

## Economic Data Inquiry

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This note is a response to the call for evidence issued on 12<sup>th</sup> June by the Economy, Jobs and Fair Work Committee, in relation to their enquiry on economic data. The note concentrates on new requirements for economic data stemming from the operation of the fiscal settlement.

There appears to have been relatively little recognition to date of the implications of the post referendum Scottish fiscal settlement for the types of decisions future Scottish Governments will be required to make: and of the effect this will have on the collection and analysis of economic data.

Central to the issues discussed here are the arrangements for indexing the abatement to the Scottish Block Grant: (the abatement is to allow for those taxes which are devolved or hypothecated to Scotland.) For the first five years of the new system, the abatement will, effectively, be adjusted in line with what is known as the Indexed Per Capita, (IPC), method. Under this method, the abatement to the block grant for income tax devolved to Scotland will be increased each year in line with the percentage growth in per capita non savings, non-dividend (NSND) income tax receipts in rUK, multiplied by Scottish population growth. After five years, there will be a review: the expectation in some quarters is that, at that stage, the indexation method will revert to the approach the Treasury favoured in the fiscal settlement negotiations: that is, the so-called Comparable Model, (CM), approach. This would expose Scotland to additional risk, that of relative population decline: (see Cuthbert<sup>1</sup> for a discussion of the relative properties of the two approaches.)

This note concentrates primarily on the implications of the IPC approach. What the block grant adjustment mechanism means is that relative economic performance, (relative, that is, to rUK), becomes a critical factor in determining the trajectory of the Scottish Budget. If Scotland fails to grow its per capita devolved tax receipts as fast as rUK, then the Scottish Budget will suffer, (compared to what Scotland would have received under the old Barnett formula.) And the effects are potentially large. According to Table 4.2 of the latest GERS report, NSND income tax in Scotland in 2016/17 was £11,313 million. So if per capita income tax receipts grow 1% more slowly in Scotland in a given year than in rUK, Scotland would take a hit on its budget of £113 million: and if the differential persisted for five years, the effect in the end year would be almost £600 million. Given that assigned VAT revenues are about half of income tax receipts, a comparative differential in the growth rate of per capita VAT receipts would have an effect roughly 50% as large.

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<sup>1</sup> "Adjusting the Block Grant Abatement: the Algebra of CM and IPC":  
Cuthbert, J. R.: Fraser of Allander Economic Commentary, vol 40, no. 3, December 2016.

Of course, Scotland would gain if it grew its per capita tax receipts more quickly than rUK. But actually, the situation is not symmetric. As will be seen below, responding to a fall in per capita devolved tax receipts relative to rUK poses particularly difficult policy decisions and risks for the Scottish Government. And it is these risks which justify the concentration in this note on the situation where per capita devolved tax receipts in Scotland grow more slowly than in rUK.

Suppose that the Scottish Government finds itself in a position where, after a period when growth in per capita devolved tax receipts had been similar to that in rUK, the Scottish growth rate in per capita devolved tax receipts dropped behind that in rUK. Then the Scottish Government has a variety of possible budgetary responses to this scenario, ranging along a spectrum.

On the one hand, it might feel that the priority is to protect public expenditure in Scotland from the squeeze implied by the effects of IPC indexation. To do this, it might raise tax rates in Scotland relative to rUK, for those taxes over which it has control: and/or, it might protect capital expenditure by borrowing, or by encouraging the use of capital expenditure funded from revenue, (like NPD schemes, or revenue funded hub schemes). As an intermediate policy response, the Scottish Government might decide to take the hit on public services implied by the indexation squeeze, while keeping devolved tax rates stable relative to rUK. And at the other extreme of the possible policy response spectrum, the Scottish Government might decide to cut taxes relative to rUK, so probably imposing an enhanced short term squeeze on public expenditure, but with the possibility that low tax rates might stimulate the economy, and restore the relative rate of growth in devolved tax receipts relative to rUK.

Which position a Scottish Government will choose to take on this policy spectrum will, of course, be heavily moderated by its political beliefs. But, in a rational world, the decision should also be underpinned by as full an understanding as possible of what factors underly the difference in growth rates of per capita devolved taxes between Scotland and rUK. In particular, a decision to protect public expenditure in the face of a decline in the relative growth rate of devolved tax receipts would make sense in a situation where there were good reasons to believe this decline was a temporary blip, which would either self-correct, or could be corrected by other policies. If, on the other hand, the decline marked the start of an adverse trend in the growth of Scottish devolved tax receipts relative to rUK, then a decision to raise Scottish tax rates in the face of such a trend could have disastrous consequences, potentially pushing Scotland into a self-reinforcing cycle of economic decline and shrinking public revenues.

It is this danger which makes it so important that the Scottish Government's budgetary and policy decisions when faced by adverse movements in the indexation of the block grant abatement are fully informed by appropriate data and analysis. Note that this is a new type of requirement, posed by the way the block grant abatement is being indexed. Under the old budgetary arrangements of the original Barnett formula, the size of the Scottish Budget

was largely independent of Scotland's relative economic performance compared with rUK.

There are a number of points about the information requirements implicit in the new system which it is important to note:-

- a) It is not enough just to have a good understanding of what is happening to the Scottish economy on its own. It will also be important to understand how the Scottish economy is performing relative to rUK. This requirement may not in itself pose any new requirements for data collection: but it will certainly pose new requirements for analysis.
- b) For both income tax, and VAT, the ratio of tax receipts to GDP for Scotland can, over quite short periods, move quite differently from the corresponding ratio for rUK. This is particularly so when Scottish GDP is calculated including a geographic share of North Sea GDP: but it is also true for the ratio of tax receipts to Scotland's non-oil GDP. What this indicates is that, in attempting to understand and forecast the relative movement in devolved tax receipts between Scotland and rUK, it will not be sufficient to rely on what is happening to movements in relative GDP. There will also need to be analysis, and understanding, of the ratio of devolved tax receipts to GDP in both Scotland and rUK.
- c) It will also be important, from an economic policy perspective, for the Scottish Government to have an understanding of how growth in different parts of the economy affects devolved tax receipts. It is quite possible, for example, that a potential area for economic growth, while it might have a significant beneficial effect on Scotland's GDP, could have relatively little effect on devolved tax receipts. Unless the Scottish Government understands the likely effect on devolved tax receipts of growth in different sectors of the economy, it will not be able to make optimal decisions, (that is, optimal within the context of the new fiscal settlement), on economic policy.

This last point raises another issue. Decisions which are optimal within the context of the new fiscal settlement might be far from optimal under other fiscal or constitutional arrangements. So responding to the rewards and incentives in the new fiscal settlement may push the Scottish Government in directions which distort the Scottish economy. Understanding such pressures will be an essential input to the review of the fiscal settlement which is due to take place after five years.

Overall, therefore, what this note suggests is that the new fiscal settlement places a new set of priorities on the collection and analysis of economic data. What will be required will be a much fuller understanding of relative economic performance relative to rUK: and specifically on the factors driving the growth in per capita devolved tax receipts in both Scotland and rUK. To highlight the urgent importance of achieving this sort of understanding, it is instructive to look at the following table, (derived from the data in Table 4.4 of the recent GERS report), which shows the year on year growth in per capita "devolved" revenues from income tax and VAT, in both Scotland and rUK.

**Year on Year Percentage Increase in Devolved Tax Revenue per head**

	Scotland				Rest of UK			
	13/14	14/15	15/16	16/17	13/14	14/15	15/16	16/17
Income Tax	3.40%	0.74%	0.92%	0.92%	2.80%	0.29%	1.90%	1.50%
VAT	8.70%	2.40%	4.40%	3.70%	4.70%	3.70%	3.80%	3.70%

The comment in the GERS report on Table 4.4 is relatively re-assuring, as follows:-

*“Whilst there are differences in growth in individual taxes between Scotland and the rest of the UK, over the five years to 2016-17, total devolved tax revenues per head in both Scotland and the rest of the UK have grown by 11%.”*

In fact, however, particularly as regards income tax, the yearly growth percentages expressed above show that, over the five year period, Scotland moved from a faster growth rate than rUK to a significantly slower growth rate. Understanding why this happened, and whether it is likely to continue, is a good illustration of the main requirement identified in this note.

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