University of Strathclyde Business School

Scotland's Budget Report 2021

Fraser of Allander Institute

Executive Summary

In a few days time, on December 9th, the Scottish government will publish its budget for 2022-23. It will be the first budget of this session of parliament, following the elections in May.

Kate Forbes' third budget in charge of the Scottish Government's finances will arguably the most difficult she has faced.

Whilst the Scottish government will have more resources at its disposal than in 2019/20, the challenges facing public services and the wider economy are far more acute now than they were then.

If the 2022-23 budget looks challenging, subsequent years look likely to become even more difficult, as spending commitments on social security and social care, amongst other things, rub up against a total budget envelope that looks set to remain fairly constant in real terms.

An uncertain economic backdrop

The economy has recovered more quickly during 2021 than was forecast at the start of the year, and in some ways has proved remarkably resilient to the pandemic. But there are signs that the recovery is slowing. The uneven pace of the recovery across sectors and regions, combined with increasing inflation, was already making for a very uncertain outlook for the economy in 2022. The emergence of the Omicron variant adds further to that uncertainty.

The latest economic forecasts imply that the Scottish and UK economies will follow a very similar trajectory over the coming years. However, growth in total earnings was in fact slightly slower in Scotland than in rUK in 2020-21. This is currently attributed in part to the pandemic related impacts on the oil and gas sector, and as such is anticipated to be a temporary blip rather than the start of something more permanent. The modest impact on Scottish income tax revenues will affect the budget in 2023-24.

The block grant is higher than pre-pandemic, but the challenges are greater too

The Scottish government's core resource block grant will be £35bn in 2022-23, some 8% higher in real terms than it was in 2019-20 and higher than it has ever been outwith the 'pandemic years' of 2020-21 and 2021-22. But whilst the most significant direct fiscal impacts of the pandemic are (hopefully) in the past, the longer term legacy of the pandemic on public services remains acute. In the subsequent two years, 2023-24 and 2024-25, the resource block grant will remain unchanged in real terms according to current UK government spending plans.

The capital block grant is also set to remain higher than it was pre-pandemic, although only marginally so. Over the coming years, the capital investment programme will be at the heart of the government's policy aspirations to reduce climate change, by decarbonising transport, improving the efficiency of the housing stock, and invest in natural capital.

There are two key decisions on tax to look out for

The government faces two key decisions on tax in its budget.

On income tax, the government's manifesto commitments leave it with little room for manoeuvre. It could freeze tax thresholds in cash terms or increase them in line with inflation. Freezing thresholds would constitute a tax increase. It would bring in around an additional £140m in revenue compared to a decision to increase thresholds in line with inflation.

The government's decision on non-domestic rates has more significant revenue implications. The decision is how quickly to rollback the 100% rates reliefs for businesses in tourism, hospitality and leisure. Providing the full relief costs the government around £736m in reduced revenue. The longer the relief is maintained, the less likely it is to have tangible benefits.

Dealing with the legacy of the pandemic, and wider reforms, to health and social care will absorb a large proportion of budget increases

Health and social care are arguably the public services where the legacy of Covid-19 continues to be most significant. NHS activity remains below pre-Covid levels across many types of treatment and backlogs continue to build. Workforce pressures and constraints are acute in both sectors.

The government's commitment to 'pass on' health related consequentials implies that the health budget will increase substantially in 2022-23, taking it to around £17bn. This represents a 15% real terms increase on the 2019-20 level.

Over half of the increase in the government's budget is set to be passed to the health portfolio in the coming years. Even so, addressing the challenges in the sector – including the aspiration to increase capacity by 10% alongside other pressures and commitments – looks extremely challenging.

This parliament will see significant change to the structure of social care. Its not yet clear how far the government will go in implementing all the recommendations of the Feeley review. But it seems likely that the commitment to increase social care spending by 25% will not be sufficient to fully implement all the proposals.

Transformative change to Scotland's social security landscape will constrain the government's wider budget choices by the middle of the parliament

Aspirations to reduce inequalities of health, income and education remain at the heart of the government's agenda.

Nicola Sturgeon used the SNP conference last week to announce that a planned increase to the Scottish Child Payment, from £10 to £20, will take place at the start of the 2022-23 financial year. This doubling of the SCP, which was backed by all parties in their manifestos earlier this year, is critical to have any hope of achieving the legislated child poverty targets.

The rollout of the SCP is one element of broader transformational change of the social security system in Scotland during the forthcoming parliament. Taken together, the SCP and the planned more expansive system of disability and carers benefits will place significant constraints on the budget by the middle of parliament.

Meeting Net Zero targets will require new approaches to budgeting

The Scottish Government has legislated that Scotland will reach net zero by 2045, 5 years earlier than the UK as a whole. An interim target for 2019 was missed.

Meeting the government's net zero ambitions will require substantial policy interventions that cut across wide areas of devolved competence. The diverse, cross-cutting nature of interventions required to support the transition to a net zero economy means that keeping track of the budget's impact on emissions is challenging.

There is a critical need to improve the way that the impact of budget decisions on net zero targets is examined and assessed, in order both to assess progress and determine what other interventions may be required.

Budget pressures are likely to increase, rather than dissipate, in subsequent years

Taken together, the commitments on health and social care and the policies on SCP and other social security will place increasing pressure on budget. The pressure is not so acute in 2022-23 but will build during parliament as changes are rolled out.

It is likely that the resources available to the Scottish government to fund spending on public services other than health, social care and social security could decline in real terms between 2022-23 and 2024-25.

In this context, the publication next year of a Spending Review takes on added significance.

Conclusions

The first budget of a new parliament is often a particularly exciting affair, as a new set of policy commitments and aspirations begin to shape the tax and spending decisions of government.

A core resource block grant in 2022-23 that is 8% higher than pre-pandemic might sound generous, but to deal with the pandemic's legacy and underlying public services pressures it is anything but. In this context, Kate Forbes' third budget may well be her most challenging.

But the challenges are unlikely to dissipate in subsequent years, as commitments and aspirations on health, social care and social security in particular rub up against a real terms budget that is currently forecast to remain flat in real terms between 2022-23 and 2024-25.

So a challenging budget for 2022-23 is the precursor to a challenging spending review next year.

Navigating the health and economic recovery from the pandemic, alongside longer term commitments on climate change and inequality will require a delicate set of budget decisions and trade-offs. This week's budget will reveal how those choices and trade-offs have been made for 2022-23, but the more difficult trade-offs may yet be to come.

Scotland's Budget Report 2021

Introduction

In a few days time, on December 9th, the Scottish government will publish its budget for 2022-23. It will be the first budget of this session of parliament, following the elections in May.

During the election campaign, all parties made expansive pledges to support the recovery of public services and the economy from the pandemic, whilst at the same time meeting key aspirations on climate change and poverty. The budget is the first opportunity for the Scottish Government to set out, in detail, the implications of these aspirations for its detailed plans for taxing and spending.

The backdrop is extremely challenging. Whilst the resources available to the Scottish government in 2022-23 will be significantly higher than in 2019-20, it will have fewer resources available to it than in either of the last two years. Yet the legacy of the pandemic on public services remains significant. At the same time, there remains significant uncertainty over the pace and strength of the economic recovery.

The budget will include detailed tax and spending plans for 2022-23 only. But it will be published alongside a new Medium Term Financial Strategy and a high level framework for a more detailed spending review. The spending review itself will be published next year.

Whilst the budget decisions for 2022-23 look challenging – given the legacy of the pandemic on public services and ongoing uncertainty – in many ways the financing pressures facing the government are likely to become more acute over the rest of the parliament, as commitments to roll-out various services ramp up.

This report sets out the context to the Scottish budget 2022-23 that will be published later this week, and the broad outlook for the two years beyond this. It describes the economic outlook and the level of funding available to the government and it sets out the fiscal implications of government's key policy commitments and choices.

The economic recovery has gathered pace, but big uncertainties lie ahead

The economy has recovered more quickly during 2021 than was forecast at the start of the year in the UK as a whole and in Scotland (Chart 1). In January, the SFC forecast that economic activity would not return to pre-pandemic levels until Q1 2024, with unemployment peaking at 7.6% in 2021. By August it was forecasting that economic activity would return to pre-pandemic levels by the second quarter of 2022, with unemployment peaking at 'just' 5.4% in the fourth quarter of 2021 (latest data indicates the unemployment rate was 4.1% in the third quarter of 2021).

The more rapid than initially forecast recovery in economic activity is the result of the success of the vaccine rollout, as a result of which restrictions could be lifted more quickly than seemed realistic in January, combined with adaptations of businesses and consumers to public health restrictions. The improvement in outlook for unemployment reflects in large part the success of the furlough scheme, although it also masks a rise in inactivity for some groups.

The SFC's upward revisions to forecasts of the economic recovery mirror those made by the OBR for the UK as a whole. Between its March and October forecasts, the OBR revised up its forecasts for UK economic growth in 2021 from 4% to 6.5%. More significantly, it also reduced its forecast of the 'scarring' effects of the pandemic – the permanent economic impacts of Covid-19 – from 3% to 2% of GDP, mirroring the same judgement the SFC had made in its August forecast.

These improvements in the short-term and medium-term economic outlook feed through to improved forecasts of tax revenues at UK level. In fact the upward revisions to the OBR's forecasts between March and October provided the Chancellor a fiscal windfall of £140 billion over the five year forecast horizon. The Chancellor effectively decided to bank half this windfall and spend the other half. We discuss what this means for the Scottish budget subsequently.

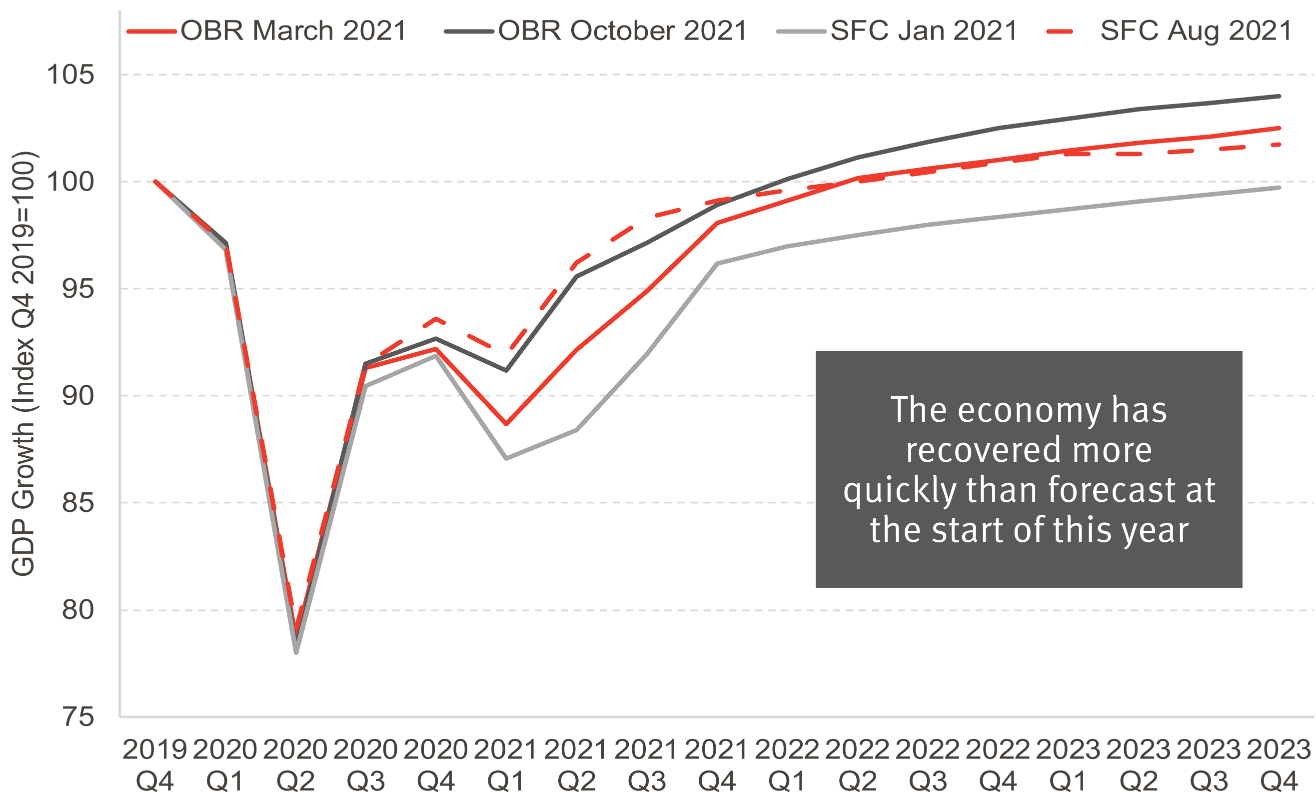
But whilst there have been improvements in the economic outlook throughout the year, for Scotland and the UK, there are a number of challenges and risks to the outlook.

There were signs that the pace of the recovery – driven in the early part of the year by a rebound in consumer spending – had begun to slow over the summer as the initial impacts of the reopening waned. Whilst the savings ratio did increase substantially during the pandemic, we cannot expect its unwinding to deliver substantially elevated spending indefinitely. A further uncertainty is the extent to which business investment – which fell substantially during the pandemic, will contribute more to growth next year.

Inflation has picked up markedly during the year due to a combination of the rebound in demand, supply bottlenecks both globally but exacerbated in the UK by changes to migration and trading regimes, and a spike in global energy prices. Even if the spike in inflation remains temporary (which continues to be the expectation of the OBR which expects inflation falling back to 2% by 2024), temporarily higher inflation in 2022, combined with the effects of tax increases, will constrain household incomes. Ongoing supply chain constraints will also dampen growth, and whilst they might create upward wage pressure in some sectors, this effect on wage pressure is unlikely to be universal.

Perhaps most significantly, the recovery from the pandemic remains very uneven across sectors and geographies, and there is ongoing uncertainty around how this might affect the recovery. Whilst the SFC forecasts economic activity will have returned to pre-pandemic levels by Q2 2022, it expects output will remain significantly below pre-pandemic level in sectors such as arts and recreation, transport, and accommodation and food. The extent to which workers can reallocate across sectors or geographical areas in response to more permanent structural changes following the pandemic is an important determinant of the ongoing recovery. Policy has a clear role to play here. And as we discuss later, the pandemic continues to have a legacy more widely on health and education, and a wide range of public services.

Chart 1: SFC and OBR forecasts for GDP growth (Q4 2019 = 100)



Source: *SFC & OBR*

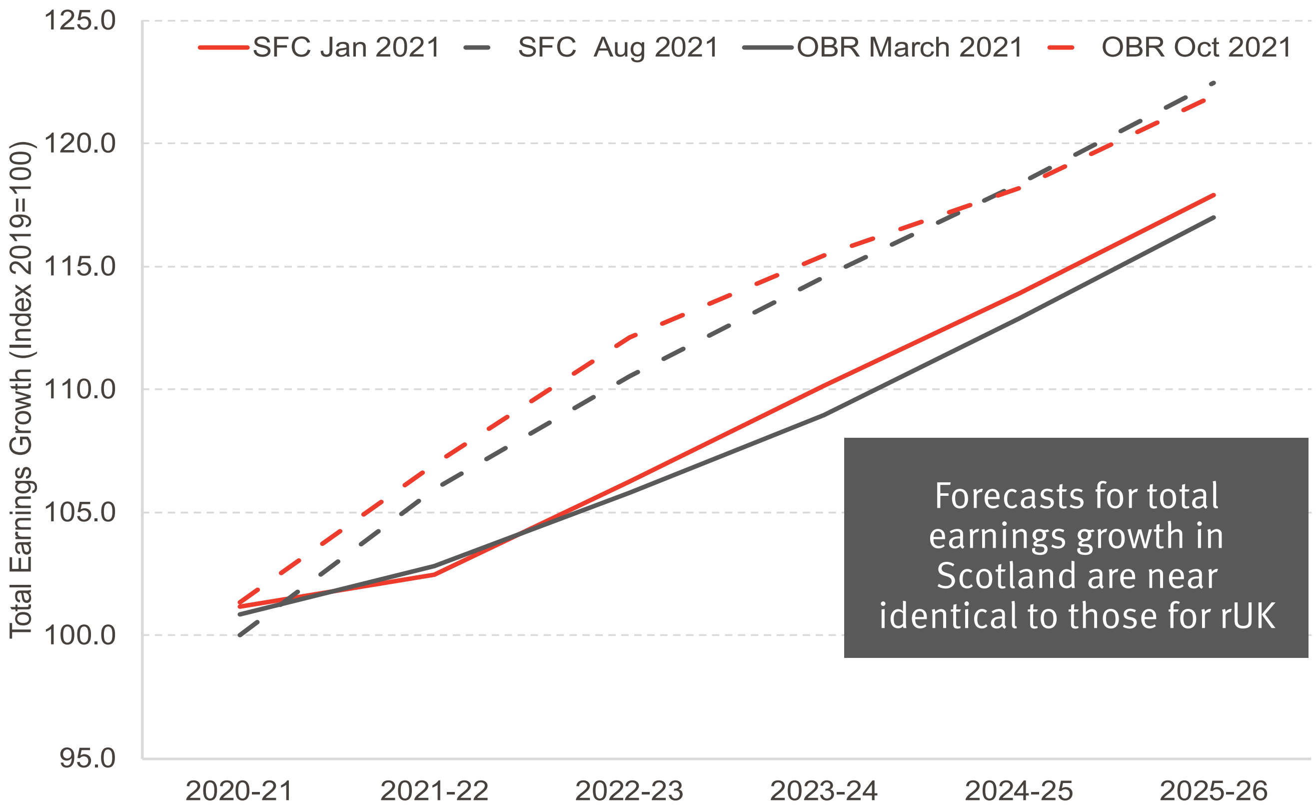
The Scottish and UK economies are forecast to follow very similar trends

That general picture outlined above is equally applicable to Scotland as it is the UK. Indeed, trends in Scottish economic activity and the labour market during the pandemic and recovery continue to mirror those in the UK very closely.

In fact, comparing the SFC's August forecast with the OBR's October forecast reveals a remarkable degree of consistency (Chart 2). The SFC forecasts that total nominal earnings (a function of both the growth in average earnings and growth in employment) will grow by 10.5% between 2020/21 and 2022/23. The OBR's forecast implies 10.6% over the same period .

This consistency is also seen over a longer period, with both the SFC and OBR forecasting growth in total nominal earnings of 22% between 2019/20 and 2025/26. (Underneath these headline numbers there are differences between the two forecasts, with employment growth contributing more to the OBR forecasts and average earnings growth contributing more to the SFC forecasts).

Chart 2: SFC and OBR forecasts for total earnings (2019-20 = 100)



Source: *SFC & OBR*

There is a caveat to this conclusion about consistency which is evidence of slightly weaker total earnings growth in Scotland in 2020/21. Both the OBR and the SFC highlight the disproportionate impact on the Scottish economy of falls in the global oil price during 2020 as a material factor in this. The impact of this relatively weaker earnings growth in Scotland, according to the latest forecasts, is that Scottish income tax revenues will contribute around £100m less in 2020/21 than was forecast at the time of the budget[1]. If confirmed when outturn data is available, this will impact the Scottish budget in 2023/24 (but not in 2022/23) via the reconciliation process. On the basis of the latest forecasts, this slight wobble in the Scottish earnings data is temporary and quickly and returns to a similar trajectory as in rUK.

Forecasts of GDP growth are also very similar across the OBR and SFC, and the technical conditions for triggering of a Scotland specific economic shock no longer apply[2].

1 The contribution of Scottish income tax to the Scottish budget depends on the difference between income tax revenues raised in Scotland, and the 'block grant adjustment' which is deducted from the block grant to offset the fiscal effects of the revenue transfer from the UK to the Scottish budget. This difference was forecast at £46m when the 2020/21 budget was set, but is negative £51m according to latest forecasts.

2 In January 2021, forecasts for economic growth indicated that Scotland's growth rate would, in Q3 2021, be below one per cent and simultaneously more than one per cent below the UK growth rate. This met the criteria for a 'Scotland specific economic shock', triggering additional fiscal flexibilities for the Scottish Government. For further information see https://fraserofallander.org/an-economic-shock-and-an-income-tax-boost-making-sense-of-the-2021-22-budget-forecasts/

This remarkable consistency in forecasts should not be taken as evidence that there is little uncertainty in the forecasts. There remains substantial uncertainty, for reasons alluded to above. But it indicates that forecasters see little evidence yet that the recovery is progressing at a materially different pace in Scotland as for the UK as a whole, nor that any of the uncertainties and risks bear more heavily on Scotland than the UK. A crucial question is whether there is any change to this general picture when the SFC publishes its next forecasts alongside the budget.

The core resource block grant is higher than it has ever been outside of the pandemic Scottish and UK economies are forecast to follow very similar trends

The Scottish Government's block grant from Westminster remains the key determinant of the of resources available to the Scottish budget to fund day-to-day public services spending. The outlook for the block grant is determined by UK Government's planned spending in England on services that are devolved to Scotland.

In the UK government's October budget and Spending Review, the Chancellor announced substantial increases in departmental spending for 2022/23 – 2024/25, relative to what had previously been planned. As a result, UK departmental spending will be £42bn (12%) higher in 2022/23 than it was in 2019/20[3], and it will be £38bn higher than had been pencilled-in at the UK government's March 2021 budget.

What does this mean for the Scottish resource block grant over the next three years? The core Scottish resource block grant in 2022/23 is set to be £35bn. This is higher in real terms than ever previously in 'normal' times – i.e. other than during the pandemic years of 2020/21 and 2021/22. But the overall size of the Scottish government's grant funding in 2022/23 will be less than in the previous two years (Chart 3).

In 2020/21 and 2021/22, when the direct costs of the pandemic on public services were acute, the Scottish Government received additional 'Covid-19' funding from the UK government of £8.6bn and £4.9bn respectively, on top of its 'core' block grant.

This distinction between core and Covid-19 grant funding complicates the picture about what is happening to the Scottish budget overall, and has led to some disagreement between the UK and Scottish governments as to interpretation.

The UK government highlights that the core block grant in 2022/23 is substantially higher (about 8% in real terms) than it was pre-pandemic, and higher than it has ever been previously. The Scottish government highlights that its total block grant – including core and Covid-19 funding – will decline in 2022/23 by around 7% compared to the previous year.

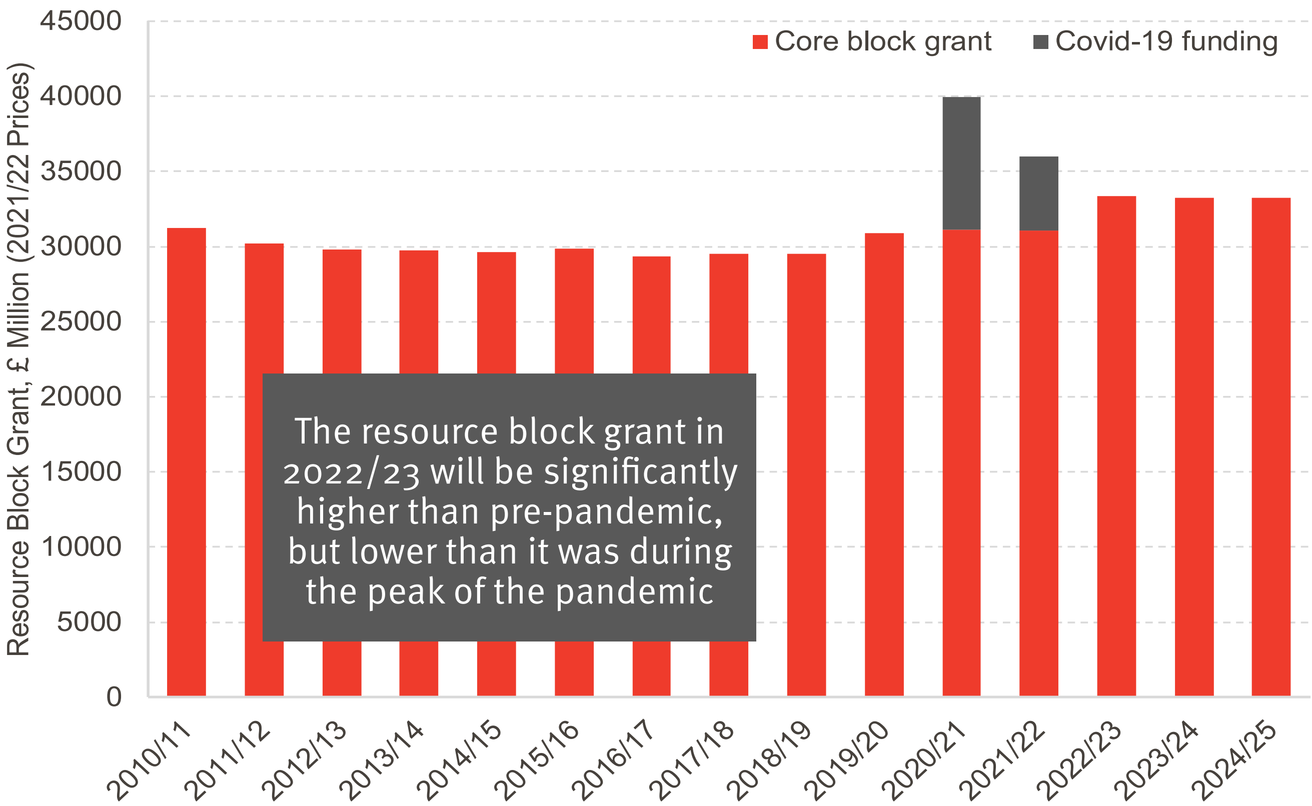
The debate about whether the block grant in 2022/23 is the 'highest ever' or a '7% cut' is somewhat unhelpful. In principle the direct costs of the pandemic on public services should be lower in 2022/23 than they were in 2021/22, and in this context, using 2021/22 as a baseline on which to judge future spending changes seems unreasonable. But at the same time, the pandemic will have ongoing, substantial legacy impacts on public spending, and in this context, using 2019/20 (or any other pre-pandemic year) is not particularly meaningful.

3 Source: Table 3.3 of OBR's Supplementary fiscal tables (October 2021)

The more important question is what is a realistic level of funding to support the public service recovery from the pandemic and achieve the public service outcomes desired? We return to this question in the context of specific services in subsequent sections of this report.

On the basis of the UK government's current spending plans, the resource block grant in real terms is set to be broadly unchanged in 2023/24 and 2024/25 from its 2022/23 level. Effectively, increased funding announced at the spending review has been 'frontloaded' in the expectation that the legacy impacts of Covid will become less acute over the spending review period.

Chart 3: Outlook for the Scottish resource block grant



Source: *HM Treasury, Scottish Government*

Capital investment will be higher this parliament than last

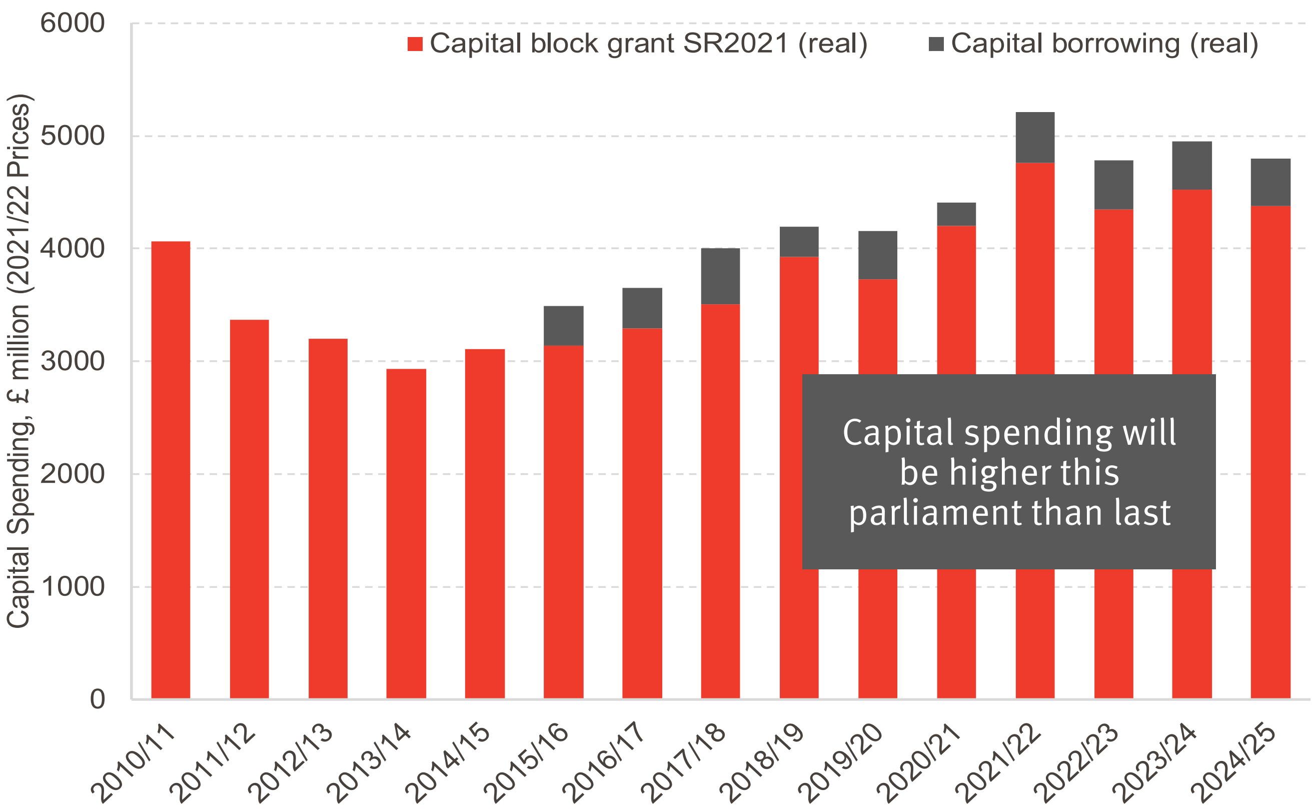
In addition to its resource spending budget (to fund day-to-day public services), the Scottish government also has a capital budget for funding longer term investment.

The Scottish budget 2021/22 set out capital spending plans of £5.8bn. The vast majority of this capital spending is funded by grant from the UK government, although it was also supported by planned Scottish government borrowing of £450m.

In the last parliament, the Scottish government's core block grant for capital investment increased substantially in real terms, undoing the impacts of capital spending cuts made by the UK government in the wake of the financial crisis (Chart 4). In 2022/23 and the subsequent two years, the core block grant for capital investment is projected to remain fairly constant in real terms, at around £4.5bn per annum.

Together with additional capital grant from the UK government associated with rail services, and its borrowing powers, the Scottish government is on course to meet the National Infrastructure Mission it established in the 2018 Programme for Government – to increase annual investment in infrastructure by £1.56 billion by 2025-26 – a total investment value of over £33 billion pounds in the next five years. Achievement of this target is, and always was, largely dependent on UK government decisions on capital spending, which determine the Scottish block grant. The UK government's capital spending plans are bounded by a target to limit public sector net investment to three per cent of GDP. There is a degree of arbitrariness to the target, but it is what will shape the outlook for the Scottish government's capital budget over the next few years.

Chart 4: Scottish government capital block grant and capital borrowing [4]



Source: *HMT, SG*

On a practical level, capital investment is largely about investments in transport, housing, and

4 For comparability, chart excludes grant in respect of National Rail; this was introduced in 2019/20 following reclassification of National Rail from a private to public operator and has been associated with additional grant of £750m in 2020/21 and 2021/22. Chart also excludes Financial Transactions, a specific form of ringfenced capital grant which can only be used to provide loans to the private sector (Financial Transactions Expenditure of £200m was included in the 2021/22 budget).

public buildings. The overall investment portfolio is framed by the government's Infrastructure Investment Plan which identifies strategic priorities around the transition to net zero, inclusive economic growth, and resilient and sustainable places. Over the coming years, the capital investment programme will be at the heart of the government's policy aspirations to reduce climate change, by decarbonising transport, improving the efficiency of the housing stock, and invest in natural capital. We consider the policy ambitions around net zero subsequently.

Taxes are on the rise in Scotland and the UK

The UK government has set out plans for significant tax increases over the next few years. Most notably these include increases in Corporation Tax, the introduction of a new Health and Social Care Levy, and freezing of the personal allowance and higher rate threshold of UK income tax for a four-year period from 2022/23 to 2025/26. The latter represents an increase in the tax burden through what is known as 'fiscal drag' – taxpayer incomes grow on average whilst tax thresholds remain fixed, increasing tax liabilities for a given level of income.

Taken together these tax rises are substantial, and will help take UK tax revenues as a percentage of national income from 33% pre-pandemic to 36% by 2026.

The first two of these changes, to Corporation Tax and the Health and Social Care Levy – will apply UK-wide. The income tax changes are somewhat more complicated given that income tax is partially devolved. The freeze to the Personal Allowance will apply in Scotland (although in principle the Scottish Government could set a higher 'effective allowance' in Scotland by introducing a new zero rate band of income tax in Scotland). However, decisions on tax thresholds in Scotland are determined by the Scottish Government.

The Scottish Government faces two big decisions on tax in its 2022/23 budget:

- First, how quickly should it unwind the 100% non-domestic rates reliefs for businesses in the retail, hospitality and leisure sector?
- Second, should it freeze income tax thresholds at 2021/22 levels, or increase them in line with inflation?

Unwinding non-domestic rates reliefs: a £700m question

The decision on non-domestic rates will have significant impacts on government revenue. The Scottish Government's most significant tax cut during the pandemic was the introduction, from April 2020, of full reliefs for businesses in the retail, hospitality and leisure sectors, which was forecast to cost £824m in reduced revenues in 2020/21[5] (this includes the cost of rates relief of 1.6% to all other businesses, at a cost of £51m).

In 2021/22 the Scottish Government has maintained the 100% retail, hospitality and leisure relief. The full cost of this relief is estimated by the SFC to cost some £736m in reduced revenues[6]. The cost of this relief in 2021/22 is somewhat lower than in 2020/21 in part because it was applied automatically in the first year, but is done on the basis of application in the second year.

The NDR relief in Scotland in 2021/22 is more generous than the equivalent relief that prevails in

5 Source: SFC NDR Supplementary costings March 2020
6 Source: SFC August 2021 forecasts

England. In England, 100% relief to businesses in the retail, leisure and hospitality sectors only applied for the first three months of the financial year, before falling to 66% for the remainder of the year (the English reliefs also included caps on the maximum level of relief that can be awarded).

It seems likely that the Scottish Government will seek to begin to unwind the 100% rates relief during 2022/23. As the economic recovery continues, the policy becomes harder to justify, particularly given its significant cost. Nonetheless, trading conditions may remain challenging in specific areas or for some specific sectors. The government will need to weigh up the importance of rates reliefs support in specific circumstances against its broader spending plans.

The UK government's decision to provide 50% NDR reliefs to retail, hospitality and leisure businesses in England in 2022/23 will also be a material factor in influencing the Scottish government's decision. Unwinding rates relief in full from April 2022 would provide around an additional £740m for public spending next year compared to 2021/22. But a decision to phase out reliefs more gradually will reduce the government's spending power.

Income tax: to freeze or not to freeze? A £140m question

On income tax, the SNP Manifesto committed to making no change to the five-band structure of Scottish income tax, and the rates applied to each of those bands. It also committed to increasing the income tax thresholds – the incomes at which the different rates apply – by a 'maximum' of inflation over the parliament.

In this context, the government's options on income tax policy are limited. Given the UK government's decision to freeze the higher rate threshold (at £50,270), the Scottish Government may well decide to freeze thresholds in Scotland at their 2021/22 cash levels. In the context of inflation of around 3 per cent, this would represent a tax increase in 2021/22, albeit one that mirrors the UK tax rate increase and thus maintains the existing divergence between the Scottish and UK income tax schedules.

Alternatively, the Scottish government could choose to increase tax thresholds in Scotland in line with inflation, currently around three per cent[7] (see Table 1). Doing so however would come at the cost of reduced revenues. Increasing the income thresholds at which different tax rates apply by inflation would reduce income tax revenues by up to a maximum of £140m, compared to the option to freeze thresholds in cash terms.

Table 1: Two scenarios for Scottish income tax bands in 2022/23

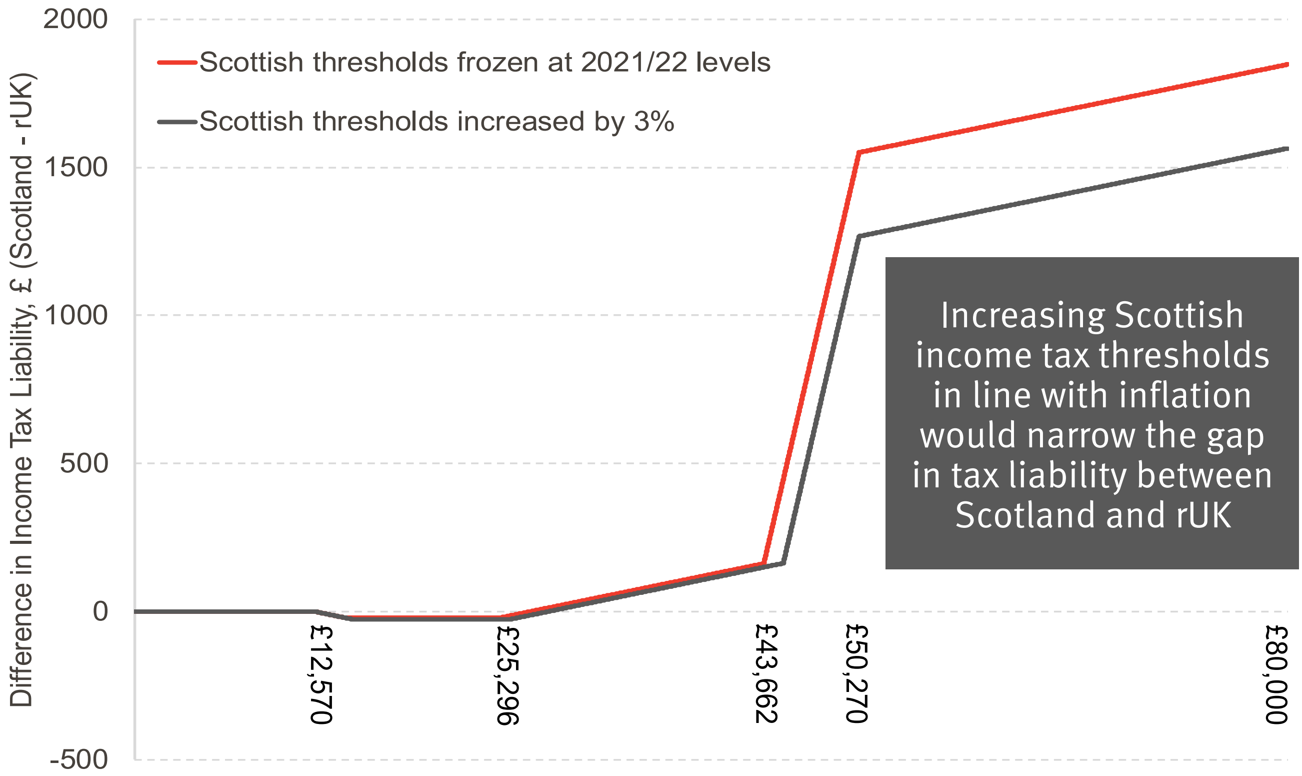
Band name	Rate	Potential bands in 2022/23	
		If frozen at 2021/22	If increased by 3%
Starter rate	19%	£12,570 - £14,667	£12,570 - £15,123
Basic rate	20%	£14,667 - £25,296	£15,123 - £26,080
Intermediate rate	21%	£25,296 - £43,662	£26,080 - £45,012
Higher rate	41%	£43,662 - £150,000	£45,012 - £150,000
Top rate	46%	Over £150,000	Over £150,000

Source: *FAI Calculations*

7 Tax threshold indexation is typically made on the basis of the annual inflation over the period to September. In the 12 months to September 2021, inflation was 2.9% and 3.1% according to the CPIH and CPI respectively.

Of course, the government could go for an intermediate option between the extremes of a cash freeze and a full inflationary increase. Confusingly, one outcome that is possible is for the government to announce that it is increasing tax thresholds 'by inflation', but for the actual increase in the income thresholds at which different tax rates apply to increase by less than inflation. This is because inflationary increases to Scottish tax thresholds tend to be applied to the 'portion' of income above the personal allowance, rather than to the cash value of the threshold itself[8]. But there is no rule that binds the government to this outcome (increasing the 'portions' of income above the PA by inflation makes sense if the PA itself is increasing by inflation, but could have odd outcomes if applied when the PA is frozen).

Chart 5: Difference in tax liabilities by gross income between Scotland and rUK under two scenarios for Scottish income tax in 2022/23



Source: *FAI Calculations*

The conclusion however is that on income tax the government has little room for manoeuvre on its income tax policy choices in 2022/23 given existing commitments. The decision is basically whether to freeze thresholds at 2021/22 levels – which maintains existing divergence with UK policy and

8 Inflationary increases to Scottish income tax thresholds are applied to the 'potion' above the Personal Allowance and added back on to the Personal Allowance, rather than being applied to the gross value of the threshold itself. So for example, the starter rate portion of £2,097 in 2021/22 would be increased by inflation to arrive at the 2022-23 starter rate portion of £2,154; as a result, the starter rate threshold in gross income terms would increase from £14,668 to £14,725, an increase of 0.4%. For the higher rate thresholds, the portion above the PA of £31,092 in 2021/22 would be increased by inflation to arrive at a figure of £32,271 in 2022/23; as a result, the higher rate threshold would increase from £43,662 to £44,841, an increase of 2.7%.

provides relatively more revenue to government – or to increase thresholds in line with inflation, implying somewhat lower tax liabilities for income taxpayers, and correspondingly lower revenues for government (relative to the freeze scenario)[9].

The latter policy would reduce the existing gap in income tax liabilities of Scottish higher rate income taxpayers relative to taxpayers with equivalent income in rUK (Chart 5).

One other tax decision to look out for is the cap on council tax increases. Council tax was frozen in 2021/22 to protect household incomes during the pandemic, although this came at a cost to government of £90m to compensate council budgets.

In relation to other taxes, there is no indication that major changes are being seriously mooted for 2022/23. Longer term the Scottish Government has been making the case for further tax devolution – potentially to include National Insurance Contributions, full devolution of income tax and VAT, and Capital Gains Tax. But it will take several years to agree and implement these sorts of changes.

Expansion of health and social care spending will dominate the Scottish Government's spending increases this parliament – but will it be enough to secure the outcomes desired?

Covid-19 has accentuated pre-existing delivery challenges

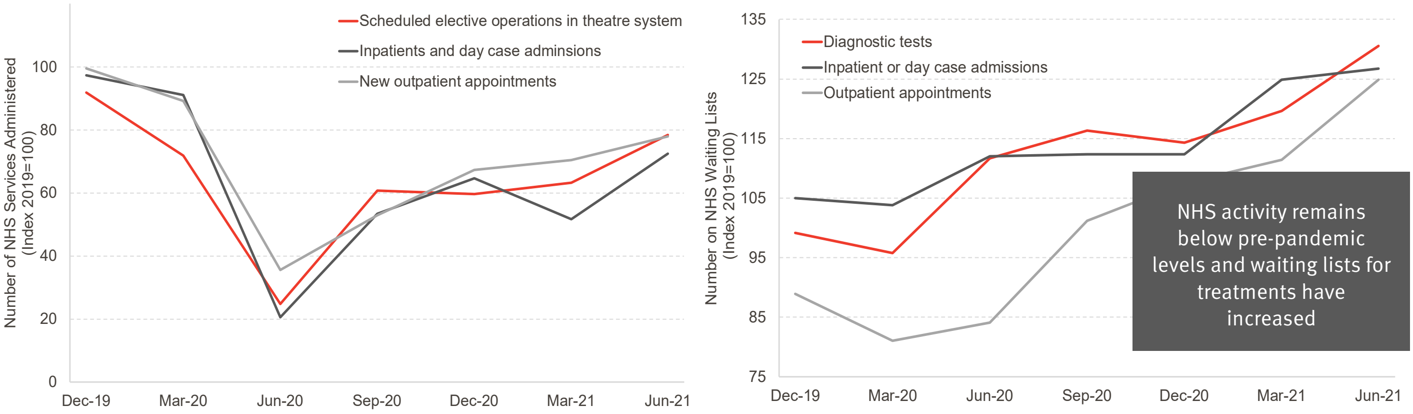
The NHS and the social care sector were under huge pressure before the pandemic. Workforce challenges and increasing demand – as a result of demographic change and increasing costs – were straining the achievement of targets and delivery of outcomes.

The pandemic has accentuated many of those challenges. In the immediate term, Covid-19 is still placing huge strain directly on the NHS. There are currently over 700 patients in hospital with Covid-19, on top of the costs associated with test and trace and vaccination programmes – and the ongoing presence of the pandemic continues to reduce the operational capacity of hospitals and social care.

Even if these direct costs dissipate by spring 2022, the legacy of Covid will continue to have an effect on demand for healthcare over the next few years. NHS Scotland data show that NHS activity declined dramatically during the first wave of the pandemic, and remains below pre-pandemic levels. As a result, the number of patients awaiting treatment is significantly above pre-pandemic levels (Chart 6). Additionally, the legacy of the pandemic is likely to include the need to treat long-Covid and a rise in the prevalence of people facing mental health issues.

9 In principle the Scottish government could reduce tax thresholds in cash terms to raise additional revenues, but we have assumed that this is unlikely.

Chart 6: Number of NHS Services administered as a percentage of 2019 average, and number of patients on NHS waiting lists



Source: *Public Health Scotland*

Covid-19 has also placed huge pressure on the social care sector. At the start of the pandemic, there were reductions in care packages for many people who drew on social care support, with family and friends asked to take on additional caring responsibilities. One impact of this is that there is likely to be a higher burden of care required in the future for people whose health deteriorated due to reduced levels of care over the course of the pandemic. Unpaid carers have reported that the continued closure of services such as day centres to pre-pandemic levels is putting increasing strain on their health and wellbeing.

Across the health and social care system, workforce challenges are key in raising capacity and quality of services. The NHS workforce increased during the pandemic, but vacancies remain high and recruitment challenging[10]. In social care, the pay and conditions of the workforce are an important factor underlying staff shortages; but the 'system' also relies on the contributions of 'unpaid' carers.

These challenges come on top of the pre-existing long-term challenges arising from demographic change and other cost pressures facing the health and social care sectors. For example, the number of people with severe dementia is forecast to rise from 39,000 in 2019 to 74,000 by 2040[11], with an associated cost increase increasing from £2.7bn in 2020 to £3.4bn by 2025, and to £6.8bn by 2040; this includes the costs to the health and social care system and to unpaid carers.

Prior to the pandemic, the Scottish Government's Medium Term Health and Social Care financial framework projected that health and social care spend would need to rise by 3.5-4% per annum (equivalent to approximately 2% in real terms) to keep up with demographic trends, more complex treatments and other cost pressures[12]. The government has committed to review this financial framework in the light of the pandemic which, as we have discussed, will have a major legacy on the health and social care system.

10 See Audit Scotland (2021) NHS in Scotland 2020 https://www.audit-scotland.gov.uk/report/nhs-in-scotland-2020
11 Wittenberg R. (2019) Projections of older people living with dementia and costs of dementia care in the UK, 2019 – 2040. London School of Economics, November 2019.
12 Scottish Government (2018) Health and social care: medium-term financial framework https://www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/documents/

In advance of this, the government has already made high profile spending commitments relating to health and social care, set out in its 2021 manifesto and reiterated in the 2021 Programme for Government.

Health spending is on course to be substantially higher than pre-pandemic, but the challenges facing the NHS are daunting

The 2021/22 budget set out health spending of £16.1bn. Of this, £0.9bn related to Covid-specific funding, leaving a core health budget of £15.2bn, with £12.2bn of this core health budget being defined as 'frontline' spending[13].

The government's health spending commitments were outlined in its 2021 manifesto, and reiterated in the 2021 Programme for Government. The government has committed to ensure that investment in frontline health services increases by at least 20% over the course of the parliament, a cash increase of at least £2.5bn.

Spending commitments expressed in such terms sound substantial, but remember that a 20% cash increase over five years amounts to a real terms increase of barely 1.5% per year given the current outlook for inflation – which is the bare minimum that health spending is expected to need to increase by in the longrun to address demographic and other cost pressures.

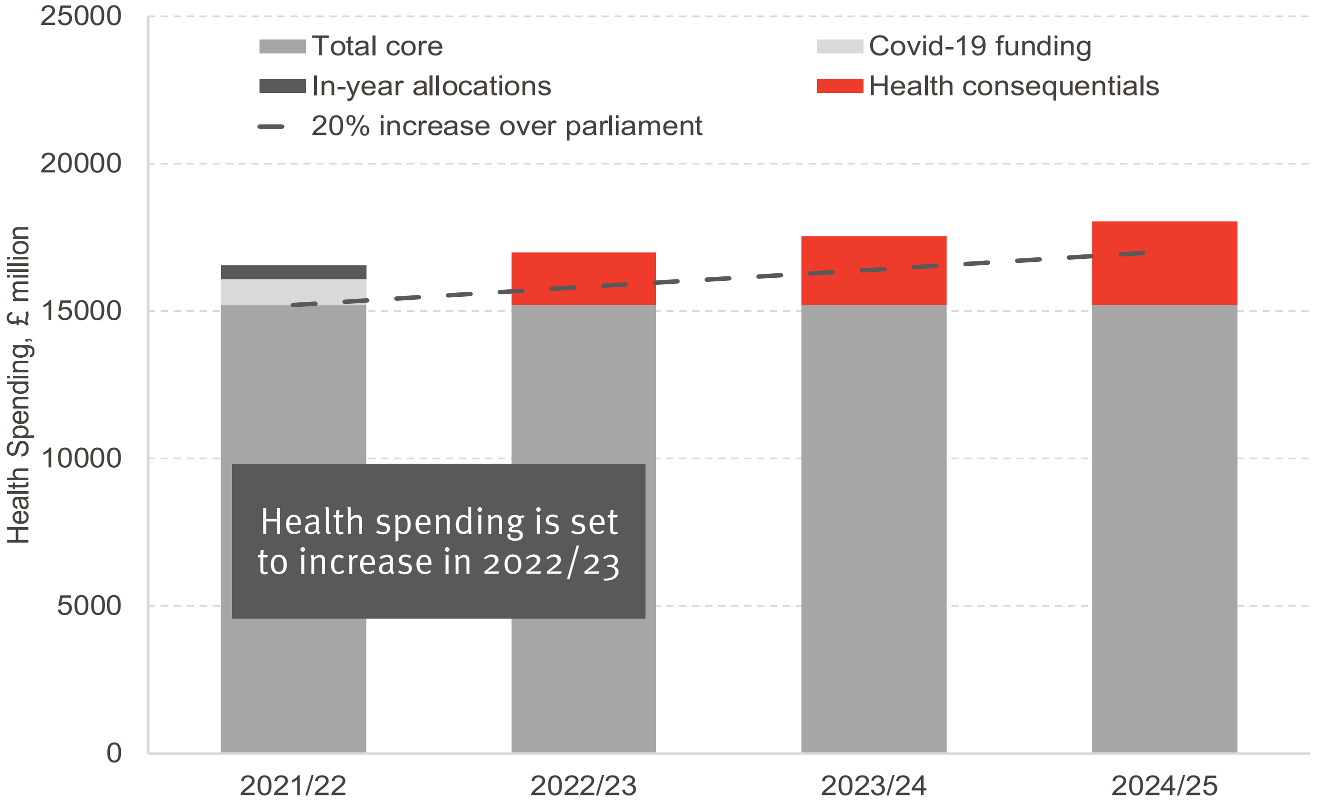
Indeed, the government has a supplementary spending target to 'pass on' all health related spending consequentials to the health budget. In practice this supplementary target will substantially exceed the former. Health consequentials allocated at the Spending Review 2021 amount to £1.8bn, £2.4bn and £2.7bn in 2022/23, 2023/24 and 2024/25 (these represent figures that are added onto the Scottish government's 2021/22 baseline, not on top of each other).

Passing these consequentials on implies that the government's commitment to a cash increase for health of £2.5bn over the course of the parliament will almost have been met by the second year of the parliament. The cash commitment (£2.5bn over the parliament) was very much the bare minimum of what would have been required to avert an NHS funding crisis. It is also worth noting that these health consequentials represent 50% of the increase in the government's 'core' block grant in 2022/23, and 60% in the subsequent two years. This has implications for other areas of government spending which we come back to later.

Chart 7 sets out the outlook for health funding over the next few years. It shows that in 2021/22, health funding has included £15.2bn core resource, in addition to £870m of Covid-funding and a further £473m allocated in-year, at Autumn Budget Revisions. The outlook in the following three years is determined by the health consequentials from the UK government (given the commitment to pass on such consequentials). These result in significantly higher expenditure on health than implied by the manifesto commitment to increase funding by 20%.

13 Frontline health services are defined as being the 14 territorial NHS boards plus the 4 patient-facing special boards (NHS 24, Scottish Ambulance Service, National Waiting Times Centre and the State Hospital).

Chart 7: Outlook for health spending



Source: *FAI Calculations*

To help support the NHS address the legacy of Covid-19 – and deal with the longer-term pressures – the government recently published an NHS Recovery Plan 2021-2026[14]. This Plan aims to increase NHS capacity by at least 10% as quickly as is possibly in order to address the backlog in care and meet ongoing healthcare needs, and to increase hospital procedures by 20% by 2026. It also sets out measures to support the workforce and increase recruitment and retention, including a 4% pay award in 2021.

The plan is supported by £1bn of investment over the course of the parliament. This investment will come from within the overall envelope for health spending outlined above. Similarly, all other health spending commitments - such as the government's commitments to abolish dentistry charges, increase investment in tackling drugs misuse – will be funded from within the broader health envelope.

We can summarise this by saying that the core resource budget of the health portfolio (excluding specific Covid-19 funding) is on course to increase by around £1.8bn in 2022/23, taking total health spending to £17bn (the £1.8bn is the health consequential allocated at the UK autumn budget, and this is added to core Scottish Government health spend in 2021/22 of £15.2bn). As a result, the health budget is on course to be 15% higher in real terms in 2022/23 than it was in 2019/20.

14 Scottish Government (2021) NHS recovery plan https://www.gov.scot/publications/nhs-recovery-plan/

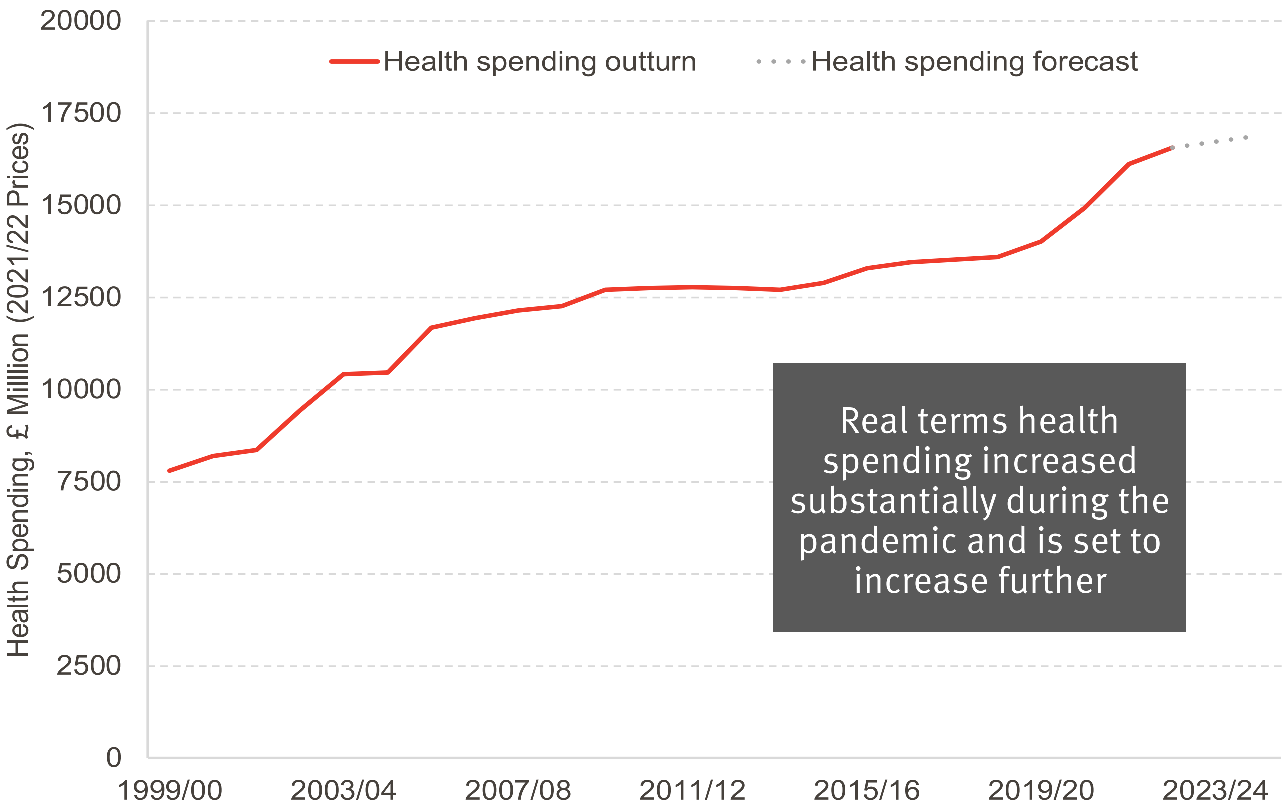
Nonetheless, the outlook for the health budget is extremely challenging given the scale of pre-pandemic pressures, the legacy of Covid, and the government's aspiration – as detailed in the NHS Recovery Plan – to increase NHS capacity by 10%. Whether this is a realistic target in the context of the resources available is debateable[15].

What is clear therefore is that whilst the health budget is on course to be significantly higher than it was pre-pandemic – both in real terms and relative to other portfolios – this is in some ways an inevitable consequence of the demands on the health service, both in terms of the need to 'recover' from the pandemic and address the longer-term challenges.

Chart 8 puts the recent and forecast evolution of Scottish health spending in a longer term context.

The trend for health spending to absorb a larger share of the total resource budget will continue. Health's share of total spending increased from 38% in 2010/11 to 42% in 2019/20; it could feasibly reach 46% over the next few years[16]. Yet when it comes to health spending there is another equally striking trend of the last 15 years, and that is the tendency for health spending per capita to increase less quickly in Scotland than in the rest of the UK. In 2006/7, Scotland spent 17% more per person on health than the rUK average. By 2019/20 it spent just 4% more.

Chart 8: Real terms health spending at successive Scottish budgets



Source: *Government Expenditure and Revenue Scotland (Scottish Government); FAI analysis of Scottish budget 2021/22 and UK Spending Review*

15 NHS recovery plan for Scotland is "unrealistic," doctors' leaders warn. BMJ 2021;374:n2125 (August 2021)

16 These figures reflect health resource spending (from GERS) as a percentage of the government's core resource budget, where this is calculated as the sum of the block grant, devolved tax revenues net of block grant adjustments, and revenues from non-domestic rates.

In short, worsening (or at best, stagnant) health outcomes, the legacy of Covid, acute workforce pressures and a desire to significantly increase NHS capacity mean that, despite large planned increases in health spending, the challenges are not going to dissipate quickly.

Substantial social care reforms are planned, but funding commitments are unlikely to be sufficient

The Scottish Government commissioned Derek Feeley to review the adult social care system in Scotland in September 2020. The independent review of adult social care was published in January 2021.

A lot of the subsequent attention on the review was understandably on its recommendation for the creation of a new national social care service. But it also places a big emphasis on the need to expand and strengthen the existing social care workforce – in social care, as in the NHS, it is issues around workforce recruitment, retention and wellbeing that must be addressed most urgently. And, when it comes to social care, the role that unpaid carers play is also fundamental, and the review makes the case to provide unpaid carers with a stronger voice and with the networks, support and respite they need to continue in their vital role.

More fundamentally the review seeks to help support a shift in how social care is perceived – less about care as an unsustainable burden on society towards seeing it as a good investment; whilst seeing social care less about managing need and more about ensuring that people's human rights are met. It also emphasises a shift away from crisis towards prevention and anticipation.

In this context the National Care Service is seen as a way to achieve parity with the NHS, greater accountability to ministers, and greater consistency of provision across the country. A national service, the argument goes, will be in a better position to drive improvements, support integration with the health service, and provide better opportunities for career progression. The extent to which a nationalised service will deliver these benefits will continue to be debated, but it is the direction that the government has firmly committed to – it plans to introduce legislation to enable its creation by June 2022.

The Feeley report provides indicative financial costings of its policy recommendations, including the costs associated with expanding access to social care support, removing charging for non-residential social care support, meeting the needs of demographic change, and providing free personal and nursing care for self-funding care home residents.

On the basis of its recommendations the Review estimates that social care funding will need to increase by 20% (£660m) on 2018/19 levels. It stresses that these costs are necessarily indicative. However, the estimated funding requirement does not include the costs associated with paying an enhanced living wage to all staff working the adult social care sector (although this is estimated indicatively as an extra £100m funding requirement for each £1 increase in living wage for social care staff), nor to the costs of increased support to unpaid carers.

In its 2021 Manifesto, and reiterated in the 2021 Programme for Government, the Scottish Government commits to increase spending on social care by a minimum of 25%, or £800m by 2026/27. Whilst this sounds generous in the context of the cost estimates in the Feeley report, it should be borne in mind that the government's £800m spending commitment is expressed in cash terms, whereas the Feeley review's £660m estimate is, largely, expressed in today's prices.

The government's commitment of an £800m cash increase in funding by 2026/27 does seem likely therefore to fall short of the Feeley review's recommendation, particularly given that the Review did not fully cost all of its proposals. Indeed, COSLA has argued that implementation costs of the Feeley Review could run to more like £1.5m[17]. If this is an estimate of the cash increase required by the end of the parliament, it does not seem unreasonable[18].

The conclusion is that social care funding will need to increase by significantly more than £800m if the Feeley Commission's aspirations are to become reality.

In addition, consultation proposals produced by the Scottish Government in Autumn 2021 suggested an increased scope for the new National Care Service, encompassing child as well as adult social care services. This will have implications for the funding requirement and the role of local government in delivery.

Tackling inequalities and poverty is a key focus of government policy

Aspirations to reduce inequality and increase opportunities feature heavily in the programme for government, and have been a major priority for the government in recent years. Inequalities of income, health and education are all seen as areas of concern, and are likely to have been accentuated by the pandemic. There are clear linkages between inequalities in these different domains. Child poverty has been linked to inequalities in educational attainment, and health outcomes are poorer in more deprived areas.

In the last parliament the government established a mission to reduce educational inequalities, and this remains a key target in this parliament. This parliament the government has established a national mission to reduce child poverty and a national mission to reduce drugs related harm.

The striking increase in drug-related hospitalisations and deaths in recent years is one of the most visceral examples of the effects of social inequalities on health. It has also become a very salient political issue. Scotland's 1,339 drugs-related deaths in 2020 represented the seventh year of increase in a row. Drug-related hospital admissions have steadily increased for the past 20 years, from just over 3000 in 1996/7 to over 10,000 in 2017/18. Drugs related hospital admissions were 18 times higher in the most deprived compared to the least deprived areas. The national mission to reduce harm, promote recovery and tackle the increase in drug related deaths is associated with a £50m a year funding commitment over the lifetime of the parliament to provide additional treatment, to be funded within the overall health budget.

Health inequalities more generally are also stark. The government's latest health inequalities monitoring report shows that, whilst there have been improvements in some measures of health inequalities in recent years, there has been deterioration in a number of the headline indicators[19]. For example, the gap in premature mortality rate between the most and least deprived areas has increased since 2010. By 2019, the premature mortality rate in the most deprived areas was 817.6

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17 COSLA response to the National Care Service Consultation https://www.cosla.gov.uk/__data/assets/pdf_file/0025/28780/National-Care-Service-Consultation-Response-COSLA.pdf

18 Consider this simple thought experiment. If spending on social care increased by 3.5% per annum over the course of this parliament – which, according to the government's medium term health and social care financial framework is what is needed simply to keep pace with demographic change and inflation – then social care spending would increase by 22%, or £700m, by the end of the parliament. The government's commitment to provide an £800m cash increase to the social care budget implies just £100m over and above this base cost pressure to meet the recommendations of the Feeley review.

19 Scottish Government (2021) Long-term monitoring of health inequalities: January 2021 report https://www.gov.scot/publications/long-term-monitoring-health-inequalities-january-2021-report/documents/

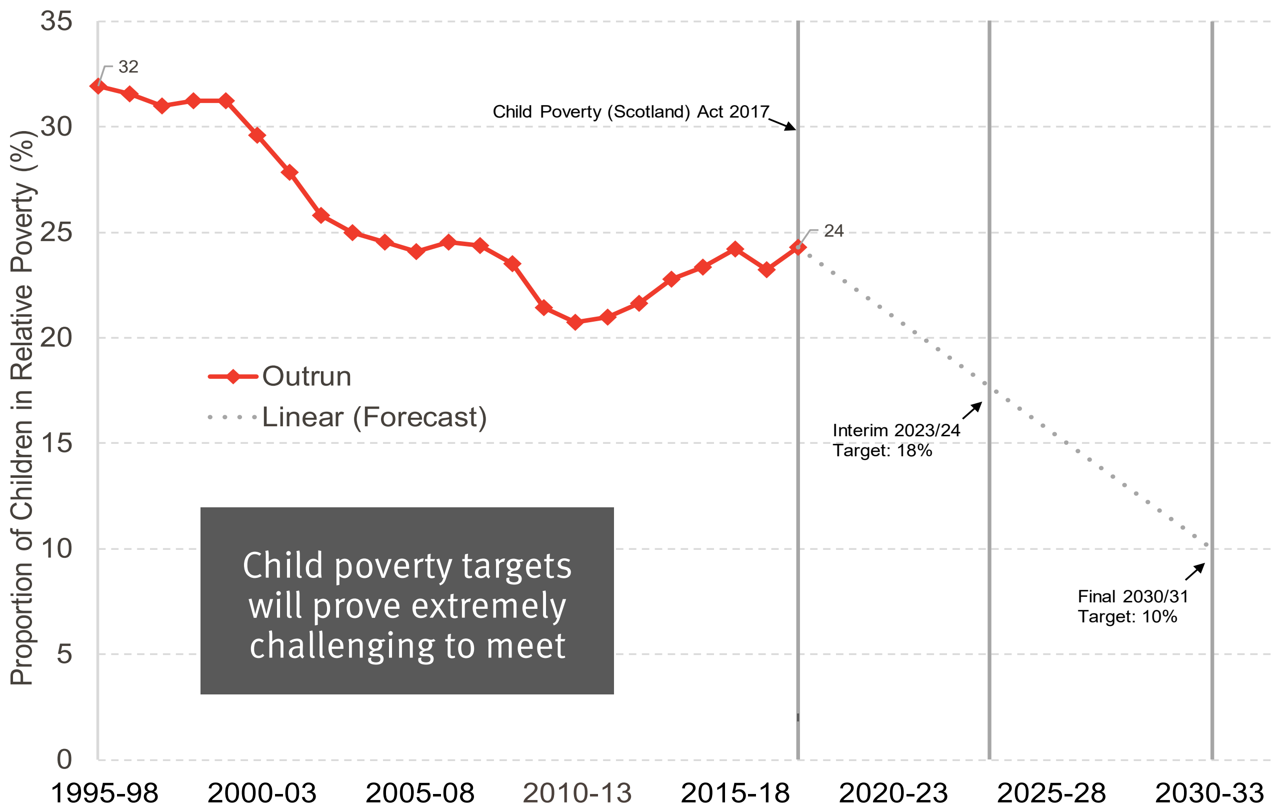
per 100,000, four times higher than the rate in the least deprived areas (198.2 per 100,000). The Covid-19 pandemic will likely have accentuated these inequalities given that the death rate from Covid-19 is more than twice as high in the most deprived areas than in the least deprived areas (183 and 79 per 100,000 population respectively) .

Tackling these inequalities will require concerted effort over many years, and will rely heavily in reducing wider societal inequalities. Here we focus on the governments policies to reduce inequalities of income and educational attainment, and the budgetary implications of those.

The government is expected to use the budget to set out the timetable for its proposed doubling of the Scottish Child Payment

The 2017 Child Poverty (Scotland) Act sets out ambitious targets to reduce child poverty. These include the target to reduce relative child poverty to 10% by 2030/31, with an interim target of 18% by 2023/24. With latest data showing a poverty rate of 24% for the period 2017-20, achieving these targets will be extremely challenging (Chart 9).

Chart 9: Rate of After Housing Cost (AHC) relative child poverty in Scotland, and child poverty targets



Source: *GScottish Government poverty statistics.*

Recognising the scale of challenge, the Scottish Government has established a 'national mission' to tackle child poverty. The government's flagship policy in response to its mission and the targets is the introduction of a new Scottish Child Payment (SCP). The SCP is a payment for each child in eligible households. Eligible households are those with children who are in receipt of Universal Credit or one of its legacy benefits (e.g. jobseekers allowance, income support).

The SCP was initially set at £10 per week. Rollout of the SCP began in February 2021, initially to eligible families with a child under six. Payment of the SCP is administered by Social Security Scotland, with the payment itself being a top-up to the UK qualifying benefit. The government aims to complete rollout of the payment to children under 16 by the end of 2022.

During the election campaign this year, all five major parties committed to double the SCP from £10 to £20 per week in this parliament. On 29 November, Nicola Sturgeon confirmed that this uplift to £20 per week would begin in April 2022/23.

The Scottish Fiscal Commission had forecast – before confirmation of the uplift from £10 to £20 per week had been made – that expenditure on the SCP would reach £55m in 2021/22, increasing to £90m in 2022/23 and £163m once it is fully rolled out in 2023/24, by which time over 300,000 children would be in receipt of payment.

Updated forecasts published alongside the Scottish budget this week will update these estimates. In broad terms, a doubling of the payment will at least double the costs of the policy assuming no other changes (a higher payment may lead to higher uptake).

A total policy cost of £320m or more per annum by the end of the parliament makes this one of the more substantial specific policy commitments made. The policy is utterly necessary if any progress is to be made towards the child poverty targets. Our internal analysis suggests that a SCP at £10 per week would reduce the child poverty rate by around 2 percentage points, whilst a SCP at £20 per week would reduce the child poverty rate by about 4 percentage points.

Doubling of the payment was critical if the government was to get anywhere close to the interim 2023/24 child poverty targets. But further policy interventions will also likely to be required when the government unveils its second tackling child poverty delivery plan before the end of March 2022.

A renewed attempt to tackle educational inequality

At the start of the last session of parliament, the Scottish Government established a mission to make significant progress in closing the educational attainment gap within the parliament, and to substantially eliminate it within a decade. The attainment gap is the difference in attainment between pupils living in the most deprived and least deprived areas, with level of deprivation being based on SIMD quintiles. The attainment gap can be measured at a number of different pupil ages/stages.

An Audit Scotland report in March this year found that 'progress on closing the gap has been limited and falls short of the Government's aims'[20]. Whilst the attainment gap has tended to narrow since 2012/13, it has only done so slightly, and attainment gaps remain high. For example, in 2018/19, 94.0 per cent of pupils from the least deprived areas achieved five or more awards at level 4, compared to 76.1 per cent of pupils from the most deprived areas – a gap of 18.0 percentage points.

The government's approach to reducing the attainment gap in the last parliament centred on the establishment of a £750m Attainment Scotland Fund. The bulk of Attainment Scotland funding was used to support the Pupil Equity Fund which provides direct financial support to schools based on the number of pupils eligible for free school meals. The Attainment Fund also provided additional financial support to local authorities and schools experiencing the most severe levels of deprivation, and funding for children who have spent time in care.

20 Audit Scotland (2021) Improving outcomes for young people through school education. https://www.audit-scotland.gov.uk/report/improving-outcomes-for-young-people-through-school-education

In its 2021 Manifesto, the government committed to allocate £1bn over the course of this parliament to close the school attainment gap and recruit 3500 additional teachers and classroom assistants.

The commitment to recruit 3,500 additional teachers is stretching but achievable. To put this in context, there were 53,400 teachers in Scotland in 2020[21]. During the last parliament, the number of teachers increased by 2,700 in FTE terms. As a result, the overall pupil-teacher ratio declined from 13.7 to 13.3 – the lowest it has been since pre-2010 (when it briefly got as low as 12.9.

Assuming that the direct costs of employing 3,500 additional teachers and classroom assistants (salaries, pension contributions and employers' national insurance, but not training costs) amount to around £175m per year by the end of the parliament, then the remaining funding for a future iteration of the Attainment Scotland Fund remains substantial although perhaps somewhat less in real terms than the £750m allocated in the last parliament.

It remains to be seen to what extent funding for attainment will be targeted or allocated differently in this parliament, and the extent to which this funding – combined with increased teacher numbers – might achieve greater success in reducing the attainment gap over the next five years than was the case in the last five. If success is limited, it is not immediately obvious that this can be attributed to a lack of school funding. Funding per pupil increased significantly during the last parliament and is higher than in other parts of the UK[22].

This parliament will see a transformation of the social security landscape in Scotland

The government's biggest single project in this parliament is the rollout of new social security payments in Scotland for people with disabilities and caring responsibilities.

The Scottish budget has already taken on the financial responsibility for 9 of 11 social security payments devolved through the Scotland Act 2016[23]. Currently, the majority of these payments continue to be administered in Scotland by the DWP on the Scottish Government's behalf. The Scottish budget receives additional grant from the UK government to fund these payments, with this additional funding based on changes in spending on the equivalent benefits in rUK. As a result, the Scottish budget already bears the risk that spending on these payments rises relatively more quickly in Scotland than in rUK.

The next few years will see a much more significant transformation of the social security landscape in Scotland. Two new payments – the Child Disability Payment and the Adult Disability Payment – are being or are about to be rolled out. Rollout of CDP for new claimants began in November 2021, with rollout of ADP scheduled to begin in summer 2022. What will also happen over the next few years is that individuals currently in recent of the legacy UK payments (Disability Living Allowance and Personal Independence Payment) will gradually be transferred onto the new Scottish payments, with their claims being administered by Social Security Scotland rather than DWP.

21 Schools in Scotland: summary statistics 2020 https://www.gov.scot/publications/summary-statistics-schools-scotland-2020/pages/1/

22 Sibieta (2021) Comparisons of school spending per pupil across the UK. IFS, Oct 2021.

23 Cold Weather Payment and Winter Fuel Payment have not yet been devolved.

This will bring delivery challenges and fiscal risks; but the potential reward is a distinctive system of social security for people with disabilities and long term illnesses.

The Scottish Government has set out an aspiration that assessment processes for the new CDP and ADP will be less onerous and intrusive than is the case for the existing UK payments, with greater support for applicants are wider application routes. As a result, the Scottish Fiscal Commission forecasts that caseloads and spending on these payments in Scotland will increase more rapidly than it will for the equivalent payments in rUK.

Quite how much higher expenditure on these benefits will be under the distinctive new Scottish policy than would have been the case under legacy rUK policy is highly uncertain. But it is likely to be significant in the longer-term (although not in 2022/23 given the anticipated pace of roll-out). The Scottish Fiscal Commission forecasts that the government's policy changes on ADP could increase spending by £34m in 2022/23, rising to almost £500m by 2025/26.

In due course the Scottish Government will announce plans for rollout of Pension Age Disability Payment (the replacement for DLA for older people). It will also announce plans for the rollout of the replacements for Carer's Allowance and Attendance Allowance in Scotland. Whilst the full detail of the design of replacements for Carer's Allowance and Attendance Allowance in Scotland is not yet available, the SFC's expectation is that policy will result in increases in expenditure relative to the legacy UK payments.

The social security system in Scotland is on course for significant transformation this parliament. This ability to set a distinctive policy is a welcome illustration of the advantages of devolution. But policy choices come with budgetary implications. These will not be very significant in 2022/23. But they will become increasingly important during the parliament. By the end of the parliament, spending on disability payments could conceivably be £500m or more higher than it would be under the legacy UK system, and hence £500m higher than the additional block grant funding from the UK government. Additional to that is expenditure on the Child Payment to tackle child poverty, which is likely to reach several hundred million pounds by the end of parliament.

These policy choices thus amount to the best part of a billion pounds by the end of parliament. The rationale for the policies is clear, but they imply stark choices. The funding implications will need to be met through a combination of tax rises or relatively lower spending in other parts of the Scottish budget than would otherwise have been possible.

Looking beyond the 2022/23 budget

Taken together, the commitments on health and social care and the policies on SCP and other social security will place increasing pressure on budget. The pressure is not so acute in 2022/23 but will build during parliament as changes are rolled out.

It is hard to predict the impacts with certainty, but it points to a familiar message. The commitments on health, social care and social security imply that the resources available to the Scottish government to fund spending on remaining areas of public policy are likely to decline in real terms between 2022/23 and 2024/25. The extent of this decline will depend on exactly what happens to the block grant, Scottish tax revenues, and the rollout of social security policy. But we could be looking at a real terms decline in funding outwith health, social care and social security of up to one percentage point per year over the next few years. This would of course represent the continuation of a longer-term trend.

In this context, the publication next year of a Spending Review takes on added significance. What we have seen in recent parliaments, but that is hard to keep track of in annual budget documents, is a budget that is increasingly dominated by spending on health and social care, and, from now on, social security. The relative losers in recent years include justice, higher education and local government. It is not clear that this trend will be bucked any time soon.

The longrun decline of the remit, responsibility and relative fiscal scale of local authorities looks set to continue. It is almost nine years since responsibility for police and fire services was removed from local government and centralised. Since then, local government's core revenue settlement has declined as a share of core Scottish government spending.

However, the extent of the relative decline is sometimes exaggerated. Estimates from the Scottish Parliament Information Centre (SPICe) suggest that local government's share of Scottish government funding declined by only one percentage point (from 34% to 33% between 2013/14 and 2021/22)[24]. In fact, local government's share of total funding has not declined more rapidly than most other portfolios outside health; the issue is rather than health's increasing share of the budget has resulted in a declining share for almost all other areas of spending.

Nonetheless it is unsurprising that local government budgets have felt extremely stretched. Core budgets have fallen by 2 per cent in real terms since 2013/14, but with social care and education services having been protected, it has meant that local government spending in areas such as environment, planning, leisure have fallen sharply. Scottish government plans to create a new national social care service seem likely to erode local government responsibility further, but the detail of what it will mean for their funding remains less clear for now.

Bringing clarity to the economic development landscape

The Scottish budget allocates a relatively large amount of funding to what could generally be described as economic development.

In the 2021/22 budget, the economy, fair work and culture portfolio had an allocation of £1bn. This included £670m of resource spending (to, amongst other things, enhance exports and inward investment, and a range of programmes to support a 'just transition' to a net zero economy), £130m of capital investment (including investment in digital infrastructure), and £200m of funding for the Scottish National Investment Bank (SNIB), which will invest in environmental and social projects where the private sector is not providing sufficient investment.

But elements of economic development are also included in various other portfolios. The education and skills portfolio includes £270m for skills development and training, whilst sector-specific support for the rural economy and tourism is contained within the portfolio of that name. And none of this includes the costs of support for businesses via non-domestic rates reliefs (currently in excess of £1bn per annum), a flagship element of the government's economic strategy.

So however you look at it, spending on economic development is substantial.

The institutional landscape that sits behind this landscape is phenomenally complex. This is

24 Liddell G. (2021) Local government finance: concepts, trends and debates. Scottish Parliament Information Centre. https://digitalpublications.parliament.scot/ResearchBriefings/Report/2021/8/27/ccf6f2ab-1d70-4269-b67c-3d9cc4fb4429

partly because of an increasingly fuzzy boundary between devolved and reserved competences in employability and jobs support, and in light of post-EU funding arrangements – the latter which is resulting in more direct interventions by the UK government in economic development activities in the devolved nations. But it is also complicated by a delivery landscape that involves national and regional development agencies, local authorities, city and region growth partnerships and other mooted or planned vehicles, such as green ports.

In this context, seeing the big picture of what is taking place and what outcomes are being delivered is challenging. And whilst this might seem an area where budget savings could be made, given the level of spending involved, there would clearly be risks of doing so at a time when the economy remains at the early stages of its pandemic recovery.

The government established a new Advisory Council for Economic Transformation this summer. The Council has been tasked with driving transformational change in the Scottish economy as it recovers from the pandemic and transitions to becoming a net zero economy. The Council's strategy is anticipated for publication imminently. It will be interesting to see to what extent the strategy brings clarity to the existing landscape of economic development activity and how much change it ushers in. It seems unlikely that the deliberations of the new Council will have a material impact on budget priorities this year, but its work could – indeed should – inform next year's spending review.

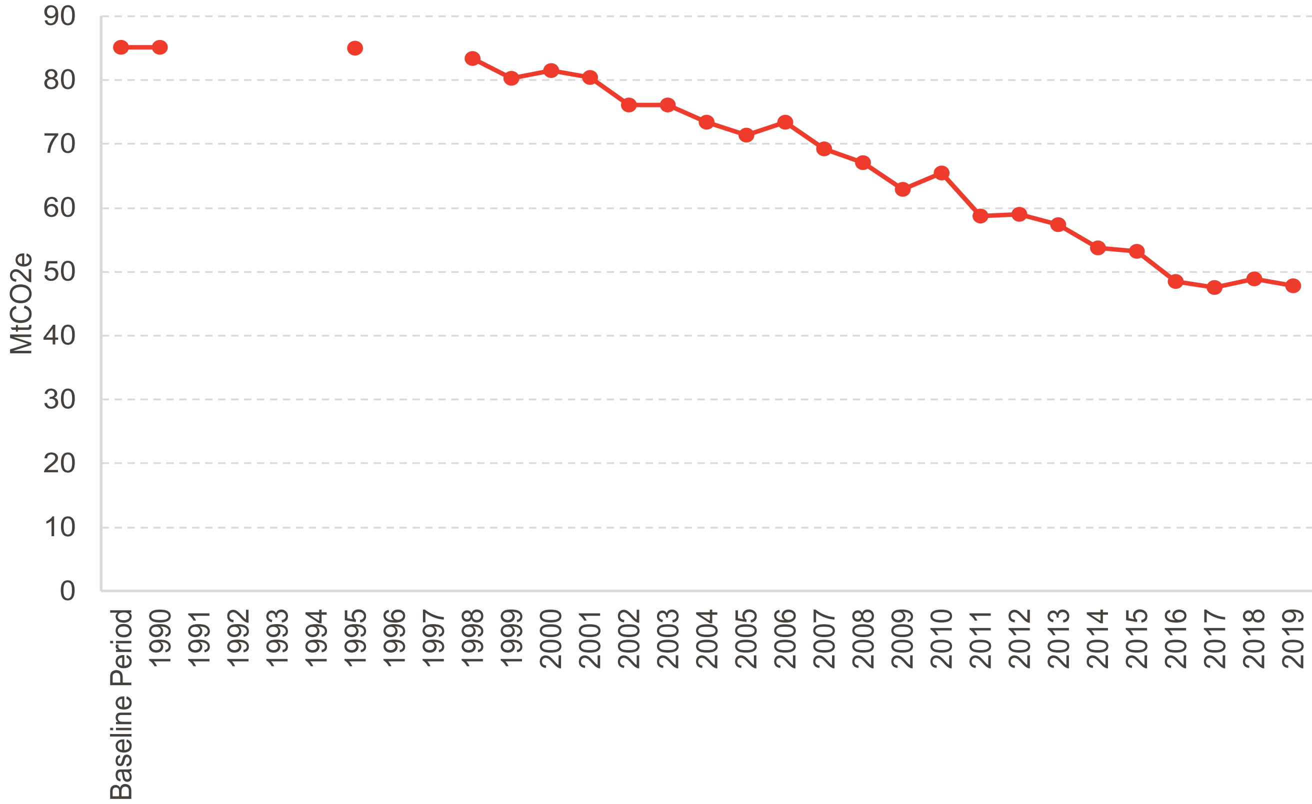
Meeting net zero targets will require new approaches to budgeting

The Scottish Government has legislated that Scotland will reach net zero by 2045, 5 years earlier than the UK as a whole. Annual emissions reductions targets, to ensure that we are on track to achieve these targets, have also been set.

Scottish greenhouse gas (GHG) emissions stood at 47.8 million tonnes of carbon dioxide equivalent (MtCO2e) in 2019 – a reduction of 2.3% (1.1 MtCO2e) on the year and 43.8% since 1990. The main drivers of this decline were from business, energy supply and domestic transport.

For purposes of reporting against GHG emission targets, the Committee for Climate Change (CCC) has recommended an alternative approach. Under this adjusted method, Scotland's GHG emissions stand at around 51.5% below the baseline, rather than 43.8% (Chart 10). Nonetheless, Scotland's target to reduce emissions by 55% by 2019 – as specified under the Climate Change (Scotland) Act 2019 -have been missed under either methodology.

Chart 10: Greenhouse Gas Emissions (Values in MtCO2e), Scotland, 1990 – 2019



Source: *Scottish Government.*

Recognising the scale of challenge, the Scottish Government has established a 'national mission' to tackle

It is also important to remember that the Government's targets are for territorial emissions. That is, emissions that are generated in Scotland, rather than emissions generated by consumption of goods and services. The risk of this approach is that it would be possible for Scotland to achieve its emissions targets by importing more goods and services from elsewhere.

Indeed, Scotland's carbon footprint – which measures emissions associated with consumption – has not reduced to the same extent as emissions produced in Scotland.

What we measure matters. Consumption patterns in Scotland have to change to become more sustainable, even if this doesn't help us meet our territorial emissions targets.

Meeting the government's net zero ambitions will require substantial policy interventions that cut across wide areas of devolved competence. The Scottish government's Climate Change Plan 2018-2032 sets out policies to reduce emissions by 75% (compared to 1990), en route to the goal for net zero by 2045.

Meeting climate change objectives will have significant long-term implications for the budget. Decarbonising domestic heating, public buildings and transportation will absorb large elements of the capital budget in particular. Indeed the impact of this can already be seen on budget plans, from investments in low emissions buses to support for the development of new technologies, and land use change. In due course the devolved tax system might also play a role, and on the revenue side there is a growing focus on supporting the types of skills that will be required in a low-carbon economy.

The diverse, cross-cutting nature of interventions required to support the transition to a net zero economy means that keeping track of the budget's impact on emissions is challenging. The challenge is compounded by the sometimes long-term and uncertain link between policy implementation and emissions reduction. But there is a critical need to improve the way that the impact of budget decisions on net zero targets is examined and assessed, in order both to assess progress and determine what other interventions may be required.

Exactly what level of resource and capital funding might be required over the longrun to achieve the aspirations is highly uncertain, but it will be substantial. Better understanding the impacts of the decisions made is a critical step in improving the efficiency and effectiveness of those decisions. The government is taking forward work in that direction, and this should help to shape the budgets of the future.

Conclusions

The first budget of a new parliament is often a particularly exciting affair, as a new set of policy commitments and aspirations begin to shape the tax and spending decisions of government.

After two unprecedented Covid budgets in 2020/21 and 2021/22, the budget of 2022/23 in principle heralds a return to more normal times. But the legacy of the pandemic on public services remains acute, significantly accentuating pre-existing pressures.

A core resource block grant in 2022/23 that is 8% higher than pre-pandemic might sound generous, but to deal with the pandemic's legacy and underlying public services pressures it is anything but. In this context, Kate Forbes' third budget may well be her most challenging.

But the challenges are unlikely to dissipate in subsequent years, as commitments and aspirations on health, social care and social security in particular rub up against a real terms budget that is currently forecast to remain flat in real terms between 2022/23 and 2024/25.

So a challenging budget for 2022/23 is the precursor to a challenging spending review next year. Navigating the health and economic recovery from the pandemic, alongside longer term commitments on climate change and inequality will require a delicate set of budget decisions and trade-offs. This week's budget will reveal how those choices and trade-offs have been made for 2022/23, but the more difficult trade-offs may yet be to come.

Fraser of Allander Institute
University of Strathclyde
199 Cathedral Street
Glasgow G4 0QU
Scotland, UK

Telephone: 0141 548 3958
Email: fraser@strath.ac.uk
Website: fraserofallander.org
Follow us on Twitter via @Strath_FAI
Follow us on LinkedIn: FAI LinkedIn