Fraser of Allander Institute

Economic Commentary

Vol 47 No 4

Foreword

As we settle into 2024, this quarter's Economic Commentary paints a mixed picture of Scotland's current economic position, with a coexistence of positive and negative indicators. While growth in 2023 was weak, and the near-term outlook remains undeniably challenging – with businesses and households alike facing the very real effects of cost pressures and elevated interest rates – there are distinct reasons for cautious optimism.

Although it remains above the Bank of England's target, inflation declined sharply during 2023, and Deloitte's economic analysis projects that it will continue to moderate throughout 2024, providing a boost to real incomes and paving the way for gradual interest rate cuts, with growth expected to pick up in the second half of the year. Though of course, there are risks to this forecast. Engineering a return to low inflation without landing the economy in recession is notoriously difficult.

The Scottish and UK governments have a difficult balance to strike between immediate fiscal decisions and ensuring long-term growth; the end of last year saw the Scottish Government tackling this predicament through its Budget statement. The government has predicted that its introduction of the advanced rate, and increase in the top rate of income tax, will raise tax revenue. As this quarter's Commentary illustrates, every £1 earned by a Scottish taxpayer in excess of £75,000 will now be taxed at a marginal rate equal to the highest rate of tax in the rest of the UK; in other words, the level of individual taxation that is applied to only the very highest incomes in the rest of the UK, will be felt much further down the income scale in Scotland.

What is difficult to predict is the level of individual taxpayer behaviour in response to these higher rates of personal tax. If, for example, individuals limit their taxable income by making additional pension contributions, that could ultimately reduce the benefit to the Scottish Budget.

If individual taxpayers perceive that their after-tax, take-home pay from an additional hour of work is insufficient to compensate for their time, then they may seek to limit their working time. At an individual level this could mean, for example, not working overtime, or adopting a reduced-hours working week. This could represent a more profound effect: a reduction in productivity and growth in the wider Scottish economy. The business community has warned the new rates could deter investment and growth in Scotland and make it harder to recruit and retain skilled workers.

The Budget also reduced university funding, meaning fewer places for Scottish students, which will naturally exacerbate the talent shortage further. With increased competition for places among Scottish students, more will be disappointed at not getting a funded place. Those who can afford it may choose to study elsewhere in the UK – making it difficult to attract them back. Scotland has excellent universities which make for rich recruitment grounds, but with a higher proportion of non-local students, businesses will inevitably recruit more graduates who don't plan to stay in Scotland for the long term.

Deloitte's latest CFO Survey, published in recent weeks, found that the UK's finance chiefs believe geopolitical factors pose the greatest external risk to their businesses over the next 12 months. Despite this, CFOs are starting the year in relatively positive spirits, with sentiment among them rising for a second consecutive quarter, and optimism above average levels. Notably, inflation and high interest rates have dropped down their risk list.

Although they are more optimistic, UK CFOs remain focused on defensive strategies. This chimes with the findings of the Fraser of Allander Institute's latest Scottish Business Monitor, which found that nearly half of firms in Scotland have cancelled or delayed planned investments in the past 12 months.

While challenging economic conditions remain for Scotland's economy as 2024 gets underway, there is good reason to be optimistic. A bolstered sense of confidence among both businesses and consumers has signalled a positive start to the year, and an anticipated fall in inflation and return to growth are very much within our line of sight.

Angela Mitchell

Senior Partner for Scotland at Deloitte

February 2024

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Summary

We are starting off 2024 in an atmosphere of cautious optimism for the year ahead.

2023 was a year of stuttering growth, with it likely that the second and fourth quarters of the year will end up in negative territory. The data for 2023 is not yet complete, with Scottish GDP data available up to November 2023. We expect that growth for the year as a whole is likely to end up at 0.2% - that is, there has been very little growth in the economy over 2023.

The wider assessment of business and consumer sentiment shows steady improvement as we move into 2024. While still weaker than pre-pandemic levels in general, this improvement is heartening and likely to be driven by inflation coming down – and the promise of interest rates that may come over the course of the year.

We are now forecasting growth of 0.6% in 2024, 1.1% in 2025 and 1.2% in 2026. Whilst these forecasts are slightly weaker than previous forecasts, it still points to improving conditions in the economy over the course of this year.

Analysis in the Commentary this quarter includes a detailed look at the recovery of different sectors in the Scottish economy from the shock of the pandemic, highlighting a number of differentials between the performance of sectors in Scotland compared to the UK as a whole.

Overall, the latest quarterly data would suggest that Scotland is not too far behind the UK in recovery from the pandemic - Scotland is 1.7% above pre-pandemic levels as at Q3 2023, whereas the UK as a whole is at 1.9% above. However, it is a concern that we have seen marked contractions in the Scottish economy in October and November.

However, picture below the aggregate shows large differentials in individual sectors.

In this Commentary, we have a section dedicated to the Scottish Budget, which the Deputy First Minister presented to the Scottish Parliament on 19th December.

The headline grabbing measure from the Scottish Budget was definitely the introduction of a new income tax band for those on incomes between £75,000 and 125,000. However, this raises around £74m – not insignificant, but small in the context of the Scottish Budget.

Much more significant were the “non-decisions”. For example, the decision not to raise the higher rate threshold by inflation raises the Scottish Government around £300m. We also analyse the assumed pathway for Scottish earnings, which has a large influence on the income tax take and therefore the SG’s budget envelope.

We also have a section devoted to transparency: what the Scottish Government could and should do to improve the transparency of their budget documents and information to aid the debate. Unfortunately, we seem to say this every budget event, and while some progress has been made it is too slow and is not feeding through to the budget discourse.

Fraser of Allander Institute
February 2024

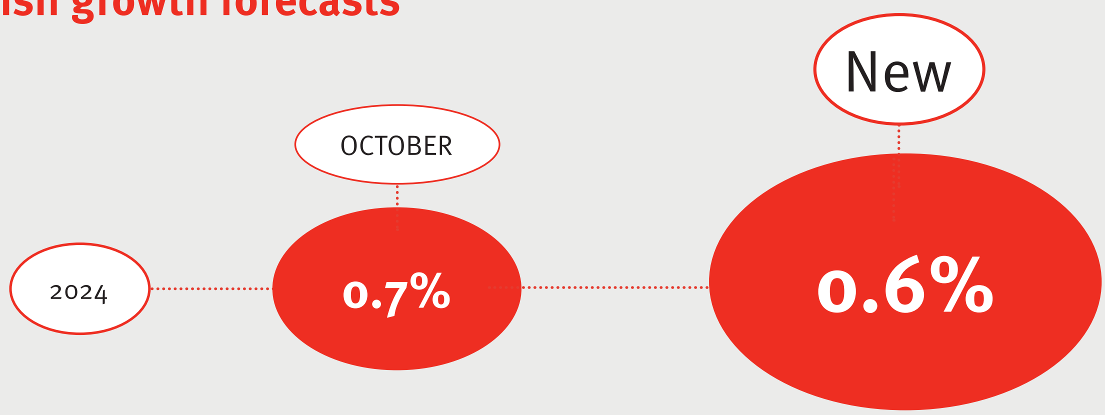
Fraser of Allander Institute

State of the economy

Indicator	% of 2019 Q4	Change on previous month	Performance	Latest data
Scottish GDP	101.2%	-0.1%	▼	Nov 2023
Production	90.9%	-3.1%	▼	
Construction	107.3%	-0.2%	▼	
Services	102.9%	0.4%	▲	
Indicator	**Level**	**Change on previous year, same month/ quarter**	**Trend**	**Latest data**
Inflation (CPI)	--	4.0%		December 2023
Employment rate	74.4%	-1.7pp	▼	Sep-Nov 2023*
Unemp. rate	4.0%	+0.6pp	▲	
Inactivity rate	22.6%	+1.3pp	▲	

* Based on experimental statistics

Scottish growth forecasts



	2023	2024	2025	2026
FAI *February 2024*	0.2%	0.6%	1.1%	1.2%
SFC *December 2023*	0.1%	0.7%	1.1%	1.3%
FAI *October 2023*	0.2%	0.7%	1.2%	--

Outlook and Appraisal

Where are we now?

Scotland has avoided a technical recession, although growth has remained relatively slow.

Scottish GDP in the third quarter of 2023 was up 0.4% on the previous quarter, although still only 0.9% above the level of GDP in the last quarter of 2019 (Chart 1).

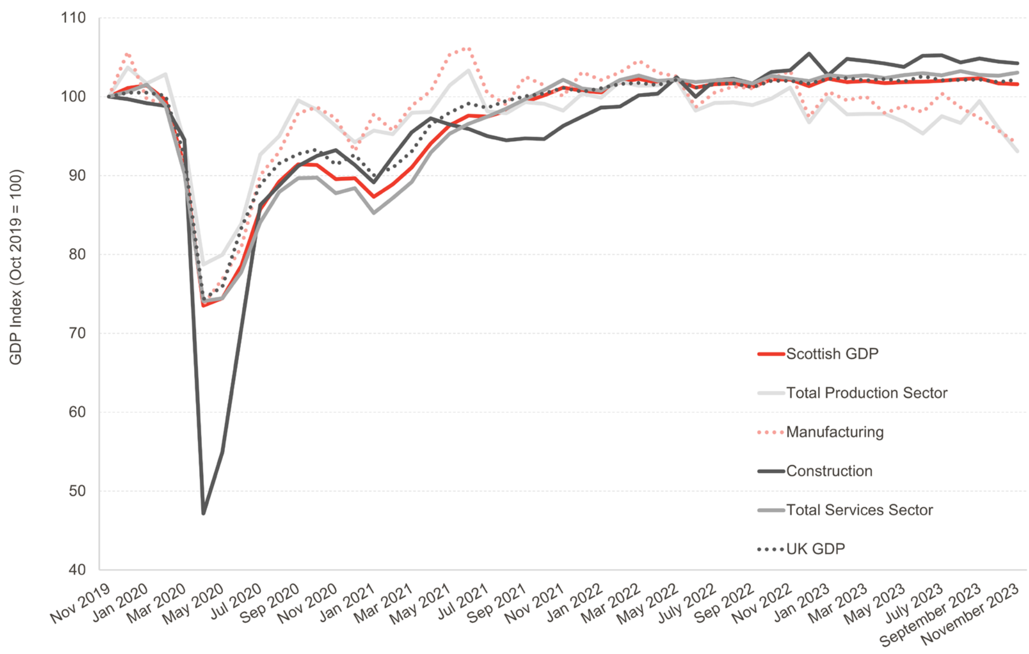
GDP contracted from September to October by 0.6%, and by another 0.1% in November. This was largely driven by the production sector, which contracted by 6.4% over these two months due to changes in the electricity and gas supply sector.

However, output in the services sector, which accounts for around three quarters of the economy, is estimated to have grown by 0.4% in November, helping Scotland to avoid a technical recession.

In contrast to the UK GDP, which contracted by 0.1% in the third quarter, Scottish growth appears comparatively positive.

However, the subdued performance in the UK during July was primarily attributed to public sector strikes rather than a genuine divergence in economic performance.

Chart 1: Scottish and UK GDP growth indices with selected Scottish sectors, November 2019 - November 2023



Source: *Scottish Government, ONS*

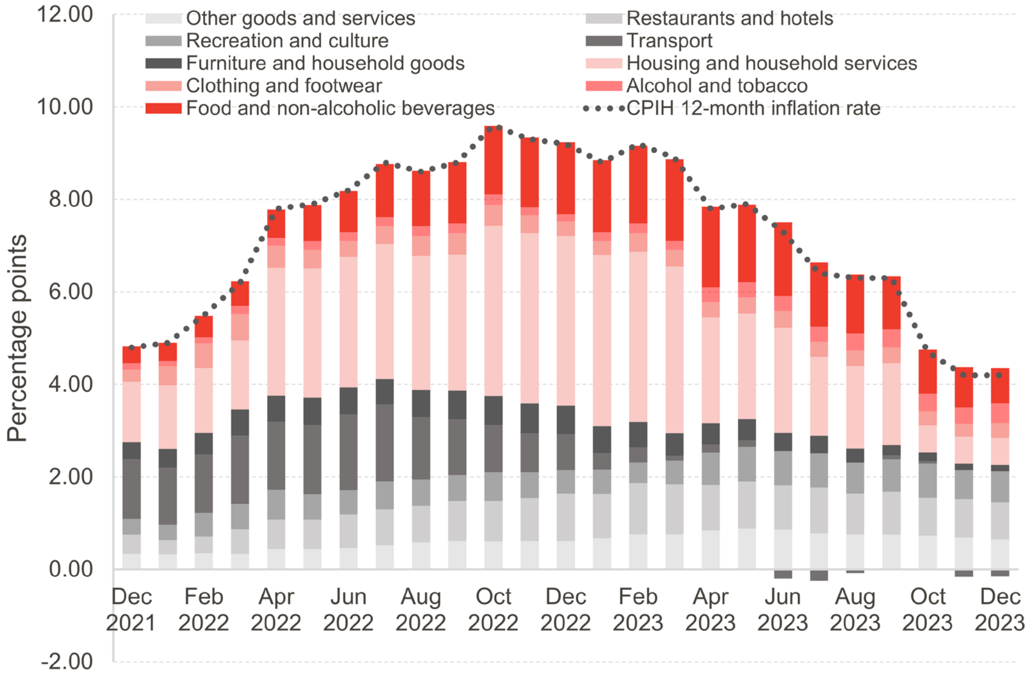
The CPI inflation rate rose to 4.0% in the 12 months to December 2023, up from 3.9% in November 2023 and a peak of 11.1% in October 2022.

Some leading forecasters have now forecast that CPI inflation will fall below 2% in the next four months. The Bank of England's next review and updated forecasts will be published next month.

The CPIH inflation rate, which includes costs paid by owner-occupiers of housing, followed a similar pattern and stayed at 4.2%.

The fall in the CPIH over recent months has been driven primarily by reduced growth in the price of transport, housing, and household services (Chart 2).

Chart 2: Contributions to the annual CPIH inflation rate, UK, December 2021 – December 2023

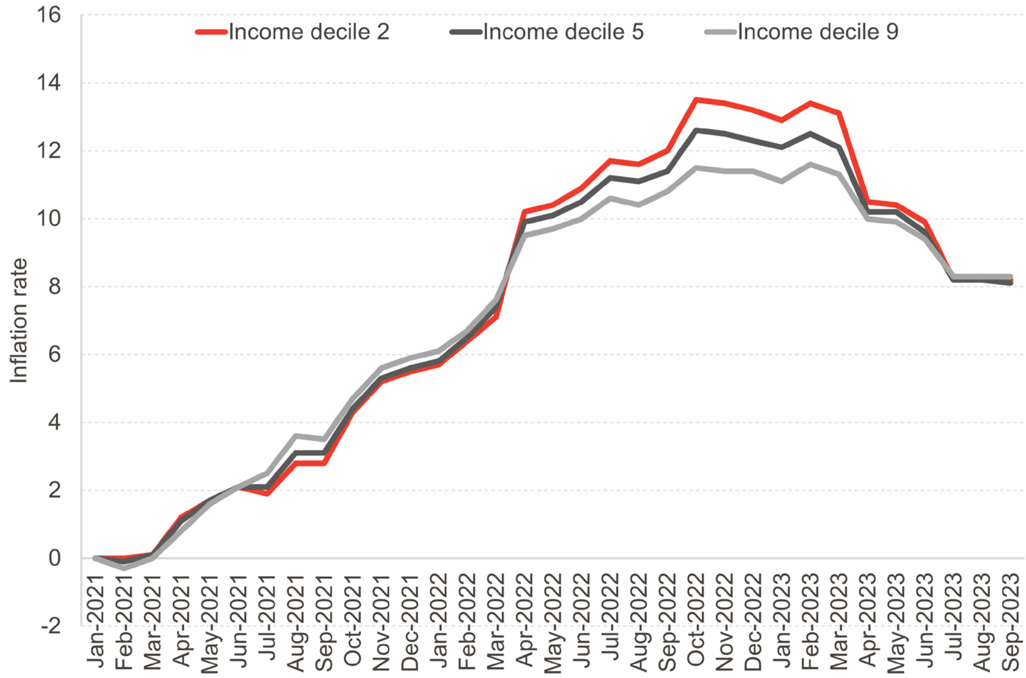


Source: ONS

Lower inflation rates have been reflected across the income distribution.

At the peak of inflation in late 2022, the inflation rate experienced by the lowest-earning households was approximately 2 percentage points higher than that experienced by the highest-earning households. These rates have now broadly equalised as inflation has fallen (Chart 3).

Chart 3: Household costs indices for UK household groups, Jan 2022 - Sep 2023



Source: ONS

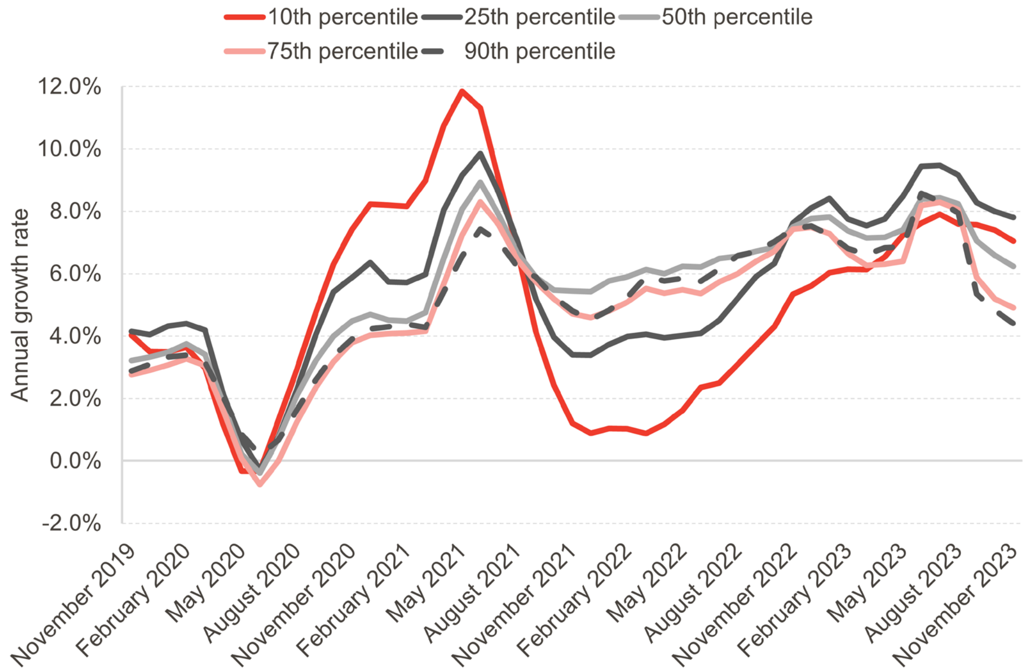
Per the ONS, the greatest contribution to different inflation rates across the income distribution between April 2022 and March 2023 came from differences in housing costs and household services. The differences in experienced inflation have therefore fallen as the growth in the price of electricity, gas, and other fuels decreases.

Growth rates in earnings have also started to converge across the earnings distribution (Chart 4).

Earnings at the 10th and 25th percentiles of the earnings distribution grew more slowly between October 2021 and early 2023, but year-on-year growth rates for earnings at these percentiles now fall between 7-8%.

Growth rates for earnings further up the earnings distribution have now dipped to between 5-7% after trending upwards earlier in the cost-of-living crisis.

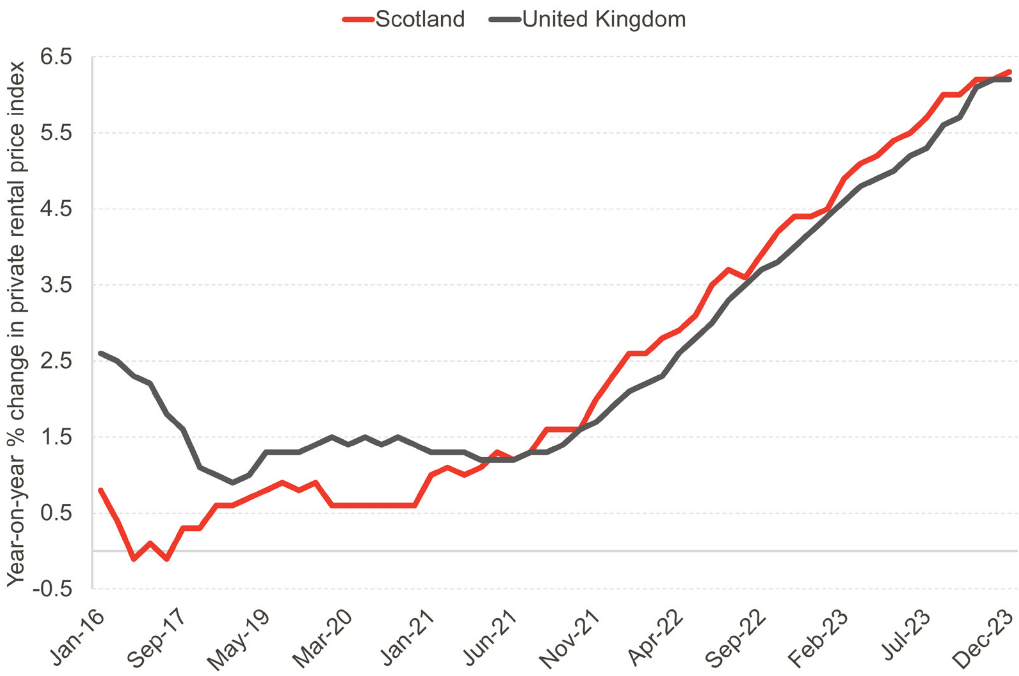
Chart 4: Annual growth rate of monthly pay by percentile (from PAYE), seasonally adjusted, November 2019 – November 2023



Source: *ONS*

Private rental price inflation remained above 6%, a relatively high rate of growth compared to previous years (Chart 5). This is likely driven by high rates of change in new rental agreements.

Chart 5: Index of private housing rental prices, Scotland and UK, Jan 2016 – Dec 2023

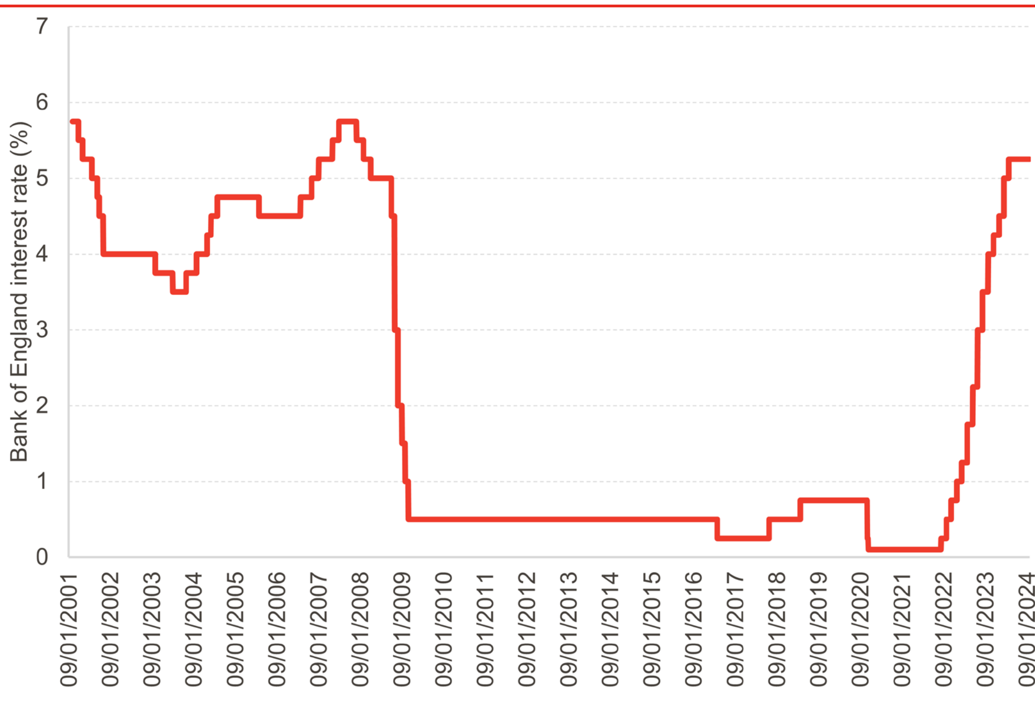


Source: *[ONS]*

The rate of increase in private rental prices in Scotland has slightly outpaced the UK since June 2021. There has been a notable surge in rate of increase for both over this time, from 1.2% in June 2021 to a 6.3% increase in December 2023. This marks a change from 2016-2020 when overall rates were lower and the rate in the UK exceeded that in Scotland.

The Bank of England have maintained the Bank Rate at 5.25% for the fourth time, after 14 consecutive increases from 0.1% in December 2021 (Chart 6).

Chart 6: Bank of England Bank Rate, January 2001 – January 2024



Source: *[Bank of England]*

The Monetary Policy Committee has, however, hinted that rate cuts may occur soon, providing some optimism for this year.

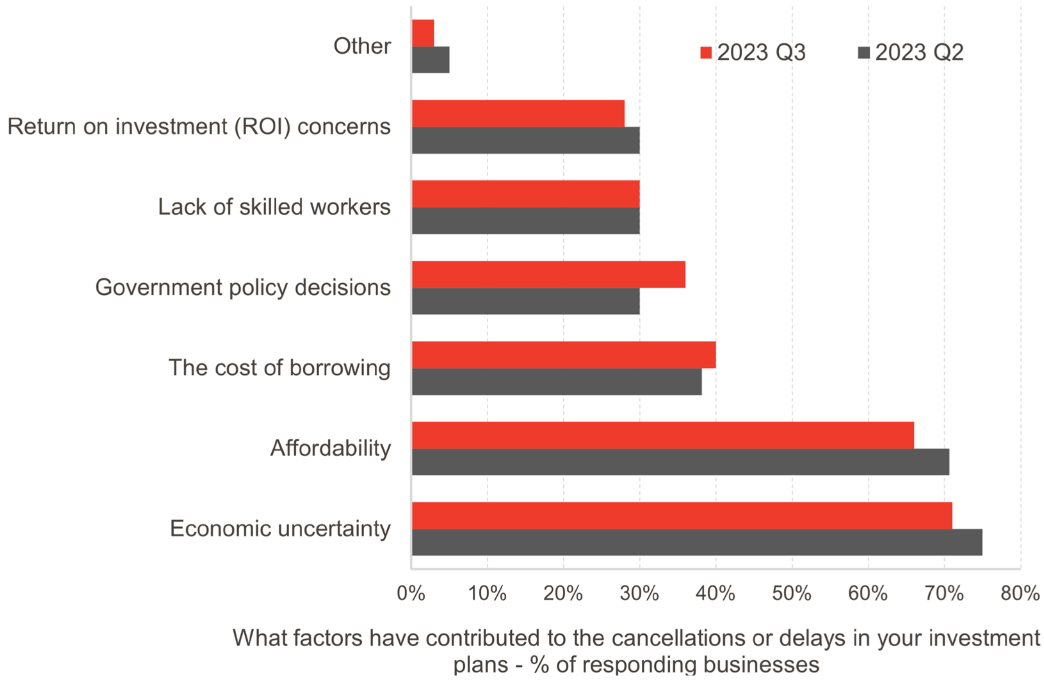
Business conditions in the UK, though still challenging, may improve through the year. It remains to be seen if the same will be true in Scotland.

Scottish firms face a challenging situation, with investment emerging as a key concern.

Nearly half of firms in Scotland have cancelled or delayed planned investments in the past 12 months, according to our latest Scottish Business Monitor.

Although concerns about affordability and economic uncertainty are easing, the influence of government policy decisions on business choices has gone up from 30% to 36% among surveyed firms (Chart 7).

Chart 7: Reasons for business investment cancellations or delays, Q2 vs Q3 2023



Source: *FAI Scottish Business Monitor*

Most of the investments that got delayed or cancelled are related to physical assets (74%), but companies are also putting a hold on investing in their workforce (41%) and upgrading technology and information systems (36%).

Given the challenging investment landscape, the news that full expensing is becoming a permanent feature, as announced in the Autumn Statement, will be particularly well-received by many businesses.

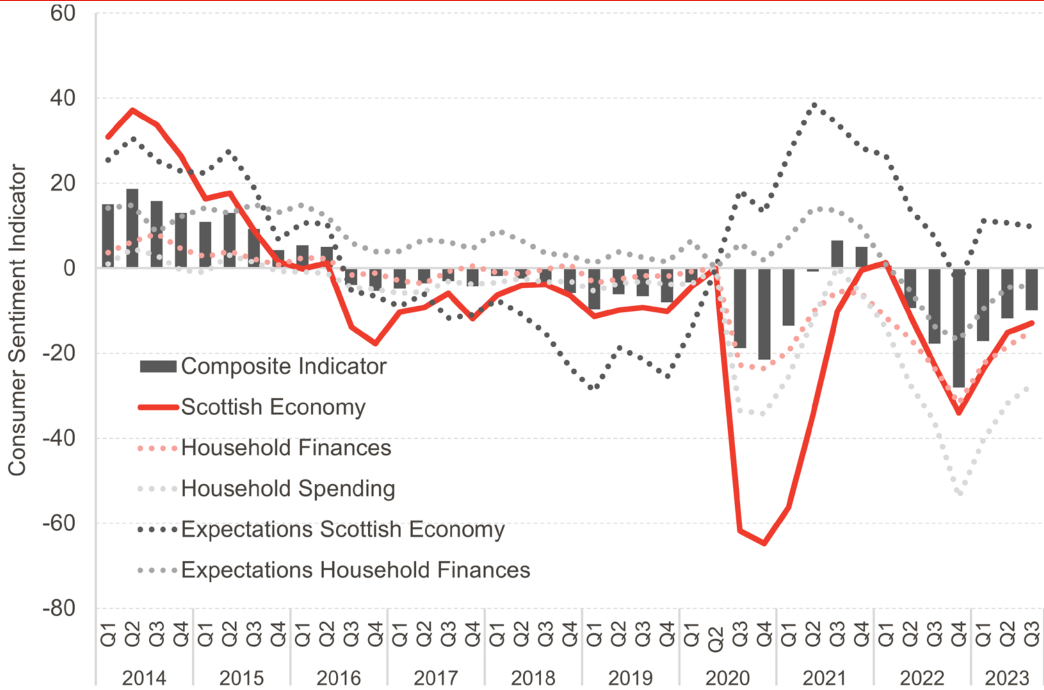
Looking ahead, however, more businesses are expressing optimism than previously, expecting an increase in activity over the next six months.

Similarly, consumer sentiment has risen for the third consecutive quarter (by 1.9 points) but remains weak compared to pre-pandemic (Chart 8).

Four out of five sentiment sub-indicators (covering the economy, household finances, and spending attitudes) remain in negative territory, despite improvements over three consecutive quarters.

Despite the severe cost of living crisis still impacting most households, this slow but persistent movement towards positive territory for the household finance and spending measures is an encouraging sign for the year ahead.

Chart 8: Scottish Consumer Sentiment Indicator, Q1 2014 – Q3 2023



Source: *Bank of England*

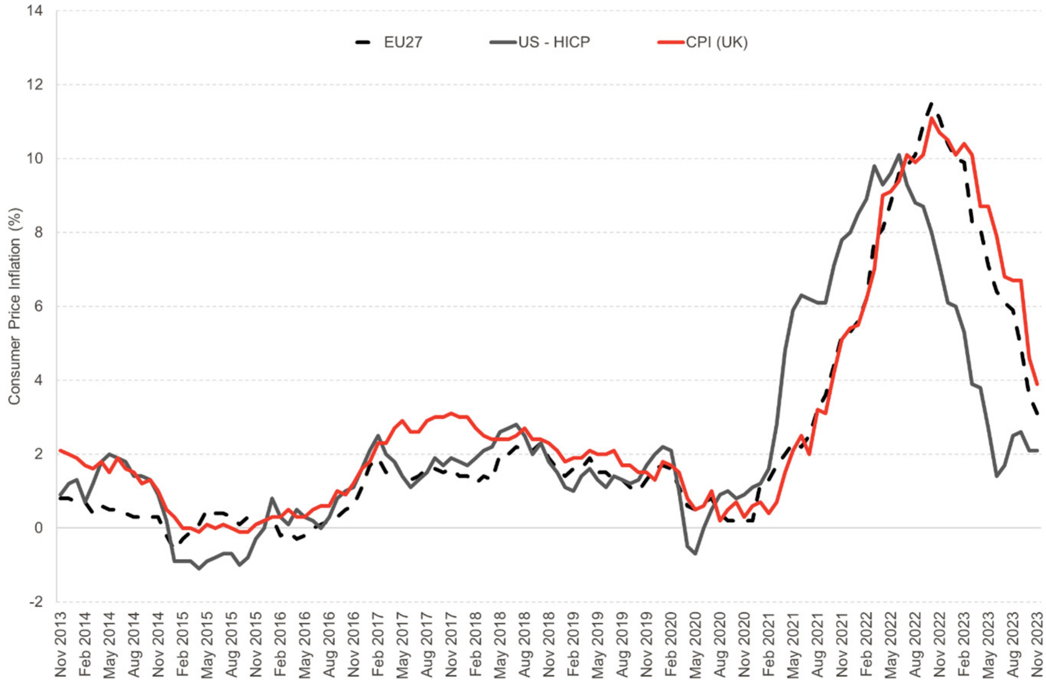
Global economy

As in the UK, inflation across the globe has fallen from its peak of the last few years.

The UK inflation rate remains slightly higher than both the Eurozone and the US (Chart 9). Consumer Price Inflation was 4.0% in the UK in December 2023, compared to 3.1% across the Eurozone and 2.1% in the US.[1]

1 There are some differences in the definition of US HICP that limit comparison – for differences, see https://www.bls.gov/opub/mlr/2006/05/art3full.pdf.

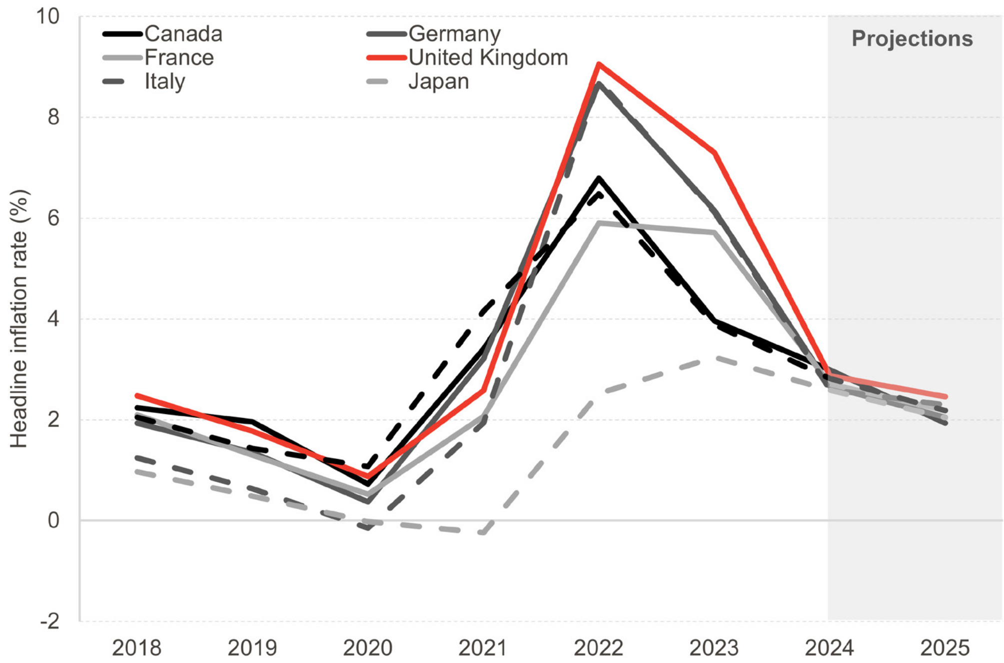
Chart 9: Consumer Price Inflation, UK, US and Eurozone, November 2013 – November 2023



Source: *ONS*

Inflation is also projected to fall across all G7 countries in 2024, with headline inflation close to 2% by 2025 (Chart 10).

Chart 10: Headline Inflation, Outturn and Projection, G7 countries, 2018 – 2025



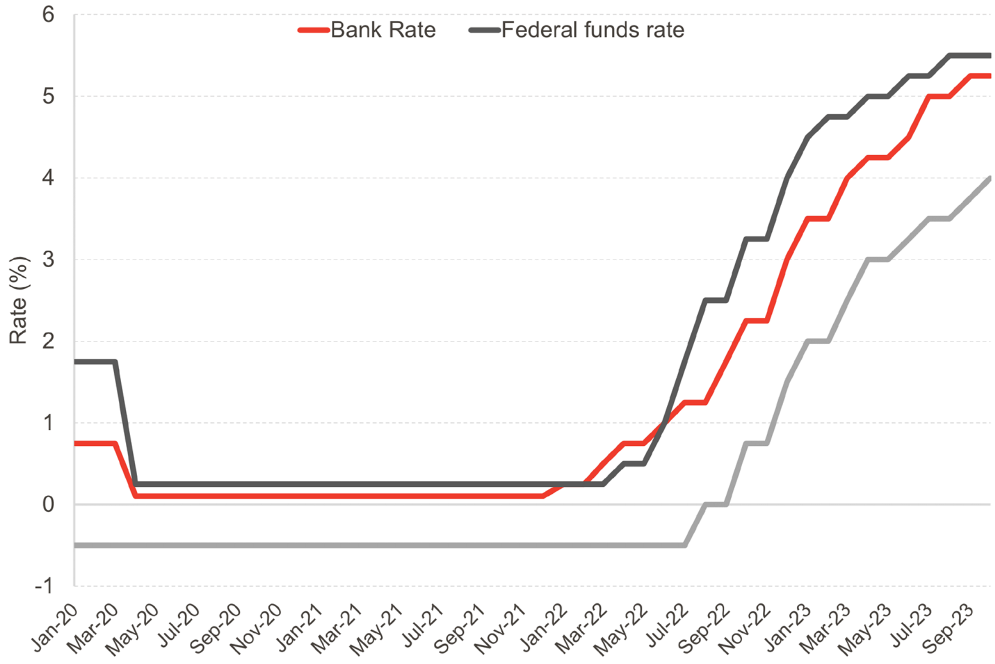
Source: *OECD*

UK inflation has been greater than other G7 countries across 2022 and 2023. This gap between countries is narrowing overtime as rates fall from their peaks in 2022.

However, UK inflation is projected remain one of the highest rates across the G7 countries at 2.9% in 2024 and 2.5% in 2025, which is above the Bank of England's 2% target.

In the past year, the Bank of England rate has risen along with rates in the US and the EU (Chart 11).

Chart 11: Central bank rate comparison between UK, US, and EU



Source: Bank of England

The Bank of England rate has moved closer to the higher US rate over time. However, as of October 2023, the Bank rate of 5.25% remained between the US Federal funds rate (5.5%) and the EU ECB Deposit rate (4%).

Towards the end of 2023, better-than-expected inflation data and signals from the Federal Reserve have caused many to predict falling interest rates in the US.

Despite this, positive US jobs figures for the first week of January 2024 suggest that upwards pressure on wages remains high, weakening the case for any imminent cuts to interest rates.

The expectation therefore is that the Federal Reserve, as well as the Bank of England and the ECB, are likely to hold rates for at least the first quarter of 2024.

The many economic pressures facing the global economies in recent years are likely to affect growth prospects moving forward.

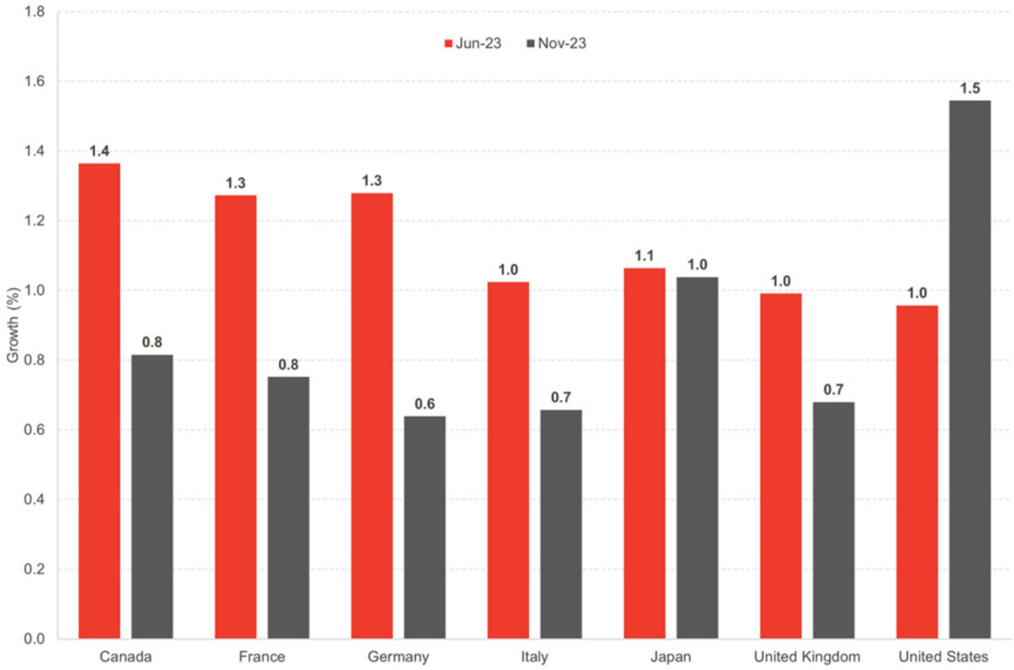
The World Bank recently announced that it expected the global economy to grow at its slowest rate since the pandemic.

Their forecasts projected the global economy to grow by 2.4% in 2024, with high interest rates a significant contributor to stifled growth.

The continuing conflict in both the Middle East and Ukraine mean global trade and investment are also likely to be supressed.

These projections are reflected in the OECD's latest growth projections (Chart 12).

Chart 12: Projections for 2024 GDP in selected countries, June 2023 vs. November 2023



Source: OECD

Their expectations for growth in 2024 have been revised down for the majority of G7 countries, with the exception of the US.

Scotland's pandemic recovery: Where are we now?

The latest data for both the Scottish and UK economies have told a similar story over the course of 2023, with some months (and indeed, some quarters) showing growth followed by periods of contraction. Overall, in aggregate, there has been very little growth in 2023.

The economy is still recovering from the COVID pandemic, which saw huge parts of the economy shut down to protect public health. This led to a huge contraction in the economy in the first half of 2020, with further shutdowns happening throughout 2020 and 2021 as the virus spiked again.

Comparing where the economy was at the end of 2019 to the latest full quarterly data (Q3 2023), we can see that some differences emerge between Scottish and UK growth for different industries, suggesting a differential (and overall, slightly poorer) recovery from the pandemic in Scotland.

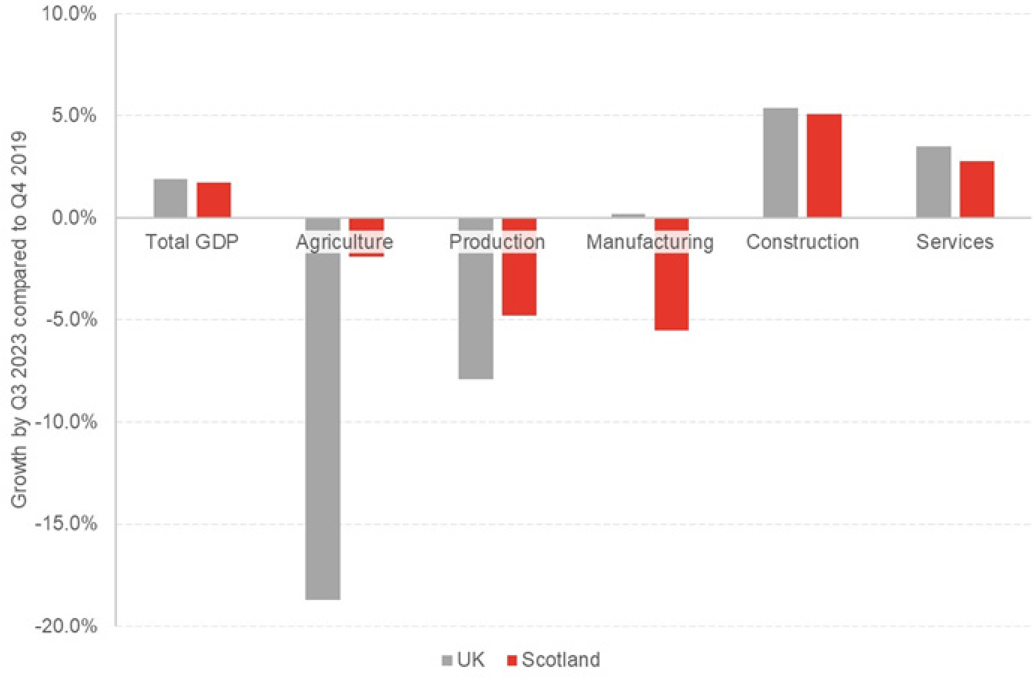
The current data suggests that there was a slightly sharper downturn in Scotland during the first lockdown, but that that difference had been caught up by the end of 2021. Throughout 2023, growth in Scotland and the UK followed slightly different paths (driven, to some extent, by the differential timing of public sector strikes). By Q3 2023, the UK economy was 1.9% above pre-pandemic levels in Q3 2023, compared to 1.7% for Scotland.

Chart 13: UK and Scottish GDP (Q4 2019 = 100)

Source: *Scottish Government, ONS*

At a sectoral level, Scotland has performed better than the UK in agriculture (which covers agriculture, forestry and fishing) and in overall production (due to a better performance in electricity and gas supply and mining and quarrying). These are outweighed by poorer performances in manufacturing and the very large services sector.

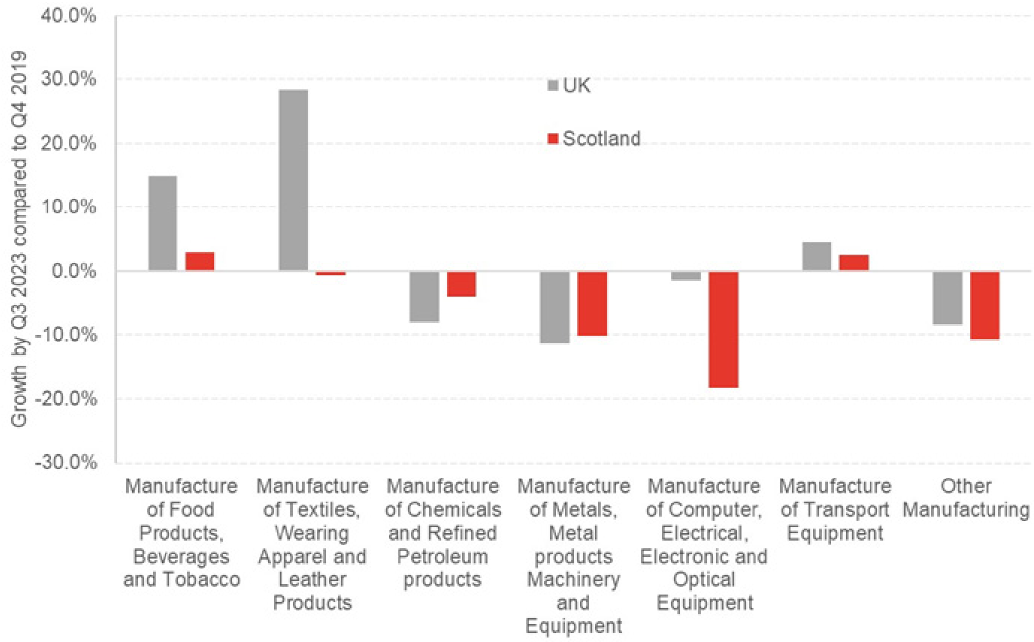
Chart 14: UK and Scottish GDP by sector, Q3 2023 vs Q4 2019



Source: Scottish Government, ONS

Firstly, on manufacturing, we examine the detail to see that Scotland is performing less well on most manufacturing sub-sectors. In particular, Scotland has fallen behind on food and beverages production, which on its own is a large component of Scottish manufacturing (representing 3% of the Scottish economy, and therefore 28% of Scottish manufacturing).

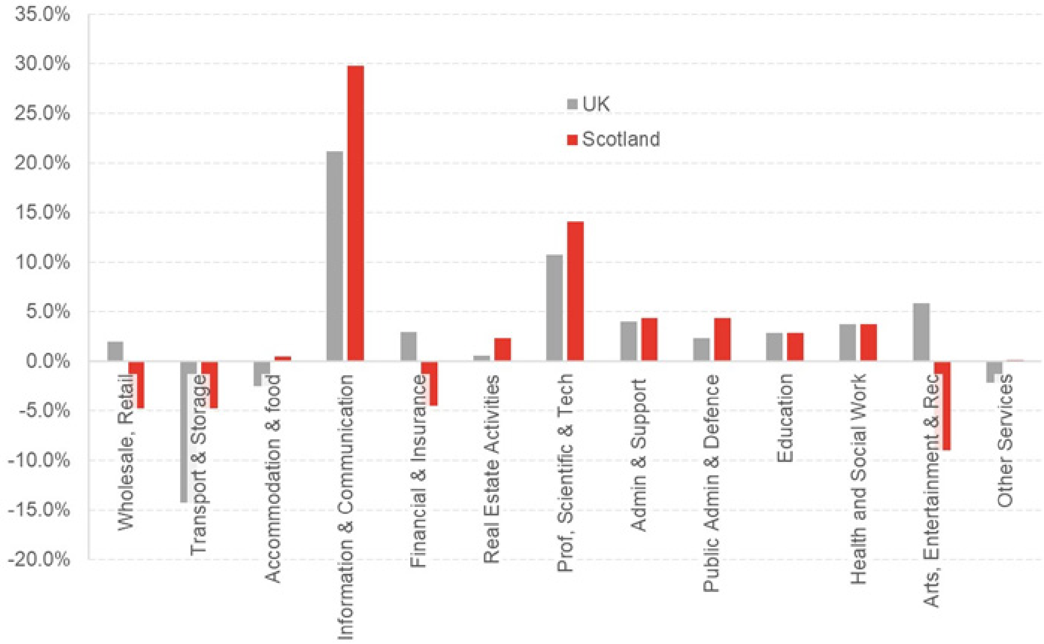
Chart 15: UK and Scottish GDP by manufacturing sub-sector, Q3 2023 vs Q4 2019



Source: Scottish Government, ONS

On services, which make up 77% of the Scottish economy, the picture is much more mixed. Scotland has performed better in some service areas, like transport & storage, accommodation & food services, information & communications and professional & technical services. However, Scotland performs significantly worse in the large wholesale & retail sector, art & recreation and finance & insurance activities.

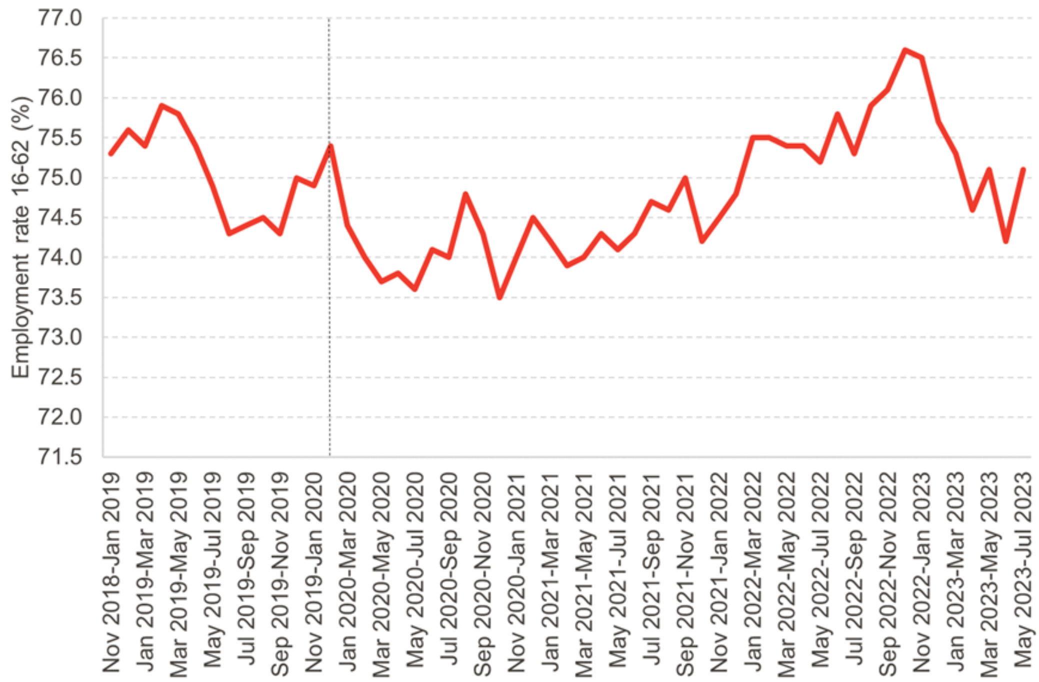
Chart 16: UK and Scottish GDP by services sub-sector, Q3 2023 vs Q4 2019



Source: Scottish Government, ONS

At the start of the pandemic, a big concern was the impact on employment of the shutdowns of huge swaths of the economy. However, employment did not fall anywhere near what was feared due to the UK government support schemes that were put in place, principally the Coronavirus Job Retention Scheme.

Chart 17: Scottish employment rate (16-64), 2019 - 2023

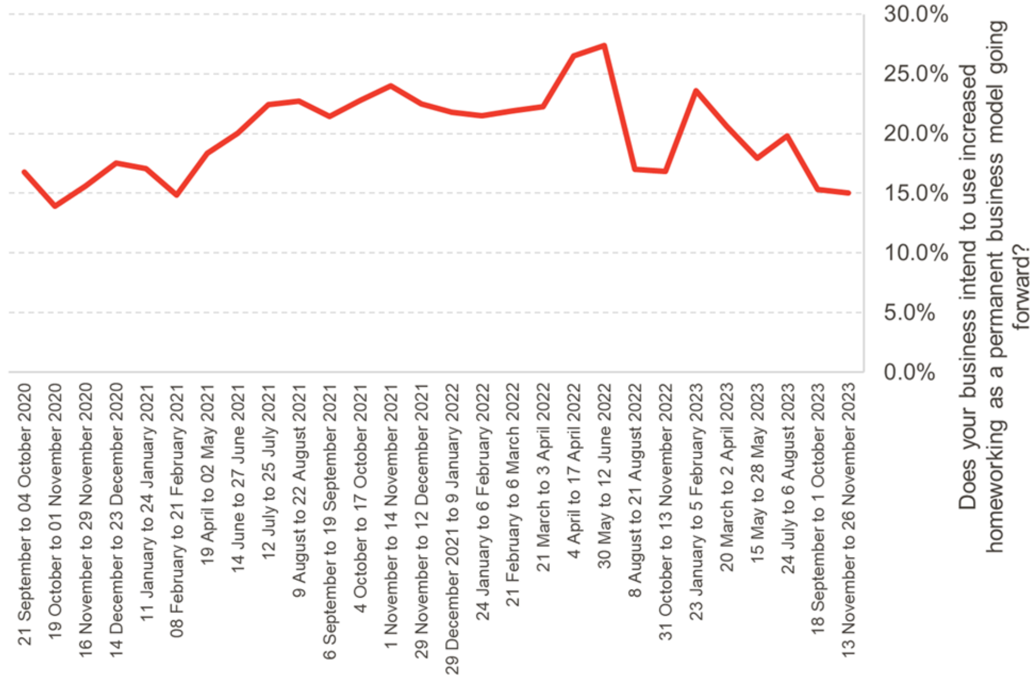


Source: ONS

One of the enduring legacies of the pandemic is the proportion of people who are now not in the labour market due to health issues like long covid and mental health difficulties. There is also a likely impact from delays to treatment, given the well-documented issues with waiting lists in the NHS.

Within the labour market, there are other changes that the pandemic set in train. The most obvious one was a greater switch to working from home.

Chart 18: Prevalence of work-from-home intentions among businesses, Sep 2020 - Nov 2023



Source: BICS

Following a move to people being forced to work from home, we saw more and more businesses considering a permanent change to their business model.

Since mid-2022, there seems to have been a reversal in that trend – perhaps businesses recognise the downsides as well as upsides of home working. Levels of home working are likely to remain higher than pre-pandemic, but not as high as previously thought.

Policy section: The 2024-25 Scottish Budget

The backdrop to the Scottish Budget

As was widely trailed before the statement on the 19th December, the Deputy First Minister (DFM) was facing a difficult backdrop to the Scottish Budget. The projections in the Medium-Term Financial Strategy (MTFS) were for a £1bn shortfall in funding relative to day-to-day spending plans, as well as a £0.5bn shortfall relative to plans on capital spending.

The Scottish Fiscal Commission (SFC) announced in the summer that the income tax reconciliation affecting the 2024-25 Budget would be less unfavourable than expected, which reduced some of the anticipated shortfall. There were also some Barnett consequentials from the retail, hospitality and leisure relief on non-domestic rates in England – which the Scottish Government chose not to pass on.

But additional spending commitments, namely additional funding to compensate local authorities for freezing council tax, NHS waiting list reductions, and higher-than-budget-for pay awards, meant that the funding position in advance of the DFM's statement remained very challenging.

In the event, some of that pressure was eased by the SFC having a significantly more positive outlook for earnings for 2024-25. This matters because it directly impacts on the outlook for income tax, which in turn directly impacts the size of the Scottish Budget. The SFC's forecast from last month determines the envelope for the next financial year, whereas outturn tax receipts will only affect the reconciliation, and therefore the envelope for the 2027-28 Scottish Budget.

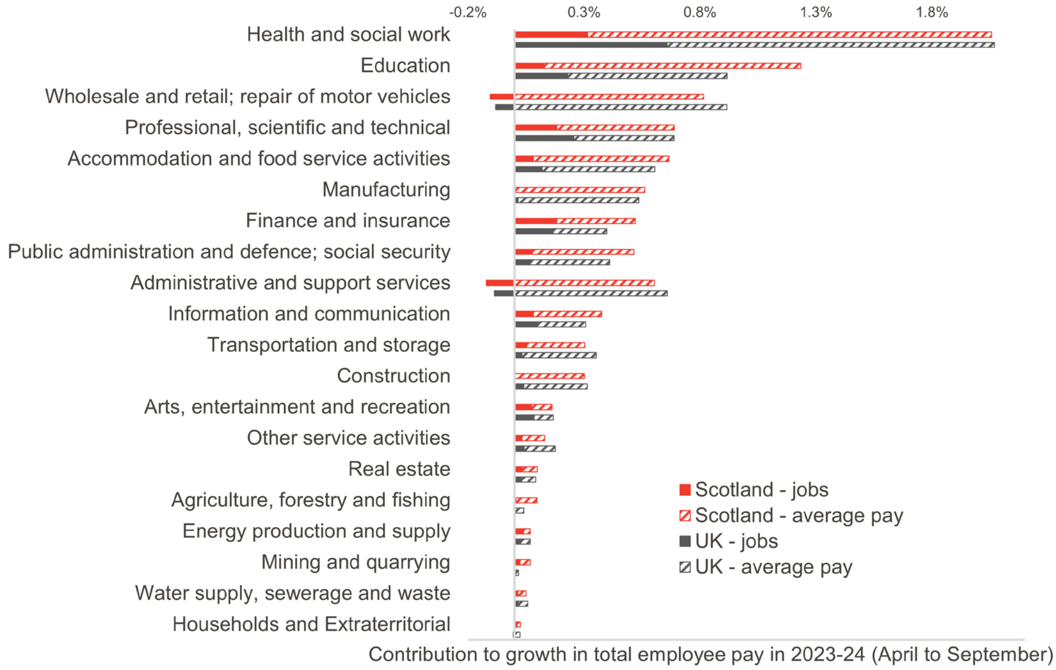
The SFC dedicated a large part of their December 2023 Scotland's Economic and Fiscal Forecasts publication to discussing the data on earnings, and why evidence of faster earnings growth in Scotland (compared to the rest of the UK) has persuaded them that this is likely to continue into 2024-25.

Data from HMRC's real-time information (RTI) system has indeed shown growth in total employee pay in Scotland (9.7% year-on-year in the first six months of 2023-24) above that for the UK as a whole (8.6%). In both cases, health and social work spending on wages and salaries is the largest contributor, though average pay has gone up considerably more in Scotland, while the number of jobs in the sector has grown more slowly.

There are a couple of sectors where the differences between Scottish and whole UK total pay has diverged in offsetting ways, particularly in the private sector. Pay in the wholesale and retail trades has grown more quickly in the UK as whole, whereas Scottish financial services pay growth has outstripped UK-wide growth.

But the main difference in contributions to growth in wages and salaries comes from industries where the public sector is heavily represented: education and public administration. Pay in education grew at an annual rate of 8.4% in Scotland in the first six months of this financial year, compared with 6.4% in the UK as whole. The difference is lower for public administration (8.3% in Scotland, 7.0% UK-wide), but still significant to the overall trajectory of total pay.

Chart 19: Contributions to growth in total pay in Scotland and the UK by industry



Source: *HMRC, ONS, and FAI calculations*

The main risk to the forecast going forward is whether this will continue to materialise, as the SFC estimate stronger growth for Scotland than the Office for Budget Responsibility (OBR) does for wages and salaries in the coming year.

To be fair, they point out that other independent forecasters – other than the OBR – are forecasting earnings growth that is closer to the earnings growth the SFC are expecting in Scotland. Essentially, they think that the OBR may well revise up their forecast in future fiscal events to come closer to their estimates. But given that the strong growth in outturn has come from faster growth in public sector pay in Scotland, and given the projected fall in public sector headcount in the SFC's forecast, there could be a significant risk of this not materialising.

And if growth in average earnings is closer to the UK as a whole, it could mean that the relatively very positive impression given by the current set of forecasts may not persist, and the SFC flag this as a significant downside risk to the forecasts, given that for every 0.1 percentage point closer growth between Scotland and the rest of the UK, the net tax position would be £25 million lower.

The spending decisions taken in the Budget

But even with this more positive than anticipated outlook, the DFM has had to make difficult choices as to which areas to prioritise.

The health budget has grown in real terms, with resource spending (excluding non-cash items) growing by 1.3% above inflation. Health capital spending is also planned to increase on 2023-24 plans by 8.4% above inflation.

It is worth noting – as we did in our Budget Report – that on the resource side, while there has been growth in funding and employment in the NHS, it has been slower in Scotland than UK-wide. One of the reasons for this is the Scottish Government's pay policy, which has led to higher pay awards but means slower employment growth, all else equal in term of budget.

There are two main issues arising from this in terms of the sustainability of the public finances. The first is that higher pay awards add to ongoing costs, as they increase spending both in-year and in future years. They will therefore require additional funding in future if they are to be maintained – or more restrained awards in future.

The second issues was flagged by the SFC in its Fiscal Sustainability Report, and refers to higher health spending going forward being highly likely – both as a result of population ageing and other cost pressures. This no doubt adds to these cost pressures and makes it harder still to provide the required level of health care for a population whose needs are increasing.

Headline resource spending allocated to local government is planned to grow as well, although there will be much debate as to whether the council tax freeze was indeed 'fully funded', as had been claimed by Scottish Government ministers. The £144m allocated for additional grants is roughly in line with our calculations for a 5% increase in rates across the board. But if allocation is equal across the board, and based on past behaviour, some councils will be winners (as they would have increased rates by less than the average) and some will lose out (as they would have increased rates well above the average). There was also no compensation for the cancellation of the increases in multipliers for higher band properties, which was consulted on and heavily expected to take place. Doing so would have cost the Scottish Government around £180m.

Of course, it is for the Scottish Government to determine the allocation of spending commitments and where they fall in terms of dealing with its priorities in terms of impacts on equalities. But it would fair to question whether additional spending to fund part of a council tax freeze which mostly benefits households in the higher brackets of the income distribution is in line with that, especially as there are already schemes to reduce council tax on the basis of income affordability for those lower down the income distribution.

There was considerably less attention focussed on the areas that did less well from the Budget settlements, and in capital spending areas in particular there were some very large cuts compared with 2023-24 plans. Of course, this is to be expected given the size of the challenge from the Scottish Government's capital allocation from HM Treasury, but it is important to note which areas will be affected.

Major changes to planned spending include:

- The Affordable Housing Supply Programme being cut by over 30% in real terms, which itself followed a more than 10% cut in real terms in 2023-24.
- The Housing Support and Homelessness budget being cut by 5% in real terms.
- Spending on the Just Transition Fund next year being cut by over 75%, with commitment only to fund existing projects next year.
- The 2023-24 cut to the Scottish Funding Council by just over £100m (5%) being made permanent, which implies (among other things) a further reduction in first-year university places for domiciled students. This will further reinforce an issue that was highlighted by the Institute for Fiscal Studies – that tuition is free only for Scottish-domiciled students who get a place, but those places are capped and the numbers are set to be reduced further.
- Scottish Forestry's woodland grants scheme being cut by over 40%.
- Local government capital grants being reduced by over 20% in real terms across both general and specific grants.

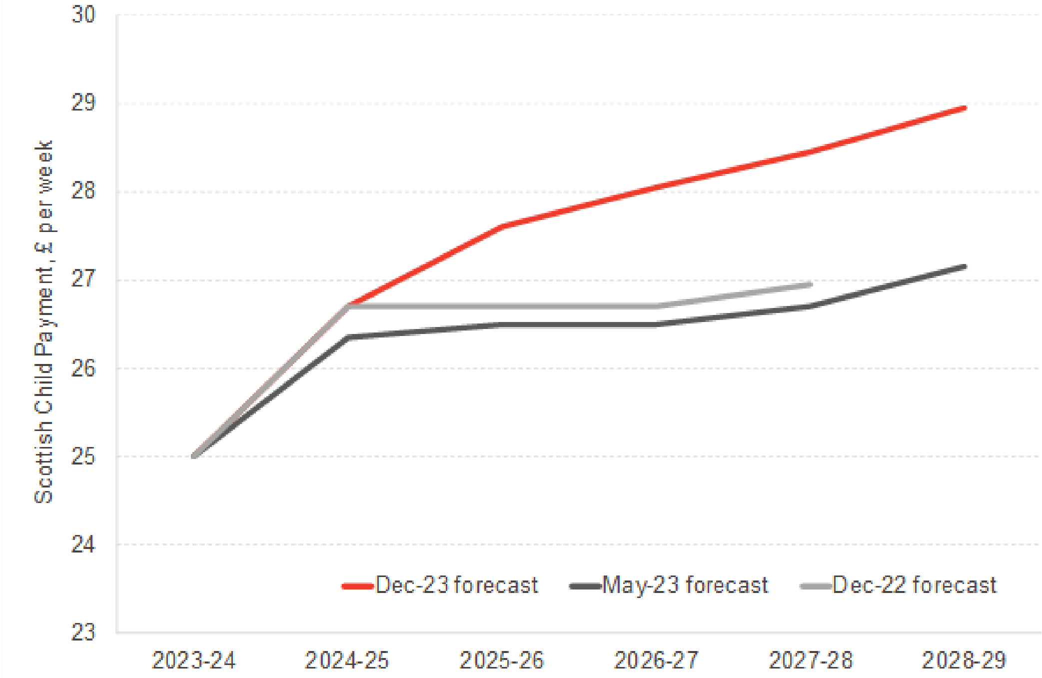
Social security benefits were uprated by 6.7%, in line with September inflation, in what was the largest announcement in the Budget – although this only confirmed what the SFC had assumed anyway, and matched the uprating implemented by the UK Government at the Autumn Statement.

Social security spending in Scotland includes spending on benefits that have been devolved to Scotland (mainly disability and carer benefits) and spending on new or top-up benefits, such as the Scottish Child Payment.

Uprating keeps the value of benefits in line with inflation. September 2023's CPI inflation reading of 6.7% was slightly below the 6.9% forecast by the Scottish Fiscal Commission in December 2022, but higher than the 5.4% assumed in May.

This means, for example, that the payment rate for Scottish Child Payment is unchanged from the forecast a year ago (owing to the rounding to the nearest 10p), but is actually 35p more than the SFC thought it would be in May. And with inflation now forecast to be higher in the medium-term, the rate will be significantly higher – although of course, this only keeps up with the rate of price increases.

Chart 20: Successive Scottish Child Payment rate forecasts



Source: *Scottish Fiscal Commission*

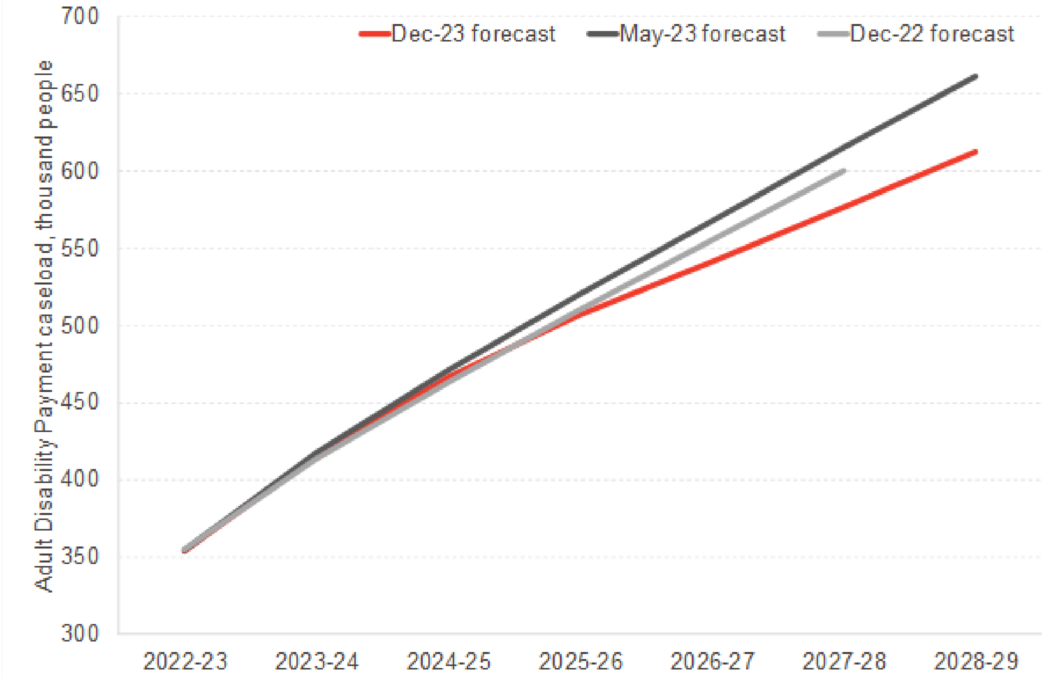
Additionally, the SFC has also revised down their medium-term assumption for Adult Disability Payment recipients. Overall spending on ADP (including Personal Independence Payment (PIP), the legacy benefit it replaces) has been revised up by £8m in 2024-25 relative to December 2022, and by £62m in 27-28. But that is essentially driven by higher inflation, which increases average awards.

But the opposite happens to the forecast for the caseload on ADP. The SFC has said it has allocated "more weight to the role of the cost of living crisis" than before in explaining the high level of applications seen so far this year – which the SFC expect to slow down as cost-of-living pressures ease. Their forecast sees only a small increase in recipients next year relative to their December 2022 forecast (3,800 people), and 4,500 fewer than anticipated in May.

By 2027-28, the SFC expect 40,000 fewer recipients of ADP than they did in May, a 6.3% reduction in the caseload. Compared with their December 2022 forecast, it's a 23,000 (3.9%) reduction.

As part of the fiscal framework, the Scottish Government gets an addition to the Block Grant in line with OBR forecasts for comparator benefits in England and Wales, where PIP continues to exist.

Chart 21: Successive forecasts of ADP caseload



Source: *Scottish Fiscal Commission*

In their November 2023 forecast, the OBR increased their view of spending on PIP over the medium term. Along with other changes, including uprating, this increased the Block Grant Adjustment (BGA) related to ADP by £451m in 2024-25 relative to December 2022, and by £548m by 2027-28.

Because spending in Scotland has been revised up by less (£398m in 2024-25, £380m by 2027-28), the net funding position has improved considerably in the SFC's view.

The December 2022 forecast for 2023-24 was for the net position to be -£208m; the December 2023 forecast puts it at -£300m.But it then grows much slower – to -£358m in 2024-25, rather than -£411m as projected a year ago, an improvement of £53m. The improvement is even greater by 2027-28, reaching £167m.

Tax decisions made at the Budget

The announcements on tax dominated discussion on the day, but in reality they did little to materially change the outlook of the Budget.

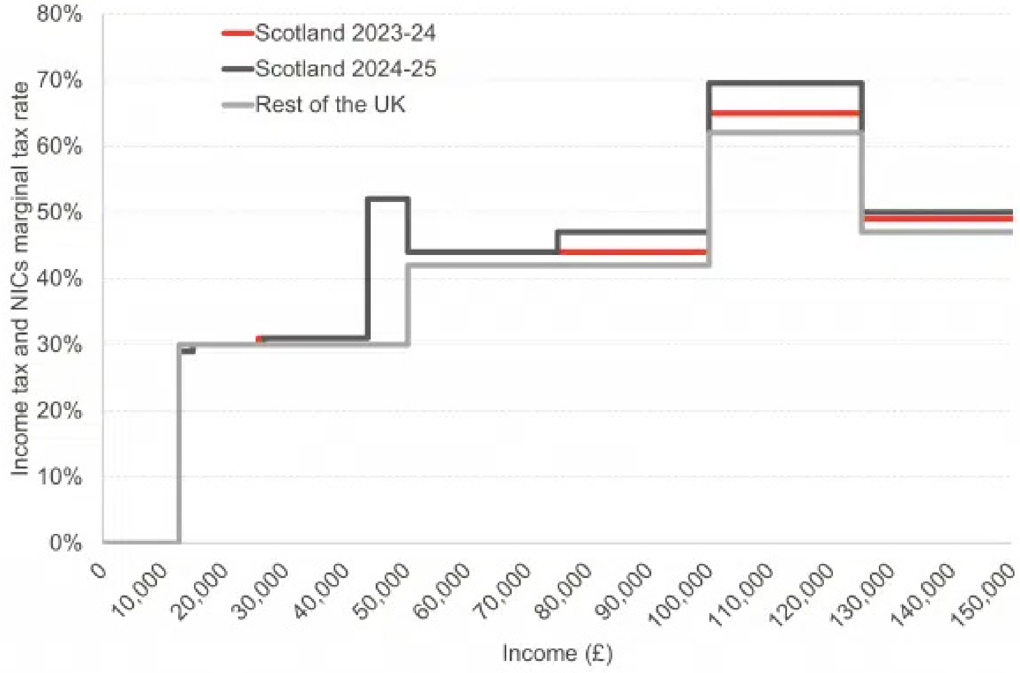
The new 'advanced' rate for earnings between £75,000 and £125,140 is expected by the SFC to raise around £75m – not nothing, but not a step change in revenues. The increase in the top rate also raises less than £10m.

In fact, the combined tax measures – when including non-domestic rates (NDR) – raise only around £50m in 2024-25. The NDR package maintains the main poundage just below that in place in other UK nations, but some of that revenue lost is clawed back by further increasing the poundage paid by those at higher rateable values.

In fact, many of the largest revenue raisers of this Budget were non-decisions, such as the non-uprating of the higher rate threshold, which means receipts are £300m higher than they would have been in the absence of inflation indexation. The continued absence of uprating of this threshold also continues to perpetuate higher marginal tax rates in Scotland for those earning between £43,663 and £50,270 than for those between £50,271 and £100,000.

Looking at the marginal tax rate schedule, the divergence between Scotland and the rest of the UK become very clear too – there is a minor (less than 50p a week) benefit to those below median earnings in Scotland, but the marginal tax rate of someone on £75,000 in Scotland is now the same as that for someone paying the highest rate of income tax in the rest of the UK.

Chart 22: Marginal tax rates for an employee, Scotland and the rest of the UK



Source: *Scottish Government, HM Revenue and Customs, FAI calculations*

Transparency

There are some improvements we would like to see made to the transparency of both documentation and announcements at the Scottish Budget, which we see as crucial for improvement the quality of the public debate.

The announcement of the uprating of the starter and basic bands felt opaque. While technically true, the word 'band' did a lot of the heavy lifting. One might think that this meant for example that the point at which one starts to pay the basic (rather than the starter) rate has increased by inflation, so it would mean that if one were only paying the starter rate, and one's pay went up by inflation, one would remain only paying the starter rate.

But that is not true. Instead, the size of the band was increased by inflation. As the table below makes clear, that means fiscal drag is still affecting some at the lower end of the income distribution, over and above the personal allowance freeze by the UK Government. This little publicised difference means the uprating also cost the Scottish Government as much as £35m less than it would otherwise have done.

The Scottish Government has done this before, and we will now assume that it will do so in future. It might also rightly point out that this matches the way it legislates, as the bands are set in reference to the personal allowance. And that is true, but the confusion is not helped by the fact that it immediately refers in the documents to the higher rate threshold being a specific number. But in legal terms, the higher rate threshold is also not the £43,663 that they refer to, but rather £31,093 above the personal allowance. So the mixing in of similar but different concepts – especially when used in different ways to what the UK Government uses – does not help with transparency.

Table 1: Scottish Income Tax bands in 2023-24, 2024-25 and if thresholds had been indexed with inflation

		Starter rate (19p)	Basic rate (20p)	Intermediate rate (21p)
2023-24	Starts at	£12,571	£14,733	£25,689
	Ends at	£14,732	£25,688	£42,662
2024-25 (band increased with inflation)	Starts at	£12,571	£14,877	£26,563
	Ends at	£14,876	£26,561	£43,662
	% increase in band	6.7%	6.7%	-4.9%
	% increase in threshold	1.0%	3.4%	0.0%
If threshold increased with inflation	Starts at	£12,571	£15,720	£27,410
	Ends at	£15,719	£27,409	£43,662
	% increase in band	45.7%	6.7%	-9.6%
	% increase in threshold	6.7%	6.7%	0.0%

Source: *Scottish Government, SFC, FAI calculations*

In terms of portfolios and comparisons across years, we welcome some additional transparency releases that have happened. The Scottish Government has made it easier to access outturn data at level 2, and we look forward to that being broken down into different components (fiscal resource, non-cash, capital, financial transactions and UK Government-funded AME), which will further help comparisons across time. Similarly, we welcomed the publication of the revised portfolio figures at the Autumn Budget Review, although again, we would like to see more resource and capital splits.

The reasons for the Scottish Government only publishing one-year projections for portfolio and more disaggregated spending lines are understandable, but we continue to urge longer-term planning and publication, even if they are subject to change. This interacts with a lot of the decisions made for both the 2023-24 and 2024-25 Budgets, and which talk in many places about re-profiling of capital spending. This makes it sounds like the spending will eventually happen, but given the capital settlement and the projects already planned (as shown in the MTFS), that cannot be true for all of them. The MTFS had a shortfall in capital funding in every year, and therefore shifting spending from one year to the next only exacerbates the problem – and means that there are capital projects currently planned which will not take place. It would help the public debate enormously if the Scottish Government were more transparent in this regard.

Finally, we would like the Scottish Government to publish all the charts and tables from the Budget and MTFS documents, including the ones in the body of the document, in a separate spreadsheet for download, and which includes the data for each of the charts, just like the SFC does for their own publication. This is not a major piece of work – the numbers are clearly all created in that format anyway, and would make it much easier for everyone to do analysis quickly rather than having to transpose unwieldy PDF tables into Excel. It would also be a good opportunity to standardise tables and definitions of budgets across them, so that calculations are more meaningful on the day. It would also make it easier to include or exclude items that make comparisons difficult across time (e.g. UK Government-funded AME for pensions, which can change depending on the SCAPE rate) at speed.

University of Strathclyde Business School

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- FAI Economic Commentary – Quarterly – First published in 1975, our quarterly Economic Commentary provides the authoritative independent assessment of economic conditions in Scotland, along with a wide range of economic and policy issues.
- Scottish Business Monitor – Quarterly – Since 1998, the FAI Scottish Business Monitor has been a key leading indicator of the Scottish economy. This survey of Scottish business sentiment provides vital insights into the Scottish economy well in advance of official statistics.
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