



Bruce Crawford MSP
Convener
Finance & Constitution Committee
The Scottish Parliament
Edinburgh
EH99 1SP

16 December 2019

Dear Convener

I am writing in response to the publication of the *Committee's Pre-Budget scrutiny 2020-21 report* on 12 November.

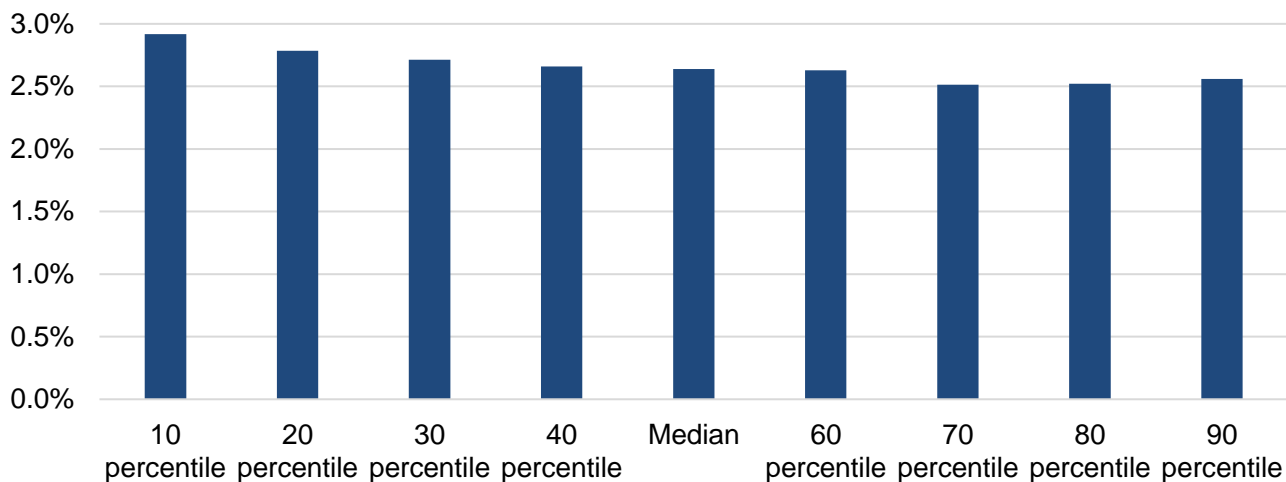
The Commission welcomes this report, and in particular the clear explanations of several components of the fiscal framework. The recent independent review of the Commission conducted by the OECD identified the fiscal framework as “not widely understood”. The Committee’s report and recommendations will support wider public understanding of the fiscal framework as well as supporting our work forecasting for the Scottish Budget.

The report included a specific recommendation for the SFC to reflect on earnings growth and income tax distributional issues. I agree that this is an important issue. To start, I thought it might help if I briefly set out our approach to handling the income distribution in our previous forecasts.

By basing our income tax model on the Survey of Personal Incomes (SPI), our forecasts initially reflect the distribution of income as it was in Scotland in the latest year for which data are available – currently 2016-17. In principle, our model allows us to grow income at different rates for different groups, for example by age or gender, by level of income, or by type of income.

In previous forecasts, our underlying judgement has been that incomes would grow at the same rate across all parts of the income distribution. This judgement was based on analysis of the Annual Survey of Hours and Earnings (ASHE) data from 2003 to the latest year available, currently 2019. Looking at growth in earned income across the earnings distribution, while there is volatility from year to year, we found no consistent pattern to earnings growth at different parts of the distribution over time. Figure 1 shows average annual growth in gross annual earnings by percentile from ASHE for the years 2003 to 2019.

Figure 1: Average annual growth in gross annual earnings by percentile, Scotland, 2003 to 2019 (%)



Source: ASHE, SFC calculations

Earnings have grown at an annual rate of 2.6 per cent since 2003 at both the median and the 90th percentile. If we look at a shorter time period, say since 2012, growth has been slightly slower at the top of the distribution than at the median, but the difference is small.

Average growth has been slightly higher at the lower end of the earnings distribution, with growth of 2.9 per cent and 2.8 per cent for the 10th and 20th percentiles respectively. However, individuals in this income range pay little or no income tax because of the personal allowance, and so we do not place much weight on these groups when forming our judgement. We have focussed more on comparing the median to the top end as this is what will drive income tax revenues.

ASHE has some limitations. The published data only looks at earnings up to the 90th percentile. This may mean we miss important information about the top 1 per cent or even top 0.1 per cent of earners, who have a significant effect on income tax growth. ASHE is also published with a lag, with data for 2018-19 published on 29 October 2019.

In response to this limitation, we have already been discussing with HMRC getting access to more disaggregated distributional earnings data from HMRC's Real-Time Information (RTI) tax system, and HMRC have shared some provisional estimates with us. This will allow us to observe earnings growth across the distribution in much finer detail than ASHE and is more timely. This should help us to better understand distributional effects and will supplement what we already know about the earnings distribution from ASHE and the SPI. We'll continue to discuss with HMRC how and when distributional information from RTI can be shared more widely.

As you identify in your report, what matters for Scotland's finances in the longer term is not just how the earnings distribution develops in Scotland, but how it develops relative to the UK. Even if Scotland and the UK experience equal average earnings growth, differential growth across the earnings distribution could lead to divergence between the BGA and Scottish income tax revenues. This could be positive or negative for Scotland's funding.

To conclude, we've identified three broad actions we'll take in the coming year in response to your recommendation.

First, for our forecast that will accompany the next Scottish Budget, we'll reflect on the latest available ASHE, SPI and RTI distributional information. We'll look at these data sources to see if there is evidence to suggest we need to adjust the distributional judgement I outlined above. Whether our judgment changes or not, we'll clearly spell out our judgement and the reasoning behind it. We will also provide sensitivity analysis to show what different assumptions about the shape of the earnings distribution could mean for our forecast of income tax revenues.

Second, we'll write to the Committee with more detailed and specific findings on distributional issues in summer 2020. We'll look at historic data, show how the distribution has developed over time, and show how different assumptions about changes in the distribution of income in future could affect tax revenues. We'll compare Scotland to the UK and show how distributional issues could affect the net effect on the Scottish budget of income tax over the longer term. We expect new 2017-18 SPI data to be available by the end of April 2020, and we'll consider this in our summer note. We'll continue to work with colleagues at the OBR to understand the interaction between our forecasts and theirs.

Finally, we are planning on giving more consideration to fiscal risks as part of our Scotland's Economic and Fiscal Forecasts (SEFF) publication. As well as our note next summer, we will reflect on distributional issues as part of our ongoing commentary on the fiscal risks Scotland is facing in future SEFFs.

I hope that these three proposed actions are helpful as you pursue further scrutiny in this important area.

Yours sincerely

A handwritten signature in black ink that reads "Susan". The signature is written in a cursive, flowing style.

Susan Rice DBE