FRASER OF ALLANDER INSTITUTE

Economic Commentary

Vol 48 No 3

University of Strathclyde Glasgow

FOREWORD

October 2024

Supported by Deloitte.

In retrospect, the summer of 2024 is likely to be characterised as one of mixed fortunes – a description that applies to more than just the unseasonable weather.

After the UK economy bounced back from recession in late 2023 to being the fastest-growing G7 economy in the first half of this year, momentum has appeared to stall over recent months.

Captured immediately after the general election in July, Deloitte's latest CFO survey showed signs of the UK's corporate sector gearing up for growth, with a sharp rise in CFO confidence complemented by a drop in external risk perception. Uncertainty dissipated, revenue prospects brightening in the face of a more predictable business environment.

This was juxtaposed, however, by the new UK Government underlining difficult economic circumstances, highlighting a £22bn "black hole" exists in the public finances, with both the new Prime Minister and Chancellor warning of "tough" decisions to come in the October 30 Budget. Perhaps unsurprisingly, recent indicators show consumer confidence has cooled as the public braces for impact.

Naturally, there has been widespread speculation about tax increases. Having ruled out increases to income tax, national insurance or VAT the UK Government will look elsewhere. We know of the changes to VAT on private school fees and rumors focus on changes to CGT and inheritance tax.

This quarter's Commentary shows how the introduction of the new Scottish advanced income tax band earlier this year has, as intended, led to an increasing share of the country's overall tax income being paid by those on the higher rate, with a lower share coming from those on the basic rate.

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Following a mixed reaction from the business community when the change was first announced, the Fraser of Allander Institute's latest Scottish Business Monitor, published last month, found a third of businesses saying they are feeling the effects. Whilst more than half of businesses have experienced 'little to no impact' so far. This may evolve in the coming months as the changes continue to take effect. This demonstrates the tightrope both governments walk with every decision on public finances: all measures will inevitably have positive impacts on some, negative impacts on others, and neutral impacts on others– and that goes for both businesses and the public.

Another matter throughout the summer was public sector pay increases. As this quarter's Commentary outlines, the proportion of workers that are in the public sector is 5% higher in Scotland than in the whole of the UK – meaning the cost of pay deals is proportionately higher in Scotland. Indeed public sector pay accounts for half of the Scottish Government's budget so variances have a big impact on Scotland's finances as this quarter's commentary explains.

Deloitte's 2024 State of the State report found Scotland's public services are fragile, with its public sector workforces under pressure. However, it also identified substantial progress in the sector's adoption of digital technologies such as joined-up data, interoperable systems and AI, with many public sector leaders ambitious about what this means for the future.

The public sector can only capitalise on such opportunities – allowing it to work towards a collective vision – through bold system-wide reform, which needs a change in mindset and a more open conversation with citizens about the role of the state, levels of taxation and how services are delivered.

Both governments are clearly facing difficult financial circumstances, attempting to address issues and plug the holes in their respective budgets with tightly limited resources.

Compromises will always be necessary, yet the Scottish Government is duty-bound to keep the country on its path to sustainable economic growth. As the outcomes of the UK Government's October Budget become clear, the Scottish Government's December Budget statement will bring to light how it intends to balance that duty with its responsibility to maintain healthy public finances.

Douglas Farish, Head of Tax for Scotland, Deloitte

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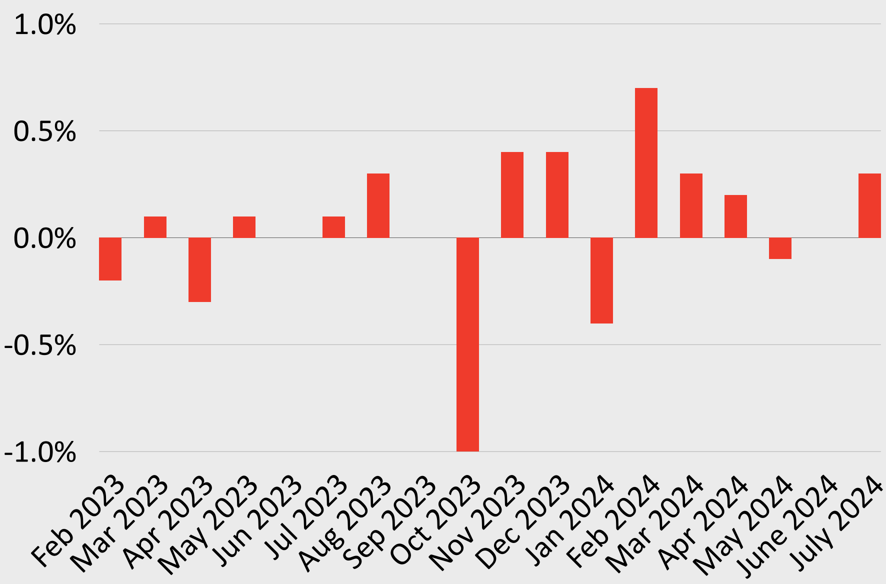
FORECASTS

The latest three months of data provide a nuanced picture which feeds into our Scottish GDP forecasts. Despite near zero growth in May and June, growth in July was more encouraging at 0.3%.

This moderate growth trajectory supports a slight upward revision to near-term forecasts. However, the inconsistent monthly performance indicates ongoing economic fragility, and it is unlikely to change the outlook in the medium-term.

Scottish Monthly Change in GDP



0.7%

Previous 2024 forecast

0.9%

2024

1.1%

2025

1.2%

2026

Scottish GDP Forecasts 2024-2026

	2024	2025	2026
FAI September 2024	**0.9%**	**1.1%**	**1.2%**
FAI *June 2024*	0.7%	1.1%	1.2%
FAI *March 2024*	0.6%	1.1%	1.2%
Scottish Fiscal Comission *December 2023*	0.7%	1.1%	1.3%

The latest forecasts show an upward revision for 2024, with GDP growth now projected at 0.9%, up from 0.7% in June and 0.6% in March.

This increase reflects the modest economic improvements observed in recent months.

Despite the near-term optimism, projections for 2025 and 2026 remain unchanged at 1.1% and 1.2% respectively.

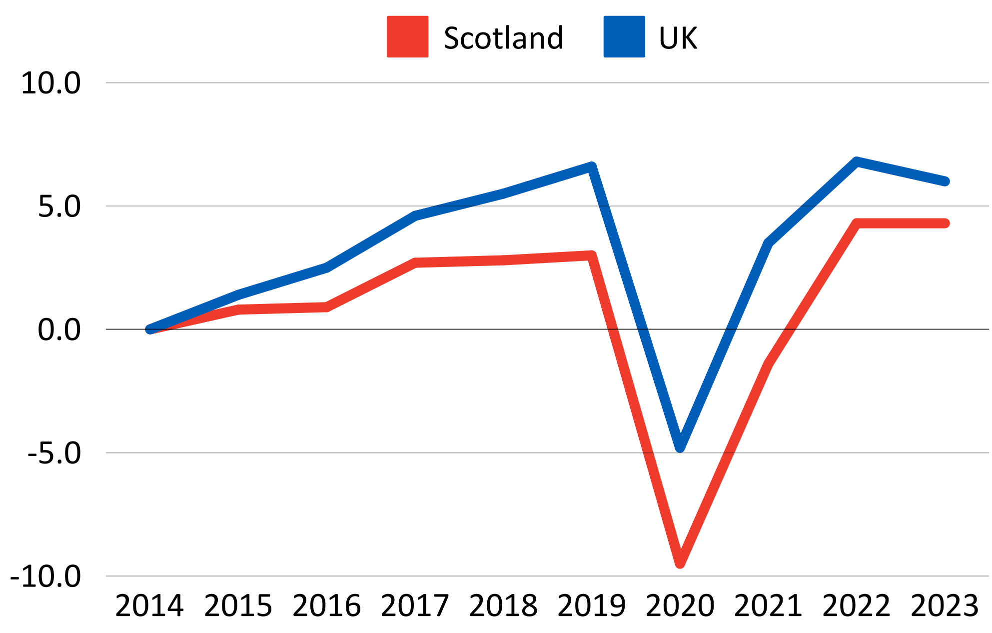
Source: ONS

THE SCOTTISH ECONOMY

Growth in 2024 has been more sustained than the stop-start pattern we saw in 2023. This means we have seen quarterly growth figures of 0.6% for Q1 and 0.5% for Q2, much stronger than in recent years and just lagging behind the UK slightly. The data for May and June showed growth close to zero, followed by 0.3% growth in July.

Data for the UK for July suggested that the economy was flatlining, which may suggest this sustained growth may be difficult to maintain for the rest of the year. Over the longer term - the last 10 years - the Scottish economy has continued to lag the UK economy.

GDP per person, Scotland and UK, 2014 to 2023, 2014=0



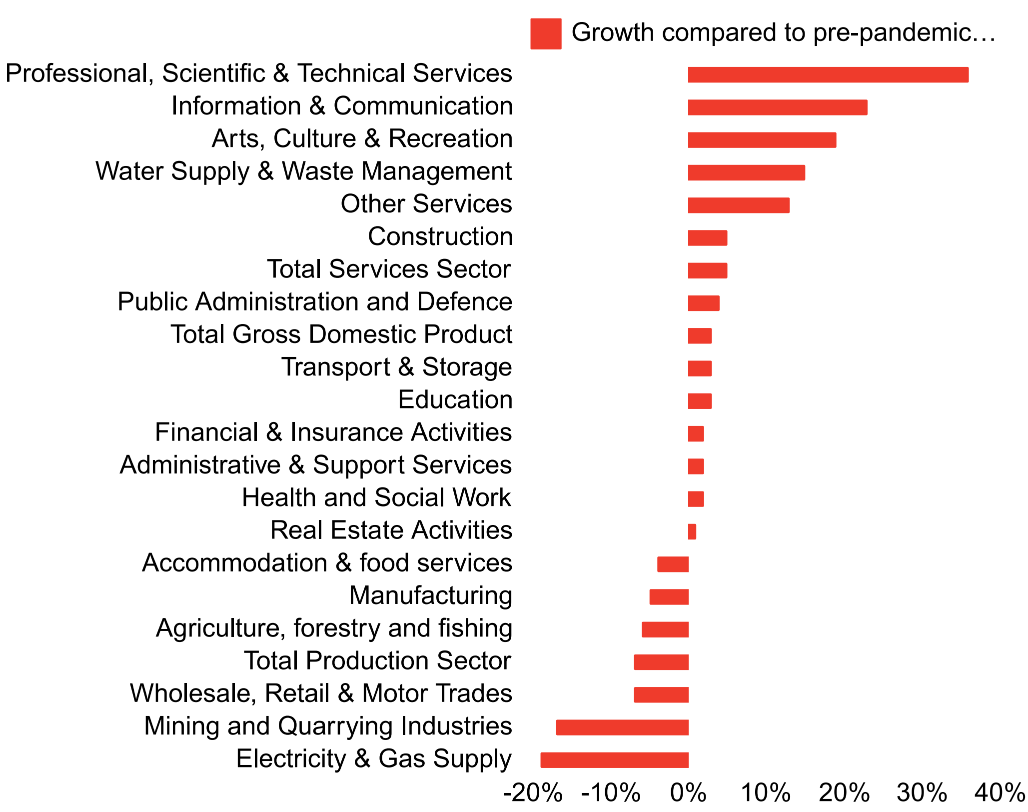
Even when the differential population growth in the UK and Scotland is accounted for (GDP per person), growth in Scotland per person over the last 10 years has been 6.0% for the UK, compared to 4.3% for Scotland.

This gap in growth opened up in the pre-COVID period between 2014 and 2019, although the gap in the rate has closed a little during the recovery from COVID.

Compared to their pre-pandemic peaks, the Professional Services and Information & Communication sectors have grown by 36% and 23% respectively. This is mirrored long term, with the latter growing 119% since 2014.

In contrast, traditional industries face headwinds. Retail trade remains 7% below pre-pandemic levels, while Manufacturing struggles to regain ground. Mining and quarrying has been hit particularly hard, still down 17%.

Scottish Sectoral Growth Post-Covid



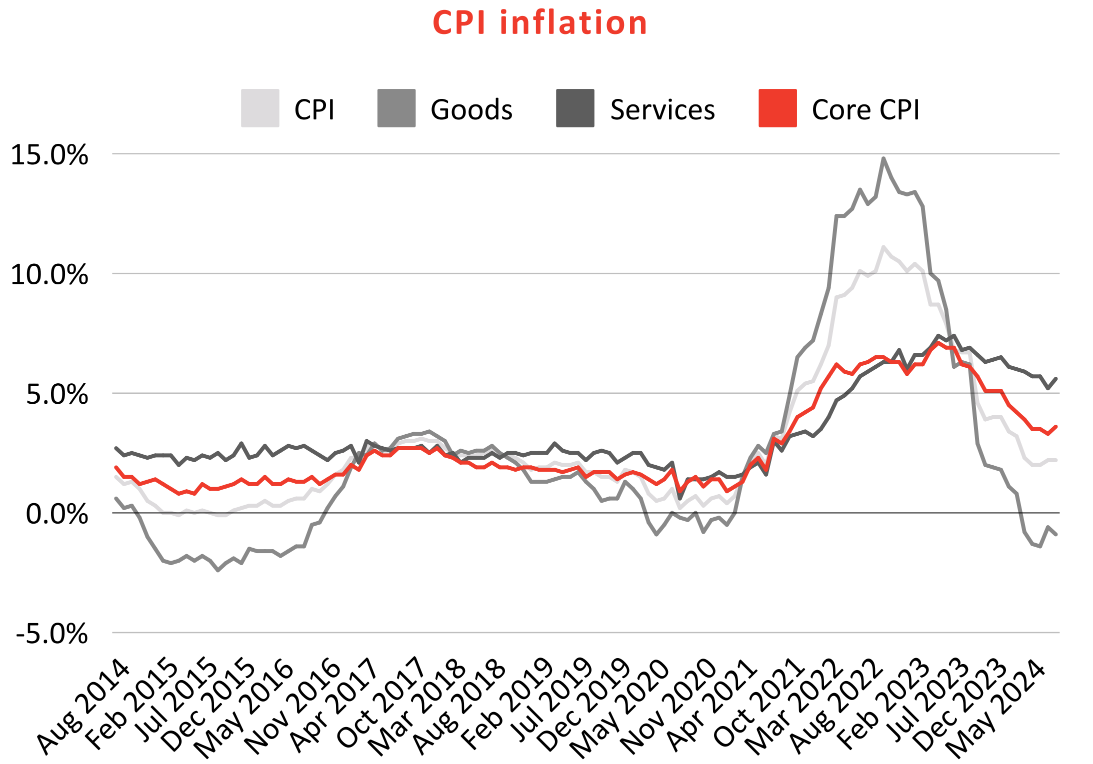
Source: Scottish Government, FAI Analysis

UK ECONOMIC INDICATORS

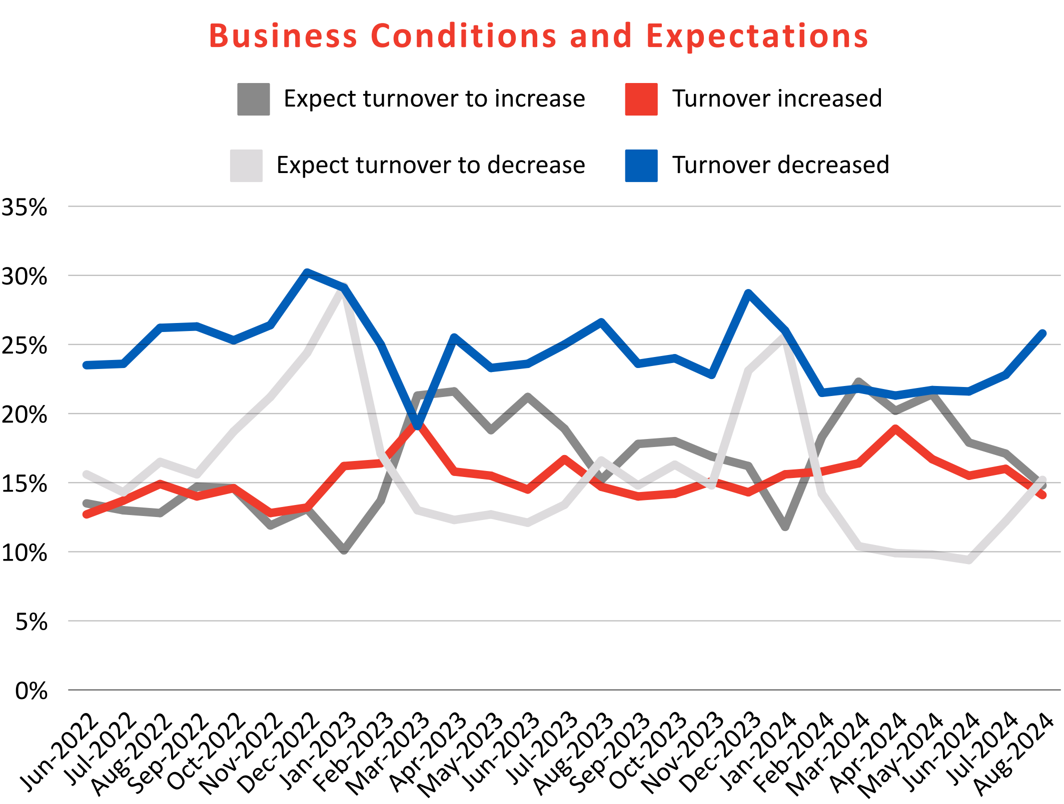
The Consumer Price Inflation rate remained at 2.2% in August, with many movements in prices in different commodities cancelling out to leave the headline rate unchanged. Increases in prices of air fares and second hand cars were offset by falling motor fuel prices and falls in restaurant and hotel prices.

Core inflation (so inflation excluding food, energy etc) rose slightly in the latest data to 3.6%.

This strength in prices in the domestic (mostly) services economy will have encouraged the Bank of England in their decision to leave rates unchanged at 5.0% at their meeting on 19th September.



Business confidence showed improvement in early 2024, driven by declining inflation and anticipated interest rate cuts. The latest data does suggest that business confidence has softened over the summer, with the percentage of firms who are expecting their activity to increase over the next few months falling back from the highs in the Spring.



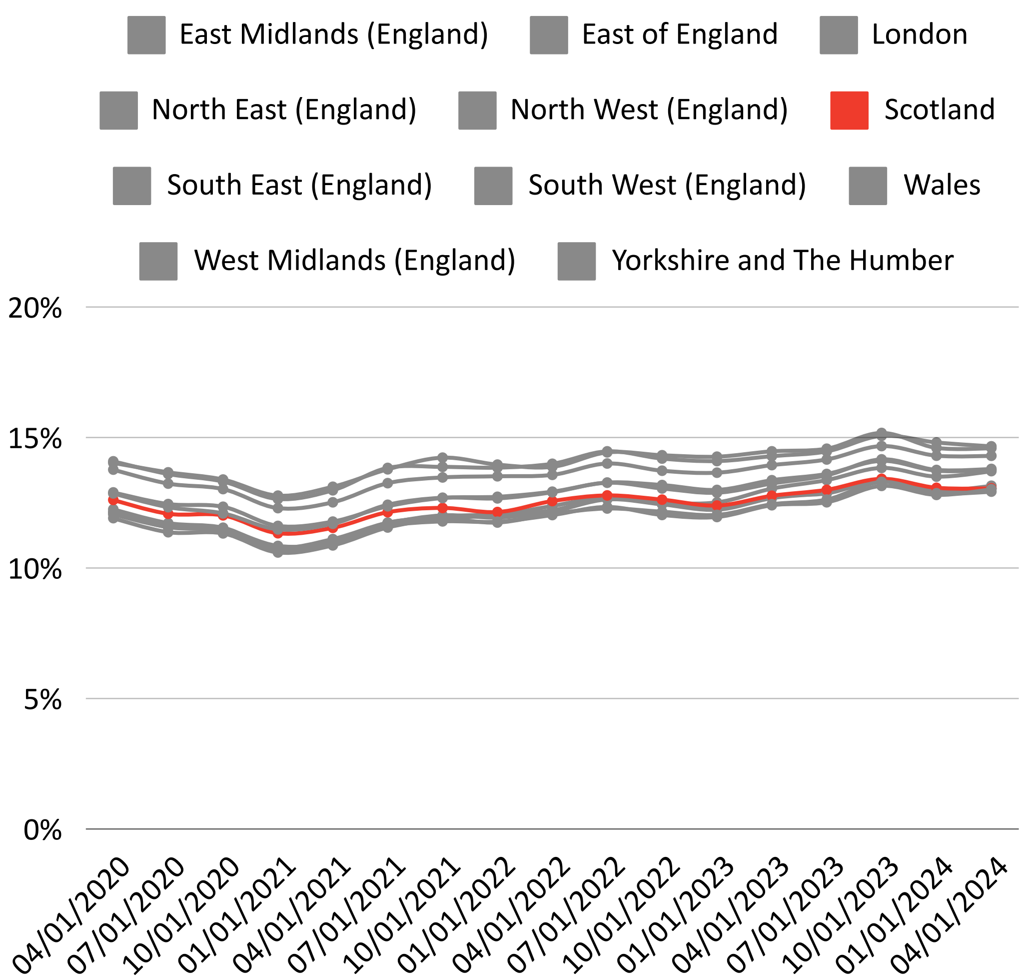
Consumer sentiment followed a similar pattern, with Scotland showing positive indicators for the first time since autumn 2022 - still weak by historic standards, but good and improving compared to recent years.

Yet, more recent UK-wide data from market research firm GfK reveals a decline in consumer confidence during July and August, with weakening perceptions of general economic conditions and the likelihood of consumers making big purchases.

Source: ONS, ONS, Scottish Government

UK ECONOMIC INDICATORS

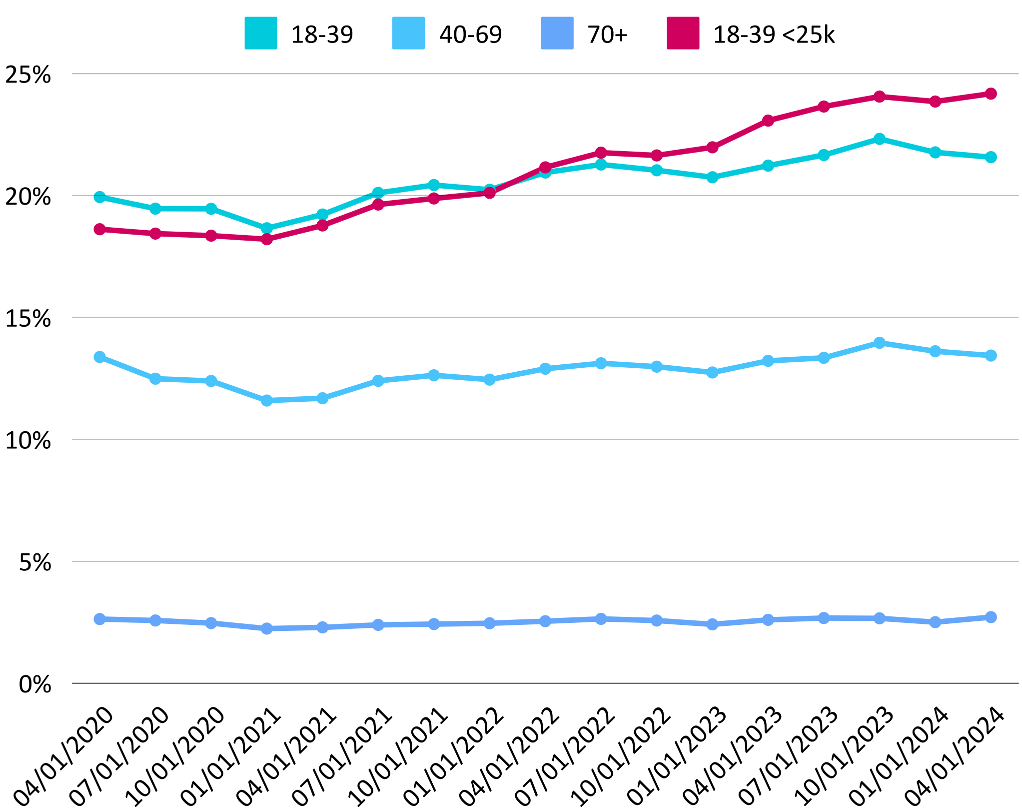
Overdraft Usage Percentage in Scotland and UK Regions



Data from the Smart Data Foundry, based on NatWest Group's UK customers, shows that the percentage of customers using their overdrafts in Scotland remained relatively stable from 2020 to 2024.

Starting at 12.6% in April 2020, overdraft usage dipped to a low of 11.3% in January 2021, likely due to reduced spending during pandemic lockdowns. Since then, there's been a slight increase, reaching 13.4% by October 2023 and stabilising around 13% into 2024.

Scotland Overdraft Usage Trends by Age and Income



A closer look reveals that overdraft usage increased most significantly among young Scots aged 18–39 earning less than £25,000. Their usage rose from 18.6% in April 2020 to over 24% by late 2023.

This sharp rise indicates growing financial pressure on young, low-income individuals, who may be turning to overdrafts to cope with rising living costs. In contrast, overdraft usage among older age groups and higher-income earners remained relatively stable.

Source: Smart Data Foundry

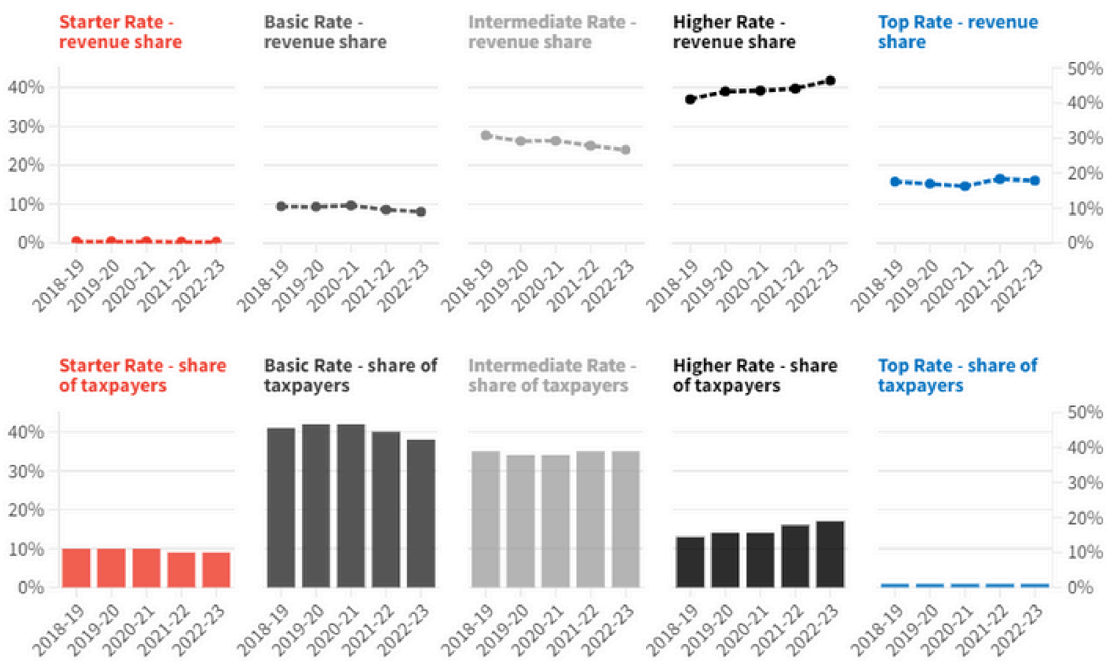
INCOME TAX OUTTURN DATA

The latest Scottish income tax outturn data was published on 11th July 2024: £15,169m was collected in 2022-23, which was an 11% increase compared to 2021-22.

The latest data shows an increasing impact of fiscal drag, with increasing shares of taxpayers going into higher bands, and an increasing share of tax paid by Higher rate taxpayers. In 2022-23, 18% of taxpayers were in the Higher and Top rates of tax, compared to 14% in 2018-19: In 2022-23, 64% of tax was paid by Higher and Top Rate taxpayers, compared to 59% in 2018-19.

A reconciliation of +£447m will be applied to the 2025-26 budget, which is lower than the Scottish Fiscal Commission estimated in December 2023 (when they estimated +£732m). The reasons for the differences between forecast and outturn data are because inflation was much higher in 2022-23 than was expected in late 2021, which therefore pushed up wages far more than was expected.

Income tax: Number of taxpayers and revenue share by band



	Revenues (£m)	Block Grant Adjustment (£m)	Net Position (£m)
Forecast at Budget 2022-23 (Dec 2021)	13,671	-13,861	-190
Outturn 2022-23	15,169	-14,912	257
Change	1,498	-1,051	447
% change	+11%	-8%	

We can see from the table that this impacted both sides of the equation, for both the revenue forecast and the forecast of the Black Grant Adjustment (BGA).

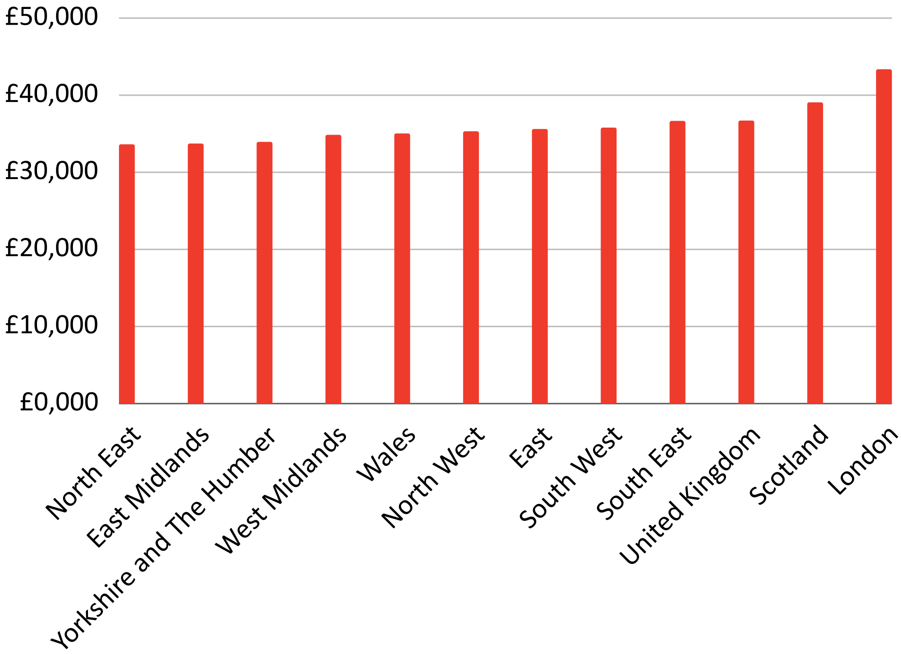
The difference between the error of 8% and 11% (not a big difference in forecast terms) has generated this reconciliation of +£447m, again highlighting the difficulties of two different forecasting organisations forecasting two very large numbers and the Scottish Government having to manage the reconciliations generated by the relative difference between them with limited flexibility.

Source: HMRC, Scottish Government

THE SCOTTISH PUBLIC SECTOR

The debate about public sector pay over the Summer has highlighted how important decisions about public sector pay are for the overall Scottish budget: pay accounts for around £25 billion in the most recent year, which is more than half of the £46 billion day-to-day spending budget.

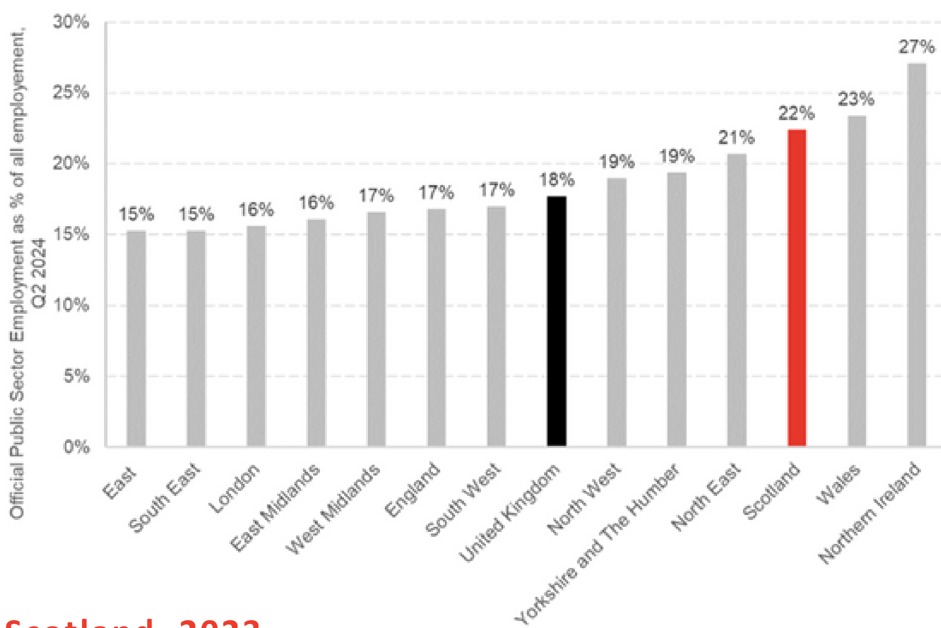
Public Sector Pay, Annual Gross FT by region



A recent publication by the Scottish Fiscal Commission showed that median pay (annual gross pay, full time) for public sector workers in Scotland was higher than the UK average, and that the public sector was larger as a proportion of the workforce. This has the implication that even if the same pay deals are reached in Scotland, the cost of them will be proportionately higher, leading to additional pressure on the Scottish Government budget.

The median gross annual salary for a full time public sector worker in Scotland is £39,072, compared to £36,708 for the UK average. Only Scotland and London are above this average.

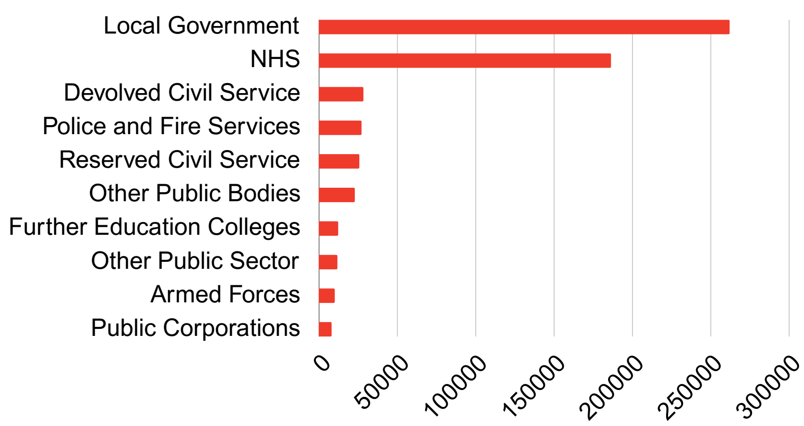
Share of employment in the public sector by region



The gap between Scotland and the UK average has grown considerably in recent years, when we've seen quite different trends in other regions and nations of the UK – for example, when London salaries relative to the UK average have been coming down.

Based on official public sector employment statistics, 22% of employees work in the public sector in Scotland, compared to 17% in the UK as a whole.

Employment in the Public Sector in Scotland, 2023



This represents almost 600,000 workers in Scotland by headcount, across both the devolved and reserved public sector. Local Government is the single biggest portion of this, with 262,000 employees working in this sector in 2023.

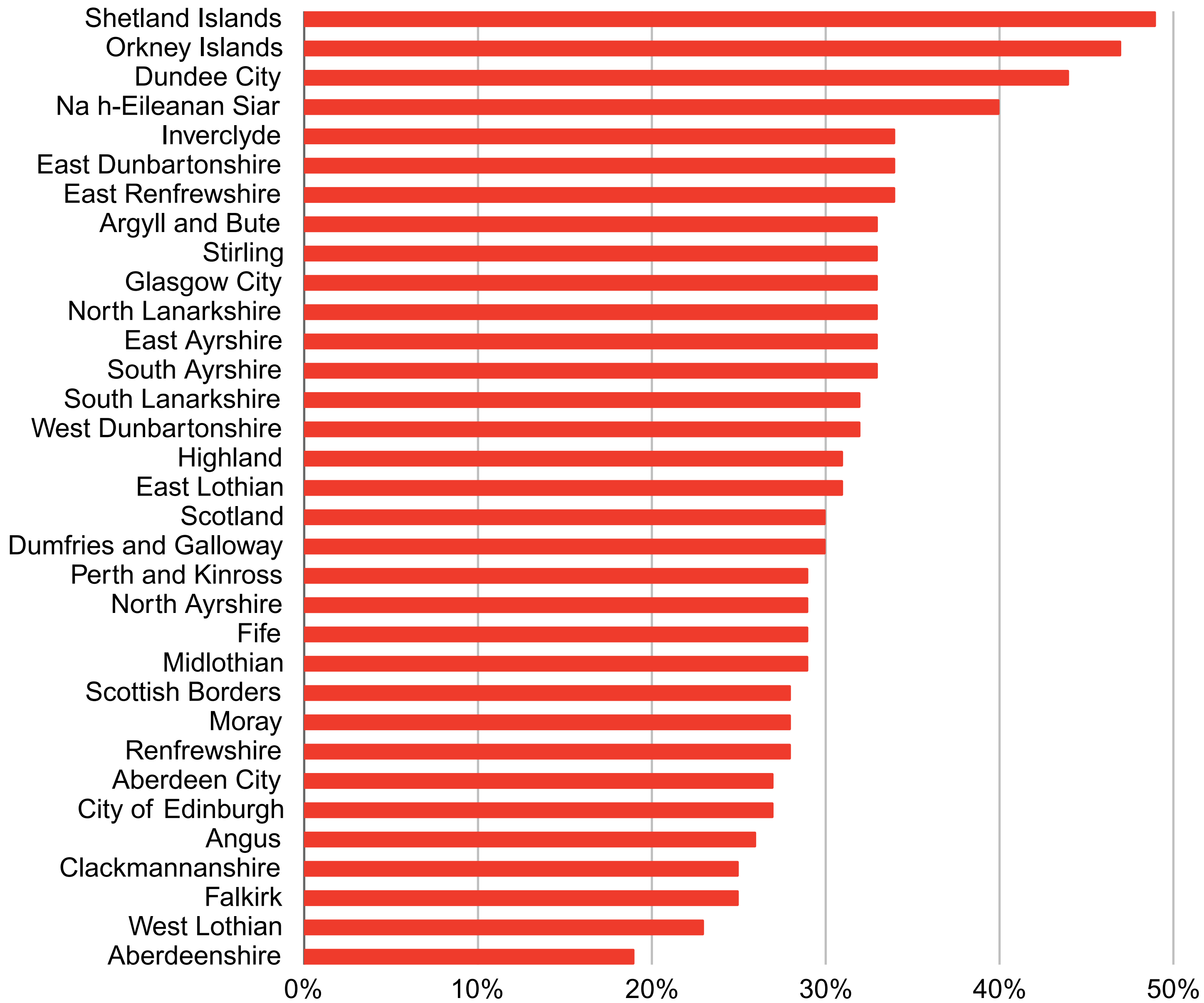
Local Government and NHS together make up three-quarters of public sector workers in Scotland.

Source: ONS, Scottish Government

THE SCOTTISH PUBLIC SECTOR

As would be expected given industrial make up and rurality, public sector employment varies hugely across Scotland. This data is from the Annual Population Survey, so is self reported, which tends to overestimate employment in the public sector, as some who work in the private sector believe they work in the public sector. For example, the Scottish figure is 30%, hihger than the offical figure of 22%.

Self-Reported public sector employment by local authority, 2023



Public sector employment in Scotland shows striking regional variation, reflecting diverse economic landscapes across the country. While the national self-reported average stands at 30% (higher than the official estimate of 22%), individual areas deviate significantly from this figure.

Remote and rural regions like Shetland Islands and Orkney Islands top the chart, with over 40% of workers self-identifying as public sector employees.

In contrast, more urbanised areas such as Aberdeen City and Edinburgh report lower percentages, likely due to their more diverse economic bases. This pattern highlights the crucial role of public sector jobs in sustaining employment in less populous, rural parts of Scotland.

Source: NOMIS

A £22 BILLION BLACK HOLE?

The Chancellor gave a statement to parliament on 29th July, which set out the new Labour Government's spending inheritance. Despite the noise around the statement in terms of what it means for future years, it is important to emphasise that the focus of the statement was about spending pressures in the current financial year.

Rachel Reeves said in her statement that pressures on public spending exceeded allocated funding by £35 billion. Some of this is additional spending from accepting the recommended pay awards from the Pay Review Boards in England, which are higher than the previous government had budgeted for. Others come from areas like accommodation for asylum claimants, which the previous government had just assumed would come from the Home Office's spending limit. Given that the Home Office's total allocation is £21 billion, it was clear that accommodating a pressure worth nearly a third the size of its envelope was not credible.

The Treasury had set aside £9 billion in reserve – a usual management practice for unforeseen circumstances during the course of the year, and which allows the government to plan in some budget cover for unspecified departments. This reduces spending pressures to £26 billion.

The Treasury also assumes that some of these pressures will either not materialise (they are pressures after all, not crystallised spending yet) or that some will be "managed away" – usually by forcing departments to find savings somewhere else. There are a few rounds of this over the course of the year, and by the time of Supplementary Estimates – usually mid-February – both sides concede somewhat, and so the Treasury assumes something about its ability to do that – what is called 'fallaway' in the document. This amounts to £7.1 billion, and bring estimated pressures down to £19 billion.

The Treasury then adds back £2.9 billion to get to what they call "total pressures", because this is how much the OBR assumes that the UK Government will underspend its limits by. Essentially, the OBR assumed actual spending would be £2.9 billion lower than the limits; given that pressures on the Treasury side are relative to the limits, this amount needs added to get to the total pressures compared with the OBR forecast. This is the £22 billion discussed in the coverage of the statement.

Faced with this, the Chancellor has several options: she can let borrowing increase – which would happen automatically if she accommodated pressures; she can reallocate spending from other areas to combat pressures; she could raise taxes; or a combination of the three.

The signal from the statement is that the Chancellor is not prepared to just borrow the additional £22 billion for this year. She has committed to £5.5 billion in savings this year: £1.4 billion coming from means-testing winter fuel payments to pensioners, with most of the rest coming from as-yet not fully specified 'efficiencies': out of the £3.2 billion pencilled in, just £0.9 billion are itemised.

This still leaves around £16 billion to cover. Rachel Reeves left the door open to some tax rises – she said she would not increase any of the headline rates of income tax, National Insurance contributions, VAT or corporation tax, but that still leaves room for base-broadening reforms and increases in other taxes.

A £22 BILLION BLACK HOLE?

The more politically heated debate was the extent to which there was some sort of hiding of the ugly truth of what spending pressures looked like in March, at the time which the OBR included the Treasury's plans in the forecasts for the public finances. Richard Hughes, Chair of the OBR, wrote a letter to the Treasury Committee announcing a review of the "adequacy of the information and the assurances provided to the OBR by the Treasury regarding departmental spending." The Chancellor announced she would be updating the Charter for Budget Responsibility to include the sharing information on 'immediate spending pressures' with the OBR. The extent to which this is actually different to the current legislation will remain to be seen.

The Chancellor also provided some clarity in terms of the spending review timetable. Essentially, an interim 1-year review will be concluded alongside the Budget on 30 October, where 2025-26 budgets will be set. The spring of 2025 will see a return to multi-year budgeting, with a full spending review covering at least three of the five forecast years. There will also be a requirement for a spending review every two calendar years, bringing a much-needed default assumption about the frequency of these exercises.

A few things stand out in terms of what this means for the Scottish Government. In terms of timings, we now know when the UK Budget will be and that it will come alongside a block grant settlement for 2025-26, a pre-condition for the Scottish Budget. This means we are likely to see the Cabinet Secretary for Finance appearing in the Debating Chamber to deliver the Budget Statement in late November 2024.

In the case of most of the measures announced, the direct impact on the Scottish Budget might be relatively limited, though the UK Budget will confirm. A non-negligible proportion of the accommodated pressures will come from reductions in other spending areas – most of those reallocations would not change budget totals, although composition matters for Barnett consequentials. If there is increased borrowing to allow for some of this additional spending, then there might be some added funding for Scotland.

The immediate impact we have seen is the decision to follow suit on means testing winter fuel payments. With eligibility being restricted, the transfer from Westminster will be reduced, and the Scottish Government have decided that they will not fund universal provision from elsewhere in the budget.

The Cabinet Secretary for Finance gave a statement to parliament earlier in the month, setting out in-year savings that have been found, which she said was due to likely public sector pay pressures. She also set out a plan to use £460m of Scotwind revenue, which are windfall licence payments from selling licences to develop offshore wind resources, and which has been earmarked for green infrastructure investment.

Due to the lack of transparency around this statement, though, we will have to wait until after the UK Budget and the Scottish Budget to understand how likely it is that this fund will actually be required to be used.

Key Budget Dates and Events

30th October UK Budget

Late November FAI Budget Report

4th December Scottish Budget