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Convener
Economy, Energy and Fair Work Committee
Edinburgh, EH99 1SP

07 July
Sent via email

Dear Convener,

Thank you for the opportunity to respond in writing to your questions shared with us by the Economy, Energy and Fair Work Committee clerk on 22 April. I apologise for the time that it has taken to respond to the Committee's questions. Our detailed responses to your questions are provided in an Annex to this letter.

The effect of COVID-19 on the Scottish economy, tax revenues and social security spending will be large, wide ranging, and highly uncertain. We published a [Fiscal Update](#) in April 2020 providing information on the Scottish Budget position accounting for the significant shift in UK and Scottish Government spending commitments since our previous forecast publication, including spending associated with the COVID-19 response. The update also discussed some of the difficulties in economic and fiscal forecasting that we return to in the Annex to this letter. I'm sure you'll appreciate that, although we are starting to see some early economic data, significant uncertainties remain and we cannot fully anticipate how COVID-19 will affect our forecasts at this time.

Our next forecast publication will include a full set of economic and fiscal forecasts that take on board the effects of COVID-19. We are discussing the timing of our next forecasts with the Finance and Constitution Committee and the Scottish Government.

In the meantime, the Commission intends to publish its Forecast Evaluation Report and the next Statement of Data Needs later this year.

Yours sincerely,

A handwritten signature in black ink that reads "Susan".

Dame Susan Rice

Annex: detailed response

1. Implications of COVID-19 for SFC forecasting

- a. How modelling assumptions will deal with COVID-19 uncertainty?**
- b. Will previous assumptions about income tax revenues be revisited?**

COVID-19 is having a fundamental effect on the economy, which economists would term a structural break. Usually we look to past data to make predictions about the future, but in this case historic data are limited as a predictor of the future. Trends seen over recent years, for example in productivity or trade, are unlikely to hold in the near future. What's more, the relationships between different parts of the economy may change in unexpected ways. In the absence of a clear historic precedent, considerable judgement will be required to anticipate the novel ways the economy will be affected by COVID-19. Our forecast errors in the coming years are almost certain to be larger than might have been expected in the absence of COVID-19.

Each time we produce a new forecast we review our previous judgements and assumptions to see where adjustments may be necessary. Given the significant effects of COVID-19, it is likely that more of our assumptions will require greater adjustments than usual.

The effect that COVID-19 will have on our forecasting process will change over time and how we adjust for COVID-19 will depend on exactly when we produce our next forecast.

For example, were we to produce a forecast today, we would need to estimate the size of the initial shock to the economy in 2020 Q2 of COVID-19, which is highly uncertain and would probably dominate the forecasting process. However, if we produce our next forecast in late 2020 we'll have outturn data for 2020 Q2 and so we will know with reasonable certainty the size of the initial shock to the economy, and instead our forecasts will focus on the pathway for recovery.

Another example is uncertainty around the process out of the COVID-19 lockdown. The Scottish Government has published a route map setting out a phased approach to easing restrictions but significant uncertainties remain, including the likelihood of a second wave and whether any subsequent restrictions will be applied. By the time we get to late 2020, we are likely to have more clarity about the process out of lockdown on which to base our forecasts.

Whenever we produce our next forecast we will have to make significant adjustments to our forecasting processes, assumptions and judgments to account for COVID-19. However, as the examples above show, those challenges will change over time. It is too early to say exactly what uncertainties we will face when we come to produce our next forecasts, but we are actively monitoring the situation and pro-actively developing our forecasting processes to ensure that we can produce a forecast when the time comes.

The above discussion applies across all our forecasts. On income tax specifically, as well as the economic effects detailed above, we will be closely analysing HMRC furlough statistics on the take-up of the Coronavirus Job Retention Scheme for employed individuals, and the Self-employment Income Support Scheme. These schemes have already reported high take-up rates, and so how they develop over the coming months will affect our income tax forecast. A regional breakdown of these data was first released in June and showed similar take-up rates in Scotland to the rest of the UK; we will continue to monitor future releases of these data to see whether any regional differentials start to emerge. There are also other income tax policies that have been affected by COVID-19. For example, the private sector IR35 reform which reduces the scope for individuals to incorporate, has been delayed for a year to April 2021.

c. Will SFC be using the OBR COVID-19 forecast to build a Scottish scenario?

The OBR has produced some informative scenario analysis of the possible effects of COVID-19 on the UK economy and public finances which we have looked at in some detail. The fiscal work was updated in May but the OBR has not yet updated its economic or fiscal analysis to reflect the UK Government's plan for easing lockdown and some of the initial data released, although its June commentary on the public sector finances provided some discussion of the latest economic and public finances data. The OBR expects to continue to update this work and has announced it will update its economic and fiscal scenarios in its next fiscal sustainability report on 14 July. The OBR said it will explore three economic scenarios: one that updates the April V-shaped scenario for the latest economic data; one that sees activity recover more slowly and incorporates some medium-term scarring to potential GDP; and one assuming even slower recover and deeper scarring.

By the time we come to produce our next forecasts there will be new data available and revised scenarios from the OBR and others which we would consider. We have a good working relationship with the OBR and we will continue to discuss the development of their scenarios and both our and their forecasts with them.

d. Any estimates of likely impact on Scottish GDP? Likely projections about recession and how long for?

Other organisations including the OBR, NIESR, FAI and the Scottish Government have provided helpful and informative analysis of the possible effects of COVID-19 on the Scottish and UK economies. The approach they have taken at this early stage in the pandemic is to develop scenarios by making assumptions about the course of the pandemic, social distancing and the sectoral effects. These assumptions are then used to tease out an illustrative economic effect. By varying these assumptions it's possible to give an early indication of the potential scale of effects.

This approach is useful – particularly at this early stage when we have very limited data on the course of the economy. We broadly agree with the findings of this work – that COVID-19 will have a sizeable and negative effect on the Scottish economy this year.

The OBR has gone further and used the approach to look at illustrative effects on the UK public finances.

Our role is focused on producing forecasts to be used in the Scottish Budget, and more generally to improve understanding of the Scottish Budget. We could make broad estimates of the likely effects of COVID-19 on the Scottish economy, on tax revenues and on social security spending, but the net effects on the Scottish Budget will depend on the differences in effects between Scotland and the rest of the UK, as well as any differences in policy responses, which are very difficult to predict at this stage. The Commission takes the view that given the way in which the Scottish Budget is determined, further detailed analysis from us would be of limited value at the moment in understanding the position of the public finances in Scotland.

We are now starting to see some early estimates of the effect of COVID-19 on the Scottish and UK economies. New monthly GDP estimates published by the Scottish Government show the Scottish economy contracting by 18.9 per cent in April 2020, following a decline of 5.0 per cent in March. This is a smaller decline than the 20.4 per cent and 5.8 per cent contractions in the equivalent data for the UK. Tourism and hospitality has been particularly hard hit during the lockdown period, with activity in the accommodation and food services industry in Scotland estimated to be 84.2 per cent lower in April 2020 than in April 2019. However, the UK saw an even greater contraction of 91.7 per cent. Scottish monthly GDP figures are a new source of information and may be subject to significant revisions, so these data and any comparisons with the UK should be treated with caution.

e. Impact on likely publication timeline for next forecast?

We produce forecasts used in the Scottish Budget and MTFs. The MTFs was due to be published on 21 May but on April 1 the Scottish Government delayed its publication because of COVID-19. In April the Finance and Constitution Committee said that revised forecasts from the SFC would not be appropriate at this time.¹ We continue to discuss the timing of fiscal events with the Government and Parliament and whenever the Scottish Government publish a Budget or MTFs we prepare forecasts alongside this. Our protocol with the Scottish Government states that we will receive at least ten weeks notification that forecasts are required for a fiscal event, and we always make this notification public and our publication details are announced in our monthly forthcoming publications release.

There is also uncertainty about the timing of UK fiscal events this year. The UK Government's Spending Review planned for this summer has been delayed. The Scottish Government previously intended to have a multi-year Resource Spending Review after the UK Spending Review; the Cabinet Secretary for Finance has now confirmed this will be postponed and the Scottish Government will focus on the

¹ Letter from the Convener of the Finance and Constitution Committee to the Cabinet Secretary for Finance – 8 April 2020 ([link](#))

Scottish Budget 2021-22.² The timing of the next UK Budget, due in the autumn, has not yet been announced and could differ from the usual schedule.

2. In its Data Inquiry Report the Committee recommended that the SFC annually sets out its statistical needs.

The data we rely on for forecasting, and against which we evaluate our forecasts, may have greater errors than in the past. Data on the economy is likely to be volatile, subject to significant revisions, and overall data errors are likely to contribute more to forecast error. This increases the challenge of forecasting in the year ahead.

a. What are your main challenges and issues relating to data access?

The publication of our annual Statement of Data Needs (SDN) which originated from the Committee's recommendation has become an essential part of ensuring that we have access to the best possible information. Since our first SDN in September 2018, we have already seen considerable improvements in data provision in response to our requirements. This document has also been an opportunity to develop our relationships with data providers.

The COVID-19 crisis has posed challenges to data collections and statistical publications. The main economic data such as GDP and labour market have continued to be published on time, but in other areas such as house prices the release of data has been delayed or temporarily suspended. Moreover, now more than ever there is a need for fast data, to understand the effects that COVID-19 is having on the economy and society. Both the Office for National Statistics and the Scottish Government have increased their monitoring of the economy in response to the crisis and started to regularly publish more frequent indicators and analyses of economic activity. We welcome this work, which improves the provision of timely and up-to-date information on the economy in a freely accessible way.

The sections below summarise the areas where further progress can be made. We will provide more details in our next SDN.

Social Security

For social security data, we mainly rely on the Department for Work and Pensions (DWP) and Social Security Scotland. Our working relationship with DWP has positively evolved over the last few years, and in spring 2019 we signed a Memorandum of Understanding to access the data required to fulfil our statutory duties. We still require more granular breakdowns of some benefit statistics that would help inform our expenditure forecasts.

Our main ask to Social Security Scotland is further improvements to the published statistics, which would enable us to better understand the factors affecting our forecasts. We are also looking to the Scottish Government to provide further

² Letter from the Cabinet Secretary for Finance to the Convener of the Finance and Constitution Committee – 1 April 2020 ([link](#))

information on operational and policy decisions taken when developing devolved social security assistance.

Income tax

Our income tax data requirements to HMRC are now less significant and focus on the usability, rather than availability, of the data provided. For example, we need more information on how the Real Time Information statistics are created and how these relate to outturn data. We would also like the publication of a revisions policy, which would provide more clarity on the current income tax outturn revision process.

Economy

Earnings data continue to be the area of most concern in our economy forecasts, particularly because of their role in our income tax forecasts. We also hope that the SG will produce labour productivity statistics using jobs and hours data based more directly on the Labour Force Survey. We are pleased that the SG is open to developing its Scottish productivity statistics publication in this direction to increase the value of these data.

Devolved taxes

We have a good working relationship with analytical and policy staff at Revenue Scotland, who have been responsive to our requests for data for the purposes of forecasting, monitoring and policy costing. We have also benefitted from their advice and expertise on how the data are compiled and how they should be interpreted. Revenue Scotland included the Commission in its consultation for the first stage of development of its new devolved taxes data management system (SETS 2) and we look forward to further consultations as the system continues to be developed in the future.

b. What response have you received from the Scottish Government to your statements of data needs?

In our first Statement of Data Needs we made a number of requests to the Scottish Government for specific developments to Scottish economic data. The response received has been very positive and there have been encouraging improvements in the range and quality of Scottish economic data available. We have been pleased to see the Scottish Government treating our data needs as a priority in its Scottish Economic Statistics plans, and that it has already delivered on many of our requirements.³

For example, last year the Scottish Government has started publishing estimates of GDP by expenditure components in real terms (adjusted for inflation), which was one of our top priorities. These new statistics have greatly enhanced the quality and transparency of the historical GDP data we use as the basis for our economy forecast.

Developments in some areas such as earnings data require cooperative action by the SG, the Office for National Statistics (ONS) and HMRC. We continue to engage

³ Scottish Government (2018) Scottish Economic Statistics Plan 2018-19 ([link](#))

with all data providers in this area on developing their products to ensure they meet our needs.

3. In February 2018, the Committee highlighted that public bodies such as SFC were paying for data from other public agencies and recommended looking at how the cost might then be shared between those bodies acquiring the data and protocols put in place for distribution. How has this situation evolved over the last two years?

We have only purchased data on an occasional and ad hoc basis. All of the core data required for our forecasts is publicly available and accessible free of charge.

In 2018 we made a purchase from Registers of Scotland (RoS) of a dataset containing all of the individual records of property transactions going back to 2003. We paid for this complete dataset to inform our LBTT analysis, which was a one-off requirement at the time. We have not subsequently purchased updates to the dataset, as our analytical needs since have not required it, but we anticipate that we may need to update the dataset in future as new analytical needs arise. We welcome the interest of the Committee in the issue of how best to spread the costs of acquiring the transaction-level data on a regular basis in future and we will continue to explore options over the coming years with counterparts at RoS and in the Scottish Government. The RoS transaction level data is the only example of a time we have purchased data from another public body.

4. Could you comment on your relationships with the Scottish Government and the Office for Budget Responsibility?

a. What protocols are in place?

b. Are there any areas for improvement?

The Commission is independent of the Scottish Government and accountable to Parliament. The nature of our work requires close working with the Scottish Government, particularly around fiscal events when we must reflect Scottish Government policy and the Scottish Budget position in our forecasts. We have a protocol for engagement with the Scottish Government which gets updated and reviewed regularly.⁴ While the protocol is helpful for shaping engagement, continually working to maintain good relationships is critical. We have good relationships with the Scottish Government at all levels and areas of the Commission's work, with no particular current concerns. We appreciate the support we've received from the current and previous Cabinet Secretary for Finance as well as senior Scottish Government officials which has helped ensure positive relationships.

COVID-19 has resulted in fast paced work in many areas and resulted in a number of staff moves within the Scottish Government, making it all the more important that both we and the Scottish Government continue to work at maintaining and building the good relationships that we have.

⁴ Scottish Fiscal Commission (2019) Protocol for Engagement with the Scottish Government ([link](#))

Because the Scottish public finances and economy are closely tied to the UK, it is important for us to work closely with the Office for Budget Responsibility. This will be particularly important this year as the OBR's forecasts of the UK economy and public finances will change substantially since their March forecasts. It is also likely that the UK Government may announce further policy changes which could affect total UK Government spending and the Block Grant Adjustments for devolved taxes and benefits. Some changes by the UK Government would directly affect Scottish revenues and spending, for example changes to the income tax base or changes to social security benefits which DWP currently administers on behalf of the Scottish Government. We have good relationships with the OBR and engage regularly with the OBR. These relationships are set out in the Memorandum of Understanding with the Office for Budget Responsibility.⁵

We have had to work at our relationships with some UK Government departments but have been impressed by the willingness of these departments to engage and work with us. We have good working relationships and MoUs formalising those relationships with HMRC and DWP. Our relationship with HM Treasury has developed over the last nine months. We now have a good relationship with officials in Treasury and for our recent fiscal update we received information on consequential from the UK Government directly from Treasury.

5. What judgements and assumptions have you used in your forecasting of the impact of Brexit on the Scottish economy? What impact has Brexit uncertainty had on the Scottish economy?

As with previous forecasts, we discussed in some detail our assumptions around Brexit in our latest February 2020 SEFF.⁶ In summary, at the time these were that:

- The UK left the EU on 31 January 2020
- This is followed by a transition period lasting until December 2020
- New trading arrangements with the EU and others slow the pace of import and export growth
- The UK adopts a tighter migration regime than that currently in place
- Slower productivity growth

These assumptions will be reviewed and adjusted accordingly when we produce our next forecasts.

We believe that Brexit has and will slow growth in the Scottish economy and our forecasts include the effect of Brexit. However, we have not separately estimated the effect of Brexit on the Scottish economy in isolation. To do this, we'd need to create a pathway that the Scottish economy would have taken in the total absence of Brexit to compare our forecasts that include Brexit to. While Brexit is important, our forecasts are affected by a large number of factors – and it is not generally possible to disentangle the effect of a single factor within our forecasts.

⁵ Scottish Fiscal Commission (2019) Memorandum of Understanding with the Office for Budget Responsibility ([link](#))

⁶ Scottish Fiscal Commission (2020) Scotland's Economic and Fiscal Forecasts ([link](#))

Other organisations including the FAI and OBR have produced informative and more in depth Brexit analysis that describes the current situation well and we don't have anything to add at this time.

There will be a complicated interaction between the effect of Brexit on the Scottish economy and the effect of COVID-19, with both highly uncertain. As we get towards the end of the year, we should have greater clarity about both the pathway out of lockdown and the outlook for Brexit. We will look at these issues in detail when we produce our next forecasts.

6. The SFC's most recent estimate of productivity growth in Scotland remains low and has been downgraded further relative to previous forecasts.

- a. What factors have driven this downgrade?**
- b. What type of policy responses would likely see an upgrade in productivity forecasts?**

The downgrade in our February 2020 forecast was mainly in response to data available at the time for 2019 showing that output per hour growth in the last year was still weak and below our previous forecasts. Productivity growth has now been near zero for most of the last decade and has shown no sign of revival, so our view is it will take longer before we start to see a real improvement in productivity performance. We therefore revised down our productivity outlook for the initial years of the forecast, from 0.7 to 0.3 per cent in 2019 and from 0.9 to 0.6 per cent in 2020.

Productivity growth has been slowing since 2004 in both Scotland and the UK, with the financial crisis exacerbating this trend. As we highlighted in previous reports, there has been an apparent disconnect between growth in GDP on the one hand and growth in employment and hours worked on the other, with output growth in recent years coming from more people being in work or working more hours rather than any increases in efficiency.

Other factors that contributed to slow productivity growth in 2019 and have led us to revise down our productivity forecasts are business investment continuing to fall amidst Brexit-related uncertainty and the global trade and economic slowdown which has weighed on Scottish GDP growth in the last year. At the time of preparing our February 2020 forecast, an immediate upturn in productivity looked unlikely after such long period of subdued growth, and so we have adjusted our productivity growth pathway in line with the assumption of a more gradual recovery.

Longer term, we continue to expect productivity growth will start to pick up over the forecast horizon, but will remain below the 1.5 per cent pre-2008 average by 2024. Our Brexit judgment of slower productivity growth, resulting from slower trade and business investment growth and a tighter migration regime, is reflected in our assessment of productivity. For our next forecast we will also update our view on

productivity to incorporate the potential effect of COVID-19. In the shorter run, output is expected to be volatile especially between Q2 and following quarters, making productivity more difficult to measure. It is also possible that measured productivity will increase as hours worked drop because of people being furloughed or unable to work. Longer term, the general view among economic forecasters such as the Bank of England and the National Institute for Economic and Social Research is that the disruptions to the economy may cause a long-lasting loss of productivity. We will consider all of these issues in detail in our next forecast.

Turning to Scottish Government responses, there is a broad range of policy areas which may be looked at to improve productivity including education, policies supporting innovation and the digital economy, and the new Scottish National Investment Bank – all of which might help to boost the supply side of the economy. However, proposing specific policies is outside our remit. The FAI and David Hume Institute have made useful contributions to the productivity debate over the last couple of years and discussed policies which may be directed at targeting Scotland's productivity performance.

7. The most recent forecast has made upward revisions to earnings growth. This higher than expected growth was driven by tight conditions in the labour market, growth in public sector pay policy, the minimum wage and national living wage. Can you provide more detail on the impact of the national living wage?

The national living wage (NLW) has been in place since April 2016, and is set to rise to 60 per cent of over-25s median earnings by 2020. The NLW which came into effect on 1 April 2020 was 6.2 per cent higher than its previous rate and in line with the UK Government's 2016 target. In March 2020, the UK Government has introduced a new target for NLW to reach two-thirds of median earnings by 2024. In our February 2020 forecast we have not explicitly quantified the effect of NLW on whole-economy wage growth, but previous annual increases are already part of our baseline wage data and we have considered future increases in forming our overall judgement on earnings growth over the next five years.

In March 2020 the OBR has estimated that NLW increases would add 0.5 percentage points to overall average earnings growth in the UK by 2024, or around 0.1 percentage points a year.⁷ This is a similar effect to that estimated in 2016 when NLW was first introduced. Estimates include spillovers further up the wage distribution, reflecting some pre-measures earnings differentials being preserved. The effect on total earnings is likely to be smaller as employers may respond to the increase in paybill by reducing employment.

⁷ Office for Budget Responsibility (2020) Economic and Fiscal Outlook – March 2020 ([link](#))

8. February's forecast stated that the labour market appears to be reaching a turning point, with employment no longer rising and the unemployment rate stabilising. The COVID-19 emergency has seen a range of business and employment support measures. How will these be captured and accounted for in forecasting?

How we capture COVID-19 support measures in the forecasting process will depend on the exact timing of our next forecast. In June we saw the first publication of HMRC regional furlough statistics and we will continue to monitor future releases of these data, which will help in our modelling and forecasting. When we come to produce our next forecast, some of the effects of these policies may already be part of our baseline data on GDP, employment and earnings. We will then be able to use this evidence, along with other available Government information on the future of these schemes, to form a judgement on how we may expect the measures that are in place to continue supporting the economy and labour market.

At present, a useful way to explain how we may account for these policies is by looking at the channels through which they can affect the economy. For example, we will closely monitor data on business investment, productivity and unemployment to understand whether the policies may have been successful in preventing a permanent damage to the supply-side capacity of the economy or whether our pathway of trend GDP growth needs to be adjusted. On the demand side, the policies will have a direct effect on household consumption – which represents almost two thirds of GDP – by keeping companies into business and supporting jobs and incomes for individuals. Household consumption is expected to have declined sharply because of lockdown restrictions. We will analyse signals from a range of data including business and consumer confidence, earnings and employment to develop a view on a possible recovery trajectory for consumer spending.

Clearly there is a range of other factors at play including the global economic outlook, consumers behaviour (both domestic and tourism), the ability of businesses to restart which will interact with the effect of the policies and that we will take into consideration for our next forecast.