

## Response to the Scottish Fiscal Commission's consultation on the approach to policy baselines

September 2023

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### Question 1

Clearly in an ideal world the Commission would be furnished with a detailed plan on indexation of baseline policies for indexing tax thresholds. That would ensure consistency between the statements of the Scottish Government and the SFC, and increase transparency in the public discourse. This should be the gold standard that the SFC should aim for going forward.

But there needs to be a holding assumption if and while that is not provided, and so we welcome this exercise in public engagement to gather views on how to balance different priorities. It is our view that forecast independence and fiscal neutrality are the key objectives that the Commission should prioritise in setting policy baselines, especially as we see those two objectives as supporting a more informed and transparent public debate.

Seemingly minor choices like whether or not to uprate income tax thresholds in line with inflation can have large consequences in terms of fiscal drag, as highlighted in the consultation document, as we generally expect individuals' nominal incomes to increase over time. The SFC recognises this in its assumptions in the *Fiscal Sustainability Report*, and to address this it assumes that thresholds do get uprated with a measure that takes inflation into account.

Applying this to the medium-term forecast period has the benefit of being neutral *a priori* in the absence of stated policy, as it retains the level of taxation on real earnings of the years for which there is defined government policy. Freezing thresholds, and therefore increasing the average rate of tax on real earnings ought to be an explicit government decision rather than a hidden one that is baked into an uprating assumption. And given that the Scottish Income Tax system works and its impact on the Scottish Government's budget through block grant adjustments is linked to UK-wide income tax, it also mirrors the approach taken by the OBR when setting the baseline for the UK Government's income tax policy: for example, when thresholds were recently frozen by the UK Government, the OBR incorporated a costing for the increase revenue due to these measures<sup>1</sup>.

The same principles apply to social security payments. While technically there is an active decision by ministers to uprate payments, we think that being too legalistic in interpreting this is counterproductive to the public discourse. The income tax needs to be renewed annually through the UK Finance Bill process, but no one would seriously assume there would be no income tax in future years just because the legislation has not been passed yet. Instead, the focus should be on what is a reasonable expectation of the system and is not likely to be politically gamed. The Scottish Government's uprating decisions for social security payments have historically followed

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<sup>1</sup> <https://obr.uk/box/the-impact-of-frozen-or-reduced-personal-tax-thresholds>

the rate of CPI inflation in the 12 months to September – much like those of the UK Government – and it would be reasonable to apply such a measure as the baseline.

The objective surrounding resilience to political change is clearly an important one to consider, and it is one that institutions such as the SFC and the OBR must consider. Political parties of different dispositions may have different views of policy, but it is reasonable to assume continuity of policy unless there is a stated policy change by the Government of the day in power – a position that is commensurate with the SFC's role as the official forecaster.

Of course, this means that the SFC's forecasts will be less accurate than if it tried to anticipate policy for the sake of accuracy. But the point of an official forecaster and of the SFC's role is not to be perfectly accurate *ex post*, but to reflect the most likely course that the economy and the public finances will take conditional on current government policy. Subsequent policy does introduce a source of error in a broad sense, but it is the Government's prerogative to change its policy, and therefore we do not think accuracy after the fact (including anticipation of policy) should be the be-all and end-all of an official forecaster's priorities.

## Question 2

Ideally the Scottish Government should publish their baseline policy, or at least inform the SFC so it can publish it alongside its official forecasts. This would be the most transparent way of approaching the setting of a baseline.

Short of that, we would support a judgement-based approach, which would allow the SFC to maintain its pragmatic position in terms of setting baselines that reflect expectations as well as the main principles outlined in the consultation document. Publishing the baseline uprating policy chosen for each tax and social security stream on the SFC's website, as well as a mechanism for regular review and an outline of what would make them change (e.g. a statement of government policy) would increase transparency and accessibility as regards to these judgements.

Our position is that a judgement-based approach is less likely to be easily influenced by the Scottish Government by means other than a clear statement of government policy. Experience from looking at the Scottish, UK and other countries' governments shows that hard-and-fast rules such as length of parliaments can encourage excessive of temporary measures that end up becoming permanent but the cost of which is understated in the interim. This would have the effect of making the public finances look in better shape than their underlying position. A judgement-based approach gives the Commission the latitude to improve the public discourse in these situations by presenting more credible and transparent estimates.

## Question 3

As discussed above, we support continuing to use a judgement-based approach, with additional steps to ensure further transparency in the setting and review of policy baselines. As this approach is being implemented already, any revision to baselines could be introduced pretty simply by making it clear in publications and dedicating a page on the website to explain why each baseline has been chosen.

Of course, as with any judgement-based approach for forecasting, the balance of whether to change the uprating as the default mechanism has to be struck between past behaviour and the need to maintain fiscal neutrality and keep decision-makers accountable. It is important that the SFC communicate the reasoning for decisions and what the consequences of changing them would be in terms of costs to the public finances and the real terms value of tax thresholds and social security payments.

Of course, it is entirely within the gift of the Scottish Government to provide a clear statement of policy that would eliminate the necessity for the SFC to make these judgements.

#### Question 4

With *Scotland's Economic and Fiscal Forecasts* due to be published alongside the Scottish Budget in December, there is plenty of time to implement any change to those policy baselines, and it would make sense to implement them at the next forecast. If there are any changes to specific default uprating assumptions, we think it would be sensible for the SFC to restate its previous forecast on that basis so that comparisons after the new assumption is applied are like-for-like. It should also probably add a box analysing the difference that changing the assumption would make to revenue/spending on an ongoing basis and what the reasoning for the change is.

#### Question 5

Our view is that there is very much a role for the Scottish Government to shape policy baselines by making clear statements about its intended path of policy. These do not necessarily have to be legislated for already – that would be too legalistic a view, and as we explained before, one that would be open to gaming by changing the timing of legislation. Instead, our view is that if the Scottish Government would like to shape these assumptions, then it is entirely within its gift to provide a list of uprating mechanisms (i.e. multi-year and not just for the subsequent one) for the SFC to use. This list should be made public, ideally by the Scottish Government, but certainly by the SFC upon publication of its forecasts.

While there may at first appear to be questions of whether the current government should make commitments beyond the next election, we do not believe this is a realistic concern. In a parliamentary system such as in Scotland, the current parliament cannot bind its successors, and therefore the uprating mechanisms should be seen as the baseline against which future proposals will be judged – which is exactly what the SFC's proposal is intended to achieve.

## Who we are

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The Fraser of Allander Institute (FAI) is a leading independent economic research institute based at the University of Strathclyde.

The FAI is different from traditional academic institutes in that it combines internationally renowned researchers with knowledge exchange specialists who have significant experience from the public and private sectors. This ensures that the Institute's analysis is not only cutting edge, but delivered in a way which is accessible and relevant. Institute staff are regularly called upon to provide independent briefing and advice to government, parliament and industry.

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