University of Strathclyde Business School

Fraser of Allander Institute

Economic Commentary

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Foreword

This quarter's Commentary leaves us in no doubt as to the difficult economic conditions we all currently face. While the first quarter of 2022 was characterised by cautious optimism, as Covid-19 restrictions were lifted and Scotland's economic recovery seemed underway, over the last 6 months historic increases in inflation and cost-of-living pressures have compounded to create a deteriorating economic environment.

The Fraser of Allander has now significantly revised down its forecasts for growth for Scotland's economy in 2023 and 2024, with contractions in activity expected in the last two quarters of this year, and first quarter of 2023, meaning Scotland is likely to enter a recession. Industry and consumers alike are bracing for a downturn.

The UK Government's growth plan or 'mini-budget' on 23 September announced that taxpayers in the rest of the UK will benefit from a cut in the Basic Rate of Income Tax (from 20% to 19%) from April next year. At the time of writing, the UK Government has said it will no longer proceed with the abolition of the Additional Rate for those earning over £150,000 a year, which had also been proposed as part of the growth plan and would have created a material divergence in income tax rates between Scotland and the rest of the UK for the highest earners. However, the change in the basic rate of income tax still presents the Scottish Government with a decision. Should they use the Block Grant Adjustment to pass on the benefit of a 19% basic rate of income tax or maintain the 21% Intermediate Rate for individuals earning over £25,689? Businesses and individuals will be keenly awaiting the response from Holyrood.

The upcoming downturn is being driven by inflationary pressures, most resembling the recession of the early 1990s, rather than the more severe contractions caused by the financial crisis and the pandemic.[1]

The Commentary this quarter sets out analysis of the cost of living on different households, making clear, if there was any doubt, that lower-income households are feeling the effects of rising prices most keenly.

Weakening Scottish consumer sentiment more generally is also a feature of this quarter's Commentary, with 'current household spending' the worst performing indicator and the 'future expectations of household finances' indicator negative for the first time since the series began.

While the UK's energy package, announced last month, will help shield households from the worst effects of high energy prices and Scottish taxpayers, like those in the rest of the UK, will gain from the recent reversal of the 1.25% increase in National Insurance and cancellation of the health and social care levy announced as part of the UK Government's growth plan, many are still likely to face a squeeze on spending power.[2]

Of course it is not just individuals and households facing difficulties. With a difficult economic outlook in the UK, and beyond, businesses face a number of challenges. It's worth noting that the cancellation of the planned Corporation Tax rate increase and the more generous Annual

1 Deloitte - Help for energy bills - with one leap, free?
2 Deloitte - British fiscal policy goes radical

Investment Allowance measures will have a direct positive effect for Scottish companies, just as for all companies throughout the UK.

Many business leaders have never navigated their business, and its people, through a period of such high inflation and weakening economic activity. Seeking counsel, and support could therefore be helpful.

We're working with many of our clients as they look at the strategic, financial, operational and people-centric levers available to tackle their most immediate business pressures. This might be optimising working capital, diversifying or streamlining product ranges and pricing strategies, exiting underperforming operations or financial restructuring.

While looking at defensive strategies, it is also really important that senior management consider how to build resilience into their business and continue to think about and plan what they want their business to look like beyond the current challenges. Investment in customer experience, automation of manual processes to free up resources, M&A and expediating an organisation's net zero journey can all provide longer term advantages. And throughout it all, authentic communications between business leaders and employees is also vital, particularly in times of uncertainty.

The Fraser of Allander rightly points out that entities such as charities and government services, unable to pass on costs or pivot plans as businesses can, are also facing immense pressure at the moment. This has also been echoed in research currently being conducted by my Deloitte colleagues to inform the eleventh annual Deloitte State of the State report. Interviews with senior public sector leaders show the unprecedented effects of the COVID-19 pandemic, now coupled with the cost-of-living crisis, are having a profound impact on the sector's spend power as well as demand for public sector services.

Undoubtedly challenges lie ahead but, unlike during the pandemic, there is the opportunity to plan and prepare for the months ahead. Developing responses to an organisation's most immediate challenges, while continuing to think longer term to create an organisation fit for the future, should help businesses to respond, recover and thrive.

Angela Mitchell
Senior Partner for Deloitte in Scotland
October 2022

Deloitte.

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Summary

After over two years of turmoil, the economy is again entering another very difficult period. With prices continuing to rise across the economy, there are clear signs that demand is likely to weaken across the economy.

In light of this, we have significantly revised our expectation of growth in the economy.

We are now forecasting growth of 3.6% in 2022, followed by a contraction of -0.6% in 2023, before returning to growth in 2024 of 0.8%.

This assumes that the last two quarters of the year, and the first quarter of 2023, show contractions in the economy given wider economic challenges. This means that Scotland is likely to be entering into a technical recession (defined as two quarters of negative growth in the economy).

It will surprise no one to hear us say that these forecasts are very uncertain at the moment. It doesn't seem in doubt though that there is a difficult winter ahead for the economy.

As well as our new forecasts, we analyse all the latest data on the UK, Scottish and global economies. As a special focus, we examine the impact that very high rates of inflation are having on different types of households.

It is in this challenging context that we saw the UK Government present its "fiscal event" – although really a budget in all but name, given the scale of measures announced.

This contained some of the most substantial tax policy changes seen in recent decades. Combined with recent announcements on the Energy Price Guarantee and Energy Bill Relief Scheme, this constitutes a huge change in the fiscal outlook.

In this context, the decision not to involve the Office for Budget Responsibility (OBR) is concerning. The OBR plays an essential role in scrutinising tax and spend forecasts, assessing the likely impact of policy announcements on growth, the deficit and debt. Its exclusion from the process weakens transparency around the impacts of the proposals.

This decision, and the overall approach to fund tax cuts from borrowing without any independent assessment of the consequences, has had clear implications in the markets. The weakening of the pound and the increases in government gilt rates are likely to exacerbate the cost pressures facing individuals and businesses in the months to come – as well as making it much more expensive for the government to borrow.

In our policy section, we analyse what these announcements mean for Scotland – and look ahead to more fiscal events later in the Autumn, including the UK Government's Medium Term Fiscal Plan in October, and the Scottish Budget before the end of the year.

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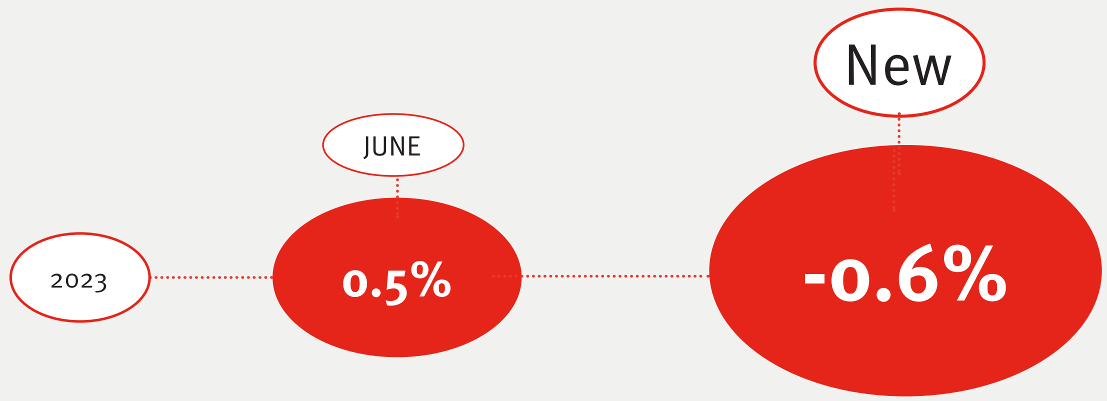
State of the economy

Indicator	% of Feb 2020 levels	Rate	Change on previous month / quarter	Performance	Latest data
GDP					
Total	100.1%		-0.2%	▼	July 2022
Production	95.1%		0.6%	▲	July 2022
Construction	102.6%		-0.8%	▼	July 2022
Services	101.1%		-0.3%	▼	July 2022
Labour Market					
Employment rate		75.2%	-0.3p.p.	▼	May 2022 - July 2022
Unemployment rate		3.1%	-0.1 p.p.	▼	May 2022 - July 2022

Scottish growth forecasts



	2022	2023	2024
FAI *OCTOBER 2022*	3.6%	-0.6%	0.8%
FAI *JUNE 2022*	3.8%	0.5%	1.0%

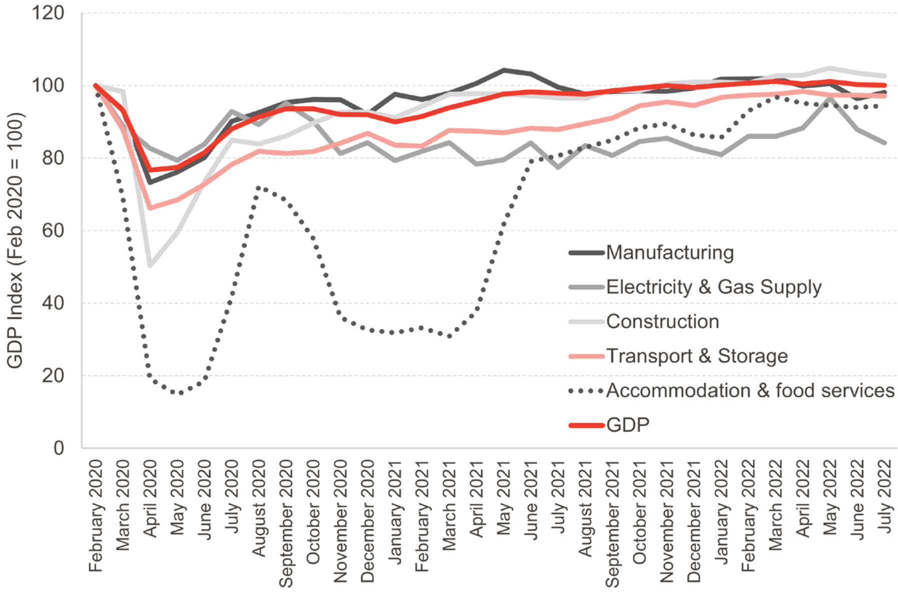
Outlook and Appraisal

Where are we now?

As in the rest of the UK, economic conditions in Scotland are fragile in the wake of high inflation and the subsequent cost-of-living crisis.

Despite a more optimistic start to the year, onshore GDP fell by 0.2% in June, up 0.6 percentage points (p.p.) on May's growth, with the economy now 0.1% above pre-pandemic levels, **Chart 1**.

Chart 1: GDP Index, Scotland, February 2020 - July 2022



Source: *Scottish Government*

Output in the services sector fell by 0.3% but remained above pre-pandemic levels in July, while the manufacturing sector grew by 1.8% in July, up 5.9 p.p. on June's figures. Construction sector output fell by 0.7% in July, following a 1.3% decrease from May to June.

On September 30th, the ONS revised GDP estimates for the UK economy through 2022 Q2. If Scottish Government follow suit, this GDP time series may be revised at a later date.

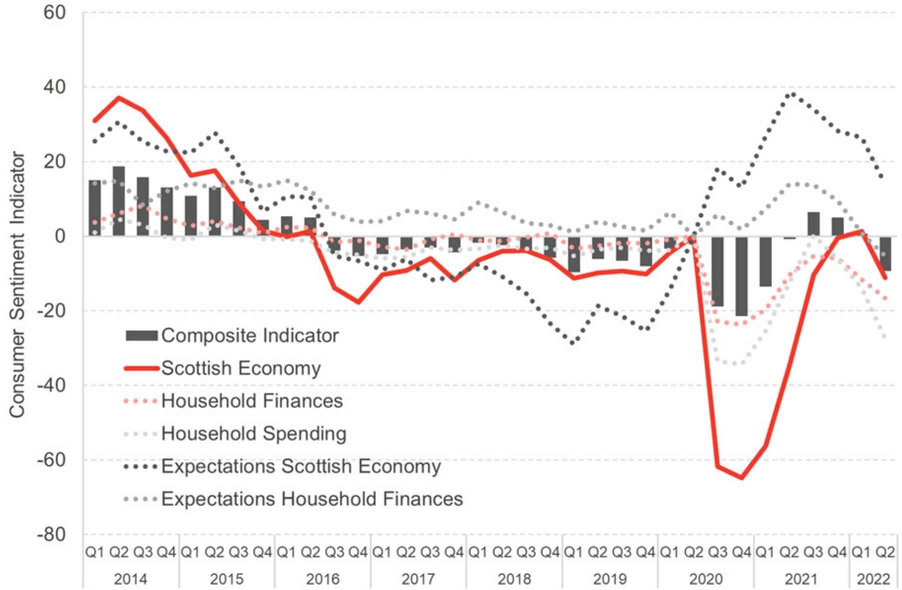
There were also significant reductions in consumer sentiment across the Scottish economy. The composite indicator[1] fell to -9.3 in Q2 of 2022, a 9.9-point fall on the indicator value for Q1, Chart 2.

All indicators for current sentiment on the Scottish economy, Household finances and Household spending were negative, with current household spending the worst performing indicator, falling to -27.4 for Q2.

Future expectations of household finances followed a similar trend, with the indicator negative for the first time since the time series began.

1 The composite indicator measures consumer sentiment based on current sentiment and future expectations of Scottish economic performance, security of households' financial position and attitudes to spending.

Chart 2: Consumer Sentiments Indicator, Scotland, Q1 2014 - Q2 2022



Source: *Scottish Government*

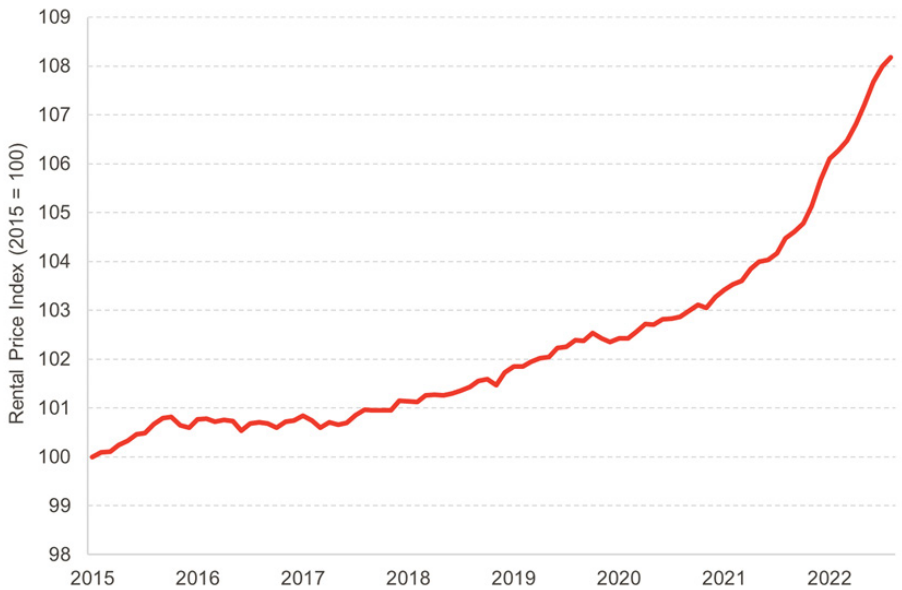
The indicator for household finances expectations was -5.3 for Q2, a decrease of 6.2 points on the previous quarter, indicating how insecure consumers feel about the coming year.

Prices in the property market, both owned and rental, have also remained high.

The average property price in Scotland was £222,894 in July 2022, the highest recorded value since the time series began. This price was a 4% rise on the previous month, and up 24% on pre-pandemic property prices.

In September, the Bank of England increased the bank rate from 1.75% to 2.25%, with expectations that this could reach as high as 6% given current market turmoil. This announcement means that even if mortgages are readily available, they may become far more expensive, particularly for first-time buyers.

Chart 3: Index of Private Housing Rental Prices, Scotland, January 2015 – August 2022 (January 2015 = 100)



Source: *ONS*

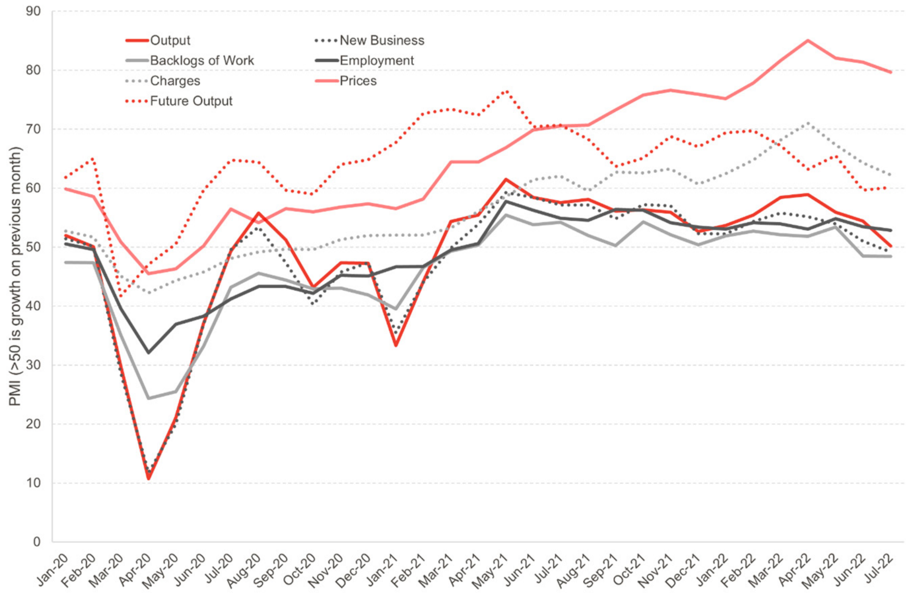
Rental prices in Scotland have also continued to rise to record levels. Private rental prices have risen by 3.6% in the past 12 months, up 6% on pre-pandemic rental prices, Chart 3.

These rental price rises are particularly evident in Glasgow and Edinburgh,[2] where rent for a two-bedroom property is estimated to have risen by 41.4% and 41.7% respectively, between 2010 and 2021.

The recent rent freeze announced by the Scottish Government will be appreciated by renters across the country, but may also have significant implications for the availability of rental properties.

For firms, the story is similar. The majority of indicators in the Purchasing Managers Index (PMI) remained positive in July 2022, Chart 4.

Chart 4: Purchasing Managers Index, Scotland, January 2020 – July 2022



**A PMI reading over 50 indicates growth, whilst a reading under 50 suggests contraction.*

Source: *IHS Markit*

The prices indicator remained positive and high,[3] around 6% higher in July than in January 2022.

There was some contraction for both the new business and backlogs of work indicators suggesting that whilst businesses are making some progress in reducing backlogs, doing so may have reduced their capacity to take on new business.

What is driving UK inflation?

In the 12 months to August 2022, prices rose by 9.9%. This inflation rate is down from 10.1% in July - the first double-digit increase recorded in more than 40 years, Chart 5.

Once owner occupiers' housing costs are accounted for, the CPIH rate was 8.6% in August 2022. As discussed in our last commentary, the high inflation rate has been primarily driven by housing and household services, which contributed 2.90 pp. to the CPIH 12-month rate.

2 Statistics are for the Lothian area only.
3 The prices indicator reports the rate of input price inflation reported by responding private sector firms.

Chart 5: Consumer Price Index, UK, January 2012 – July 2022

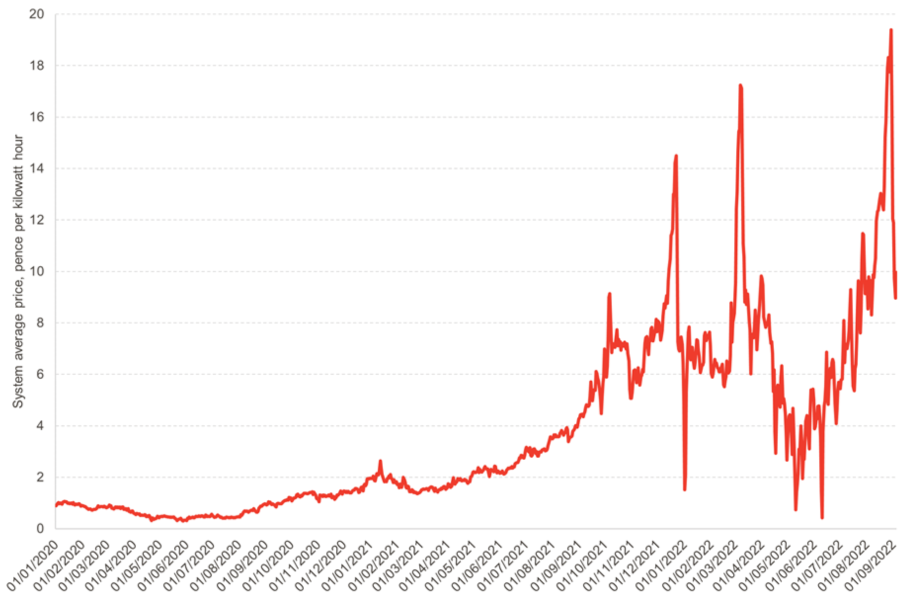
Source: *ONS*

Other heavily contributing sectors were transport (1.36 pp.) and the food and non-alcoholic beverage (1.20 pp.). These three industries together accounted for around two-thirds of the overall CPIH annual rate.

Persistent increases in housing costs are still driven by the price of electricity, gas and other fuels.

Gas prices also remain high, with the wholesale cost 9.96p per kilowatt in September 2022, 58% higher than the beginning of the year but down 23% on the average price in August, Chart 6.

Chart 6: Growth in UK wholesale gas prices, January 2020 – September 2022



Source: *ONS*

The recent announcement by the UK Government to freeze annual energy bill prices at £2,500 for the typical household for the next two years will help to ease some of the financial burden facing many households.[4]

4 BBC News - Energy bills to be capped at £2,500 for typical household.

The new price cap is in addition to the existing plan for a £400 discount for all households. ONS has announced that they will count the discount as a transfer payment.[5] This classification means that the payment will not affect the calculation of official price indices going forward.

Fuel prices have also stayed high. The average pump price of unleaded petrol was 168.93p in September 2022, still 16% higher than prices at the beginning of the year, whilst the average diesel price was 182.82p.

Like consumers, the majority of firms have experienced monumental increases in their energy bills over the past year. Entities like charities and government services, however, cannot pass the cost of rising prices to their users. High electricity and heating bills will place pressure on budgets for charitable and government services while demand increases.

The recently-announced Energy Bill Relief Scheme guarantees a discounted price for businesses and other non-domestic energy users, including charities and government organizations.[6] The support will last for six months. Although this will partially relieve higher energy prices, high inflation will continue to place pressure on businesses and other organizations.

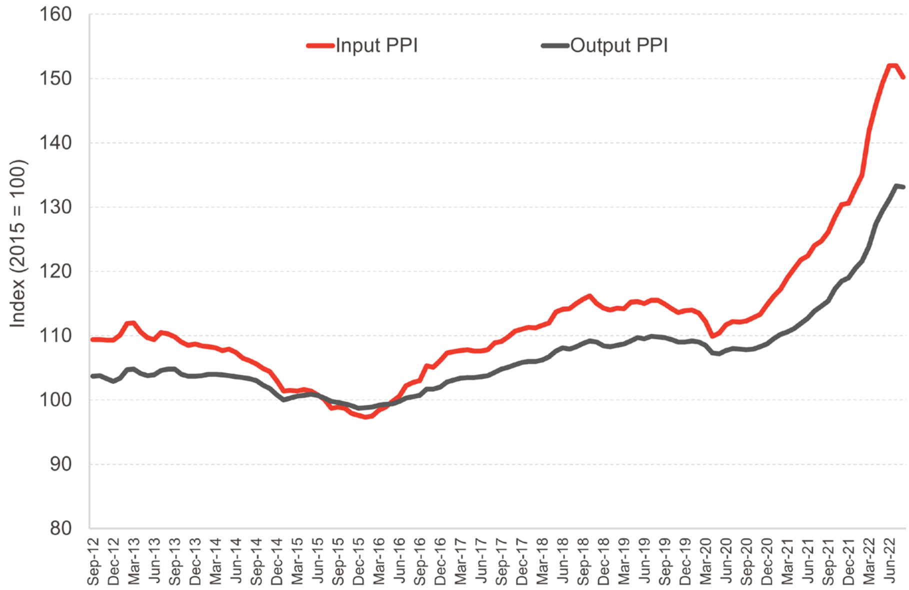
Firms are also experiencing severe supply chain delays and incurring much higher costs at the beginning and end of production.

The input producer price inflation (PPI) rate rose by 20.4% in the 12 months to August 2022, down from 22.6% in July.

The high annual PPI rate was primarily driven by the price of crude oil and materials such as metals, non-metallic minerals, and chemicals.

Producer output prices i.e., prices at the factory gate, have also grown quickly, with a twelve-month inflation rate of 16.1% in August 2022. This is down from 17.1% in July, the highest output inflation rate since 1977, Chart 7.

Chart 7: Producer price inflation, input and output, UK, July 2012 - July 2022



Source: *ONS*

5 ONS - Energy Bills Support Scheme classification.
6 UK Government - Energy Bill Relief Scheme: help for businesses and other non-domestic customers

The ongoing inflationary pressures facing firms and households are also feeding directly into UK economic growth.

UK GDP grew by 0.2% in July 2022, following a contraction of 0.6% the month prior. The economy grew by 0.2% over the second quarter (April to June), resulting in positive growth of 4.4% since the same quarter last year. Real quarterly GDP remained 0.2% below pre-pandemic levels in 2019 Q4.[7]

This slowing rate of growth is reflected in the majority of economic forecasters for the UK economy, with most revising down their expectations for UK growth in the coming years.

In August, the Bank of England forecast that the UK will enter a recession in Q4 2022, causing even more uncertainty for households and businesses, Table 1. In September, they made it clear that they thought growth for Q3 would also be negative.

Table 1: UK GDP growth projections, 2022-2025

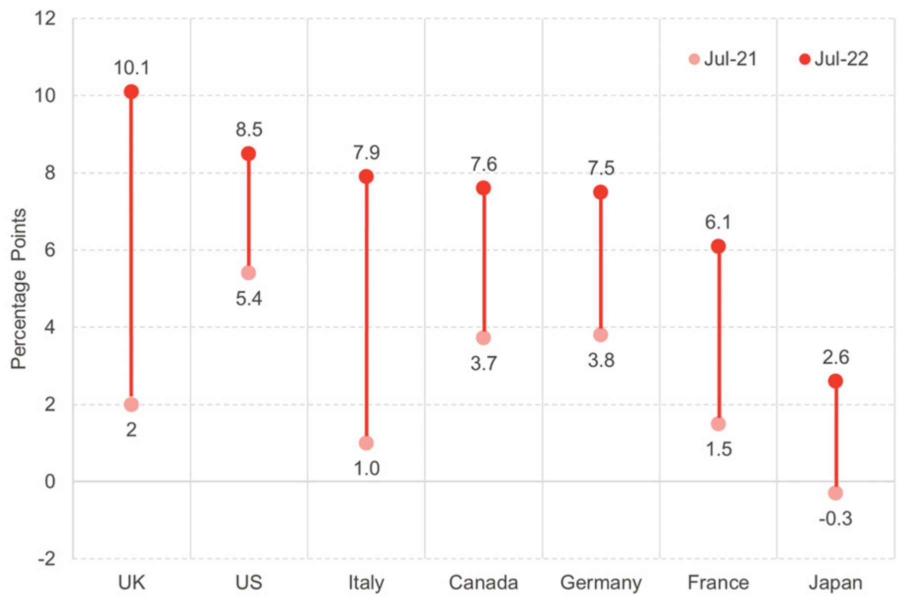
	2022	2023	2024	2025
BofE	3.5	-1.5	-0.25	-
OBR	3.8	1.8	2.1	1.8
NEISR	3.5	0.5	-	-
IMF	3.7	1.2	-	-
OECD	3.6	0.0	-	-
Oxford Econ	3.6	0.8	-	-
ITEM Club	4.1	1.9	-	-

** Some forecasts are from earlier this year and may not be a fair reflection of the current economic conditions*

Global economy

The vast majority of economies across the world are also experiencing higher prices and slower growth, Chart 8.

Chart 8: CPI Inflation, G7 countries, July 2021 – July 2022



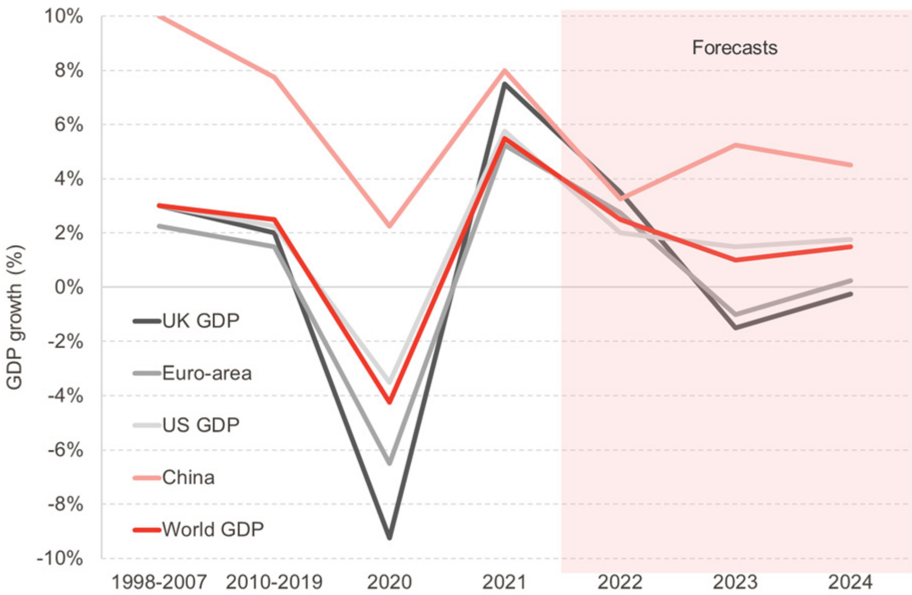
***Source:** Bank of England, OECD, Bank of Japan*

7 Quarterly GDP estimates are based on revisions by the ONS published on 30th September, 2022. Revised monthly estimates are not yet available.

Most recent data suggests that the UK was the first of the G7 countries to reach a double-digit headline inflation rate in 2022. Of the other countries, excluding Japan,[8] average inflation was 7.5%, far higher than the average 12 months prior.

These inflationary pressures are also now present in many forecasts for the global economy with the majority of forecasters revising down their expectations for global GDP, Chart 9.

Chart 9: Bank of England Economic Growth Forecasts, 1998-2007 – 2024



Source: *Bank of England*

The Bank of England now expect global GDP growth of 1% in 2023, one percentage point lower than their previous forecast.

As Europe continues to work towards reducing their reliance on Russia and away from the Nord Stream 1 pipeline for gas supply, the winter months are rapidly approaching bringing higher usage and inevitably higher costs as people look to heat their homes.

As well as this, the practicalities of entirely removing Russia as a supplier of gas to Europe are difficult, with countries such as Germany reporting that an end to Russian energy supplies would lead to gas rationing for gas-intensive firms in their capital city, Berlin.

The key therefore will be to find a way to support households and firms in the short term while finding longer-term solutions to the global energy crisis to prevent such emergencies in the future.

8 Japan has relatively low inflation given their central bank's loose approach to monetary policy and substantial subsidisation of goods and services within the economy.

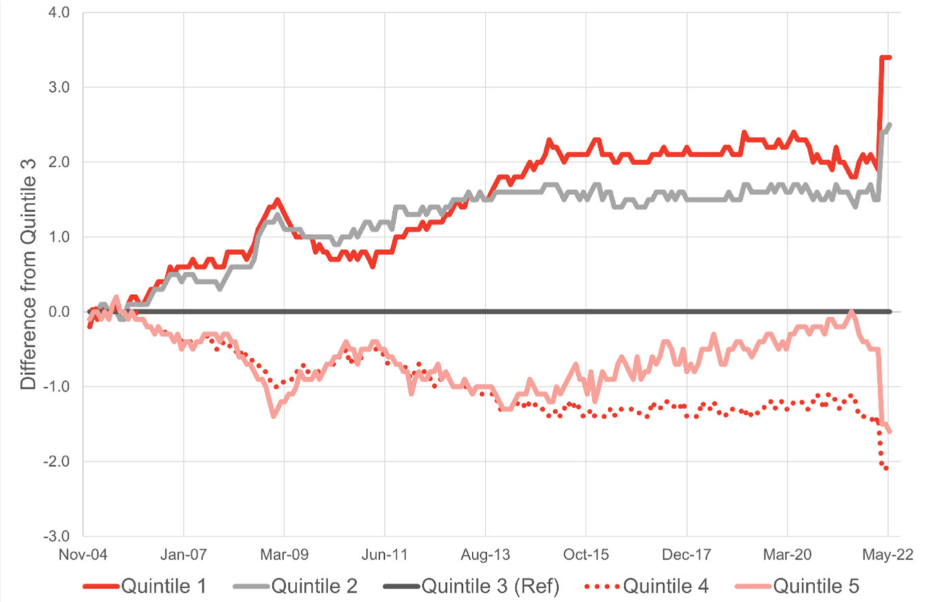
Households' experience of the cost-of-living crisis

Cost-of-living across the income distribution

Not all households are equally affected by rising prices. New ONS data for the UK released in August divides price indices, expenditure shares, and inflation by income quintile, retirement status, whether or not households have children, and residence type.[9]

As many have anticipated, the households that earn the least are feeling the effects of rising prices most keenly, Chart 10.

Chart 10: Relative CPIH price indices by income quintile, 2005-2022



** Indices are differenced from the index for households in the 3rd quintile (the reference group).*

Source: *ONS*

The first quintile (the lowest-earning 20% of households) faced an effective annual inflation rate of 9.8% in June, compared to 9.0% for the middle quintile and 7.9% for the highest.

Resolution Foundation's forecast estimates that households in the lowest income decile will face inflation of 15% by October, while inflation will be 11% for those in the highest decile.[10]

The difference in price indices across the income distribution are not new, but they have spiked this year. From 2013 to early 2022, the price index for the first quintile was about 2 points higher than for the third quintile. By June 2022, that difference had grown to 3.5 points.

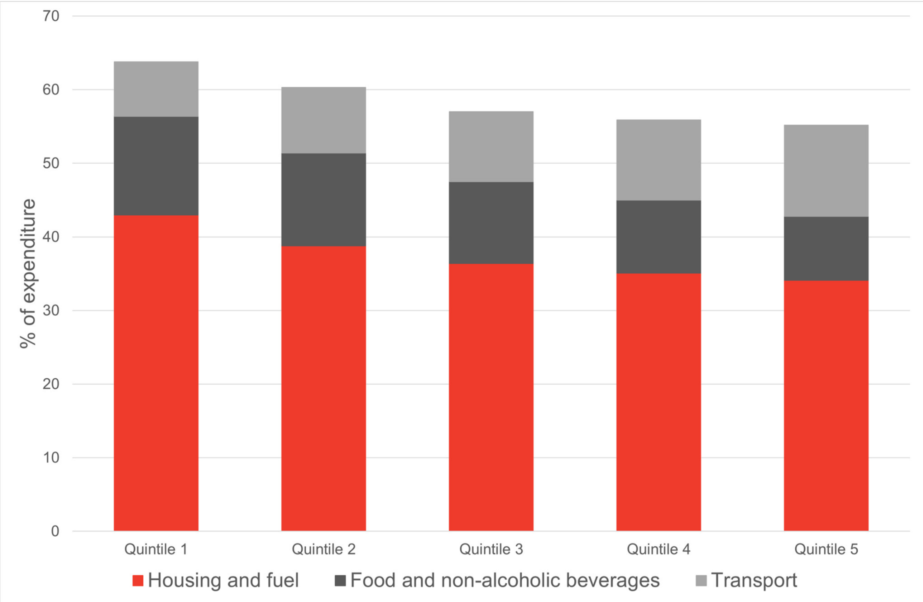
In comparison, the cost-of-living crisis has impacted the highest earners least.

Household spending patterns drive different effective inflation rates across the income distribution. Food, fuel, and housing make up a larger proportion of spending for lower-income households than for higher-income households.

9 ONS - CPIH-consistent inflation rate estimates for UK household groups: 2005 to 2019.
10 Resolution Foundation - The Living Standards Outlook 2022 – Summer Update.

The largest contributors to rising inflation are housing and household services, transport, and food and (non-alcoholic) beverages.[11] The share of expenditures on these categories falls as income increases, Chart 11.

Chart 11: Expenditure shares on selected categories by income quintile, Feb-Dec 2022



Source: *ONS*

This year, fuel, food, and transport comprised 64% of the expenditure of the lowest-earning quintile. The highest quintile spends 55% of expenditures on the same categories.

Lower-income households are also more likely to use pre-payment meters, and cannot spread costs across the year. High energy prices are more likely to result in reduced consumption during the winter for these households.

How does inflation affect real incomes?

Price inflation erodes real disposable incomes. In August 2022, the Bank of England estimated that real post-tax incomes will fall by 1.5% in 2022 and by 2.25% in 2023.[12]

In a recent report, the Resolution Foundation concluded that rising inflation will wipe out twenty years of real earnings growth.[13]

These effects are not evenly felt across the earnings distribution.

In addition to facing higher inflation, the lowest-earning households have seen a drop in year-on-year nominal earnings growth this year compared to higher-earning households. This slower wage growth will compound the effects of higher experienced inflation.

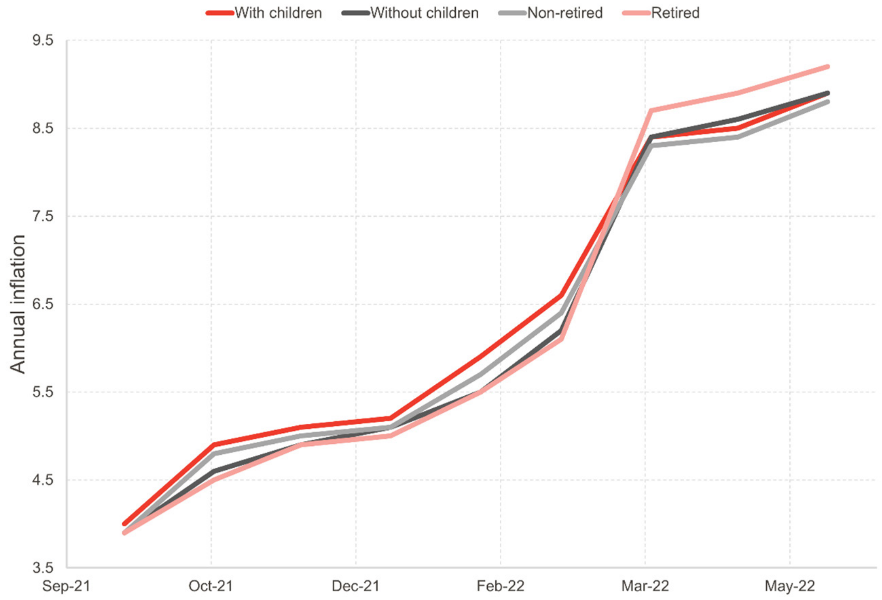
Cost-of-living for retired households and households with children

Household composition may also change how households experience changes in the cost of living, also due to differences in the composition of expenditures.

11 ONS – Consumer price inflation, UK: July 2022.
12 Bank of England - Monetary Policy Report - August 2022.
13 Resolution Foundation - The Living Standards Outlook 2022 – Summer Update.

Retired households typically face higher inflation than non-retired households, Chart 12. The inflation rate for retired households has been about 0.4 percentage points (pp) higher than for non-retired households since March. This trend highlights concerns about pensioners rationing fuel this winter.

Chart 12: Inflation by household composition



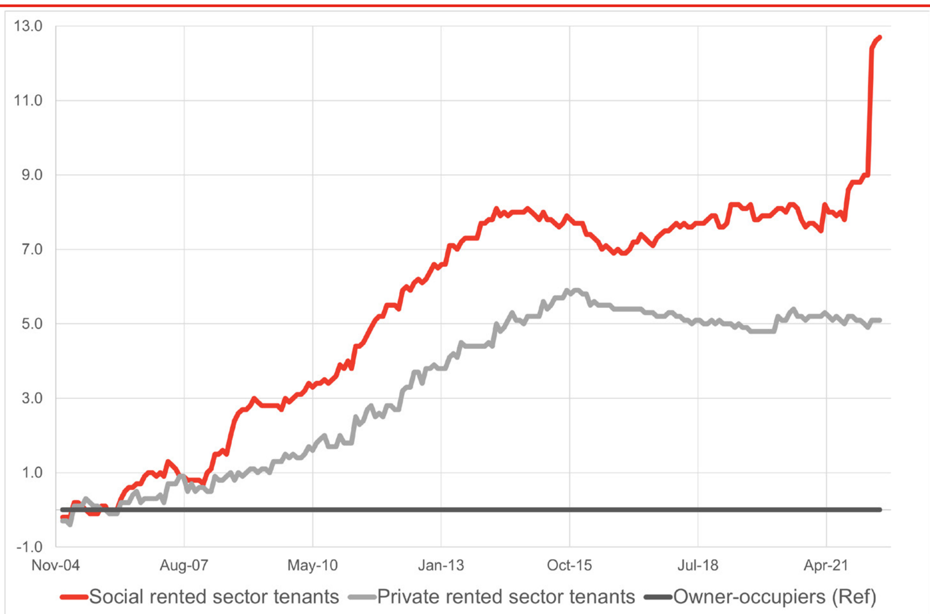
Source: *ONS*

Unlike retirement status, whether or not a household has children does not materially change the inflation rate they face.

Cost-of-living for renters and homeowners

Housing costs contribute to rising inflation, but the rates faced differ by residency type, Chart 13.

Chart 13: Relative CPIH price indices by resident type



** Indices are differenced from the index for owner-occupier households (the reference group). CPIH indices include housing costs.*

Source: *ONS*

Similarly to price indices across the income distribution, the price index for social rented sector tenants has spiked in 2022 compared to private rented sector tenants and owner-occupiers.

In June 2022, inflation for social rented sector tenants was 11.2%, compared to 8.2% and 8.6% for other renters and owner-occupiers respectively.

The most likely driver of this difference in experienced inflation is food costs rather than housing; social rented sector tenants spend 16.3% of expenditures on food and non-alcoholic beverages. The same share is about 10% for other renters and owner-occupiers.

Subsidised renters spend a smaller share of their expenditures on housing, fuels, and transport, so these are not likely sources of the difference in inflation rates. Regardless, subsidised renters are likely to be relatively low-income, and concerns about reduced food and fuel consumption, particularly in winter, are still salient.

Rising rent and mortgage rates are also likely to exacerbate pressure on household budgets, particularly for new homeowners.

Do proposed policies to combat the cost of living address distributional inequalities?

Both the UK and Scottish governments have announced policies to tackle the cost-of-living crisis, but it remains to be seen if these policies will effectively target those most impacted by inflation.

The £2,500 price cap announced by the UK government in September is guaranteed for two years and applies to all households equally. A £400 discount on energy bills starting in October and the cancellation of green levies on fuel are also universal.

A £15 billion support package announced in May provides one-off payments of £650 to low-income households on certain types of benefits, £300 to pensioner households, and £150 to individuals on disability benefits.[14]

Scottish Government has also recently announced policies that target the most vulnerable households. Initiatives include a rent freeze and a hold on increases to ScotRail fares.[15] The rent freeze in particular may help some in the short-term, but is likely to reduce rental property supply and quality if not carefully implemented.[16]

Some previously-planned policies, such as increasing the Scottish Child Payment from £20 to £25 per week, per child and extending the benefit to under-16s, will also help households with children to manage rising costs.[17]

The full distributional effects of the the cost-of-living crisis and the UK and Scottish governments' response remain to be seen.

14 UK Government - Millions of most vulnerable households will receive £1,200 of help with cost of living.
15 Scottish Government – Rent freeze focus of Programme for Government.
16 Economics Observatory - Does rent control work?
17 SPICe - Cost of living: Scottish Government support.

Scotland's spending and revenue

In August, the 2021-22 edition of the Government Expenditure and Revenue Collection Scotland publication was released.

Also known as GERS, this publication shows the level of spending for the residents of Scotland in a given year, as well as the revenue collected.[18]

Broadly, the statistics in GERS set out three main things:

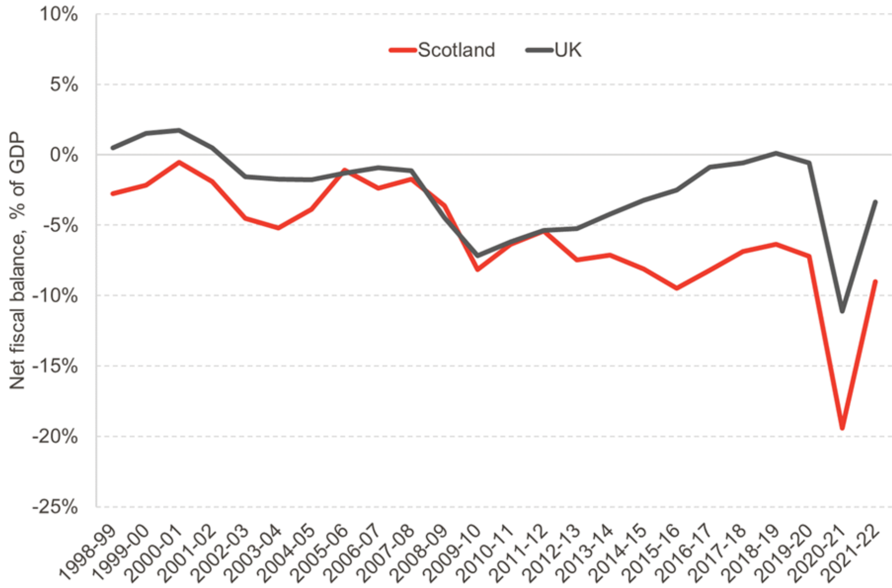
- The revenues raised in Scotland from both devolved and reserved taxation;
- Public expenditure for and on behalf of Scotland, again for both devolved and reserved expenditure;
- The difference between these two figures, which is called the net fiscal balance.

These statistics often spark debate over Scottish independence, particularly fiscal sustainability and the spending and taxation choices that would be available to an independent Scotland.

Net fiscal balance

In 2021-22, Scotland had a net fiscal balance of -£23,727, equal to -12.3% of GDP, Chart 14.

Chart 14: Net fiscal balance, Scotland and the UK, % of GDP, 1998-99 to 2021-22



Source: *Scottish Government*

This figure means that Scotland had a net fiscal deficit in 2021-22, which occurs when Scottish spending exceeds Scottish revenue.

Compared to 2020-21, which was the first year of COVID-related spending, Scotland's deficit has decreased by 43% - an amount equal to £13.3 billion.

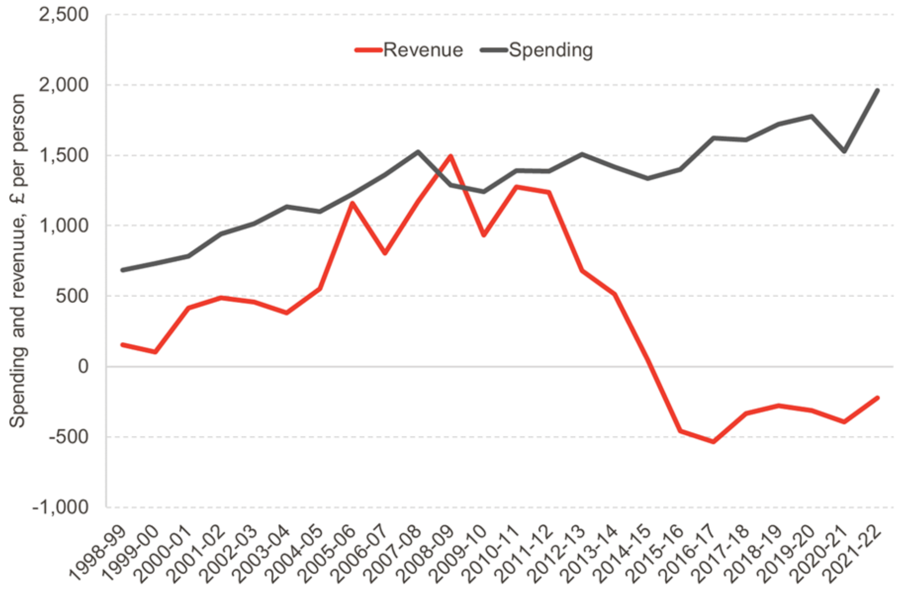
18 GERS is independently produced by statisticians at the Scottish Government, free of interference from Government ministers, and accessed by the UK Statistics Authority to ensure it is methodologically sound and in line with the Code of Practise for Statistics.

It is worth noting however, that COVID-19 hugely inflated Scotland's net fiscal deficit, and that Scotland's fiscal position has still not come back into line with its pre-pandemic level.

The divergence between Scotland and the UK's net fiscal balance in 2021-22 was driven by both revenue and expenditure.

Scotland raised £221 less revenue per head than the UK in 2021-22, but spent £1,963 more per head than the UK average, Chart 15.

Chart 15: Difference in spending and revenue between Scotland and the UK, £ per head, 1998-99 to 2021-22

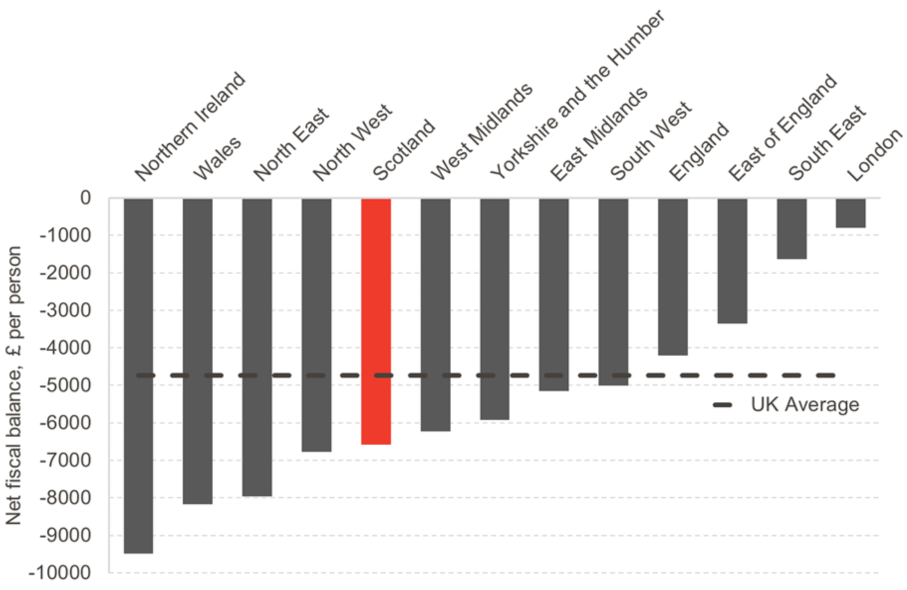


Source: *Scottish Government*

Scotland's net fiscal deficit was in line with that of the other countries and regions in the UK.

In March 2021, all countries and regions in the UK had a net fiscal deficit. Only London and its two surrounding regions had a net fiscal balance that surpassed the UK average, Chart 16.

Chart 16: Net fiscal balance by country and region, £ per head, March 2021

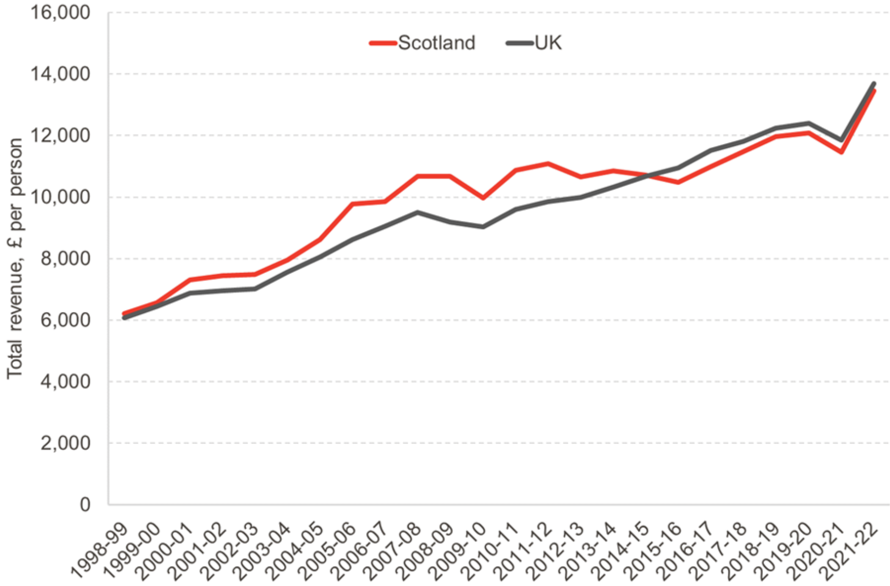


Source: *ONS*

Revenue

Scotland's total revenue (including its geographic share of North Sea revenue) was £73.8 billion in 2021-22, equivalent to 8.0% of total UK income, Chart 17.

Chart 17: Total revenue per person, Scotland and the UK, £, 1998-99 to 2021-22



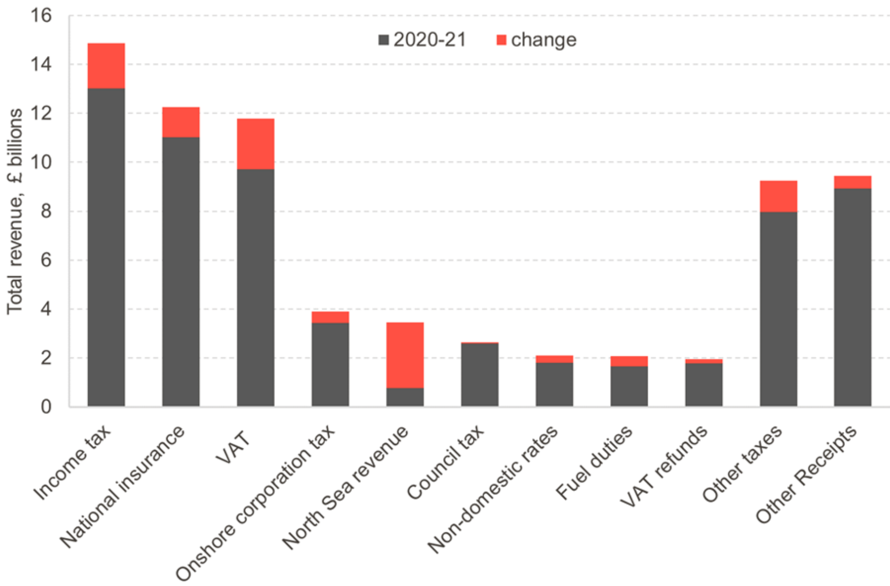
** The value for Scotland includes the geographical share of North Sea revenue.*

Source: *Scottish Government*

As Scotland accounts for 8.2% of the UK population, Scotland's total revenue was slightly lower than its population share.

Compared to the 2020-21 figure, Scottish total revenue rose by £11.1 billion, Chart 18.

Chart 18: Change in total revenue relative to 2020-21 value, £ billions, 2021-22

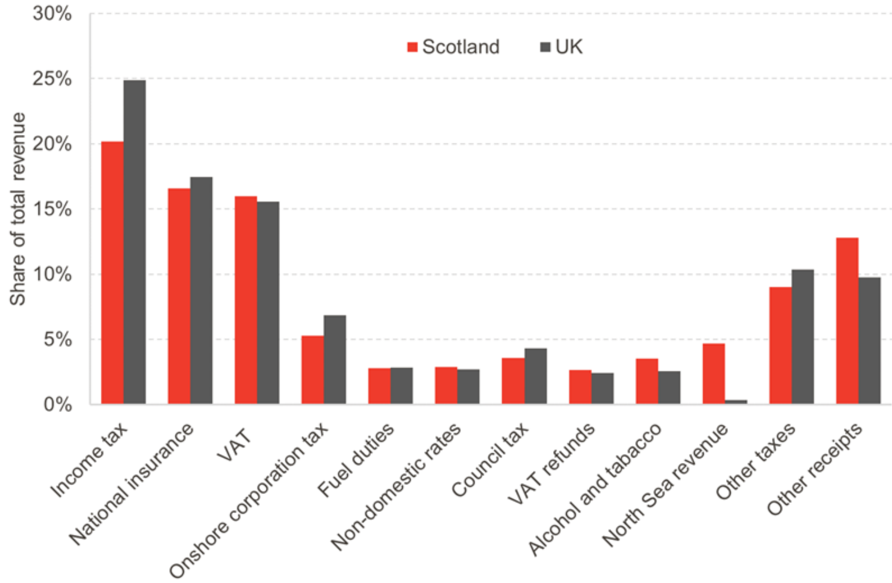


Source: *Scottish Government*

This was largely driven by growing economic activity following the reduction of COVID-19 restrictions and the growth in North Sea revenue.

From this rise in economic activity, Scottish revenue from income tax in 2021-22 grew by 14.3% to £14.9 billion, revenue from national insurance contributions rose by 11.1% to £12.2 billion, and revenue from VAT grew by 21.5% to £11.8 billion, Chart 19.

Chart 19: Shares of total revenue (%), 2021-22



Source: *Scottish Government*

North Sea revenue rose by 352.8% to £3.5 billion, its highest level since 2013-2014, as a result of rising oil and gas prices.

Including North Sea revenue, total revenue in Scotland grew 17.7% between 2020-21 and 2021-22.

However, excluding North Sea revenue, total revenue in Scotland grew by only 13.6% - a rate 1.4% lower than the UK's rate of revenue growth.

Scotland and the UK's divergence in revenue growth (excluding North Sea revenue) was primarily due to Scotland's lower growth in income tax receipts and non-domestic rates income, which lagged 2.2% and 11.2% respectively.

In comparison to the UK, Scotland raised a higher percentage of its total revenue from the North Sea, VAT, non-domestic rates, VAT refunds, alcohol and tobacco duty, and other receipts. Notably, in 2021-22, North Sea oil accounted for 4.7% of total Scottish revenue, but only 0.4% of UK total revenue, and alcohol and tobacco duties accounted for 3.5% of Scottish total revenue, but only 2.6% of UK total revenue.

Expenditure

GERS records all expenditure that benefits the residents of Scotland, even expenditure that occurs outwith Scotland's borders.

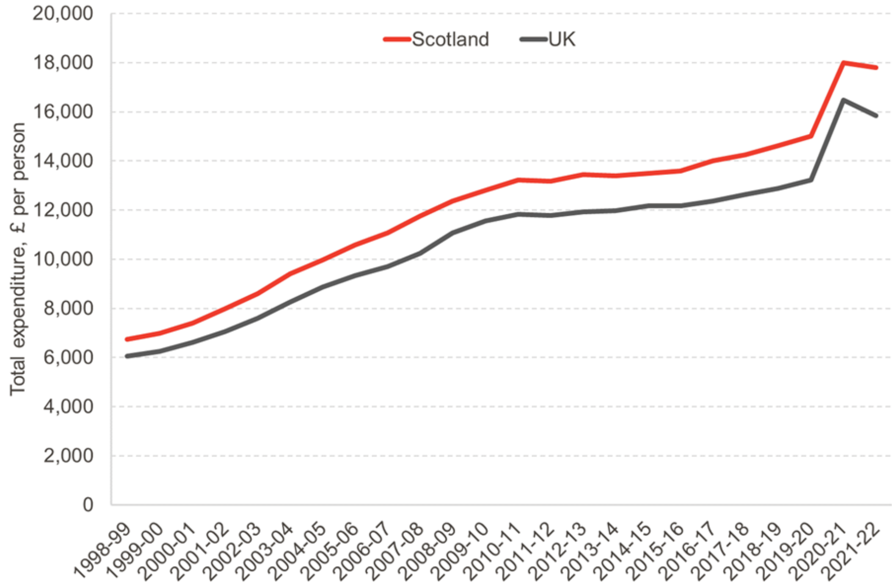
In 2021-22, total expenditure for Scotland was £97.5 billion, a decrease of 1.0% relative to 2020-21.

Much of the decrease was due to the winding-down of COVID-related support schemes, including record levels of funding for health, social security, enterprise, and economic development in 2019-20.

In 2021-22, Scotland's share of UK total expenditure was 9.2% - a value 1.0% higher than its population share of the UK.

In per capita terms, Scotland spent £17,793 per person in 2021-22, a value £1,963 (12.4%) higher than the UK average per capita spend of £15,830, Chart 20.

Chart 20: Total Expenditure Per Person, Scotland and the UK, 1998-1999 to 2021-22



** The value for Scotland includes the geographical share of North Sea revenue.*

Source: *Scottish Government*

Across most expenditure categories, Scotland spent more per person relative to the UK in 2021-22, with the outlier being defence, where the UK spent £3.36 more person.

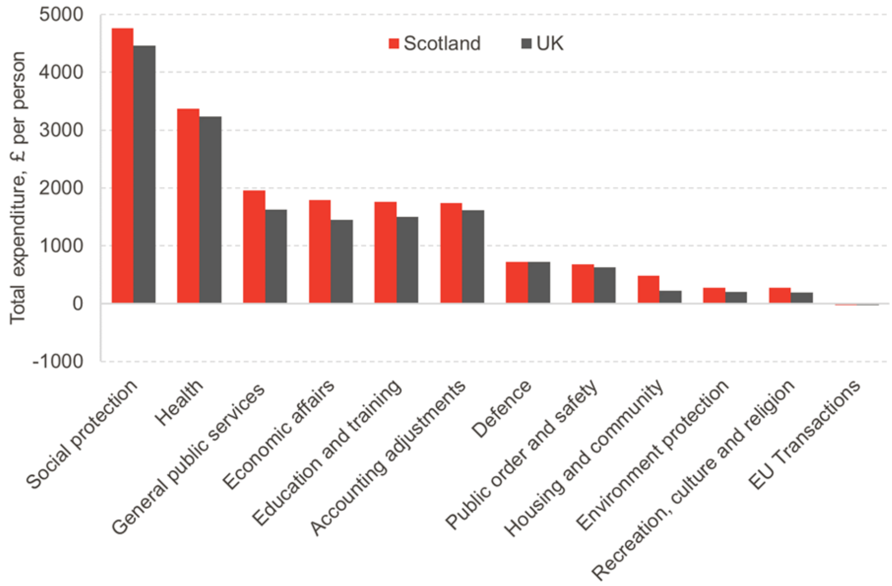
To deliver general public services, Scotland spent £339.45 more per person than the UK in 2021-22.

Elsewhere, per person, Scotland spent £340.38 more on economic affairs, £229.24 more on social protection, £261.05 more on education and training, and £250.94 more on housing and community amenities – a value nearly double that which the UK spends.

Between 2020-21 and 2021-22, Scotland's per capita expenditure fell by £205.14.

During this period, changes in Scottish expenditure largely followed spending trends in the UK as a whole, Chart 21.

Chart 21: Categories of total expenditure, Scotland and the UK, £ per person, 2021-22



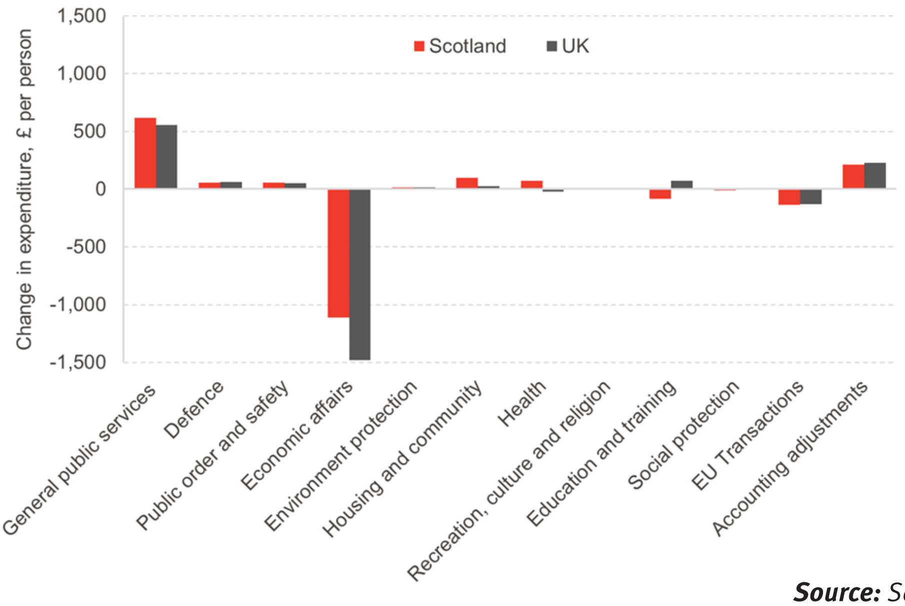
** Economic affairs spending includes employment policy expenditure.*

Source: *Scottish Government*

For example, between 2020-21 and 2021-22, there was a decline in economic affairs expenditure in both Scotland and the UK, primarily driven by reduced enterprise and economic development spending, which fell 64% and 74% respectively.

Furthermore, expenditure on employment policies and general public services rose in both the UK and Scotland, increasing by 60% and 46% respectively for Scotland, and 61% and 52% respectively for the UK, Chart 22.

Chart 22: Per capita change in expenditure categories between 2020-21 and 2021-22, Scotland and the UK (£)



Source: *Scottish Government*

Box 1: Micro spending

Looking closer at the expenditure data included in GERS, estimates of Scottish spending can be observed at a more micro level.

In this section, we provide an overview of Scottish expenditure on some of the more interesting projects and institutions using data from 2017-18 to 2020-21 – the most recent data available.

HS2

HS2, also known as High Speed 2, is Britain's new flagship railway project that will connect London with the North West of England.

Between 2017-18 and 2020-21, the UK spent £11.8 billion on HS2 – amounting to a total per person spend of £177.09 over the four years.

In their country and regional analysis database, HM Treasury estimated Scotland's share of this expenditure to be £49.52 per person over the four years.

However, as Scottish Government statisticians do not hold the view that expenditure on HS2 is for the benefit of Scottish residents, in GERS, the HM Treasury's estimates are revised to a value of zero.

The House of Commons

The House of Commons is where UK Members of Parliament (MPs) come to meet, propose new laws, and scrutinise government policies.

In GERS, expenditure on the House of Commons is split across administration costs and the costs of its members.

Between 2017-18 and 2020-21, £1.89 billion was spent by the UK on the House of Commons, with £1.86 billion of this allocated to administration costs, and £32 million allocated to the costs of its members.

Unlike HS2, GERS agrees with HM Treasury that spending on the Houses of Common is for the benefit of Scotland.

As such, Scotland has the same per person spend on the House of Commons as the rest of the UK. In 2020-21, this amounted to £15.86 per person, with £15.75 spent on its administration and 11p spent on members.

The House of Lords

The House of Lords is a branch of the UK Parliament, where members meet to review bills proposed by the House of Commons, and question government policies.

Like the House of Commons, GERS considers the House of Lords to benefit the people of Scotland. As such, the per person spend on the House of Lords in Scotland is the same as the per person spend in the rest of the UK.

In 2020-21, this was £2.25 per person, which amounted to £150.64 million across the entirety of the UK. Scotland's share of this £150.64 million was £12.28 million in 2020-21.

Nuclear-related expenditure

In GERS, nuclear-related expenditure includes energy generating activities, power plant decommissioning, and security and regulation.

In the UK, nuclear-related expenditure totalled £3.19 billion in 2020-21, which translates to spending of £47.54 per person.

In 2020-21, in the country and regional analysis calculations, HM Treasury estimated that Scotland spent £1.38 more per person on nuclear-related expenditure relative to the UK average – equivalent to £7.56 million.

In GERS, Scottish statisticians disagree with this point, arguing that energy generation in Scotland is for the benefit of the entire UK.

As such, in GERS, Scottish nuclear-related expenditure has been revised to match UK per person expenditure, which was £47.54 per person in 2020-21.

The Crown Estate Office

The Crown Estate office manages assets that belong to the British Monarchy, with the revenue from these assets managed by HM Treasury.

Between 2017-18 and 2020-21, the UK spent an average of £54.5 million per year on the Crown Estate Office, with particularly high spending in 2018-2019 totalling 238.76 million.

In HM Treasury's country and regional analysis, Scotland's share of this expenditure was estimated to be £17.85 million over the four years, with consistent per person spending on the Crown Estate Office aligning with the rest of the UK.

However, as GERS statisticians do not agree that all the expenditure on the Crown Estate Office is for the benefit of Scotland, GERS revised the 2020-21 expenditure figure for Scotland down from 4p per person to 2p per person.

Policy section: What the mini-budget means for Scotland

The announcements made by the UK Government on Friday 23rd September contained some of the most substantial tax policy changes seen in recent decades. Combined with recent announcements on the Energy Price Guarantee and Energy Bill Relief Scheme, these announcements constitutes a huge change in the fiscal outlook.

In this context, the decision not to involve the Office for Budget Responsibility (OBR) is concerning. It might be billed as a 'Growth Plan', but the September announcements are a budget in all but name. The OBR plays an essential role in scrutinising tax and spend forecasts, assessing the likely impact of policy announcements on growth, the deficit and debt. Its exclusion from the process weakens transparency around the impacts of the proposals.

This decision, and the overall approach to fund tax cuts from borrowing without any independent assessment of the consequences, has had clear implications in the markets. The weakening of the pound and the increases in government gilt rates are likely to exacerbate the cost pressures facing individuals and businesses in the months to come – as well as making it much more expensive for the government to borrow.

So what was announced?

There were two 'tax cuts' that more accurately constitute reversals in recent or planned increases.

- A planned increase in the Corporation Tax rate from 19% to 25% will now not go ahead. The Treasury estimates this will cost £12bn in reduced revenue compared to its previous plans in 2023-24, and more in subsequent years.
- The Health and Social Care Levy has also been scrapped, together with the 1.25% increase in dividend tax rates. These changes will cost almost £18bn in reduced revenues in 2023-24 compared to previous plans.

Both of these changes had been pre-announced and apply UK-wide. The big surprises came on income tax. Here the government announced the biggest reforms (at UK level) since 2009.

- The basic rate will be reduced from 20p to 19p one year earlier than expected, applying from April 2023 rather than April 2024.
- The 45p additional rate will be abolished in April 2023 (a decision later reversed on 3rd October).

Of course, since income tax is devolved, any changes made by the UK government do not apply in Scotland. Instead, the Scottish Government will see a smaller reduction in its block grant next year than it was expecting, boosting the resources available to it in 2023-24.[19]

19 The reduction to the Scottish Government's block grant is broadly designed to reflect what the UK government would have raised from income tax in Scotland if income tax were not devolved, and if the UK government income tax policy had continued to apply in Scotland.

In the context of this additional resource through its block grant, the Scottish Government will then need to decide whether and how to respond through its own tax policy.

It could of course keep Scottish tax policy unchanged. This would enable it to use its additional block grant to invest in public services in Scotland. The cost of it doing this politically would be that the gap between Scottish and rUK tax policy would widen substantially. Almost all Scottish income taxpayers would pay more income tax than they would in rUK. A Scottish taxpayer with an income of £29,000 would face liabilities around £160 higher. A Scottish taxpayer with an income of £50,000 would face liabilities almost £2,000 higher.

Alternatively the Scottish government could mirror UK tax cuts with tax cuts of its own. It could for example decide to reduce the starter, basic and intermediate rates by 1p. This would broadly retain the difference in tax liability for individuals between Scotland and rUK at current levels. It would allow the Scottish Government to retain its treasured mantra that 'the lowest income half of Scottish taxpayers pay less tax than they would in rUK'. But such a policy would cost the Scottish government around £400m in foregone revenues.

Other policy decisions are possible. The Scottish government could decide to cut just the starter and basic rates in Scotland, rather than the intermediate rate as well, at a revenue cost of around £250m.

The announced reversal of the abolishment of the 45p additional rate has removed the need for a difficult policy decision regarding whether or not to match the removal.

Stamp Duty changes and implications for Scotland

The Chancellor also announced changes to Stamp Duty in England and NI, amounting to an increase in the threshold at which Stamp Duty applies to residential transactions. As with income tax, these changes will not apply in Scotland. The changes to English policy will pose dilemmas for the Scottish Government when considering its policy on the Land and Buildings Transaction Tax.

The Scottish Government has until now set LBTT in such a way that homes sold in Scotland for less than around £335,000 pay less tax than an equivalent property in England. Above this price, transactions in Scotland face noticeably higher tax liabilities. The changes announced by the UK government today mean that – if there are no changes to the existing Scottish LBTT rates – all property transactions in Scotland would face higher tax liabilities than they would in England.

The Stamp Duty cuts in England will generate some additional resources for the Scottish Government via its block grant. In ballpark terms the increase in resource might be around £80m. It could use this additional resource to fund public services, or to cut LBTT rates in order to maintain existing tax differentials.

Investment zones – an option for Scotland, but at what cost?

The UK government announced the establishment of several dozen 'investment zones'. It is hoped that these zones will 'drive growth and unlock housing… by lowering taxes and liberalising planning frameworks'. Policies implemented within the investment zones will include business rate reliefs for newly occupied or expanded premises, and stamp duty relief on land bought for commercial purposes, and a zero-rate of employer National Insurance Contributions for new employees earning below £50,270.

The hoped-for impacts of these investment zones on UK-wide economic activity – as opposed to their effect on displacing economic activity within parts of the UK – remains to be seen. Several dozen potential zones have been identified in England. The UK government says that it will work with the Scottish government and local authorities to identify zones in Scotland.

What is not yet clear is how the costs of investment zones in Scotland – in the form of reliefs on business rates and stamp duty (which are devolved) and NICs reliefs (which are not devolved) – will be distributed between the Scottish and UK governments. The Treasury's costing document does not seem to give an indication of the funding associated with the planned investment zones in England, so it is difficult to get a sense of the fiscal scale of these interventions at this stage.

A gamble on growth with long odds…

It is undeniably the case that the UK (and Scottish) economies have been characterised for the last 15 years by very weak growth. This has resulted in stagnation in household incomes and living standards, and constrained the growth of government revenues – with implications for investment in public services.

It makes sense therefore for the government to put the objective to raise economic growth at the centre of its strategy. But setting a 2.5% annual growth target, as the UK government has done, is much easier said than achieved.

The government's decision to reverse the Health and Social Care Levy and cancel the planned Corporation Tax increases merely take policy back to where it has been in the recent past. It is a return to orthodoxy rather than a break from the norm, and in this sense it is difficult to see that it will make any difference to growth.

The substantial cuts to income tax do represent a bigger change to existing policy, but there is no definitive evidence internationally that countries with lower tax rates grow more quickly. Historically, UK growth rates were highest when tax rates were higher.

Whether these announcements unleash economic growth remains very much to be seen. Strikingly, what there was no mention of was any plans for additional public sector investment. Despite the government's rhetoric about reforming the 'supply-side' of the economy, there was little mention of the role that the skills and health of the population play in influencing the capacity of the economy to grow.

Whilst the government seems comfortable borrowing an additional £30bn or so a year to fund the tax cuts announced today, and is apparently relaxed about an over-growing burden of national debt, the path set out today will constrain the government's room for manoeuvre on investment in public services in coming years.

At a time when parts of the public sector are struggling to deal with the legacy of the pandemic and other longstanding challenges, the implied prioritisation of tax cuts over public services investment will prove highly contentious, particularly given the regressivity of the cuts. Households in the top 10% of the income distribution in Scotland will be better off by around £24 per week on average as a result of the cancellation of the Health and Social Care Levy, whereas those in the middle of the distribution will be only £4 per week.

The hope that the policies announced will boost growth and hence revenues despite cuts in tax rates is a big gamble with long odds. The market reaction shows the nervousness that exists about the approach the government is taking with the nation's finances.

So what next?

Given the market turmoil that followed the Government’s announcements, the Treasury has announced that a Medium-Term Fiscal Plan will be published in October, alongside a full OBR forecast.

In Scotland, the Deputy First Minister has said that they will respond to the UK Government's mini-budget in the week beginning 24th October.

On income tax however, it is likely that the Scottish Government will wait for the publication of their full draft budget, once they have all of the information they need about their budget envelope from the full OBR forecast. We expect the Scottish Budget by the end of the year.

University of Strathclyde Business School

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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
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