Finance and Public Administration Committee

34th Meeting, 2023 (Session 6), Wednesday 20 December 2023

Scottish Budget 2024-25 and Scottish Fiscal Commission's December 2023 Economic and Fiscal Forecasts

Purpose

1. The Committee is invited to take evidence from the following witnesses in relation to the Scottish Budget 2024-25 and the Scottish Fiscal Commission's December 2023 Economic and Fiscal Forecasts—

    - Professor Graeme Roy, Chair of the Scottish Fiscal Commission (SFC)
    - Professor David Ulph, Commissioner, SFC, and
    - Claire Murdoch, SFC Head of Fiscal Sustainability and Public Funding.

2. The Committee has agreed to build on the recommendations in its Pre-Budget 2024-25 Report by focusing its scrutiny of the Scottish Budget 2024-25 on establishing the affordability of the Scottish Government's tax and spending plans and how it has prioritised spending to deliver its three missions of—

    - Equality: Tackling poverty and protecting people from harm
    - Opportunity: A fair, green, and growing economy, and
    - Community: Prioritising our public services.

3. This paper provides background information to support this evidence session ahead of the Scottish Budget 2024-25 and accompanying SFC Forecasts being published on 19 December 2023.

Scrutiny of the Scottish Budget 2024-25

Background

4. The Committee published its Pre-Budget 2024-25 Report on the Sustainability of Scotland's Public Finances on 6 November 2023. The Report set out the Committee's concerns regarding the Scottish Government's lack of long-term financial planning, affordability in decision-making, and the absence of an overall strategic purpose and objectives for its public service reform

programme. The Scottish Government's response to the Committee's report is expected on 19 December, after publication of the Scottish Budget 2024-25.[1]

5. The Scottish Government has committed to publishing alongside the Scottish Budget 2024-25:

- Refreshed multi-year spending envelopes for both resource and capital. The Capital Spending Review and Infrastructure Investment Plan (IIP) period is being extended by one year, taking these plans up to 2026-27.[2] In its Pre-Budget 2024-25 report, the Committee asked that the multi-year spending envelopes include sufficient detail to enable meaningful parliamentary scrutiny and to allow public bodies to plan ahead. The Committee also said it would examine this information along with the updated IIP as part of budget scrutiny.
- Outcomes from the Tax Advisory Group[3] which the Scottish Government announced in the MTFS in May 2023, will "feed into the Scottish Budget 2024-25"[4]. In its report, the Committee welcomed this Group's establishment, "as a step towards the creation of a clear strategy for taxation in Scotland" and concluded that "it is imperative that this work progresses at pace".
- The Scottish Government's first six-monthly update to the Committee on the public service reform programme.[5] The Committee asked that the Scottish Government includes in this first update:

    - a clear vision and strategic purpose for what it wants to achieve with the programme, including how it will provide leadership and oversight to support public bodies to deliver on this vision.
    - the financial strategy to accompany the reform programme that was committed to by the then Deputy First Minister in March 2023.
    - details of each workstream under the programme, milestones for their delivery and clear measurements of success, and
    - an explanation of how the programme will impact on delivery of the national outcomes.

- An enhanced taxonomy approach to identify and categorise all spending lines across the Scottish Budget with regards to their climate impact.[6] For the first time, this will include resource as well as capital.

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[1] Under the Written Agreement, the Committee can expect a detailed response from the Scottish Government within five sitting days from publication of the Budget.
[2] This commitment is included in the Scottish Government's Medium-Term Financial Strategy 2023.
[3] Information on the Group and its membership can be found here: Advisory group on tax strategy - gov.scot (www.gov.scot).
[4] An update on the development of a longer-term tax strategy will be published alongside the May 2024 MTFS.
[5] This commitment was included in the MTFS 2023, which noted "it is critical that progress is effectively quantified and tracked, including through regular updates to the Committee". The Deputy First Minister confirmed in her letter of 25 May 2023 that this first update would be provided "no later than alongside the 2024-25 Budget and before the end of this calendar year".
[6] Further information on this can be found in this Joint Letter from the Deputy First Minister and Cabinet Secretary for Net Zero, Energy and Transport to the FPA Committee, 18 November 2022.

8. The Scottish Government's Medium-Term Financial Strategy published in May 2023 stated that "the Government will prioritise the programmes which have the greatest impact on delivery of the three missions set out in our policy prospectus", adding "within this, we will not back away from tough choices and targeting". During evidence to the Committee on 3 October 2023, the Deputy First Minister explained that the Scottish Government is looking at whether existing programmes, "some of which have been around for quite some time", meet the test of the three missions of equality, opportunity, and community. The Committee recommended in its report that "the Scottish Government explicitly sets out in the Scottish Budget 2024-25 if there are any areas of spending it has assessed as not meeting its three missions test and where funding will, as a result, be reduced or ceased entirely".

9. The Deputy First Minister also stated on 3 October that "the budget will be a budget of difficult decisions [and] in making those decisions, we will be required to address the scale of the challenges that our public finances face". She went on to say that "the limited tax lever that we have must be considered very carefully" including "the consequences of any changes further to the changes that we have already made" and that the Scottish Government is also looking at "the need for reform of the workforce in our organisation and across the public sector". More recently, on 26 November 2023, the Deputy First Minister said that "the size of the [public sector] workforce will need to reduce, there is no doubt about that".[7]

10. On 21 November 2023[8], the Deputy First Minister wrote to the Committee providing an update on 2023-24 in-year budget changes, which she indicated she had no option but to make, in the absence of additional UK Government funding. These in-year budgetary revisions total £680.3 million (£391.4 million in resource and £288.9 million in capital), £284.4 million of which was set out as part of the Autumn Budget Revision[9]. The Deputy First Minister explained that the revisions were a result of inflationary pressures as well as pay deals, which are estimated to add £1.26 billion to the Scottish Government's recurring pay costs in 2023-24 and £1.75 billion across the public sector. She indicated she would provide further details on how the Scottish Government intends to meet this "ongoing challenge to manage the costs of our vital workforce in future years … as part of the upcoming budget process".

11. In its blog on What to look out for in next week's Scottish Budget, SPICe highlights the "potential £1 billion pound funding gap in 2024-25 rising to £1.9 billion by 2027-28", as well as affordability concerns raised by this Committee, likely decisions around reform and workforce levels and options for changes to tax levels.

12. The Fraser of Allander Institute's annual budget report 2023 published on 15 December includes an assessment of the funding position for next year in advance of the Scottish Budget being published. The report suggests that the

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[7] Shona Robison - Public sector jobs will have to reduce - BBC News

[8] The day before the UK Autumn Statement, on 22 November 2023.

[9] The Committee considered and agreed to recommend approval of the ABR at its meeting on 7 November 2023.

funding shortfall for 2024-25 is now at around £1.5 billion (£800m on day-to-day spending and £700m on capital investment) due to increased spending pressures and new announcements.[10] This, it argues, “represents one of the most challenging fiscal backdrops in the history of Scottish devolution”. Commenting on the report, FAI Director Professor Mairi Spowage notes that “of course, the DFM may choose to use powers over income tax to raise more revenue to plug this gap, but it is unlikely that this would be sufficient in isolation”, adding that “significant spending cuts are also likely to be required”. The report also includes estimates for how much might be raised by changes to income tax - a new 44p rate on incomes between £75,000 and £125,000 would raise around £41m, while a 45p rate on incomes between £58,285 and £125,140 would raise around £136m.

Block Grant Adjustments and the Fiscal Framework

13. The Deputy First Minister wrote to the Committee on 6 December 2023 setting out how the OBR’s published UK Government tax revenue and social security expenditure forecasts inform the Block Grant Adjustments (BGAs) for the Scottish Budget 2024-25. She advised that—

> “We have calculated the in-year reconciliations required to the 2023-24 Scottish Budget … A reconciliation of £46 million will be added from the 2023-24 Block Grant. As noted above, this only provides one side of the calculation, and the SFC forecasts alongside the 2024-25 Scottish Budget will allow a rounded picture of the net position. The final reconciliation applying to the 2024-25 Scottish Budget relating to previous years’ outturn is negative £338.0 million”.

14. She went on to say that Department of Work and Pensions outturn data used to calculate the England and Wales element of social security BGAs is undergoing a final quality check and will be confirmed after the Scottish Budget is set.

15. Both the UK Government’s Autumn Statement and publication of the Scottish Government’s Scottish Budget 2024-25 are the first fiscal events since the Fiscal Framework was updated in August 2023. Under the revised Fiscal Framework, the annual and total limits for borrowing on capital expenditure of £450 million a year and £3 billion respectively are maintained, but will increase in line with inflation from 2024-25 (using the GDP deflator). The Scottish Government’s annual borrowing powers increase to up to £600 million each year, within a statutory overall limit for resource borrowing of £1.75 billion for in-year cash management and for forecast error. Both limits are indexed in line with inflation from 2024-25. The drawdown limits of £250m a year for resource and £100m a year for capital and Financial Transactions on Scotland’s reserve will also be abolished. The overall reserve limit of £700m will also be indexed in line with inflation from next year.

[10] The Report quotes these figures from University of Strathclyde Economists.

UK context

UK Government's Autumn Statement

16. The Chancellor of the Exchequer, The Rt Hon Jeremy Hunt MP, labelled his Autumn Statement on 22 November 2023 as an "autumn statement for growth", highlighting that the package includes "110 growth measures". The Chancellor explained his announcements are focused on five areas: reducing debt; cutting tax and rewarding hard work; backing British business; building domestic and sustainable energy and delivering world-class education". He indicated that, due to "difficult decisions we have taken in the last year", the fiscal situation now allowed him to deliver a package of tax cuts to support growth.

17. Key tax measures announced include reduced national insurance contributions, permanent full expensing of plant and machinery investment costs[11], extending business rates relief for retail, hospitality and leisure sectors in England, an alcohol duty freeze until 1 August 2024, and tobacco duty increases. The Chancellor's spending announcements include increases to universal credit in line with inflation (September figures) and the state pension in April 2024 by 8.5% in line with annual earnings growth for May to July 2023. He also increased the national living wage from 1 April 2024 by 9.8% to £11.44 an hour for eligible workers across the UK aged 21 and over and announced £80 million for the expansion of the Levelling Up Partnership programme to Scotland[12].

18. The Chancellor reaffirmed the UK Government's commitment set out in the Spring Budget 2023 that from 2025-26, planned departmental resource spending will continue to grow at 1% a year on average and that public sector capital spending will be frozen in cash terms. The House of Lords Library states in its briefing on the Autumn Statement that these spending targets restated by the Chancellor for 2025-26 onwards "imply real terms spending reductions for 'unprotected' departments". It highlights OBR estimates that the spending of unprotected departments would need to fall by 2.3% a year in real terms from 2025-26, increasing to 4.1% a year, should the UK Government continue with its ambition to increase defence spending to 2.5% of GDP and return overseas development assistance to its 0.7% of gross national income target.

19. The Chancellor stated that the Scottish Government is receiving £545 million in additional funding "as a result of decisions at the Autumn Statement".

OBR's Economic and Fiscal Outlook – November 2023

20. The OBR published its 'Economic and fiscal outlook: November 2023 alongside the UK Autumn Statement. These five-year forecasts highlight that—

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11 This was due to end in April 2026.

12 For Na h-Eileanan an Iar, Argyll and Bute, Dundee, and the Scottish Borders. He stated that the UK Government will consider how to extend this programme further and will work in partnership with the Scottish Government "with the intention of delivering an extension to the Investment Zones programme in Scotland".

- The economy recovered more fully from the pandemic and weathered the energy price shock better than anticipated**.**
- Inflation is expected to remain higher for longer, taking until the second quarter of 2025 to return to the 2% Bank of England target, more than a year later than forecast in March.
- This domestically driven inflation increases nominal tax revenues compared to the OBR's March forecasts, however "it also raises the cost of welfare benefits, and higher interest rates raise the cost of servicing the Government's debts".
- The Chancellor meets his target to get debt falling as a share of GDP in five years' time "by an enhanced margin of £13 billion, but mainly thanks to the rolling nature of the rule giving him an extra year to get there".
- The tax burden rises in each of the next five years to a post-war high of 38% of GDP.
- The OBR has revised down its estimate of the medium-term potential growth rate of the economy to 1.6% from 1.8% in March, "largely driven by a weaker forecast for average hours per worker, which we now expect to fall in the medium term, rather than holding flat".
- Unemployment is forecast to rise to 1.6 million people (4.6% of the labour force) in the second quarter of 2025, around 85,000 people higher, and a year later, than expected in March.
- Living standards[13] are forecast to be 3% lower in 2024-25 than their pre-pandemic level.

21. The OBR further sets out the main changes to AME[14] spending since its March forecasts, including an increase in the Scottish Government's current expenditure by an average of £1.9 billion a year over the forecast, due to higher RDEL[15] spending and tax receipts.

22. During evidence on the OBR's forecasts and the Autumn Statement on 12 December 2023, Richard Hughes, Chair of the OBR noted that the "real spending power of Government departments in England goes down by about £19 billion over the forecast period" due to the Chancellor leaving public service spending plans unchanged in cash terms, despite a higher forecast for inflation". The implication for Scotland, he suggested, is that "if those spending plans are sustained, there will be fewer real increases in Barnett consequentials for Scottish departments because in practice less is being spent in real terms on health, education, transport and other areas where spending is devolved here in Scotland".

23. The Committee's Pre-Budget 2024-25 Report includes the following conclusion, in light of its continuing interest in the need to grow the tax base and increase productivity levels—

[13] As measured by real household disposable income (RHDI) per person.
[14] AME (Annually Managed Expenditure) is largely difficult to forecast public expenditure such as demand-led benefits and tax credits; non-cash costs; and bank holdings and loan repayments. Spending in AME is separate to DEL.
[15] The OBR defines RDEL spending as departmental or day-to-day spending.

> "The Committee has consistently recommended that more action is needed to increase productivity, wage growth and labour market participation in Scotland and notes the Scottish Government's response pointing to its National Strategy for Economic Transformation (NSET) as key to addressing these issues. We ask what progress has been made in delivering actions in the NSET that will help increase productivity, wage growth and labour market participation."

24. In evidence, IFS Deputy Director, Carl Emmerson argued that, to address the UK's labour market challenges, "first, we need a strategy for getting people who are out of work and are economically inactive into work [and] secondly, we need to know how to help who are in work to progress, and how we can get the productivity gains that can ultimately deliver wage gains". He added that "we have done the latter particularly badly during the past 15 years".

25. On UK tax levels and workforce productivity levels, Mr Hughes from the OBR explained to the Committee that—

> "Tax burdens are rising pretty much everywhere in the world, because working populations are shrinking and the numbers of people who are on state pensions or consuming public healthcare are rising. Therefore, if working people are not becoming significantly more productive than they were in the past—we heard in the earlier part of the evidence session that they are not—you need to get more tax out of your working population in order to deliver those pensions and to pay for those services. Working people are less productive than they were in the past. That is the arithmetic that is driving tax burdens higher everywhere."

26. David Phillips, Associate Director at the IFS, suggested that "rather than just looking at tax rates or tax thresholds, there could be opportunities for a fundamental reform of taxes", including in relation to property tax both in England and Scotland. He went on to highlight that the data on labour market trends "is being exposed as being quite poor", with a substantially lower response rate to the Office for National Statistics (ONS) labour force survey leading to inconsistencies between that data and HMRC's real-time information. For example, "based on the labour force survey, Scotland seems to have had an improvement in its labour force participation and employment relative to the rest of the UK, since before the pandemic …, however HMRC data shows that Scotland has the lowest increase in employment of any region of the UK—2.7% compared with about 4% in both England and Wales and 6% in Northern Ireland".

27. On the UK Government's decision to freeze total capital spending, Tom Joseph from the OBR stated that "the Government has not set any detailed spending plans beyond next year [and so] it is not really possible for us to say what the implications are for public investment in the UK". He went on to say that "capital spending has increased as a share of GDP over the past few years, but it is expected to fall back down again over the forecast period if it is frozen in cash terms", adding "if such freezes were to be maintained over a long period, we

would expect that to have a negative impact on economic growth over the longer term. Reductions in the capital funding available to the Scottish Government was an issue raised by the Committee in its Pre-Budget 2024-25 Report, when it noted its disappointment in this trend and said it is “particularly concerning during times of financial strain when governments should be investing in infrastructure to stimulate economic growth”.

28. During evidence, Mr Phillips drew the Committee’s attention to the SFC’s previous forecasts of “more claims, more successful claims and longer claims in Scotland’s disability benefits system”, due to the eligibility conditions and how claims are assessed and reassessed. He added if this is the case “that will push up costs”. He went on to say that “the next set of SFC forecasts will give some indication about the extent to which things are coming forward in the first 18 months or so of the roll out of Adult Disability Payment”, including any rises in expenditure and potential implications for the Scottish Budget.

Next steps

29. The Committee will continue hearing evidence as part of its scrutiny of the Scottish Budget 2024-25 on 9 and 16 January 2024 and aims to report its findings to Parliament at the end of January.

Committee Clerking Team
December 2023