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Fiscal Framework Outturn Report 2018

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The Scottish Government published the first Fiscal Framework Outturn Report on Thursday 20 September 2018. This briefing summarises the key elements of the document.

Fiscal Framework
Outturn Report

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Executive Summary

The Fiscal Framework Outturn Report (FFOR) was proposed by the Budget Process Review Group to report on the budget implications of outturn data for Scottish revenues, together with final block grant adjustments. The first Fiscal Framework Outturn Report was published on 20 September 2018.

The report presents the reconciliations required in 2019-20 for the fully devolved taxes of Land and Buildings Transaction Tax and Scottish Landfill Tax.

This year's FFOR report does not have significant budget implications. This is because the reconciliation between forecasts and outturn revenues for income tax (by far the most significant devolved tax power in budgetary terms) will not be available until next year, and will not require any budgetary adjustments until financial year 2020-21. The latest set of official forecasts do point to a potential reconciliation in 2020-21 of -£267 million for income tax forecast error. However, latest Scottish tax forecasts are far from certain as they were undertaken prior to a large recent upward revision to Scottish GDP figures.

The Fiscal Framework Outturn Report also presents the latest residual balance in the Scotland Reserve, which is provisionally anticipated to be £192 million at the end of 2018-19.

The Scottish Government's use of borrowing powers are also presented. The Scottish Government has accumulated nearly half of its overall capital borrowing limit of £3 billion, but has yet to drawdown any of its available resource borrowing limit.

What is the Fiscal Framework Outturn report?

The Fiscal Framework Outturn Report (FFOR) [1] was published on 20 September 2018. It follows a recommendation of the Budget Process Review Group [2] and is designed to support the new budget process as agreed by the Parliament earlier this year.

The Budget Process Review Group final report included the following recommended content for the FFOR.

- That is be published annually in September and is based on audited information as far as possible

That it covers the following elements of the Fiscal Framework

Reconciliation process:

- outturn data for Scottish tax revenues (including comparison against forecast)
- calculation of outturn BGAs (and comparison against forecast)
- net budgetary position (revenues minus forecast) for each tax relative to forecast
- implications of any reconciliation for the subsequent financial year
- commentary on latest available interim outturn data on income tax.

Scotland Reserve:

- payments into the Reserve and withdrawals from the Reserve (with explanations for reasons for withdrawal or source of surplus)
- Balance of Scottish Reserve at the start and end of the previous financial year.

Borrowing:

- borrowing undertaken in past financial year, assessment of how far Government remains below its various borrowing limits
- implications of borrowing in terms of estimated profile of future repayments.

The remainder of this briefing covers each of these elements in turn.

Reconciliation process

The key purpose of the FFOR is to report on outturn data for Scottish revenues, along with the outturn and final block grant adjustments (BGAs). This comparison of outturn revenue and BGAs with the forecasts made at the time of the budget allows the FFOR to identify the degree of 'reconciliation' that will be required in the subsequent budget.

Scottish budgets are now underpinned by two sets of forecasts.

- Forecasts for a block grant adjustment (BGA), which is an estimate of the revenue foregone by the UK in devolving tax powers to Scotland - these forecasts are undertaken by the Office for Budget Responsibility (OBR)

- Forecasts for the revenues to be raised by Scottish taxpayers based on Scottish Government policy decisions - these forecasts are undertaken by the Scottish Fiscal Commission (SFC).

The forecasts are reconciled with outturn data when that becomes available, so that the funding available to the Scottish Government ultimately corresponds to the actual revenues and BGAs.

As outturn data is available on different timescales for each of the taxes, there are different processes in place for how income tax is reconciled compared with the fully devolved taxes. For the fully devolved taxes, outturn data is available approximately 6 months after the end of the Financial year. For income tax, outturn data is available around 15 months after the end of the financial year. This longer lag time for income tax relates to the self-assessment income taxpayers having around 10 months after the end of the financial year to pay income tax dues.

Once outturn data is available, a reconciliation is made to the subsequent budget to account for any difference between forecast and outturn data BGAs; and with income tax for differences between forecast and outturn tax revenues.

Scottish Income Tax

The FFOR provides the following helpful representation of the reconciliation process for Income tax, which is a partially devolved tax.

Reconciliation process for Income tax

1. To determine funding for the Scottish Budget, SFC's forecasts are used for tax revenues and OBR's forecasts are used to inform the BGA, set by HMT.

2. The forecast BGA for income tax is deducted from the Scottish Government's Block Grant.

3. Forecast tax revenues are added to the Scottish Government's residual Block Grant. Effectively, the Block Grant includes the expected income tax revenue which is transferred by HMT. Revenues and BGA are fixed until outturn data is available.

4. Reconciliations are made to reflect differences between outturn and forecast figures for revenue and the BGA. When revenues increase more (or decline less) than the BGA compared to the initial forecasts, the Scottish Government has more resources available than anticipated.

5. It is this net effect of the revenue and BGA reconciliations which determines whether the Scottish Government's Budget is higher or lower than originally forecast and thereby the impact on the Budget at which the reconciliation takes place.

The Scottish Income tax powers became operational in 2017-18, and that will be the first year for which any reconciliation will apply. Outturn data for Scottish income tax receipts in 2017-18 will not be available until summer 2019, and will not have any budgetary impact until 2020-21.

There is, however, now outturn data available for 2016-17 non-savings non-dividend income tax raised in Scotland. This shows outturn revenues of £10.7 billion in 2016-17, substantially below previous forecasts (which were £11.5 billion in Autumn 2016 and £11.3 billion in May 2018).

The SFC state that they consider most of the error to be a result of data issues, specifically that the number of higher and additional rate taxpayers was lower than previously thought. Previous HMRC forecasts for income tax receipts assumed there to be 18,000 additional rate taxpayers and 337,000 higher rate taxpayers. The latest data shows that there were in fact 13,000 additional rate and 294,000 higher rate taxpayers. The reduced number of higher and additional rate taxpayers is estimated by the SFC to account for £500 million of the £550 million forecast error. [3]

Budgetary impact?

What will be the Budgetary impact of 2016-17 income tax outturn being lower than expected?

2016-17 is used as the baseline year for the purpose of adjusting the Scottish block grant for the new income tax powers. The lower the revenues, the smaller the 'initial deduction'. What matters for the Scottish budget in 2017-18 is how quickly income tax revenues grow after 2016-17 in Scotland compared to the rest of the UK .

A lower than forecast outturn figure does not tell us about the relative growth rate of Scottish revenues in future years. It may mean that the SFC revise down its forecast of

Scottish Revenues for 2017-18 and beyond. But the block grant adjustment for income tax will be revised down too, as the starting point is lower.

However, one implication of the outturn data is that Scotland appears to have relatively fewer higher and additional rate taxpayers compared to rUK than was previously thought. This could mean that it is less likely that the growth of Scottish income tax revenues per capita will match the growth of rUK tax revenues per capita.

Revenue and budgetary impacts from lower than expected numbers of higher and additional rate taxpayers will need to be carefully considered as new data comes to light. Until the outturn data for 2017-18 is available, the forecasts made for the 2017-18 Budget will be 'locked in'.

The FFOR does compare the forecasts made at the time of the 2017-18 budget with the latest forecasts in table 3.1 of the FFOR. When the budget was set, Scottish revenues were forecast to be £107 million higher than the BGA. According to the latest forecasts (made for the UK by the OBR in March 2018, and for Scotland by the SFC in May 2018), Scottish revenues are forecast to be £159 million less than the BGA. There has thus been a £267 million deterioration in the budget position. However, the FFOR also points out that the latest SFC forecast came before the revisions made to the Scottish GDP growth figures for 2017-18. GDP growth in 2017-18 is now estimated at 1.3 per cent (compared with the SFC forecast 0.7 per cent).

All of this points to continuing uncertainty about what the final income tax reconciliation will bring.

Fully devolved taxes

The FFOR sets out forecast and outturn for both tax revenues and BGAs, and then highlights the reconciliation already made in the 2018-19 budget and the remaining reconciliation required in the 2019-20 budget.

Reconciliation process for Land and Buildings Transaction tax and Landfill tax

1. In advance of the forthcoming financial year, SFC's forecasts are used for tax revenues and OBR's forecasts are used to inform the BGA, set by HMT.

2. The forecast BGA for each tax is deducted from the Scottish Government's Block Grant for the forthcoming financial year.

3. Revenue Scotland collects revenues over that financial year.

4. Block Grant Adjustments are updated twice. The first update is made within that financial year at the UK Budget, on the basis of the most recent OBR forecasts. Once outturn data is available in the following financial year, a final reconciliation is applied to the Scottish Government's Block Grant for the financial year thereafter (i.e. two years after the year to which the revenues relate).

5. Whether the Scottish Budget is in a better position at outturn than as originally forecast depends on both: i) how outturn revenues compare with forecast, and ii) how the outturn BGA compares with forecast. For both fully devolved taxes the net outturn position has improved compared to the 2017-18 budget forecast.

Table 1 below summarises the forecast compared to outturn position for the fully devolved taxes.

Table 1: Forecast and outturn revenues and BGAs, 2017-18 Budget, £ million

	Budget forecast			Outturn		
	Revenues	BGA	Difference	Revenues	BGA	Difference
LBTT	507	545	-38	557	584	-27
Landfill tax	149	119	30	148	113	35
Total	**656**	**664**	**-8**	**705**	**697**	**8**

LBTT was forecast to raise £507 million, less than the £545 million forecast for the BGA. As such, according to these forecasts, the Scottish budget was expected to be around £38 million worse off than it would have been without devolution of LBTT, given the slightly slower forecast growth of Scottish revenues compared to the equivalent rUK tax.

Landfill tax was the opposite, with forecast revenues higher than the forecast for the BGA.

On actual revenues, LBTT was £50 million higher than forecast, but outturn rUK revenues were also higher than forecast, so the BGA was higher than forecast as well. Ultimately, LBTT revenues were lower than the BGA, but not by as much as had been forecast (the gap had been forecast at -£38 million, but it turned out to be just -£27 million). So in terms of LBTT, the Scottish Government had £11 million more revenues than it had budgeted for.

For Landfill tax, the Scottish budget also ended up being in a slightly better position than forecast. The gap between revenues and the BGA had been forecast at £30 million in Scotland's favour, but ended up being £35 million in Scotland's favour.

Overall for 2017-18, the Scottish budget was set on the basis of revenues from LBTT and Landfill tax being £8m less than the BGA. However, outturn data showed the Scottish revenues to be £8m higher than the BGA, an improvement on the budget position of £16 million.

Reconciliation to be made to the 2019-20 budget

Given the £16 million improvement on the budget position of the devolved taxes, you might expect the reconciliation to be a £16 million gain to the 2019-20 budget. However, there is a further complication related to the timing of the LBTT and Landfill tax reconciliations.

The Scottish Government collected the additional £50 million LBTT revenues during financial year 2017-18, and likewise it collected the higher than forecast revenues from Landfill Tax. Thus the revenue part of the reconciliation shown in Table 1 happens automatically during the course of the financial year.

The BGAs, however, are updated twice following the Budget Act:

- First they are updated half-way through the 2017-18 financial year based on an updated forecasts for rUK Stamp Duty and Landfill Tax revenue outturn, and this update is applied to the Scottish block grant in 2017-18;
- The second update happens in the 2018-19 financial year, once full rUK outturn data is available, and this update is applied to the Scottish block grant in 2019-20. This means that some of the BGA reconciliation for 2017-18 is still to take effect.

The first update to the BGA forecast that the BGA for the year would increase to £591 million (compared to the £545 million forecast at the budget). This update to the BGA was applied to the Scottish block grant mid-way through financial year 2017-18. Given that the final outturn BGA for LBTT was actually slightly lower, at £584 million, it actually means that there is a £7 million adjustment in Scotland's favour still to be made in the 2019-20 budget. See Table 2.

Similarly, the first update to the Landfill Tax BGA forecast the BGA decreasing from £119 million to £104 million. The final outturn BGA was higher than this, at £113 million. So there is a -£9 million reconciliation remaining to be applied to the Scottish block grant in 2019-20 on this basis.

The +£7 million adjustment for LBTT and -£9 million adjustment for Landfill Tax together imply a £2 million downward adjustment being made to the Scottish block grant in 2019-20 to address remaining issues of reconciliation for 2017-18.

Table 2: BGA reconciliation to be made in the 2019-20 budget, £ million

	Forecast BGA: Budget	Updated forecast BGA: mid-year	Outturn BGA	Difference between mid-year and outturn
LBTT	545	591	584	7
Landfill Tax	119	104	113	-9

Scotland Reserve balance

Scotland Act 2016 introduced a Scotland Reserve, allowing the Scottish Government to build up funds when devolved revenues are higher than forecast and to carry over underspends from one year to the next. The Reserve is designed to assist in managing tax receipt volatility and allow the Scottish Government to smooth spending when required.

The Scotland Reserve applied from 2017-18 onwards and is split between capital and revenue. The Reserve is capped at £700 million, and annual draw downs from the Reserve are limited to £250 million for resource and £100 million for capital.

The FFOR sets out the payments into, payments out from and balance of the Scotland Reserve for both resource and capital. It also lays out the Scottish Government's intended drawdowns form the Reserve in 2018-19.

The residual balance of the Scotland Reserve is anticipated to be £192 million (all resource) at the end of the current financial year (2018-19). However this figure excludes any underspends arising during the course of the year.

The Scottish Government has not yet needed to use any of its resource borrowing powers for forecast error. This is because the forecast errors for the fully devolved taxes have been sufficiently small.

Borrowing

Scotland Act 2012 give the Scottish Government power to borrow from the National Loans Fund (NLF), through the issuing of bonds, or through commercial loans. Resource borrowing can only be funded from the NLF, whereas capital borrowing can come from the NLF, commercial loans or the issue of bonds subject to a statutory aggregate cap of £3 billion and annual limit of £450 million.

The Scottish Fiscal Commission is responsible for assessing the reasonableness of Scottish Ministers borrowing projections.

The FFOR sets out the capital borrowing powers that have been utilised in each year, the loan terms and annual repayments. It notes that by the end of 2018-19, the Scottish Government will have accumulated £1,459 million of capital debt, well within the overall £3 billion limit. The Scottish Government has borrowed the maximum available amount in each year since it received borrowing powers in 2015-16. If it were to continue to draw down its maximum allocation each year, and continue to borrow on the basis of relatively long terms (25 years), it would likely run up against its borrowing limit by 2022.

The FFOR notes the resource borrowing powers available to the Scottish Government for in-year cash management, forecast error in relation to devolved and assigned taxes and devolved social security spending, and Scottish specific economic shocks. The Scottish Government has not used resource borrowing powers to date.

Conclusions

Income tax is by far and away the most significant tax power devolved to the Scottish Parliament in absolute budgetary terms. This year's FFOR is not overly significant for the Budget as it does not contain outturn income tax data for 2017-18 due to the much longer lag in outturn data availability.

As highlighted in a recent Fraser of Allander blog [4] , income tax reconciliations, however, have the potential to become far more significant in future FFORs where there is scope for substantial revisions to the income tax forecasts. Indeed the latest forecasts for income tax revenues and the income tax BGA imply that the Scottish budget for 2017-18 and 2018-19 could be hundreds of millions of pounds worse off than when the budget was set.

Additionally, there is the scope for forecast error in relation to assigned VAT, once that comes into the equation in 2020-21, and for forecast error in relation to spending on the new social security benefits.

As a result, future FFORs could have substantial implications for the Scottish budget, with consequences for spending plans, use of reserves, and borrowing.

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