Finance and Public Administration Committee

33rd Meeting, 2023 (Session 6), Tuesday 12 December 2023

Scrutiny of the Scottish Budget 2024-25: UK context

Purpose

1. The Committee is invited to take evidence from the following two panels of witnesses in relation to the UK Government's Autumn Statement 2023 and wider UK context, with a view to informing its scrutiny of the Scottish Budget 2024-25.

Panel 1

- Richard Hughes, Chair, and Professor David Miles and Tom Josephs, Members of the Budget Responsibility Committee, Office for Budget Responsibility.

Panel 2

- Carl Emmerson, Deputy Director, and David Phillips, Associate Director and Head of Devolved and Local Government Finance, Institute for Fiscal Studies.

Background

2. The Committee will take evidence on the Scottish Budget 2024-25, which is due to be published on 19 December 2023, at its meetings on 20 December, and 9 and 16 January 2024, before reporting its findings in late January.

UK Context

UK Government's Autumn Statement

3. 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.

4. Key tax measures announced by the Chancellor include—

- **National insurance contributions** (NICS): from January 2024, the main rate of class 1 employee NICs will be reduced from 12% to 10%. From 6 April 2024, no-one will be required to pay class 2 self-employed NICs and the main rate of class 4 self-employed NICs will be reduced from 9% to 8%.
- **Capital allowances**: full expensing of plant and machinery investment costs, previously introduced up until April 2026, will be made permanent.
- **Business rates**: the current 75% relief for retail, hospitality and leisure sectors in England is being extended for 2024-25, with up to £110,000 cash support available for eligible businesses.
- **Alcohol duty** will be frozen until 1 August 2024.
- **Tobacco duty** rates will increase by retail price index (RPI) inflation plus 2%, with duties on hand-rolling tobacco products increasing by RPI inflation plus 12%.

5. Spending measures announced by the Chancellor in his Autumn Statement include:

- increasing universal credit in April 2024 by 6.7%, in line with September’s inflation figure,
- uprating the state pension in April 2024 by 8.5%, as part of the ‘triple lock’ and in line with annual earnings growth for May to July 2023.
- increasing 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,
- increasing the Local Housing Allowance rates to the 30th percentile of local market rents, and
- £80m for the expansion of the Levelling Up Partnership programme to Scotland, 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”.

6. 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 notes 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.

7. 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

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

- 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.
- More persistent inflation means markets expect interest rates to be more than a full percentage point higher than the OBR assumed 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".
- Higher inflation and other forecast changes reduce borrowing by £27 billion in 2027-28 compared to the OBR's March forecast, mainly due to the Chancellor's decision to leave departmental spending broadly unchanged and higher than previously forecast tax receipts.
- This £27 billion windfall is being spent on cuts in NICs, permanent up-front tax write-offs for business investment, and a package of welfare reforms "which together provide a modest boost to output of 0.3% in five years".
- 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.
- Borrowing was £19.8 billion lower in the first half of this financial year than forecast in March, due to stronger receipts growth**.**
- 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".
- It expects the Chancellor's policy package in his Autumn Statement to provide "a modest boost to demand in the near term and a small but lasting benefit to the supply side of the economy".
- It forecasts unemployment 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[1] are forecast to be 3% lower in 2024-25 than their pre-pandemic level.

9. The OBR sets out the main changes to AME[2] 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[3] spending and tax receipts.

Block Grant Adjustments

10. 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. This letter is attached at Annexe A. She confirms 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".

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

12. This is the first fiscal event since the Fiscal Framework was updated in August 2023.

OBR Fiscal Risks and Sustainability Report – July 2023

13. The OBR published its latest [Fiscal Risks and Sustainability Report in July 2023], which focused on three risks "which have crystallised over the past three years, but whose economic and fiscal consequences continue to unfold". These are—

    - the rise in health-related inactivity "which represents perhaps the most worrying economic and fiscal legacy of the Covid pandemic",
    - the spike in gas prices in the wake of the Russian invasion of Ukraine and the impact this has had on energy demand, energy supply, and the fiscal costs of reaching the Government's net zero objective, and
    - government debt and the impact of recent rises in inflation and interest rates on its long-term sustainability.

[1] As measured by real household disposable income (RHDI) per person.
[2] 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.
[3] The OBR defines RDEL spending as departmental or day-to-day spending.

14. The report explains that almost 650,000 more adults were outside the labour market in the autumn of 2022 than at the start of 2020, due in part to one-off factors including an increase in the number of students going into further or higher education, and an increase in early retirements during the pandemic. However, the largest source of this rise in economic inactivity has been amongst those citing ill-health as their reason for not being in employment or looking for work. The OBR notes the fiscal impacts of this health-related inactivity, including—

- an additional £7 billion being spent this year on health-related benefits both for those in and out of work,
- £9 billion in forgone tax revenue from those no longer working for health reasons or working with a health condition, and
- on top of this, the OBR estimates that each individual moving into health-related inactivity could be costing the health service an additional £900 to £1,800 a year.[4]

15. The OBR notes that the significant increase in gas prices has brought considerable fiscal costs, both directly in the form of £78 billion of Government support for households and businesses in 2022 and 2023, and indirectly in the form of higher inflation. It further highlights "little sign in the UK of significant new investment in low-carbon energy and heating technologies in response to the rise in gas prices".[5]

16. Public debt, the OBR highlights, has more than trebled from below 30% of GDP at the start of the century to 100% of GDP now. It explains—

"Up until recently, the fiscal burden of the Government's rising debt stock was offset by low inflation and falling interest rates, with 10-year gilt yields falling from around 6% in 2000 to an all-time low of 0.2 per cent at the depths of the pandemic in 2020. However, both of these trends have dramatically reversed over the past year with RPI inflation peaking at a 40-year high of 13.8% in February of this year; and 10-year gilt yields climbing above 4 per cent in recent months."

17. In his presentation on the report, IFS Director, Paul Johnson, argued that "early action to tackle these risks and vulnerabilities can help to contain their fiscal consequences", adding "delay or inaction is likely to see debt continuing to rise toward unsustainable levels in the decades to come".

[4] It is unclear from the report whether these figures include the picture in Scotland.
[5] July 2023 Fiscal risks and sustainability report speaking notes (obr.uk)

Commentary on the UK Autumn Statement and wider context

Institute for Fiscal Studies

18. Paul Johnson stated in the IFS analysis on the Autumn Statement 2023 published on 22 November that—

    “Mr Hunt is, by the narrowest of tiny margins, still on course to meet his (poorly designed) fiscal rule that debt as a fraction of national income should be falling in the last year of the forecast period. In reality debt is set to be just about flat at around 93% of national income over the whole period. And that is on the basis of a series of questionable, if not plain implausible, assumptions. It assumes that many aspects of day-to-day public service spending will be cut. It assumes a substantial real cut in public investment spending. It assumes that rates of fuel duties will rise year on year with inflation – which they have not done in more than a decade and they surely will not do next April. It assumes that the constant roll over of “temporary” business rates cuts will stop. It assumes, of course, that the economy doesn’t suffer any negative shocks.”

19. He went on to say that “the fiscal forecasts have not in any real sense got better [and] debt is not declining over time”. Taxes, he explained “are still heading to record levels” and “spending is also due to stay high by historic standards, not least because of high debt interest payments”. However, “those payments plus pressures on health and pension spending mean current plans are for some pretty serious cuts across other areas of public spending”. He went on to argue that, in the context of no real improvement to the economic forecasts, the Chancellor was able to afford tax cuts by banking “additional revenue from higher inflation” and pencilling in harsher cuts to public spending.

Fraser of Allander Institute

20. The Fraser of Allander Institute, in its Autumn Statement 2023 Reaction published on 22 November provides analysis of the impact of the Chancellor’s announcements on Scotland. It notes that the “two main tax measures – lower NICs and making full expensing permanent – are UK-wide and apply automatically in Scotland”. Some other measures which apply to England only “bring additional funding for the Scottish Government, through the Barnett formula, totalling £233m in this financial year and £281m in the next”. This includes announcements on funding the pay award for the NHS in England in 2023-24, business rates relief, and freezing the small business multiplier in England.

21. The FAI further highlights that if the OBR’s “slightly higher spending assumption” than in March comes to pass, “it would mean Scottish Government spending power being higher in each year by between £1.1 bn and £1.4 bn from 2025-26 onwards”.

22. On 4 December, the FAI commented on the Scotland's economic outlook, observing that "the higher level of interest rates is likely to cool demand substantially, and is one of the main reasons for the OBR downgrading real GDP growth forecasts at UK level". It notes in relation to inflation that—

"CPI-measured inflation peaked in the UK at 10.7% in quarter 4 of 2022, and has been falling since then – though nowhere near as fast as in other countries, and at a slower pace than the OBR had previously anticipated. Whereas in March it expected CPI inflation to fall below target by early 2024, the OBR now sees it remaining above 2% until mid-2025."

23. The FAI goes on to highlight that, while inflation is falling this is not the same as falling prices, just that they are rising less quickly. While welcome, this still means there has been a permanent increase in the level of consumer prices which FAI notes will continue to grow for a further 18 months. The FAI states that "the sheer level of the inflationary shock, has caused a large increase in the price level which has not been met in full by increases in both labour and non-labour income". This impact, along with the freeze in thresholds for taxes on labour income by both the UK and Scottish Governments, has impacted on real household disposable income (RHDI) per person. The FAI notes that "the OBR is forecasting UK RHDI per person to fall for three years in a row – from 2022-23 to 2024-25 – in what would be the first time it has happened since records began in 1955".

SPICe

24. A SPICe blog on the Autumn Statement 2023 published on 23 November highlighted the Chancellor signalling that spending would remain tight in the medium term with day-to-day (resource spending) increasing by on average 1% in real terms (adjusted for inflation) from 2025-26 to 2028-29. It went on to note that the Chancellor reiterated the UK Government's intention for infrastructure (capital) spending to be held flat in cash terms through to 2028-29, and therefore to fall in real terms. This, SPICe suggests, means that the Treasury allocations for Scottish and UK departmental spending will grow more slowly than in recent years.

25. The blog further highlights the Deputy First Minister's letter to the FPA Committee of 21 November 2023, which sets out the budget lines where savings will be realised in the 2023-24 Budget and provides broad indications of how these funds would be used. As SPICe explains, "precise allocations were not presented but the letter states that the £680 million in savings were to fund things like public sector pay deals, the Scottish Child Payment, the Fuel Insecurity Fund, and inflationary pressures within the health and social care budget.

26. The Deputy First Minister explained in her letter that "in the absence of additional funding from the UK Government, I have no option but to make these tough choices", adding "this is critical, to balance the Scottish Government budget, whilst working to ensure that our resources are focused on our three critical missions outlined in the Policy Prospectus". In its blog, SPICe states that

"it is unclear why the Deputy First Minister chose to set out these budget savings the day before the Autumn Statement" and suggested that "the additional Barnett consequentials could go some way towards offsetting the savings required in 2023-24. It added "the exact impact will remain unclear until the Scottish Government's Spring Budget (expected in January or February 2024)".

Next steps

27. The Committee will take evidence from the Scottish Fiscal Commission on its December 2023 Economic and Fiscal Outlook and the Scottish Budget 2024-25 on 20 December 2023, following their publication on 19 December.

Committee Clerking Team
December 2023

Letter from the Deputy First Minister to the FPA Committee, 6 December 2023

Dear Kenneth,

The Office for Budget Responsibility (OBR) published updated UK Government tax revenue and social security benefits expenditure forecasts on 22 November. These forecasts inform the Block Grant Adjustments (BGAs) for the Scottish Budget 2024-25. Table A in the annex to this letter sets out the BGAs for Income Tax, Land and Buildings Transaction Tax (LBTT), Scottish Landfill Tax (SLfT), and the devolved social security benefits.

These BGAs only provide a partial view as the full impact on Scotland's Budget will not be known until the SFC publish its forecasts for devolved tax revenues and benefit expenditure in December.

This is the first fiscal event since the Fiscal Framework Review was agreed. It was agreed in the review that the Index per Capita method would be the permanent method for calculating BGAs, which protects Scotland from potentially slower population growth. The other BGA impact from the review is that Fines, Forfeitures and Fixed Penalties will now have a set BGA of £25m which will be applied at each Budget, rather than having a BGA based on forecast which is then reconciled to outturn.

As the 2023-24 BGAs for the Fully Devolved Taxes and Social Security benefits have been updated to reflect the latest forecasts of corresponding tax receipts and social security expenditure in the rest of the UK, we have calculated the in-year reconciliations required to the 2023-24 Scottish Budget, as outlined at Table B in the Annex. 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 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, as outlined in Table C in the Annex. Please note that the DWP outturn used to calculate the England and Wales part of social security BGAs is undergoing a final quality check and will be confirmed after the Scottish Budget is set. This outturn is not expected to change.

I hope you have found this update helpful, and my officials would be happy to provide any further information on the BGAs to Committee Members, as required.

Shona Robison MSP
Deputy First Minister

Annex

Table A: Block Grant Adjustments - OBR forecasts November 2023 (£m)

TAX	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Income Tax	-14,768	-16,530	-17,432	-18,125	-18,960	-19,877	-20,693
LBTT	-697	-533	-521	-592	-697	-800	-905
SLfT	-95	-82	-84	-76	-77	-77	-76
Total Tax	-15,560	-17,145	-18,037	-18,793	-19,734	-20,754	-21,674

SOCIAL SECURITY	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
AA	548	643	724	767	784	801	831
PIP	2,026	2,494	2,927	3,258	3,516	3,769	4.,005
DLA	735	820	877	909	925	942	937
CA	308	353	389	416	434	452	459
IIDS	78	83	85	84	81	79	76
SDA	6	6	5	5	4	3	2
CWP	23	6	6	6	6	6	6
WFP	N/A	N/A	178	181	182	180	181
TOTAL SS	3,724	4,405	5,191	5,625	5,931	6,231	6,497

indicates outturn data; Figures may not sum due to rounding

Table B: In-year reconciliations to the 2023-24 Budget

	2023-24 BGAs applied to 2023-24 Scottish Budget in December 2022 (£m)	2023-24 BGAs based on OBR 22 November forecast (£m)	Change in the forecast BGA from Scottish Budget (£m)
LBTT	-517	-533	-16
SLfT	-99	-82	+17
Fines, Forfeitures and Fixed Penalties*	-26	-25	+1
Social Security Benefits with a BGA**	+4,360	+4,405	+45
TOTAL	**+3,719**	**+3,765**	**+46**

*Ordinarily, there are no in-year reconciliations for Fines, Forfeitures and Fixed Penalties (FFFP). An agreement has been reached with HMT to apply a one-off in-year reconciliation of +£0.6m in order to align the BGA to the fixed position of £25m, as agreed in the Fiscal Framework Review.

**AA, PIP, DLA, CA, IIDS, SDA, CWP, WFP

Table C: Total Final Reconciliation Requirements for the 2024-25 Budget (£m)

Income Tax 2021-22		-389.9
Of which: Final Revenue reconciliation	+1,461.1	
Final BGA reconciliation	-1,851.0	
LBTT 2022-23 final BGA reconciliation		+19.5
SLfT 2022-23 final BGA reconciliation		+7.8
FFFP 2022-23 final BGA reconciliation		+3.2
PoC 2022-23 final BGA reconciliation		N/A
Social Security 2022-23 final BGA reconciliation		+21.4
Total Final Reconciliation Requirement		**-338.0**

*The baselines for three social security benefits (Personal Independence Payment, Severe Disablement Allowance and Industrial Injuries Disablement Scheme) have been revised due to changes to historic DWP outturn. The baselines for Scotland and England/Wales have changed by the same proportion, resulting in no substantial change to the BGAs.