University of Strathclyde Business School

Scotland's Budget Report 2022

The Fraser of Allander Institute (FAI) is a leading economic research institute with over 45 years experience of researching, analysing and commentating on the Scottish economy.

The FAI undertakes a unique blend of cutting-edge academic research, alongside applied commissioned economic consultancy in partnership with business, local and national government and the third sector.

For over 45 years, *The Fraser of Allander Institute Economic Commentary* has been the leading publication on the Scottish economy providing authoritative and independent analysis.

For regular analysis on the Scottish economy and public finances please see our blog
www.fraserofallander.org

Summary

Few would envy John Swinney his position right now. After a difficult Autumn of emergency budget reviews and public sector pay disputes, many of which still have no end in sight, the Deputy First Minister has made no secret of the fact that he feels that this is the most difficult period he has overseen for the public finances.

In our report today, we set out the main issues and challenges the DFM will be grappling with when he sets out the 2023-24 budget on Thursday.

As was illustrated by the Office for Budget Responsibility (OBR) in their recent forecasts, the economic situation has deteriorated markedly since the 2022-23 budget was presented, with high inflation set to eat away at living standards over the next two years.

This high inflation environment eroded the value of the Scottish Government's (SG's) budget in 2022-23, leading to cuts to preannounced spend earlier in the autumn. While the impact is unlikely to be as large as the SG claims, it would be fair to say that the budget is worth about £1bn less in real terms than was the case when spending decisions were originally made.

The announcements made by the Chancellor on 17th November did not help the situation in 2022-23, but they have generated significant consequentials for 2023-24 and 2024-25 – which more or less offset the impacts of inflation on the budgets for these years. So, as difficult as the outlook is, there is no doubt that this will help the SG in setting their budget.

Of course, the SG has significant devolved tax powers and therefore has decisions to make on Thursday about whether or not to use them to generate more revenue for public services. We discuss in the detail of this report what the context could mean for income tax, council tax and non-domestic rates. It seems likely that that the SG will follow suit on most of the UK tax decisions, including income tax threshold freezes and the reduction of the Top Rate threshold to around £125k.

We will also be looking out to any further announcements on social security and any decision on uprating Scottish benefits in 2023-24. Social Security is an increasing

proportion of the budget and there is increasingly a gap between the expenditure on devolved benefits and the funding from the UK Government because of devolution.

The industrial unrest we are currently seeing in public services at the moment about the current round of pay deals for 2022-23 provides an interesting backdrop to the presentation of the SG's public sector pay policy for 2023-24, which we will see alongside the budget on Thursday.

Given the assumptions that were made in the SG's resource spending review in May about keeping the public sector pay bill flat in cash terms (which looked infeasible even then), we will have to see how these assumptions affect the overall portfolio allocations.

Despite the excitement of Thursday, and the fun we will have trawling through all the tables, it's important to remember that the budget is not an end in itself.

Rather, it should be a means of delivering the Scottish Government's 'Purpose' as set out in the National Performance Framework and the National Outcomes.

Ensuring that the Budget allocations align with the priorities set out in government speeches and in the publication of its myriad strategies is incredibly important for trust in government.

We hope more progress is made this year in demonstrating that evidence of the impact of policies has been integral to the Budget making process.

Fraser of Allander Institute

December 2022

Introduction

The Scottish Budget for 2022-23 was described by Kate Forbes as the most challenging that she had delivered. The government's block grant from Westminster was set to be lower than it had been the previous two years, as Covid-specific funding was rolled back. The government's budget for 2022-23 did remain higher in real terms than pre-Covid, but in the face of severe challenges facing public services this was cold comfort.

Since the 2022-23 budget was published, the outlook has become even more challenging. This leaves the Deputy First Minister John Swinney, who is covering for Ms Forbes while she is on maternity leave, to deal with an extremely challenging situation. Indeed, he has remarked, "in all of my experience, now and during my previous tenure as Finance secretary, there has never been a time of greater pressure on the public finances"[1].

Inflation, which was forecast at the time the budget was published to reach 3.7% in 2022-23, is now running as high as 11.1%. This has constrained the spending power of the government, and set the scene for protracted negotiations over public sector pay – the pay policy at the time the budget was published having been abandoned earlier in the year.

In 2022-23, with no additional resources allocated by the UK government, and with the Scottish government having very limited scope to raise revenues 'in-year', the government's response has been to reallocate funding to absorb the higher costs as best it can. In a recent report on the public finances, Audit Scotland warned that there is a 'real risk' that the Scottish government overspends against its 2022-23 budget[2].

The outlook looks a little better for 2023-24. Whilst the UK government announced no additional spending to cope with higher inflation in 2022-23, it has announced additional funding, relative to its previous plans, for 2023-24 and 2024-25. We discuss in this report the extent to which that additional funding offsets, or more than offsets, the impact of higher inflation on the government's spending plans.

In May this year, the Scottish government published its Resource Spending Review which set out spending plans in broad terms for the remaining four budgets of the parliament, from 2023-24 – 2026-27.

As such, we have a much clearer idea about how it is likely to prioritise its spending next year, in advance of the budget itself, than is usually the case pre-budget. We discuss in this report the extent to which changing circumstances and the evolving budget position may result in material changes to the spending plans for next year that the government set out in May.

[1] Emergency Budget Review Ministerial Statement
[2] Scotland's public finances: challenges and risks. Audit Scotland, Nov 2022

The economic outlook has worsened substantially since last year, with higher inflation contributing to a recession and a serious deterioration in household income

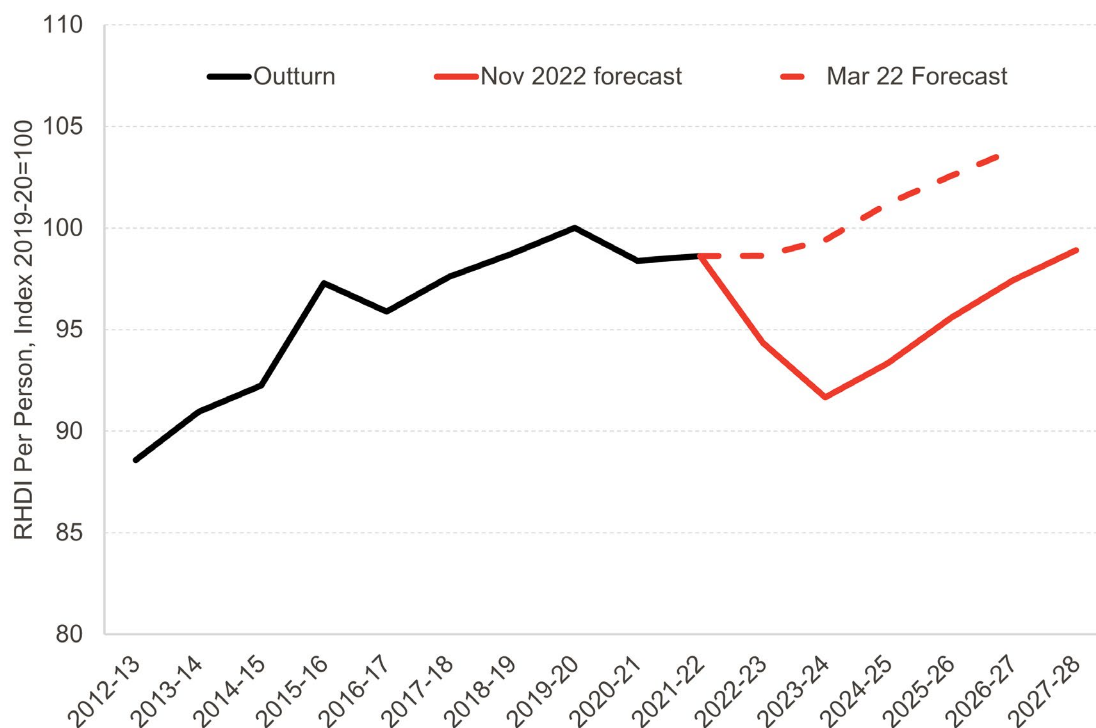
The economic outlook has got considerably worse since last year, with the economy now entering a recession, which, according to the OBR, will last for around a year. The OBR are positive compared to the Bank of England, who in their latest set of forecasts thought the recession was going to last for two years – which would be the longest on record.

One of the interesting things about the OBR's forecasts is how relatively buoyant they are for 2024 and beyond, again in stark contrast to the views of the Bank who are expecting very poor growth even as the economy starts to recover. The timing of the two forecasts, with the OBR factoring in decisions announced at the Autumn Statement, may explain some of the divergence, but it also reflects difficulties of forecasting amongst such economic uncertainty.

We await with interest the Scottish Fiscal Commission's views on this when they publish their new set of forecasts on Thursday. All else being equal, we would expect that growth in Scotland would be slower overall due to slower population growth, but there are a number of different judgements that the SFC will have to make in a very uncertain environment.

The starkest part of the OBR forecast that was published alongside the Autumn Statement was the impacts they are expecting on living standards, as measured by Real Household Disposable Income (RDHI). The OBR are forecasting that this will fall by 7% over the next two years.

Chart 1: Real Household Disposable Income, 2012-13 – 2027-28



Source: OBR

Box 1: Sources of Scottish Government funding

The Scottish Government's Resource Spending Review of May 2022 set out plans for resource spending of £43.3bn in 2023-24. What are the sources of this spending?

- The largest element is core **block grant funding** from the UK government that is determined by the Barnett Formula. This accounted for £34.9bn.
- The **net tax position** is the difference between the revenues raised by the Scottish Government from the three devolved taxes (income tax, Landfill Tax, and Land and Buildings Transactions Tax) and the deductions from the block grant to account for the transfer of revenues from these taxes from the UK government to the Scottish government.
- According to the May 2022 forecasts, the 'net tax' position was forecast to be -£265m. This implies that the Scottish budget was £265m worse off than it would have been had these taxes not been devolved. We discuss the next tax position in further detail in the report.
- Additional grant funding of £4.1bn accounts for the **social security payments** that have been devolved to Scotland following the recommendations of the Smith Commission. According to the May 2022 forecasts, the 'net social security' position was forecast to be -£357m in 2023-24.
- **Revenue from Non-Domestic Rates**, which is collected by local authorities, pooled centrally, and then redistributed to local authorities, was projected at £3.2bn.
- **Other elements** of funding include £700m of ring-fenced funding associated with the Rail Resource Grant and EU replacement funding streams. It also includes £400m of resource borrowing and drawdown from reserves, and various other small or one-off sources of revenue.

Higher than expected inflation has eroded the real terms value of the Scottish budget in 2022-23 – but not by as much as the government has claimed

Before going on to consider the future outlook, let's consider 2022-23 – the current financial year – first. The Scottish government published its budget for 2022-23 in December 2021. Since then, the outlook for inflation has worsened considerably. At the time the budget was published, inflation was expected to be 3.6% in 2022-23.

The war in Ukraine changed that. CPI inflation is now running at 11.1%, and is expected to be 10.1% over 2022-23 as a whole. However, the UK government has kept its departmental spending plans for 2022-23 unchanged from those that it set out in October 2021, expecting departments to absorb any additional cost pressures from within their existing budgets. As a

result, there has been no change to the Scottish government's block grant for 2022-23 – the £43.3bn that informed its budget has not been 'topped-up'.

What is the impact of higher inflation on the real terms value of this block grant? We have heard John Swinney say[3] several times that the block grant is worth £1.7 billion less than when the budget was set in December.

In order to discuss this, we need to have a discussion first about the way that government spending is generally put into real terms.

In general, government spending is deflated (i.e. expressed in 'real terms') using the GDP deflator, which generally does a reasonable job of reflecting the cost pressures faced by the government sector. The GDP deflator captures domestically generated inflation across the whole economy and is generally much better than, for example, a measure of consumer inflation when deflating government spending.

After a bit of investigation, we understand that the £1.7 billion figure is calculated using the difference in the GDP deflator that was assumed in December (2.7% for 2022-23) and the HMT's August survey of external forecasters for the estimate of GDP deflator (7.8% for 2022-23).

However, the OBR is now expecting that the GDP deflator will be 4.9% in 2022-23, so this figure (on this basis) now looks overblown.

More generally, it is reasonable to question the measure of inflation used right now to adjust government spending, given the influence that very high consumer inflation is having on public sector pay. We consider this just for the resource block grant (rather than the whole block grant) as this is the part of the budget that these pay deals are putting under pressure.

Using the GDP deflator, the Scottish government's resource block grant is around £0.7bn lower in 2021 prices now – given what has happened to inflation – than it was when the budget was published.

If we use CPI rather than the GDP deflator, then the Scottish Government's resource block grant is around £1.7bn lower than it was when the budget was published.

Whilst there is a case for saying that the GDP deflator underplays the effect of inflation on the government's budget, CPI almost certainly overstates it. The cost pressures facing government are not increasing 10% this year (pay does account for a large proportion of government spending, but pay is increasing by less than 10%).

Nonetheless, what this discussion shows is that the Scottish budget has been substantially squeezed during 2022-23 as a result of faster-than-expected inflation. The Scottish Government's preferred figure of £1.7bn arguably somewhat overstates the effect of inflation on the budget, but it would not be unreasonable to say that the real terms value of the budget has declined by around £1bn.

[3] Emergency Budget Review Ministerial Statement

Funding increases in 2023-24 offset or almost offset the effects of higher than expected inflation

In May this year, the Scottish Government published its Resource Spending Review. This set out its broad spending plans from 2023-24 to 2026-27.

Two things have changed since it was published. First, additional increases in inflation (over and above the increases that took place between December 2021 and May 2022) have continued to erode the real terms value of these allocations. Second, the UK government has announced some changes to its spending plans which will impact the Scottish Government's block grant. In brief, these changes amount to some funding increases in 2023-24 and 2024-25, relative to what was previously set out, but reductions in planned spending in 2025-26 and 2026-27.

The additional spending announced by the UK Government in the Autumn Statement generates 'consequentials' for the Scottish budget of £1bn in 2023-24 and £800m in 2024-25. To what extent does this additional spending for the Scottish block grant offset the effects of higher inflation?

The answer again depends to an extent on the choice of deflator. Using the GDP deflator, then the effect of higher forecast inflation – since May 2022 – is to erode the real terms value of the Scottish resource block grant in 2023-24 by £500m. This is more than offset by the increase in consequentials – even if we factor in the fact that, in its Resource Spending Review, the Scottish Government assumed that it would receive £250m of additional consequentials for 2023-24.

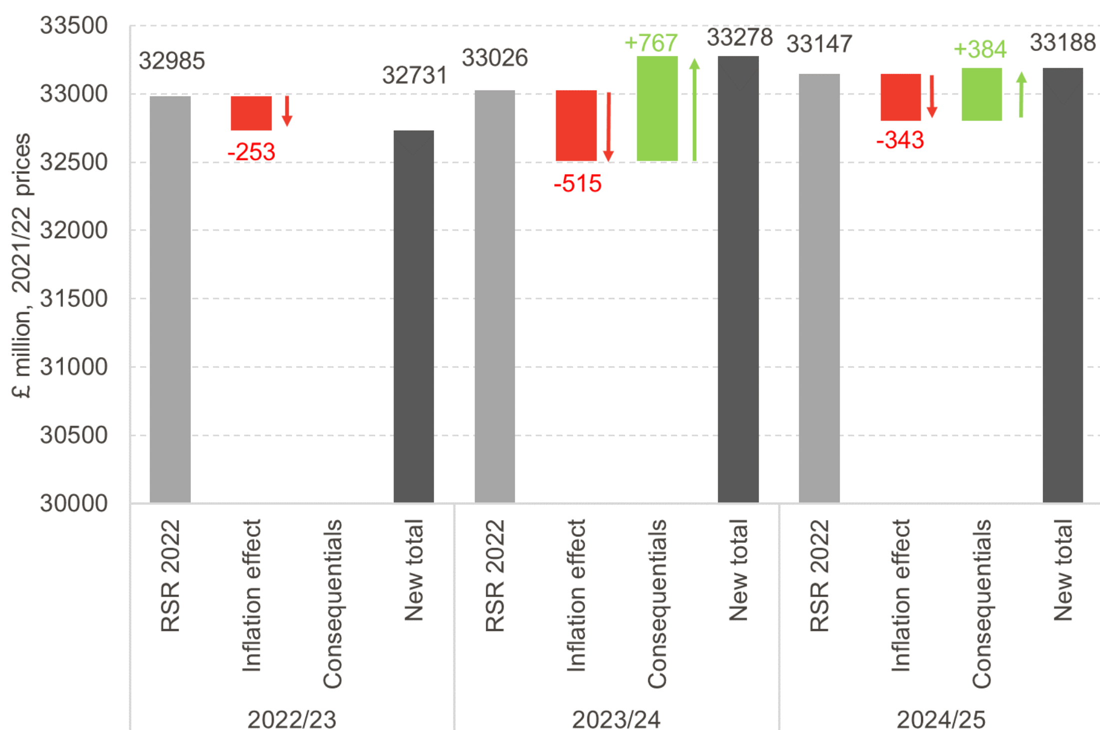
In 2024-25, the effect of higher inflation is to erode the real terms value of the resource block grant by almost £400m. In addition, the Scottish government had assumed at the time of its Resource Spending Review that it would receive £400m in additional consequentials for 2024-25 by the time it came to deliver its budget for that year. The £800m additional consequentials announced at Autumn Statement thus just offset the combined effects of higher inflation and the government's previous assumptions, leaving its real terms spending plans unchanged.

The analysis so far uses the GDP deflator. It would be unreasonable to use CPI itself to deflate the government's budget. As noted above, this would overstate the impacts of inflation. However, it would not be unreasonable to take the mid-point of the GDP and CPI deflators. Then the outlook for the Scottish resource block grant deteriorates slightly – by just over £300m in 2023-24 and 2024-25 – relative to the outlook in May. In the scheme of things, this is a small deterioration in the outlook, equivalent to around one per cent. But two points are worth making.

- First, the funding outlook for 2023-24 and 2024-25 was already extremely constrained in the context of the funding commitments made. Any deterioration in the outlook will be difficult to manage.

- Second, we are talking here about changes in the outlook since the Resource Spending Review was published in May 2022, as that is the right comparison to make. But it is worth noting that the real terms value of the Scottish funding outlook has deteriorated significantly more than this since October 2021 (when the UK Government Spending Review was published).

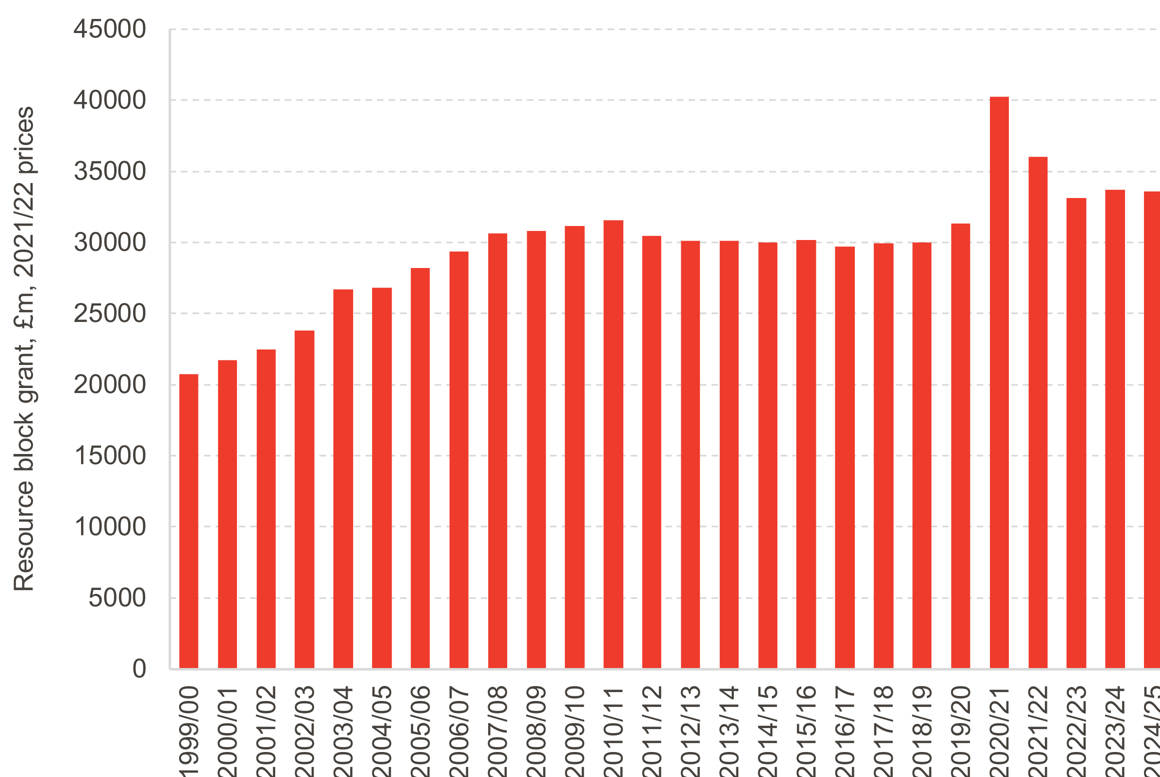
Chart 2: Changes to the real-terms outlook for the resource block grant since May 2022, using GDP deflator



Source: FAI analysis of Scottish Government Resource Spending Review (May 2022) and UK Government Autumn Statement, Nov 2022. Notes: The 'consequentials effect' is net of funding that the Scottish government anticipated it would receive in its Resource Spending Review. Anticipated consequentials were £250m and £400m in 2023-24 and 2024/25 respectively.

The Scottish Government's resource block grant over the long-term is shown in Chart 3. This shows that the resource block grant is the highest it has ever been in real terms, excluding the "COVID" years of 2020-21 and 2021-22.

Chart 3: Scottish government resource block grant, 2021/22 prices



Source: FAI analysis of Scottish Government Budget information – note:deflated using the GDP deflator

The income tax burden is set to increase

With its budget relatively constrained in 2023-24, the government might consider how it could use its devolved tax powers to further boost its spending power.

The reality is however that income tax – by far the most significant devolved tax – is already on course to increase next year. The Personal Allowance – which is determined by the UK government – is set to be frozen in cash terms. In the face of inflation, 'fiscal drag' will bring more income taxpayers into tax, and increase the tax burden of existing taxpayers.

Tax thresholds in Scotland are set by the Scottish Government. The Scottish Government could increase thresholds in line with inflation (its manifesto commits it not to increase thresholds by more than inflation) if it wanted to prioritise household incomes. But doing so would imply lower revenues compared to a policy of freezing thresholds in cash terms.

Given that the UK Government is freezing the higher rate threshold in rUK, as well as freezing the Personal Allowance, it seems most likely that the Scottish Government will choose to freeze the Scottish basic, intermediate and higher rate thresholds in cash terms, or at least to increase them by much less than inflation. Given the constraints on its budget, and given that thresholds are being frozen at UK level, there seems little to be gained economically, fiscally or politically by deviating in any significant way from a 'threshold freeze' policy.

Box 2: Who pays income tax in Scotland?

The latest outturn data, for the 2020-21 financial year, shows that there are 2,537,900 taxpayers in Scotland, which represents 57% of its adult population. The majority of taxpayers are at the starter or basic rate, with only around 16% of taxpayers paying the higher or top rate of tax.

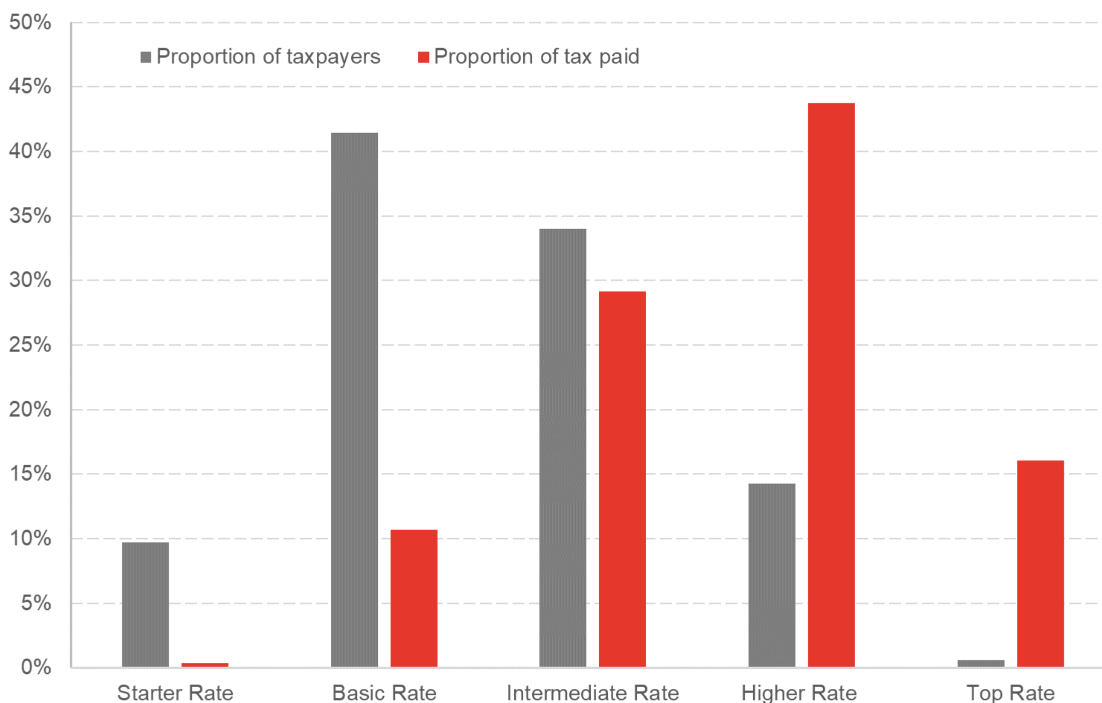
Table 1: Number of taxpayers by band, 2020-21

Starter Rate	246,900
Basic Rate	1,052,000
Intermediate Rate	862,200
Higher Rate	362,100
Top Rate	14,700
All bands	**2,537,900**

Source: HMRC

However, when we consider how much tax each of these groups pay, the majority of tax is paid by higher and top rate taxpayers – with 60% of tax receipts coming from these two groups.

Chart 4: Proportion of taxpayers vs tax paid by taxpayer status, 2020-21



Source: HMRC

It also seems likely that the Scottish Government will replicate the UK government's decision to reduce the threshold at which the top rate of tax becomes payable, from £150,000 to £125,140. This policy fits in with the Scottish Government's aspiration for progressive tax policy change. And whilst there would have been political risks for the Scottish Government in implementing this policy unilaterally in Scotland, the political risks are substantially reduced when the policy has been announced for rUK.

The policy to reduce the top rate threshold in Scotland from £150,000 to £125,140 may bring *up* to an additional 12,000 taxpayers into the top rate in Scotland (up from around 22,000 if the threshold remained at £150,000). The precise number of top-rate taxpayers there would be under this policy is uncertain as it will depend on the extent to which inflation feeds into salary increases, and behavioural responses of taxpayers to the reduction in threshold.

What we do know is that the reduction in threshold is unlikely to raise much additional revenue for the Scottish budget, relative to keeping the threshold unchanged. A reduction in the threshold would increase the tax liabilities of top-rate taxpayers by up to £1,250 per annum. This might sound a lot, but when there are relatively few of those taxpayers the aggregate effects on revenues are modest – perhaps up to a maximum of £40m in additional revenues, depending on the scale of behavioural responses (which might include, for example, making greater use of allowances or reliefs in order to reduce the amount of income that is subject to the top rate).

If the government wanted to raise additional revenues through income tax, beyond those arising from the threshold freezes or reduction in top rate threshold described above, then it does of course have opportunities available to it. For example, putting an additional 1p on the basic rate would raise almost £200m, whilst a more progressive policy to put a penny on the intermediate rate would raise almost £150m (the two policies could be implemented in combination). Alternatively, the intermediate or higher rate thresholds could not just be frozen, but cut in cash terms. However, such policies would represent a breach of manifesto commitments, and would also be difficult to justify politically in the current climate, given the dire outlook for household living standards. It seems unlikely therefore that the government will give those ideas serious consideration in budget 2023-24.

The government's ability to raise revenue from Council Tax is constrained by the legacy of failure to reform

Are there any other ways the government could raise revenue? Council Tax raised around £2.7bn in 2021-22 and in principle, there is ample opportunity to raise additional revenues from this tax base.

One legacy of the decade-long council tax freeze in Scotland is that residential properties are subject to much lower levels of taxation than in England or Wales. A typical band D property in Scotland faced a council tax bill of £1,347 in 2022-23, compared to £1,777 in Wales and £1,966 in England.

The costs of this differential in lost revenues are significant. Matching Council Tax policy in England or Wales would raise over £500m in additional resources for devolved public spending in Scotland.

The decision to change Council Tax rates usually sits with Council's, but the Scottish Government usually often sets the tone for the scale of increases. In 2022-23, it was the first year since the SNP came to power that Councils had complete freedom to increase rates, and most did so by 3%. The Scottish Government may seek to temper the increase for 2023-24, but precedent dictates that it will need to compensate local government for at least some of the revenue foregone.

One legitimate reason against raising council tax rates significantly is that council tax increases are regressive, both with respect to property value and with respect to income (even once the effects of council tax reduction are considered). The other reason is that the property values used to calculate council tax are from the early 1990s, and as more time goes on, the more they will become out of sync with the current relative market values of properties, particularly given the issues with valuing new builds (which tend to be overvalued relative to their market position).

What is needed in the medium-term is reform of the council tax system so that tax is levied on up-to-date property values, is progressive with respect to property value, and includes safeguards for those on low incomes. Once this is done, the scope for revenue-raising changes that are politically acceptable and economically justifiable will become much stronger. These reforms will not be implementable for the 2023-24 budget, but the process of moving toward this system can and should start now.

April 2023 will see new rateable values for business premises, with the overall change to business rates depending on decisions on poundage and reliefs

Non-Domestic Rates (NDR) were forecast to raise £3.3bn in 2023-24 according to forecasts from May 2022.

Unlike with Council Tax, revaluations of business premises have periodically taken place in Scotland, with April 2023 set to see the next update in values as calculated for 1 April 2022 (the 'tone' date). New rateable values reflect, mainly, changes in rental values of premises. Revaluations are meant to be revenue neutral by adjusting the poundage for any increase in aggregate rateable values to leave the overall tax take unchanged in real terms.

Draft rateable values have been released in Scotland meaning that business owners and tenants can look at the proposed changes for their premises. The poundage announced next week will determine whether they will pay more or less following the revaluation.

No aggregated figures on the changes in rateable values have been published in Scotland. However, in England, the Valuation Office Agency have reported an overall increase in rateable values of 7.1% for premises. The retail sector however showed a 10% fall in rateable values, the only sector to show a decrease. However, to add a complication, the

tone date for the England and Wales revaluation is 1 April 2021 – a year prior to the Scottish tone date. Change in Rateable Values in Scotland are not therefore directly comparable to the English and Wales values although are likely to follow similar trends.

Despite the rise in Rateable Values in England and Wales, at the Autumn Statement the UK Chancellor announced that he was freezing the multiplier (the equivalent to poundage in England & Wales). It is not clear how revenue neutrality has been applied in arriving at this decision. There is a more generous transitional relief scheme so that, unlike in previous years, relief for those who see an increase in bills due to revaluation will not be accompanied by so-called 'downwards transitional relief' for those whose bill was due to fall. This amount needed to fund this new system of transitional relief could form part of the revenue neutrality calculation.

However, HMT costings do not help to clear this up, with both the freezing of poundage and the transitional relief change showing as negative income to UKG. Whilst the size of the tax base (i.e. the new revalued aggregate of rateable values) is listed as an uncertainty, it is unclear whether it is the new or old tax base that underpins these costings. It may have been the case that the new revaluation figures were not available in time, and further changes may result, which in turn would have an impact on consequentials to SG.

Hopefully, the Scottish Government will be more transparent in its explanation of the impact of revaluation and the choices that have been made as a result. We would expect that there will be a mirroring of UKG reliefs for retail, hospitality and leisure which are due to be 75% for 2023-24, recognising the ongoing challenges in these sectors. In principle, additional resources could be raised by reducing the generosity of existing reliefs such as the small business bonus. In practice, the challenging economic environment would make this a difficult sell politically.

It's not just revenue raised that's important for the overall funding position, but also the "net tax position"

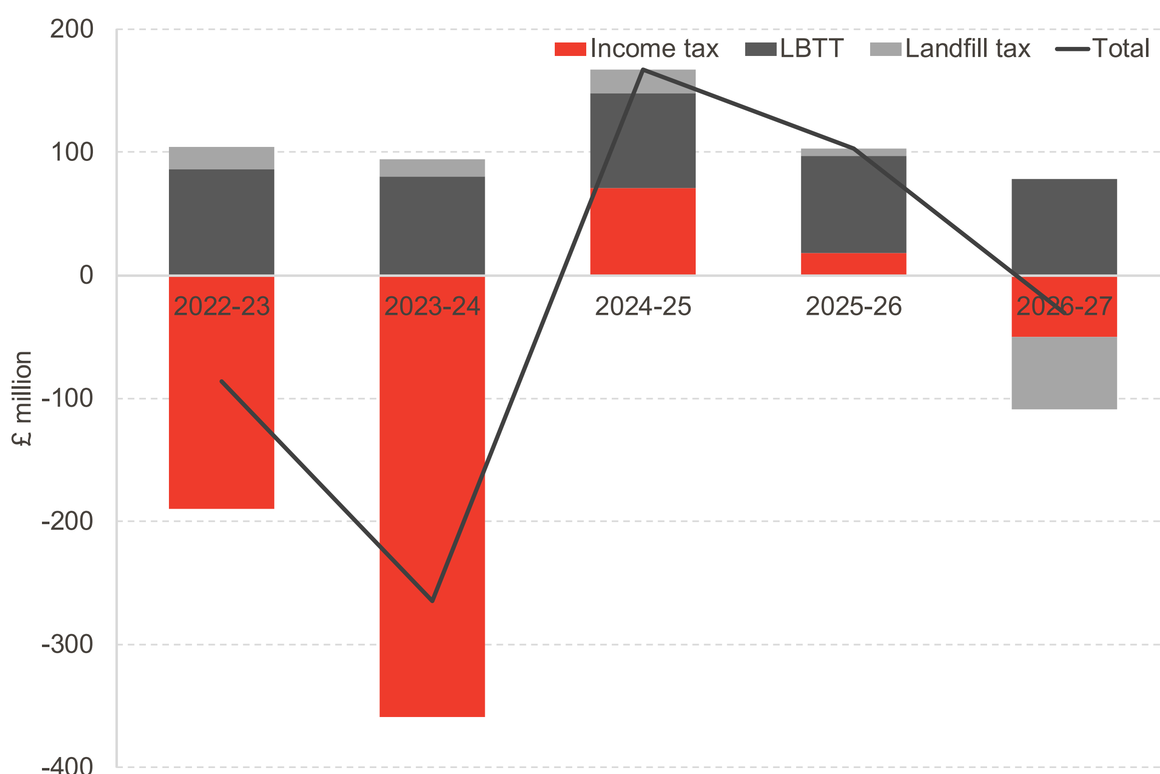
The Scottish budget is not only determined by the block grant. Additionally, it is also determined by tax revenues from the three devolved taxes – income tax, LBTT, and landfill tax. Importantly, however, what matters from a budget perspective is not just how much revenue is raised from these taxes in Scotland, but also how these revenues compare to the block grant adjustments (BGAs).

The BGAs are deductions that are made to the block grant to account for the transfer of revenues from the UK to the Scottish government. If devolved tax revenues raise more than the relevant BGA, it is said that the 'net tax' position is positive. A positive 'net tax' position implies that the Scottish budget is better off as a result of tax devolution than it would have been had tax devolution not occurred. A positive net tax position can come about either because tax policy implemented in Scotland raises Scottish revenues by relatively more than it raises revenues in rUK; or because growth of the underlying tax base has been faster in Scotland than it has in rUK.

Alternatively, a negative 'net tax' position implies that the Scottish budget is worse off as a result of tax devolution than it would have been had tax devolution not occurred. A negative net tax position can come about either because tax policy implemented in Scotland reduces Scottish revenues relative to the equivalent revenues in rUK; or because growth of the underlying tax base has been slower in Scotland than it has in rUK.

When the Medium Term Financial Strategy was published in May 2022, the forecasts at that point implied that the combined net tax position would be negative in 2022-23 and 2023-24, before becoming positive in 2024-25 and 2025-26.

Chart 4: Forecast Net tax position, May 2022



Source: Medium Term Financial Strategy, May 2022

Both LBTT and Landfill Tax were projected to contribute positively to the Scottish budget in 2023-24 (Chart 4). In LBTT's case, this largely reflects policy divergence, with the Scottish government setting higher tax rates on higher-priced residential transactions.

The negative overall net tax outlook was driven predominantly by the outlook for income tax. Income tax was associated with a net tax position of -£190m in 2022-23 and -£359m in 2023-24. This was in essence because tax base growth was forecast to continue to be lower in Scotland than in rUK, with the result that growth in income tax revenues was somewhat slower in Scotland than in rUK – despite the policy to set higher tax policy in Scotland.

This income tax net position was forecast to become positive in 2024-25. This result was driven by increasing policy divergence between Scotland and rUK, and in particular the stated policy of the UK government to reduce the basic rate of income tax in rUK to 19p in April 2024. Assuming the Scottish government did not replicate this policy, then the resultant

policy divergence would have been enough to generate a positive net tax position, even if Scottish tax base growth remained relatively slower than in rUK. The UK Government now intends to keep the basic rate of income tax at 20p indefinitely. The next set of forecasts for the net tax position will change as a result and are likely to no longer look quite so buoyant.

There are other reasons why the net tax position may change when SFC publishes its updated forecasts on budget day. In its latest forecasts, published alongside the autumn statement in November, the OBR slightly revised up its forecasts of rUK income tax in the near-term (2022-23 and 2023-24), reflecting the effects of higher inflation on pay settlements, whilst at the same time revising down its forecasts for later years, as a result of weaker medium-term economic growth.

The extent to which the net tax position for income tax improves or worsens will depend on the extent to which the SFC takes similar judgments about what is likely to happen in Scotland and the extent to which it judges that the determinants of income tax revenues – including earnings growth and employment – are likely to grow more or less quickly in Scotland than rUK.

One factor that may improve the outlook is that the outturn income tax net tax position for 2020-21, published in the summer, was somewhat better than anticipated. But this effect could easily be dwarfed by broader considerations about the economic outlook, and the implications for forecasts of earnings growth and employment.

In summary, the 'net tax' position makes relatively little difference to the overall size of the Scottish budget in the scheme of things, but politically and economically it is a significant number since it indicates the impact of policy and economic performance on the Scottish budget. It is therefore an important number to look out for.

The spending outlook remains extremely tight

In May this year, the Scottish Government set out its spending plans for the remainder of this parliament, from 2023-24 to 2026/27.

In it, the government laid out its plans to prioritise spending on health, social care, and social security.

- On health, the government's plans implied that health spending would increase by around 3 per cent in real terms over the course of the parliament. This maintains the rates of real terms spending increases seen pre-Covid; but this is well below the rate of spending increases seen prior to the 2010 austerity period.
- Spending on social care was projected to increase by 25% in cash terms over the parliament, as part of efforts to establish the new National Care Service.
- Spending on social security was projected to increase substantially. This reflects policy aspirations around the roll-out of new disability replacements in Scotland (replacing Disability Living Allowance and Personal Independence Payments) and the flagship Scottish Child Payment, forecast to cost £500m per year.

Whilst spending on these areas is projected to increase in real terms over the spending review period, many other significant areas of public spending see their allocations remain flat in cash terms throughout the SR period.

We should not need to remind anyone that when inflation is high, a budget that is flat in cash terms is declining in real terms.

The May Spending Review implied that the local government budget would decline by 7% in real terms between 2022-23 and 2026-27. The enterprise agencies saw their allocations decline by 16%. Meanwhile, universities and colleges (including student grant support), the police authority, prisons, fire and rescue services and the legal aid budget, amongst other areas, saw real terms declines in their allocations of 8% over the period.

The outlook for 2023-24 and 2024-25 was particularly challenging. Chart 5 shows how the allocations for key areas of spending was projected to change between 2022-23 and 2023-24 according to May's Resource Spending Review.

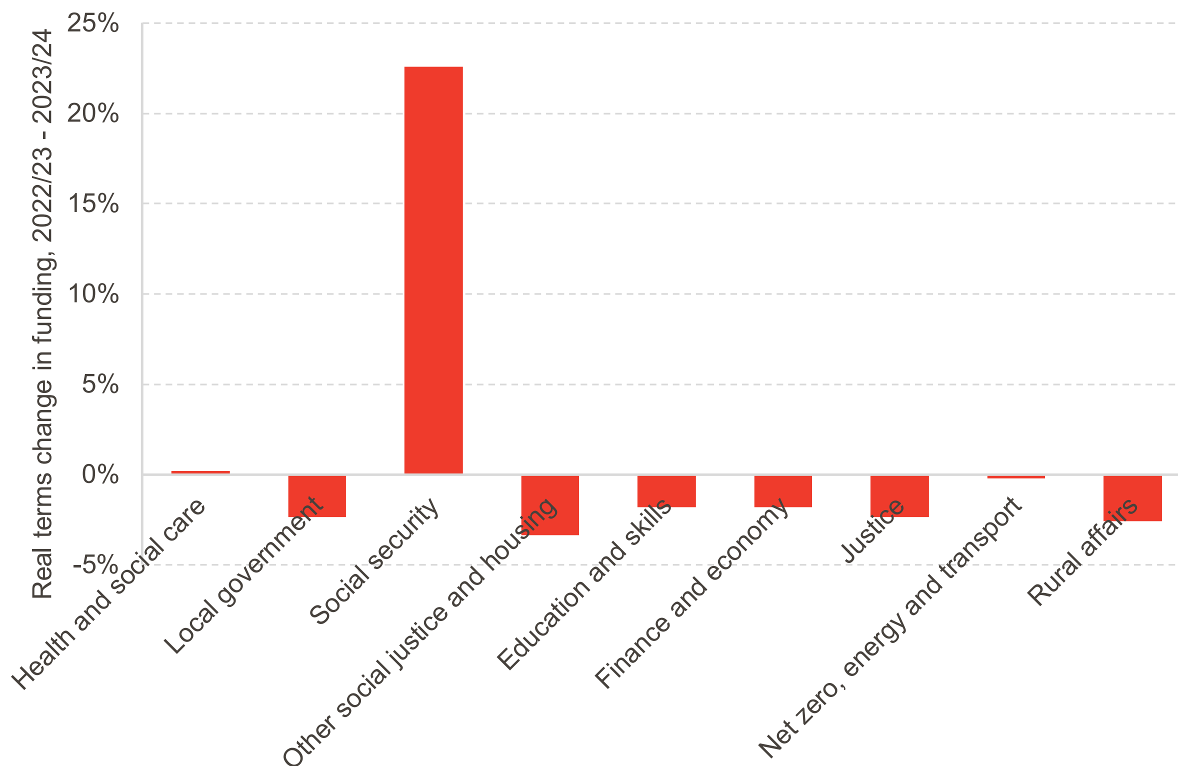
In short, total resource spending increases by £500m, but with spending on social security and health projected to increase by £900m, the implication was that spending on other areas was projected to decline by £400m.

Note that whilst spending on health was 'protected' from cuts, the health budget was not projected to increase in real terms between 2022-23 and 2023-24.

As we described earlier, the Scottish Government block grant allocation for 2023-24 has been boosted by additional consequentials of around £1bn since the Spending Review was published. But these only just offset the effects of higher inflation.

We should therefore not really expect the real terms spending changes between 2022-23 and 2023-24 to change radically when the budget is published. The interesting question will be the extent to which the government allocates the additional consequentials across all portfolio areas to offset the effects of higher inflation, or whether it concentrates the additional resources on its key priority areas, health and social care in particular.

Chart 5: Real terms spending changes as set out in Resource Spending Review, 2022-23 – 2023-24



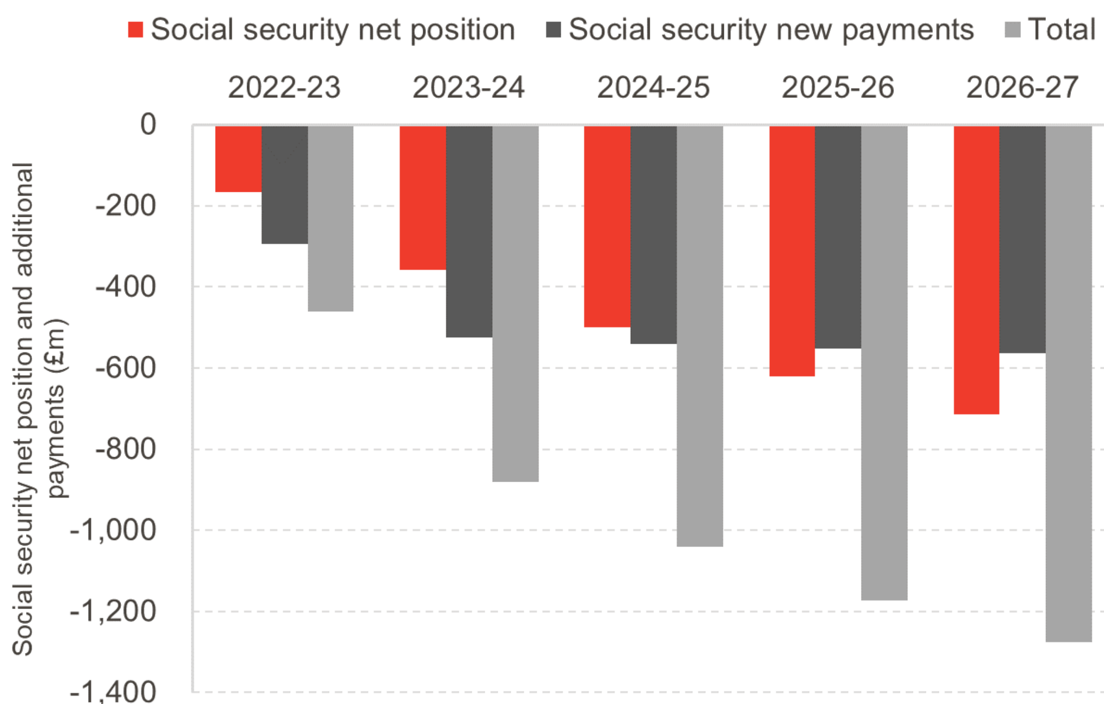
Source: Resource Spending Review, Scottish Government May 2022. Note, spending is deflated using the GDP deflator as at May 2022

The gap between what is spent on devolved social security vs the funding provided by the UK Government continues to grow

As we have already documented, social security spending was due to increase in 2023-24 due to new measures, and aspirations over the new devolved benefits (including the fact that it is hoped that take-up will be higher due to a 'friendlier' application system). The SFC forecasts clearly showed that this would mean a growing wedge between the money transferred from UKG through the Block Grant for spend on devolved benefits in England and Wales, and the amount actually spent in Scotland: a negative social security net position.

Compared to the plans set out at the Spending Review, we expect there to be some additional spend for the financial year 2022-23. Firstly, we expect that the Scottish Government will use the September 2022 CPI figure to uprate devolved benefits next year. This will mean uprating benefits by 10.1%, above the forecast of 7.5% used by the SFC in their forecasts in May 2022.

Chart 6: Social Security Net Position and new payments, 2022-23 – 2026-27



Source: Scottish Fiscal Commission

There is some additional uncertainty here due to the decision in March 2022 to ignore September 2021 CPI and use a higher rate of 6% to uprate 2022-23 benefits, which was more in line with inflation observed in early 2022. Additional money was found in the budget to provide an uplift above and beyond the 3.1% uplift for the equivalent of the devolved benefits in the rest of the UK.

It seems unlikely, given pressures on household finances, that benefits would be uprated by a lower amount than the September CPI rate of 10.1%, and indeed an uplift of this amount will largely be funded via transfers from UKG. Whether we will see an amendment to this come March 2023 if the inflation situation is markedly different by that point remains to be seen. Moving away from UK precedent and using more up-to-date inflation in regulations obviously adds additional risks to the budget, but these could be both upside and downside risks (albeit depending on factors wholly outwith the control of the Scottish Government, which could be large in scale).

The other likely change to spending will also largely be funded from UK coffers. The bad news from the labour market, with more people inactive due to long-term ill health, has been mirrored in new claims for Personal Independence Payment (PIP) in England and Wales. The OBR reported that there was an average of 64,000 new claims a month between April and July compared to an average of 37,000 a month in 2019. In Scotland, PIP is gradually being replaced by Adult Disability Payment (ADP), but adding together new PIP and ADP claims for Scotland produces a similar magnitude of increase in new claims compared to the equivalent benefit in England and Wales.

The adjustment made to the Block Grant from UKG to SG as a result of uprating and higher caseload for 2023-24 will be £116m. As John Swinney made clear to the Finance Committee, he expects that the change in the net budget position (and we assume therefore the net social security position) will be zero with this money being required to deal with the same issues north of the border.

Are there reasons why the net social security position may worsen? For the net social security position to deteriorate further when looking just at the devolved benefits, we would either need to see a proportionally higher change in caseload than has been the case in England & Wales, or a policy change that increases generosity. We will have to wait and see what the SFC judgment is on the former, but based on our own analysis of we think a large divergence is unlikely. On the latter issue of policy change, we have seen this in the past and expect to see more of this in the future, but there has been no new changes announced since May that would materially affect the forecast at this time.

Social security spending as a whole could increase proportionally more in Scotland if there was increased spending on new benefits such as the Scottish Child Payment. As it stands, there is no indication that the Scottish Child Payment will be adjusted above the £25 a week amount that came into force in November 2022. That means, for 2023-24 at least, the payment will not be subject to the same uprating as other Scottish Benefits and remain at its new (current) level. This means it will be worth less in real terms in 2023-24 than is currently the case, but with such a recent uplift from £20 to £25, it is likely that the Scottish Government will feel justified in leaving it at this level for now. This will be harder to defend in future years, and because there is no equivalent benefit in England and Wales, there will be no Block Grant Adjustment to compensate.

New benefits are not strictly part of the net social security position as it is clearly not a like-for-like comparison of the same benefits north and south of the border. However, it is useful to show both elements as it gives a full picture of what money the Scottish Government is needing to find from elsewhere in its budget in total to fund its social security obligations.

One other reason why the net social security position may change is due to changes in forecast methodology and/or corrections following outturn data. There is a large amount of uncertainty in the SFC forecasts because of the lack of precedent for the changes the SFC is forecasting, and the difficulty in forecasting demand for non-means tested benefits. Over time, the accuracy of forecasting by the SFC should improve, but we may see unexpected adjustments in forecasts in the meantime.

Alongside the budget, there will be more interest than ever in the Scottish Government's Public Sector Pay policy for 2023-24

Accompanying the budget, as usual, will be the government's public sector pay policy for the financial year to come. Given the focus on public sector pay disputes and accompanying industrial action at the moment, the approach to this is likely to attract more interest than usual.

Things have changed a lot since last December (on this, as with so much of course).

In the 2022-23 pay policy, employees earning up to £25,000 were guaranteed an inflationary uplift of at least £775, which equated to a rise of 3.1% for someone earning 25,000, in line with the September 2021 inflation figure.

However, even with that comparatively modest inflation level a year ago, those earning over £25,000 were not going to see their pay keep up with inflation. Those earning up to £40,000 were to get an uplift of £700, while those earning over £40,000 were to get an uplift of £500 – or around a 1% uplift for someone earning £50,000.

By the time we had got to May, it was clear both that inflation was going to be much higher than had been expected in December, and also that industrial action was likely to be on the cards for many public services.

In its Resource Spending Review on 31st May, the SG assumed that the public sector pay bill would remain frozen in cash terms over the period of the spending review. They made it clear that this was assuming pay increases, so therefore the only way to achieve this would be to manage down the public sector workforce over the period. The overall workforce had seen some increases during the pandemic, and the narrative from the Government suggested that we could go back to pre-pandemic levels of employment to achieve this goal.

This didn't seem particularly credible at the time, given the increased pay demands from many public sector workers, and also because much of the increase in workers over the period of the pandemic had come from workers in the health service, which didn't seem like a likely target for reductions.

The circumstances now make this even more difficult and are also likely to provide the backdrop to ongoing discussions with public sector unions.

The devil will be in the detail, but it's worth taking a step back to think about what how this Budget fits into the big picture

Amidst all the nitty-gritty detail, it can be easy to forget that the Budget is not an end in itself, but a means to deliver the Scottish Government's 'Purpose' as set out in the National Performance Framework as well as the various obligations the government has set itself in relation to improving equalities, reducing the disadvantage from low income, and ensuring that all of Scotland can realise their human rights.

The Equality and Fairer Scotland Budget Statement is published each year alongside the Budget. Over the years, it has become a more useful document and has demonstrated that in the development of the Budget, officials have at least been thinking about the impact of the decisions being made. There is still some way to go, and there is still a tendency for it to read as an analysis of impact produced after decisions have been made, rather than a genuine tool for informing decisions. There also remains little evaluation of whether spending at previous Budgets led to the impacts set out.

Ensuring that the Budget allocations align with the priorities set out in government speeches and in the publication of its myriad strategies is incredibly important for trust in government. Equally, knowing whether spend makes the impact assumed is a key part of the fiscal responsibility of government.

We hope more progress is made this year in demonstrating that appraisal and evaluation have been integral to the Budget making process.

Fraser of Allander Institute
University of Strathclyde
199 Cathedral Street
Glasgow G4 0QU
Scotland, UK

Telephone: 0141 548 3958
Email: fraser@strath.ac.uk
Website: fraserofallander.org
Follow us on Twitter via @Strath_FAI
Follow us on LinkedIn: FAI LinkedIn

---

the place of useful learning
www.strath.ac.uk
University of Strathclyde Glasgow

The University of Strathclyde is a charitable body,
registered in Scotland, with registration number SC015263