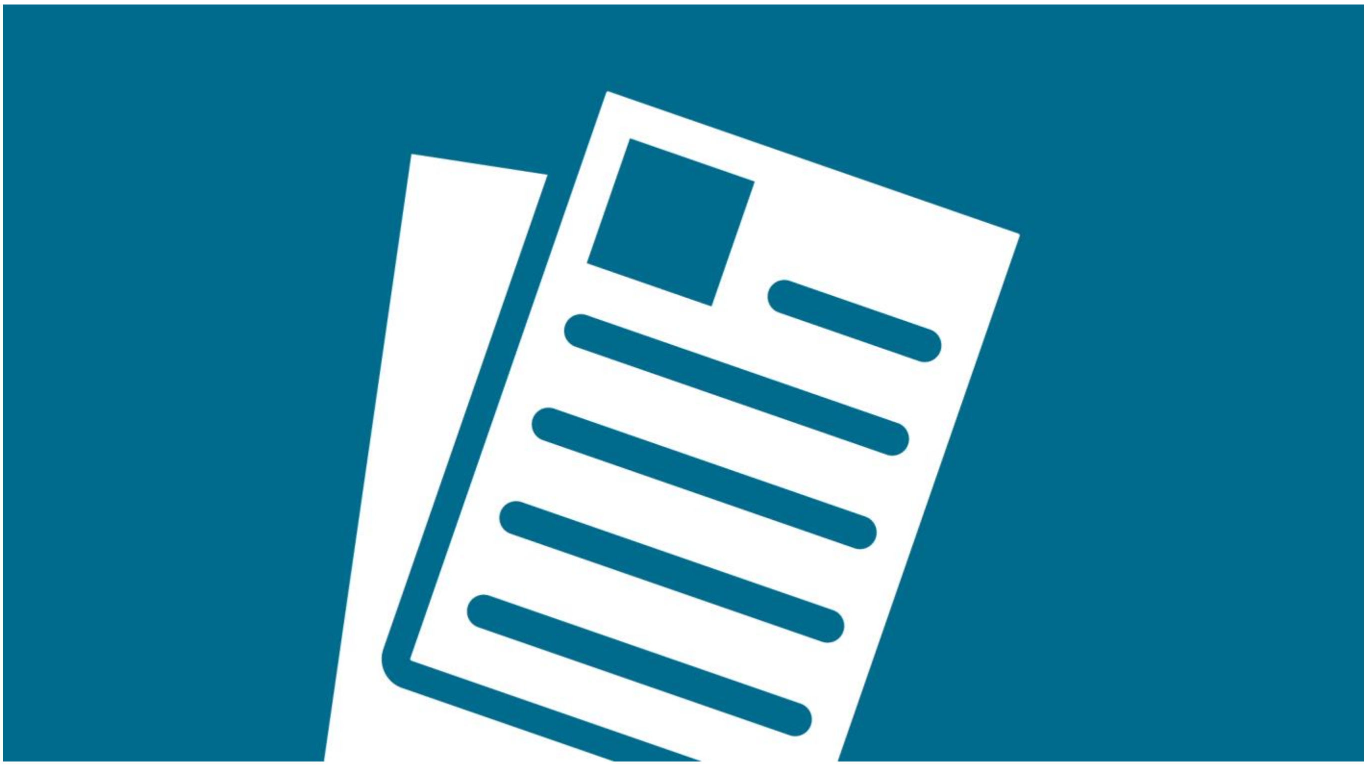
Administration of Scottish income tax 2023/24



Prepared by Audit Scotland
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Key messages

- The National Audit Office's approach to providing assurance over Scottish income tax is reasonable and covers the key audit risks.
- The Scottish income tax outturn for 2022/23 is £15.169 billion. The net reconciliation of 2022/23 income tax will increase the 2025/26 Scottish budget by £449 million. This is the largest adjustment to the budget resulting from the reconciliation to date. Reconciliations correct for the difference between forecasted tax receipts used in the Scottish budget and the actual outturn which is known later.
- HMRC's provisional estimate of Scottish income tax for 2023/24 is £17.254 billion. The provisional estimate is provided for financial reporting purposes and does not affect the Scottish budget. The C&AG concludes that HMRC's approach to establishing the provisional estimate is reasonable.
- While income tax revenues are continuing to rise, the impact on the Scottish budget is significantly reduced by relatively slower economic growth in Scotland compared to the rest of the UK. Between 2017/18 to 2022/23, Scottish taxpayers have paid an additional £3.367 billion due to tax policy differences in Scotland (both Scottish and UK policy changes). However, slower economic growth means the net benefit to the budget over the same period has been a much lower £629 million. Taxes and the economy are important pillars of the Scottish Government's approach to financial sustainability. This current economic performance gap underlines the importance of relative economic growth to Scotland's public finances and should be a key area of focus for the Scottish Government in the coming years.
- There have been positive developments in governance and assurance arrangements in 2024. For example, I previously reported that the Scottish Government and HMRC should consider if more frequent checks are required to provide additional assurance over the accuracy of HMRC's address records. The completion of the additional third-party data exercise in 2024, one year earlier than originally planned, is a positive development, however the results of this exercise have not yet been published and

therefore cannot be reflected in this report. The timeliness of these exercise is critical to support public scrutiny. I also note that HMRC and the Scottish Government set up a compliance working group in 2024 to evaluate HMRC’s approach to compliance in Scotland. HMRC expects to report to the Scottish Income Tax Board on the first phase of the evaluation in January 2025.

- HMRC continues to apply the same risk-based compliance approach to collecting income tax in Scotland as it does in the rest of the UK, as it has assessed the compliance risk to be consistent. This relates to the risk of tax evasion, rather than taxpayers changing their behaviour in legal ways, such as working less hours or leaving Scotland. The C&AG reports that HMRC is now carrying out work to assess whether its current compliance approach in Scotland remains sufficient if the further divergence in tax policy from 2023/24 increases compliance risks.

- HMRC has also now published further analysis in 2024, both of Scottish taxpayers’ behavioural responses to Scottish income tax policy over time, and of the incomes and location of UK taxpayers over a 12-year period. It may not be until 2027 that HMRC can assess how migration has been affected by the recent changes in tax rates in Scotland in 2023-24 and 2024-25. Obtaining better quality data will help inform future tax policy decisions. In my view, further analysis in the coming years is needed to draw out the extent of any causal relationship between tax policy changes and taxpayer behavioural responses.

Introduction

1. The Scotland Act 2016 extended the Scottish Parliament's power to vary all income tax rates and thresholds to the non-savings, non-dividend (NSND) income of Scottish taxpayers. The power to determine any reliefs or exemptions, including the personal allowance, remains with the UK Government. From 2017/18 onwards, the total amount of NSND income tax, now referred to as Scottish income tax, collected by HM Revenue and Customs (HMRC) in Scotland is paid to the Scottish Government.

2. HMRC's annual report and accounts are audited by the National Audit Office (NAO) and the Comptroller and Auditor General (C&AG) issued his opinion on the 2023/24 HMRC annual report and accounts in July 2024. The C&AG is also required to report to the Scottish Parliament on HMRC's administration of Scottish income tax by 31 January of the financial year after the one to which the report relates.[1]

3. In 2014, the predecessor Public Audit Committee of the Scottish Parliament recommended that the Auditor General for Scotland should provide additional assurance on the NAO's audit work on Scottish income tax.[2] I make this report to the Public Audit Committee in response to that recommendation.

Background

4. HMRC collects and administers Scottish income tax on behalf of the Scottish Government as part of the UK's overall income tax system. This includes separately identifying the amounts that relate to Scottish taxpayers. The Scottish Government is responsible for:

- reimbursing HMRC for the cost of implementing Scottish income tax
- ensuring that the cost of implementing Scottish income tax represents value for money
- seeking assurances that the system collects the correct amount of tax

[1] Scotland Act 1998, section 80HA as amended by the Finance Act 2014, section 297.

[2] 1st Report, 2014 (Session 4): Framework for auditing the Scottish rate of income tax, Public Audit Committee, 2014.

- discussing and agreeing with HMRC aspects of the approach to the administration of Scottish income tax as set out in a Service Level Agreement.

5. The amount of Scottish income tax collected each year is identified separately in HMRC's annual report and accounts. HMRC's annual accounts for 2023/24 were published in July 2024. This report relates to 2023/24, including the final outturn calculation of Scottish income tax for the 2022/23 tax year. This amount is used to calculate the reconciliation applied to the Scottish budget for 2025/26.

6. In 2022/23, income tax receipts across the UK increased markedly due to factors such as recovery from Covid-19 and increases in inflation. Total Scottish NSND income tax revenues rose by 11.5 per cent between 2021/22 and 2022/23, compared to an increase of 10.5 per cent in NSND income tax revenues across England and Northern Ireland.[3] Between 2020/21 and 2021/22, Scottish income tax revenues rose by 14.9 per cent compared to a rise of 15.4 per cent across England and Northern Ireland.

7. The report also covers HMRC's provisional estimate of Scottish income tax receipts for 2023/24. This provisional estimate does not affect the Scottish budget. The final outturn for 2023/24 is expected to be reported in summer 2025.

[3] Scottish Income Tax Outturn Statistics: 2022 to 2023, HM Revenue & Customs, July 2024.

Audit and assurance

8. The C&AG made his tenth annual report to the Scottish Parliament on 17 January 2025. His report relates to 2023/24 and considers:

- HMRC's calculation of the 2022/23 income tax revenue attributable to Scotland and provides assurance on the correctness of the amounts brought to account
- HMRC's estimation of the 2023/24 income tax revenue attributable to Scotland and his view on the methodology used to estimate the amount
- key controls operated by HMRC to assess and collect Scottish income tax
- HMRC's approach to assessing and mitigating the risk of non-compliance with Scottish tax requirements
- the cost of administering Scottish income tax and provides assurance on whether the amounts are accurate and fair in the context of the costs incurred by HMRC.

9. Audit Scotland considered:

- the NAO's approach to identifying the key risks to the successful administration of Scottish income tax
- the NAO's audit working files, with focus on the audit evidence underpinning the key findings and conclusions in its report
- the NAO's arrangements for ensuring the quality of the audit work and reporting.

10. Audit Scotland's review was limited to consideration of the NAO's audit work; it did not directly review evidence obtained from HMRC or discuss any matters relating to Scottish income tax directly with HMRC. The judgements and conclusions set out in the report of the C&AG are his alone, based on the audit work undertaken by the NAO on his behalf.

11. Based on Audit Scotland's review, I am satisfied that the NAO's approach was reasonable and that its audit work covered the key audit risks. I am also satisfied that the findings and conclusions in the C&AG's report are reasonably based.

12. To support audit scrutiny, following assurances over the NAO's approach and findings, this report contains a further section on audit insights. This is to draw attention to issues and developments useful for scrutiny and outside of the scope of NAO activity. This includes analysis of how Scottish income tax figures impact the Scottish budget, and Scottish Government developments and activity in areas such as behavioural change.

Correctness of the sums brought to account

13. HMRC’s 2023/24 annual report and accounts included Scottish income tax outturn figures relating to the 2022/23 year. Scottish income tax in 2022/23 was £15.169 billion.[4]

14. For the 2023/24 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £17.254 billion. HMRC will publish the final Scottish income tax outturn for 2023/24 in its 2024/25 accounts, and an adjustment will be made to the 2026/27 Scottish Budget. The impact of tax outturns on the Scottish budget is explained in further detail at paragraphs 52-57 of this report.

2022/23 final outturn

15. The C&AG concludes that Scottish income tax revenue outturn for 2022/23 is fairly stated.

16. The 2022/23 outturn calculation of £15.169 billion is largely based on established tax liabilities, after the tax owed has been finalised and the taxpayer records have been reconciled. The remainder is based on estimated liabilities; including, HMRC's estimate of PAYE tax liabilities that have not yet been finalised and where tax liabilities are expected from future self-assessment returns or compliance activity.

17. The net effect of these estimation adjustments is to reduce the Scottish income tax outturn arising by £17 million (0.1 per cent of the outturn). The methodology used to arrive at these adjustments was agreed between the Scottish Government and HMRC. The C&AG notes that this methodology has remained broadly the same since the prior year.

18. As in 2021/22, both income tax receipts and the number of people paying tax has increased markedly in 2022/23, both in Scotland and in England and Northern Ireland. The C&AG notes that in Scotland, the outturn for 2022-23 represents an increase of 11.5 per cent compared with 2021/22 (£15.169 billion compared to £13.607 billion). The outturn for NSND income tax for England and Northern Ireland increased by 10.5 per

[4] Administration of Scottish income tax 2023-24, National Audit Office, January 2025.

cent in 2022/23. HMRC and the Scottish Fiscal Commission have pointed towards economic recovery from the pandemic and tight labour market conditions in a period of inflation as contributing factors.

19. The Scottish Fiscal Commission highlights higher earnings growth in Scotland than in the UK in 2022/23 as being an important driver of the relatively higher growth in tax revenues in Scotland. The Commission also highlights the distribution of tax rates in Scotland has resulted in a greater proportion of taxpayers crossing into a higher tax band than in the rest of the UK, which contributes to relatively greater income tax revenue growth in Scotland. The combined growth in revenue from higher rate and top rate taxpayers was around three percentage points higher in Scotland than in the equivalent bands in the UK in 2022/23.

20. There was a 4.4 per cent increase in taxpayers overall in 2022-23 compared to 2021/22. HMRC noted in their outturn publication report[5] that fiscal drag has resulted in the increases in the proportion of intermediate, higher, and top rate taxpayers in Scotland. There was a larger increase in taxpayers overall in England and Northern Ireland, with the number of taxpayers increasing by 4.9 per cent in 2022/23.

21. Fiscal drag occurs when wages rise, due to factors such as inflation, while tax rates and bands remain unchanged. Some taxpayers will become newly liable to pay income tax or to move between tax bands and consequently pay more tax.

22. The impact on the Scottish budget, explored later in this paper from paragraph 52 onwards, relates to per capita growth in receipts relative to the rest of the UK under the terms of the **Fiscal Framework**.

The **Fiscal Framework**, established in 2016, is an agreement between the Scottish and UK governments in response to the Scottish Parliament's new responsibilities for taxes, social security and borrowing. The framework sets out the Scottish Government's financial arrangements including how the grant received from the UK Government is calculated and how much money the Scottish Government can borrow. We have previously reported on the operation of the Fiscal Framework, setting out detail on the arrangements and the financial, economic and policy risks for the Scottish Government. The Scottish and UK governments agreed a revised Fiscal Framework in August 2023.

[5] Scottish Income Tax Outturn Statistics: 2022 to 2023, HM Revenue & Customs, July 2024.

The percentage growth in tax receipts does not result in a similar level of growth in the Scottish budget. It is therefore important that the Scottish Government continues to monitor and consider the impact of relative economic performance and tax policy change in the rest of the UK to the Scottish budget. This is particularly important given that the Scottish taxpayer base has a different **income distribution** to that of the rest of the UK, meaning factors such as fiscal drag may affect Scotland differently. This is likely to remain the case for future budget years, influencing budget growth from future tax policy decisions.

Income distribution is a measure of how many people earn different amounts of income.

2023/24 provisional estimate

23. HMRC's provisional estimate is for reporting purposes and does not affect the Scottish budget. The C&AG concludes that HMRC's approach to establishing the provisional estimate is reasonable.

24. Since 2018/19 the provisional estimate methodology is based on data from its Survey of Personal Incomes (SPI) and Personal Tax Model to give a Scottish percentage share of UK NSND tax income. HMRC compares this amount to the liabilities from the latest (2022/23) Scottish income tax outturns and adjusts its estimate accordingly. HMRC performs this calibration because, historically, actual tax outturns have been lower than the provisional estimates. The C&AG notes that the methodology is largely consistent with that used to calculate last year's 2022/23 estimate.

25. The C&AG notes that the estimated share that HMRC calculates is based on 2021/22 survey data. The C&AG has outlined several limitations in using SPI data to determine the provisional estimate, which includes the risk that using 2021-22 data may not be reflective of the taxpayer base for 2023-24.

26. The C&AG reports that for the 2023/24 tax year, HMRC provided a provisional estimate that Scottish income tax revenue will be £17.254 billion. The C&AG remarks that the 2023/24 Scottish income tax estimate represents an increase of £2,085 million (13.7 per cent) against the 2022/23 outturn, compared to an 11.9 per cent increase for the UK overall against the 2022/23 outturn. The C&AG notes that these increases reflect continued rises in earnings, together with the changes to the Scottish taxpayer thresholds and rates in 2023/24, moving some taxpayers into higher tax brackets.

27. I note that the Scottish Fiscal Commission's most recent forecast[6] for 2023/24 Scottish income tax receipts is £17.315 billion which is similar to HMRC's provisional estimate of £17.254 billion (a difference of less than 0.5 per cent).

[6] Scotland's Economic and Fiscal Forecasts – December 2024.

Adequacy of HMRC’s rules and procedures and compliance with these

28. The C&AG concludes that 'HMRC has adequate rules and procedures in place to assess and collect Scottish income tax and that these are being complied with’.

29. The administration of Scottish income tax is governed by a Service Level Agreement (SLA) between HMRC and the Scottish Government.[7] This is updated every year to reflect HMRC’s planned work. The SLA sets out the requirements and performance measures for the operation of Scottish income tax. HMRC shares the results of assurance exercises and compliance activities with the Scottish Government throughout the year and publishes an annual summary of its performance against the requirements.[8]

30. The Scottish Income Tax Board meets quarterly as part of its annual cycle of governance and discusses the performance of HMRC procedures on Scottish taxpayer checks, PAYE (Pay As You Earn) reconciliations and compliance plans. The Scottish Government has told us this provides it with a high level of assurance over HMRC’s administration of Scottish income tax. From 2023/24 onwards, the Scottish Government and HMRC have published the minutes of the Scottish Income Tax Board.

Scottish Tax Base

31. Accurate identification of Scottish taxpayers remains fundamental to the effective operation of the Fiscal Framework, to the size of the Scottish budget and in ensuring that the right amount of tax is collected from individuals.

32. The C&AG reports that HMRC carries out several assurance activities to maintain the completeness and accuracy of the Scottish taxpayer

[7] HM Revenue & Customs, Service level agreement for operation of Scottish Income Tax by HMRC, 14 December 2023.

[8] Scottish Income Tax HMRC Annual Report 2024, HMRC, November 2024.

population. This includes a series of checks on HMRC's records of Scottish taxpayers. The Scottish Government and HMRC agreed in October 2020 that third-party data checks (where taxpayer address records held by HMRC are compared with third-party data sources) should be run every two years. This comparison is the main source of assurance over HMRC's address information and is part of a wider suite of assurance activity as detailed in Figure 8 of the C&AG's report.

33. The C&AG has reported that HMRC has agreed with the Scottish Government to run an additional third-party data exercise in 2024, and in each of the next two years to more closely track any impact from increasing divergence in tax policy. HMRC and the Scottish Government have agreed that they will return to undertaking the third-party data assurance exercise every two years if, in the 2026 exercise, there are fewer than 15,000 address records where the residency data held by HMRC does not match the residency suggested by third-party data.

34. The C&AG has reported that the results of the 2024 exercise have not yet been made available. The most recent exercise for which results are available was completed in August 2023. These were included in last year's additional assurance report, and showed a slight increase in the number of taxpayer records that could be corroborated to third-party data. The undertaking of the additional exercise in 2024 and subsequent years is a positive development, however it is disappointing that the results are not available in time to include in this report. In my view, the Scottish Government should continue to consider the assurance required over the accuracy of HMRC's address records and how existing arrangements could be strengthened, including more timely publication of results.

35. The Scottish Government's joint statement with HMRC, Income tax reconciliation 2022/23, published in October 2024, highlights revisions to prior years outturns based on an HMRC data discovery. Between 2016/17 and 2021/22, HMRC had double counted PAYE liabilities where PAYE taxpayers had also submitted unsolicited self-assessment (SA) returns. This issue related to all taxpayers in the UK, including Scotland and Wales.

36. No taxpayers have paid the incorrect tax as a result of this issue. However, it has led to both the Scottish income tax outturn figure, and the corresponding UK income tax figure being overstated in each of these years. The C&G has reported that between 2016/17 and 2021/22, this led to HMRC overstating the Scottish income tax outturn by an average of £78 million per year, or 0.7 per cent of the previously reported outturn. HMRC has since revised its outturn calculations to remove the duplicate records for each of the affected years.

37. The C&AG reports that he has reviewed the revised calculations of Scottish income tax outturns for the period 2016/17 to 2021/22 and is satisfied that the adjustments determined are reasonable.

38. HMRC has calculated that, cumulatively over the period from 2016/17 to 2021/22 the Scottish budget should have had undergone a further negative reconciliation of £29 million as a result of this issue. The process of producing the outturn figures has been corrected for the 2022-23 outturn.

39. The C&AG has reported that HM Treasury and the Scottish Government have been discussing the historical discrepancies in the outturn calculations but have not yet agreed whether any adjustments are needed to amounts previously paid to the Scottish Government.

Compliance risks

40. HMRC continues to assess compliance risk for Scottish taxpayers in the same manner as it does for the entire UK taxpayer population; through its Strategic Picture of Risk (SPR). The Scottish SPR identifies risks for Scottish income tax by taking the Scottish share of UK NSND income tax. Scotland's share of the estimated revenue lost in 2021/22 (the latest year for which data is available) from risks identified in the SPR, such as tax evasion and not declaring income, is £1.1 billion.

41. The C&AG reports that HMRC generated an estimated additional £350 million in Scottish income tax through its enforcement and compliance activities in 2022/23 by generating additional revenues or preventing revenue losses.

42. Both figures are calculated based on a proportion of the UK figure, rather than using Scotland-specific data to quantify the risks. The C&AG emphasises that HMRC has limited information on specific compliance activity undertaken in Scotland. Unlike the income tax system which can flag Scottish taxpayers HMRC's compliance system cannot readily identify people living in Scotland.

43. The C&AG notes that, as in previous years, HMRC's compliance approach is based on its assumption that compliance risk in Scotland is consistent with the rest of the UK. This assumption is not tested by HMRC because of the methodological challenges and costs involved. The C&AG has previously reported that, with tax policy diverging further there is a risk that HMRC's assessment may not be sustainable in the longer term.

44. The C&AG also reports that there is typically a lag in HMRC's compliance procedures and the reporting or analysing of the data that HMRC monitors. Therefore, any compliance risk arising from further divergence in tax policy between Scotland and the rest of the UK from 2024/25 is unlikely to be considered until 2026/27.

45. This can lead to two separate risks for the Scottish Government to manage. Firstly, the delay means that the Scottish Government are not able to make tax policy decisions on the most up to date consideration of compliance risk. Secondly, the delay means that by the time any change in compliance risk is identified, it is too late to reflect in the confirmed outturn for the year in question.

46. For example, the outturn for 2024/25 Scottish NSND income tax will be known in summer 2026, with the adjustment to the Scottish budget then being made to the 2027/28 budget. Therefore, reconciliations to the 2027/28 budget would be made before compliance risks arising from further tax divergence in 2024/25 are fully known.

47. In line with the SLA, further compliance activity can be undertaken by HMRC and paid for by the Scottish Government. The C&AG reports that HMRC is now carrying out work to assess whether its current compliance approach in Scotland remains sufficient and to ensure it is prepared if the further divergence in tax policy from 2023-24 increases compliance risks. HMRC and the Scottish Government set up a compliance working group, which met for the first time in May 2024 and has been directed by the Scottish Income Tax Board to evaluate HMRC's approach to compliance in Scotland. This evaluation will cover how the current approach is working; the limitations in the approach and how these can be addressed; and how the scope of compliance activity could be increased and to what impact. HMRC expects to report to the board on the first phase of the evaluation in January 2025.

48. The C&AG has highlighted that as part of its evaluation, HMRC is seeking agreement from the Scottish Government on what is an appropriate response to any discrepancies identified from its assurance exercises both on third-party data and the number of incorrect 'S' codes applied by employers for Scottish residents. Responses being considered include opening a selected number of compliance cases to investigate further; sending letters to taxpayers; or doing further work to understand the reliability of third-party datasets.

49. Each year, HMRC also monitors cross-border migration trends to identify potential instances of taxpayers erroneously changing their address to obtain a tax advantage. The C&AG reports that for 2022/23 and 2023/24 HMRC encountered difficulties with importing land and property transaction data into its systems for the purposes of identifying Scottish taxpayers who have purchased property outside Scotland. It is instead reliant on other sources of information which are not as reliable.

50. In my view, the Scottish Government should regularly evaluate the costs and benefits of additional compliance activity in Scotland. The setting up of the compliance working group is an important step towards recognising the need to monitor, respond to, and report on the effects of the increasing divergence in tax policy between Scotland and the rest of the UK.

The accuracy and fairness of the administrative expenses

51. The C&AG notes that ‘based on our audit work, we have concluded that the amount paid by the Scottish Government (for the year ended 31 March 2024) was accurate and fair in the context of the agreement between HMRC and the Scottish Government’. HMRC invoiced the Scottish Government for £1.0 million of costs relating to the administration of Scottish income tax in 2023/24 (£0.6 million in 2022/23). Of this amount, £0.6 million related to running costs, a similar amount as in 2022/23. The remaining £0.4 million related to the implementation of the advanced rate of Scottish income tax, in particular ensuring systems such as its National Insurance and Pay As You Earn system and the Annual Tax Summary were updated ahead of the new tax band becoming operational in 2024-25. HMRC expects to recharge the Scottish Government £0.6 million in 2024-25 to finish implementing the advanced rate, this time for HMRC’s self-assessment systems.

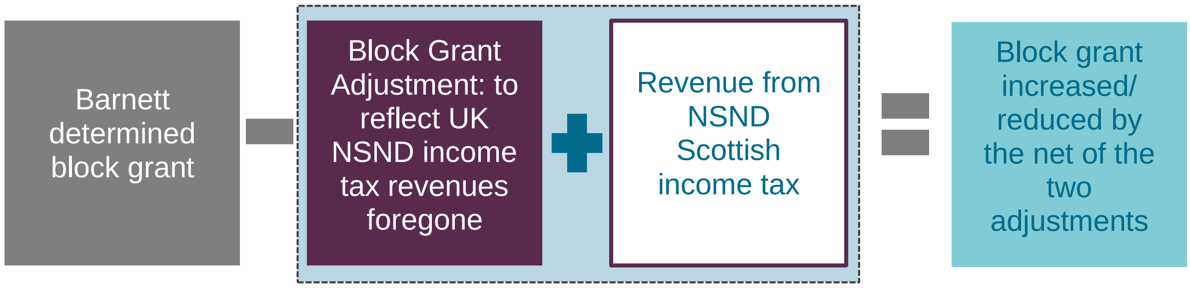
Audit insights

Impact of tax outturns on the Scottish budget

52. The block grant received from the UK Government remains the main source of funding for the Scottish budget. Since NSND income tax was devolved to Scotland in 2017/18, the total resource funding is now adjusted to take account of actual Scottish income tax revenues raised in Scotland. These are known as block grant adjustments (BGAs).

53. For Scottish income tax, the block grant is reduced by the amount of income tax foregone by HM Treasury by devolving it. Scottish income tax receipts are then added to the block grant in its place (Exhibit 1).

Exhibit 1
The block grant is adjusted for NSND Scottish income tax



Source: Audit Scotland

54. The 2022/23 budget figures for Scottish income tax were based on independent forecasts prepared by the Scottish Fiscal Commission (SFC) and the Office for Budget Responsibility (OBR). The OBR forecasts the BGAs and the SFC forecasts the Scottish income tax revenues. A budget adjustment (or 'reconciliation') is made in later years once outturn data is known.

55. The reconciliation resulting from 2022/23 outturn figures is a budget increase of £449 million. This is the largest adjustment to the budget resulting from the reconciliation to date. This will be added to the funding envelope for the 2025/26 Scottish budget.

56. The forecasts originally used for the 2022/23 Scottish budget reduced the budget by £190 million, the net difference between forecast tax foregone by HM Treasury and forecast Scottish Income tax receipts.

Outturn data shows that there was an increase of £259 million, a positive difference of £449 million from the forecast reduction (Exhibit 2).

Exhibit 2
How the Scottish income tax outturn relates to the 2025/26 budget reconciliation

£ million	BGA – reflecting income tax foregone by HM Treasury	Revenue from NSND Scottish income tax	Net effect on budget
Forecasts used for the 2022/23 budget	-13,861	13,671	-190
Final outturn	-14,909	15,169	259
Reconciliation required through the 2025/26 budget			**+449**

Source: Audit Scotland, based on Scotland's Economic and Fiscal Forecasts, Scottish Fiscal Commission, December 2024

57. The SFC notes that it set its forecasts during a period of uncertainty as the UK was still being affected by the Covid-19 pandemic, and after the forecast was published there was a period of high inflation caused in part by the impact of the invasion of Ukraine and a subsequent increase in energy prices.

The economic performance gap

58. The positive reconciliation provides additional funding in 2025/26 beyond the block grant that can be used to support the Scottish Government's overall financial challenges. Audit Scotland has previously published more detail on the mechanics of tax reconciliations in its Operation of the Fiscal Framework papers.

59. The Scottish Government set out in its 2023 Medium-Term Financial Strategy that economic growth and tax revenue generation are important levers to move towards a more financially sustainable position.

60. Since the devolution of Scottish income tax in 2017/18, the net benefit to the Scottish budget has been significantly less than the additional taxes actually paid in Scotland. This is due to the relatively slower economic growth in Scotland.

61. The net amount added to, or deducted from, the Scottish budget for Scottish income tax depends on two main factors:

- the relative tax policy of Scotland compared to the rest of the UK (for example different tax rates and tax bands)
- the relative economic performance of Scotland compared to the rest of the UK. Specifically, this is the relative change in tax per head of the population, indexed from a 2016/17 baseline year.

62. To date, higher rates of tax compared to the rest of the UK, and a different tax band structure has increased relative tax revenues. However, as the SFC points out in its Fiscal Update, August 2024, relatively slower economic growth has 'acted as a drag' on these revenues for budget purposes.

63. Exhibit 3 shows how Scottish tax policy and economic performance compared to the rest of the UK has impacted the Scottish budget since Scottish income tax was devolved.

Exhibit 3
The impact of relative tax policy and economic performance on the Scottish budget for Scottish income tax

(£ million)	17-18	18-19	19-20	20-21	21-22	22-23	Cumulative
Additional tax paid due to tax policy differences (both Scottish and UK policy changes)	94	386	620	638	749	881	**3,367**
Economic performance differences (relative employment and earnings divergences and other factors)	-185	-259	-465	-542	-663	-624	**-2,738**
Net position (increase or decrease to the Scottish budget)	**-91**	**127**	**155**	**96**	**85**	**257**	**629**

Source: Audit Scotland analysis of Scottish Fiscal Commission, Fiscal Update – Charts and Tables – August 2024. Note: the final net position in December 2024 shown in Exhibit 2 is £259 million, compared to the £257 million known at the point of the SFC August report

64. For 2022/23, the SFC estimates that differential income tax policies implemented since 2017/18 have raised up to an additional £881 million from Scottish taxpayers. However, slower economic growth and other factors reduced the net benefit to the budget by £624 million. This is called the economic performance gap.

65. Cumulatively, the analysis at Exhibit 3 shows that of the additional £3.367 billion contributed by Scottish taxpayers due to tax policy divergence since the tax was devolved, the direct net impact on Scottish budgets arising over the same period is £629 million.

66. The economic performance gap is expected to grow in 2025/26. SFC forecasts published alongside the 2025/26 Scottish budget estimate that, of the additional £1,676 million income tax estimated to be raised because of tax policy divergence, £839 million will be netted off because of slower Scottish economic growth. This means that of the additional £1.7 billion Scottish taxpayers will pay in 2025/26, the Scottish budget will increase by only around half of this sum, £839 million.

67. This highlights the importance of relative economic performance in Scotland compared with the rest of the UK, including relative earnings and employment compared to the baseline 2016/17 year.

Potential future economic performance and the impact on tax

68. The SFC stated in its December 2023 Scotland Economic and Fiscal Forecasts publication that from 2024/25 through to 2028/29, its forecasts for earnings growth in Scotland were higher than those for the rest of the UK. This, alongside expected increased relative tax revenues due to factors such as fiscal drag and higher tax rates, were forecast to lead to increasingly positive budget reconciliations over the medium term.

69. Positive budget reconciliations from all devolved taxes, including Scottish income tax, were forecast to add around £1.5 billion to the budget in 2024/25, rising to around £2.4 billion by 2028/29. Improvements in the income tax net position account for most of the growth.

70. These forecast additions to the budget are important to the Scottish Government in managing the fiscal sustainability of its budget over the medium term. However, the SFC flagged as an explicit risk that if, rather than stronger growth, earnings growth in Scotland is more similar to the UK, then the income tax net position and the funding available for the Scottish budget will be lower than currently projected.

71. In its August 2024 Fiscal Update, the SFC noted that the latest data suggests Scottish earnings growth is indeed slowing relative to the UK, meaning the period of catch-up in Scottish income tax revenues may be coming to an end in 2024/25.

72. In its most recent December 2024 forecasts, published alongside the 2025/26 Scottish budget, the SFC states that while it still expects Scottish income tax policy and fiscal drag to continue to contribute positively to the income tax net position in the coming years, the income tax net position may not turn out to be as positive as thought a year earlier (Exhibit 4).

Exhibit 4
Changes in the income tax net position since December 2023

£ million	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Dec-23	827	1,412	1,749	1,896	2,178	2,288
Dec-24	788	711	838	1,314	1,774	2,051
Change	**-39**	**-701**	**-911**	**-582**	**-405**	**-237**

Source: Audit Scotland analysis of Scottish Fiscal Commission, Scotland's Economic and Fiscal Forecasts – Charts and Tables - December 2024

73. The Scottish Government will need to monitor this closely, given the impact on overall fiscal sustainability of lower than forecast returns. I have highlighted previously the importance of economic performance to public finances, and this is also a key pillar of the Scottish Government's overall approach to medium-term fiscal sustainability. I have recently set out the need for better medium-term planning in my Fiscal Sustainability and Reform in Scotland performance report.

Taxpayer behaviour

74. Due to the importance of both tax policy and economic growth, the way that taxpayers respond in relation to diverging tax policies between Scotland and the rest of the UK is important. The Scottish Government's additional work in this area through the Scottish Income Tax Board is encouraging, and understanding the way taxpayers behave will be important to understand the potential future budget impact or tax policy decisions.

75. Taxpayers may respond to divergences in tax policy by changing their behaviour. Behavioural responses can cover a wide range of taxpayers' responses to policy changes, including:

- **Economic responses**: seeking work or increasing the number of hours worked or vice versa.
- **Cross-border mobility**: taxes could also affect migration, both into and out of Scotland.

- **Tax planning or avoidance**: shifting income into a more tax-efficient source, such as dividends; or artificially reducing one's tax liability.

- **Evasion**: where there is a deliberate (and illegal) attempt not to pay the tax which is due.

76. The SFC account for behavioural change in their forecasts (behavioural costings), which can reduce the overall impact of tax policy changes on the budget. These costings represent the legal responses that could arise, such as migration and economic responses.

77. In 2023, SPICe published a blog on behavioural change which set out the inherent uncertainties of forecasting and measuring behavioural change.

78. In December 2021, HMRC published an analysis of Scottish taxpayer liabilities and behaviour over time. This showed some limited evidence of Scottish taxpayers lowering their taxable income in response to increasing tax rates. The analysis also found that generally taxpayers earning higher levels of income decreased their declared income by more than those on lower incomes. The Scottish Government reflected the findings in relation to Scottish taxpayers in its policy evaluation of Scottish income tax, also published in December 2021.

79. The C&AG has reported that HMRC published further analysis in April 2024 which showed no evidence of a change in labour market participation, but some evidence of a decrease in net migration to Scotland from the rest of the UK in the first year of the policy change for Scottish taxpayers above the higher rate income tax threshold.

80. HMRC also published in April 2024 its first analysis of incomes and location of UK taxpayers over a 12-year period up to and including 2021/22. The analysis showed a gradual increase in net migration to Scotland and Wales from the rest of the UK from 2016-17 onwards, with this increase accelerating in 2020-21 and 2021-22, the years of the Covid-19 pandemic. However, HMRC says it cannot draw conclusions about whether migration trends were affected by income tax policy as it does not know what level of migration would have been expected without any divergence in tax policy. The C&AG remarks that it may not be until 2027 that HMRC can assess how migration has been affected by the recent changes in tax rates in Scotland in 2023-24 and 2024-25.

81. The publication by HMRC of the analysis on migration and taxpayer behaviour in relation to income tax changes over time is a positive development. Obtaining better quality data will help inform future tax policy decisions. In my view, further analysis to draw out the extent of any causal relationship between tax policy changes and taxpayer behavioural responses and migration would be beneficial.

Administration of Scottish income tax 2023/24

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