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Bee Boileau
David Phillips

Income tax performance

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3. Income tax performance

Bee Boileau and David Phillips

Since the partial devolution of income tax to Scotland, revenues have disappointed. For example, whereas increases in tax rates and changes to tax bands are – before accounting for behavioural responses – estimated to have generated over £600 million in 2020–21, revenues were only £96 million more than the amount subtracted from the Scottish Government’s block grant funding (the block grant adjustment, or BGA) to account for devolution. This is because the underlying tax base grew less quickly in Scotland than in the rest of the UK (rUK),[1] offsetting most of the revenue generated by the Scottish Government’s tax changes.

Forecasts suggest that this trend has continued into the current year. In particular, the Scottish Fiscal Commission (SFC) has forecast that the Scottish Government’s tax changes will raise the equivalent of £850 million this year (again before accounting for behavioural responses), yet revenues will be around £100 million lower than the BGA. In other words, slower tax base growth is expected to more than offset Scotland’s higher tax rates.

In both December 2021 and May 2022, the SFC was forecasting the trend to continue in the medium term. However, the forecasts published last month are for a significant reversal of this trend, with revenues set to exceed the BGA by £1.1 billion by 2026–27, and £1.3 billion by 2027–28. This is an important change, providing a notable boost to the Scottish Budget (see Chapter 2).

This chapter of the report therefore looks at what we know about why Scotland’s tax base has grown more slowly so far since devolution, and discusses the SFC’s explanation for the partial catch-up expected over the next few years.

[1] Strictly speaking, the comparator has switched to England and Northern Ireland, following the devolution of tax powers to Wales in 2018–19 (Stamp Duty Land Tax and landfill tax) and 2020–21 (income tax). We use the term rUK throughout for ease of reference.

Key findings

1. Scottish Government policy measures – which include reducing the higher rate threshold, moving to a five-band system of income tax, and increasing the higher and top rates of tax – have raised significant amounts of revenue relative to if it had followed UK government tax policy that applies in rUK. The SFC estimates that, before accounting for any behavioural responses, these changes boosted revenues by £385 million in 2018–19 and will boost revenues by £852 million in the current financial year, 2022–23.

2. However, slow growth in Scotland's underlying tax base compared with rUK has exerted downwards pressure on Scottish income tax revenues, despite these reforms to Scottish income tax policy. In 2018–19, revenues from income tax were only £127 million higher than the BGA subtracted from Scotland's block grant funding to account for tax devolution (which is updated each year in line with growth in revenues in rUK), and in the current financial year, 2022–23, revenues are forecast to be £107 million lower than the BGA. In other words, slow growth in the underlying tax base is forecast to more than offset the additional revenues from Scotland's higher tax rates this year.

3. Relatively slow employment growth in Scotland, compared with rUK, has been one factor behind this poor net tax position. Scotland's population is ageing more rapidly than the population of rUK, and there have been falls in economic participation rates within age groups. For adults aged 35–49, the labour force participation rate in 2014–15 was comparable in Scotland to that in the UK as a whole (86.8% versus 86.9%), but by 2021–22, a 3.5 percentage point gap had emerged (84.5% versus 88.0%), with participation falling in Scotland and rising in rUK. This depresses tax revenues per person in Scotland relative to rUK, worsening Scotland's net position.

4. Scottish earnings growth has also been weak compared with earnings growth in rUK over the period in which income tax has been devolved. Scottish Government analysis suggests that this primarily reflects two factors. The first is strong growth in earnings in London and its surrounding regions, related to growth in the finance and insurance sector in particular. In the period between 2016–17 and 2021–22, changes in London, the South East and the East of England can account for more than half of the shortfall in growth in average earnings in Scotland relative to rUK. The second factor is the weak performance of the oil and gas sectors and associated industries, particularly affecting earnings – and so income tax revenues – in North Eastern Scotland.

5. As recently as May 2022, the SFC was expecting this slow growth in the Scottish tax base to continue in 2023–24 onwards, with negative impacts on forecast net income tax revenue in Scotland. This was largely as a result of its forecast for continued slower employment growth in Scotland compared with rUK.

6. In its latest forecasts, however, the net income tax position for 2023–24 onwards is much stronger. Forecasts for Scottish revenues were revised upwards from their May levels in each year between 2023–24 and 2026–27, while the BGA forecasts by the Office for Budget Responsibility (OBR) were revised downwards (apart from a slight upwards revision in 2024–25). Only a small part of this net improvement is as a result of income tax policy changes announced in the December 2022 Scottish Budget, which include increasing the higher rate of tax (from 41% to 42%) and the top rate (from 46% to 47%).

7. The most important factor causing the improvement in the forecast net position from 2023–24 between May and December 2022 is the change in underlying economic forecasts. Employment forecasts have been revised downwards by the OBR in the UK for 2023–24 and 2024–25, but the SFC has not done the same. The OBR also forecasts that earnings will grow much more slowly (at an average of 2% per year between 2024–25 and 2027–28) in the UK than is forecast for Scotland by the SFC (2.6% on average).

8. To some extent, these differences are likely to reflect Scotland-specific factors: much elevated energy prices are likely to boost employment and earnings in the oil and gas sectors in North Eastern Scotland, and a recession and rising interest rates may slow earnings growth in the large financial sector in rUK. But part of the differences are also likely to reflect different judgements about the economic outlook for the UK as a whole. If the SFC's more 'optimistic' position is borne out, the OBR's revenue forecasts will be too low, and the BGAs will be revised upwards. If the OBR's forecasts are more accurate, Scottish revenues will be lower than is forecast. In both cases, Scotland's net income tax position would be weaker than currently forecast. Risks to Scotland's net income tax position are therefore likely to be weighted to the downside.

9. Despite the improved outlook for the income tax net position from 2023–24, forecasts are still lower than would be expected as a result of income tax policy alone. In 2026–27, for example, the latest forecast for the net position is £1,068 million, but the effect of tax policy alone, according to SFC analysis, would be a net position of £1,528 million. This reflects the fact that the stronger forecast growth in the tax base over the next few years is only expected partly to undo the slower growth in the tax base during the first few years of income tax devolution.

3.1 Income tax performance to 2022–23

The power to vary income tax rates and bands charged on income other than interest and dividend income (termed non-savings, non-dividends or NSND income) was devolved to the Scottish Government in 2017–18. At the same time as these powers and associated revenues were devolved, the block grant funding provided by the UK government to the Scottish Government was reduced. This block grant adjustment (BGA) was initially set equal to estimates of the tax revenues to be devolved to the Scottish Government. In subsequent years, it is changed in line with the percentage growth in income tax revenues per person in the rUK and with growth in the change in the Scottish population. This means that there would be a net increase in funding (from the devolved revenues and offsetting BGAs) if income tax revenues per person were to grow at a faster rate in Scotland than in rUK since the point of devolution, and a net decrease if they were to grow at a slower rate.

Two main factors could affect the relative growth rate in revenues per person in Scotland compared with rUK:

- first, changes in income tax policy in Scotland and rUK (for example, if the Scottish Government were to increase tax rates relative to those in rUK, all else equal, we would expect revenues per person to grow more quickly than in rUK);
- second, changes in the underlying tax base (the amount of income subject to tax) as a result of different trends in demographics, employment, earnings and other economic variables.

The Scottish Government has in fact used its tax powers to make a series of changes to income tax policy relative to rUK that would be expected to lead to a bigger increase in revenues per person since devolution. In the current financial year, these changes include:

- a reduction in the higher rate tax threshold relative to that set in rUK (£43,662 compared to £50,270 as of 2022–23), meaning that more income is taxed at the higher rate of tax;
- the introduction of a five-band system of income tax by splitting the basic rate (20% in rUK) into three bands, which are a starter rate of 19% applying on a small band of income between £12,571 and £14,732, a basic rate of 20% applying between £14,733 and £25,688, and an intermediate rate of 21% applying between £25,689 and £43,662;
- an increase in the higher and additional rate of tax to 41% and 46% (compared to 40% and 45% in rUK), with a further increase – to 42% and 47% – to come in April 2023.

The distributional effects of these reforms are discussed in Chapter 5. In terms of revenue, the SFC estimates that these reforms would be expected to raise approximately £850 million this year, before accounting for any behavioural response to them, relative to following income tax policy in rUK.

However, slower growth in the underlying tax base has offset the impact of higher tax rates, as can be seen in Table 3.1. Part 1 shows the forecasts for income tax revenues and for the associated BGAs at the time the Scottish Budget was initially set each year, along with the resulting net revenue position, in each year between 2017–18 and 2022–23. These are the amounts that were used to determine how much funding the Scottish Government has to spend each year. The forecasts for revenues were made by the SFC, while the forecasts for the BGA are based on OBR forecasts for revenues in rUK. Part 2 shows the final figures for revenues, BGAs and the net position once the amounts actually collected in Scotland and rUK were known. Part 3 shows how much the outturn net position differed from the initial forecasts for each year: negative figures mean the Scottish Government has to pay back funding to the UK government as the forecast net position was optimistic, while positive figures mean the UK government has to provide additional funding to the Scottish Government as the forecast net position was pessimistic. These 'reconciliation' payments are made three years following the tax year in question (for example, the reconciliation payment for 2017–18 took place in 2020–21, and any reconciliation payment for 2022–23 will take place in 2025–26). Finally, part 4 shows the SFC's aforementioned estimates of the effects of changes in income tax policy compared with rUK, before accounting for any anticipated behavioural changes.

Looking first at part 1, we can see that initial forecasts were for Scottish income tax revenues to exceed the BGA by £107 million and £428 million in 2017–18 and 2018–19, respectively. Part 4 shows that this was mostly explained by tax policy changes relative to rUK, which were expected to raise £94 million and £385 million in these years. However, part 2 shows that the outturn net position was much weaker than forecast: −£91 million in 2017–18 and £127 million in 2018–19. This resulted in a need for negative reconciliation payments (whereby the Scottish Government pays back funding to the UK government) of £198 million and £302 million for these two years, which were applied in the 2020–21 and 2021–22 Budgets, respectively.

The weaker-than-expected relative performance of Scottish revenues had become evident by the time the Scottish Budget for 2019–20 was set, and the initial net position (£182 million) was much lower than SFC estimates of the effects of changes in tax policy (£621 million) and much closer to final outturn figures (£155 million) than in previous years, meaning a much smaller reconciliation payment (£50 million), which was applied in the current financial year.

This pattern has been repeated since then, with the exception of 2021–22, for which the SFC's forecasts of Scottish revenues (made in January 2021) could account for the relatively rapid roll-out of the COVID-19 vaccines boosting the economy and revenues, but the OBR's forecasts of rUK revenues and the BGAs (made in November 2020) could not. In particular, the initial forecast for the net position has been close to the outturn figures (or the latest forecasts where outturns are not yet available); however, the net position has fallen further and further behind what would have been expected based on income tax policy alone. In particular, for the current financial year, 2022–23, the SFC estimates that the effect of tax policy has been to boost revenues by £852 million. However, the latest SFC forecast is for revenues to be £107 million *lower* than the BGA. This means that the direct effects of Scotland's higher income tax rates are forecast to have been more than offset by slower growth in the underlying tax base.

Table 3.1. Income tax revenue and BGA forecasts, outturns and reconciliations, and SFC estimates of impact of policy changes (£ millions)

	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23
1. Forecast						
Revenue	11,857	12,177	11,684	12,365	12,263	13,671
BGA	11,750	11,749	11,501	12,319	11,788	13,861
Net position	107	428	182	46	475	−190
2. Outturn						
Revenue	10,908	11,549	11,825	11,948	13,337	14,575
BGA	10,999	11,423	11,670	11,852	13,594	14,681
Net position	−91	127	155	96	−256	−107
3. Reconciliation (1c minus 2c)	−198	−302	−28	50	−732	83
4. SFC estimate of impact of policy change only	94	385	621	642	757	852

Note: Reconciliation payments for a given year are applied to the Scottish Budget three years later. The SFC's estimates of the impact of policy changes on revenues are prior to any behavioural responses.

Source: Authors' calculations using Scottish Fiscal Commission (2022b). Shaded cells are the latest forecasts for outturns (made in December 2022), rather than outturns themselves.

Part of the slower growth in Scotland's tax base may reflect a behavioural response to Scotland's higher income tax rates. For example, when higher and additional rates of tax were increased from 40% to 41% and from 45% to 46%, respectively, in 2018–19, the SFC forecast that behavioural response would reduce the revenue raised from the higher rate in 2022–23 by 15% (from £156 million to £132 million), and from the top rate by over half (from £69 million to £29 million). Therefore, if these assessments of behavioural effects are broadly accurate, then these responses can only explain a small part of the slower growth in Scotland's tax revenues.

Analysis by the SFC and Scottish Government has highlighted a number of other factors that together, are likely to explain the deteriorating underlying net tax position – the following draws heavily on Scottish Fiscal Commission (2022c) and Scottish Government (2022).

The number of people in employment in Scotland has grown less quickly than in rUK since income tax was devolved. For example, between 2016–17 and 2021–22, employment in the UK as a whole is estimated to have increased by around 2%, whereas employment in Scotland is estimated to have fallen by 0.9%. This partly reflects slower population growth in Scotland than in rUK (which, because of the way the BGAs are calculated, using growth in revenues per person in rUK and growth in the Scottish population, should not affect the net tax position) but not fully. Scotland's population has also been ageing, but the SFC suggests that while this has contributed to the absolute decline in employment, the ageing of the rUK population would, all else equal, have led to a similar decline in employment there. Instead, the differences relative to rUK are a result of declining participation rates for given age groups. For example, whereas the labour force participation rate for adults aged 35–49 was 0.1 percentage points lower in Scotland (86.8%) than in the UK as a whole (86.9%) in 2014–15, it was 3.5 percentage points lower (84.5% versus 88.0%) as of 2021–22. For adults aged 16–64 as a whole, the participation rate went from being 0.3 percentage points lower in 2014–15 to 2.7 percentage points lower in 2021–22. The relative fall in employment in Scotland would depress income tax revenues relative to rUK.

Scottish earnings growth has also been weaker than in rUK over the period in which income tax has been devolved. For example, while average earnings are estimated to have grown by 17.7% between 2016–17 and 2021–22 in Scotland, they are estimated to have increased by 20.3% across rUK: 2.6 percentage points or 14% more. The SFC estimates that this contributed more to the deterioration in the underlying income tax position than slower employment growth, reflecting the fact that the tax-free allowance and progressive income tax rate structure means a 1% increase in earnings raises more revenues than a 1% increase in employment.

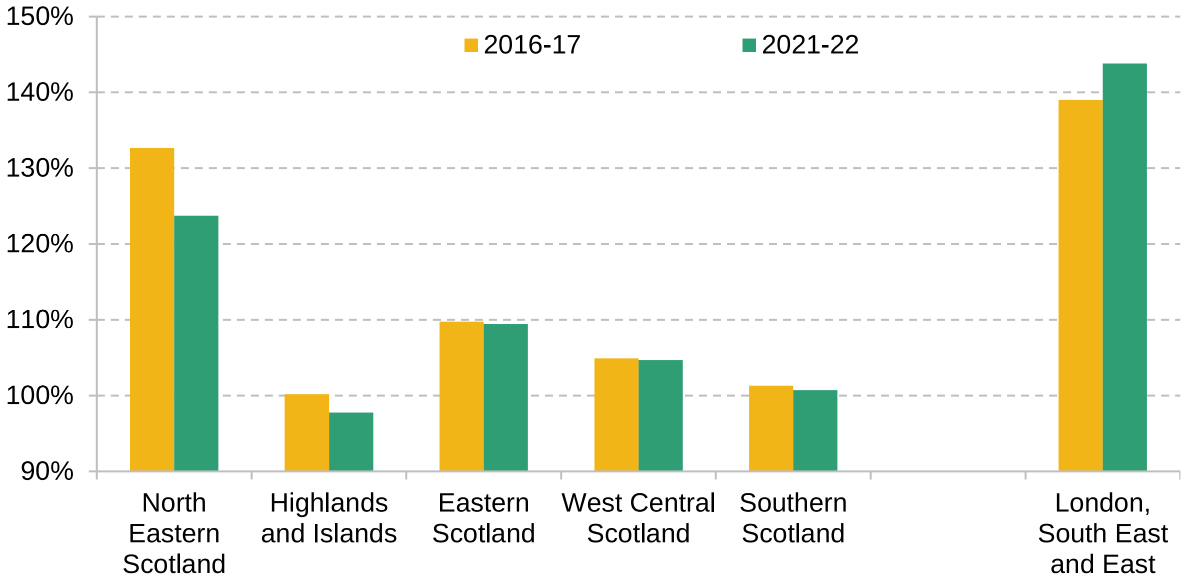
Analysis by the Scottish Government (2022) suggests that two factors explain much, if not all, of the slower growth in Scottish earnings.

- There was strong growth in earnings and, in turn, income tax payments in London, the South East and East of England. In particular, the shortfall in growth in average earnings in Scotland relative to rUK *excluding* London, the South East and East of England between 2016–17 and 2021–22 is estimated to be less than half the shortfall relative to rUK as a whole. Analysis of earnings by industry suggest that, particularly in 2021–22, a significant part of this relates to strong earnings growth in the finance and insurance sector in London, the South East and East of England. Because many people working in this sector in London, in particular, are highly paid and subject to a high marginal rate of income tax, the strong earnings growth for this group would have a disproportionate effect on rUK income tax revenues and hence the BGA.
- Additionally, the performance of the oil and gas sectors and associated supply chain industries deteriorated from 2015–16 onwards, probably reflecting falls in oil and gas prices,

and particularly affecting North Eastern Scotland. Analysis by the Scottish Government suggests that average earnings in Scotland excluding the North East nearly kept pace with average earnings in rUK excluding London, the South and East of England between 2016–17 and 2021–22. Again, the high average earnings among those working in the oil and gas (and related) sectors mean that the subsequent poor performance of earnings in these sectors is likely to have had a disproportionate effect on Scottish revenues, contributing to the deterioration in the net income tax position.

Analysis of earnings data based on real-time tax information reported to the HMRC by employers suggests that mean earnings have grown by less in recent years in most parts of Scotland than in rUK. When excluding London, the South East and East of England from the comparisons, the differences are only notable in North Eastern Scotland and the Highlands and Islands though. This is illustrated in Figure 3.1, which shows mean earnings for the different NUTS2 regions of Scotland, as a share of mean earnings in England and Northern Ireland (E&NI) excluding London, the South East and East of England. It shows that whereas mean earnings in North Eastern Scotland fell from 132.7% to 123.7% of mean earnings in E&NI excluding London, the South East and East of England between 2016–17 and 2021–22, and those in the Highlands and Islands fell from 100.2% to 97.8%, there was little change in the relative earnings of Eastern, West Central and Southern Scotland. The figure also shows that in all regions of Scotland except for the Highlands and Islands, mean earnings are higher than mean earnings in E&NI outside of London, the South East and East of England.

Figure 3.1. Mean earnings as a percentage of mean earnings for England and Northern Ireland excluding London, South East and East of England



South: Authors' calculations using Office for National Statistics (2022).

However, what matters for the net income tax position is how trends in income tax revenues per person across the whole of Scotland compare with trends across rUK as a whole. And slower growth in employment and earnings in Scotland has contributed to slower growth in the underlying tax base, offsetting the effects of Scotland's higher income tax rates.

3.2 Forecasts for 2023–24 to 2027–28

As of May 2022, in its forecasts published alongside the Resource Spending Review, the SFC was expecting this trend of slower growth in the underlying tax base to continue, driven largely by an expectation of a continued fall in employment in Scotland relative to rUK (the SFC was forecasting that earnings growth in Scotland would largely keep pace with that in rUK).

Part 1 of Table 3.2 shows the SFC's May forecasts for revenues, forecasts for the associated BGAs and the implied net income tax position, as well as SFC estimates of the impact of policy changes relative to rUK on the net position, before any behavioural response. It shows an improvement in the forecast net position between 2023–24 and 2024–25 (from −£359 million to £71 million), and then a slow worsening over the subsequent years (to −£50 million in 2026–27) as the forecast slower growth in employment takes its toll on the relative growth in Scotland's income tax base. The forecast improvement between 2023–24 and 2024–25 was the result of the then planned cut in the basic rate of income tax in rUK to 19% from April 2024: the resulting lower tax revenues would have reduced the BGA, and hence improved the net position. Stripping out that policy-driven effect, the SFC's forecasts imply that the underlying change in the tax base, and hence the net income tax position, was negative in that year too.

A comparison of the third and fourth rows of part 1 of Table 3.2 shows just how stark an impact Scotland's relatively slow growth in the tax base was expected to have on the net income tax position back in May 2022. For example, whereas the net position was forecast to be −£50 million in 2026–27, the direct effect of changes in policy relative to rUK were expected to raise £1.8 billion. This means slower growth in the underlying tax base was expected to have cost the equivalent of more than 10% of forecast income tax revenues in that year and, essentially, all the net income tax raising measures were essentially 'running to stand still' in terms of income tax revenues.

Table 3.2. Income tax revenue and BGA forecasts, outturns, and reconciliations between 2023–24 and 2027–28 (£ millions)

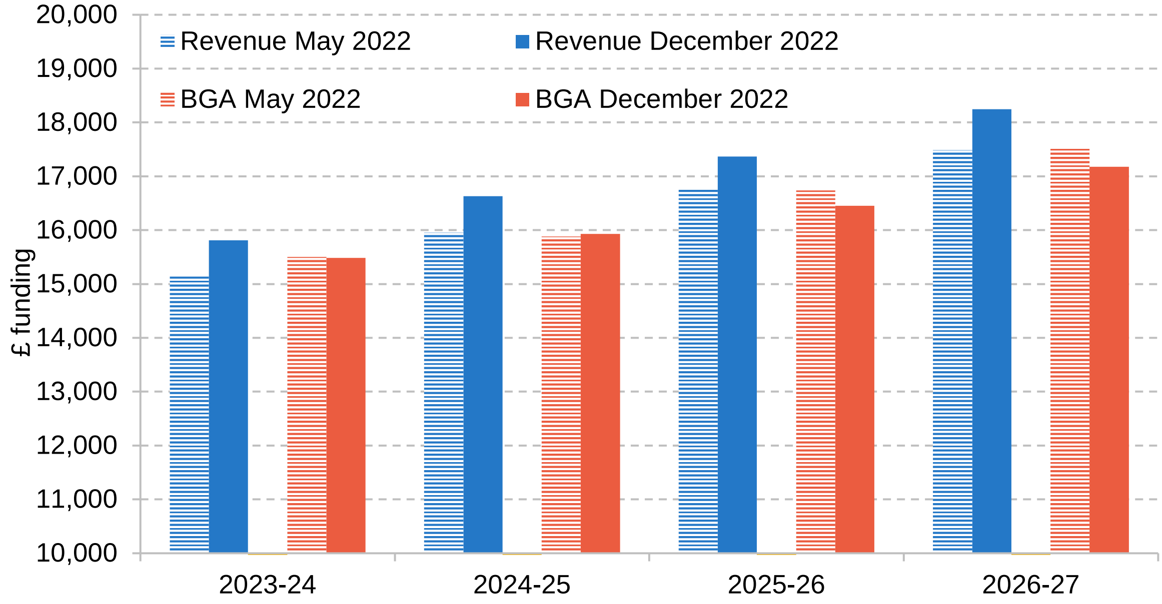
	2023–24	2024–25	2025–26	2026–27	2027–28
1. May 2022 forecasts					
Revenue	15,143	15,954	16,754	17,484	n/a
BGA	15,502	15,883	16,737	17,534	n/a
Net position	−359	71	18	−50	n/a
SFC estimate of impact of policy change only (December 2022)	895	1,459	1,613	1,810	n/a
2. December 2022 forecasts					
Revenue	15,810	16,633	17,370	18,247	19,437
BGA	15,485	15,932	16,455	17,179	18,105
Net position	325	700	915	1,068	1,332
SFC estimate of impact of policy change only (December 2022)	994	1,177	1,330	1,528	n/a

Note: Figures may not sum due to rounding.

Source: Authors' calculations using Scottish Fiscal Commission (2022a, b, c).

Part 2 of the table shows the same information as part 1, but for the December 2022 forecasts. It shows a significant change, with the net income tax position now forecast to be far stronger. For example, while in May 2022 Scottish income tax revenues were expected to be around £350 million lower than the BGA in 2023–24, the forecast position has now reversed with revenues expected to be around £325 million *higher*. The difference is similar for the 2024–25 net position, which was forecast to be £71 million in May but £700 million in December. In the following two years, the net position has improved by still more: by almost £900 million in 2025–26, and by more than £1.1 billion in 2026–27. This is despite the cancellation of the planned cut in the basic rate of income tax in rUK, which, all else equal, would have been expected to increase revenues in rUK and hence the BGA, worsening the net position by around £0.4 to £0.5 billion.

Figure 3.2. Comparison of income tax and BGA forecasts, May 2022 and December 2022



Note: Shaded bars represent May forecasts, while solid bars represent December forecasts.

Source: Scottish Fiscal Commission (2022a, 2022b).

Figure 3.2 illustrates visually how the forecasted revenues and BGAs have changed in each year to produce these improvements in the net position. As can be seen, the December forecasts for revenues have been revised considerably upwards from their May levels in each financial year between 2023–24 and 2026–27. The BGA forecasts have been revised downwards, adding to this improvement in the forecast net position, in each of these years apart from 2024–25, where they have been revised slightly upwards (from just under to just over £15.9 billion), likely reflecting the cancellation of the previously planned cut in the basic rate of income tax in rUK that year.

The largest driver of these substantial revisions has been the changes to the Scottish tax revenue forecast. The SFC's revenue forecasts for each of the next four years was increased by around £700 million between May 2022 and December 2022.

To some extent, this is the result of changes in income tax announced in the Scottish Budget in December 2022. This includes an increase in the higher rate of tax from 41% to 42%, and in the top rate from 46% to 47%, as well as confirming a freeze in most tax bands – although it was worth noting that the SFC had already assumed the higher rate threshold would be frozen in its May forecasts. Together, these changes are forecast to raise £121 million in revenue in 2023–24, increasing to £160 million in 2027–28, contributing modestly to the improvement in the net income tax position. In addition, the Scottish Government matched the UK government's change to the top rate threshold, which was reduced from £150,000 to £125,140. This is forecast to raise £8 million in the coming year, rising to £16 million by 2027–28. However, the combined effect of the reduction in the top rate threshold in Scotland and rUK is actually to worsen slightly the net income tax position because the greater share of individuals affected in rUK means revenues there, and hence the BGA, will increase by more than Scottish revenues.

Much more important to the improvement in the net position are changes in underlying economic forecasts. For example, since May 2022, the OBR has revised employment growth forecasts down in the UK for 2023–24 and 2024–25, as a result of the expected recession following the energy price increases. Employment is then forecast to grow more quickly but not return to previous forecast levels until 2027–28. This would act to depress revenues in rUK and hence reduce the BGA. However, the SFC has not revised down employment in 2023–24 for Scotland, and has in fact revised up employment for future years. This would increase revenues in Scotland, further improving the net income tax position.

Updated forecasts for earnings growth also contribute to improved forecasts for Scottish tax revenues relative to rUK. The OBR's latest forecasts are for UK earnings to grow in nominal terms by an average of 2% per year between 2024–25 and 2027–28 (and just 1.6% and 1.7% in 2024–25 and 2025–26, respectively), while the SFC has forecast earnings in Scotland to grow by an average of 2.6% per year (and by 2.5% and 2.1% in 2024–25 and 2025–26). Relatively faster earnings growth in Scotland would again contribute to an improvement in the net positions by boosting Scottish revenues relative to rUK revenues (and hence the BGA).

The differential changes in the employment and earnings forecasts by the SFC and OBR may reflect both Scotland-specific factors and more general differences in modelling approaches and forecast judgements.

Focusing first on Scotland-specific factors, the slower growth in earnings in Scotland between 2016–17 and 2021–22 relative to rUK was, as discussed earlier, to a significant extent driven by slowing activity in the oil and gas sector (causing a fall in earnings in North Eastern Scotland and, to a lesser extent, the Highlands and Islands), and strong growth in earnings in the financial services in rUK (and particularly London and its environs). Higher energy prices – which, although expected to fall back somewhat, are forecast to remain substantially above previous levels, especially for gas – are likely to boost employment and earnings in the oil and gas sector in Scotland. And the economic slowdown and rising interest rates may reduce earnings growth in the financial sector in rUK (and especially London) by more than Scotland, reducing the likelihood of further divergence (and potentially even allowing catch-up). It is worth noting, however, that there is so far little sign of such a turnaround. For example, there was, if anything, a further decline in relative earnings in North Eastern Scotland in the Summer and early Autumn of 2022 (following the energy price rise), with mean earnings falling to 21% above the mean in England and Northern Ireland (excluding London, the South East and East of England) between

July and October 2022, compared to 22% during the same period in 2021, before the rise in energy prices. The same is true for all other regions of Scotland to a greater or lesser extent.

The Scottish Fiscal Commission (2022b) also suggests that the smaller mortgage debts of Scottish households relative to those in rUK means that they will be less affected by rising interest rates, supporting consumption and, in turn, employment and earnings in Scotland.

However, to some extent, the differences in forecasts for earnings and employment growth, and hence income tax revenues, made by the OBR and SFC are likely to reflect different judgements about the economic outlook for the UK as a whole. For example, underpinning the OBR's earnings forecasts are assumptions about the share of overall economic output (GDP) that is captured by workers via wages. While wages are falling behind inflation, they are outstripping output per worker currently. This has pushed the wage share above its average long-run share of output. If wages were to move back towards their long-run share of output, there would therefore be a period of wages growing by less than output per worker. This may contribute to the slow increase in earnings forecast by the OBR in 2024–25 and 2025–26, in particular. In contrast, the SFC does not make assumptions about wages as a share of output, and instead is guided more by past relationships between wage growth and economic growth.

To the extent that part of the difference between the SFC's forecasts for Scottish revenues and the OBR's forecasts for rUK revenues (and hence the BGA) reflect different judgements about the UK as a whole, this represents a downside risk to Scotland's net income tax position. This is because if the more 'optimistic' implicit SFC position for the UK as a whole is borne out, the OBR will have been overly pessimistic about rUK revenues, and the BGA would be revised upwards. This would worsen the net income tax position compared to current forecasts. Conversely, if the more 'pessimistic' OBR position is borne out, Scottish tax revenues would be lower than currently forecast. This would again lead to a worse net income tax position than currently forecast.

It is entirely possible, of course, that differences in economic, employment and earnings growth are even stronger in Scotland relative to rUK than the December forecasts imply. There is a lot of uncertainty. But the potential for differences in judgements about the UK as a whole to be driving part of the current improvement in the net tax position represents a notable downside risk to the Scottish Budget. As we showed in Chapter 2, if the income tax position does not improve as forecast, the outlook for funding for public services would be significantly more challenging for the Scottish Government. The importance of the net income tax position – and hence differences between the SFC's forecasts and judgements for Scotland, and the OBR's for the UK – for the Scottish Budget mean that it would be worthwhile for the SFC and OBR to invest more time in understanding the factors leading to differences in their forecasts, and the extent to which they are Scotland-specific.

Finally, it is worth noting that while the latest forecasts show a much-improved net income tax position compared to those in May 2022, there is still a shortfall compared with what would be expected given changes in income tax policy alone. For example, the SFC forecasts that the net position will be just under +£1.1 billion in 2026–27, but the effect of tax policy alone would be to raise over £1.5 billion in revenues. This means that slower growth in the tax base (partly due to behavioural responses to tax changes, but mostly other factors) so far will be partly but not fully undone. This likely reflects the fact that the relative improvement in future employment forecasts would prevent a further fall in employment in Scotland relative to rUK, but would not significantly undo the falls seen between 2016–17 and 2021–22. It will therefore remain the case that part of the higher tax rates paid by Scottish residents will be offset by slower underlying growth in the tax base since income tax devolution.

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