate the potential ways in which productivity affects the projections”.

17. The analysis set out in the paper suggests that the budget gap identified in the SFC’s March 2023 report on Fiscal Sustainability gets larger in a high productivity scenario and lower in low productivity scenario. Figure 2.7 (p16 of the paper reproduced below) shows the modelled effect on the annual budget gap from high and low ‘Scotland-only’ productivity scenarios.

Scenario	Block Grant	Tax net position	Spending	Total effect
High productivity (Scotland-only)	**Unaffected**. Block Grant funding is determined by UK Government spending, so is unaffected by Scotland productivity.	**Higher**, as Scotland has increased tax revenues relative to the BGAs	**Higher**, as spending grows in line with wages.	**Larger** Annual Budget Gap
Low productivity (Scotland-only)		**Lower**, as Scotland has lower tax revenues relative to the BGAs	**Lower**, as spending grows in line with wages.	**Smaller** Annual Budget Gap

18. This holds even in UK-wide high and low productivity scenarios (figure 2.9, reproduced below).

Scenario	Block Grant	Tax net position	Spending	Total effect
High productivity (All UK)	**Higher**, as UK Government spending grows in line with wages, determined by UK productivity.	**Higher**, as Scotland has increased tax revenues relative to the BGAs	**Higher**, as spending grows in line with wages.	**Slightly greater** Annual Budget Gap
Low productivity (All UK)	**Lower**, as UK Government spending grows in line with wages, determined by UK productivity.	**Lower**, as Scotland has lower tax revenues relative to the BGAs	**Lower**, as spending grows in line with wages.	**Slightly smaller** Annual Budget Gap

19. The report reiterates the points made by Professor Roy in his letter to the Committee—

"This paper illustrates how under the current devolution arrangements, improving productivity growth on its own is not necessarily a solution to the fiscal challenges the Scottish Government faces. We conclude that even though higher productivity growth leads to a larger economy and higher wages for the people of Scotland, it does not necessarily translate into a more sustainable fiscal position. While higher productivity growth has a clear positive effect on the economy, decisions would have to be taken by governments so that the public finances benefit more from those increases in productivity by changing either public spending or tax policy."

20. This analysis, the paper notes, "requires a number of simplifying assumptions: that higher productivity results in higher wages with no other effects such as a change in working hours or participation rates, and that higher productivity results in higher public spending mainly because public sector wages grow at the same rate as the private sector". The SFC's assumptions mirror those made by the OBR for the UK, so there is consistency in their assessment of fiscal sustainability.

21. The SFC further highlights that the economy over the next 50 years is likely to change in ways that cannot be predicted at this moment in time—

"The advance of artificial intelligence may have a large effect on labour productivity in the future and thus the shape of the workforce and economy Similarly, economic disruption could lead to labour productivity gains as sector are incentivised during periods of demand or supply constraints."

22. **The Committee is invited to explore the issues raised in both the FER and the paper on Productivity and Fiscal Sustainability with the SFC at the evidence session on 5 September 2023.**

Financial Scrutiny Unit in SPICe and Committee Clerking Team
September 2023

ANNEXE A

Letter from Professor Graeme Roy to the Committee dated 29 August 2023

Dear Convener

Today we have published two reports. In our Forecast Evaluation Report, we evaluate our December 2021 forecasts of the economy, devolved taxes and social security used to set the 2022-23 Scottish Budget; and, due to the longer publication lag of income tax data, our earlier income tax forecast used in setting the 2021-22 Scottish Budget.

The economy, devolved taxes and social security forecasts were published at a time of ongoing uncertainty due to the COVID-19 pandemic, and before the Russian invasion of Ukraine and the subsequent energy price shock. Despite these significant events, our forecast for economic growth proved reasonably accurate with Scottish GDP growing by 2.0 per cent in 2022-23, compared to a forecast of 2.2 per cent. Land and Building Transaction Tax revenue was £99 million higher than forecast because residential properties saw faster price growth and there were more high value property transactions than forecast. Social security spending was £127 million higher than forecast, mainly driven by higher spending on disability payments and the Scottish Government announcing policies after the Budget.

Our forecasts for Scottish income tax for 2021-22 were made in January 2021 at a much earlier point during the pandemic: the furlough scheme was in operation; a national Scottish lockdown was in place; and COVID-19 vaccines were just starting to be rolled out. Scottish income tax revenues were £1,461 million or 12 percent higher than our forecast for the 2021-22 Scottish Budget. This difference was primarily because the economic recovery from the COVID-19 pandemic in 2021-22 was stronger than expected and higher inflation led to faster nominal earnings growth. Income tax revenues in the rest of the UK were also higher than forecast by the OBR, with the net effect being for a negative reconciliation of £390 million to be applied in the 2024-25 Scottish Budget.

We have also published a report on Productivity and Fiscal Sustainability which explores how changes to productivity growth would affect the projections made in our Fiscal Sustainability Report in March.

We conclude that even though higher productivity growth leads to a faster economic growth, higher wage growth and likely better public services for the people of Scotland, on its own it does not necessarily translate into a more sustainable fiscal position. While higher productivity growth has a clear positive effect on the economy, the net effects on the public finances are complicated and to improve fiscal sustainability will require changes in public spending or tax policy.

I look forward to discussing these reports with you when I give evidence to the Committee on Tuesday 5 September.

Yours sincerely

Professor Graeme Roy