What will this week's labour market data tell us about the outlook for Scottish income tax revenues?

In a little over six weeks, the transfer of Scotland's new income tax powers will be complete.

With this in mind, each new release of economic or labour market data will now have even greater significance than before. Crucially they will give us an early – albeit imperfect – indicator of whether the Scottish economy is likely to be generating the revenues policymakers are hoping for.

The new fiscal framework

The fiscal framework governs how the mix of the remaining block grant, the block grant adjustment and Scottish devolved tax revenues will operate.

The Scottish Government's block grant will continue to be determined by the Barnett Formula – the formula that allocates to Scotland a population share of changes in 'comparable spending' in England.

But the Barnett block grant is being adjusted to reflect the fact that income tax revenues collected in Scotland will – from April – be directly transferred to the Scottish Government. This 'block grant adjustment' (BGA) can be interpreted as a counterfactual estimate of the revenues that the UK Government will forgo as a result of transferring the tax to the Scottish Government.

At the outset, this is straightforward with the initial deduction simply equal to the estimated income tax collected in Scotland last year. But what happens from this point on? If it was to remain fixed in cash terms its value would be eroded over time. Ultimately, and after much negotiation, the two governments agreed that the BGA would grow in line with the growth in UK income tax receipts per head (at least up until the scheme is reviewed in 2021).

So what does this mean? In effect, all the complex analysis ends up with a simple result. If Scotland can grow its income tax revenues per head more quickly than in the UK this will more than offset the BGA, and the Scottish Budget will be better off compared to under Barnett.

But on the other hand, if Scottish tax receipts grow more slowly, then Scotland will be worse off.

This point can't be emphasised enough – what now matters for future Scottish Budgets is not just Scotland's absolute economic performance but crucially how we are faring compared to the UK.

Current Scottish Government forecasts

So how are the forecasts for Scottish tax revenues shaping up compared to the UK?

For the first time, in the December Draft Budget the Scottish Government set out its forecasts for Scottish income tax revenues up to 2021-22. In the Autumn Statement, the OBR forecast revenues for the equivalent income tax in the rUK.

Backing out these two sets of forecasts is extremely difficult. In part, because the Scottish Government's approach to forecasting is slightly different to the OBR's but also because the Scottish Government choose to lump together its forecasts for tax revenue growth alongside the increase it hopes to receive from its decision to freeze the higher rate threshold below that of the UK. As we highlighted in a blog here, breaking out these determinants of tax revenue changes is vital to deliver transparency.

Looking at these two forecasts we see that Scottish income tax revenues are forecast to grow slightly more quickly than the equivalent BGA (i.e. faster than equivalent growth in the UK) for the foreseeable future. However, we don't know to what extent this is because of policy differences, differences in the growth of underlying determinants, or methodological differences used in the modelling.

To better understand what is driving the results, it is helpful to look at the assumptions underpinning the forecasts.

In terms of economic growth, the Scottish Government is forecasting growth in Scotland to be broadly in line with the UK over the next couple of years – with growth of 1.3% and 1.6% in 2017/18 and 2018/19 respectively compared to UK growth of 1.4% in 2017/18 and 1.7% in 2018/19.

In terms of earnings, the Scottish Government's forecasts are derived from the OBR's forecasts for UK wages and salaries growth on the grounds that UK and Scottish earnings tend to be strongly correlated. As a result "Scottish wages are therefore assumed to grow in line with the corresponding OBR forecasts for the UK as a whole".

On the other hand, the Scottish Government is forecasting slightly slower employment growth than the OBR is for the UK. But this largely reflects forecast demographic changes, rather than any significant divergence in the employment rate (and therefore it has less impact on forecast tax receipts per head). Indeed the Scottish unemployment rate forecast by the Scottish Government is slightly lower than that forecast by the OBR for the UK as a

whole in 2017/18 and 2018/19 – 5.1% vs. 5.3% and 5.3% vs. 5.5% respectively.

Other factors will also be important, including the number of part-time vs. full-time jobs created and also the 'types' of jobs create – e.g. are they high paid or low paid jobs etc.

The Outlook

Broadly speaking therefore, the Scottish Government is assuming similar growth in the underlying determinants of income tax revenues as for the UK as a whole.

In most years this would be a reasonable approximation – the economies of Scotland and the UK tend to be highly correlated.

However, we have seen in recent months a divergence between Scotland and the rest of the UK:

- Scottish GDP growth is currently around 1/3 of that of the UK as a whole – with growth of 0.7% over the year to Q3 2016 compared to 2.2% for the UK.
- The latest wage data indicates that wages grew less quickly between 2015 and 2016 in Scotland than in the UK. This differential was particularly marked among higher wage earners, who account for a disproportionate amount of tax revenue.
- Scotland's employment, unemployment and inactivity rates are all now weaker than the UK.

Perhaps this divergence is temporary and Scotland's economy will bounce back.

But if these forecasts turn out to be too optimistic and Scotland continues to experience relatively sluggish growth in 2017/18 and 2018/19 vis-à-vis the UK, then Scottish tax revenues may come in below those of the UK.

With 2018/19 and 2019/20 budgets looking particularly tight with further real-terms cuts in the block grant, being hit for a bill to repay over-optimistic tax forecasts is not ideal.

The Scottish Government will therefore be hoping that Wednesday's labour market data is the start of more positive news for the Scottish economy.