

Chapter 1

Introduction

What is in this report?

- 1.1 This report presents economic and fiscal forecasts to inform the Scottish Government's Medium Term Financial Outlook published on 31 May 2018. This is the second set of official, independent forecasts produced by the Scottish Fiscal Commission. Our first forecasts were produced in December 2017 for the Scottish Draft Budget 2018-19.¹ We produced a supplementary income tax forecast in February based on changes announced by the Scottish Government to the Draft Budget 2018-19.² The Commission is required to produce at least two sets of forecasts a year, as set out in the Scottish Fiscal Commission Act 2016.
- 1.2 Alongside the Commission's forecasts, the report provides a full explanation of all assumptions and judgements made as part of the forecasting process. We also set out what has changed since the last set of forecasts we produced in December 2017.
- 1.3 The report is divided into the following sections:
 - Summary – a standalone, non-technical, high-level summary of the forecasts produced by the Commission, and the main assumptions and judgements that underpin them.
 - Economy Chapter – a chapter which sets out the Commission's five-year forecasts for the Scottish economy, including the underlying judgements and sensitivity analysis where appropriate. This includes an assessment of whether the Commission has forecast a 'Scotland-specific economic shock' which would mean that that the Scottish Government would be

¹ Scottish Fiscal Commission (2017) Scotland's Economic and Fiscal Forecasts December 2017 ([link](#))

² Scottish Fiscal Commission (2018) Supplementary Budget Bill Publication January 2018 ([link](#))

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able to access additional borrowing under the terms of the Fiscal Framework.

- Tax Chapter – a chapter presenting the Commission’s five-year forecasts of receipts from the fully and partially devolved taxes within our remit, covering:
 - Non-Savings Non-Dividend Income Tax
 - Non-Domestic Rates
 - Land and Buildings Transaction Tax
 - Scottish Landfill Tax
 - Scottish share of Air Passenger Duty
- Social Security Chapter – a chapter presenting the Commission’s forecasts for devolved social security expenditure:³
 - Carer’s Allowance and the Carer’s Allowance Supplement
 - Discretionary Housing Payments
 - Scottish Welfare Fund
 - Employability Services
 - Funeral Payments
 - Healthy Start Vouchers
 - Sure Start Maternity Grant
- Borrowing Chapter – A chapter which fulfils the Commission’s duty to assess whether the Scottish Government’s projections of borrowing are reasonable. The Government’s capital and resource borrowing plans are assessed against the limits set out under Scotland Act 2016 and the associated Fiscal Framework. The position of the Scotland Reserve is also considered.
- Annex A: Policy Costings – An Annex containing detail for all the policy costings the Commission has produced for this set of forecasts. This shows how much any individual policy will cost or raise, and how the Commission has arrived at that estimate.
- Annex B: Policy Re-Costings – An Annex containing revised estimates of costings for policies previously costed. Re-costings may be required due to new outturn data or revisions to key assumptions and judgements
- Annex C: Developing our approach to forecasting VAT – An Annex setting out how we propose to forecast VAT receipts and the planned development work ahead of the publication of our first VAT forecasts in December 2018.

³ The Commission’s specific role is defined in the Scottish Fiscal Commission (Modification of Functions) Regulations 2017 ([link](#))

Limitations of forecasting

- 1.4 The future is highly uncertain. The past is an imperfect guide to the future in a rapidly changing global economic, social, political and technological environment. Analytical models, based on historic data and theory, can help provide some insight into how the economy and public sector finances may change over time, but all have limitations. Forecasts cannot perfectly predict the future – the Commission’s forecasts aim to present a balanced pathway through a broad range of possible outcomes.
- 1.5 There will exist a range of valid approaches on each of these issues and so the Commission is required to make judgments where appropriate. Our forecasts will evolve over time. In each section we have set out how our forecasts have changed since the last forecasts in December and explained the reasons driving those changes.
- 1.6 Forecasting is an on-going process of intelligence gathering, learning from previous forecasts, reflection and refinement. Judgements will be made on the basis of the best evidence and intelligence available at the time of publication, but may change from one forecast to the next as the economy evolves and our understanding develops along with it.

Box 1.1: OBR Forecasting – uncertainties and challenges

The Office for Budget Responsibility (OBR) is the UK Independent Fiscal Institution (IFI) which was established in 2010. Twice a year they provide a detailed central forecast for the economy and the public finances. These forecasts are designed to provide a transparent benchmark against which to judge the significance of new economic and fiscal data, and against which to estimate and explain the likely impact of policy decisions.

The OBR emphasise in every Economic and Fiscal Outlook⁴ that since the future can never be known with precision, all such forecasts are necessarily surrounded by uncertainty. Like many IFIs, the Commission is required to evaluate its forecasts. Similarly the OBR produce an evaluation of their forecasts once a year in their Forecast Evaluation Report (FER) and highlight how “the likelihood that any given forecast will turn out to be accurate in all respects is essentially negligible”.⁵

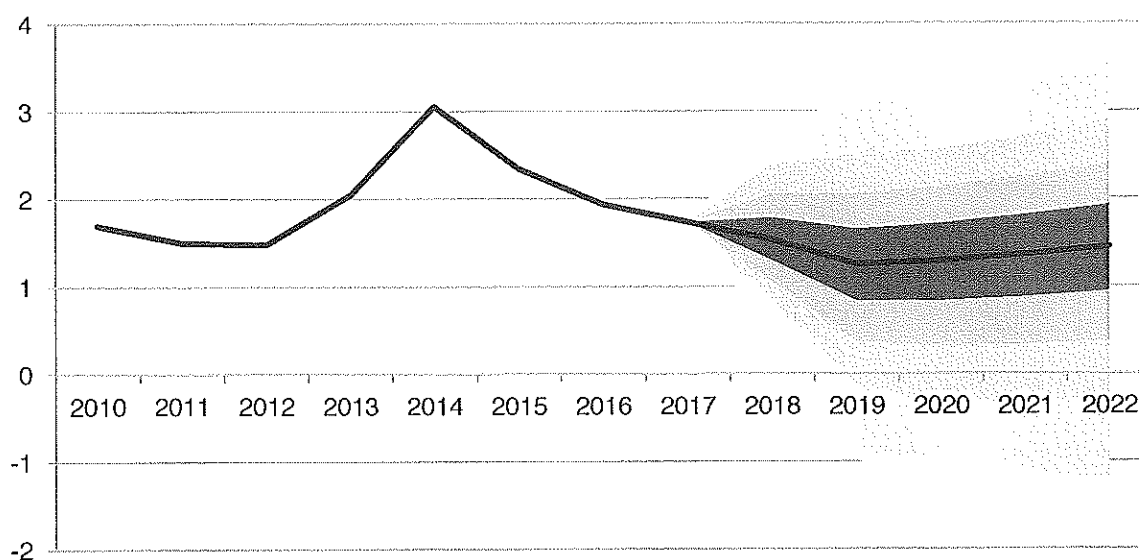
⁴ OBR (2018) Economic and Fiscal Outlook, March 2018 ([link](#))

⁵ OBR (2017) Forecast Evaluation Report, October 2017 ([link](#))

The OBR seek to present this uncertainty at each fiscal event.⁶ In common with many forecasters the OBR publish a 'fan chart' such as Figure 1.1 that illustrates the uncertainty in their economy forecast. These charts are usually drawn using information on historical forecast errors. As these are only the Commission's second forecasts we are not in a position to provide similar charts.

However, the Commission will follow the OBR and many other forecasters in giving an insight to forecast uncertainty by discussing the sensitivity of our forecasts to alternative assumptions and the risk factors for our forecasts.

Figure 1.1: OBR's GDP growth forecast



Source: OBR (2017) Economic and Fiscal Outlook, March 2017 ([link](#))

Background to the Commission

1.7 In April 2017 the Scottish Fiscal Commission became responsible for producing independent economic and fiscal forecasts to inform the Scottish Budget.

1.8 The Commission produces independent forecasts of:

- Revenue from fully devolved taxes;
- Non-savings non-dividend income tax receipts;

⁶ OBR (2012) Briefing Paper 4: How we present uncertainty, June 2012 ([link](#))

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- Onshore Gross Domestic Product (GDP) in Scotland; and
- Devolved social security expenditure.⁷

- 1.9 Regulations to amend our functions to include VAT forecasting are currently being considered by the Scottish Parliament.
- 1.10 The Commission will produce forecasts at least twice a year. We will also produce annual Forecast Evaluation Reports, and will from time to time publish working papers on related subjects.
- 1.11 The Scottish Fiscal Commission is structurally and operationally independent of the Scottish Government. More details about the remit and history of the Commission, including previous publications, can be found on our website: www.fiscalcommission.scot.
- 1.12 The Commission was previously a non-statutory body, established in 2014 to scrutinise Scottish Government forecasts of devolved taxes following the Scotland Act 2012. In December 2016, the Commission found the Scottish Government's forecasts of non-savings non-dividend Income Tax, Land and Buildings Transaction Tax and Scottish Landfill Tax to be reasonable. We also had a role in scrutinising the buoyancy and inflation elements of the Non-Domestic Rates forecast, which we also found to be reasonable.⁸

Box 1.2: Commission Forecasts and the Fiscal Framework

The Scottish Fiscal Commission's forecasts are an important component in determining the total budget that is available to the Scottish Government to spend in each fiscal year. However, it is important to remember that they are not the only relevant forecasts.

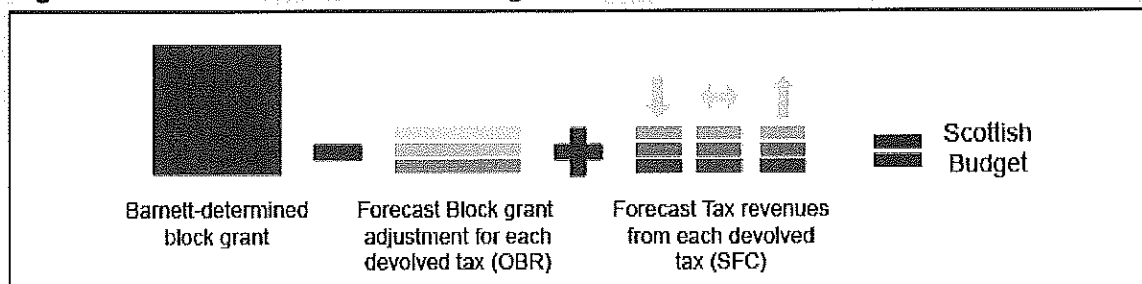
The diagram below is a stylised representation of the way the Scottish Budget will be determined under the Fiscal Framework agreed alongside the Scotland Act 2016. The forecast block grant adjustment (BGA) changes are based on OBR forecasts of UK Government receipts of corresponding taxes, they do not relate to the OBR's forecasts of Scottish taxes. These UK Government receipts forecasts are then used by the UK and Scottish Government to calculate the BGAs, in which process the OBR has no involvement.

The Scottish Government has published estimates of the Block Grant Adjustments from 2017-18 up to 2021-22. Table 1.1. shows a comparison of our forecasts to the most up to date BGA estimates for income tax, LBTT and Scottish Landfill Tax.

⁷ The Commission's specific role in social security forecasting is defined in the Scottish Fiscal Commission (Modification of Functions) Regulations 2017 ([link](#))

⁸ Scottish Fiscal Commission (2016) non-statutory Report of Draft Budget 2017-18 ([link](#))

Figure 1.2 How is the Scottish Budget Determined?



Source: SPICe Briefing (2017) UK Autumn Budget 2017 – impact on Scotland ([link](#))

Table 1.1: Comparison of forecasts to BGA estimates

£ million		2017-18	2018-19	2019-20	2020-21	2021-22
Income Tax	SFC Forecast	11,467	11,969	12,345	12,805	13,335
	BGA*	11,571	11,873	12,157	12,553	12,954
LBTT	SFC Forecast	550	614	656	697	738
	BGA*	586	588	606	630	656
Scottish Landfill Tax	SFC Forecast	142	114	93	95	87
	BGA*	104	106	91	81	77
Total	SFC Forecast	12,159	12,697	13,093	13,596	14,160
	BGA*	12,261	12,567	12,854	13,264	13,687

Source: Scottish Fiscal Commission, Scottish Government 2018 Block Grant Adjustment Estimates written letter ([link](#))

*Estimates are based on Indexed Per Capita methodology

Taxes which were devolved before the Scotland Acts 2012 and 2016, such as Council Tax and Non-Domestic Rates Income (NDRi), are outwith the Fiscal Framework and so have no impact on the Block Grant. This means there is no indexation mechanism with equivalent UK Government taxes. The Commission has been tasked with producing a forecast of NDRi, but is not responsible for forecasting Council Tax.

Only some social security benefits will have corresponding BGAs, smaller benefits, including all those already devolved, will result in additions to the block grant which are indexed using the Barnett formula and do not directly correspond to UK Government expenditure on the same benefit. As further taxes and social security benefits are devolved, and corresponding block grant adjustments agreed we will include detail on these in our future publications.

Budget Process

- 1.13 In developing these forecasts, the Commission has engaged with the Scottish Government by following the process set out in the agreed and published Protocol between the organisations.⁹ This Protocol has been revised to reflect our experiences in our first year of statutory operation and the changes to the budget process which have since been agreed.
- 1.14 We have also added arrangements for the publication of forecasts to accompany primary or secondary legislation which affects revenue raised from a tax or expenditure on social security payments within the Commission's remit. Our first forecasts to accompany secondary legislation were published on 17 May to accompany the introduction of the Scottish Government's secondary legislation on Group Relief.
- 1.15 Since formal notification of the date of the Medium Term Financial Outlook in March, the Commission has had several rounds of meetings to discuss our pre-measures forecasts. These have included discussions with the Scottish Government, Revenue Scotland, the Office for Budget Responsibility and HMRC.
- 1.16 Headline dates of interest are:
- 8 May: The Scottish Government presented the Commission with all finalised policy measures and economy moving measures.
 - 16 May: The Commission presented the Scottish Government with final forecasts to allow the finalisation of the Medium Term Financial Outlook.
 - 24 May: The Commission's report was shared with the Cabinet Secretary for Finance and Constitution.
 - 29 May: Formal Meeting between Lady Rice, Chair of the Commission and Cabinet Secretary took place
 - 31 May: Commission report published.
- 1.17 In accordance with the Protocol, more detail of timings and attendees at different rounds of meetings is published on our website.¹⁰
- 1.18 The Commission's final forecasts were provided to the Scottish Government on the 16 May. The economy forecasts were finalised on the 11 May to allow inclusion into the fiscal forecasts. To produce all our forecasts new data and information published after a certain date are not included in our forecasts.

⁹ Protocol for engagement between the Scottish Fiscal Commission and the Scottish Government Version 2.0 published March 2018 ([link](#))

¹⁰ Scottish Fiscal Commission (2018) Scottish Economic and Fiscal Forecasts May 2017 [ADD LINK](#)

Box 1.3 provides further information on the inclusion of data releases in our forecasts.

Box 1.3: Data inclusion in our forecasts

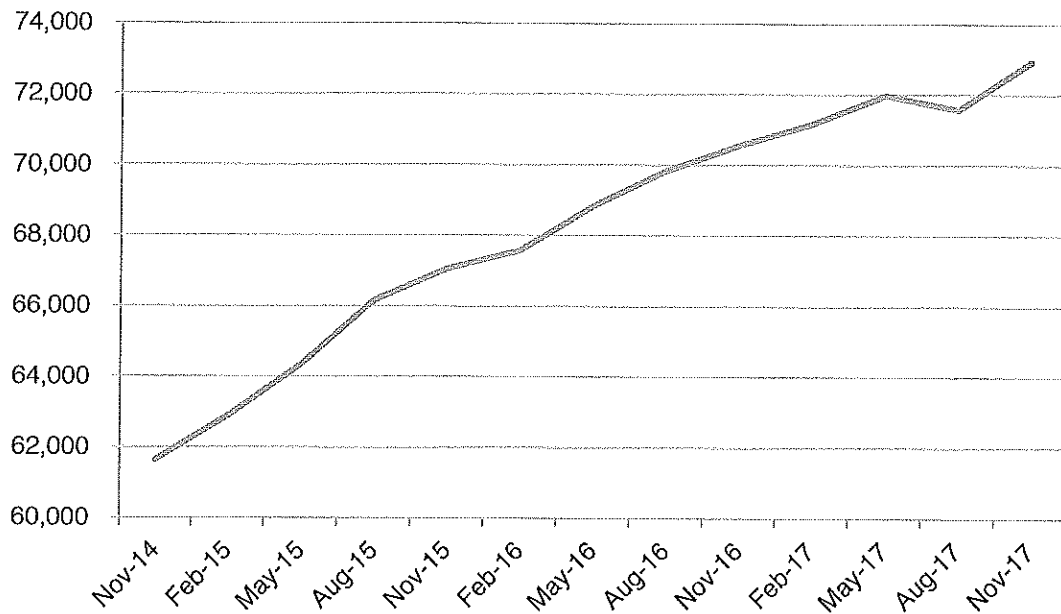
The Commission develops its forecasts over a number of months in the run up the date of publication. Over this period, new data will be published and historic values revised. The Commission will do its best to include all new data and revisions in its forecasts. However, there will be a series of data cut-off points for the inclusion of new data prior to publication. The cut-off points need to weigh in the balance the importance of a particular data publication and its potential impact on the forecast against allowing sufficient time for forecasts, analysis and documents to be finalised.

In some instances where there is insufficient time to include new data, we may still consider more broadly what the new data are telling us and adjust our judgements accordingly.

For May 2018, our core economy forecasting model was updated to include GDP and QNAS published for 2017 Q3 in February. We adjusted our forecast to account for GDP published for 2017 Q4, but the historic revisions published alongside 2017 Q4 were not included due to time constraints. This creates some slight inconsistencies between the latest available published data and some of our values. In the body of our report, outturn is as the latest available data including revisions. In our supplementary tables, the values are drawn directly from our core forecasting model, including the historic series, and this may introduce some slight presentational inconsistencies in the historic data. This issue only applies to revised historic data and does not affect the Commissions forecasts.

Our Carer's Allowance forecasts were finalised on the 14 May, a day before DWP released new caseload data for November 2017. This data point was therefore not included in our forecasts. The Commission also decided not to include an earlier data point for August 2017 in our forecasts, this quarter of data showed a fall in the number of individuals in receipt of Carer's Allowance. This did not tally with our expectation or understanding of the likely changes in the number of individuals receiving Carer's Allowance payments. In the absence of information explaining the fall, we chose not to include it. The subsequent release on the 15 May showed an increase in claimants and a return to the previous trend. The Commission will continue to monitor data as they become available and we will review our judgements in future forecasts.

Figure 1.3: Carer's Allowance Caseload



Source: DWP's StatXplore ([link](#))

Professional Standards

- 1.19 The Commission is committed to fulfilling our role as an Independent Fiscal Institution (IFI), in line with the principles set out by the OECD for these institutions.¹¹
- 1.20 The Commission also seeks to adhere to the highest standards for analysis possible. While we do not produce official statistics as we produce forecasts, the Commission and our work voluntarily complies as much as possible with the principles of the Code of Practice for Official Statistics.
- 1.21 The Commission has published a statement on our compliance with the Code of Practice for Official Statistics on our website. This sets out how the Commission demonstrates voluntary compliance with as many parts of the code as possible.¹²

Comments & Contact

¹¹ OCED Recommendation on Principles for Independent Fiscal Institutions ([link](#))

¹² Scottish Fiscal Commission (2018) Compliance with the Code of Practice for Official Statistics ([link](#))

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- 1.22 This is the second set of forecasts produced by the Commission. We welcome comments from users about the content and format of our publications. In particular, if there are particular analyses, or disaggregations of data which users would find useful as part of future forecast reports, please let us know.
- 1.23 All charts and tables in this publication have also been made available in spreadsheet form on our website.¹³ If you have any feedback, or would like to request further information about any of our analysis, please email info@fiscalcommission.scot.

¹³ Scottish Fiscal Commission (2017) Scottish Economic and Fiscal Forecasts December 2017 ([link](#))

Comments relating to the Chapter 1 – Introduction PDF

Box 1.2: Commission Forecasts and the Fiscal Framework – page 5

It is forecasts at Budget Bill that directly impact the Scottish Government's Budget, as they determine how much initially is assigned to the Scottish Government's budget for income tax and later VAT. MTFO forecasts have no direct impact in determining the Scottish Government's budget.

I would suggest changing to 'Scottish Fiscal Commission's Forecasts at Budget Bill...' to clarify this.

Table 1.1: Comparison of forecasts to BGA estimates – page 6

Until outturn data for 16-17 income tax receipts is available, the UK and Scottish Governments have agreed to use the SFC's 16-17 forecast for income tax receipts in Scotland to inform the block grant adjustments for income tax. The Commission has revised this forecast from £11,214m at Budget Bill to £11,267m.

The latest BGA estimates therefore need to be reprofiled using £11,267m as the baseline adjustment. Using the latest data available at Spring Statement for indexation thereafter results in the following indicative estimates:

2017-18 = 11,626

2018-19 = 11,930

2019-20 = 12,215

2020-21 = 12,612

2021-22 = 13,015

2022-23 = 13,531

9 of 11 benefits that will be administered by the Scottish Government will have corresponding block grant adjustments (n.b. discretionary housing payments are administered by local authorities). 2 benefits will be transferred through machinery of government transfers and then normal application of the Barnett formula (i.e. indexation to a population share of corresponding UK Government changes in expenditure).

So I would suggest 'most social security benefits will have corresponding block grant adjustments although some smaller benefits will be funded through machinery of government transfers and then the normal application of the Barnett formula.'

I'm not sure I understand the point that benefits funded through MoG will 'not directly correspond to UK Government expenditure'. In a sense neither the BGAs nor Barnett directly correspond to UKG expenditure, in that both methodologies are initial baseline additions to the block grant and then grown in line with relative change in UKG expenditure.

N.B. Barnett in this case has two Ts.

1.14 – page 7

Is 1.14 font different to other text?

1.16 – Bullet 4 – page 7

1.16 29 may no meeting is taking place