University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

Vol 46 No 4

Deloitte.

Foreword

As we settle into 2023 it is clear the effects of the economic challenges that defined 2022 will very much continue to be felt this year. While inflation is largely believed to have peaked, it remains close to multi-decade highs and the Bank of England will need more convincing evidence that inflation is beaten before calling time on further rate hikes.

The UK economy is likely to enter recession this year, or at best stagnate, as elevated inflation squeezes demand and the impact of higher interest rates further weighs on activity. However, the economy showed unexpected resilience in the closing months of 2022 and by the standards of past recessions this is likely to be a shallow one, with growth expected to resume towards the end of the year.

Despite the good news that unemployment remains at low levels, this quarter's Commentary highlights the stubbornly high rates of economic inactivity and job vacancies that exist in Scotland and the rest of the UK, with over 80% of businesses in Scotland recently reporting they have struggled to fill vacancies due to a lack of required skills or experience.

This sentiment is echoed by the results of Deloitte's Q4 2022 CFO Survey. While it found a net of 59% of UK CFOs expect to reduce hiring over the next 12 months - and those surveyed reported an easing of recruitment difficulties over Q4 2022 - almost a third still rate the labour shortages faced by their businesses as severe or significant.

One way to tackle this issue of 'job matching' is for organisations to focus on upskilling their existing workforce. The training and development of staff can often fall down the priority list during difficult economic periods, but it is an investment that offers countless benefits to employee and organisation and is a vital step in retaining talent and ultimately safeguarding any business.

However, more immediate issues such as high energy costs and high prices unsurprisingly continue to cause most concern for those currently running businesses in Scotland, as the Fraser's recent quarterly Business Monitor highlighted. It found that 60% of businesses in Scotland expect to make energy efficient improvements to combat the energy crisis, while just under half of the businesses surveyed reported that they expected to reduce operations to some extent due to high energy costs. It is likely the replacement of the UK government's Energy Bill Relief Scheme with the new Energy Bills Discount Scheme from April will be awaited nervously by some.

On income tax, the Commentary details the increasing divergence between Scotland and rUK following December's Scottish Budget. This is a combination of maintaining current tax band thresholds and increasing upper bands rates. The analysis indicates that at the very top of the income distribution, more than 80% of the headline additional tax revenue from these measures is vulnerable to erosion by behavioural changes.

Behavioural change is complex and inherently difficult to predict when setting tax policy. Some behavioural change may directly affect overall economic activity in Scotland, and some may not. The tax result may not always be the deciding factor in influencing any individual's choice of location or activity, but it is important not to slow the growth of our economy by disincentivising experienced business leaders and entrepreneurs from coming to Scotland or encouraging migration South from the same communities already here. This is a difficult balancing act.

In the headlights of a recession it's important to remember that downturns and tough circumstances can also provide opportunities for businesses, as well as threats. Where possible, company leaders must resist the temptation to follow the status quo. Thinking longer term and continuously seeking ways to diversify operations and reduce costs can help to futureproof a business.

Thinking longer term and looking at Scotland's future is something my colleagues and I are passionate about, particularly leveraging the huge ambition in Scotland to drive inclusive growth. In late November Deloitte hosted a gathering of over 70 senior leaders from across Scotland's private, public, academic and third sectors at the University of Glasgow. Delegates at our Shaping Scotland's Future Economic Landscape event took part in highly energised, constructive discussions about the practical actions they, their organisations and their wider sectors can take to create a fairer, more sustainable and successful Scotland for everyone. We were very encouraged by the energetic contributions at the event and we're now turning our focus to working with the delegates on an ongoing basis to reach our common goals.

As 2023 unfolds, the economic uncertainty that has characterised this decade so far remains. Notwithstanding the challenges ahead, we can take some reassurance from the fact that the resilience of consumers and businesses alike was tested to previously unimaginable levels during the pandemic, emerging far less sensitive to economic shocks and primed to face whatever headwinds this year has in store.

Douglas Farish
Office Senior Partner for Deloitte in Edinburgh
February 2023

Deloitte.

Deloitte supports the production of the Fraser Economic Commentary. It has no control over its editorial content, including in particular the Institute's economic forecasts.

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ECONOMIC COMMENTARY

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Summary

Inflation continues to loom large over all discussions both economic and fiscal. With the latest data for December showing inflation at 10.5%, we've now had 3 consecutive months of double-digit inflation.

The expectations for the year ahead are for inflation to fall, perhaps getting down to 3-4% by the end of the year. Whilst some will be looking to take credit for this politically, the truth is that this was likely to happen anyway as we move past the first anniversary of the Russian invasion of Ukraine: given that the annual change in 2023 prices will now be compared to the much higher level in 2022.

Everyone has to remember that this does not mean that prices will start to come down anytime soon. In April, we'll have the rollback of government support for energy for households - and a hugely significant reduction in the support for businesses and charities. Despite this coming as we move into the Spring, this signals a very tough time for households and businesses during Q2 and Q3 of 2023 in particular.

Our new forecasts reflect these tough conditions. We are forecasting a contraction of -1.0% in 2023, before returning to growth in 2024 of 0.6%. This is a slight revision down from our previous set of forecasts in October.

We assume that the final quarter of 2022 shows slight growth after a dip in Q3 2022, followed by three-quarters of contraction in 2023. Growth then returns in the final quarter of 2023, bringing the end to a three-quarter-long recession. Data on Friday will give the first indication of whether our prediction for Q4 is correct.

As well as our new forecasts, we analyse all the latest data on the UK, Scottish and global economies.

We also reflect at length on the announcements in the Scottish Government Budget for 2023-24, which has gone through Stages 1 and 2 in parliament over the last week.

Income tax changes announced in the Budget on 15th December grabbed the headlines, but there were many significant decisions made by John Swinney which underlined the priorities of the Government – protecting social security and health while many other areas are facing real terms cuts.

But there were also many unanswered questions. We are still none the wiser about what the Government plans to spend on the National Care Service. None of the promised detail on the approach to Public Service Reform or to the reduction in the public sector workforce was forthcoming in the Budget or accompanying documents.

As ever, there is much to do to improve the transparency of figures in Scottish Government Budget Documents.

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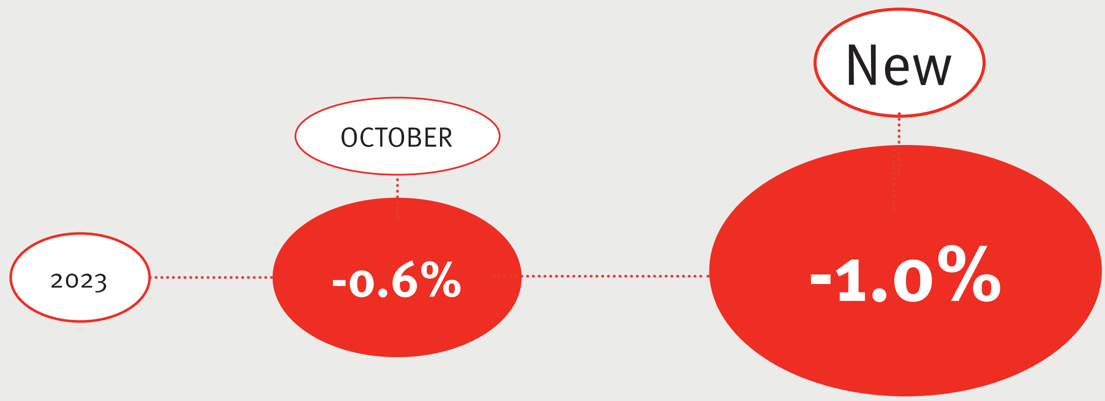
State of the economy

Indicator	% of February 2020 levels	Change on previous three months	Performance	Latest data
Scottish GDP	100.9%	0.0%	-	September - November 2022
Production	96.1%	0.6%	▲	
Construction	113.9%	-0.2%	▼	
Services	101.0%	-0.1%	▼	

Indicator	% Change on previous year, December	% Change on previous year, November	Inflation trend	Latest data
Inflation (CPIH)	9.2%	9.9%	▼	December 2022
Food	16.9%	16.5%	▲	
Electricity & Fuels	87.8%	88.2%	▼	
Housing costs	11.7%	11.7%	-	
Transport	6.9%	7.6%	▼	

Scottish growth forecasts



	2023	2024	2025
FAI *FEBRUARY 2023*	-1.0%	0.6%	1.7%
FAI *OCTOBER 2022*	-0.6%	0.8%	-

Outlook and Appraisal

Reflecting on 2022

Many hoped 2022 would be a return to normality and a year of recovery following two years dominated by the Covid-19 pandemic. But Russia's invasion of Ukraine quickly turned 2022 into another extraordinary year.

Surging energy prices have driven inflation to a 40-year high in the UK and across much of the global economy. This has eroded living standards, with households and businesses facing increased bills and government budgets being stretched.

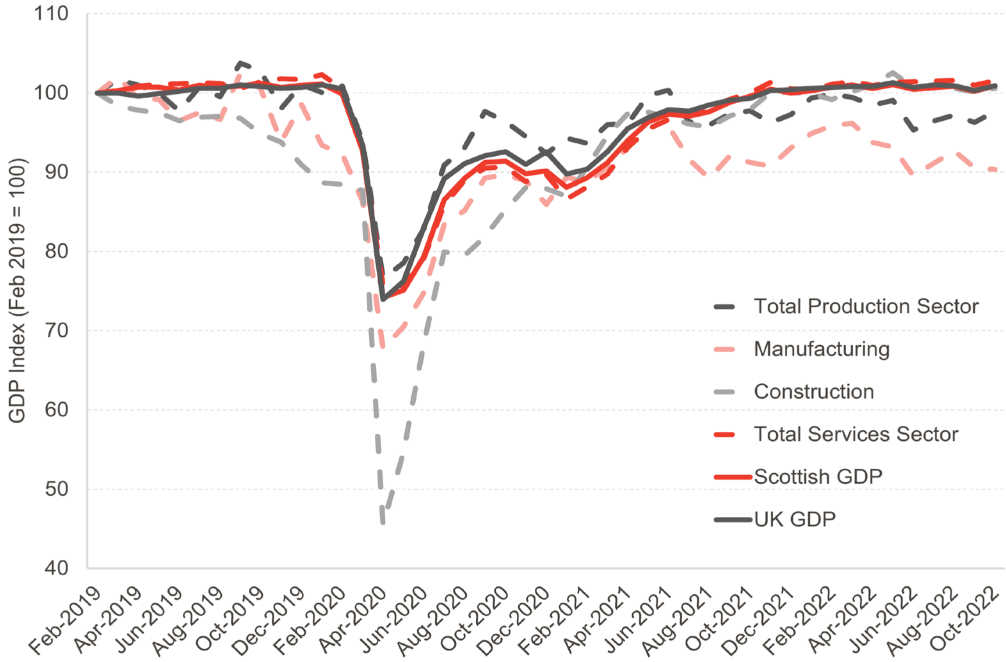
The economic headwinds have necessitated government interventions on a vast scale and the first significant interest rate rises since the 2008 financial crisis.

In September, the economic turbulence was exacerbated in the UK by the so-called "mini budget". The response from financial markets forced a series of U-turns and the eventual resignation of the Prime Minister and Chancellor of the Exchequer.

GDP growth was broadly flat throughout the year in both Scotland and the wider UK.

Scottish GDP returned to pre-pandemic levels in 2022, although growth remains slow. This is due largely to the total production sector – namely the manufacturing industry – recovering more slowly than other sectors of the economy.

Chart 1: Scottish and UK GDP growth indices with selected Scottish sectors February 2019 – November 2022 (February 2019 = 100)



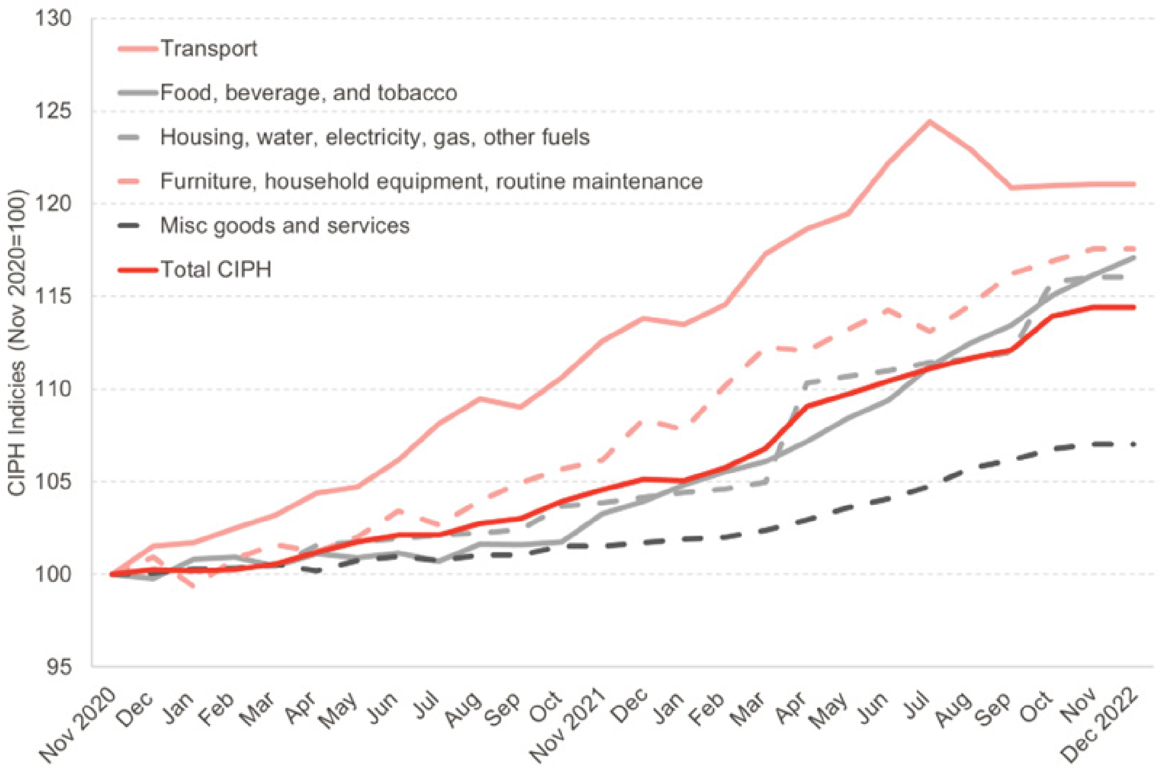
Source: *Scottish Government*

Whilst GDP growth has disappointed, 2022 has been characterised by persistently high inflation.

Consumer price inflation peaked at 11.1% in October 2022, but growth rates relaxed slightly in November and December. CPI averaged 9.1% for the 2022 calendar year and it look likely that inflation will fall back in 2023.

Factoring in the costs of homeownership (CPIH), inflation averaged 7.9% in 2022. This has been primarily driven by the cost of housing and energy, linked with interest rate rises and the war in Ukraine. Transport faced the highest price increases, however, with prices nearing 12% higher on average compared to 2021.

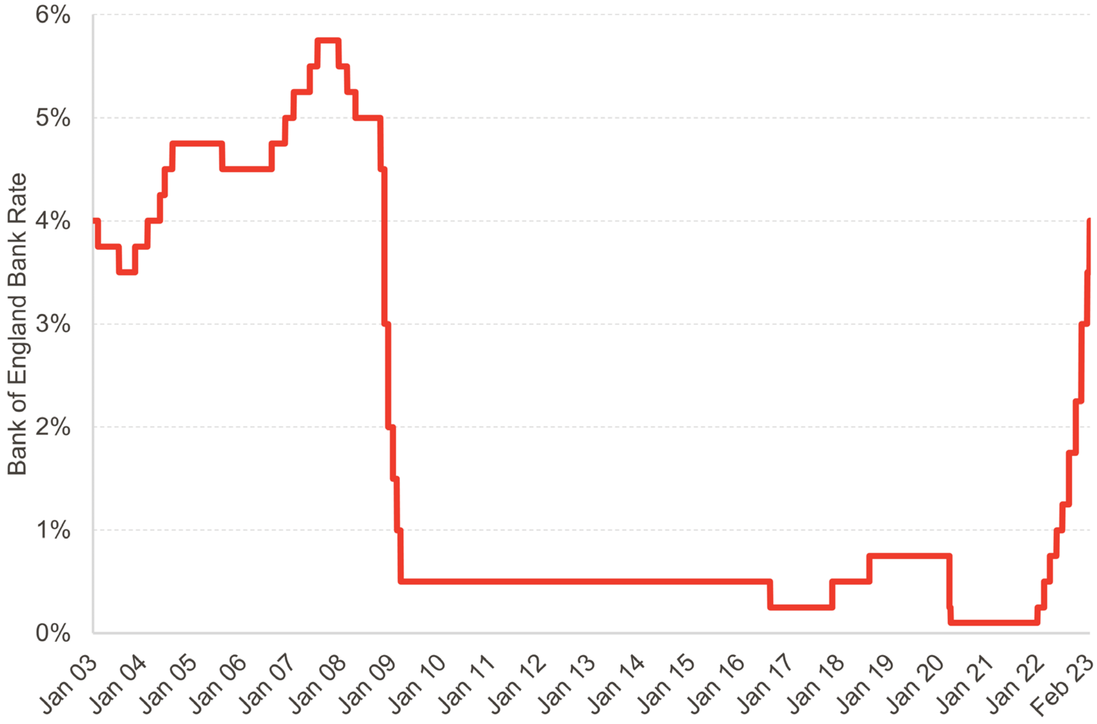
Chart 2: Price change indices of top contributors to CIPH, November 2020 – December 2022 (Nov 2020 = 100)



Source: *ONS*

In an effort to counteract inflation, the Bank of England increased the base rate throughout the course of 2022, following 14 years of historically low rates in the wake of the 2008 financial crisis. 2022 began with a rate of 0.25% and ended at 3.5%.

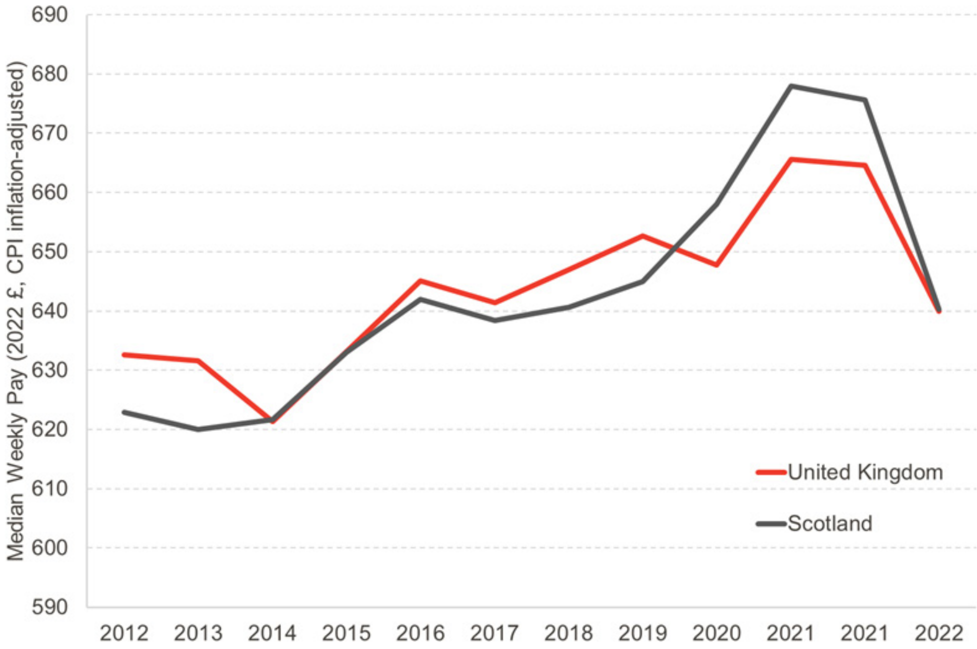
Chart 3: Bank of England Bank Rate, January 2003 to February 2023



Source: *Bank of England*

High inflation has meant that 2022 was marked by a significant decrease in the real value of household incomes. Median weekly earnings for full-time employees dropped below 2018 levels in 2022 due to the combined pressure of higher prices and the lowered value of the pound.

Chart 4: Median weekly earnings for full-time employees, UK and Scotland, 2012-2022, in 2022 £



Source: *House of Commons Library*

One piece of good news has come from the labour market, with unemployment outperforming many expectations. Unemployment levels in both Scotland and the UK reached their lowest levels in the last ten years, at around 3.3% for Scotland and 3.7% for the UK as a whole (Chart 5).

On the other hand, large numbers have left the labour force, resulting in higher rates of economic inactivity and job vacancies.

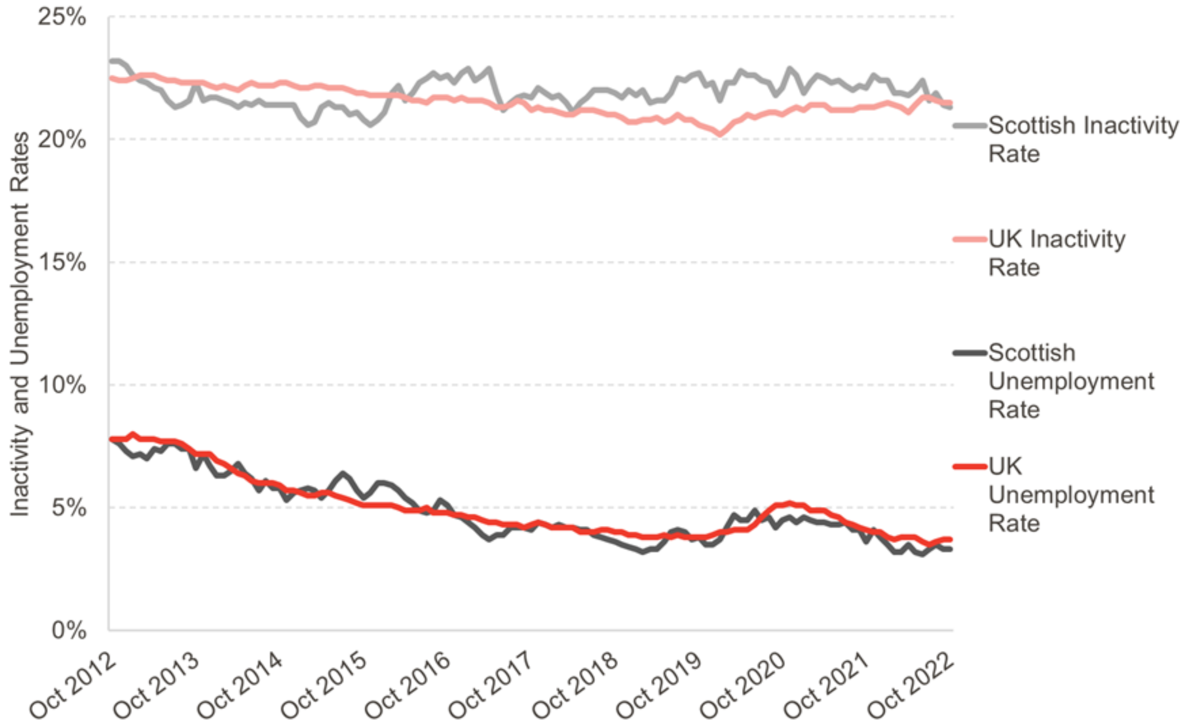
Economic inactivity in Scotland over the past ten years has varied, hovering between 21% and 23% of the population. In the UK, however, average rates of economic inactivity have increased from a ten-year low of 20.4% in early 2020 to around 21.5% throughout 2022.

Job vacancies reached a record high level in Q1 2022 (Chart 6) and have remained far above pre-pandemic norms. In 2022, the number of jobs available exceeded the number of individuals looking for work in the United Kingdom for the first time in at least the last 20 years.

This phenomenon may be attributed to a decrease in EU workers, in spite of an overall increase in UK visa applications – large proportions of the workforce, who previously did not need a visa, likely left in the face of Brexit. The increase in inactivity rate since the start of the pandemic can also be attributed to older workers opting for early retirement[1].

Our own analysis of Scottish business found that job matching was a crucial factor in the high vacancy rate – just over 80% of businesses reported that they were struggling to fill vacancies due to a lack of required skills or experience.

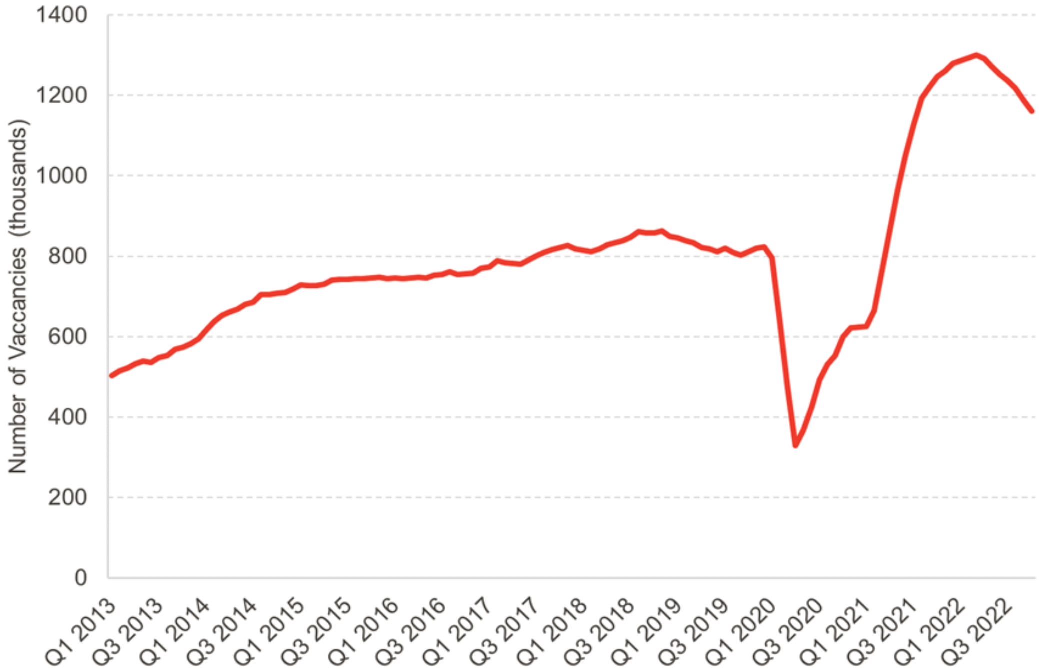
Chart 5: Scottish and UK Unemployment and Inactivity Rates, seasonally adjusted, Oct 2012 to Oct 2022



Source: *ONS*

1 IFS - The rise in economic inactivity among people in their 50s and 60s

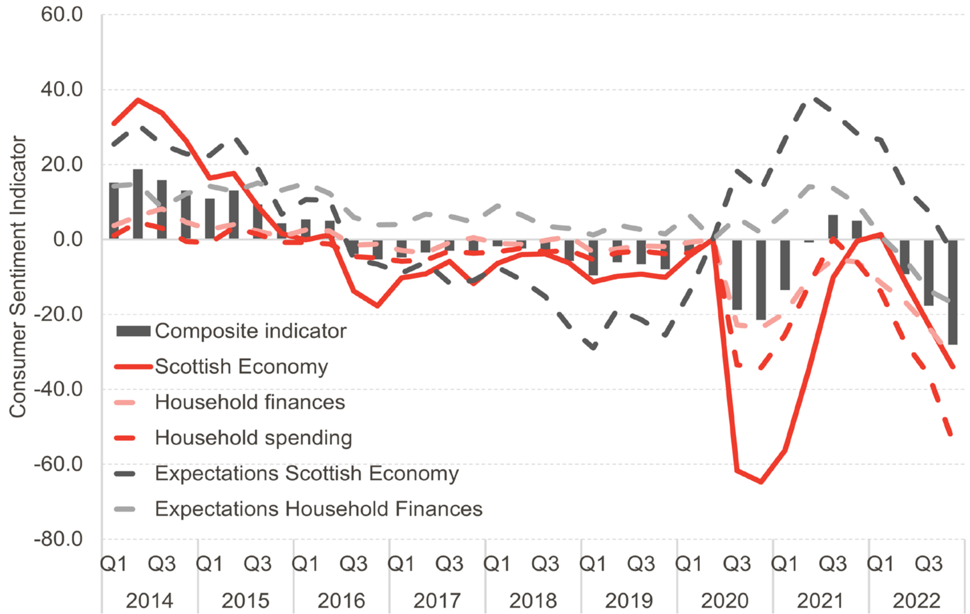
Chart 6: Number of vacancies in the UK, seasonally adjusted, Q1 2013 to Q4 2022



Source: *ONS*

Unsurprisingly, consumer sentiment was generally negative throughout 2022. Only future expectations for the Scottish economy were generally positive, although they declined over the course of the year., and ended in negative territory in Q4 Attitudes towards spending fell to its lowest levels, with Scottish households responding that they felt inclined to spend less money than in previous periods.

Chart 7: Consumer sentiment indicator, Scotland, 2014-2022



Source: *Scottish Government*

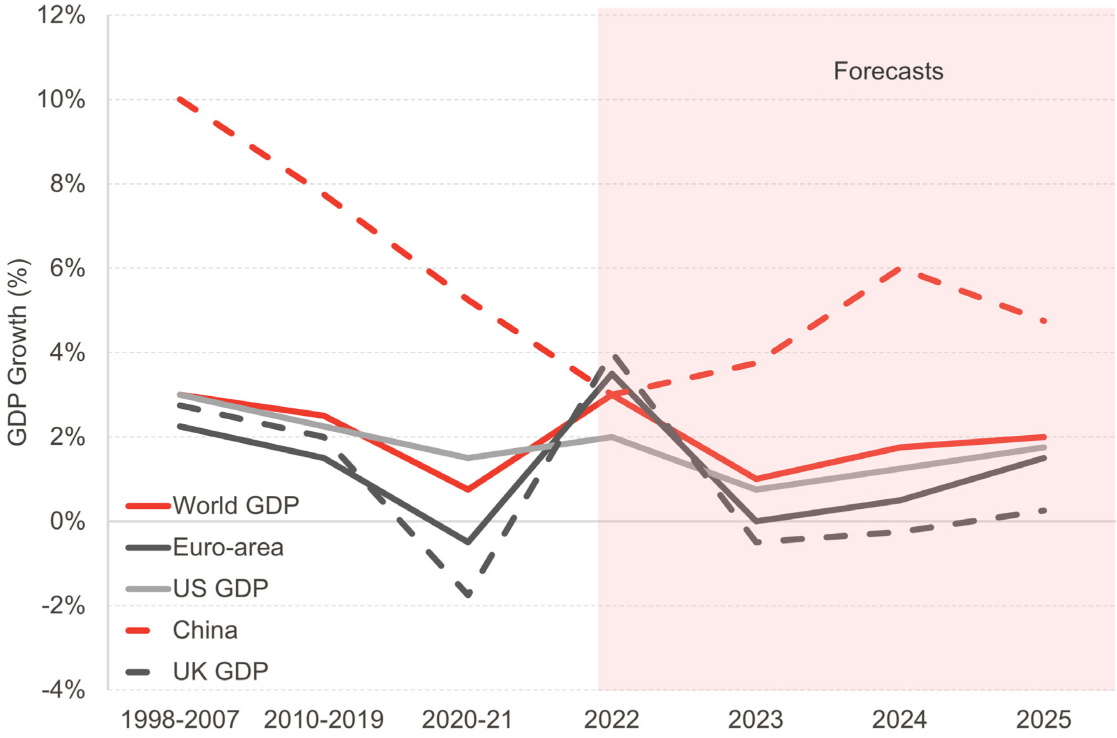
Global Economy

Scotland and the UK are not the only economies struggling from the geopolitical headwinds following the pandemic. In what was expected to be a bounce-back year, global GDP growth has been modest.

The Bank of England anticipate many western economies to be in recession well into 2023 and the UK is forecast to fare worse than most. The Bank's rather pessimistic forecast is for the UK's recession to continue into 2024, although the recession will likely be less severe than previously forecasted.

Given its sheer size and role played in global supply chains (see below), many will be watching China's recovery, as it moves beyond its zero Covid policy.

Chart 8: Projected world and selected region GDP growth, 1998-2025

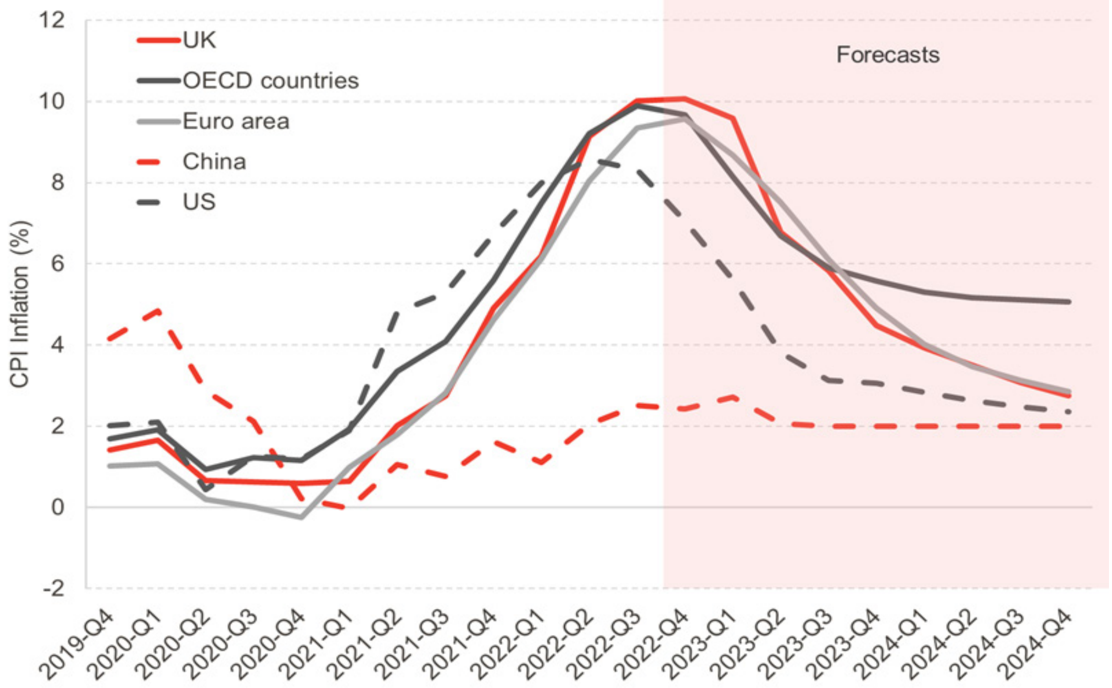


Source: *Bank of England*

As with GDP growth, the pattern of high inflation has been mirrored internationally. Indeed, part of the challenge for policy makers and central banks worldwide has been the nature of this spike in inflation.

Interest rate rises are an effective tool for demand management, but this inflationary pressure has been driven by a global supply side shock to energy markets, for which there is no quick fix.

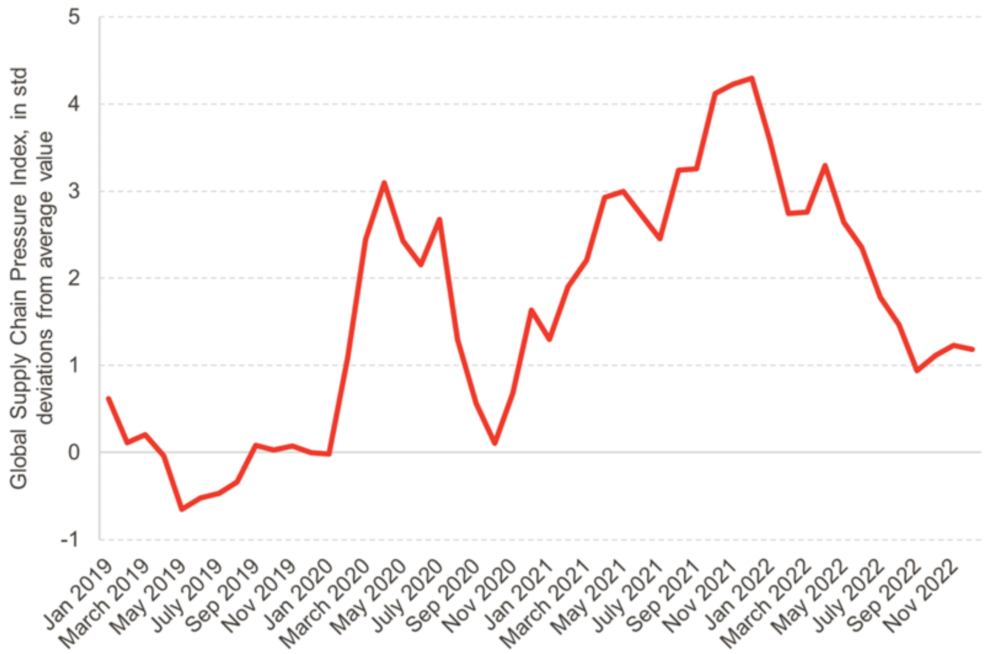
Chart 9: CPI inflation forecasts for selected regions, 2019 – 2024 (%)



Source: *OECD*

Throughout 2022, supply chain disruptions slowly inched towards normality, although with worsening Covid levels in China, the level of pressure on the global supply chain increased during October and November. Slowdowns in global supply also come from issues with deliveries and inventories in Korea and Taiwan.

Chart 10: Global supply chain pressure index, January 2019-December 2022



Source: *Federal Reserve Bank of New York*

Looking Ahead to 2023

Independent GDP projections from December are slightly more optimistic about 2023 than the Bank of England and OBR previously forecasted. Most forecasters predict that GDP will decline into 2023, although the extent of the decline varies. In general, the upcoming recession is expected to be shallow but long – lasting the majority of 2023.

Table 1: UK GDP and CPI growth projections 2022-23

UK GDP Growth Projections

	2022	2023
Bank of England	4%	-0.5%
OBR	4%	-1%
OECD	4%	-0.4%
Average independent projections	4%	-1%

UK CPI Projections

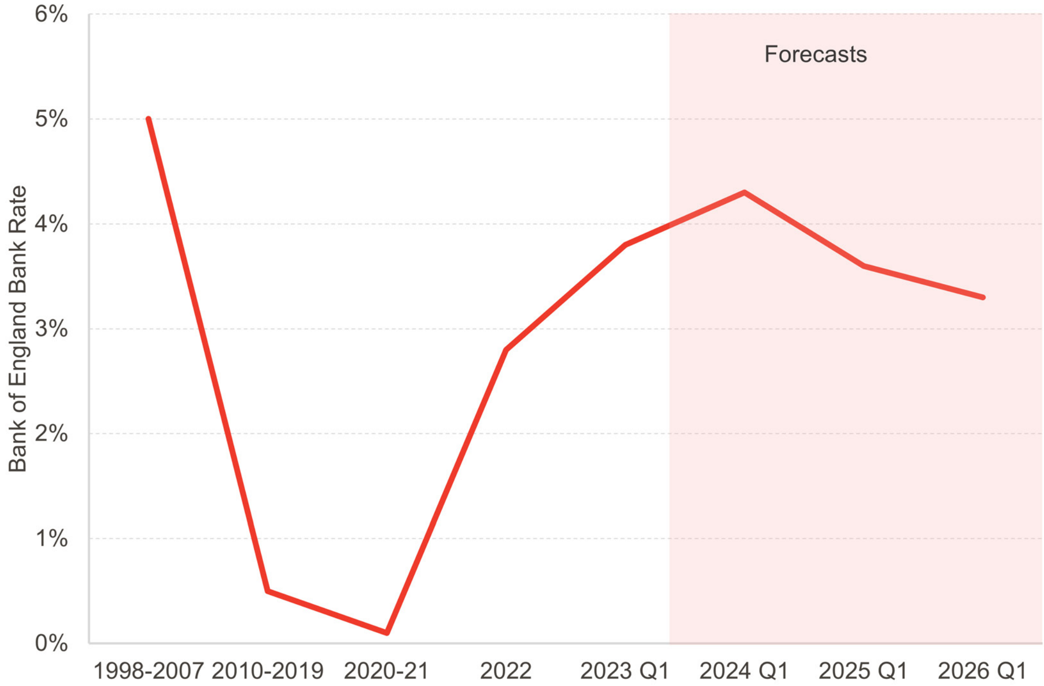
	2022	2023
Bank of England	11%	5%
OBR	11%	4%
OECD	10%	4%
Average independent projections	11%	5%

Source: *HM Treasury*

CPI projections vary between 4-5.5% for 2023, a significant improvement on 2022 figures. The Bank of England predicts that CPI will return to the 2% target by 2024, while the OECD maintains that the UK inflation will take another year to meet that goal.

The outlook for interest rates is less predictable than it has been in years. The Bank of England predicts ongoing bank rate rises throughout 2023 and then declining into 2024 and 2025. In doing this, the goal is to slow hiring patterns, some business investment and household consumption, thus slowing overall price increases.

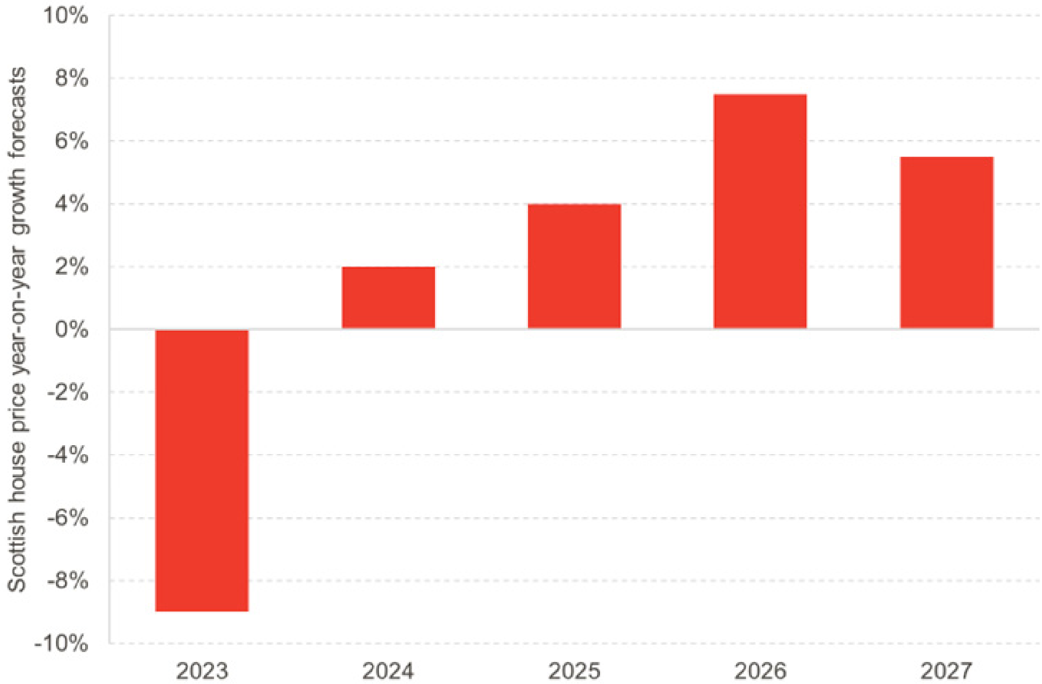
Chart 11: Bank of England Bank Rate Forecasts, 2019 Q4 to 2025 Q4



Source: *Bank of England*

Another figure to watch in 2023 is average house prices. A higher cost of borrowing and higher overall prices in the economy are expected to act as a drag on demand in the housing market, with house prices set to decline significantly in Scotland in 2023.

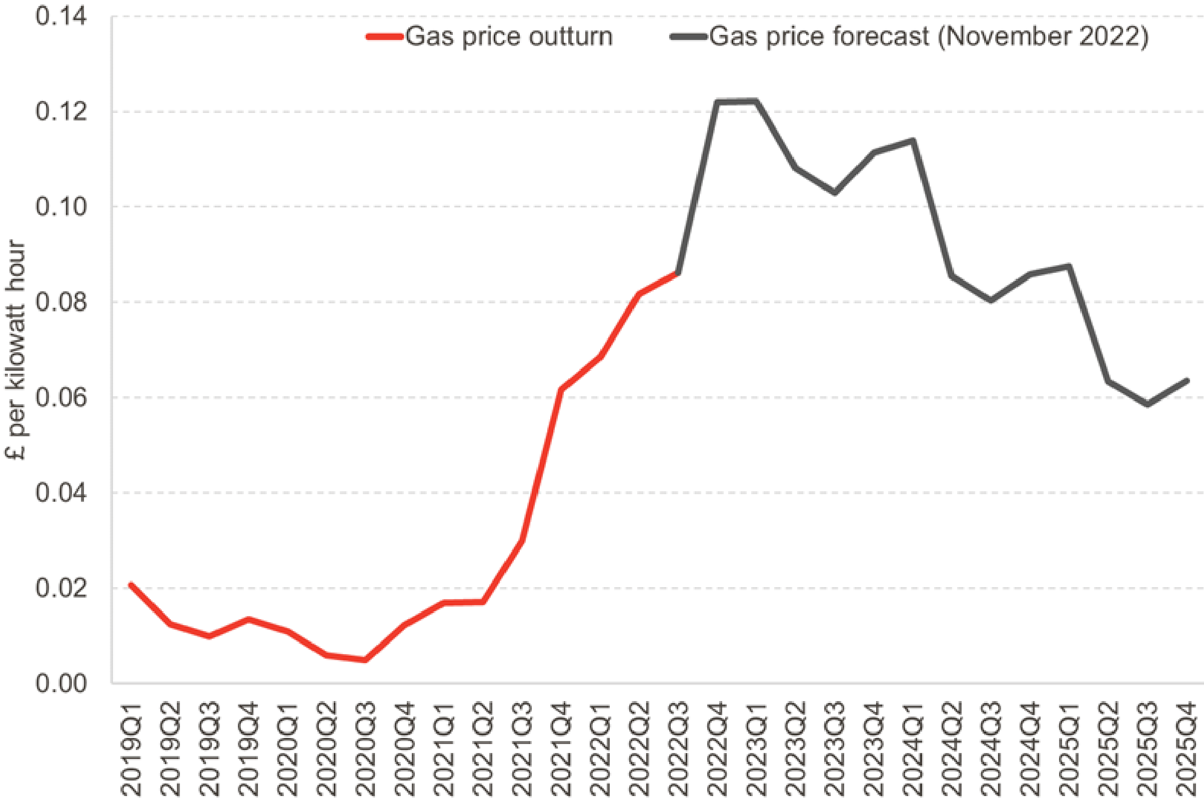
Chart 12: Scottish house price growth forecasts 2023-2027



Source: *Savills*

Gas prices can be difficult to forecast due to the volatile nature of wholesale pricing. OBR gas price forecasts reflect the UK Government's energy price guarantee, a price cap which ends in March 2023. Gas prices were originally forecasted to peak in Q1 2023 and are currently coming down. The OBR's next forecasts are due out in mid-March, however. High energy prices are a major contributor to current inflation rates, and are likely to remain high, although they are not expected to increase at the rates seen throughout 2021 and 2022.

Chart 13: UK Consumer gas price outturn and forecasts, Q1 2019 – Q4 2025



Source: *OBR*

In response to higher prices, higher cost of borrowing, and lower real incomes, households and businesses are set to pull back spending in 2023. The OBR forecasts that private consumption will decline by nearly 2%, with other forecasters predicting a decline of around 1.1%.

Business investment forecasts are scattered; in November, the OBR predicted that investment would continue to rise in 2023 by around 2%; on average, independent forecasts predicted that it would decline by about 1.4%[2] .

Our research found that, for Q4 2022, about 60% of businesses in Scotland expect to make energy-efficient improvements to combat the energy crisis. High energy cost and high prices were the most common concerns among the Scottish firms we surveyed for our quarterly business monitor. Just under half of the businesses surveyed reported that they expected to reduce operations to some extent due to high energy costs.

2 HM Treasury - Forecasts for the UK economy: a comparison of independent forecasts

Public Sector Pay

Ongoing industrial disputes have placed focus on public sector pay, which could dominate headlines again in 2023. Public sector pay, whilst complex, is of great fiscal importance – particularly given the large share of the workforce currently employed in the public sector, both in Scotland and the UK.

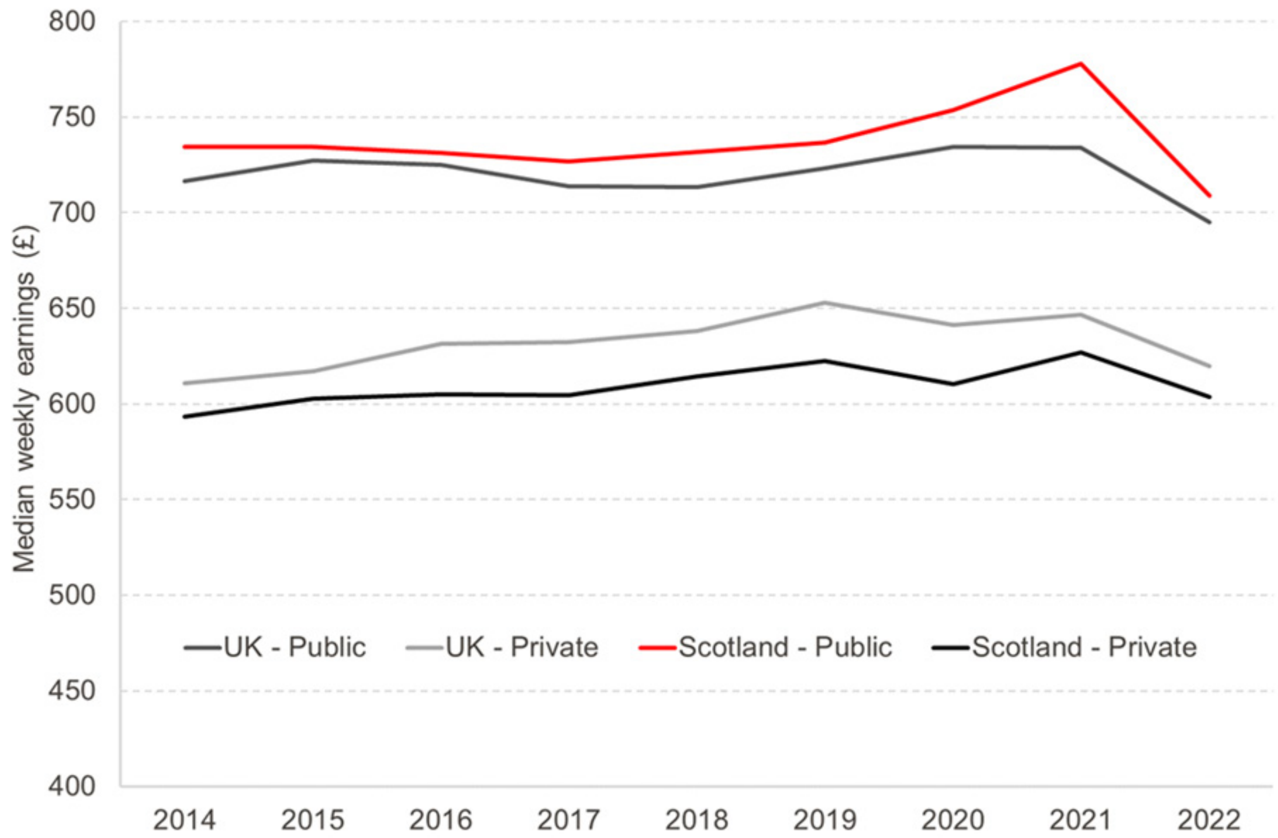
In October 2022, median weekly earnings for full-time employees were £695 in the public sector in the UK compared to £620 in the private sector, meaning earnings were 12% higher in the public sector[3].

Public sector earnings for full time workers were also higher in Scotland, with weekly earnings of £709, around 2% greater than in the UK, however private sector earnings were slightly lower, with weekly earnings of £604, 3% lower than the UK.

Chart 14 shows that public sector earnings in both Scotland and the UK have been at higher levels than private sector pay since 2014, once adjusted for inflation.

The difference between public and private sector earnings did fall from 15% in 2020 to 12% by 2022 in the UK, mostly due to the public sector pay freeze announcement by the UK government in 2021, however the gap has always remained.

Chart 14: Scotland and UK real median weekly earnings, public and private sector, 1997 – 2022



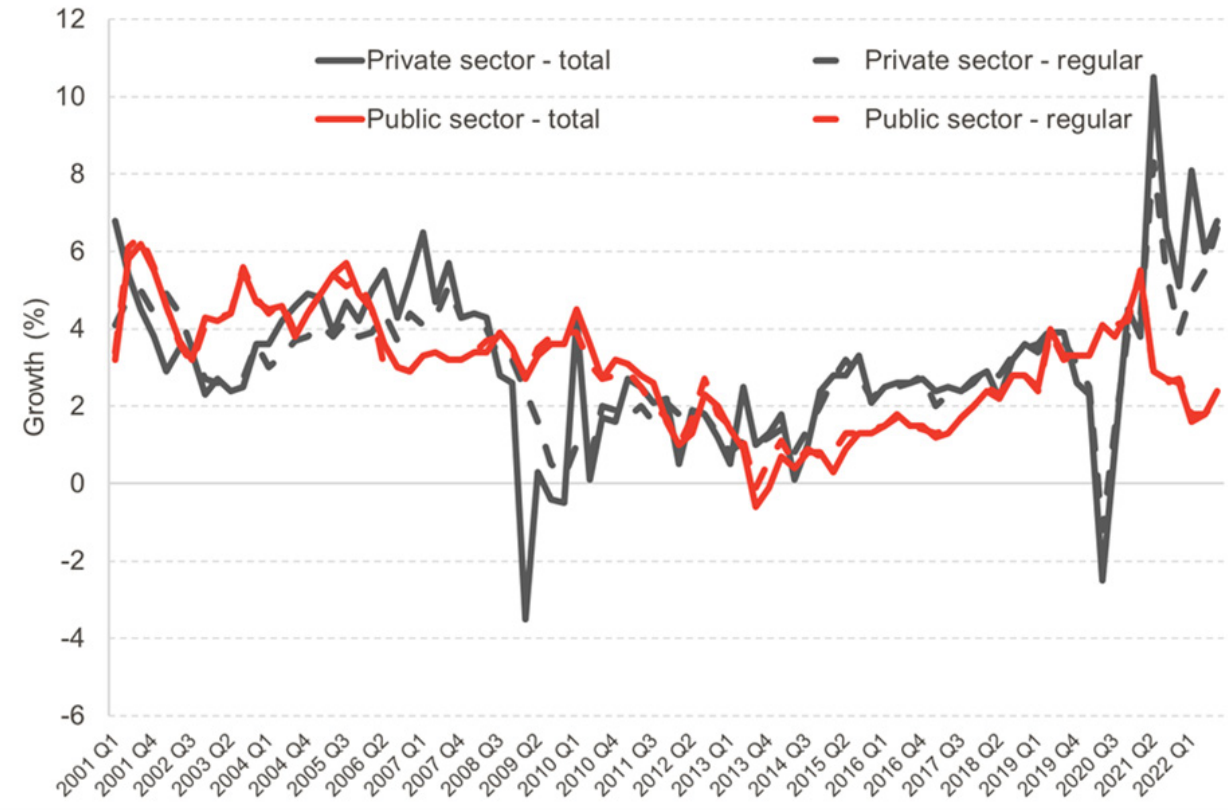
Source: *ASHE, Statista*

3 ONS - Earnings and hours worked, public and private sector: ASHE Table 13

Comparing public and private sector earnings is complex, given the structural nature of both labour forces and the fact that in the private sector, bonuses can also be paid on top of base salaries.

However, in recent months, much of the argument surrounding public sector pay has focused less on how it compares to private sector wages and more on slower growth when compared to rising inflation over recent years (Chart 15).

Chart 15: Average weekly earnings growth in total and regular pay, UK, 2001 Q1 – 2022 Q3, December 2022 £



Source: *ASHE*

The Scottish Budget 2023-24

In December, the Scottish Government set out its budget for the forthcoming financial year against a backdrop of high inflation, public sector pay disputes and uncertainty surrounding the economic outlook.

As the budget moves to Stage 2 in Parliament this week, it is important to make sense of the choices made and what these tell us about the government's priorities.

The headlines were dominated by changes to income tax and the impact of inflation on the purchasing power of the budget but beyond this, there were some consequential decisions that deserve attention.

Broadly, the government stuck to its spending priorities set out in May's Resource Spending Review, with real terms increases in the budgets for health and social care and social security, driven by the Scottish Child Payment and devolved disability benefits. These choices leave a difficult outlook for other areas of the public sector, notably local government.

But overshadowing the entire budget is uncertainty surrounding public sector pay. The government chose not to publish a public sector pay strategy (a break with previous budget day norms), as disputes are yet to be resolved for the current year, let alone 2023/24.

With inflation running at 10.5%, it is difficult to see the government meeting its ambition to keep the public sector pay bill flat in cash terms over the next 3 years, as it assumed in the Resource Spending Review in May 2022. So, don't be surprised if another in-year emergency budget is required in 2023.

The Impact of Inflation

Before the budget, there were claims and counter claims made about its real terms value, which has been eroded to some extent by high inflation. These conversations generally surrounded the falling real terms value of the in-year 2022-23 budget versus when it was announced.

Looking ahead to 2023-24, Barnett consequentials announced at the UK Government's Autumn Statement will help soften the impact of inflation on the real terms value of the Scottish resource block grant. The extent to which it does depends on the measure of inflation used.

Reasonable estimates range from a small net increase in the real terms value of the block grant to a deterioration of around £300m (approx. 1%) relative to the outlook in May. A more detailed look at these different inflation measures can be found in our pre-budget report, but two broader points are worth making.

First, the funding outlook for 2023-24 and 2024-25 was already extremely constrained, given 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, 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) costs.

Table 2: Overview of resource and capital funding position in 2023-24 (£m)

		Resource	Capital
Funding from UK Government	UK Autumn Statement Baseline*	36,023	4,943
	Block grant adjustment (BGA) for social security	4,360	-
	Non-Barnett funding + non-tax BGAs	1,226	632
Revenue raised by the Scottish Government	NDR income & other funding	3,482	488
	Devolved taxes	16,688	-
Other fiscal framework adjustments	Tax block grant adjustment	-16,642	-
	Reconciliations	46	-
Borrowing	Borrowing	41	300
	Resource & capital borrowing costs	-232	-
Total Resource Funding Available		**44,992**	**6,363**

*Includes Consequentials

Source: *Scottish Fiscal Commission*

The Income Tax Burden is Increasing

Changes to income tax policy are largely in line with those being made in rUK, but there is some further divergence that raises additional revenue.

Similar to tax policy in rUK, the Scottish Government have decided to freeze the basic, intermediate and higher rate thresholds in cash terms, and to reduce the threshold at which the top rate of tax becomes payable, from £150,000 to £125,140.

The government have also announced increases in the top rates of income tax in Scotland, which are not mirrored in rUK. 2023-24 will see 1p increases in both the higher and top rates of tax, to 42p and 47p, respectively.

Table 3: Scottish tax bands, rates, and changes, 2022-23 to 2023-24

	2022-23		**2023-24**		**Changes**
	Earned Income	**Scottish Tax Rate**	**Earned Income**	**Scottish Tax Rate**	
Personal Allowance*	£12,570	-	£12,570	-	Unchanged
Starter rate	£12,571 - £14,732	19%	£12,571 - £14,732	19%	Unchanged
Basic Rate	£14,733 - £25,688	20%	£14,733 - £25,688	20%	Unchanged
Intermediate Rate	£25,686 - £43,662	21%	£25,686 - £43,662	21%	Unchanged
Higher Rate	£43,663 - £150,000	41%	£43,663 - **£125,140**	**42%**	Scottish Tax Rate increased by 1p to the £
Top Rate	Over 150,000	46%	Over 125,140	**47%**	Threshold reduced from £150,000 to £125,140. Scottish tax rate increased by 1p to the £

* Level not under control of Scottish ministers. The personal allowance is reduced by £1 for every £2 earned between 100,00 and £125,000.

Source: *Scottish Government*

Table 4: Additional revenue raised from income tax policy change, 2022-23 to 2025-26 (£m)

	2023-24	**2024-25**	**2025-26**
Total Policy	**129**	**142**	**150**
Top rate threshold reduction to £125,140	8	13	15
Basic rate band freeze	18	19	20
Starter rate band freeze	6	6	6
Top rate increased by 1p to 47p	3	3	3
Higher rate increased by 1p to 42p	92	98	104
RTI adjustment	3	3	3

Source: *Scottish Fiscal Commission*

Overall, these income tax changes are forecast to raise £129m of additional revenue to fund the Scottish budget in 2023-24. The increase in the higher rate alone raises over £90m in 20234-24 and accounts for around 70% of the additional revenue raised from income tax policy changes.

It is worth noting that this is dwarfed by the revenue raised by freezing the higher rate threshold at £43,663, which the Scottish Government estimate to be £390m in real terms. This is not included in the SFC forecasts, as they already assume this threshold freeze is baked into the baseline for comparison.

Of all these changes to income tax policy, the change that raises the least amount of revenue in the SFC's forecasts is the £3m raised from increasing the top rate to 47p. This is a reflection of both behavioural changes and the number of taxpayers in each band in the SFC's forecasts.

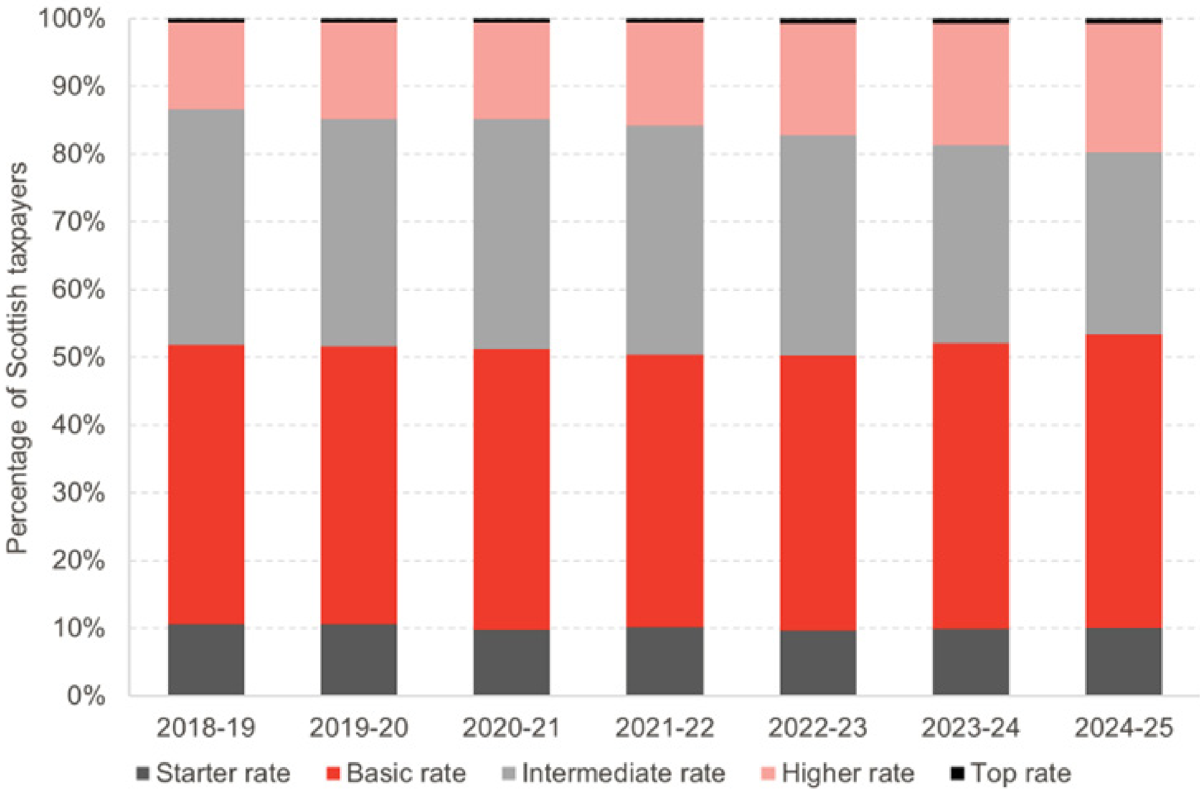
Indeed, behavioural changes significantly impact SFC forecasts of revenue raised by changing the top rate of tax and threshold. Behavioural changes are where taxpayers respond to changes in tax policy, for example by relocating, tax planning or reducing hours worked.

In the SFC's forecasts, the static revenue (revenue that would be raised without behavioural responses) from reducing the top rate threshold to £125,140 and increasing the top rate of tax to 47p is £65m in 2023-24. Once behavioural changes are added, the forecasted revenue raised is £11m.

The SFC forecast that there will be an additional 2,000 taxpayers in the top rate of income tax in 2023-24, which is dwarfed by the extra 48,000 taxpayers who are forecast to fall into the higher rate band. This explains why decisions around the higher rate raise far more revenue.

Since 2018-19, when the 5-band system was introduced in Scotland, the higher rate threshold has been held relatively flat in nominal terms. This has pulled more taxpayers into the higher rate band. This means that between 2018-19 and 2024-25, the pecentage of taxpayers who are forecast to be in the higher rate band or above will have increased from 14% to 20%.

Chart 16: Percentage of taxpayers in each band



Source: Scottish Government

As a result of these changes, taxpayers face an increased divergence in tax liabilities between Scotland and rUK, particularly for incomes that fall in the higher rate band and above. This is not new, however, and continues a trend of income tax policy seen since it was devolved in 2016.

Land and Buildings Transaction Tax

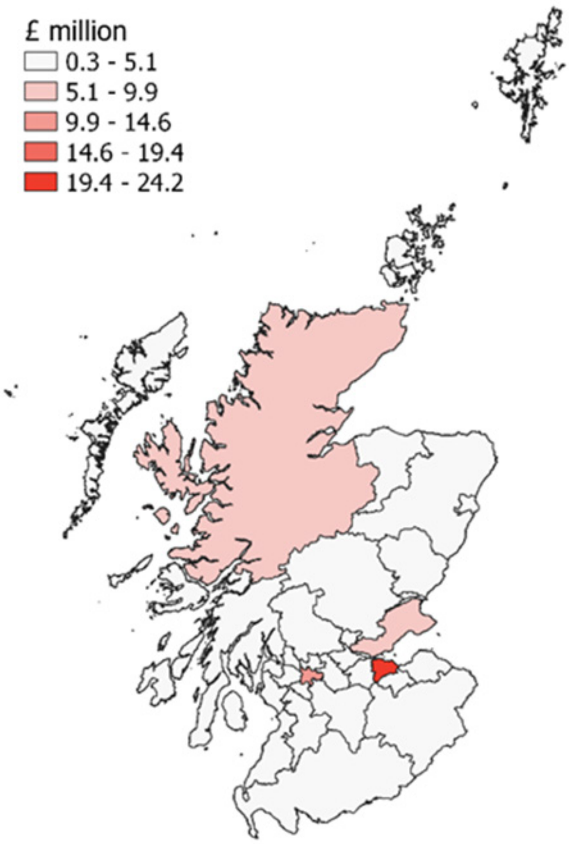
Another key announcement was an increase in the Additional Dwelling Supplement (ADS) from 4% to 6%.

LBTT is a tax paid on property transactions and replaced Stamp Duty in Scotland in 2015. ADS is a tax paid in addition to LBTT on property purchases that result in the buyer(s) owning more than one dwelling when they are not replacing their main dwelling. Therefore, the tax applies to those who own more than one property and is paid when purchasing any property that is not the purchaser's main dwelling.

The increase in the ADS rate is likely to have the largest impact in particular areas. For example, over 44% of ADS transactions in 2020/21 occurred in just five local authority areas – Glasgow, Edinburgh, Fife, South Lanarkshire, and Highland.

A similar pattern holds for revenues (Chart 18). Glasgow and Edinburgh together account for over 35% of total ADS revenue. Of 32 local authorities, 28 account for less than 5% of total revenue each.

Chart 17: Revenue raised from additional dwelling supplement, 2020-21



Source: *Revenue Scotland*

Between 2016 and 2021, 22% of transactions that resulted in an LBTT return included some amount of ADS. The average gross ADS paid per transaction was approximately £6,000.

The Scottish Fiscal Commission has projected that the increase in tax will raise an additional £34m in 2023-24. This forecast takes into account expected behavioural changes due to the increase in tax, which may reduce the number or value of transactions that incur ADS.

Interestingly, if the increase in tax dampens demand for non-primary dwellings, home movers and first-time buyers may face slightly lower prices. As fewer transactions become subject to ADS, the rest of the market is forecast to absorb 50% of these 'lost' transactions. This figure is assumed to rise to 75% by 2024-25. However, the SFC stress a high level of uncertainty around these forecasted behavioural responses.

The Net Tax Position

The resources available to the Scottish Government are not just determined by the block grant. They are also determined by revenues raised from the three devolved taxes (income tax, LBTT and landfill tax). At the time the budget is set for a particular year, these are based on SFC forecasts.

What really matters is how this revenue compares with block grant adjustments (BGAs). BGAs are deductions from the block grant to account for the transfer of revenues from these taxes from the UK Government to the Scottish Government. At the time the budget is set for a particular year, these are based on OBR forecasts for the equivalent UK taxes.

For example, if Scottish income tax raises more revenue than would have been the case if income tax policy were not devolved, the budget is said to have a positive 'net tax' position. This leaves the Scottish budget better off and the Scottish Government is free to spend this additional revenue on its devolved responsibilities.

Conversely, a negative net tax position implies the Scottish budget is worse off than it would have been had these taxes not been devolved. More information on how this works is available in our Scottish Budget guide.

Table 5: Tax Net Positions, 2022-23 to 2025-26 (£ million)

	2022-23	**2023-24**	**2024-25**	**2025-26**
Income Tax	-107	325	700	915
LBTT	133	256	219	190
SLfT	-3	-19	-21	-29
Total taxes	**24**	**562**	**898**	**1,076**

Source: *Scottish Fiscal Commission*

The net tax position is derived from forecasts made by the SFC and OBR and is very sensitive to changes in these forecasts. Since the equivalent forecasts made a year ago, the net tax position for income tax alone has improved by £582m.

The improvement in the net tax position for income tax is driven by three factors:

- £129m of additional revenue is raised by the changes to income tax policy announced in this budget (see above).
- The higher rate threshold has been frozen at a lower level in Scotland (£43,663) than in rUK (£50,270). As nominal earnings rise at a faster pace than recent historical standards, revenue raised from income tax is expected to rise faster in Scotland than in rUK.
- The employment and earnings outlook for rUK has deteriorated since previous forecasts were made.

After a period of slower earnings growth compared with rUK (and therefore slower growth in the income tax base), the relative outlook for Scotland has improved in the SFC's forecasts. This is driven by three factors within those forecasts:

- A more positive forecast for earnings in the oil and gas sector.
- A relative improvement in forecasted earnings growth in Scottish financial services.
- Lower levels of mortgage debt in Scotland. This means households are expected to be less affected by rising interest rates, which the SFC assume would support economic activity in Scotland.

The net tax position for LBTT is also positive for 2023-24, forecast to be £256m. This is largely due to a relatively shallower forecasted fall in house prices north of the border over the forecast period.

The negative net tax position for Scottish Landfill Tax is set to grow over the forecast period and the SFC forecast the revenue raised from this tax to decline by 84% over five years. This is in line with the policy imperative – the Scottish Government are set to ban landfilling Biodegradable Municipal Waste.

Health and social care is the spending priority

On the spending side, the priority once again is health and social care, which is set to receive a real-terms increase of 2.8% next year. Whether this is sufficient to ease the pressures on the NHS remains to be seen.

Frustratingly, the status of funding for the National Care Service reform is unclear. Most of the 5.4% nominal increase in the care service line item is likely allocated to the £100m for supporting a £10.90 real living wage for adult social care workers. The budget statement highlights that other areas of spend will "pave the way" for the National Care Service in future.

More details on the cost of establishing the service are anticipated in the coming months, as an amended Financial Memorandum to the parliamentary legislation is expected to be published. We have written more about this in a briefing published last year.

Devolved decision making is increasing spend on social security on Scotland

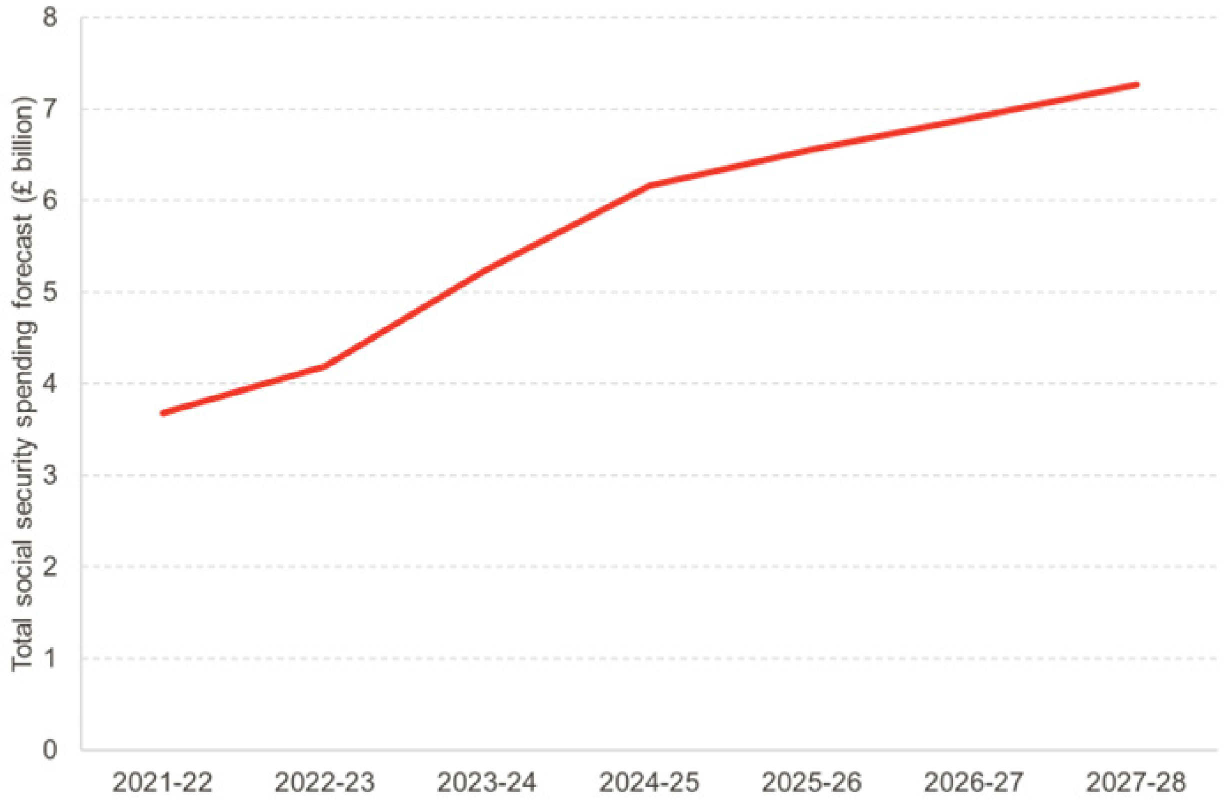
The Scottish Government has been in the process of transferring a range of devolved benefits from DWP to Social Security Scotland for many years now. These benefits are primarily to support people with disabilities and parents on low incomes. New 'versions' of some of these benefits have now launched, with Adult Disability Payment (ADP) (previously the DWP benefit Personal Independent Payment), being the most significant in terms of cost. ADP has redesigned application processes to try and boost take-up and has made some (so far) small changes to generosity for some claimants.

The SFC forecast that cost of this benefit will be higher than PIP and this additional spending falls solely on the Scottish Government (ie. is not covered by the block grant).

Devolved social security powers have also been used to create new 'top-up' benefits that sit on top of existing DWP UK wide benefits. The flagship Scottish Child Payment, a top up to Universal Credit, has now reached £25 per week and been extended to eligible children under 16. It will nearly double in cost in nominal terms between 2022-23 and 2023-24.

The net result of these, and other, commitments on social security mean that estimated devolved social security spending is set to rise by £1bn in the space of a year (see Chart 18).

Chart 18: Social security total spending forecasts, 2021-22 to 2027-28 (£ billion)



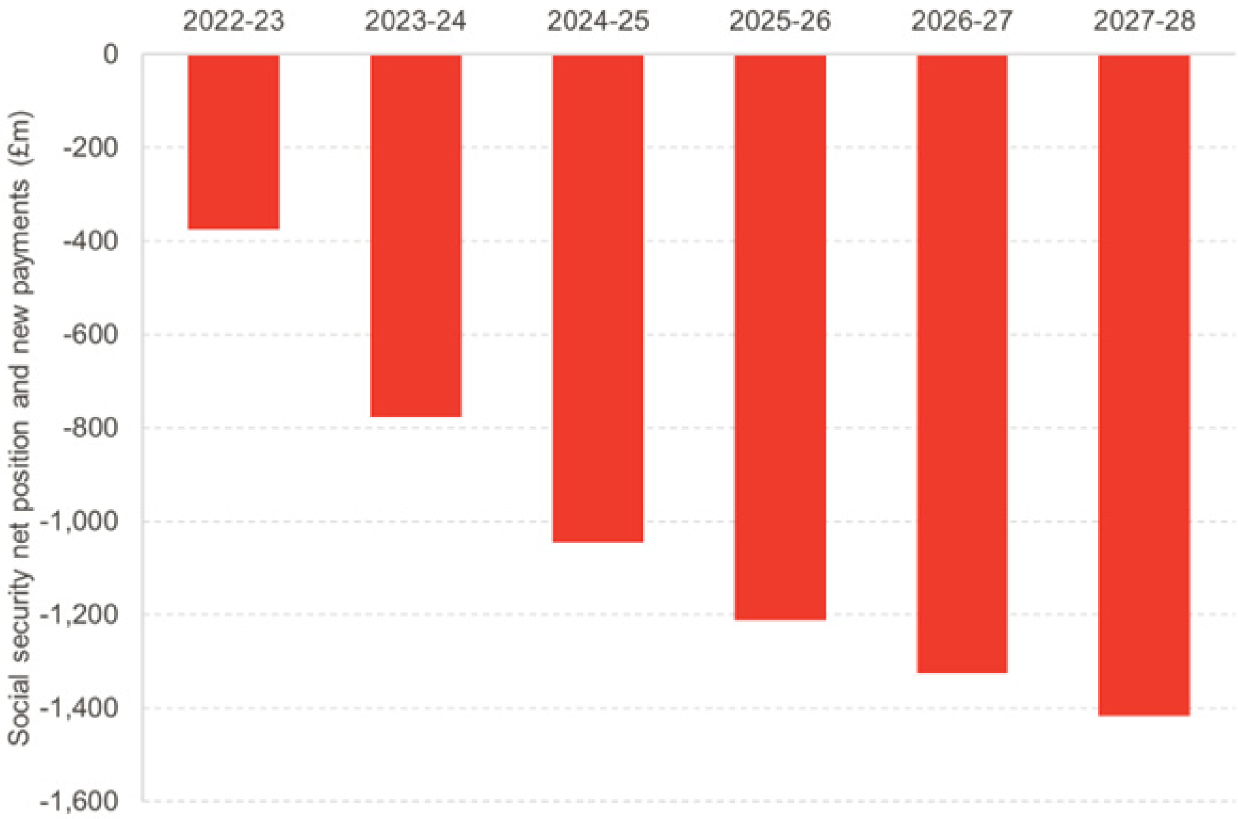
Source: *Scottish Fiscal Commission*

This means there is a growing gap between the social security budget and the funding received through BGAs. This funding gap reflects the different choices made over social security by the UK and Scottish Governments and in particular is the result of two policy choices made in Scotland:

- The Scottish Government has introduced new benefits not available elsewhere in rUK, such as the Carer's Allowance Supplement and the Scottish Child Payment.
- The Scottish Government has introduced a different application process for newly devolved disability benefits that is expected to result in a higher number of claimants than the reserved benefits they replace.

This funding gap must be met entirely within the Scottish budget. It is forecast to more than double in 2023-24 to £776m (18% of BGA) and rise to £1.4bn (25% of BGA) by 2027-28. For context, the changes to income tax polixy announced in this budget are forecast to raise £129m in 2023-24.

Chart 19: Social security net position and new payments, 2022-23 to 2027-28



Source: *Scottish Fiscal Commission*

These policy choices fit with the Scottish Government's wider aims. There is no question that they will significantly reduce child poverty and have been welcomed by disabled persons' organisations.

Recent data have shown that in the period since the pandemic, there has been a significant increase in the number of adults receiving disability benefits in Scotland - a trend that is mirrored across the UK. The Scottish Fiscal Commission attribute this increase to the combined impact of the following factors:

- Eligible people considering sources of support as a response to the cost of living crisis.
- People waiting longer for NHS treatment, potentially leading to conditions worsening or treatment being less effective, to such an extent that they become eligible for disability benefits.
- Continuing long-term impacts from Covid-19, including long Covid and broader impacts of the pandemic on mental health.

But these policy decisions are not cheap. Factoring in these spending choices will become a new, increasingly complex, part of the budget decision making process in the years ahead.

Net Zero

On the face of it, the transition to net zero was one of the three key priorities within the budget, alongside eradicating child poverty and supporting sustainable public services. Indeed, the net zero, energy and transport portfolio is set to receive a a higher percentage increase in real terms funding in 2023-24 than most portfolios.

But the latest budget document doesn't delve far into any new spending on transitioning to net zero and, in nominal terms, 61% (£144m) of the additional spending is allocated to ferry services – perhaps not the most obvious spending priority to reduce emissions.

The budget does rehash some policies from the May 2022 Resource Spending Review, including increased resource for the Heat in Buildings strategy, support for public transport, and funding for woodland, peatland and marine protections.

However, the only major new policy announced was in the form of a trial removing some peak-time rail fares in a bid to increase public transport uptake. Details are yet to be announced, but the scheme is expected to last six months and will run sometime in the financial year 2023-24.

A lack of new announcements doesn't necessarily mean that Scotland is not on track to meet its emissions targets. But what has been in announced is far from the transformational activity required to decarbonise at pace.

Despite recently publishing a draft Energy Strategy and Just Transition Plan, it is difficult to see how budget decisions around net zero tie into a wider strategy to decarbonise our economy. Indeed, it is difficult to follow how budget decisions have been shaped by the transition to net zero at all. We've written about this in a recent report for ClimateXchange.

Public Sector Pay

In the UK Autumn budget in 2021, Rishi Sunak, the now prime minister, announced the end of the previous year's freeze on public sector pay, and announced that over the next 3 years, public sector workers would receive "fair and affordable" pay rises.

In Scotland, alongside their budget for the coming year, the government produced their public sector pay policy in December 2021.

This pay policy provided:

- a £10.50 public sector wage floor by April 2022
- a cash uplift of £775 for public sector workers earning up to £25,000
- £700 for workers earning between £25,000 and £40,000
- £500 for those who earn above £40,000

This policy was based on the September 2021 inflation figure of 3.1%. However, by December, consumer price inflation had risen to 5.4% leading to cuts in real public sector earnings and, inevitably, the government scrapping their public sector pay policy for 2022-23.

At the same time, the Scottish Government published its Resource Spending Review in May 2022, a multi-year spending review to 2026-27. In it, the government outlined their plans for public sector workforce reform, including their ambition to freeze the total public sector pay bill at 2022-23 cash levels until 2026-27.

Despite anticipated pay rises over this period, the Scottish Government planned to keep the total pay bill constant by reducing the size of the public sector workforce to pre-pandemic levels. As yet, there has been no further detail on where these proposed cuts are likely to be made and no published strategy for public service reform.

If the government were to follow through on their plan to reduce the public sector headcount to pre pandemic levels, then the number of workers employed in the public sector would need to fall by around 7% over the 4 years to 2026-27, or 1.6% per year.

Even at the time, freezing the public sector pay bill looked like a very ambitious proposal. Much of the staff increases seen in recent years have been in the health and social care sectors, which, given the current pressures in the system, will struggle to cope with any staff reductions.

Since May, these proposals have become even more difficult to deliver. Then, CPI inflation was 9% and has continued to rise throughout 2022, reaching 10.5% by December 2022.

This has led to prolonged negotiations surrounding public sector pay and subsequent industrial action for many public services over the past year.

Many of these negotiations are yet to be resolved. Given this, the Scottish Government chose not to publish their annual public sector pay policy for 2023-24 alongside the budget in December 2022.

Table 6 provides an illustrative estimate of how much the pay bill would likely rise, if the government were to offer various pay rises to all staff and let the pay bill rise in line with these.

Table 6: Public pay bill rise scenarios, 2023-24

Average pay rise	Pay bill
Baseline	£22bn
2%	£23.02bn
3%	£23.03bn
4%	£24.07bn
5%	£25.12bn
6%	£26.18bn
7%	£27.25bn
8%	£28.33bn
9%	£29.42bn
10%	£30.52bn

Source: *FAI Calculations*

Our (very rough) estimates suggest that average pay rises similar to current inflation would increase the public sector pay bill by £8.5bn, to around £30bn.

If the government were to offer 3% rises, similar to what is already agreed in the rest of the UK, then the pay bill would rise by around £1bn, which whilst more feasible, would still likely lead to significant cuts to other areas of the resource budget.

All of this increases the probability of another emergency in-year budget review in 2023-24.

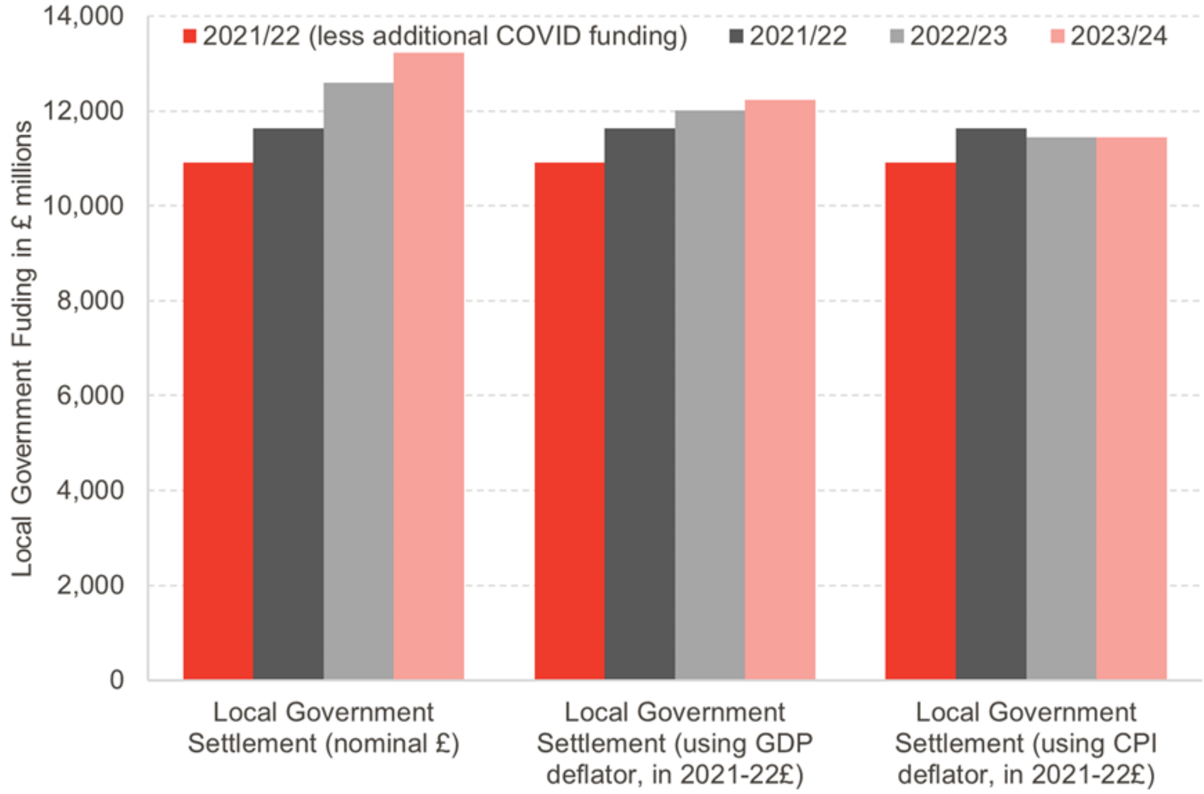
Local Government Funding

Local government funding increased nominally by £573 million in 2023-24 compared to the previous year's budget (see issues around transparency below). An additional £64 million was added for school lunch support for the 2023-24 fiscal year, bringing the total budget line to £13.2bn. In real terms, however, this represents a 1.9% increase in the stated budget line between 2022-23 and 2023-24.

There are also potentially some issues in calculating the budget line in real terms – these figures use a GDP deflator of 3.2%, which may underestimate the inflationary pressures associated with the costs of delivering services and public sector pay claims in the current environment.

Finding a correct range of inflation for funding is tricky, however. Since the government does not purchase items in the same way as households, using consumer price inflation is an overestimate of the true value of financing to local governments. Using CPI, local government funding was essentially flat between 2022-23 and 2023-24 – funding increased by less than 0.1%.

Chart 20: Local government funding settlement by inflation measure, 2021-22 to 2023-24



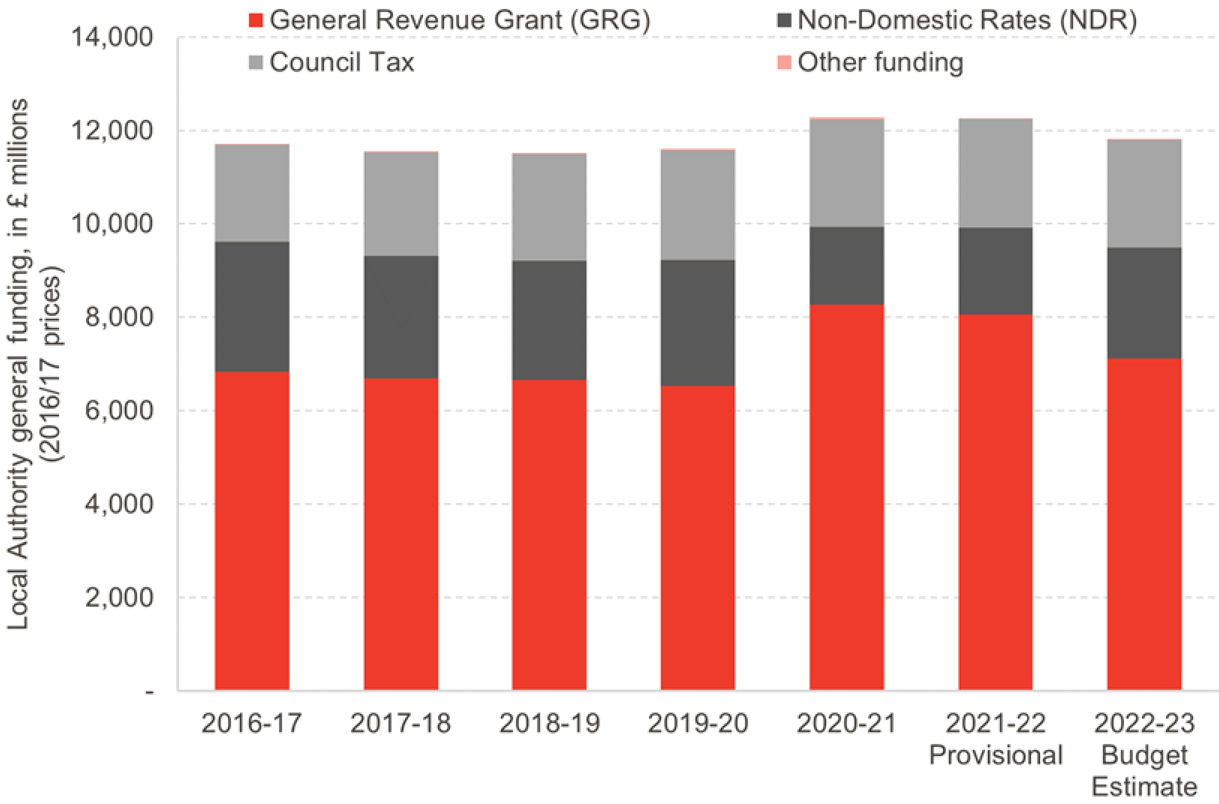
***Source:** Scottish Government, OBR*

Importantly, the 2022-23 budget line that the Scottish Government are using for comparison does not include significant additional resources that were allocated to local government in-year - it is the figure that was presented in December 2021. For example, there was an extra £120 million during the Stage 1 debate in January 2022, and an additional £140 million announced in Summer 2022 to help fund local government pay deals.

If we compare the funding for 2023-24 to the latest funding position known for 2022-23, this gives us a real terms reduction of 1.9% over the year.

Funding for local authorities comes predominantly from the general revenue grant from the Scottish Government. Between 56-67% of total funding comes from this pool. Roughly 20% of funding comes from council tax, with 14-23% coming from non-domestic rates (frequently referred to as business rates). Non-domestic rates are set by the Scottish Government, collected by local authorities, pooled nationally and then redistributed amongst local authorities depending on factors, such as population and need.

Chart 21: General funding sources for local governments, in 2016-17 £ million*



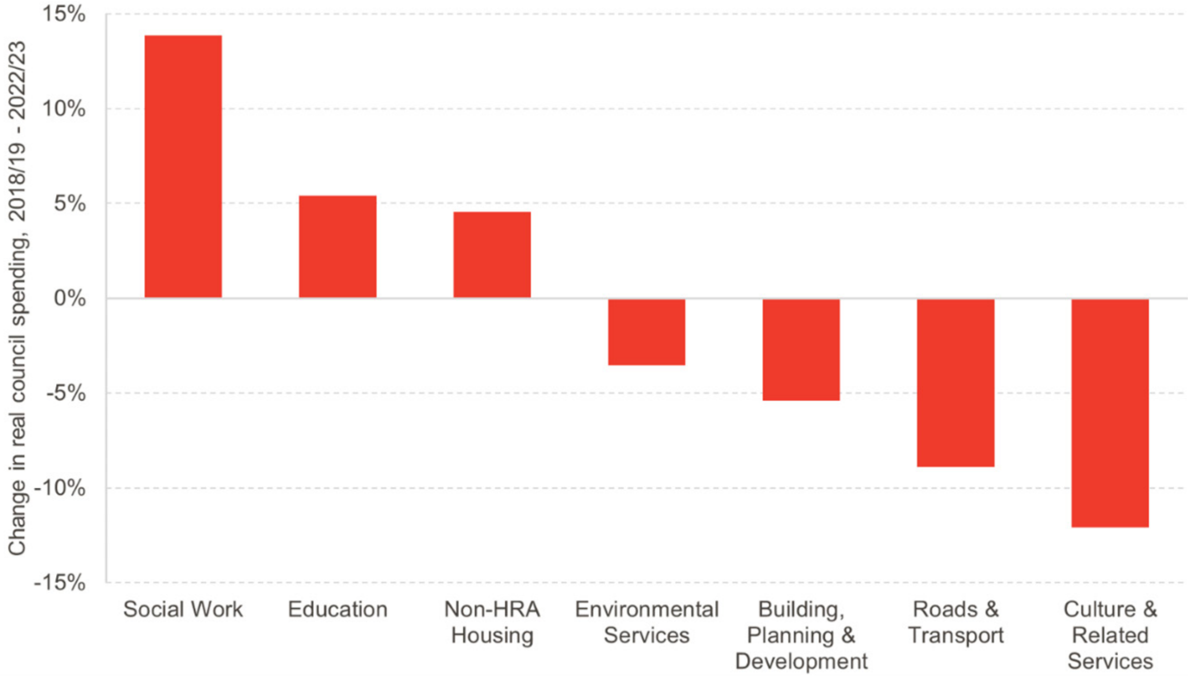
* Figures from 2020-2023 exclude grants which are paid to local authorities via the General Revenue Grant. It is unclear which grants are being excluded and their values.

Source: *Scottish Government, OBR*

In real terms, local authority budgets increased by less than 1% between 2016-17 and 2022-23. Over the same time period, the number of full-time equivalent staff employed by local governments increased by 8%. According to COSLA, about 70% of council budgets are spent on staff. This results in an obvious budget gap – maintaining real pay for staff increases over this time period would necessarily result in cuts in other areas.

Since 2018-19, these cuts have mainly been focused on road and transport maintenance, environmental services, building and development, and cultural services. COSLA found that increased pressure on local authorities is set to result in a potential funding gap of up to £1 billion in 2023-24.

Chart 22: Changes in real council spending, 2018-19 to 2022-23



Source: *Scottish Government*

Budget Transparency

And finally – how easy is it to tell what's going on?

Much of the discussion about the Scottish budget in recent years has been focussed on the transparency – or otherwise – of the figures in the budget, particularly when considering whether particular budget lines have gone up or down. We've shown this above in the debate over the local government budget line.

The Scottish Fiscal Commission has also raised this with the government, asking them to publish budgets on a "Classification of Functions of Government", or COFOG basis, which allows analysis based upon what services money is actually spent on, rather than which portfolio it happens to be in.

The Scottish Government have committed to do this for the current year and a few previous years before the February recess, so we wait with interest for this. The hope is that this could be published on a regular basis, and also form part of the plans as set out in the budget, so we can tell on a consistent basis how things are changing.

Another issue that continues to muddy the waters is the basis of comparison, which again came up in the discussion about the local government budget line this year. That is, budget plans for 2023-24 are compared to budget plans to 2022-23 as set out the previous December, rather than the best current understanding of the likely spend level in 2022-23.

This has been the convention for many years in the presentation of the budget. But, just because it has always been done, it is reasonable to ask whether this is good enough any more, given the size of in-year changes we have seen in recent years. What is really of interest – how much we are planning to spend on local government next year compared to how much we planned to spend this year, or compared to what we actually spent? The latter is much more pertinent.

When HM Treasury present the UK budget, for example, we see previous years' outturn information compared to current best understanding of spend for the current year compared to plans for years to come. Why not in Scotland?

The final issue is transparency over the way some of the challenges in the budget over the next few years will be dealt with. We've covered this above in regard to public sector pay. However, as part of the budget we were also expecting a strategy on Public Service Reform more broadly, which would need to set out what types of efficiencies and changes to the delivery of services the government would be pursuing in order to make public services sustainable. There was nothing accompanying the budget on this, and in subsequent comments the Deputy First Minister has indicated no such plan will be produced.

All of this means there are significant risks to the fiscal outlook for the coming year and beyond.

University of Strathclyde Business School

Fraser of Allander Institute
University of Strathclyde

The Fraser of Allander Institute (FAI) at the University of Strathclyde entered Scottish public life in 1975. Since then, it has become established as a leading independent economic research institute working with a wide range of clients on a variety of different topics.

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For 45 years, the Fraser of Allander (FAI) has been monitoring and commentating on the Scottish economy. Our regular publications include:

- FAI Economic Commentary – Quarterly – First published in 1975, our quarterly Economic Commentary provides the authoritative independent assessment of economic conditions in Scotland, along with a wide range of economic and policy issues.
- Scottish Business Monitor – Quarterly – Since 1998, the FAI Scottish Business Monitor has been a key leading indicator of the Scottish economy. This survey of Scottish business sentiment provides vital insights into the Scottish economy well in advance of official statistics.
- Scotland's Budget Report – Annual – The Fraser of Allander Institute's analysis of the Scottish Budget and the choices, risks and opportunities facing the Finance Secretary.
- Our blog – Launched in 2016, and viewed over 200,000 times, our FAI blog is a keenly watched discussion platform on the Scottish economy. The blog publishes short reflections on economic developments as well as the policy debate.

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