Scottish Income Tax Ready Reckoners for 2022-23

Office of the Chief Economic Adviser

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Summary

This note presents a set of ready reckoners which show the estimated revenue impact of illustrative changes to Scottish Income Tax policy in 2022-23. These are intended to assist researchers and policymakers, improve transparency and facilitate public understanding in this area. The note complements similar publications by HMRC and the Welsh Government[1] and updates the ready reckoners presented in our 2017 publication *The Role of Income Tax in Scotland's Budget* and following the 2021-22 Scottish Budget.[2]

Official forecasts of Scottish Income Tax policy are produced by the Scottish Fiscal Commission (SFC) and therefore these ready reckoners are indicative.

The ready reckoners only show the direct impact on Scottish Income Tax liabilities and do not include any wider effects on the Scottish economy, other devolved or local receipts, or UK Government revenues. They do, however, factor in taxpayers' behavioural responses, such as decisions whether to work or not; how many hours to work; whether to incorporate and pay business related taxes; or whether to re-locate to or from other parts of the UK or the world.

Table 1: Scottish Income Tax Ready Reckoners, 2022-23

Income Tax Policy changes	Estimated change in revenue (£m)
Rate Changes	
Increase Starter Rate by 1p	54
Increase Basic Rate by 1p	192
Increase Intermediate Rate by 1p	147
Increase Higher Rate by 1p	70
Increase Top Rate by 1p*	Negligible
Decrease Top Rate by 1p*	Negligible
Income Tax Threshold or Band Changes	
Freeze the Starter Rate Band	2
Reduce the Starter Rate Band by £100	4
Freeze the Basic Rate Band	5
Reduce the Basic Rate Band by £1,000	18
Reduce the Top Rate Threshold by £10,000*	Negligible
*Changes to the Top Rate or Threshold produced very small revenue estimates, and the exact magnitude and direction of which are highly uncertain. The impact could feasibly be positive or negative for any of the policy changes costed.	

[1] See for example HMRC's Ready Reckoners and Welsh Income Tax Ready Reckoners (Annex 1).
[2] The Role of Income Tax in Scotland's Budget, page 23

The Scottish Parliament has the power to set Income Tax rates and bands for the non-savings non dividend (NSND) income of Scottish taxpayers. The responsibility for defining the Income Tax base, which includes the setting or changing of Income Tax reliefs and exemptions, and the tax-free Personal Allowance, remains reserved to the UK Parliament. Income Tax on savings and dividends is also reserved.

The Income Tax ready reckoners provide an order of magnitude of how much revenue could be raised in addition to the existing policy for 2022-23, by varying each of the components for which the Scottish Parliament has devolved powers. They can be used to understand the impacts of tax policy proposals in terms of the additional cost or benefit to the Scottish Budget:

- The revenue implications of any combination of policies can be broadly estimated by summing the impact of each individual change. For example, a policy which adds 1p to each rate would raise around £461 million. However, if thresholds are changed substantially, and combined with rate changes, there might be interactions which mean that the policy effects are not purely additive.
- The estimates can also be scaled up or down to some extent, in that a 2p rise in a tax rate will raise twice as much as a 1p increase. For example, a 2p increase in the Higher Rate would raise around £140 million. This approach is reasonable for changes of up to a few percentage points. However, caution has to be applied when assessing larger changes, particularly to the Top Rate of Income Tax, as top earners are much more responsive to tax changes. In this instance, there is also a greater risk of forestalling, which occurs when taxpayers bring forward their income to minimise their tax liability. The greater the time between the announcement of a tax increase and its implementation, the greater the risk of lost revenue.
- However, threshold changes cannot be scaled up or down as easily, as any change in the band or threshold would affect the cost base itself, i.e. the number of taxpayers affected by the policy. The table therefore presents estimates for different reductions in the bands and thresholds.
- For rate changes, the impacts of tax increases and tax cuts are also broadly symmetric so that a 1p cut in the Intermediate Rate would cost around £147 million. However, caution needs to be applied for threshold changes where the effects of increases and decreases are not fully symmetric.
- In the case of the Top Rate, revenue effects are particularly uncertain as there is a risk that behavioural responses might significantly reduce the additional yield, or costs, from a rate change. Based on the SFC's current behavioural framework, these policies would have a negligible impact on tax revenues. The revenue effects of changes to the Top Rate are discussed in more detail in the Scottish Government's December 2021 evaluation of Income Tax policy.[3]
- No policy changes to the Higher Rate Threshold have been costed, as the Higher Rate Threshold has already been frozen in 2022-23.[4] All the estimated revenue impacts above already assume the Higher Rate Threshold is frozen in 2022-23.

[3] Scottish Government, *Scottish Income Tax: 2018-19 Policy Evaluation*, December 2021
[4] The SFC estimate the freeze to the Higher Rate Threshold in 2022-23 will raise an additional £106 million in 2022-23.

Tax receipts depend on a number of key economic variables, most importantly growth in the working-age population, earnings and employment. The estimates in the table are consistent with the latest economic forecasts by the SFC from December 2021. The responsibility for forecasting Scottish Income Tax receipts, including policy costings for official Government policies, lies with the SFC. While the above ready reckoners have been produced in line with the SFC's general framework and assumptions for policy costings[5], in practice the SFC costs policies on a case by case basis, taking into account the details of each individual policy and the wider economic context. The ready reckoners in the table should therefore be used to provide only an indication of the revenue impacts, as the SFC's final policy costings could be different.

Methodology

The ready reckoners are estimated using the Scottish Government's internal Income Tax model, which is closely aligned with the SFC's forecasting model and runs on 2018-19 data from HMRC's Survey of Personal Incomes (SPI). The SPI comprises a detailed sample of over 40,000 anonymised Scottish tax records, which are weighted to be representative of all Scottish taxpayers.

All ready reckoners show the impact of illustrative changes over a counterfactual, or baseline forecast,which assumes that Income Tax thresholds and bands for 2022-23 increase in line with September 2021 CPI inflation (3.1%), except for the Higher Rate and Top Rate Thresholds which remain fixed at £43,662 and £150,000 respectively. This pre-measures forecast is consistent with the SFC's published forecast at the Scottish Budget on 9 December 2021. The tax parameters in the baseline forecast are summarised overleaf.

Table 2: Scottish Income Tax Policy, 2022-23

Rate Name	Income Range	Rate
Starter Rate	Over £12,570 - £14,732	19%
Basic Rate	Over £14,732 - £25,688	20%
Intermediate Rate	Over £25,688 - £43,662	21%
Higher Rate	Over £43,662 - £150,000	41%
Top Rate	Above £150,000	46%

Following the SFC's methodology, the ready reckoners are built up in two steps. Firstly, we identify and estimate the number of taxpayers affected by the policy change and compare their tax liability before and after the tax change, assuming there is no behavioural response. This is called a static estimate.

The second step involves estimating taxpayers' behavioural responses to calculate the final, post-behavioural, estimate. The scale of taxpayers' behavioural responses to policy changes remains a highly debated and uncertain issue. The empirical literature suggests that responsiveness increases with income because top earners have greater means and incentives to limit their tax liabilities. Behavioural responses cover a wide range of taxpayers' actions, including: decisions to seek work or adapt the number of hours worked; in/out-migration; and

[5] See Scottish Fiscal Commission, *How We Forecast Income Tax*, May 2021

tax planning, avoidance and evasion. Further detail is available in our 2020 review of the academic literature.[6]

Taxpayers' responsiveness to changes in Income Tax policy are estimated through taxable income elasticities (TIEs), which measure the percentage change in taxable income in response to a one per cent change in the net of tax rate. The more responsive taxpayers are, the greater the TIE. For the purpose of this note, we adopted the TIEs currently used by the SFC for their policy costings, shown in Table 3 below.

Table 3: Scottish Taxable Income Elasticities[7]

Income Range	Taxable Income Elasticity
Below the Basic Rate Limit	0.015
Basic Rate Limit to £80,000	0.1
£80,0001 to £150,000	0.2
£150,000 to £300,000	0.35
£300,001 to £500,000	0.55
Above £500,000	0.75

In addition, the SFC's methodology also accounts for tax induced cross border migration and behavioural responses resulting from interactions with reserved policies. An example of this is the current misalignment of the Scottish Higher Rate Threshold and the Upper Earnings Limit for National Insurance Contributions, which means Scottish taxpayers pay a higher combined marginal NICs and Income Tax rate on a certain segment of their income compared to their rUK counterparts.

Areas of uncertainty

There are a number of uncertainties when it comes to producing ready reckoners. The first is in the scale of the behavioural response. New analysis published by HMRC in December 2021 used the change in Scottish Income Tax policy in 2018-19 to estimate empirically the scale of Scottish taxpayers' behavioural response to policy changes.[8] While the estimates produced by HMRC are largely consistent with the behavioural parameters used by the SFC – themselves based on a range of international studies – they showed a high degree of uncertainty in the estimates of behavioural responses for Top Rate taxpayers. As noted above, under the SFC's current behavioural parameters, small changes to the Top Rate of Income Tax have a minimal impact on revenue, and the exact magnitude of any revenue impacts from a policy change remains highly uncertain. The impact of new estimates of taxable income elasticities on revenue estimates is discussed in more detail in the evaluation of Scottish Income Tax policy published by the Scottish Government in December 2021.[9]

[6] Scottish Government, *Understanding the Behavioural Effects from Income Tax Changes*, February 2020
[7] Scottish Fiscal Commission, *How We Forecast Income Tax*, May 2021, p17
[8] HMRC, *Estimating Scottish taxpayer behaviour in response to Scottish Income Tax changes introduced in 2018 to 2019*, December 2021
[9] Scottish Government, *Scottish Income Tax: 2018-19 Policy Evaluation*, December 2021

The second major area of uncertainty relates to the economic assumptions underpinning the costings. While the SFC's forecasts from December 2021 incorporate the economic impact of COVID-19, any forecast produced under the current circumstances is subject to a much greater degree of uncertainty and crucially depends on the future path of the pandemic.

COVID-19 is likely to have reshaped the structure of the labour market and therefore the Income Tax base. Since the Income Tax model remains based on pre-COVID tax data, this is not fully reflected in the latest forecasts. We expect Income Tax outturn data for 2020-21, due to be published in July 2022, to provide an initial picture of how COVID-19 has affected the tax base.

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