Response to Scottish Fiscal Commission consultation on approach to first Fiscal Sustainability Report

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Preliminaries

1. Before addressing the consultation questions, I will make a number of general points even though I appreciate that the SFC and its staff are probably already aware of them.

2. There is a fundamental difference between conducting fiscal sustainability analysis for a country and doing this for a sub-national government whose funding is heavily dependent on central government grants and on central government taxation decisions. It is therefore vitally important to keep flagging up that the analysis relates not to Scotland as a geographic entity (as is the case with *Government Expenditure and Revenues in Scotland*) but to the Scottish Government. Not least, this means that very tight editorial control is required to avoid public misunderstanding. In the consultation document there is a lapse in paragraph 3.35 where the sentence begins "To understand Scottish fiscal sustainability…". Moreover, the SFC will have to put great emphasis on the distinction between short-term forecasts (which will shape Scottish Budgets) and long-term fiscal projections (subject to massive uncertainty and in reality a prompt to policy makers to take remedial action when unsustainability is revealed).

3. All fiscal sustainability modelling requires the specification of 'existing policy'. It is genuinely difficult to determine what is government policy, for example, in relation to benefits uprating and tax thresholds. In the context of a 50-year horizon, often what is claimed to be government policy is not credible. There are particular difficulties in the UK at the present time, given that there have been three Prime Ministers in 2022 and there have been six Chancellors of the Exchequer since 24 July 2019. Exactly which policy documents and which ministerial statements should be taken as continuing policy? Has the power in the *Scotland Act 2016* to partially assign VAT revenues been (thankfully) forgotten?

4. Paragraph 1.44 reads: "The Commission is restricted by its founding legislation and cannot consider the effects of policy options until the Scottish Government has a reached a firm policy decision." This raises two questions: (a) are these restrictions different from those affecting the Office for Budget Responsibility and the Northern Ireland Fiscal Council?; and (b) what legislative changes would relax such constraints, particularly as 'not taking decisions' can become government policy (eg allowing fiscal drag to increase tax revenues and not fully indexing benefits to reduce real-terms expenditure)?

5. The above considerations matter because fiscal sustainability modelling for the Scottish Government is massively affected by relativities in relation to the UK Government. This does not mean that the SFC cannot produce a useful document (the Northern Ireland Fiscal Council has already done this) but it does mean that the exercise is subject to huge uncertainties which have to be communicated to the public.

6. My own reaction to the 23 September 2022 abolition of the Additional Rate of rUK Income Tax was that, in financial as opposed to presentational terms, this was relatively unimportant, costing £2 billion out of tax cuts of £45 billion. The Additional Rate was introduced as a temporary measure during the global financial crisis (temporary tax measures have a habit of sticking), and I have long taken the view that the level of the highest marginal rate is less important than whether the relevant tax base is secure from avoidance and evasion. However, if this abolition had been implemented, it would have put huge pressure on the Scottish Government to reduce or abolish the Scottish Top Rate. Small differences in Scottish and rUK income tax rates are sustainable, but whether this would apply to a difference between 46% and 40% is questionable. The conclusion I drew was that the then UK Government either did not understand, or not care about, the devolved fiscal settlement.

7. There is considerable discussion in the consultation document about demography relative to rUK. There are two other issues to which I would draw attention. First, in broad terms, there is a shift in economic prosperity within Scotland from west to east, while North East Scotland, which makes a large contribution to Scottish Income Tax revenues, is suffering relative decline. Even if Scotland's total population were to be flat, this geographic redistribution creates problems both in prospering areas (new infrastructure is required) and declining areas (managing decline is difficult, especially if there is differential out-migration). Second, when considering trends in Scottish population relative to rUK, out-migration from Scotland to rUK might have a large component of graduates educated from the Scottish Budget. This is also a problem for English regions outside the wider south east, but the Scottish Fiscal Framework means that loss of higher earners has a direct impact on the Scottish Budget.

8. The Northern Ireland Fiscal Council has produced a guide to Northern Ireland public finances, making distinctions between where provision is at parity with Great Britain and where provision is above or below parity. There are several cases of above-parity provision and few of below-parity provision. A valuable aspect of the Scottish Fiscal Framework is the ability of the Scottish Government to diverge from rUK policy. Nevertheless, such upward divergence, both on public services and on social security, creates budgetary risks from unpredictability and from the fact that such divergence has to be funded out of the Barnett consequentials generated by other programmes.

9. I commend the SFC for putting this project out to public consultation and I am impressed by the thoroughness of the exposition in the consultation document. I respond below on the numbered questions.

Q1. Is our approach to projecting Scottish Government funding appropriate?

I agree that OSCAR, PESA, Block Grant Transparency reports and UK Spending Reviews (together with other fiscal events) are the appropriate sources. Wherever possible, there should be alignment with OBR modelling assumptions, and, where there is good reason for diverging, the numerical effects of divergence should be disclosed. This will require a measure of collaborative working with the OBR which, for its own purposes, may not require the same level of granularity. There will also have to be collaboration with HMRC for which establishing who are Scottish taxpayers is not as mission-critical as the results are for the Scottish Government.

Q2. Is our approach to projecting Scottish Government spending appropriate?

I have commented in 'Preliminaries' above about the internal demography of Scotland and about the importance of monitoring expenditure which is above parity. This is not an argument that above-parity items are undesirable but that they represent a significant budgetary risk, especially if not carefully monitored.

Q3. Is the annual budget gap reasonable to use as our main sustainability measure?

Given the parameters of this fiscal sustainability analysis (ie the Scottish Government, not Scotland as a geographic entity), expressing budget shortfalls as a percentage of GDP is irrelevant. Unlike sovereign governments the Scottish Government does not have access to the full range of tax and borrowing instruments. Moreover, expressing as a percentage of Scottish GDP would understate the size of the budgetary problem. The budget gap should be expressed as a percentage of projected expenditure.

Q4. Are our stress tests useful for testing the robustness of the fiscal position?

I am satisfied with what the SFC proposes for the first Fiscal Sustainability Report. In Preliminaries above, I have emphasised the vulnerability of the Scottish Budget to factors outside the control of the Scottish Government and the increased uncertainty about future UK fiscal direction resulting from the turnover of governments and ministers.

Q5. Are readers content with our focus on demographics for our first FSR in 2023?

Demography relative to rUK is of fundamental importance to Scottish public finances. In Preliminaries above I have emphasised that within-Scotland demography and differential out-migration are relevant to the fiscal position of the Scottish Government.

Q6. What topics should we focus on for future FSRs?

The suggestions in the prompts provided to respondents are all reasonable. I would prefer to reserve judgement on the choice between them until after the publication of the first Fiscal Sustainability Report. Taking a different major topic in successive reports is a way of combining thoroughness with comprehensive coverage over a period of time.

Q7. How should we use stress tests to assess Scottish Government fiscal sustainability?

As emphasised in Preliminaries above, there are massive uncertainties about the future of UK public finances, both in terms of UK Government policy preferences and what the debt and foreign exchange markets will tolerate. When undertaking sensitivity analysis, I would advise wider margins than usual on both rUK tax policy relevant to the taxes devolved to the Scottish Government and on rUK expenditure that feeds through the Barnett formula. The latest UK Spending Review, as recent as 27 October 2021, appears to have been superseded by recent events.

Q8. Is our scope fitting for the aims of our FSR?

The proposed scope is appropriate. Much effort will be required on the part of the SFC to communicate clearly the results of the fiscal sustainability analysis to the Scottish Government, Scottish Parliament, media and other stakeholders.

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