

# Finance and Public Administration Committee

18<sup>th</sup> Meeting 2023 (Session 6), Tuesday 13 June 2023

## Medium-Term Financial Strategy and Economic and Fiscal Forecasts May 2023

### Purpose

1. This paper invites the Committee to take evidence from Shona Robison MSP, Deputy First Minister and Cabinet Secretary for Finance, in relation to the [Scottish Government's Sixth Medium-Term Financial Strategy](#) and the accompanying [Scottish Fiscal Commission's Economic and Fiscal Forecasts May 2023](#). It also provides an opportunity to discuss the outcomes the Deputy First Minister has committed to achieving by 2026, as set out in [Equality, Opportunity, Community: New Leadership – a fresh start](#).
2. The Deputy First Minister will be accompanied by Scottish Government officials:
  - Kathy Johnston, Deputy Director, Office of the Chief Economic Adviser,
  - Alison Cumming, Director of Budget and Public Spending, and
  - Andrew Scott, Director of Tax and Revenues.
3. This paper provides background information on the key issues set out in the documents referred to in paragraph 1 of this paper, as well as issues raised at the Committee's evidence session with the SFC on its latest forecasts on 6 June.

## Medium-Term Financial Strategy

### Background

4. In her Foreword to the MTFs, which provides a medium-term perspective on the sustainability of Scotland's public finances over the next five years, the Deputy First Minister stated that—

“... my number one priority is to ensure the Scottish finances remain on a sustainable trajectory so that we can deliver first class public services for our communities, improve equality by reducing poverty and seize the opportunities of an economy that is fair, green and growing”.
5. The MTFs states that “tough and decisive action must therefore be taken to ensure the sustainability of public finances and that future budgets can be

balanced”, adding that the following three pillars will underpin its strategic approach to managing the public finances—

- **Focusing spending decisions on achieving the Scottish Government’s three critical missions**<sup>1</sup>. The MTFS commits to publishing alongside the 2024-25 Budget refreshed multi-year spending envelopes for resource and capital and extend the Capital Spending Review and Infrastructure Investment Plan period by one year, taking these plans up to 2026-27. “Recognising the changes since publication of the RSR [it plans to] deliver a fresh set of actions for reform, with priority now placed on four key workstreams: Public Bodies and Public Service Reform, Efficiency Levers<sup>2</sup>, Revenue-raising, and Pay Sustainability.
  - **Supporting sustainable, inclusive economic growth and the generation of tax revenues.** The Scottish Government commits to explore, ahead of the Budget 2024-25, “areas such as seizing opportunities in areas where Scotland has a competitive advantage, such as the Green economy, and supporting entrepreneurs, start-ups and scale-ups; helping businesses to raise productivity; and further boost labour market participation including through an enhanced childcare offer”.
  - **Maintaining and developing the Scottish Government’s strategic approach to tax.** The Scottish Government is establishing an external tax stakeholder group this summer, chaired by the Deputy First Minister, “to consider how best to engage with the public and other stakeholders on the future direction of tax policy, including whether a national conversation on tax is required”. The outcomes of this engagement will feed into the Budget 2024-25 and development of a longer-term tax strategy to be published alongside the MTFS in 2024. The Scottish Government is also working with HMRC to develop new robust data sources and evidence to “help better understand potential behavioural responses”.
6. The MTFS provides further information on the Scottish Government’s approach, including that it will “unapologetically direct our resources to those in greatest need [and] we will review opportunities for more effective targeting of existing provision and services”. It will, as part of its update of the projects in the Infrastructure Implementation Plan, prioritise capital spending which supports employment and the economy and has greatest impact on realising the three missions. It plans to develop a pay and workforce strategy for 2024-25 and indicates that “where a reduction in workforce is required for a public body to remain sustainable, we would expect this to be through natural turnover wherever possible<sup>3</sup>”. The forecast difference between Scottish benefits compared to block grant adjustment funding (£756 million in 2023-24 increasing

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<sup>1</sup> Equality, Opportunity and Community.

<sup>2</sup> The Efficiency Levers workstream involves: Digital, Shared Services, Public Sector Estates, Procurement and Grant Management. The first four were priorities in the RSR along with revenue-raising

<sup>3</sup> The Scottish Government has restated its commitment to no compulsory redundancies in the 2023-24 pay strategy.

to £1,274 million in 2027-28) will “need to be funded from elsewhere within the Scottish Budget, through tax and spending changes”. Scottish benefits will aim to “help those with the greatest need, supporting low-income families with their living costs and older people to heat their homes in winter, and enable disabled people to live full and independent lives”.

7. During her [statement to Parliament on 25 May 2023](#), the Deputy First Minister called on the UK Government “to increase capital funding in line with inflation and to provide additional funding to cover reasonable pay settlements for our public sector workers”. The Scottish Government also intends to continue to press the UK Government to provide sufficient funding to meet the scale of these challenges, and for more powers and necessary reforms to the Fiscal Framework through the forthcoming Review.
8. The MTFS confirms that “the final version of the independent report on Block Grant Adjustments (BGAs) jointly commissioned by the UK and Scottish governments has been submitted to both governments for consideration, but the timing and arrangements for publication are still under discussion with the UK Government”.<sup>4</sup> Discussions are also “ongoing between the governments about the timing and process for the subsequent review”.
9. The then [Cabinet Secretary for Finance and the Economy](#) and the then [Chief Secretary to the Treasury](#) wrote to the Committee on 2 November 2021, confirming the agreed arrangements, at that stage, for the independent report and subsequent Fiscal Framework Review, including that—
  - preparations for the review (including its scope) were to take place in parallel with the independent report; (at that stage anticipated to start in early 2022),
  - the review would be wider in scope than the independent report and would include input obtained from stakeholders as part of the overall process,
  - the Scottish Government would undertake a programme of analysis to inform its views and build on the independent report, and other key publications and evidence, including the [Session 5 Joint Committee and Scottish Government report](#) on the fiscal framework review.
10. The MTFS states that “heading into the review the Scottish Government will aim to:
  - Ensure the BGA methodology continues to protect the Scottish Budget from potential slower population growth in Scotland than in rUK,
  - Secure greater budgetary flexibility and appropriate budget management tools,
  - Continue to protect the Scottish Budget from economic shocks that affect the Scottish and UK economies equally, and

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<sup>4</sup> The Finance and Public Administration Committee [provided its response](#) to inform the Fiscal Framework Independent Report on 20 September 2022.

- Ensure the Scottish Government has the appropriate suite of policy levers and is not unduly exposed to risks outside its control.

## SFC May 2023 Forecasts

11. The SFC's Economic and Fiscal Forecasts 2023-24 were published on 25 May 2023 and inform the Scottish Government's Sixth Medium-Term Financial Strategy, also published that day.
12. The SFC's May 2023 Forecasts set out its five-year forecasts of the Scottish economy, tax receipts, social security expenditure and an assessment of whether the Scottish Government projections of borrowing are reasonable. Key issues highlighted include:
  - The overall outlook for the Scottish economy remains largely unchanged since the SFC's December 2022 Forecasts, with "slow and fragile economic growth over the short term", however, the SFC, in line with the latest GDP data, now forecasts the economy to remain broadly flat this year rather than fall into a shallow recession. This is due to "energy prices falling back more quickly than expected, leading to slightly lower expectations for inflation and interest rates in the near term".
  - Living standards are still likely to fall this year because the overall rate of inflation, which now reflects a broader range of price rises than just energy, continues to outpace growth in nominal household disposable incomes. This, the SFC suggests, means "the coming years will continue to be difficult for many households, especially those with lower incomes".
  - Total resource funding is forecast to grow from £45.3 billion in 2023-24 to £52.6 billion in 2028-29, an increase of 8% in real terms. The central scenario in the Scottish Government's MTFs shows spending exceeding funding by 2% (£1 billion) in 2024-25, rising to 4% (£1.9 billion) in 2027-28. The SFC notes that, "as the Scottish government is required to have a balanced budget, the challenge of such a gap will have to be addressed each year in the budget setting process". For capital funding the outlook is "more constrained" and by 2028-29, it is expected to be 14% smaller in real terms than in 2023-24.
  - The Scottish Government plans to use its borrowing powers to contribute to capital funding at a level of £250 million each year. This could rise to £450 million a year if its assumption of further funding of £200 million from sources other than the block grant does not materialise. The SFC expects the total debt stock to reach 90% of the limit in 2028-29 if £250 million is borrowed in each year of the forecast.
  - Social security spending is forecast to increase from £5.3 billion in 2023-24 to £7.8 billion in 2028-29, with the number of people receiving payments expected to increase and the continuing impact of inflation on payments. By 2027-28, the SFC expects the Scottish Government to spend £1.3 billion more on social security than the funding received from the UK Government through BGAs. The Scottish Government has also introduced new payments only available in Scotland and for which there are no UK equivalents. Any spending above the level of funding received

from the BGAs and on new payments must be met from the overall Scottish Budget. The SFC explains that “while our forecast of spending has increased since December 2022, the estimate of the BGA funding for social security has increased by more, meaning that the gap between spending and BGA funding in 2027-28 has narrowed by £142 million”.

- Devolved taxes are expected to raise £20.1 billion of revenue in 2023-24, £384 million more than set out in the SFC’s December 2022 Forecasts. The SFC explains that “rising nominal earnings growth combined with tax thresholds that are fixed in nominal terms are driving up income tax revenues”. The effect of increased fiscal drag, where tax thresholds do not rise at the same level as inflation, is greater in Scotland than in the UK.
- In 2024-25, the SFC continues to anticipate a negative income tax reconciliation of around -£712 million relating to 2021-22 revenues<sup>5</sup>. This, the SFC notes, will have a negative effect on resource funding. While there is uncertainty over the exact figures involved – and these will not be confirmed until final outturn data is published in July 2023 - the SFC expects “the 2021-22 reconciliation will be large, negative, and greater than the Scottish Government’s borrowing powers or potential use of the Scotland Reserve”. The Scottish Government plans to use its borrowing powers in full to offset these reconciliations, but there is a resource borrowing limit of £300 million under the fiscal framework, with the remaining reconciliation having to be met from elsewhere within resource funding.

## Evidence session on 6 June 2023

13. At the Committee’s evidence session with the SFC on 6 June, the following issues were discussed:

- The exact figure to be applied as a reconciliation to the 2024-25 Scottish Budget will not be confirmed until the outturn data is published in July 2023. However, the SFC can “be fairly confident it is a very large, negative reconciliation”.
- The size of the reconciliation is due to the forecast from the Office for Budget Responsibility (OBR) and the SFC taking place at different times in 2020-21 when there were different economic impacts anticipated from the Covid pandemic. There is an argument to better align the publication dates of the OBR and SFC forecasts, particularly given the potential for significant negative reconciliations where there is a material change in circumstances between the forecasts. It was however recognised that forecasting is just one part of a much wider UK and Scottish budget process.
- While this reconciliation figure is the result of special circumstances, the SFC expects future reconciliations to be “in a similar ballpark” due to growing budgets (through inflation).

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<sup>5</sup> The SFC refers to the total revenue reconciliation currently forecast to be -£687 million, primarily because of the large negative 18 income tax reconciliation.

- The SFC identify a divergence in earnings growth between its own forecasts and those of the OBR, which is the main driver of the strongly positive estimated income tax net position for Scotland. Should the OBR revise up their forecasts in line with the SFC, “the drivers for income tax will converge and that’s why the net tax position could decline”.
- On earnings growth, the SFC estimates that 0.1% extra growth in Scottish average nominal earnings relative to the rest of the UK would lead to a £25 million increase in the net position.
- Following concerns raised by the SFC in previous Statement of Data Needs publications, “good progress had been made”, including constructive relations with Social Security Scotland.
- With the capital budget in Scotland expected to be 14% smaller in real terms in 2028-29 than in 2023-24, the SFC noted that governments cutting capital spend, in a similar way to the UK Government in this case, is not uncommon in the face of financial pressures.
- Capital expenditure in areas such as transport and education infrastructure can lead to improvements in productivity, and less so in other areas such as government buildings or prisons infrastructure.

## Commentary on the MTFS and Forecasts

14. A SPICe blog on the [Medium-Term Financial Strategy: decisions pushed back](#), published on 30 May, highlights some key aspects of the SFC Forecasts and MTFS, as well as some areas that are missing from the MTFS where decisions have yet to be taken. This includes how the Scottish Government might fill the ‘budget gap’ between spending available and existing commitments, further plans on high-profile policy areas such as the National Care Service or to tackle climate change, or how much additional resource will be needed for future pay awards.
15. The [Fraser of Allander Institute Blog](#) on the MTFS, published on 26 May, notes that “this is not the first one of these documents to highlight a potential funding gap if things continue as they have been”, adding “the difference was that the Deputy First Minister was very upfront about the fact that this was going to mean tough decisions were necessary”. It went on to highlight that policy commitments the Government has already made, such as the National Care Service and expansion of childcare provision are not included in the MTFS and, “therefore, Ministers will have to be clear over the summer and in the Programme for Government that they are acknowledging the tough decision environment when policy announcements are being made”.
16. The Institute for Fiscal Studies (IFS) also published an [Immediate response to the Scottish Government’s MTFS](#) on 25 May, which notes “a significant funding gap looming for the Scottish Government – and little sense of how to address it”. It suggests that, while the outlook for future funding and spending needs are highly uncertain, “future UK government spending plans seem more likely to be topped up than cut back, generating additional funding for the Scottish Government via the Barnett Formula”. The IFS goes on to say however that—

“The Scottish Government should plan on the basis of having to either hold down growth in spending or increase tax revenues to address the funding gap it has identified. This will require ruthless prioritisation of spending, and consideration of which parts of the population the Scottish Government is willing to further increase taxes on. However, it should also plan how it would spend additional funding, if it were to become available, in order to help maximise the value-for-money achieved”.

## Equality, Opportunity, Community: New Leadership – A fresh start

17. This evidence session also provides an opportunity for the Committee to discuss the outcomes the Deputy First Minister has committed to achieving by 2026, which are set out in Equality, Opportunity, Community: New Leadership – A fresh start, published by the Scottish Government on 18 April 2023. In this Prospectus, the First Minister sets out three “critical – and interdependent – missions for my government which will make a difference, tackling the issues which matter most and grasping the opportunities we have, to improve the lives of people across the country”. These Missions for 2026 are:
  - Equality: Tackling poverty and protecting people from harm
  - Opportunity: A fair, green and growing economy
  - Community: Prioritising our public services
  
8. The First Minister explains that “the Prospectus describes what we aim to achieve by 2026 which, when taken together, will deliver upon these three missions”.
  
9. The Deputy First Minister opens her section of the Prospectus by stating that—
 

“Good governance begins with sound public finances. The shocks of recent years have strained our budgets and stretched our resources. Achieving and maintaining a balanced budget, while delivering against our three central missions, will be my highest priority and my most important work. Sound finances are the strong foundations from which we will deliver for people and progress the vital missions set out by the First Minister.”
  
10. She commits that by 2026 she will have:
  - managed the Scottish public finances on a sustainable trajectory, balancing budgets through maximising the value of public spending and putting robust policies in place to support and sustain effective public service delivery,
  - used tax powers to deliver the most progressive tax system in the UK, making tax policy choices that are informed by public and stakeholder views and ensuring that the revenue we generate helps to achieve the three missions,

- prioritised capital investment to achieve net zero and to maintain high quality public infrastructure and services across Scotland, and
  - completed the first review of Scotland’s Fiscal Framework, “subject to negotiation with the UK Government”.
10. In relation to the reform of public services, she commits to progressing a 10-year programme for public bodies and public service reform, strengthening the resilience of public services, and targeting both short-term efficiencies and “wider, deeper, and longer-term reform”. Plans to agree and implement a New Deal for Local Government, to bring forward legislation giving councils discretion to apply a Local Visitor Levy, and to consider further reforms for council tax, are also highlighted.

## Next steps

18. The evidence gathered during sessions with the SFC on 6 June and Deputy First Minister and Cabinet Secretary for Finance on 13 June will inform the Committee’s pre-budget 2024-25 scrutiny, along with that gathered as part of its inquiry into the Scottish Government’s public service reform programme.

Committee Clerking Team  
June 2023