Scottish Income Tax Ready Reckoners: March 2021

Office of the Chief Economic Adviser

Summary

This note presents a set of ready reckoners which show the estimated revenue impact of illustrative changes to Scottish Income Tax policy in 2021-22. 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*.[2]

As discussed in more detail below, official forecasts of the costs 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 indeed 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.

Income Tax Ready Reckoners 2021-22	Estimated Change in Revenue including behavioural effects (in £m)
Income Tax Rates	
Change Starter Rate by 1p	48
Change Basic Rate by 1p	170
Change Intermediate Rate by 1p	126
Change Higher Rate by 1p	64
Increase Top Rate by 1p**	Negligible*
Cut Top Rate by 1p**	Negligible*
Income Tax Thresholds	
Freeze the Starter Rate Band[3] (i.e. reduce Band by 0.5%)	Negligible*
Reduce the Starter Rate Band[3] by £100	2
Freeze the Basic Rate Band[3] (i.e. reduce Band by 0.5%)	Negligible*
Reduce the Basic Rate Band[3] by £1,000	12
Freeze the Higher Rate Threshold (i.e. reduce Threshold by 0.5%)	16
Reduce the Higher Rate Threshold by £1,000	70
Reduce the Top Rate Threshold by £10,000 (to £140,000)	3

* The policy raises/costs less than +/-£2 million.

** The estimates for changes to the top rate of tax are particularly uncertain. These revenue numbers do not account for any forestalling effects, which could significantly change the profile of revenue in the short term.

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 2021-22, by varying each of the components for which the Scottish

[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.
[3] This is slightly different from freezing the Higher Rate Threshold as it maintains the band width, regardless of changes in the UK-wide Personal Allowance.

Government 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 £407 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 £128 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.
- 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 £126 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. The table presents our central estimate, based on the SFC's current behavioural framework which suggests that these policies would have a negligible impact on tax revenues.

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 January 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[4], 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 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 2017-18 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 increase in line with September 2020 CPI inflation (0.5%), except for the Top Rate Threshold which remains fixed at £150,000. This pre-measures forecast is consistent with the SFC's published forecast at the Scottish Budget on January 28. It is assumed that changes apply from April 2021. The tax parameters in the baseline forecast are summarised overleaf.

[4] See for example SFC, How we forecast behavioural responses to income tax policy, March 2018.

Scottish Income Tax Policy 2021-22		
Band name	**Income Range**	**Rate**
Starter Rate	Over £12,570 - £14,667	19%
Basic Rate	Over £14,667 - £25,296	20%
Intermediate Rate	Over £25,296 - £43,662	21%
Higher Rate	Over £43,662 - £150,000	41%
Top Rate	Over £150,000	46%

Following the SFC's[5] 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 the so called 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; 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.[7] These TIEs are point estimates and we do not consider ranges or uncertainty around them.

Income Start	Income End	Elasticity (TIE)
Low	£31,092 (Basic Rate Limit)	0.015
Basic Rate Limit (£31,092)	£80,000	0.1
£80,001	£150,000	0.2
£150,001	£300,000	0.35
£300,001	£500,000	0.55
£500,001	High	0.75

In addition, the SFC's methodology also accounts for tax induced cross border migration[8] and behavioural responses resulting from interactions with reserved policies.[9] 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 certain segments 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 relates to the economic assumptions underpinning the costings. While the SFC's forecasts from January 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.

[5] SFC, Approach to Policy Costings, September 2019.
[6] Understanding the Behavioural Effects from Income Tax Changes, February 2020.
[7] Table 4.3, SFC, How we forecast behavioural responses to income tax policy.
[8] See for example SFC, Scotland's Economic and Fiscal Forecasts 2020, page 61.
[9] See for example, SFC, Scotland's Economic and Fiscal Forecasts 2018, pages 98-100.

Secondly, it is already evident that Covid-19 is reshaping the structure of the labour market and therefore the Income Tax base. The nature of the economic crisis means that customer facing sectors, such as Retail, Hospitality and Leisure, have been hit particularly hard. Since low income earners, the young and women account for the majority of workers in those sectors, they are more likely to have seen their incomes fall, to be furloughed or made redundant, although income losses can be observed across the income distribution. Since the Income Tax model is currently based on pre-Covid tax data from 2017-18, this is not fully reflected in the Income Tax forecasts although the SFC assume that labour force participation rates amongst the 16-24 year olds will decrease as a result of Covid-19.

Finally, as noted above, another major uncertainty concerns the scale of the behavioural response. Although the ready reckoners are based on the best available information and international academic studies, they are currently treated as point estimates. Moreover the evidence base remains limited with regard to the behavioural responses of Scottish (and UK) taxpayers. We continue to monitor the evidence base and work with HMRC, the SFC, the Office for Budget Responsibility and the Welsh Government to improve our understanding of the Scottish Income Tax base and the magnitude of behavioural responses.