Finance and Public Administration Committee

9th Meeting 2023, (Session 6), Tuesday 28 March 2023

The Scottish Fiscal Commission's Fiscal Sustainability Report

Purpose

1. This paper invites the Committee to take evidence from the Scottish Fiscal Commission (SFC) on its first Fiscal Sustainability Report, which was published on 22 March 2023. A letter from the SFC introducing its report is contained in Annexe A whilst the full report is available on the SFC website.

2. The paper provides background information and highlights some key issues both from the Report, from a written submission from the Northern Ireland Fiscal Council (NIFC) as well as commentary from the Scottish Parliament's Information Centre and the Fraser of Allander Institute.

Background

3. The Budget Process Review Group (BPRG) recommended in 2017 that "budget scrutiny should have a long-term outlook and focus more on prioritisation, addressing fiscal constraints and the impact of increasing demand for public services". Given this stated need, the Organisation for Economic Co-operation and Development (OECD) in its 2019 review suggested that the Scottish Fiscal Commission (SFC) "may wish to consider undertaking initial work in this area in coming years". It went on to state—

> "The SFC already publish an assessment of fiscal risks pertinent to its tax and benefit forecasts and the Scottish Budget in its key publication, Scotland's Economic and Fiscal Forecasts. However, the SFC may wish to consolidate this information, and further augment it with more in-depth longer-term analysis of the risks facing the full Budget, in a standalone publication that eventually becomes comparable to other Independent Fiscal Institutions' assessments of fiscal risks and long-term fiscal sustainability".

4. The Legacy Expert Panel established by the Session 5 Finance and Constitution Committee recommended that "the successor Committee considers inviting the SFC to publish a long-term fiscal sustainability report at least once during each session of the Parliament". Responding to a letter from the Chair of the SFC of 9 September 2021, the Finance and Public Administration Committee wrote on 6 October 2021 welcoming the SFC's plans to consult in 2022 before producing its first long-term fiscal sustainability report in 2023.

SFC consultation

5. In August 2022 the SFC published a consultation paper outlining the proposed scope and methodology for producing its first fiscal sustainability report and inviting feedback. This was accompanied by a paper on Trends in Scotland's population and effects on the economy and income tax. This set out its demographic projections and illustration of Scottish GDP over the next fifty years, stating that—

> "Our 2023 Fiscal Sustainability Report will continue this work and will show how we can expect population change to influence Scottish Government funding and spending. It will provide evidence to Scottish Parliament, policy makers and stakeholders on the coming pressures and challenges for Scottish Government finances".

6. The paper highlighted that "Scotland's population is projected to be 7.6 years older on average in 2072 than in 2022, in comparison the UK population is set to be 6.1 years older over the same time period" It goes on to note that "the more acute ageing population in Scotland is primarily a result of a low number of births caused by a low fertility rate combined with an already older population", adding that "a decrease in net migration also contributes to this change but to a lesser extent".

7. The Committee took evidence from the SFC on 6 September 2022 in relation to these two papers[1]. During that session, the Chair of the SFC, Professor Graeme Roy told the Committee that—

> "The purpose of the fiscal sustainability report is to take a certain issue, such as population change and set out what its impact will be on the economy. That is not to say that it will happen; instead, it puts the ball back in the court of policy makers to ask them how to address it—how do we attract more migrants to Scotland, what do we think about migrants from the rest of the UK coming to Scotland and how can we boost our productivity and boost our tax base? All those things could, ultimately be much better informed using a projection that is set out in such a way."

8. The SFC's consultation paper also listed topics it had identified as "potentially important to investigate in future fiscal sustainability reports", which it invited respondents rank in order of priority. The list included: Effects of climate change, Population health and health inequalities, Health Spending, Adult Social Care, Child Poverty and Achieving Net Zero.

Fiscal Sustainability Report: key issues

9. The SFC published its first Fiscal Sustainability Report on 22 March 2023. In its report the SFC set out the methodology and assumptions that it has used to make its projections to 2072-73, including that Scotland's constitutional arrangements

[1] The session also covered the SFC's Forecast Evaluation Report and Statement of Data Needs, which were published around the same time.

including the fiscal framework don't change. In assessing sustainability, the SFC focus solely on the projected annual gap between spending and funding.

10. Key issues highlighted in the report include:

- many of the fiscal sustainability challenges Scotland face are common across the UK;
- given the interlinked nature of the Scottish Government's spending and tax policies with that of the UK Government (through the fiscal framework) the fiscal sustainability of the Scottish Government's spending and tax policies is also interlinked with that of the UK Government's. Taking this into account the Scottish Government will face significant challenges in funding the future provision of devolved public services in Scotland.
- The SFC's funding projections are based on the OBR's central scenario as set out in their projections for UK Government spending and revenue for the next 50 years. Under this central scenario:
    - combining the SFC's projections for funding and spending, if public services continue to be delivered as they are today, Scottish Government spending over the next 50 years will exceed the estimated funding available by an average of 1.7% each year.
    - the OBR conclude that, "combined with their projections for tax revenues, their projections for UK Government spending are not sustainable." Should the UK Government respond to this through fiscal tightening applied evenly across all areas of the UK Government spending and taxation then SFC modelling suggests that it would result in a considerably higher fiscal gap in the Scottish Government's budget - with an average over the next 50 years of 10.1%.
- As a result of low birth rates, the Scottish population is also ageing which:
    - the SFC expects to lead to a decline in overall participation rates in the workforce;
    - has implications for the demand for public services, with more demand for services used by older people, such as health (from 35% of devolved spending in 2027-28 to 50% in 2072-73), and less demand for those used by younger people, such as education (from 18% of devolved spending in 2027-28 to 11% in 2072-72);
- Economic projections are determined by the supply of labour and productivity and, aligning productivity assumptions with those of the OBR, the SFC "assume productivity will grow by 1.4% a year until 2035-36 and by 1.5% a year thereafter."
- Scottish GDP is projected to grow on average of 1.2% per year between 2027-28 and 2072-73, with the main driver of long-term economic growth being productivity (given the lack of growth in labour supply).
- Total funding is projected to grow in real terms from £54 billion in 2027-28 to £117 billion in 2072-73. Scottish Government funding is made up of revenue from income tax and devolved taxes plus the block grant funding from the UK. The SFC considers it notable that "the largest factor in the

growth of the block grant over the next 50 years is the increase in the projected UK Government spend on health in England."

- the SFC projects that income tax revenue will grow by 91% in real terms between 2027-28 and 2072-73 factoring in its demographic projections and growth in average real incomes. The income tax net position for the Scottish Government (tax minus the Block Grant Adjustment[2]) will be positive over the next 50 years with the projected decline in the Scottish population slowing the growth in the income tax BGA. The SFC explain that whilst "total tax revenues in England and Northern Ireland grow faster than revenue in Scotland, the population effect on the BGA means the net position remains positive."
- The Scottish Government's policy and operational changes to Social Security result in social security expenditure exceeding the BGA by more than £1 billion in 2027-28 which then persists to 2072-73.

11. Given the magnitude of the fiscal gap and the findings from its analysis the SFC's explains its report "needs to be considered across the public sector in Scotland when planning the future delivery and finding of public services, and in making decisions now to help prepare for the future."

12. The Scottish Government has responded to the SFC's report, on 22 March, setting out the Scottish Government's approach to managing sustainability and its initial reactions to the key points raised in the SFC report.

Committee submissions

13. To inform the Committee's evidence session with the SFC on 28 March, the Committee wrote on 1 March seeking views from the Office for Budget Responsibility (OBR), the Northern Ireland Fiscal Council (NIFC), and the OECD. The OBR has been producing this type of report for over 20 years, while the NIFC produced its first fiscal sustainability report in September 2022. Both were asked to provide any insights that might support the Committee's scrutiny, such as on their approach to producing these reports, methodology, the sharing of information between the OBR and devolved fiscal institutions, and how their reports are being used and scrutinised. The OECD was invited to provide further context on the value of such reports, how they should be used and scrutinised, the key principles and approach that should guide their development, and the challenges faced by devolved nations in producing such long-term fiscal sustainability reports where some tax and other powers may lie elsewhere.

14. In its response (see Annexe B) the NIFC explain that given the significant differences in fiscal powers between Northern Ireland and Scotland "We understand that the SFC's approach to its first sustainability report is rather different from the

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[2] The fiscal framework describes how funding for the Scottish Budget should be adjusted following devolution of taxes and social security, called Block Grant Adjustments (BGAs). Tax BGAs remove funding from the Scottish Budget, because the Scottish Government is now raising its own tax revenue whilst Social Security BGAs add funding, because the Scottish Government has become responsible for social security payments.

way in which we tackled it." They provide a short note that explains in summary the approach and methodology used by the NIFC.

15. That said, they also highlight areas in which both the NIFC and SFC share common objectives and difficulties including in explaining the framework for public finances, consistency with the approach taken at the UK level by the Office for Budget Responsibility while recognising the complexities of asymmetric devolution, and the availability of comparable data.

16. Responses from the OECD and OBR will be published once received.

Commentary

17. The Scottish Parliament's Information Centre (SPICe) has produced a blog on the Report – Fiscal Sustainability: Long term thinking required! In it they provide a high level summary and some initial analysis of the report highlighting how the SFC projections of a falling and ageing population will impact on devolved public services prompting questions around what policies might need to be adapted to accommodate the trajectory Scotland is on.

18. The Fraser of Allander Institute has also commented on the Report in their blog – How Sustainable are Scottish Tax and Spending Policies? They highlight "how important this sort of long-term analysis is to ensure that sustainable decisions are taken" given the SFC report that if public services in Scotland are to continue to be delivered as they are today, Scottish Government spending over the next 50 years will exceed the estimated funding available by an average of 1.7% each year.

Next steps

19. The Committee will consider its next steps in relation to this report at a future meeting.

Committee Clerking Team
March 2023

Kenneth Gibson MSP
Convener
Finance and Public Administration Committee
The Scottish Parliament
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22 March 2023

Dear Convener

The Scottish Fiscal Commission published its first Fiscal Sustainability Report this morning.

The report shows that over the next 50 years spending on public services by the Scottish Government will increase because of pressures from an ageing population and from rising costs of delivery. Spending on health is projected to grow more quickly than that on other services, increasing from around a third of total devolved spending at present to about half in 50 years' time.

The increased spending on public services will run ahead of the likely increases in the funding available to the Scottish Government from the UK Government's Block Grant and from the revenue from devolved income tax and other taxes.

We show that under current Scottish and UK fiscal policies, if public services in Scotland are to continue to be delivered as they are today, Scottish Government spending over the next 50 years will exceed the estimated funding available by an average of 1.7 per cent each year.

However, in addition many of the fiscal sustainability challenges that Scotland faces are common across the UK. The Office for Budget Responsibility (OBR) have suggested that current UK wide tax and spending policies are not sustainable in the long term. We estimate that the average budget gap in Scotland would be 10.1 per cent each year if future UK Governments were to move towards a more sustainable position as projected by the OBR.

Our consultation paper last August covered the scope of future work on fiscal sustainability.

The long term nature of the analysis means that the substantive conclusions do not change sufficiently to justify annual reports along the lines of the one we have just published. However, I hope today's report can support a wider and more informed conversation about public services and tax policy in Scotland. The Commission intend to play their part by ensuring that the report's conclusion are available to a broad range of public bodies and other interested parties.

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Over the course of the next year the Commission intends to focus on two aspects of fiscal sustainability.

Following the recommendation in your Pre-Budget Scrutiny 2022-23 report, the first area is climate change. The Scottish Government faces three sets of costs associated with climate change. These are those from mitigating emissions in line with its legislative targets, the costs of adapting infrastructure to combat changes in environmental conditions, and thirdly the disruption costs such as increased flooding that result from these changes. Our aim would be to produce an initial qualitative assessment of the impact on the Scottish Government's fiscal sustainability as well as an audit of the information that would be needed to produce a full assessment.

The second is to look in more detail at the issue of health spending by the Scottish Government and its likely path over the next 50 years. Today's report identified health as the major pressure on the Scottish Government's long term budget with projected growth from £19 billion in today's prices in 2027-28 to £60 billion in 2072-73, an increase of 218 per cent. Our initial analysis identified the impact of rising costs and the increasing prevalence of long-term health conditions as factors in this growth as well as an ageing population.

Yours sincerely

Professor Graeme Roy

ANNEXE B

Northern Ireland Fiscal Council

Sir Robert Chote
Chairman

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Kenneth Gibson MSP
Convener
Finance and Public Administration Committee

22 March 2023

Dear Kenneth,

The Scottish Fiscal Commission's first fiscal sustainability report

Thank you very much for your letter of 1 March 2023 requesting written input in support of your committee's scrutiny of the Scottish Fiscal Commission's (SFC) approach to producing a sustainability report within a devolved context.

As you noted in your letter, we in the NI Fiscal Council have recent experience in producing our first sustainability report. We have produced a short note that explains in summary our approach and methodology. I attach a copy for your information and I hope it may be useful for your upcoming discussions with the SFC.

We understand that the SFC's approach to its first sustainability report is rather different from the way in which we tackled it. This is entirely understandable given the very significant differences between Scotland's fiscal framework and the much more limited tax powers devolved to NI. Having said that, here are several areas in which both the NIFC and SFC share common objectives and difficulties, including:

- Explaining the framework for public finances in both NI and Scotland is challenging to do succinctly and accurately. In the end, we opted to produce a detailed Comprehensive Guide,[1] which we intend regularly to revisit and update;

[1] https://www.nifiscalcouncil.org/files/nifiscalcouncil/documents/2021-11/the-public-finances-in-northern-ireland-final-version_0.pdf

- Achieving consistency with the approach taken at the UK level by the Office for Budget Responsibility while recognising the complexities of asymmetric devolution. In this regard, we faced perhaps a slightly less daunting task than our colleagues in the SFC because we do not currently have to wrestle with the intricacies of tax forecasting or significant Block Grant Adjustment mechanisms; and,
- Comparable data, as we have noted in our reports, is not always as readily available as one might expect it to be, and this presents barriers when one comes to consider the expenditure needs arising from different devolved policy areas.

Despite these challenges, we believe we have produced robust and valuable sustainability reports, which have been broadly welcomed by NI departments and commentators. I am aware that the NIFC staff team works collaboratively with their SFC counterparts, which is an approach that as a Council we have very much encouraged and welcomed.

I look forward to reading both the SFC report and the outcome of the committee's deliberations and scrutiny.

For you information, I have included a copy of our forthcoming publications as Annex A to this letter.

With best regards,

Sir Robert Chote

Chair of the NI Fiscal Council

ANNEX A

NI Fiscal Council Upcoming Publications

The NIO's 2022-23 Budget for Northern Ireland: an assessment

Expected release date: March 2023

Technical Paper 02/23: Estimate of the relative need for public spending in Northern Ireland

Expected release date: Spring 2023

The 2023-24 Budget for Northern Ireland

Expected release date: dependent on 2023-24 Budget process

Technical Paper 03/23: The In-Year Monitoring process

Expected release date: Spring / Summer 2023

Sustainability Report 2023: *special focus* - Infrastructure

Expected release date: Autumn 2023

The public finances in Northern Ireland: a comprehensive guide (v2 - updated 2023)

Expected release date: Winter 2023

NIFC Sustainability Report: Approach and Methodology

Approach

At UK level, the Office for Budget Responsibility (OBR) regularly assess the sustainability of UK public finances, including preparing a 50-year projection of public spending, revenue, borrowing and debt. The fiscal position is judged to be unsustainable if spending is set to exceed tax revenue sufficiently such that public borrowing and debt rise inexorably as shares of Gross Domestic Product (GDP)

At a Northern Ireland level sustainability cannot be assessed in the same way. The NI Executive's ability to borrow and accumulate debt is much more constrained – by legislation and agreement with HM Treasury.

As with Whitehall departments and other devolved administrations, the Treasury divides the Executive's spending into Departmental Expenditure Limits (DEL) which can be planned and controlled over several years and Annually Managed Expenditure (AME) which is more volatile and demand led. Expenditure covered by DEL includes building costs, public sector pay, and grants. Whereas AME includes expenditure on public sector pensions and social security benefits.

The NIFC's assessment of sustainability focuses on spending covered by DEL which covers the day-to-day costs of public services, grants and administration, plus capital investment. The majority of this expenditure (over 80%) is funded via the core Block Grant from the UK Government. The Block Grant applies the Barnett formula to changes in spending in England (or England and Wales or GB) announced at Westminster Budgets and non-Barnett additions which may include funding for political agreements or funding to replace funding previously received from the European Union (EU).

Given the Executive's limited room for manoeuvre in determining the overall size of its budget, sustainability in NI is best interpreted largely as a question of sufficiency - can the Executive deliver the same quantity and quality of public services as in the rest of the UK? As well as a need to make the most efficient use of the funding available.

The Barnett Formula gives the devolved administrations a population share of changes to spending in England. However, this does not account for differences in need based on different age structures, different economic structures and weaknesses, historical impacts etc. However, judging the quality and quantity of services in NI relative to other nations/regions is not straightforward, as data is not always comparable across the regions. The purpose of devolution is to allow policy decisions on various matters to diverge according to local preferences and needs. So our approach, where possible, is to identify data that are comparable across the UK (e.g. by using expenditure data under the international measure of Classification of Functions of Government (COFOG)).

If prospective funding did look insufficient on current policy, the options for the Executive would be:

- to accept relatively lower public service provision;
- to try to increase the efficiency with which services are provided;
- to cease or reduce the provision of lowest priority services;
- to make additional fiscal effort (raising the Regional Rates and/or fees and charges);
- to seek greater tax raising or borrowing powers from the UK Government; or,
- to seek additional funding from the Treasury either as part of another political agreement or more durably by trying to persuade the UK Government to incorporate an assessment of relative need for spending per head to deliver equivalent services in the calculation of the Block Grant.

Sustainability of public finances in NI requires funding per head at least equal to some appropriate (albeit hard to estimate) measure of relative 'need' for spending per head. This 'need' would reflect the proportion of people requiring each service (due to the age structure and other characteristics of the population), as well as the factors impacting the cost of providing it (e.g. population sparsity).

The Barnett squeeze "is an issue with the Barnett Formula which can lead to a gradual convergence in funding per head in the devolved administrations and England" Holtham Commission Report[1].

Methodology

The NIFC uses the OBR's most recent assessment of the sustainability of the UK public finances in the *Fiscal Risks and Sustainability Report* (FRSR) as a starting point. This is because any cuts to or constraining of growth in public services spending deemed necessary to move the UK public finances to a more sustainable path would have implications for the Block Grant which pays for most of the NI Executive's spending. The OBR intends to publish the FRSR annually, however, if this were not the case in a particular year the NIFC Sustainability report would be tailored to update the current position using other published data, such as population projections.

Fiscal sustainability has a long-term perspective, the fundamental question is:

> "Can current policy settings and decisions be realistically maintained over the long term or whether a future government would at some point need to change them?"

If current policy is deemed unsustainable it signals the need for present and near future policymakers to consider when and what action might be taken.

As at the UK level, the NIFC is interested in NI's long-term outlook for income and spending,[2] as well as whether demographic and non-demographic influences might require policy

[1] https://researchbriefings.files.parliament.uk/documents/SN06288/SN06288.pdf

[2] The NIFC Terms of Reference require us to provide an annual report on the sustainability of the Executive's public finances, including the implications of spending policy and the effectiveness of long-term efficiency measures

changes. But the consequences of remaining on an unsustainable path are different to UK level and so too are the potential responses available to NI policymakers.

In order to determine the sustainability of NI's public finances an assessment is made of:

- **Comparison of the characteristics of NI population compared to the rest of the UK** - Do they imply a need for a higher amount of public spend per person than in England? This uses information from various reports. An assessment of characteristics such as
    - *size and age structure* – using ONS and OBR population projections including proportions of population aged 65 and above, 16-64 and under 16.
    - *poverty and social deprivation* – this is not easy to compare across the UK as deprivation scores are not directly comparable. Therefore, the NIFC uses the ONS data which underpins these: working-age economic inactivity, unemployment, relative proportion of people in poverty (households with disposable household income below 60% of that region's median in that year), persistent low income (been in relative low income for at least 3 out of past 4 years), rate of child poverty.
    - *socio-economic factors* – for example using the *State of the Nation* publication from the Social Mobility Commission to compare regions on qualification levels, wages, proportion of high-paid jobs, rate of job creation and new start-up growth.
    - *health of the population* – a 'special focus' sustainability report was published alongside the first sustainability report. Among other things, this included an assessment of real per capita health spending across the regions from HM Treasury in PESA
    - *population dispersion* – rurality is difficult to compare across UK nations – the report used publish reports including the House of Lords *Fact File Rural Economy*, Nuffield Trust *Rural Health Care*.

- **Examine relative levels of spending per head between NI and England**, to monitor the extent of convergence with levels in England and to assess whether this is appropriate for NI's level of needs. This may include an assessment of the Barnett squeeze – which causes per head spend to converge to English levels over the long term. Meaning future increases in UK Government spending in England on services the NI Executive is responsible for will not generate proportionate additional funding per person via the Barnett formula. This uses per head spending from HM Treasury in PESA at times adjusted to remove Whitehall spending which is not comparable and therefore the Barnett formula does not apply. Long term forecasts use OBR 50-year projections in FRSR and estimate Barnett consequentials based on the projections. Various scenarios, which can be adjusted, are also forecast. The first report included:
    - Need – having a fiscal floor of 120% of England's spend per head
    - Needs adjustment of 20% on the Barnett consequentials also adjusted for slower population growth
    - Increasing fiscal effort – increasing regional rates bills by 50% by 2028-29

- **In addition to assessing the projected path of the Block Grant, we also considered NI Executive generating additional financing**, as mentioned above. In our first report – relying on the final report from Independent Fiscal Commission for NI - we concluded that the Executive had options in the long run, including the– partial devolution of income tax and full devolution of stamp duty land tax, landfill tax and air passenger duty. Also investigated are raising additional income via powers NI Executive has including:

- *Regional Rates* – increasing regional rate poundages and reducing reliefs and allowances.
- *Capital Borrowing* – increasing the borrowing maximum level from £200 million to £340 million. Forecasting repayment costs which are a loss of regional rate income which could be used for resource spending.
- *Fees and charges* – this is difficult to project, the largest ones are non-domestic water charges, Health Trust receipts and tuition fees. Additional fees and charges could include domestic water charges and bring average household bills for rates and water charges to England level.
- *Other external funding* – such as non-Barnett additions to block grant (typically one off or time limited and earmarked for a particular purpose), EU funding (there is a risk that NI will receive less of this sort of funding in long term than it would have received from the EU).

Working with Others

Throughout the production of these forecasts the NIFC have met and shared methodology with DoF, the OBR and their Scottish counterparts in the Scottish Fiscal Commission. All of which have provided valuable input and comment.

As mentioned above, the NIFC also produced a special focus piece in parallel with the Sustainability report which focused on the largest area of DEL spend in NI – Health.