Finance and Public Administration Committee
33rd Meeting, 2023 (Session 6)
Tuesday 26 November 2024

Scrutiny of the Scottish Budget 2025-26: UK context

Purpose

1. The Committee is invited to take evidence from Richard Hughes, Chair, Office for Budget Responsibility (OBR), and Professor David Miles and Tom Josephs, Members of the Budget Responsibility Committee, OBR, in relation to the UK economic and fiscal outlook, to inform its scrutiny of the Scottish Budget 2025-26.

2. Following publication of the Scottish Budget 2025-26 on 4 December 2024, the Committee will take evidence on the Scottish Government's tax and spending plans at its meetings on 10 and 17 December 2024 and 7 and 14 January 2025.

UK Context

UK audit of public spending

3. On 29 July 2024, the UK Government published the outcomes of its Fixing the foundations: public spending audit 2024-25 carried out by HM Treasury, which "shows that the forecast overspend on departmental spending is expected to be £21.9 billion above the resource departmental expenditure limit totals set Treasury in the Spring Budget 2024". The document "sets out the savings that have been identified [which …] together … will deliver £5.5 billion savings in 2024-25 rising to £8.1 billion in 2025-26". This includes the following decisions—

    - departments absorbing at least £3.2 billion of the public sector pay pressure this year,
    - taking immediate action to stop all non-essential government consultancy spend in 2024-25 and halving government spending on consultancy in future years,
    - delivering a 2% saving against government administration budgets,
    - reducing communications and marketing budgets, and
    - continuing to dispose of surplus public sector estates.

4. The Chancellor also announced that winter fuel payments would be targeted from this year. A multi-year Spending Review will conclude in Spring 2025[1], setting spending plans for a minimum of three years of the five-year forecast period and "departmental expenditure limits for 2025-26 will be set out

[1] The UK Autumn Budget 2024 confirmed that the UK Government would be carrying out a Spending Review to conclude in **late** Spring 2025.

alongside the Budget in October, which will also confirm control totals for 2024-25".

5. The Scottish Government's Cabinet Secretary for Finance and Local Government, Shona Robison MSP, wrote to the Committee on 23 August 2024 stating that "… additional measures are now necessary following the UK Treasury's recent audit of public spending and lack of clarity over whether their decision to deliver Pay Review Body recommendations will be fully funded".[9] She confirmed that the Scottish Government has "introduced a set of spending controls with the intention of further reducing spend in 2024-25" and that it would replicate in Scotland the UK Government's decision to target winter fuel payments. In her fiscal statement to the Scottish Parliament on 3 September, the Cabinet Secretary outlined up to £500 million of further savings measures including resuming peak train fares and not progressing the concessionary fares extension to the asylum seekers' pilot. At that time, she was also planning on using up to £460 million of ScotWind money to plug funding gaps.

6. The Committee took evidence from the Minister for Public Finance on 12 November 2024 in relation to the Autumn Budget Revision which includes some of these changes to spending plans for 2024-25.

UK Autumn Budget 2024

7. The UK Autumn Budget 2024 published on 30 October 2024 "confirms that the [UK] Government is progressing the savings commitments announced as part of [the] audit of public spending in July". It also formally launched the Office for Value for Money "to realise benefits from every pound of public spending".

8. The Chancellor announced significant increases in public spending, financed by a combination of tax rises and higher borrowing. Public spending is set to increase by £70 billion per year over the next five years, with two-thirds going to day-to-day resource spending, and one-third to capital spend, such as transport, housing and research and development. She suggested that this rise in capital spending will "keep public investment broadly flat at around 2.5% of GDP over the next five years, rather than dropping to the 1.7% assumed in the previous Government's plans"[2]. The national minimum wage will increase to £12.24 an hour from April 2025 (an increase of 6.7%); the rate for 18–20-year-olds will increase from £8.60 to £10 per hour and the minimum wage for apprentices will rise from £6.40 to £7.55 per hour. In addition, extra funds have been allocated for the infected blood and Post Office horizon compensation schemes.

9. In its blog What's in the Budget? Ask Reeves, SPICe notes that significant increases in tax revenues of £36 billion more per annum, will fund just over half of the extra public spending. Key tax measures announced by the Chancellor include—

[2] Autumn budget 2024: Key announcements and analysis - House of Lords Library

- Employer **National Insurance Contributions** (NICs) will rise by 1.2% to 15% from 6 April 2025. The level at which employers will start paying NICs for each employee is to fall from £9,100 to £5,000. This measure is expected to raise a forecasted £25.7 billion per year by 2029-30.
- **Capital gains tax** will rise on disposals made on or after 30 October 2024 (the lower rate from 10% to 18%, and the higher rate from 20% to 24%).
- The freezing of **inheritance tax** thresholds will be extended to 2030[3]. From April 2026, inheritance tax relief for business and agricultural assets will be capped at £1million, with a new reduced rate of 20% being charged on assets above that.
- **Value-added Tax** (VAT) will be charged on private school fees across the UK.
- The temporary 5p cut in **fuel duty** announced by the previous Government will be extended for one year to 2025-26.
- The freeze in **income tax** thresholds will end in 2028-29, at which point thresholds will increase in line with inflation. (England only)

10. The Chancellor also announced increases in borrowing, averaging around £32 billion per annum higher than the previous Government's plans over the forecast period. This will fund just under half of the extra spending announced. To allow space for this extra borrowing, the Chancellor changed the definition of debt in her fiscal rules. The Office for Budget Responsibility (OBR) has explained that the UK Government intends "to target Public Sector Net Financial Liabilities (PSNFL) as the main balance sheet aggregate in its fiscal rules". PSNFL is a wider measure of debt which includes financial assets and liabilities (such as the Student Loan Book and funded public sector pension schemes) meaning interest rates may take longer to fall[4].

11. Decisions in the UK Autumn Budget have led to additional consequential funding for the Scottish Budget, with £1.5 billion added to this year's budget[5] (2024-25), rising to £3.4 billion for 2025-26[6]. While public sector employers are expected to be compensated by HM Treasury for higher costs resulting from the NICs increase, it is unclear what level of compensation will apply to Scotland, which has a larger proportion of its working population employed in the public sector than in England. The Scottish Government has estimated that the UK Government's increase in NICs would add £500 million to Scottish public sector costs.[7]

12. During evidence to the Committee on the Autumn Budget Revision on 12 November 2024, the Minister for Public Finance said that "we welcome the additional funding, but that funding is necessary to correct for persistent

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[3] The previous UK Government had announced that this freeze would continue until 2028.

[4] Report on Pre-Budget Scrutiny 2025-26 - Managing Scotland's Public Finances: A Strategic Approach

[5] The Scottish Budget 2024-25 approved by Parliament earlier this year amounted to approximately £60 billion.

[6] £1.5 billion baselined into the 2024-25 Budget, and an additional £1.9 billion added for 2025-26, totals £3.4 billion.

[7] What's in the UK Budget? Ask Reeves. – SPICe Spotlight | Solas air SPICe

underinvestment in public services and to address the cost pressures that we face". He went on to explain that "the amounts provided by way of consequentials arising from the UK autumn budget are broadly consistent with what has been factored into our planning and we are therefore not in a position to reverse the savings that were previously announced".[8]

OBR Economic and Fiscal Outlook – October 2024

13. The OBR published its Economic and Fiscal Outlook – October 2024 alongside the UK Autumn Budget 2024 on 30 October. These five-year forecasts highlight that—

- Having stagnated last year, the economy is expected to grow by over 1% this year, rising to 2% in 2025, before falling to around 1.5%, over the remainder of the forecast.
- Budget policies temporarily boost output in the near term but leave GDP largely unchanged in five years.
- Consumer Price Index (CPI) inflation is projected to rise to 2.6% in 2025, and then gradually fall back to the Bank of England target of 2%. (The Office for National Statistics (ONS) reported on 20 December 2024 that CPI inflation rose by 2.3% in the 12 months to October 2024, up from 1.7% in September, mainly due to electricity and gas prices.)
- Overall, policy decisions increase the current budget deficit by an average of £9.3 billion a year over the next five years "as the policy-driven increase in current spending is not fully offset by the increase in receipts".
- The rise in employer NICs is estimated to lower real wages and profits, with firms reducing labour supply and demand in response. The OBR forecasts that labour supply will reduce by 50,000 average hours equivalent.
- The unemployment rate is forecast to fall from 4.3% this year to 4.0% in 2026, before returning to its estimated structural rate of 4.1% in 2028.
- Nominal earnings growth is expected to fall from 4.7% this year to around 3.5% in 2025 and then average 2.25% over the remainder of the forecast.
- Living standards[9] are expected to grow by an average of 0.5% a year over the forecast.
- Public sector net borrowing is forecast to rise from £121.9 billion (4.5% of GDP) last year to £127.5 billion this year, before falling steadily back to £70.6 billion (2.1%) by 2029-30. Overall, borrowing is £28.4 billion (0.9% of GDP) a year higher on average over the forecast compared to March 2024, with the largest driver for this increase in the medium-term being the UK Government's policies set out in its Autumn Budget 2024. Borrowing is now projected to decline less sharply from its peak at the end of the forecast.

[8] Official Report
[9] Real household disposable income (RHDI) per person.

- Tax as a share of GDP is forecast to rise from 36.4% this year to a historic high of 38.2% in 2029-30, 5.1% of GDP higher than before the pandemic. The tax take in 2028-29 is 1.1% of GDP higher than in the March forecast.
- Spending as a share of GDP is forecast to rise from 44.9% last year to 45.3% this year, before falling back slightly to 44.5% in 2029-30, 4.9 percentage points higher than pre-pandemic
- Overall departmental spending is an average of £55.3 billion a year higher than in the OBR's March forecast, in which the previous Government's plans entailed spending falling by 1% of GDP between 2023-24 and 2028-29.

14. The OBR goes on to state that "productivity growth is one of our most important and uncertain judgements", highlighting that trend productivity growth (output per hour worked) "picks up over the forecast from 0.2% in 2023 to 1.25% in 2029, little changed from March". The OBR notes this to be "a significant rise from an average rate of 0.75% in the decade following the financial crisis…, but it is still well below the average of around 2.25% in the decade preceding the financial crisis".

15. In addition to productivity levels, the Committee has a long-standing interest in labour market participation. The OBR indicates that the participation rate is forecast to gently decline to 62.5% by 2029, driven by rising health-related inactivity, the overall ageing of the population, and the rise in employer NICs announced in the UK Budget 2024. This figure, it notes, "is well down from a peak of 64% in the final quarter of 2020". Inactivity due to long-term sickness remains high at around 2.8 million, accounting for a third of total inactivity, "although the latest data suggests it may have reached its peak".

16. The latest labour market information from the ONS published on 12 November 2024 sets out quarterly changes for areas of the UK, seasonally adjusted, from July to September 2024. This data shows that Scotland's employment rate for those aged between 16 and 64 years was 73.7%, a growth of 0.3% on the previous quarter. This compared to 74.8% in the UK. The inactivity rate in Scotland was 23.7%, an increase of 0.6% on the previous quarter, and compares to a rate of 21.8% in the UK.

OBR Devolved tax and spending forecasts – October 2024

17. In its Devolved tax and spending forecasts – October 2024, the OBR presents forecasts for fully devolved taxes and for devolved elements of income tax, along with illustrative projections for some taxes that are yet to be devolved. Also included are forecasts that "the UK, Scottish and Welsh Governments use as part of their agreed block grant funding mechanisms, which largely flow from those devolved taxes that we forecast".

18. The OBR explains that "it is not possible to fully replicate the methodologies that we use to produce our UK-wide forecasts when producing these devolved tax forecasts", adding "this is largely because we lack sufficiently detailed or timely data that is required to produce forecasts for Scotland or Wales on the

same basis". As a result, the OBR "generally use approaches based on estimating and projecting representative shares of relevant UK-wide tax streams in Scotland and Wales [and] we then adjust these shares if the evidence suggests that there are factors contributing to either divergence or convergence over the forecast horizon". It explains that "for the fully devolved taxes our forecasts, do however, benefit from timely outturn data".

19. The OBR compares its latest forecasts for the taxes devolved to Scotland and their UK Government equivalents and reports that:

- "The Scottish income tax share rises slightly in 2023-24 but then falls from 2025-26 (from 7.5% to 7.3% in 2029-30). This decline is largely driven by a change to our baseline threshold assumptions, which we now assume will rise in line with CPI inflation (to align with Scottish Fiscal Commission assumptions) instead of being frozen." Later in the report, the OBR explains that this forecast "also partly reflects weaker in-year RTI[10] outturn in 2024-25 and updated population data".
- For property transaction taxes, the OBR forecasts that the Scottish share rises in 2024-25, from 6.8% to 7.8%, before falling sharply to 6.1% in 2029-30.
- Scottish landfill tax receipts as a share of their UK Government equivalent follow a much sharper downward trend, with receipts falling from 15% in 2023-24 to just 6.5% in 2029-30. This, the OBR explain, is the result of the biodegradable municipal waste ban in Scotland from 2025-26 onwards.

20. In relation to Scottish Income Tax forecasting, the OBR notes that "differences in modelling approaches, data used, and judgements applied can all contribute to differences between our and the SFC's forecasts". This year, the OBR observes that "the cancellation of the SFC's May forecast due to the announcement of the General Election means that its most recent forecast was published in December last year". It goes on to suggest that "the gap between this previous SFC forecast and ours means that making a detailed comparison and analysing differences between the forecasts is less informative than usual at this stage".

21. The OBR explains that it expects to produce its first full forecast on the Scottish Aggregates Tax prior to its introduction on 1 April 2026. The report therefore uses the average of the most recent estimated Scottish share of UK-wide aggregates levy receipts produced by the ONS and the Scottish Government, relating to 2022-23 and 2023-24 respectively. It forecasts that the Scottish share of the levy is up compared with its March forecast "due to updated share estimates in the latest statistics more than offsetting the downward revision to the UK forecast to which it applies".

22. The OBR also provide forecasts for VAT and Air Passenger Duty "simply for illustrative purposes" at Annexe A of the report.

[10] Real time information.

OBR Fiscal Risks and Sustainability Report – September 2024

23. The OBR published its [latest Fiscal Risks and Sustainability Report in September 2024], which focused on the following three risks to the long-term fiscal outlook:

- the potential economic and fiscal costs of climate-related damage,
- the impact of changing health trends on the public finances, and
- an updated set of long-range fiscal projections, including alternative scenarios concerning productivity and migration.

24. The assumptions in this report are based on March 2024 policy intentions from the previous UK Government, and therefore, are not replicated in any detail in this paper. However, the report does make some general conclusions including that—

- limiting the rise in global temperatures to less than 2°C rather than 3°C could alleviate around 10 percentage points of upward pressure on the debt-to-GDP ratio,
- improving the health of the population could reduce the rise in debt by a further 40 per cent of GDP, and
- boosting the productive potential of the economy, “if it does not simply result in higher public spending, could make the biggest difference of all, with every 0.1 per cent increase in productivity growth reducing the rise in the debt-to-GDP ratio by 25 percentage points”. The OBR adds that “a full 1 percentage point increase, equivalent to a return to pre-financial crisis rates of productivity growth, could keep debt below 100 per cent of GDP throughout the next 50 years”.

Commentary on the UK Autumn Statement and wider context

Institute for Fiscal Studies

25. In the Autumn Budget 2024: initial Institute for Fiscal Studies (IFS) response, IFS Director, Paul Johnson suggested “look beyond the headline numbers, and there are two big judgements – one could say gambles – that the Chancellor seems to be making”. The first gamble, he explains is that a “big cash injection for public services over the next two years will be enough to turn performance around, and that many of the temporary spending pressures won’t persist”. He suggests, that if spending pressures do not dissipate after two years, “then to avoid cutting unprotected areas [the Chancellor] may well need to come back with another round of tax rises in a couple of years’ time – unless she gets lucky on growth”.

26. The second gamble, in Mr Johnson’s view, is that the extra borrowing will be worthwhile. He suggests that “the additional investment is extremely front-loaded, which doesn’t fill me with confidence on how effectively it will be spent – if indeed it is spent in that timescale”.

27. The IFS also recently published a report considering behavioural impacts from Scotland having relatively higher income tax rates for those earning over £30,000. This noted that, although conclusive evidence is still to emerge, research suggests income tax affects how much people work, avoid or evade tax, and migrate – it notes SFC findings that such responses will offset half of revenues from the Scottish 45% rate and almost 90% from Scotland's top rate of tax. Although the overall package of Scottish income tax reforms will have raised revenues for the Scottish Budget, the increases in the top rate of tax may have reduced revenues.

Fraser of Allander Institute

28. In its 2024 UK Autumn Budget reaction, the Fraser of Allander Institute (FAI) suggests that the Chancellor leaves less headroom against the current budget surplus than the previous Chancellor had, and "with such little room to manoeuvre, if many of the highly uncertain revenue raisers don't bring in as much money as forecast, it's not certain at all the Chancellor will meet these new rules". The FAI goes on to say that—

> "The government's game plan appears to be front-load the spending now, with a slowdown planned for later. The big bet? That these investments spark enough economic growth in the coming years to give the Chancellor more flexibility down the line".

29. The FAI welcomes the certainty of an annual UK fiscal event in the autumn and notes a significant uprate in spending for Scotland as a result of Barnett consequentials this year and next.

SPICe

30. The aforementioned SPICe briefing[11] on the UK Autumn Budget notes that the planned increase to capital spending "is good news for Scotland's capital budget, which had previously been projected to fall significantly, but will now rise by 7.1% in real terms next year".

31. The increases to the resource budget of over £1.5 billion, SPICe suggest, "may make balancing this year's budget easier than the Scottish Government previously thought and might negate the need for some of the ear-marked cuts for this year – for example, the drawing-down of ScotWind monies".

Next steps

32. The Committee will take evidence from the Institute for Fiscal Studies on the UK Autumn Budget and wider UK context on 3 December 2024.

Committee Clerking Team, November 2024

[11] What's in the UK Budget? Ask Reeves. – SPICe Spotlight | Solas air SPICe