Finance and Public Administration Committee

1st Meeting, 2023 (Session 6), Tuesday 10 January 2023

Scrutiny of the Scottish Budget 2023-24

Purpose

1. The Committee is invited to take evidence from the Deputy First Minister and Cabinet Secretary for Covid Recovery in relation to its scrutiny of the Scottish Budget 2023-24.

2. This paper provides background information on the Scottish Budget 2023-24 and on issues raised at the Committee's evidence sessions with the Scottish Fiscal Commission on its latest Economic and Fiscal Outlook, and the Scottish Government's Expert Panel on its Final Commentary on the implications of the UK Government Fiscal Statements for the Scottish Budget. Both sessions were held on 20 December 2022. The Committee is also able to draw on, for the wider UK context, its recent evidence sessions with the Institute for Fiscal Studies on 6 December and the Office for Budget Responsibility on 13 December.

Scottish Budget 2023-24

3. The Scottish Government published the Scottish Budget 2023-24 on 15 December 2022. In his statement to Parliament that day, the Deputy First Minister and Cabinet Secretary for Covid Recovery opened by noting that "despite reductions in spending of £1.2 billion", he was "still working in this financial year to find a path to fully balance this year's Budget". Secondly, he explained "as a consequence of that issue, for the first time since this government took power, I am announcing a Budget today for the next financial year assuming that we do not carry forward any fiscal resources from this year into next", adding that "the absence of that carry over increases the scale of the financial challenge that we face in the next financial year".

4. The Budget document states that the total Scottish Budget for 2023-24 is £59,813 million, comprised of £41,944m in resource spending (day-to-day expenditure), £6,363 million in capital spend (infrastructure), £10,491 million in Annually Managed Expenditure (AME)[1], and £1,015 million in non-cash. As noted in the SPICe blog, Scottish Budget 2023-24: Pulling the Income Tax Lever, "resource is due to increase by 3.7% in real terms in 2023-24 and capital is set to fall by 2.9% in real terms".

5. The Deputy First Minister noted that the 2023-24 Budget "will prioritise the Scottish Government's strategic objectives of eradicating child poverty; transforming the economy to deliver a just transition to Net Zero; and providing sustainable public

[1] AME is difficult to predict expenditure such as public sector pensions and non-domestic rates.

services". He said he would not be publishing a Public Sector Pay Policy for 2023-24 at this stage, "given the uncertain outlook and the need to still conclude some pay deals for the current year".

6. As a backdrop to announcing the Scottish Government's Budget, Mr Swinney indicated that "where we have the power, we are choosing a different, more progressive path for Scotland". He announced that:

- all devolved benefits would be uprated in April 2023 in line with inflation (at September CPI of 10.1%) at a cost of £428 million and the Scottish Child Payment continues to be uprated to £25 per week, as announced in November 2022,
- in terms of income tax, the top rate threshold will be reduced to £125,140, and an additional 1p will be added to both the higher and top rates, bringing them to 42p and 47p respectively, from 6 April 2023. Other rates will remain frozen. Mr Swinney indicated that the extra revenues from the 1p increase would go towards the NHS getting an extra £1 billion in funding. The income tax policy changes are forecast by the Scottish Fiscal Commission to raise £129 million.
- while Land and Building Transactions Tax rates and bands will remain unchanged, the Additional Dwelling Supplement will increase from 4% to 6% from 16 December, raising £34 million additional revenue in 2023-24.
- changes to the Scottish Landfill Tax will see increases to the standard rate to £102.10 per tonne and to the lower rate to £3.25 per tonne in 2023-24, in line with UK Government policy.
- work will progress on a devolved replacement for the UK Aggregates Levy Tax, with legislation being introduced this session. A consultation to inform development of the proposals closed on 5 December.
- he will freeze non-domestic rates poundage and continue to support the Small Business Bonus Scheme to remove 100,000 properties from rates and use the NDR regime to further incentivise investment in renewables through new exemptions for onsite renewable energy generation and storage from 1 April 2023 until 31 March 2035. Local authorities will have "full discretion" over Empty Property Relief for Non-Domestic Rates, with "£105 million added to the settlement to support local priorities including the option to develop local relief schemes".
- pressures on the capital budget mean that the Scottish Government will not be able to fund all measures set out in the Capital Spending Review, despite its plans to borrow the maximum £450 million in its borrowing limits. Impacted projects were not specified.
- local government will receive an additional £550 million next year in its settlement from the Scottish Government. This is short of the £1 billion called for by COSLA and CIPFA Directors of Finance in the run up to the Budget.
- £1.7 billion will be provided for social care and integration to improve services, "while paving the way for the introduction of the National Care Service".

7. The budget document was accompanied by an Equality and Fairer Scotland Statement setting out where the Scottish Government is proposing to spend money and how it aims to reduce inequality. In it, the Scottish Government sets out which national outcomes different portfolios contribute towards as well as which human rights are most applicable to which portfolios. This they explain "illustrates how the budget content aligns to key human rights."

8. The SPICe briefing on the Scottish Budget 2023-24 provides detailed analysis of the budget and accompanying documents.

9. Professor Ruane from the Expert Panel told the Committee that "one of the roles of Government in a time of uncertainty is to give as much certainty as it possibly can [and] at the moment, crucial to that is helping households and businesses that have suffered this huge price shock and allowing them to deal with that in the right kind of way without inflation becoming embedded". She added that "the crucial issue for a Parliament is therefore to make sure that what is being done in the short term will align well with the Scottish economy growing in the medium term in a fair and sustainable way".

The Committee's pre-budget scrutiny

Overview

10. In its Pre-budget Report on Scotland's Public Finances in 2023-24 and the Impact of the Cost of Living and Public Service Reform, published on 3 November 2022, the Committee accepted that the Scottish Government "faces difficult choices" on spending and taxation, against inflationary pressures. The Scottish Government's letter of 20 December responds to a number of the Committee's recommendations as follows:

- its plans to strengthen the accessibility of financial data "will take many years", in response to the Committee's call to make quicker progress. A prototype for "a technical solution to structuring, standardising and visualising the data" is to be delivered in Q1 2023 and "a Minimum Viable Product by end 2023", as part of the Open Government project.
- it will provide the SFC with Classification of the Functions of Government (COFOG) information on the 2023-24 Scottish budget "in the weeks following publication" and this will be published on the Scottish Government website. The Committee had endorsed a previous recommendation by the SFC that this information be included in the 2023-24 Scottish Budget. The SFC reiterated to the Committee on 20 January that COFOG is particularly important for its long-term fiscal sustainability work, which looks at potential spend "in the very long term".
- work is underway between officials to develop a Terms of Reference for the Fiscal Framework Review, "which will be agreed by Ministers in the coming months".
- after reducing spend on employability services in the Emergency Budget Review (EBR), it will "reinstate funding to support the employability response to child poverty, with £69.7m committed in the Budget in recognition of the

important role that employability support has to play in tackling child poverty". It confirms that no formal impact assessments were conducted specifically for the EBR changes announced to employability interventions.

- in response to cost-of-living pressures, it plans to continue the £20m Fuel Insecurity Fund, uprate all devolved benefits in line with September CPI of 10.1%, and continue the Scottish Child Payment at £25 per week.
- recruitment controls are within the Scottish Government itself "to ensure the organisation continues to deploy its resources flexibly with any required growth focused on priority areas", and that "it is for public bodies to establish fair and sustainable 2023-24 pay levels in dialogue with their respective trade unions", and
- net zero is one of three priorities in the Scottish Budget and progress is being made towards targets. It advises that further emissions cuts "will involve some genuinely difficult decisions for Scotland requiring significant long-term private investment and behaviour change, and discussions are ongoing on how best to secure the financing that will be required".

Tax and spending choices

11. On 4 October 2022, the Deputy First Minister told Parliament that "it is … essential that we engage more broadly on the tax and spending choices that are before us, including our commitments, priorities and values as a Government". He said he would therefore publish a discussion paper alongside the Emergency Budget Review "to encourage public engagement on those important and difficult choices on tax and public expenditure".

12. The Committee, in its pre-budget report, called for "an open and honest debate with the public about how services and priorities are funded, including the role of taxation in funding wider policy benefits to society" and suggested that "a wider public discussion on these issues would be helpful". A discussion paper has not been published by the Scottish Government. It did however publish a separate paper relating to taxation alongside the Scottish Budget: A summary of public attitudes to tax and stakeholder roundtable. This sets out views gathered by the Scottish Government during its pre-Budget engagement programme and draws on answers to a recent Scottish Social Attitudes Survey, which suggested, amongst other things, that 68% of people think the government should redistribute income from the better off to those less well off, and that 64% favoured increasing taxation to fund more public spending on health, education and social benefits.

13. During evidence, Professor Sir Anton Muscatelli told the Committee that "Scotland is actually more progressive [in relation to taxation] than it is elsewhere in the UK, because it puts greater burden on those with higher incomes". He suggested that "the one area that is probably less progressive is property tax", noting that "it is probably the area where we would have most freedom to act". Professor Ruane indicated that "it would be appropriate for the Scottish Parliament to think about the sustainability of the tax system in the face of volatility and whether, in fact, the system contains the right elements and then to remove as many anomalies as possible in relation to the interaction between what Westminster does and what you do at Holyrood".

Public Service Reform

14. The Scottish Government, in its Resource Spending Review published in May 2022, had stated that its public service reform programme would “be undertaken over the remainder of the Parliament, with initial outcomes to be reported in the 2023-24 Scottish Budget” and that it would also, alongside this Budget, “set out proposals for the future public body landscape”. These initial outcomes were not reported in the Scottish Budget document. Instead, the Deputy First Minister, in his statement to Parliament on 15 December, said that the Government will set out further plans “in due course”, adding “we will take forward an agenda consistent with the principles of the Christie Commission with a significant emphasis on early intervention and prevention as we work to create person-centred public services”.

15. The Scottish Government’s response to the Committee’s pre-budget report highlights officials are working with public sector bodies “to identify opportunities to reduce overhead costs, such as rationalisation of estates and of public bodies, and frontline delivery costs”, and indicates that further details will be developed in consultation with public bodies “in the coming weeks”. It does not however respond to the Committee’s call for assurances that it will approach reducing the public sector headcount in a “systematic, transparent and co-ordinated way, in tandem with the public service reform agenda, with a view to minimising any impact on the delivery of public services”.

16. The Expert Panel’s Final report stated that the public sector reform programme “remains key” to ensure public services become more productive and take advantage of new technologies. Professor Sir Muscatelli explained to the Committee during evidence that it is “an important time for the Scottish Parliament to think seriously about how it engages in public service reform to get the most efficient outcomes from total public spending, simply because there will be pressures on public service salaries and hard choices might need to be made”.

National outcomes

17. In its report on the National Performance Framework: Ambitions in Action, the Committee made a number of recommendations aimed at closer alignment between the NPF and those who advise and take funding decisions in the Scottish Government. The Committee also repeated in its pre-budget report its earlier calls for there to be a clearer link between spending decisions in the Scottish Budget and their impact on the delivery of national outcomes and asked the Scottish Government to confirm it will make progress on this matter in its 2023-24 Scottish Budget. The Scottish Government, in its response, noted that “it is challenging to identify in a meaningful way the individual annual impact of multiple budget lines on the delivery of longer-term complex national outcomes”, and instead it is “developing an approach centred around multi-year programmes, the associated outcomes and the annual spend profiles attached”.

18. During evidence, Professor Sir Anton Muscatelli noted that “it is difficult to use the NPF as a short-term guide on where to allocate spending”. He suggested that “what we have to do is trade off the difference that an extra pound of spending on

health will make to every indicator in the NPF versus the difference that an extra pound of spending on economic development will make", while noting that considerations on where funds are invested "must be based on much more granular considerations".

19. The Scottish Government has confirmed that it is preparing for the next statutory review of the national outcomes and is set to start its public engagement in the coming months and conclude during Term 3 of Parliament (2023). The review must start no later than June 2023.

Productivity

20. Further details of the priorities and budgets attached to delivery plans under the Scottish Government's National Strategy for Economic Transformation (NSET) are set out in the Scottish Government's response, as requested by the Committee. This includes investment of £500,000 to run the Digital Productivity Lab Project and expanding the Scottish Council for Development and Industry-led network of Productivity Clubs for businesses.

21. During evidence-gathering with the Expert Panel, Professor Sir Anton Muscatelli, told the Committee that actions in the NSET "must be pursued with vigour because it is aimed at genuinely lifting business investment and productivity". He added that "if I were in Parliament, I would be asking for evidence of how that is driven and what co-investment is being done between the private and public sector in those areas of activity". Dr Mike Brewer noted that "one of the most important things that any Government could do right now is be clear on its strategy, to make businesses feel able to invest in themselves—it is about business confidence in the Government, stability and having a clear strategy, and I see some of that in the budget that the Deputy First Minister announced". He added that "I also note that some decisions have been put off, probably rightly because of the severe challenge that has been caused by the cost-of-living crisis".

22. Chair of the SFC, Professor Graeme Roy, told the Committee that when publishing its Fiscal Sustainability Report in March the SFC would "speak more … about the challenges that Scotland faces with its ageing population", adding that "productivity is key [and] is the one thing that drives growth in the economy". He noted that Committee Members were "therefore entirely right to ask how we get those high-value jobs into other highly valued sectors because that is crucial for income tax revenues in the future".

Economic and fiscal outlook

23. In Scotland's Economic and Fiscal Outlook – December 2022, the Scottish Fiscal Commission (SFC) sets out its latest five-year forecasts for the Scottish economy, tax receipts, social security expenditure and an assessment of whether the Scottish Government's projections of borrowing are reasonable.

24. Overall, the SFC states that "higher energy prices and their consequences for inflation more generally mean that we now think the Scottish economy has entered

recession this year, and Scottish households are expected to see the biggest real-terms fall in their disposable income since Scottish records began in 1998". The SFC further indicates that the Scottish Government "will also have to deal with the effects of higher prices and demand for higher wages in the public sector". It "considers the Scottish Government's funding assumptions for the 2023-24 Budget to be reasonable", while noting "pressures in future years including a large negative income tax reconciliation for 2024-25 and an increasing social security bill".

25. The SFC expects:

- annual Consumer Price Index (CPI) inflation to peak at around 11% in Quarter 4 of 2022, which "is lower than it might have been in the absence of the UK Government's Energy Price Guarantee".
- inflation to "drop sharply over the course of next year as global energy prices level off and domestic inflationary pressures unwind due to the recession".
- in the shorter-term, "our judgement is that Scotland has already entered a recession which will last six quarters, with a total peak to trough fall in GDP of 1.8%". This compares to the OBR's forecast for the UK of 2.1%. The SFC expects the Scottish economy to recover to its pre-recession peak by the first quarter of 2025, one quarter behind the UK.
- longer-term, "both the underlying capacity of the Scottish economy to produce goods and services – its potential output – and the outlook for productivity growth are uncertain" and so the SFC has "reduced our view of the size of Scotland's potential output in recent forecasts and are therefore forecasting a lower level of cumulative growth rate of GDP".
- the Scottish Government's policy changes announced in the Scottish Budget are anticipated to raise an additional £129 million of income tax revenue in 2023-24.[2]
- overall social security spending to rise from £5.2 billion in 2023-24 to £7.3 billion in 2027-28.
- the outlook for the income tax net position[3] "has improved significantly", driven in part by the Scottish Government's policies to raise additional income tax. Other factors have been revised data and shifts in the relative economic outlook with the UK. The SFC however "strongly caution that the outlook remains very sensitive to changes in the OBR's forecasts".

26. During evidence, Professor Graeme Roy explained to the Committee that "despite that challenging backdrop, the net contribution of income tax to the Scottish Government's 2023-24 budget has improved by £582 million since last year's projections". This, he explained, was "due in part to last week's Scottish Government policy changes, but also to other reasons including the revised data in the most recent figures from His Majesty's Revenue and Customs, which pointed to a relatively better tax position for Scotland and projected rising earnings". He went on

[2] The freezing of the higher rate threshold is already included in the SFC's forecasts and so the Scottish Government's decision to freeze the higher rate threshold does not yield additional revenue. This is because in May 2022, the SFC judged this to be "the most reasonable assumption to make in our forecasts in line with historical patterns".
[3] The amount by which SFC forecasts are higher than the Block Grant Adjustment removed from the Budget results in what is known as the income tax net position.

to suggest that "the positive income tax net position over the next five years marks a change in the funding position of the Government relative to what we previously forecast", however he pointed to "the caveats inherent in its assessment and the potential for change" which could affect these projections.

27. On social security, he highlighted that "the gap between our forecast social security spending and the funding received from the UK Government is projected to widen" which reflects "the extra costs of delivering some payments such as adult disability payment, which we forecast to run ahead of the block grant adjustment, and distinct payments such as the Scottish child payment, which have to be funded from within Scottish Government budget resources". The SFC estimates that that gap will be £776 million next financial year, growing to £1.4 billion by 2027-28.

28. He noted that "broadly speaking … we think that the recession will be slightly shallower in Scotland, compared with the rest of the UK", due in part to the level of mortgage debt being lower in Scotland, the UK being more at risk of high interest rates in investment banking, and earnings in the north-east of Scotland "doing slightly better" due to greater demand for energy.

29. Professor Graeme Roy wrote to the Committee on 22 December with follow-up information in response to questions from Committee Members on taxes as a proportion of GDP and the SFC's costings of the change in the Additional Dwelling Supplement rate. This letter is attached at Annexe A.

30. Forecasts by the SFC and OBR, along with actual income tax outturn receipts determine the size of future reconciliations to the Scottish Budget. The OBR gave evidence to the Committee on 13 December in relation to its latest forecasts for the UK economy and public finances which accompanied the UK Government's Autumn Budget Statement. That session, along with an earlier evidence session with the Institute for Fiscal Studies, on 6 December, was intended to provide wider context to the Committee's scrutiny of the Scottish Budget 2023-24.

Expert Panel commentary

31. The Scottish Government's Emergency Budget Review (EBR) published on 7 November identified a further £615 million in savings for this financial year, on top of the initial package of £560 million announced by the Deputy First Minister on 7 September. These savings were made to allow funds to be diverted to tackle the cost-of-living crisis, including improved pay offers for public sector workers.

32. The paper, Implications of the UK Government fiscal statements for the Scottish Government Budget: Expert Panel Interim Commentary, was published alongside the EBR on 7 November. This Panel was established on 27 September to provide advice to the Scottish Government in response to the fiscal approach of the UK Chancellor of the Exchequer's Mini Budget 2022 ('The Growth Plan') announced on 23 September. Most of the announcements made in the Mini-Budget 2022 have however since been reversed.

33. The Panel's Final Commentary on the implications of the UK Government Fiscal Statements for the Scottish Budget was published on 15 December, setting out considerations for the Scottish Government when preparing its Budget for 2023-24. In broad terms, the Panel noted that it is "important to prioritise improving wellbeing and productivity across all areas of government spend" as "public services and government spending provide an important stabiliser during economic downturns and can help maintain the productive capacity of the economy and the wellbeing of citizens".

34. The Panel also noted that "Scotland is constrained by reliance on the UK Government for capital grant allocations as well as limited capital borrowing powers." As such, the UK Government's decision to not enhance capital funding given the high levels of inflation "will lead to a steep decline in the purchasing power of Scottish Government investments and will lead to a reprioritisation of projects." The Panel suggested that this may hamper the Scottish Government's ability to meet its net zero targets and damage the economic recovery, which will in turn bring further uncertainty to industries during these challenging and turbulent times.

35. The Panel further suggested that the Scottish Government should continue to consider "ways that the tax system could be made fairer and better aligned to improving productivity and wellbeing, either through reforms to existing taxes or through the introduction of new taxes". It noted that the UK Government has begun to take small steps toward new taxes, such as bringing electric vehicles into the tax system, but that "it is not straightforward for the Scottish Government to introduce new taxes, as any new tax requires the approval of the UK Government". The Panel added that, "as has been shown by the lack of progress on implementing the Vacant Land Tax in Wales, the process for obtaining consent from the UK Government is not straightforward [and] as such, it is likely that new taxes will take several years to progress".

Recent statistics and wider commentary

36. Publication of the Scottish Budget 2023-24 came a day after the Office for National Statistics reported that CPI rose by 10.7% in the 12 months to November 2022, down from 11.1% in October (which was the highest annual CPI inflation rate after recording started in 1997). It coincided with the Bank of England Monetary Policy Committee's decision to raise interest rates by a further 0.5 percentage points to 3.5%. It suggests that CPI inflation is expected to continue to fall over the first quarter of 2023, as earlier increases in energy and other goods prices drop out of the annual comparison".

37. Latest labour market statistics from the Office for National Statistics published on 13 December 2022, show that the employment rate in Scotland between August and November was 75.9%, up by 0.7% from the previous quarter. The employment rate in the UK for the same period was 75.6%. The unemployment rate in Scotland over the same period was 3.3% (up 0.2%), as compared to 3.7% in the UK, while the inactivity rate in Scotland was 21.4% (down by 0.9%) compared to 21.5% in the rest of the UK.

38. The ONS, in revised figures published on 22 December 2022, showed that the UK economy performed “slightly less well over the last year than we previously estimated”, with manufacturing “notably weaker”. It said that Gross Domestic Product (GDP) was now estimated to be 0.8% below where it was before the pandemic struck, revised downward from the previous estimate of 0.4% below.

39. Responses to the Scottish Government’s Budget 2023-24 were published in blogs by SPICe: Scottish Budget 2023-24: Pulling the income tax lever, the Fraser of Allander Institute in: A first glance: the Scottish Budget 2023-24, and the Institute for Fiscal Studies in the Scottish Budget 2023-24 confirms big cuts to many public services.

40. The SPICe briefing on the Scottish Budget 2023-24 provides more detailed analysis of the budget and accompanying documents.

Next steps

41. The Committee is expected to publish its report on the Scottish Budget 2023-24 in late January 2023.

Committee Clerking Team
December 2022

Scottish Fiscal Commission

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Convener
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22 December 2022

Dear Convener

During our evidence session on Tuesday, 20 December I offered to write to provide the Committee with further information on two points.

The first concerns the taxes as a proportion of GDP. During the session we discussed the potential difficulties in calculating and interpretating a measure for devolved taxes in Scotland along these lines. We also discussed a UK wide measure and you asked what the value would be in 2027-28. Chart 15 of the latest OBR report shows that they forecast a post-measures ratio of 37.1 percent in 2027-28.

The second issues concerns our costing of the change in the ADS rate on residential LBTT described in Annex A of our report where Ms Smith asked if we have taken account of recent developments in the rental market that may discourage the purchase of residential properties for let.

The behavioural element of our costing was based on OBR elasticities that were updated in 2017. We do not explicitly include the impact of rent caps and eviction moratoria as it the Commission's view that recent policies in the private rental market are likely to be relatively small in terms of their impact on ADS and LBTT receipts.

Although there is some informal evidence that private landlords are leaving the rental market this may lead to additional transactions that are liable for LBTT as properties are sold for other uses. In part, this is also likely to be due to landlords responding in ways that offset some of the direct impact of rent caps, for example, the reported increase in up-front payment of rents at the start of leases.

I hope this additional information is useful.

Yours sincerely

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