Today we publish our annual Budget report, “Scotland’s Budget 2018” which is available at the following **link**.

The aim of the report is to set out the opportunities, risks and choices facing the Scottish Government as it prepares it draft budget for 2019/20. The report covers the outlook for the Scottish economy and the Scottish budget.

Each year we also focus on a variety of longer term public finance questions. This year we focus on the options for reforming taxes and introducing new taxes, and discuss the differences in the funding of higher education between Scotland and England.The Scottish Budget will come at a time of improving economic growth for Scotland. This growth has been relatively broad-based but also still weak by historical standards. At the same time, a cloud of uncertainty hangs over the economic outlook due to Brexit.

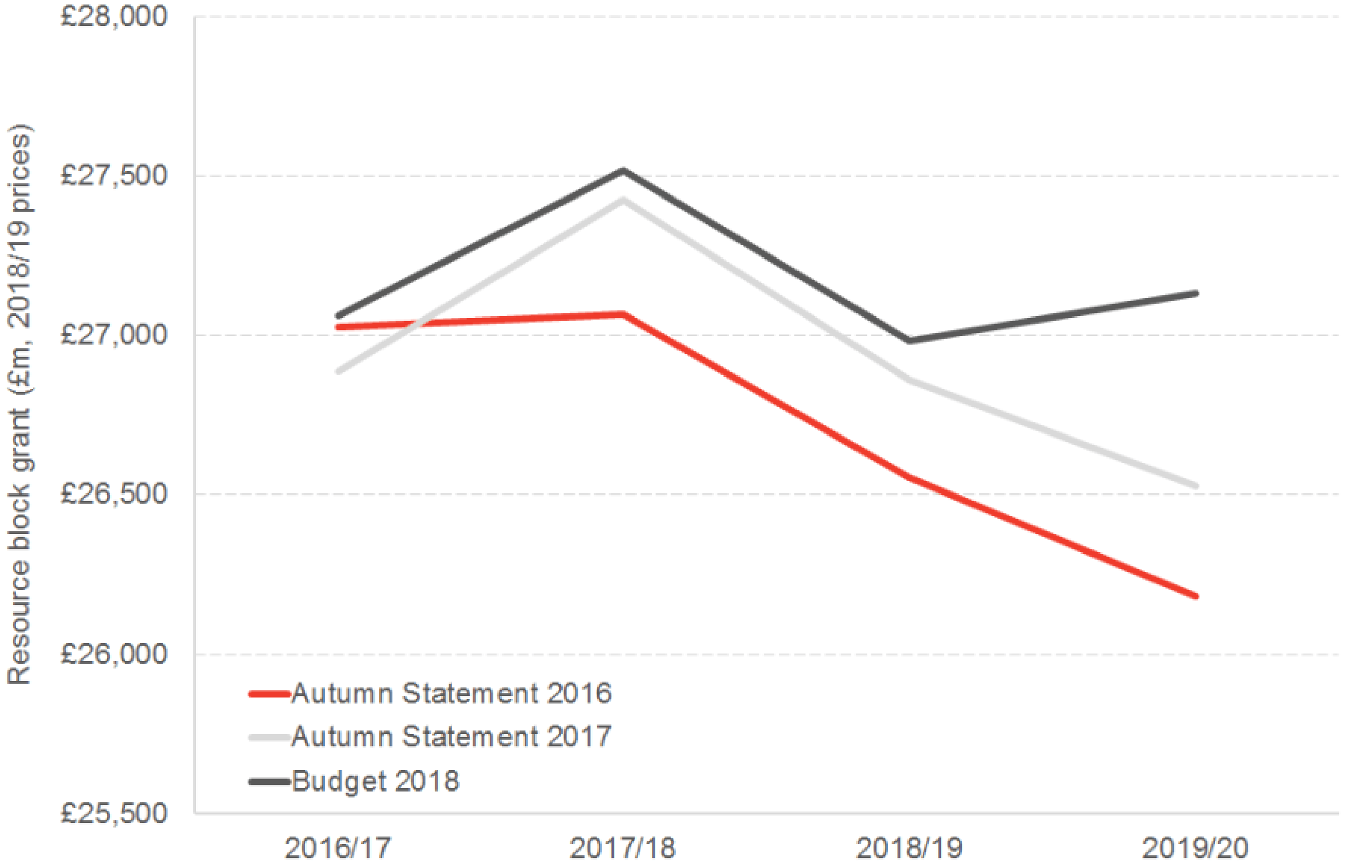
Unlike in his previous budget and autumn statements, at the 2018 Autumn Budget the Chancellor had relatively little to say about the economic context and focussed instead on announcing increased spending and tax cuts.

The outlook for the overall budget

Following these decisions by the UK Government, the outlook for the Scottish block grant improved in each of the remaining years of the parliament.

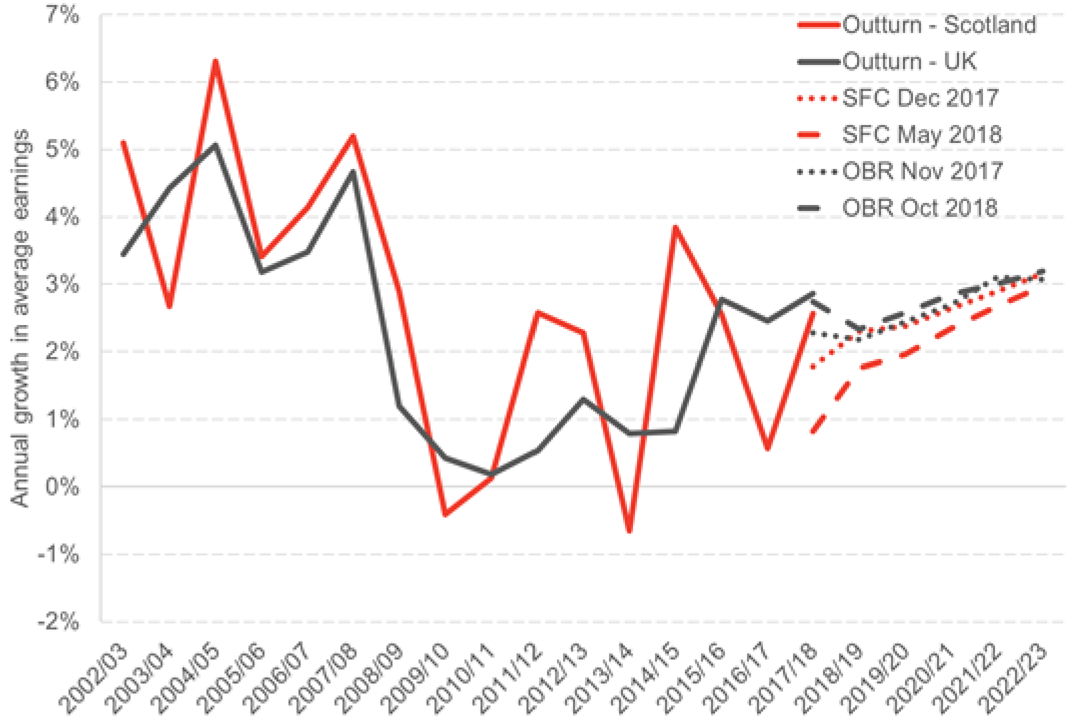
The Scottish Government’s block grant from Westminster will be £700m higher in 2019/20 than had been indicated this time last year. Rather than declining in real terms, it will increase slightly.

Chart: Outlook for Scottish block grant



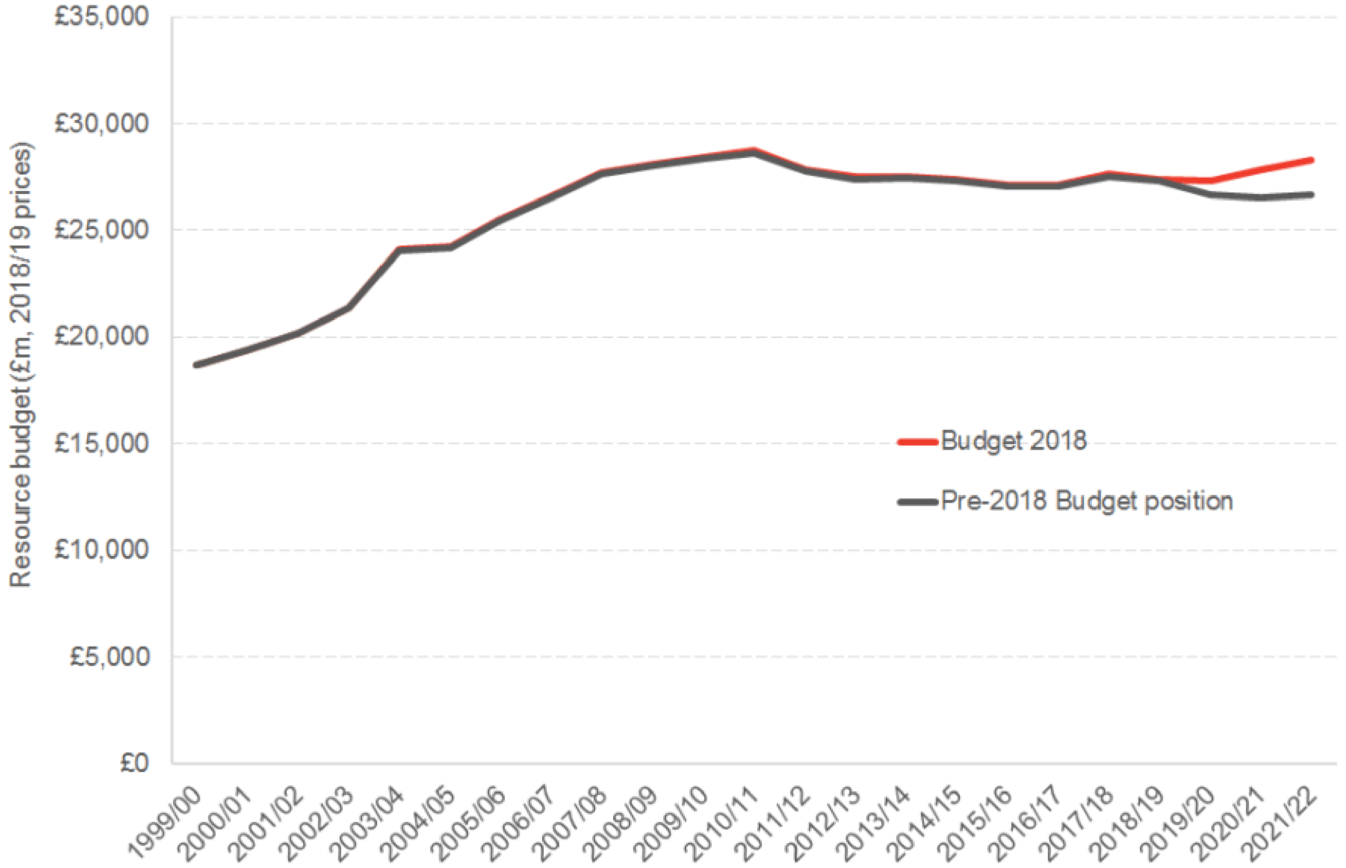
However, some of this improvement in the outlook for 2019/20 is likely to be offset by a deterioration in income tax forecasts since last year. This deterioration was driven by a downward revision to the forecast for Scottish wage growth made by the SFC in May 2018 compared to its forecast in December 2017. Recent outturn data suggests that earnings growth in 2018 was higher than the SFC forecast, so there is likely to be some upward revision in its forthcoming forecasts this December – but these are unlikely to be sufficient to offset the previous deterioration.

Chart: Average earnings in Scotland



What does this mean for the Scottish Government's overall budget outlook (taking into account the block grant and the tax revenues)? The projection for the resource budget has improved since last year in each of the remaining years of parliament. The Scottish budget 2021/22 is projected to be £1.5bn higher than anticipated a few months ago, and is set to increase in real terms by 3% over next three years.

So it's all good news then? Not quite. On the basis of the latest projections the total resource budget (block grant and tax revenues) will still be lower by the end of parliament than it was in 2010/11 (although back to where it was in 2008/09) – with the block grant being back at around 2006/07 levels. And in per capita terms, the budget at the end of the parliament will be some 7% lower than it was at the start of the austerity period.



Austerity may be ending, but the outlook is still for significant constraint.

What about spending?

How will the government allocate its budget? It set out its high level spending plans in May. Its major spending commitments relate to the NHS, childcare, policing, school attainment, and social security.

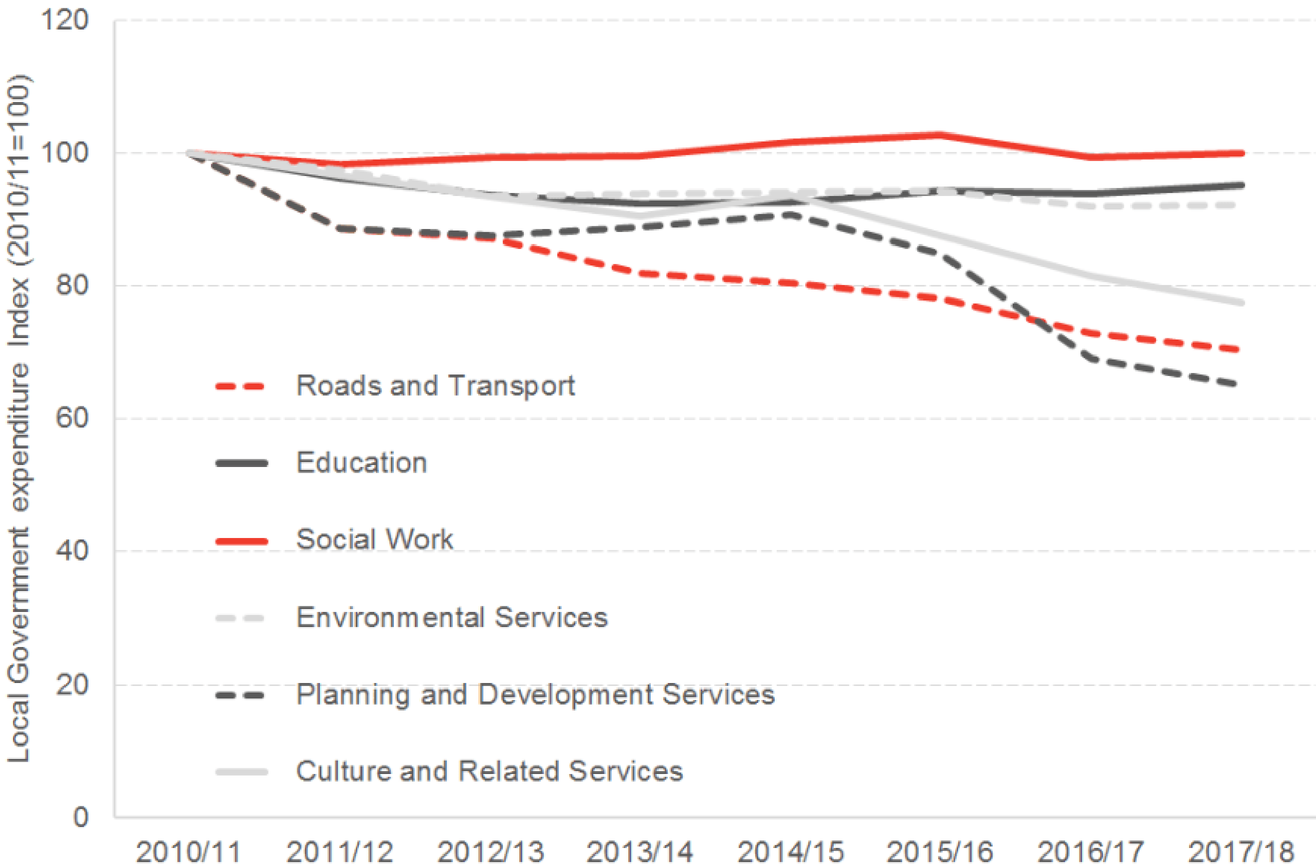
Given the outlook for the budget at the time, these commitments implied cuts to remaining areas of 12%.

Since then, the outlook for the budget has improved. The government's commitment to 'pass on' health consequentials means that the health budget will grow at 2.7% per annum for the next three years of the parliament, compared to 1.5% per annum under the May plans. At the same time, the outlook for unprotected portfolios has improved too – cuts are still projected, but they are less severe.

But the government still faces difficult choices. Further spending increases for health, to match projected demand growth, would entail opportunity cost in terms of faster cuts elsewhere.

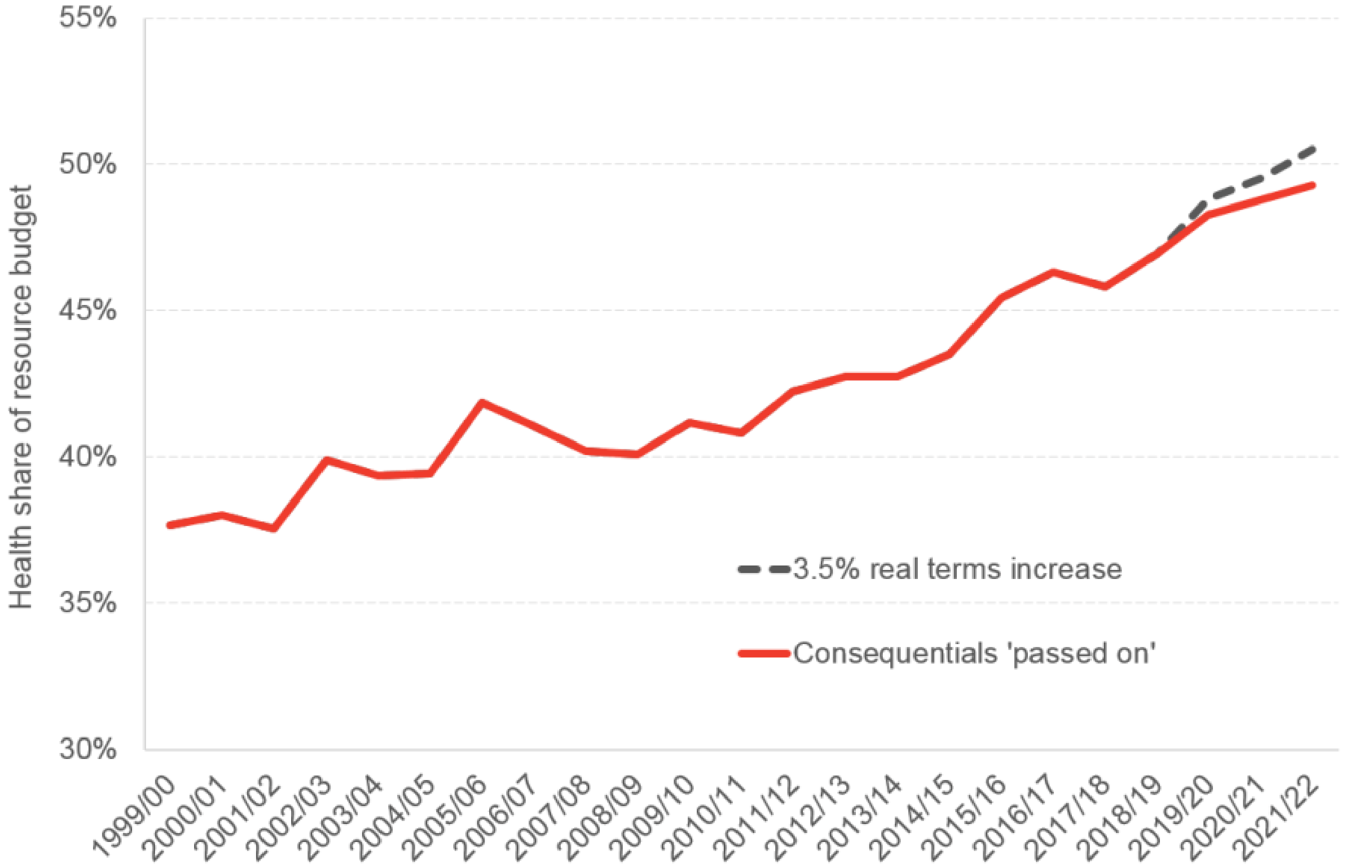
Local Government has seen cuts to its core resource budget of 8% since 2010, with many non-statutory services seeing cuts of over 15% since 2010.

Chart: Local government spending priorities



The trajectory of public spending since 2010 has been of a retrenchment of spending onto core areas of health, education and social care. This pattern is set to continue – health spending will account for almost 50% of resource budget by end of parliament, if not before.

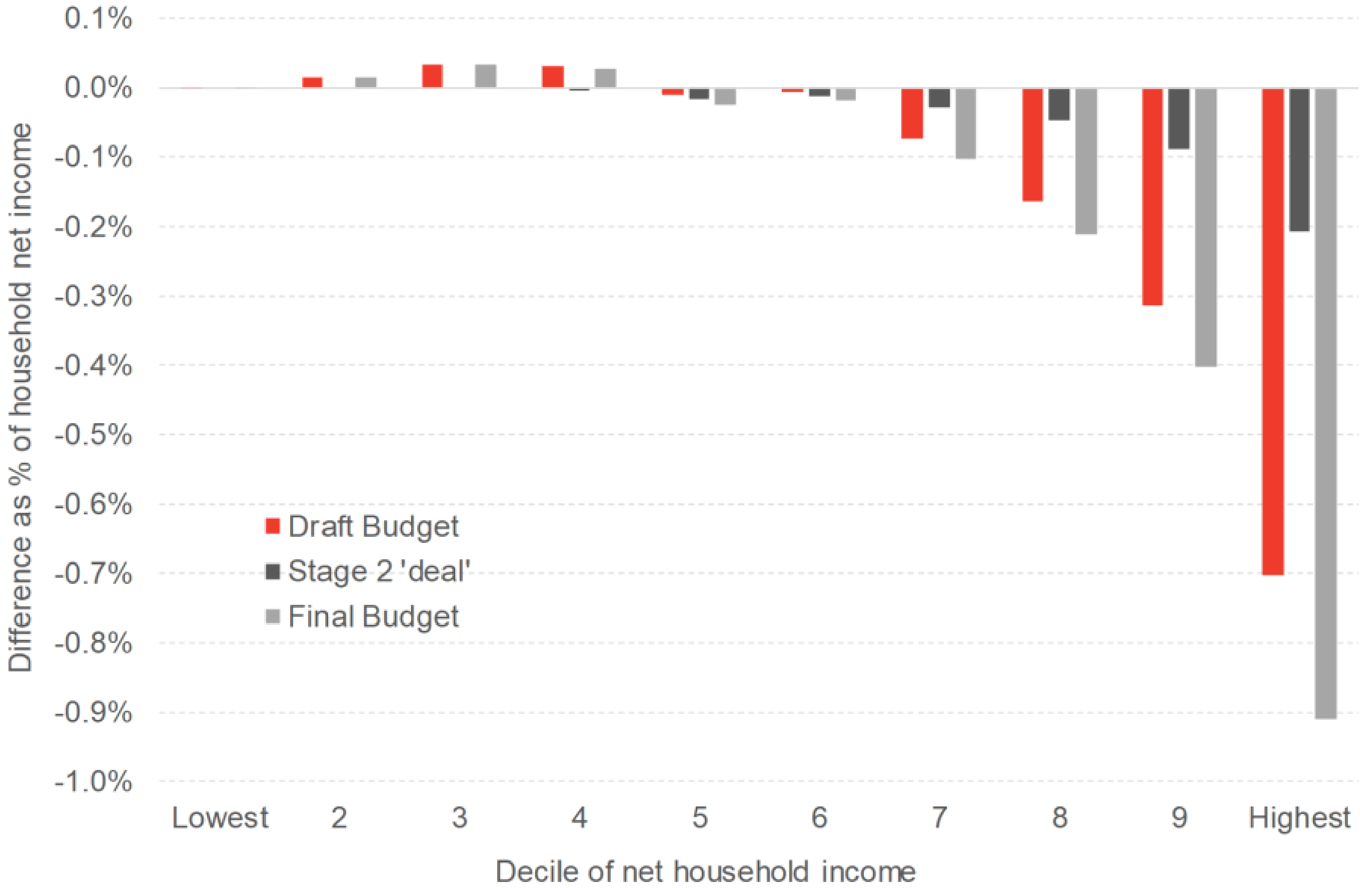
Chart: Outlook for health spending



Tax choices

In its last two budgets, SG raised money for public services from income tax changes. These changes been progressive across distribution, but opened up a tax differential with rUK that is particularly stark for the 13% highest income taxpayers.

Chart: Distributional effects



Income tax choices will be hotly debated again this year. The government may feel pressure to at least partly close gap in the higher rate threshold with rUK, but this would come with big price tag. The government has a range of options for raising revenues from income tax – but only relatively broad-based increases are likely to make a substantial difference to the budget position.

Policy	Revenue
Freeze HRT rather than increasing with inflation	£64m
Increase HRT to £46,850	-£132m
Increase HRT to £50,000	-£280m
1p on Basic Rate	£167m
1p on Intermediate Rate	£128m
1p on Higher Rate	£64m
1p on Additional Rate	£2m
Freeze Intermediate Rate	£6m

A genuine reform would consist of revaluation and a more progressive tax structure – and this could be designed to be revenue neutral with respect to the existing system, or to raise revenue. But change may manifest itself simply in a further tweak to bands, similar to that in 2017.

Or perhaps 2019/20 will be the year we see steps towards genuine reform of council tax – given the Greens' enthusiasm and their importance in the current parliamentary arithmetic.