Finance and Public Administration Committee
34th Meeting, 2023 (Session 6)
Tuesday 3 December 2024

Scrutiny of the Scottish Budget 2025-26: UK context

Purpose

1. The Committee is invited to take evidence from David Phillips and Ben Zaranko, Associate Directors at the Institute for Fiscal Studies, to inform its forthcoming 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 Government's 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 by HM 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 alongside the Budget in October, which will also confirm control totals for 2024-25".

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

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 will 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—

    - Employer **National Insurance Contributions** (NICs) will rise by 1.2% to 15% from 6 April 2025. The level at which employers will start paying

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

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]. 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 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".[7]

12. While public sector employers are expected to be compensated by HM Treasury for higher costs resulting from the NICs increase, it has yet to be confirmed what level of compensation will apply to Scotland, which has a

[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] Official Report

larger proportion of its working population employed in the public sector than in England. In October 2024, the Scottish Government has estimated that the UK Government's increase in NICs would add £500 million to Scottish public sector costs.[8]

13. On 20 November 2024, the Scottish Government published the indicative costs of the policy to the Scottish public sector based on newly collected data, gathered by the Scottish Government between 8 November and 15 November 2024 from estimates provided by portfolios and organisations. Key findings include that "the static increase in employer NICs might cost between £520 million and £580 million in financial year 2025 to 2026 for directly employed public sector employees in Scotland's devolved public sector, with a central estimate of £550 million". The Scottish Government also notes the latest estimates on potential Barnett consequentials of up to £380 million, suggesting a potential shortfall of around £140 million to £200 million. However, it adds, that this estimate of up to £380 million is subject to a high degree of uncertainty and could be much lower if, for example, some of the additional funding does not generate consequentials, or be higher if HM Treasury chooses to increase the overall sum available outside the normal operation of the Barnett formula.

14. The OBR observes in its October 2024 Economic and Fiscal Outlook 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". The Committee, in its Pre-Budget 2025-26 Report, expressed disappointment at the Scottish Government's decision not to publish an MTFS (and accompanying forecasts) during 2024. It stated that "the absence of an MTFS this year has undermined our ability to consider how the priorities for the next Budget sit within this longer-term context". The IFS may also have a view on these issues.

Productivity and labour market participation

15. In its October 2024 Economic and Fiscal Outlook, the OBR states 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".

16. In addition to productivity levels, the Committee has a long-standing interest in labour market participation. The OBR forecasts the participation rate 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

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

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”.

17. 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.

Institute for Fiscal Studies (IFS): recent publications

IFS response to the Autumn Budget 2024

18. In the Autumn Budget 2024: initial IFS response, IFS Director, Paul Johnson suggests to “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”.

19. 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”. In speaking notes for the IFS post-Budget presentation, Mr Johnson further notes that the Chancellor’s decision to raise borrowing in order to increase investment was, given benefits would not be seen for some time, “a courageous move and a welcome focus on the long term”. However, he went on to say that “if this government really wants to focus on growth, then part of the plan needs to be a much more coherent tax strategy than we saw [… in the 2024 Budget].

20. Mr Johnson further highlights that “the most striking aspect of the spending decisions is how incredibly front loaded the additional spending is”, explaining that “day-to-day public service spending, after inflation and the additional cost to public sector employers of rising National Insurance, is set to rise by 4.3% this year and 2.6% next year, but then by just 1.3% each year thereafter”. He suggests that 1.3% overall would almost certainly mean real terms cuts for some departments and “it would be odd to increase spending rapidly only to start cutting back again in subsequent years”. He goes on to say that “when it comes to settling with departments for the period after 2025-26 keeping within that 1.3% envelope will be extremely challenging”.

UK Budget impact on Scottish Budget 2025-26

21. In a paper published on 26 November 2024, the IFS states that the combined effects of changes made in Scotland's Autumn Budget Revision (ABR) and the UK's Autumn Budget have improved the Scottish Government's resource funding position this year. It highlights that—

    "Based on the latest inflation forecasts, the amount available for day-to-day spending on public services as of the original Scottish Budget plans would have been 0.6% *lower* in real terms than was spent last year. The top-ups announced in the ABR changed this to a 2.3% increase, while the further top-ups as a result of the UK Budget, if spent in full, would mean an increase of 5.9%. Some of the top-ups reflect SCAPE[9] funding for higher assumed pension costs – and so not a genuine increase in spending power – but even stripping this out the increase would be around 4.9%. The Scottish Government could choose not to spend all the resources now available to it – which the more difficult financial outlook for future years means may be wise."

22. The paper notes that the UK Government's decision to target winter fuel payment led to a reduction in funding for the Scottish Government of around £140 million. It states that, "if it wanted to, the Scottish Government could choose to defer the reduction in funding (given the UK Government's policy decision was made after the 2024-25 Scottish Budget was finalised), which would allow it to spend that money elsewhere in the short-term, but it would need to be paid back later on". While the Scottish Government is yet to make a final decision on deferral, the IFS highlights that "the funding figures published at the ABR assume the funding adjustment will be applied in-year rather than deferred".

23. The IFS notes that "the UK Autumn Budget confirmed substantially larger block grants for both day-to-day (resource) and capital spending next year: £41.1 billion and £6.5 billion, increases of £2.8 billion (7%) and £0.9 billion (17%), respectively, compared with the expectations set out in the 2024-25 Scottish Budget last December".[10]

24. Its own projections imply increases in funding between 2025-26 and 2028-29 that average 2.6% a year in cash terms and 0.7% a year in real terms, as compared with increases of 0.4% a year in real terms projected by the Scottish Fiscal Commission (SFC) in December 2023. Capital funding "may grow a little in real terms between 2025-26 and 2028-29, rather than fall …, but growth will be much slower than the bumper increase now planned for

[9] This refers to superannuation contributions adjusted for past experience, or SCAPE, discount rate. The IFS explains that discounting is used to reduce the value of future payments and express them in present-day terms. The choice of rate used for discounting … can have a large effect on the current value of a given future payment, especially when the payment is a long while away (as is often the case with pensions)".

[10] £0.3–0.4 billion reflects extra SCAPE costs rather than an increase in spending power. These figures also exclude compensation for Scottish public sector employers for the big increase in employer National Insurance contributions announced for April 2025.

next year". The IFS suggests that, despite these increases in funding, "tough choices on tax and spending in future years still loom for the Scottish Government". It goes on to argue that "in this context, the Scottish Government should plan realistically – recent years have seen something of a habit of over-promising and then delaying or scaling back some initiatives in order to free up funding for pay and NHS pressures".

25. The IFS further argues that the Scottish Government should set out its plans for future years in a Spending Review in the summer and evaluate key policies that increasingly differentiate it from the rest of the UK, including higher public sector pay, income tax policies and wider tax strategy.

Income tax: behavioural responses

26. The IFS also recently published a paper considering the behavioural impacts arising from Scotland having relatively higher income tax rates for those earning over £30,000. This notes that, although conclusive evidence is still to emerge, research suggests income tax affects how much people work, avoid, or evade tax, and migrate. It highlights the SFC's findings that such responses will offset half of revenues from the Scottish 45% rate and 85% from Scotland's top rate of tax.

27. The IFS states that, 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 slightly more than had been previously assumed in the SFC's policy costings. It further notes that the Scottish Government's income tax policies have "led to an increasingly complex income tax schedule in Scotland [and] the complexity introduced by having 19%, 20% and 21% is particularly unwarranted: for example, a small 0% band followed by a 21% band would be simpler and a little more progressive".

28. The IFS goes on to say that there remains a significant degree of uncertainty about the scale of effects, particularly for the changes in policy over the last two years. It also suggests "reports that the Scottish Government's tax strategy will commit to a structured process of policy appraisal and evaluation are welcome – it is important that this work continues for income tax".

29. It further suggests that the Scottish Government and HMRC should develop "more rapid indicators of the impacts of tax policy, using information from monthly PAYE income tax submissions by employers and changes of address by taxpayers—ideally publishing summaries and making (suitably anonymised) data available". Information from recruitment firms, payroll providers and financial services providers could also be explored. Finally, it argues that the Scottish Government should "be open to reversing course if new evidence again suggests bigger-than-expected behavioural impacts – a strategy should always be open to revision, not set in stone".

Operation of the Fiscal Framework

30. David Phillips is one of the authors[11] of the independent report that informed the fiscal framework review, which took place in July 2023. The IFS may therefore have a view on how the fiscal framework is operating in light of the changes that were put in place as part of last year's review. Following that review, the IFS (Mr Phillips) published an immediate response, which suggests that the changes arising from the review - inflationary increases to capital and resource borrowing limits, the doubling of borrowing limits to address forecast errors and abolition of limits on how much reserves the Scottish Government can draw down in any given year – are "an important step in the right direction … and will provide some extra flexibility to the Scottish Government to respond to forecast errors and financial shocks".

31. However, the paper goes on to suggest that "rather than link the limits to inflation, it would make more sense to link them to the amount of revenue and social security spending at risk, which will typically grow faster than inflation".

32. The independent report had also recommended granting the Scottish Government powers to be able to borrow a small amount of money to cover shocks other than tax and social security forecast errors, including unexpected shocks to public service spending or falls in tax revenues or rises in social security spending that are forecast in advance. This change was not implemented as part of the 2023 review. At the time the then Cabinet Secretary for Finance, Shona Robison MSP, stated that "the changes agreed with the UK Government are balanced and pragmatic [and][this new agreement strengthens the Scottish Government's financial management levers, and provides the Scottish Parliament and Government with greater long-term funding certainty".

NHS Recovery in Scotland

33. Published on 27 November 2024, the IFS has updated its analysis of NHS performance in Scotland. The IFS notes that "healthcare is the Scottish Government's largest area of spending, set at £20.6 billion this year, around one-third of the total Scottish Government Budget.

34. This analysis found that performance in the Scottish NHS remains below pre-pandemic levels across many measures [and] even more concerningly, many measures of performance have continued to worsen over the last year", including some waiting lists. This, it explains, is in large part because most NHS hospital activity remains far below pre-pandemic levels, as the average length of stay in hospital is much longer than before the pandemic. In contrast, in England, most performance measures considered in the analysis have improved over the last year, with a significant focus from the previous and current UK Governments on improving NHS performance and productivity. The IFS concludes that similar focus is needed in Scotland.

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[11] Professor David Bell and David Eiser were the other two authors.

35. The IFS makes clear that an important limitation of this comparison between England and Scotland is that it compares changes over time for each nation, rather than performance across nations. For example, “it may be that for some measures, performance was higher in Scotland than in England pre-pandemic, and so although performance is still declining, it could still be higher than in England”. The IFS goes on to say “however, performance comparisons between nations are complicated by measurement differences, so here we focus on how each nation’s performance has changed on its own terms”.

36. In relation to the Scottish Budget 2025-26, the IFS suggests that “the key question is to what extent this poor NHS performance will force the Scottish Government to prioritise further increases in health spending relative to other services”. It also notes that "there remains the ongoing challenge of ensuring that money is spent well, staff are deployed effectively, and productivity in the NHS is enhanced – all essential if waiting times are to be reduced”.

Funding for Scottish universities

37. In a paper published on 19 November 2024, the IFS highlights that “falls in funding for home students, a decline in international enrolments and higher labour costs[12], put Scottish university finances under pressure”. According to the IFS, Scottish universities in the year to July 2023 appeared to be in reasonable financial health, with the vast majority in surplus, of on average 5.2% of their income. It notes however that Scottish universities will receive 22% less per student this academic year than in 2013-14, with more than half of this fall taking place over the last three years.

38. As the Committee heard during pre-budget 2024-25 scrutiny, the decline in international students is a “… major risk to university finances”. The IFS highlights that fees income from full-time, non-EU postgraduate taught students in 2022-23 “accounted for more than a quarter of teaching resources at several universities, and for 40% at the University of Glasgow”.

39. The paper goes on to note that, “in the 10 months to October 2024, there were 16% fewer applications for visas to study in the UK than in the same period in 2023, and 14% fewer than in 2022”, Although these visas for study anywhere in the UK, “… we might expect the same drivers … to have dented demand for study in Scotland”.

40. The IFS also notes that “the tuition fee for home fee students remained flat in cash terms in 2024–25 at £1,820 – remarkably the fifteenth year in a row that it had been at that same cash level”. If the Scottish Government increased tuition fees in line with England, funding for universities would increase, while the UK Government’s decision to raise employer national insurance contributions will also impact on the finances of Scottish universities.

[12] Higher than anticipated staff costs as a consequence of the UK Government’s decision to increase employer national insurance contributions.

Disability payments

41. In a paper published on 8 November 2024, the IFS explores latest trends in relation to the Adult Disability Payment (ADP), introduced in Scotland in August 2022 as a replacement for the Personal Independent Payment (PIP), which remains in place in England and Wales. The IFS explains that “ADP has the same eligibility criteria and pays the same rates as PIP but is designed to be easier to apply for and, if a claim is successful, to get renewed at the end of the award”. It highlights that, “as of July 2024, the cumulative increase in Scotland relative to pre-pandemic norms was 32%, compared with 30% in England and Wales”, due to the consistently higher rate of applications since the launch of the ADP, when figures were 9% and 12% respectively. The IFS notes the SFC’s initial estimates in 2021 that ADP spending by 2026-27 would be £3 billion, £529 million above what would have been spent on PIP if the ADP reforms had not occurred. In December 2023, the SFC reduced its estimates for 2027-28 from £659 million to £409 million, “believing that the factors driving the rise in PIP in England and Wales would interact with the ADP introduction in such a way that the increase in Scotland relative to England and Wales would no longer be so large”.

42. The IFS goes on to highlight that “although we now appear to have passed the initial spike in applications, it is too early to judge the extent to which disability benefit reform in Scotland may lead to persistently higher caseloads”. It adds that the decline in face-to-face assessments and changes in award review outcomes in England and Wales “do offer one explanation […for] this smaller impact on recipient numbers than predicted”. However, it warns that more data will be required and that the Scottish Government “would be wise to bear … in mind” this significant uncertainty around the future path of disability benefit spending across the UK, when making its plans for the upcoming Budget”.

Next steps

43. The Committee will begin taking evidence in relation to the Scottish Budget 2025-26 on 10 December 2024.

Committee Clerking Team
November 2024