Finance and Public Administration Committee

2nd Meeting, 2021 (Session 6), Tuesday 31 August 2021

Scottish Fiscal Commission: Scotland's Economic and Fiscal Forecasts – August 2021, Fiscal Update, and Supplementary Forecast Evaluation Report

Purpose

1. The purpose of this paper is to provide background information for the Committee's evidence session with the Scottish Fiscal Commission (SFC) on three separate publications which were published on 26 August—

    - Scotland's Economic and Fiscal Forecasts – August 2021;
    - Fiscal Update – August 2021;
    - Supplementary Forecast Evaluation Report – August 2021.

2. A letter from the Chair of the SFC is attached at Annexe A. It explains that—

    > "Our new forecasts run to 2026-27 and are the second set we have produced since the start of the COVID-19 pandemic. With the success of the vaccination programme the outlook for the economy is more positive than in our January 2021 forecasts, but the path out of the pandemic is unlikely to be smooth and significant risks remain."

3. The letter further notes that—

    > "Following a recommendation from the Finance and Constitution Committee we have added a comparison of our income tax forecasts against the OBR's. From now on we and the OBR will both publish a standard set of comparisons with each of our forecast updates."

4. The SFC has also published its "first costing for the new Adult Disability Payment that is launching next year, which we expect to increase spending by £0.5 billion by 2026-27."

5. Further information on each report is provided below and Members have separately received a private briefing paper from the Financial Scrutiny Unit in SPICe.

1

Scotland's Economic and Fiscal Forecasts – August 2021

6. Scotland's Economic and Fiscal Forecasts (SEFF) provides the SFC's latest forecasts for the economy, tax revenues and social security spending. This would normally have been published in May but, given the timing of the Scottish Parliament election, the Session 5 Finance and Constitution Committee recommended that publication be delayed until August.

7. The SFC has provided a summary of the report which is attached at Annexe B.

8. The summary notes that the public health and economic situations have improved since the SFC's last forecasts in January 2021 and that there are indications that the economy has recovered more quickly than envisaged in January. The SFC has therefore revised up its expectations for Scotland's GDP growth in the near term and GDP is now expected to reach its pre-COVID-19 level in 2022 Q2, almost two years earlier than previously forecast. The SFC has also lowered its estimate of the permanent economic damage from COVID-19 to 2 per cent of long-run GDP, down from 3 per cent in its January 2021 forecast.

9. The labour market has performed better than might have been expected and the unemployment rate is now expected to peak at 5.4 per cent in 2021 Q4 after the furlough scheme expires on 30 September 2021, compared with 7.6 per cent in 2021 Q2 in the January 2021 forecast.

10. The SFC also notes that international supply pressures as well as domestic recruitment difficulties both appear to be contributing to rising inflation. Further information on how inflation affects its forecasts is provided in the annexe along with a note of its population and demographic projections and how a slight decline in the labour force, coupled with an ageing population is expected to "act as a drag on GDP per capita."

Tax

11. The SFC states that "many of its tax forecasts have been revised up significantly since our January 2021 forecast, both because of the improved economic outlook and rising inflation. Our income tax forecast for 2021-22 has been revised up by around £0.9 billion."

12. The SFC highlights the relationship between its forecasts and the OBR's in respect of the block grant adjustment but points out that the OBR's forecasts were last updated in March 2021, since when there have been significant changes to the outlook for both the Scottish and UK economies, both of which are now expected to grow more quickly. This "timing mismatch between the component forecasts means the estimated £1.3 billion net funding position is artificially high and does not reflect the likely true net funding position for 2021-22." The SFC's expectation is that "updated OBR forecasts due to be published

on 27 October will reduce the gap between the BGA and our forecast of income tax revenues" and that, subsequently "the net funding position for income tax to return to a level similar to previous years." The SFC points out that "these updated forecasts have no direct effect on the Scottish Budget as the 2021-22 figures remain fixed from January 2021."

13. The SFC also notes that the improved economic outlook has affected its forecasts for the devolved taxes with revenues from the Land and Buildings Transaction Tax and Scottish Landfill Tax both revised upwards. Non-domestic rates revenue is reduced in 2021-22 following the Scottish Government's decision to extend the retail, hospitality, leisure and aviation relief for the full financial year, but from 2023-24 onwards the SFC's revised inflation forecast increases revenue compared to its January forecast.

Fiscal Overview

14. The SFC notes that the UK Government has not guaranteed any additional funding for Covid-19 for 2021-22 and that there are currently no arrangements for deferred funding. Given the Scottish Government's requirement to maintain a balanced budget, "large changes in COVID-19 funding late in the financial year may create difficulties for the Scottish Government's management of its budget."

15. Given the significant changes to the outlook for the UK and Scottish economies, the SFC notes that "any comparison between our forecasts and the BGAs will not reflect the likely true position" but it expects to "be able to comment on these comparisons to assess the outlook for the funding of the Scottish Government" when it published its next forecasts alongside the Scottish Budget.

Social Security Spending

16. The SFC forecasts that "devolved social security spending will increase from £3.7 billion in 2021-22 to £5.2 billion in 2026-27, as more people receive social security support each year and payment amounts are uprated by inflation."

17. These forecasts include the SFC's first estimate of spending on the new Adult Disability Payment which is expected to replace Personal Independence Payments from summer 2022. The SFC estimates that "by 2026-27, spending on ADP will be £0.5 billion higher than what would have been spent on PIP with total spending reaching £3.0 billion in 2026-27."

18. The summary paper also provides information on expected increases in spend on Carer's Allowance, the Scottish Child Payment and other Scottish Government commitments and notes that "many of these changes will increase spending on social security, which may put further pressure on the resource budget."

Fiscal Update – August 2021

Scottish Budget 2021-22

19. The SFC has also published its Fiscal Update and a summary is attached at annexe C. The SFC describes the update as being “part of our regular series of publications which monitor how funding for the Scottish Budget is changing over time” and notes that the 2020-21 budget has “changed a great deal” since the Budget Bill was introduced in February 2020 (before additional funding had been provided for the pandemic). COVID-19 funding “went on to increase this Budget by £8.6 billion, accounting for 17 per cent of total funding.”

20. The update also provides the latest funding position for 2021-22, setting out changes since the Budget Bill was introduced in January 2021 and focuses on changes since 9 March, the largest of which is an increase in Covid-19 funding of £1,175m in total. The 2021-22 Scottish Budget is expected to continue to evolve and the SFC will produce additional Fiscal Updates in future to explain further changes.

21. The SFC further notes that capital funding has increased since March, “largely as a result of non-Barnett funding.”

Scottish Budget 2020-21

22. The SFC has produced a number of fiscal updates to explain how “funding in the 2020-21 Scottish Budget has changed through the year.” Provisional outturn information for 2020-21 was announced by the Scottish Government on 17 June 2021, which means that this update “is able to provide the near-final funding position and a summary of total changes to the Budget since it was introduced.”

23. The SFC confirms that the resource funding position for 2021-21 has been “revised marginally” since its last update in March 2021 but notes that “capital funding has not changed as significantly as resource during 2020-21.”

Supplementary Forecast Evaluation Report – August 2021

24. The SFC’s Supplementary Forecast Evaluation Report considers forecast error for income tax in 2019-20 and Non-Domestic Rates in 2020-21. This completes the SFC’s annual forecast evaluation exercise, which was otherwise covered in its July Forecast Evaluation Report. These new forecasts run to 2026.

Income Tax

25. In July 2021, HMRC published outturn data for Scottish income tax receipts in 2019-20, which allows a reconciliation to be made between the forecasts at the time at which the 2019-20 budget was set, and what was actually collected.

26. The SFC Supplementary Forecast Evaluation Report notes that—

> "the Scottish Budget for 2019-20 was set using our income tax forecast published in December 2018 of £11,684 million. Compared to the 2019-20 outturn data of £11,833 million, our Budget setting forecast from December 2018 underestimated Scottish income tax revenues by £149 million, or 1.3 per cent. Our inclusion of Real Time Information (RTI) tax data in our January forecast has led to our 2019-20 forecast being very closely aligned to outturn data. We will continue to monitor the effect of RTI tax data in future evaluations."

27. The SFC confirms that income tax revenues in 2019-20 were largely unaffected by Covid-19 since the first lockdown began only days before the end of the 2019-20 fiscal year. The report further confirms that the SFC underestimated Scottish income tax revenues by £149m or 1.3%. The report explains that "further analysis shows that there are two offsetting errors – the economic forecast contributes a positive £519 million, and other unobservable factors such as policy costings contribute a negative £370 million." The SFC considers this to have been "reasonable forecast error" and notes that "the error compares favourably to both the average one-year and two-year ahead forecast error from OBR."

28. The SFC points out that in addition to its underestimate of £149m, the income tax block grant adjustment was also underestimated by £184m and notes that "as the forecast errors were in the same direction, they partially offset each other. The combined effect of these forecast errors is a negative income tax reconciliation of -£34 million."

Non-Domestic Rates

29. The SFC confirms that "NDR revenue for 2020-21 was £1,816 million which is £933 million or 34 per cent lower than our February 2020 forecast of £2,749 million."

30. The SFC further states that—

> "This is considerably larger than both the average one-year-ahead error of 1 per cent from our previous forecasts, and the OBR's average one-year-ahead absolute forecast error of 2 per cent for UK-wide NDR. The main reason for this large forecast error is that NDR revenues were affected by significant policy changes in response to the COVID-19 pandemic."

Committee Clerks
August 2021

ANNEXE A

Letter from the Chair of the Scottish Fiscal Commission to the Convener of 26 August 2021

Dear Convener,

Today the Scottish Fiscal Commission has published three reports. Scotland's Economic and Fiscal Forecasts – August 2021 gives our latest forecasts for the economy, tax revenues and social security spending. Usually we would have produced a forecast in May, but this was not possible given the Scottish Parliament election, and following a recommendation from the Finance and Constitution Committee we committed to publishing a forecast in August.

Our Fiscal Update, sets out the latest position for the 2020-21 and 2021-22 Scottish Budgets in light of funding changes and outturn data since March.
The Supplementary Forecast Evaluation Report looks at our forecast error for income tax in 2019-20 and Non-Domestic Rates in 2020-21. This completes our annual forecast evaluation exercise, which was otherwise covered in our July Forecast Evaluation Report.

Our new forecasts run to 2026-27 and are the second set we have produced since the start of the COVID-19 pandemic. With the success of the vaccination programme the outlook for the economy is more positive than in our January 2021 forecasts, but the path out of the pandemic is unlikely to be smooth and significant risks remain. Following a recommendation from the Finance and Constitution Committee we have added a comparison of our income tax forecasts against the OBR's. From now on we and the OBR will both publish a standard set of comparisons with each of our forecast updates.

We have also included our first costing for the new Adult Disability Payment that is launching next year, which we expect to increase spending by £0.5 billion by 2026-27.

We are committed to being independent, transparent, accessible and open. We are holding an online public event next month, and look forward to discussing our reports with you next week.

Yours sincerely,

Dame Susan Rice DBE

Scottish Fiscal Commission

Scotland's Economic and Fiscal Forecasts – Summary

August 2021

fiscalcommission.scot

This publication is available at www.fiscalcommission.scot

Any enquiries regarding this publication should be sent to us at: Scottish Fiscal Commission, Governor's House, Regent Road, Edinburgh EH1 3DE or info@fiscalcommission.scot

Published by the Scottish Fiscal Commission, August 2021

Foreword

The Scottish Fiscal Commission is the independent fiscal institution for Scotland. Our statutory duty is to provide independent and official forecasts of Scottish GDP, devolved tax revenues and devolved social security spending to inform the Scottish Budget.

COVID-19 continues to have a profound effect on the economy and the Scottish Budget. However, the economic outlook has improved significantly since we published our previous forecasts in January 2021, and this is reflected across our tax and social security forecasts. Despite the improvements in the economic outlook, significant uncertainties and risks remain about how the pandemic may continue to develop. This in turn means our forecasts are subject to greater uncertainty than in a typical year.

Our forecasts represent the collective view of the four Commissioners of the Scottish Fiscal Commission who take full responsibility for them. We are very grateful to the staff of the Commission for their ongoing hard work and dedication in producing these forecasts.

Our forecasts rely on data from a range of providers and we are grateful for their support. We would also like to thank officials from the Scottish Government, Revenue Scotland, Social Security Scotland, DWP, HM Treasury, HMRC and the OBR as well as the Scottish Commission on Social Security for their constructive challenge of our judgments and for ensuring that we considered all the available evidence.

Dame Susan Rice DBE

Professor Francis Breedon

Professor Alasdair Smith

Professor David Ulph

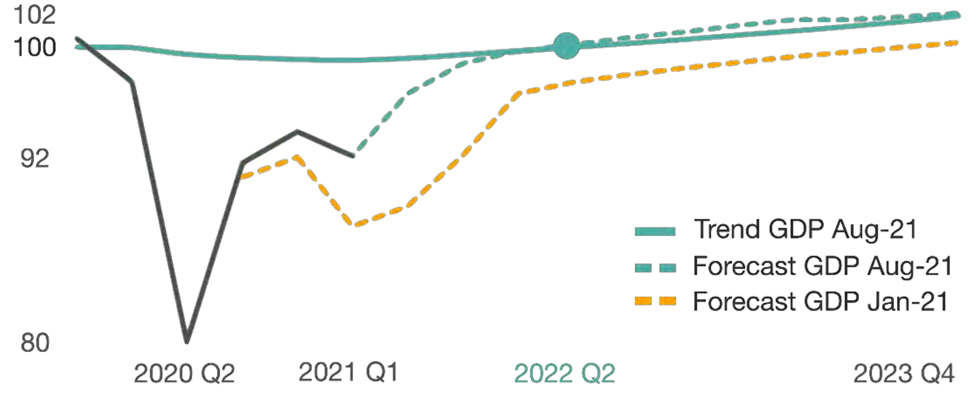
26 August 2021

Economy

Since January 2021, the public health and economic outlook has significantly improved. With COVID-19 restrictions being lifted at a faster pace than anticipated, the economy has recovered more rapidly.

We now expect GDP to reach its pre-COVID level in 2022 Q2, almost two years earlier than we forecast in January 2021.

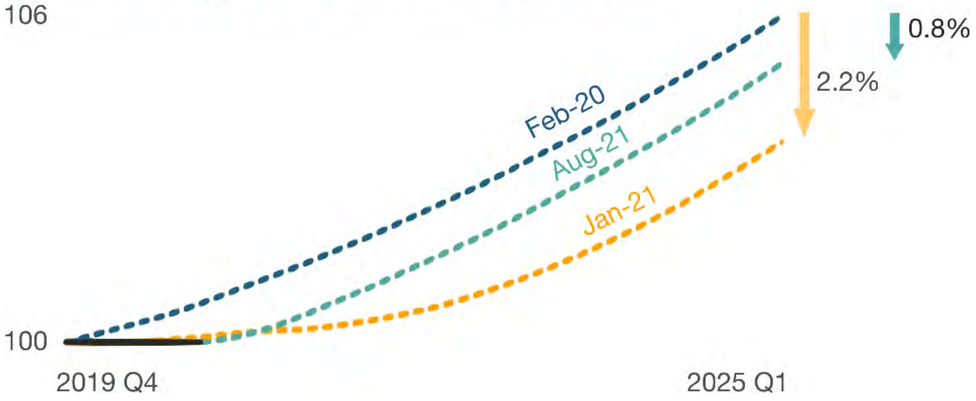
GDP returns to pre-pandemic levels in 2022 Q2



In light of the speed of economic recovery, we have reduced our estimate of COVID-related scarring to trend productivity to 0.8 per cent, compared to 2.2 per cent which we estimated in January 2021.

As a result, trend GDP in 2025 Q1 is 2 per cent lower than our pre-pandemic February 2020 forecast, down from 3 per cent.

Productivity scarring reduced to 0.8%



Devolved Taxes

Our income tax forecast for 2021-22 has increased by £899 million compared to our previous forecast, primarily because of the improved economic outlook.

The forecast includes the latest 2019-20 income tax outturn data, and timely RTI tax data up to and including 2020-21.

Income tax forecast for 2021-22 revised up

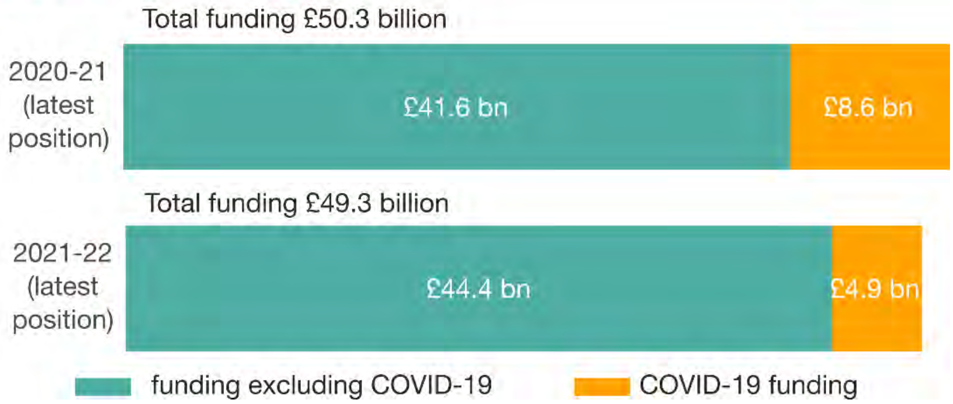
In 2020-21 the average Scottish house price was above £200,000 for the first time. We expect prices to stabilise in 2021-22, and grow in all years after that, driven by our higher forecast of incomes.

By 2025-26, we expect average house prices will be £20,000 higher than we forecast in January, raising an additional £72 million of LBTT revenue.

House price forecast revised up in line with income

Fiscal Overview

COVID-19 funding

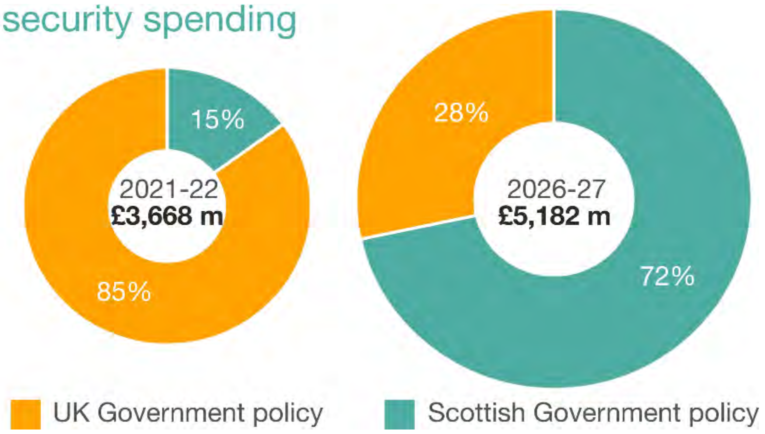


COVID-19 funding has formed an important part of both last and this year's Budgets.

Final COVID-19 funding will be confirmed in early 2022, large increases or decreases late in the financial year may create difficulties for the Scottish Government managing the Scottish Budget.

Social Security

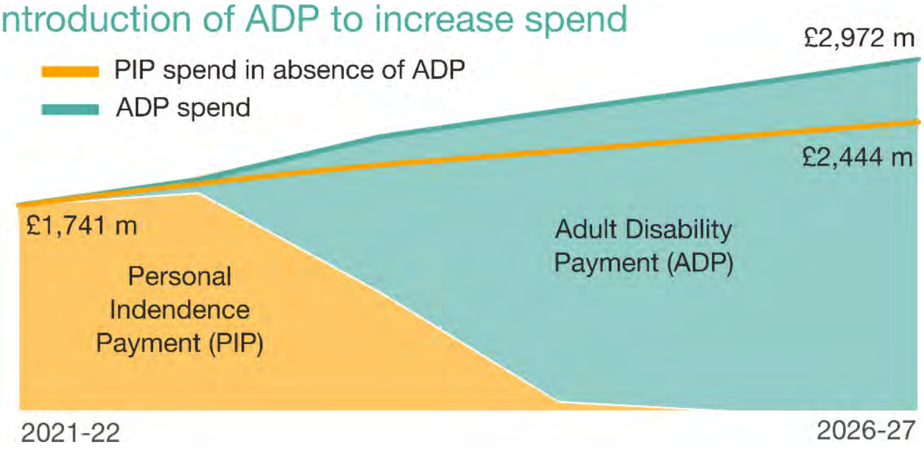
Social security spending



In 2021-22, most Scottish Government social security spending, over £3 billion, is administered by the Department for Work and Pensions based on UK Government policy.

With the introduction of new disability payments, 72 per cent of forecast spending in 2026-27 is based on Scottish Government policy.

Introduction of ADP to increase spend



The Scottish Government's new Adult Disability Payment (ADP) replaces Personal Independence Payment (PIP) from summer 2022.

We expect spending on ADP to be £0.5 billion higher than PIP in 2026-27 because of changes to the application and review processes as well as how the payment is delivered.

Introduction of ADP increases caseloads (2026-27)

By 2026-27, we expect that the introduction of ADP will increase the caseload by an additional 70,000 clients on top of the 400,000 people who would have received PIP in the absence of ADP.

An increase in the number of people receiving ADP leads to 10,000 more people qualifying to claim CA in Scotland by 2026-27.

Scotland’s Economic and Fiscal Forecasts August 2021

Fiscal Overview

Fiscal Overview	2020-21	2021-22	£ million
COVID-19 funding **(latest position)**	8,600	4,877	COVID-19 funding has played an important part in last and this year’s Scottish Budgets.

Economy

Economy	2021-22	2022-23	2023-24	2026-27	% growth
GDP	10.5	2.4	1.0	1.7	GDP rebounds in 2021-22, mainly driven by household consumption, then stabilises.
Trend Productivity	0.6	1.1	1.3	1.8	Growth revised up in the near term, in line with our assumption of lower long-term scarring from COVID.
Nominal Earnings	5.1	3.8	3.3	3.5	Growth revised up because of the improved economic outlook and higher inflation.
Employment	1.0	0.5	0.3	0.0	Grows in 2021-22, after falling last year. With Government support coming to an end, the labour market outlook remains uncertain.

Tax

Tax	2021-22	2022-23	2023-24	2026-27	£ million
Income Tax	13,162	14,069	14,845	17,348	Income tax revenues revised up across the forecast period because of higher average nominal earnings growth.
Non-Domestic Rates	2,073	2,927	3,280	3,435	Policy to support businesses reduces revenue in 2021-22 with growth in later years driven by upward revisions to our inflation forecast.
LBTT	653	694	733	886	Upward revisions because of house price growth and a faster recovery in the non-residential market.
Scottish Landfill Tax	113	105	90	18	Upward revisions in line with higher than expected outturn data in 2020-21 and the improved economic outlook.

Social Security

Social Security	2021-22	2022-23	2023-24	2026-27	£ million
All devolved social security assistance	3,672	3,945	4,436	5,182	Inclusion of the new Adult Disability Payment increases spending; as well as revisions to our inflation forecast.

Policy announcements

Policy announcements	2021-22	2022-23	2023-24	2026-27	
Total additional cost of Adult Disability Payment		35	236	568	Includes the additional spend on the replacement of Personal Independece Payment and additional spend on Carer’s Allowance.

Summary

Introduction

1 The success of the COVID-19 vaccination programme has weakened the links between case numbers, hospitalisations and deaths and has led to a shift in the public health approach of both the UK and Scottish Governments. Formal restrictions have eased significantly and we now appear to be moving in to the recovery phase from the pandemic. In our forecast, we assume there are no future waves of rapidly rising COVID-19 deaths and hospitalisations, though cases may rise again significantly for periods. With deaths and hospitalisations remaining low, public health restrictions remain minimal. Overall, this leads to a more positive outlook for the economy compared to our January 2021 forecasts.

2 The pathway out of the COVID-19 pandemic is unlikely to be completely smooth. We expect it will take time for households and businesses to adjust to a new normal, so economic activity will remain lower than pre-pandemic until 2022. It is, however, not yet clear how individuals and businesses will respond to the easing of restrictions while COVID-19 remains prevalent. There are also ongoing international supply pressures which combined with domestic recruitment challenges present risks to our forecasts. The downside risk remains of new public health restrictions being imposed if the vaccines become less effective at preventing hospitalisations and deaths through vaccine escaping variants of the virus emerging or a general reduction in the effectiveness of vaccines that is not countered by a booster programme.

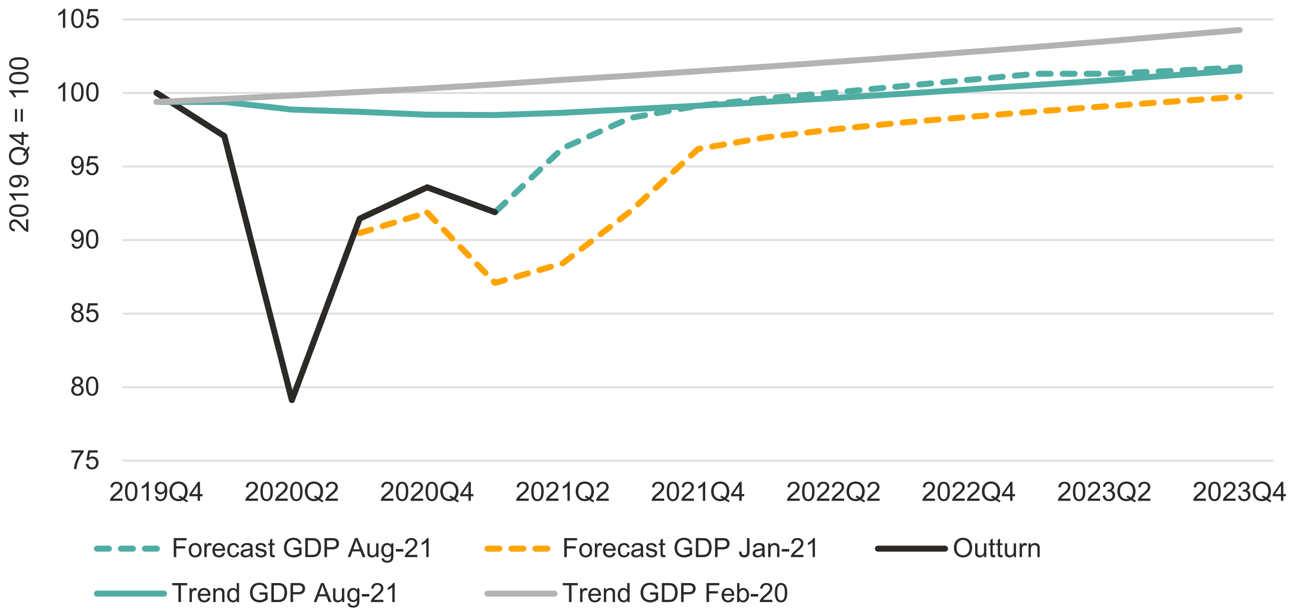
3 In this report, we discuss our latest official forecasts of the Scottish economy, tax and social security spending, as well as the Scottish Budget.

The economic outlook

4 Figure 1 summarises our latest Gross Domestic Product (GDP) forecast relative to our February 2020 and January 2021 forecasts. When we published our last forecast in January 2021, GDP was still considerably below its pre-crisis level. Two weeks before we closed our forecast, a new lockdown was announced in Scotland to control rising COVID-19 cases following the emergence of the Alpha variant of the virus. We expected GDP to fall in 2021 Q1 by around 5 per cent, followed by a gradual recovery in economic activity.

5 Since January 2021, the public health and economic situations have improved. There is good evidence now that the vaccines have been very effective in suppressing deaths and serious illness allowing for a faster pace in lifting restrictions. There are also indications that the economy has recovered more quickly than we envisaged in January. There was a smaller fall in education activity than we forecast because of the phased reopening of schools in February and March, and the swift vaccine rollout contributed to output growth in the health sector.

Figure 1: Trend and forecast Scottish GDP



Source: Scottish Fiscal Commission, Scottish Government (2021) GDP Quarterly National Accounts: 2021 Quarter 1 (January to March) (link).

6 The continuing pace of the wider recovery so far this year has led us to revise up our expectations for Scotland's GDP growth in the near term.

7 Our forecast for 2021-22 as a whole is for growth of 10.5 per cent, mainly fuelled by household consumption, as it reverts to pre-pandemic levels with the removal of restrictions and higher-income consumers start to spend savings accumulated during the pandemic. There may be a partially offsetting effect from changes in consumer behaviour as some people may be hesitant about resuming their pre-pandemic spending habits. We now expect GDP to reach its pre-COVID-19 level in 2022 Q2, almost two years earlier than we forecast previously.

8 We had previously expected there to be a significant degree of 'scarring', long-term economic damage, from the effects of the pandemic, but the speed of economic recovery following the 2021 reopening has made us more optimistic. We have lowered our estimate of the permanent economic damage from COVID-19 to 2 per cent of long-run GDP, down from 3 per cent in our January 2021 forecast. Reduced productivity has been our major source of scarring; but we now expect productivity in 2025 Q1 to be 0.8 per cent lower than the pre-pandemic February 2020 forecast, rather than the 2.2 per cent we estimated in January 2021.

9 Throughout the pandemic, the labour market has performed better than might have been expected, in part because of the success of job support schemes and business support schemes. We now expect the unemployment rate to peak at 5.4 per cent in 2021 Q4 after the furlough scheme expires on 30 September 2021, compared with 7.6 per cent in 2021 Q2 in our January 2021 forecast. Significant uncertainties about the labour market remain because it is unclear how the labour market and businesses will respond when the exceptional level of Government support comes to an end.

10 Another feature of the Scottish and UK economies in 2021 has been rising inflation. International supply pressures as well as domestic recruitment difficulties both appear to be contributing to rising prices. Box 1 explains how we have captured this higher inflation in our forecasts and the effect that it has.

Box 1: How inflation affects our forecasts

We normally base our inflation forecast on the Office for Budget Responsibility's (OBR) forecast. In March 2021, the OBR forecast Consumer Price Index (CPI) inflation for 2021 of 1.5 per cent, but inflation since March has been a lot stronger than expected earlier this year. We have therefore aligned our inflation projections for 2021 and 2022 with those published in the Bank of England's August 2021 Monetary Policy Report. In that report the Bank of England expected annual UK CPI inflation to be 4.0 per cent in 2021 Q4 and 2022 Q1, decreasing to 2.5 per cent at the end of next year.[1]

Higher inflation means that many of the nominal values in our forecast, for example earnings, household consumption and house prices, have been revised up significantly. However, the increase in these values in real terms, that is after adjusting for inflation, is far less.

Because of the improving economic outlook, we have revised up our forecast of real earnings growth in 2021-22 from 1.2 per cent in our January 2021 forecast to 1.9 per cent in our latest forecast. With inflation peaking at 4.0 per cent, we forecast nominal earnings growth of 5.1 per cent in 2021-22, significantly higher than our forecast of 2.5 per cent in January.

Higher nominal values across our economy forecast feed through to many of our tax and social security forecasts. For example, we now forecast nominal house prices to rise by 3.1 per cent in 2022-23, driven in part by higher nominal earnings which increases our Land and Buildings Transaction Tax forecast.

In addition, higher inflation directly affects many tax thresholds and social security payment rates. For example most social security payments are increased each year by September CPI inflation from the previous year. We now expect CPI in September 2021 to be 2.7 per cent, higher than the 1.4 per cent forecast in January 2021. This has increased our forecasts of social security spending in 2022-23 by £45 million, and by 2025 26 our forecasts are £125 million higher than we forecast in January because of inflation.

11 Population and demographic change is an important feature behind many of our forecasts. Birth rates in Scotland have been falling for some time, and the repercussions of COVID-19 have likely reduced them further. In addition, Brexit is expected to reduce migration. Overall, we now expect the Scottish population to decline over the coming years. Box 2 provides an overview of our latest population projections.

Box 2: Scotland's population

Over the next five years we expect the Scottish population to decline by 15,000.

A falling number of births is the main driver of the overall change in the level of the population. We expect the number of births and the size of the child population to continue to fall, reducing spending on some social security payments.

We project the Scottish population aged 16-64, who make up the majority of the labour force, to fall by around 60,000 people between 2020 and 2026, an average fall of 10,000 people per year. After a drop in migration in 2020 and 2021, we expect net migration to slowly increase but, following the UK exit from

[1] Bank of England (2021) Monetary Policy Report – August 2021 (link)

the European Union, we expect migration to be lower than pre 2019-20 levels in every year of our forecast. This reduction in the working-age population affects our economic and fiscal forecasts.

We now anticipate that the labour force will decline in size slightly over the forecast period, both because of the reduction in the working age population and the fact that a higher fraction of this group will become economically inactive for a variety of reasons: retirement, younger people choosing to remain in education for longer, and those not participating in the labour force for example because of caring responsibilities, disability or ill health. This will act as a curb on growth on the total size of the Scottish economy. In the longer term, the Scottish working age population shrinking faster than the total population is also expected to act as a drag on GDP per capita.

The population aged over 65 is projected to continue to increase by over 110,000 between 2020 and 2026 reflecting the aging population. The aging population is expected to lead to increased spending on social security payments related to ill-health and disability.

Tax

12 Many of our tax forecasts have been revised up significantly since our January 2021 forecast, both because of the improved economic outlook and rising inflation. Our income tax forecast for 2021-22 has been revised up by around £0.9 billion.

13 Funding for the Scottish Budget related to income tax depends on the comparison of our Scottish income tax revenue forecasts to forecasts of the income tax Block Grant Adjustment (BGA), based on forecasts by the OBR. However, OBR forecasts were last updated in March 2021, and there have been significant changes to the outlook for the Scottish and UK economies since then, with both economies forecast to grow more quickly.

14 Following upwards revisions to our forecasts, our latest forecast of income tax revenue for 2021-22 is around £1.3 billion higher than the latest available estimate of the 2021-22 BGA based on the OBR March 2021 forecast. This large difference is the result of significant changes in the economic outlook between when the OBR made their March 2021 forecast and now. This timing mismatch between the component forecasts means the estimated £1.3 billion net funding position is artificially high and does not reflect the likely true net funding position for 2021-22.

15 There is no evidence of a significant divergence in Scottish and UK economic performance that would support such a high net funding position. We expect that the updated OBR forecasts due to be published on 27 October will reduce the gap between the BGA and our forecast of income tax revenues. Subsequently we expect the net funding position for income tax to return to a level similar to previous years. Importantly, these updated forecasts have no direct effect on the Scottish Budget as the 2021-22 figures remain fixed from January 2021.

16 In March we wrote to the Finance and Constitution Committee to explain how the OBR and the Commission would provide additional information in future reports that will help explain income tax forecast differences and effects on the net tax position.[2] We have provided a new set of tables in Chapter 4 that compare our latest income tax forecast to the OBR's latest forecast. These will be updated iteratively and published by us and the OBR each time we publish a new set of forecasts.

[2] Scottish Fiscal Commission (2021) Letter to Finance and Constitution Committee – 3 March 2021 (link)

17 The improved economic outlook has also affected devolved tax revenues. Our Land and Buildings Transaction Tax forecast is revised upwards in all years, because of higher house prices and a faster recovery in the non-residential property market. Similarly, stronger outturn data and revisions to the economy forecast have led to upward revisions to our Scottish Landfill Tax forecast. Non-domestic rates revenue is reduced in 2021-22 following the Scottish Government's decision to extend the retail, hospitality, leisure and aviation relief for the full financial year, but from 2023-24 onwards our revised inflation forecast increases revenue compared to our January forecast.

Fiscal Overview

18 Since the start of the pandemic in March 2020, funding for COVID-19 has played an important role in the Scottish Budget, accounting for 17 per cent of the 2020-21 Scottish Budget and 10 per cent of the 2021-22 Scottish Budget so far.

19 In 2020-21, the UK Government guaranteed the level of funding the Scottish Government would receive, removing the risk of funding being reduced later in the year. The guarantee was increased several times through the year, and it did provide the Scottish Government with more certainty to plan its budget. In addition, when the UK Government announced £1.2 billion of additional funding in February 2021 with only a few weeks of the fiscal year remaining, HM Treasury allowed the Scottish Government to defer the funding into 2021-22.

20 This year there is no such guarantee and currently no arrangement for deferring funding. The Scottish Government is required to maintain a balanced budget, matching its spending to available funding each year with limited capacity in the Scotland Reserve to move funding between years. The latest estimate of COVID-19 funding in 2021-22 is £4.9 billion, and the final level of funding will not be confirmed until the UK Government's Supplementary Estimates in early 2022. Large changes in COVID-19 funding late in the financial year may create difficulties for the Scottish Government's management of its budget. These difficulties may be more significant than in 2020-21 if the guarantees and flexibilities of last year are not available.

21 The overall funding outlook of the Scottish Budget depends not only on our forecasts of tax revenue and social security spending, but also on the corresponding funding changes for the BGAs. The latest estimates of the BGAs are based on the OBR's forecasts published in March 2021. Since then, the outlook for the Scottish and UK economies has changed significantly and this means any comparison between our forecasts and the BGAs will not reflect the likely true position. When we publish our next forecasts, alongside the Scottish Budget, we will be able to comment on these comparisons to assess the outlook for the funding of the Scottish Government.

Social Security Spending

22 Overall, we forecast devolved social security spending will increase from £3.7 billion in 2021-22 to £5.2 billion in 2026-27, as more people receive social security support each year and payment amounts are uprated by inflation.

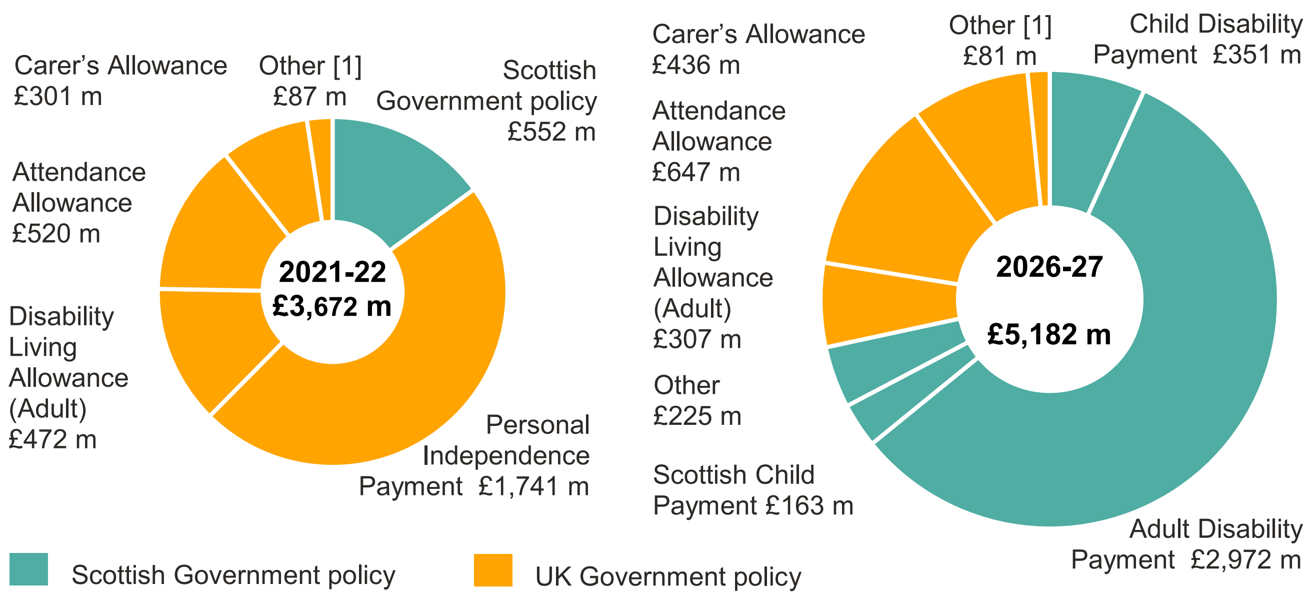
23 In these forecasts, we have produced our first estimate of spending on the new Adult Disability Payment (ADP), due to replace the Personal Independence Payment (PIP) nationally from summer 2022.[3] PIP and ADP provide financial assistance to contribute towards the increased costs incurred by an individual because of a disability or long-term health condition. We estimate that, by 2026-27,

[3] A small pilot scheme will launch in spring 2022.

spending on ADP will be £0.5 billion higher than what would have been spent on PIP with total spending reaching £3.0 billion in 2026-27.

24 Figure 2 shows how much more devolved social security spending in Scotland is going to be based on Scottish Government policy over the next few years. In 2021-22 most social security spending, over £3 billion, is administered by the Department for Work and Pensions (DWP) under agency agreements with the Scottish Government. By 2026-27, we expect 72 per cent of spending to be based on Scottish Government policy. When the Scottish Government announces details of the replacements for the remaining payments still administered by DWP, we will incorporate the changes in our forecasts and this percentage will rise further.

Figure 2: Social security spending in 2021-22 and 2026-27



Source: Scottish Fiscal Commission
Scottish Government policy includes Best Start Foods, the three payments of Best Start Grant, Carer's Allowance Supplement, Child Winter Heating Assistance, Funeral Support Payment, Discretionary Housing Payments, Fair Start Scotland, Self-Isolation Support Grant and Scottish Welfare Fund. Child Disability Payment is included as being costed on Scottish Government policy in 2021-22; however this includes spending on the UK Government Disability Living Allowance (Child).
[1] Includes Industrial Injures Disablement Scheme and Severe Disablement Allowance

25 New policies are always harder to forecast: it is inherently more difficult to predict how many people will be eligible and claim the payments, since we have very limited information on which to base our forecasts. In the past, reforms of major disability payments have cost more than initially expected. The introduction of Disability Living Allowance in 1992, which PIP subsequently replaced, was intended to extend eligibility and therefore spending was expected to increase, but the OBR has noted that it rose by much more than originally expected. PIP was launched in 2013, and was expected to cut costs by 20 per cent by 2015-16, but was costing 15 to 20 per cent more by 2017-18.[4] The OBR's Welfare Trends Report in 2019 concluded that "PIP, a reform intended to reduce spending has actually increased it".

26 Although the Scottish Government are not changing the overall structure of ADP, compared to PIP, there are changes to the processes for applying, award reviews and appeals and how the payment is promoted. Social Security Scotland has developed its own social security Charter and intends to promote a positive view of social security. We expect operational changes in delivery of the

[4] OBR (2019) Welfare Trend Report – January 2019 (link)

payment.[5] Our view is that these changes will increase the number of people receiving payment, and the average amount they receive.

27 There is very limited information on which to base our estimates of the additional costs of ADP. Although we have considered evidence from UK disability payments and new payments introduced in Scotland, the lack of comparability means that this information is of limited use, so our forecasts inevitably rely on a significant element of judgement. To estimate the additional spending, we have considered the effects of the changes made on a range of areas: how many successful applications are received; how average payments may change; how long clients have between award reviews; the outcome of award reviews; the new Short Term Assistance payments for those who challenge a reduced or disallowed award; and, new rules for those with a terminal illnesses. We expect the most significant increases in spending to occur because we expect more successful applications with higher average awards under ADP than under PIP. We also expect the new light touch review process to result in fewer clients having their award disallowed and therefore more people remaining on the caseload. Clients currently receiving PIP will gradually be transferred to Social Security Scotland and ADP from September 2022.

Figure 3: Costing of Adult Disability Payment

£ million	2022-23	2023-24	2024-25	2025-26	2026-27
Total additional cost of ADP	**35**	**236**	**363**	**462**	**568**
Policy cost to ADP	34	226	341	431	529
Carer's Allowance spending [1]	1	11	22	31	40

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.
[1] Additional cost to Carer's Allowance and Carer's Allowance supplement because of the introduction of Adult Disability Payment.

28 We also expect spending on Carer's Allowance to increase as more people become eligible through the larger ADP caseload. These changes will have long-term spending consequences, since awards are made on an on-going basis and all successful applications will have to be paid. This is unlike other resource spending commitments where budgets are set a year or more ahead. The Scottish Government receives funding from the UK Government based approximately on what would have been spent on PIP in Scotland, so the additional costs of ADP will need to be met from elsewhere in the Scottish Budget. The Scottish Government will either need to reallocate funding from other areas to cover social security or raise additional revenues through taxes.

29 As we receive information from Social Security Scotland on ADP our forecasts will increasingly be based on data which reflects new Scottish Government policy rather than assumptions about how many people successfully apply and how much they receive on average. We therefore expect the uncertainty in our forecasts to decrease once the payment has launched.

30 The Scottish Government has commitments to increase social security spending in other areas. The SNP manifesto included a commitment to double Scottish Child Payment (SCP). We currently expect spending on SCP to reach £163 million in 2026-27, and the cost of the manifesto commitment is not included in our forecast. As SCP is not replacing any existing payment, its costs must be met entirely from the Scottish Budget. Other Scottish Government commitments, which are also not part of our forecast, include replacing Carer's Allowance, Attendance Allowance, Industrial Injuries Disablement Scheme, Cold Weather Payments and Winter Fuel Payments with new

[5] Social Security Scotland: Our Charter (link)

Scottish payments. In 2020-21 spending on these five payments was over £1 billion. We expect many of these changes will increase spending on social security, which may put further pressure on the resource budget.

Additional Information

Abbreviations

ADP	Adult Disability Payment
BGA	Block Grant Adjustment
COVID-19	Coronavirus
CPI	Consumer Price Index
DWP	Department for Work and Pensions
GDP	Gross Domestic Product
OBR	Office for Budget Responsibility
OECD	Organisation for Economic Cooperation and Development
PIP	Personal Independence Payment
SCP	Scottish Child Payment

A full glossary of terms is available on our website:

https://www.fiscalcommission.scot/explainers/glossary/

Professional Standards

The Commission is committed to fulfilling our role as an Independent Fiscal Institution, in line with the principles set out by the Organisation for Economic Cooperation and Development (OECD).[6]

The Commission also seeks to adhere to the highest possible standards for analysis. While we do not produce official statistics, we voluntarily comply as far as possible with the UK Statistics Authority's Code of Practice for Statistics. Further details and our statement of voluntary compliance can be found on our website.[7]

[6] OECD (2014) Recommendation on Principles for Independent Fiscal Institutions (link)
[7] Scottish Fiscal Commission (2018) Compliance with the Code of Practice for Official Statistics (link)

Correspondence and enquiries

We welcome comments from users about the content and format of our publications. If you have any feedback or general enquiries about this publication or the commission, please contact info@fiscalcommission.scot. Press enquiries should be sent to press@fiscalcommission.scot.

All charts and tables in this publication have also been made available in spreadsheet form on our website. For technical enquiries about the analysis and data presented in this paper please contact the responsible analyst:

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Foreword

The Scottish Government sets out its funding and spending plans for the year ahead in its Scottish Budget document, which is presented to the Scottish Parliament before the start of each financial year. The funding and spending plans are adjusted through the year as more information becomes available. This Fiscal Update is part of our regular series of publications which monitor how funding for the Scottish Budget is changing over time.

The 2020-21 Scottish Budget, first introduced to the Scottish Parliament on 6 February 2020 has changed a great deal as it was set before any funding had been introduced for the COVID-19 pandemic. COVID-19 funding went on to increase this Budget by £8.6 billion, accounting for 17 per cent of total funding. The Scottish Government announced provisional outturn information for 2020-21 on 17 June 2021, which allows us to now present near-final funding for this year.

For 2021-22 we present the latest funding position, setting out changes since it was introduced to Parliament on 28 January 2021. COVID-19 funding again plays an important role, increasing the Budget by £4.9 billion, and accounting for 10 per cent of total funding so far. The 2021-22 Scottish Budget will continue to evolve over the coming months and we will publish future Updates to explain any changes.

Dame Susan Rice DBE

Professor Francis Breedon

Professor Alasdair Smith

Professor David Ulph

26 August 2021

Contents

Chapter 1
2021-22 Scottish Budget

Introduction

1.1 The Scottish Government sets out its spending plans for the year ahead in the Scottish Budget document, which is presented to the Scottish Parliament before the start of each financial year. These plans are set by the Scottish Government and are adjusted through the year at formal Budget Revisions. We show how these spending plans are funded, and how the level of funding has changed through the year.

1.2 We first consider the Scottish Budget for this year, 2021-22. The Scottish Budget Bill was first introduced to the Scottish Parliament on 28 January 2021 and a number of changes have occurred since. We published two previous Updates to explain the funding position, one to accompany the Budget Bill on 28 January and one on 9 March 2021 to incorporate funding changes from the UK Budget and the Scottish Budget becoming an Act.[1,2]

1.3 This update focuses on changes since 9 March, the largest of which is an increase in COVID-19 funding. These changes occurred following the publication of the UK Government's Main Estimates which announced further COVID-19 funding.[3,4] We expect the 2021-22 Scottish Budget to continue to evolve and we will produce additional Fiscal Updates in future to explain further changes.

Changes in funding since our last Fiscal Update

1.4 We published our last Fiscal Update on 9 March 2021 alongside Stage 3 of the Budget Bill. In this Chapter we set out how funding for the 2021-22 Scottish Budget changed since it was introduced.

1.5 Figure 1.1 sets out changes to 2021-22 resource funding since our previous two Fiscal Updates. The first of these was published alongside the introduction of the Scottish Budget Bill on 28 January 2021 and the second was published on 9 March 2021, to incorporate changes from the UK Budget and the Scottish Budget passing through Parliament to become an Act.

[1] Scottish Fiscal Commission (2021) Fiscal Update – January 2021 (link)
[2] Scottish Fiscal Commission (2021) Fiscal Update – March 2021 (link)
[3] UK Government (2021) Main Supply Estimates 2021 to 22 (link)
[4] Letter from the Cabinet Secretary for Finance and the Economy to the Committee, 16 June 2021 (link)

Figure 1.1: Changes to 2021-22 resource funding

£ million	28 January 2021	Changes up to 9 March 2021	Changes since 9 March 2021	Latest position
Barnett-determined block grant	30,923	0	0	30,923
Non-Barnett funding	756	-40	0	716
Non-COVID Barnett funding	0	+9	+25	34
COVID-19 funding [1]	1,828	+1,580	+1,175	4,583
SFC tax forecasts [2]	12,937	0	+92	13,029
Tax and non-tax BGAs	-12,430	0	0	-12,430
Social security BGAs	3,310	0	0	3,310
Final reconciliations	-319	0	0	-319
Resource borrowing	319	0	0	319
Resource reserve drawdown	231	0	+168	399
Other	246	0	+25	271
NDR distributable amount	2,631	-541	0	2,090
Total resource funding	40,431	+1,008	+1,485	42,924

Source: Scottish Fiscal Commission
Figures may not sum because of rounding.
[1] Changes to COVID-19 funding since 9 March 2021 includes £1,000 million which was allocated at the UK Government's Main Estimates and the Scottish Government's estimated £175 million funding based on further UK Government funding announcements.
[2] The £92 million increase is made up of £67 million increase for Land and Buildings Transaction Tax and £25 million increase for Scottish Landfill Tax.

1.6 COVID-19 funding has increased by £1,175 million since our last Fiscal Update. Of this, £1,000 million was allocated by the UK Government in its 2021-22 Main Estimates.[5] An additional £175 million has been estimated by the Scottish Government based on further UK Government funding announcements, but the figure will not be confirmed until the UK Government's Supplementary Estimates, expected early 2022.[6]

1.7 Capital funding has also increased since our March Fiscal Update as shown in Figure 1.2. This is largely because of an increase in non-Barnett funding. An explanation of non-Barnett funding can be found in our recent occasional paper: funding for the Scottish Budget.[7]

[5] UK Government (2021) Main Supply Estimates 2021 to 22 (link)
[6] Letter from the Cabinet Secretary for Finance and the Economy to the Committee, 16 June 2021 (link)
[7] Scottish Fiscal Commission (2021) Funding for the Scottish Budget (link)

Figure 1.2: Changes to 2021-22 capital funding

£ million		28 January 2021	Changes up to 9 March 2021	Changes since 9 March 2021	Latest position
Capital (excluding financial transactions)	Barnett-determined block grant	4,973	0	0	4,973
	Non-Barnett funding [1]	0	0	+188	188
	Non-COVID Barnett funding	0	0	+34	34
	COVID-19 funding	0	+237	0	237
	Capital borrowing	450	0	0	450
	Capital reserve drawdown	0	0	0	0
	Other	0	0	0	0
Financial transactions	Barnett-determined block grant	208	0	0	208
	Non-COVID Barnett funding	0	0	0	0
	COVID-19 funding	0	+42	+16	57
	Financial transaction reserve drawdown	200	0	0	200
	Other	0	0	0	0
Total	Total	5,831	+278	+237	6,347

Source: Scottish Fiscal Commission

Figures may not sum to totals because of rounding.

[1] Non-Barnett funding includes £75 million of reprofiled Network Rail funding and £113 million of city deal funding.

Chapter 2
2020-21 Scottish Budget

Introduction

1.8 We now turn to the previous year's budget, 2020-21. This Budget was first introduced to the Scottish Parliament on 6 February 2020 and has changed a great deal, as it was set before any funding had been introduced for the COVID-19 pandemic.

1.9 We have produced a number of Fiscal Updates to explain how funding in the 2020-21 Scottish Budget has changed through the year. Provisional outturn information for 2020-21 was announced by the Scottish Government on 17 June 2021, which means this Update is able to provide the near-final funding position and a summary of total changes to the Budget since it was introduced.[8]

1.10 Provisional outturn information is pre-audited and we expect the final outturn to be published between September and December 2021 at which point we will have a total picture of changes to the 2020-21 Scottish Budget through the year.

Changes in funding since our last Fiscal Update

1.11 The resource funding position has been revised marginally since our last update in March 2021 as shown in Figure 2.1. We have aligned our January 2021 tax forecasts with provisional outturn information for Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) and a small adjustment has been made to the reserve drawdown to bring it in line with provisional outturn figures.

[8] Scottish Parliament (2021) Provisional Outturn Statement (link)

Figure 2.1: Changes to 2020-21 resource funding

£ million	6 February 2020	Changes up to 9 March 2021	Changes since 9 March 2021	Latest position
Barnett-determined block grant	29,569	0	0	29,569
Non-COVID Barnett funding	142	+65	0	207
COVID-19 funding	0	+8,600	0	8,600
SFC tax forecasts [1]	13,123	-145	+12	12,989
Tax and non-tax BGAs	-12,991	+166	0	-12,825
Social security BGAs	3,203	-17	0	3,185
Final reconciliations	-177	0	0	-177
Resource borrowing	207	0	0	207
Resource reserve drawdown	106	+65	-0.4	171
Other	736	+42	0	778
NDR distributable amount	2,790	-922	0	1,868
Total resource funding	36,707	+7,853	+11	44,572

Source: Scottish Fiscal Commission
Figures may not sum to totals because of rounding.
[1] The £12 million change is aligning our January 2021 forecasts with provisional outturn for LBTT and SLfT.

1.12 As the Scottish Government receives funding from full devolved taxes directly, we have adjusted this funding in line with the provisional outturn.[9] Funding from Block Grant Adjustments is managed differently, aligning these with outturn will lead to final reconciliations, which will be applied to future Scottish Budgets.

1.13 Capital funding has not changed as significantly as resource during 2020-21 as shown in Figure 2.2. Since our last Update in March the position has changed to reflect provisional outturn, with greater drawdowns from the capital and financial transaction reserves and reduced capital borrowing.

1.14 Capital borrowing was initially planned to be £450 million when the Scottish Budget was set then reduced through the year, with actual borrowing of £200 million occurring at the end of the year, in February and March 2021. The flexibility to reduce capital borrowing can help the Scottish Government manage underspends, as reducing borrowing can either reduce surplus capital funding or remove capital funding from the Scotland Reserve, allowing more space for resource funding. We discuss capital borrowing more fully in our main forecast publication.[10]

[9] Fully devolved taxes includes Land and Buildings Transaction Tax and Scottish Landfill Tax. Income tax is not adjusted here as it remains fixed until a final reconciliation is calculated and applied to 2023-24.
[10] Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts (link)

Figure 2.2: Changes to 2020-21 capital funding

£ million		6 February 2020	Changes up to 9 March 2021	Changes since 9 March 2021	Latest position
Capital (excluding financial transactions)	Barnett-determined block grant	4,408	0	0	4,408
	Non-COVID Barnett funding	326	+152	0	478
	COVID-19 funding	0	0	0	0
	Capital borrowing	450	-150	-100	200
	Capital reserve drawdown	5	+60	+15	80
	Other	15	-75	0	-60
Financial transactions	Barnett-determined block grant	606	0	0	606
	Non-COVID Barnett funding	0	+5	0	5
	COVID-19 funding	0	0	0	0
	Financial transaction reserve drawdown	32	-50	+18	0
	Other	-25	0	0	-25
Total	Total	5,817	-58	-67	5,692

Source: Scottish Fiscal Commission
Figures may not sum to totals because of rounding.

Additional Information

Abbreviations

BGA	Block Grant Adjustment
COVID-19	Coronavirus
LBTT	Land and Buildings Transaction Tax
SFC	Scottish Fiscal Commission
NDR	Non Domestic Rates
OECD	Organisation for Economic Cooperation and Development
SLfT	Scottish Landfill Tax
UK	United Kingdom

A full glossary of terms is available on our website:

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All charts and tables in this publication have also been made available in spreadsheet form on our website. For technical enquiries about the analysis and data presented in this paper please contact the responsible analyst:

Public funding	Chris Dunlop

[11] OECD (2014) Recommendation on Principles for Independent Fiscal Institutions (link)
[12] Scottish Fiscal Commission (2018) Compliance with the Code of Practice for Official Statistics (link)

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