University of Strathclyde Glasgow

FRASER OF ALLANDER INSTITUTE

Economic Commentary

Vol 49 No 4

FOREWORD

January 2025

Supported by Deloitte.

As we navigate the start of 2025, it remains clear that the current economic landscape is marked by both challenges and opportunities.

Last year ended with a subdued economic outlook for Scotland. Businesses faced challenges from inflation and taxation, creating uncertainty and hindering sustained growth. Recent data from The Scottish Government on GDP growth has highlighted continued instability for the Scottish economy, with September's 0.3% rebound followed by a 0.2% contraction in October.

This quarter's Commentary reveals a tightness in the labour market and challenges with talent retention, largely down to demographic trends and shifting economic priorities, with employers facing ongoing challenges in attracting and retaining the skilled workforce necessary to drive innovation and productivity.

This is further exacerbated by the priorities of Chief Financial Officers (CFOs) in the UK, with findings from Deloitte's latest survey of UK financial leaders, published last week, showing that CFOs are entering 2025 with a sharp focus on cutting costs – a long-standing priority for finance chiefs which has only been made more pronounced by the forthcoming rise in National Insurance Contributions. This has resulted in hiring expectations seeing the sharpest fall since the start of the pandemic, with only 18% of finance leaders noting now as a good time to take additional risk onto their balance sheets.

The Commentary also highlights that wages for the Scottish public sector remain higher than the UK average – policymakers must be conscious of public sector wages keeping pace with inflation but balancing this with the pressure on public finances.

Alongside these shifts in public sector earnings, and with competitiveness across regions at play, there are broader implications to retaining talent – shortages can dampen productivity.

Source: Scottish Government

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Addressing talent retention and attraction is not merely an operational necessity, but a cornerstone of long-term economic stability and competitiveness: proactive measures will ensure the Scottish economy can capitalise on growth opportunities and maintain its competitive position.

And as AI continues to permeate, business owners integrating it into their workflows should be mindful of combining it with human expertise, which will ensure creative problem-solving and a strategic approach to innovation.

Despite the challenges, data from this quarter's Commentary reflects cautious optimism about Scotland's economic recovery in the medium term, with the Institute forecasting that growth in 2024 will end up at 0.9%, followed by 1.3% growth in 2025 and 1.2% growth in 2026.

These upwardly revised growth projections, fuelled in part by increased public spending and improved business sentiment, mean 2025 may herald a modest improvement compared to last year.

Indeed, findings from the Institute's Q3 Scottish Business Monitor indicate a gradual improvement in sentiment throughout 2024, with one in four firms anticipating moderate economic growth in Scotland over the next year. However, challenges persist, with nearly 60% of firms expecting growth to remain weak or very weak.

The Business Monitor also found that falling demand and the impact of taxation show cause for concern, with nearly 12% of businesses identifying taxation as a primary challenge in December 2024.

Businesses cite increasing tax burdens as a deterrent to investment and innovation, and the implications of these policies extend beyond just finances, potentially affecting job creation and wage growth. These conditions create additional pressure on real incomes and on the survival of businesses.

So, while the UK Government's fiscal measures announced in the October Budget provided a short-term boost, they may carry unintended consequences of a longer-term outlook of higher inflation and interest rates.

And while the Scottish Budget, announced in December, contained limited changes to the taxes devolved and partially devolved to Scotland, it's worth reflecting on the incremental changes that have made an impact.

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Over the past decade, Scotland has developed a distinct and increasingly autonomous tax system, shaped by the devolution of powers following the Smith Commission's recommendations in 2014. Key changes included the introduction of six income tax bands, resulting in more progressive taxation that benefits lower earners while imposing higher liabilities on higher earners compared to the rest of the UK. Scotland's tax landscape now reflects a unique approach guided by a dedicated Tax Strategy and Framework.

Addressing concerns around tax requires a nuanced approach to policy – one that centres economic growth without placing undue strain on working people and enterprises. As a devolved government, the Scottish Government faces additional pressures, balancing limited fiscal powers with the need to deliver public services and stimulate the economy.

2025 represents a pivotal year for the Scottish economy. It's a period where the long-term impacts of the pandemic will intersect with critical decisions on taxation, talent, and global economic forces. The choices made this year will determine whether Scotland can translate fragile gains into lasting, inclusive growth.

Douglas Farish, Head of Tax for Scotland, Deloitte

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FORECASTS

0.9%
2024 forecast

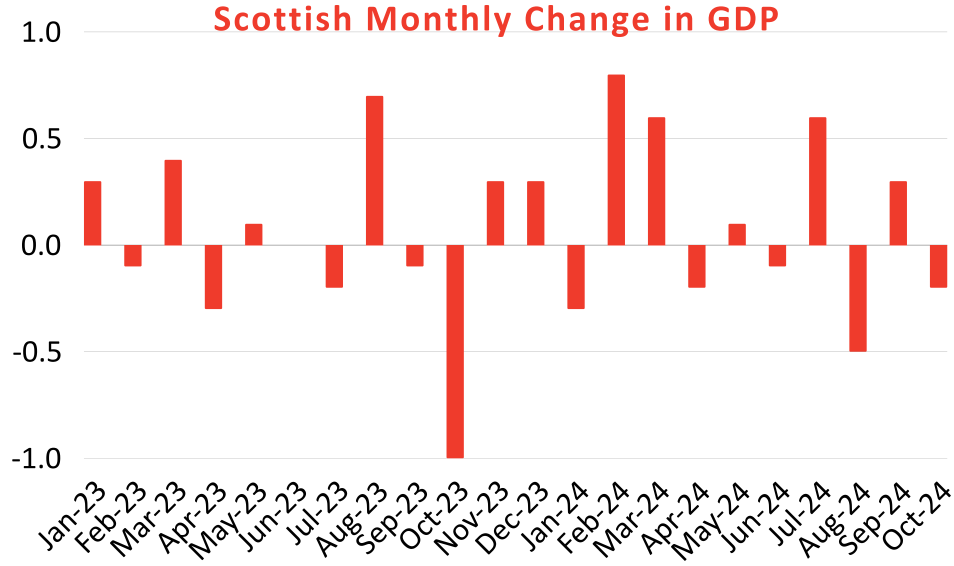
1.3%
2025 forecast

1.2%
2026 forecast

Struggling for Stability
Recent data on GDP growth highlights continued turbulence for the Scottish economy, with September's 0.3% rebound followed by a 0.2% contraction in October.

Despite this, however, the latest forecasts suggest optimism for future growth.

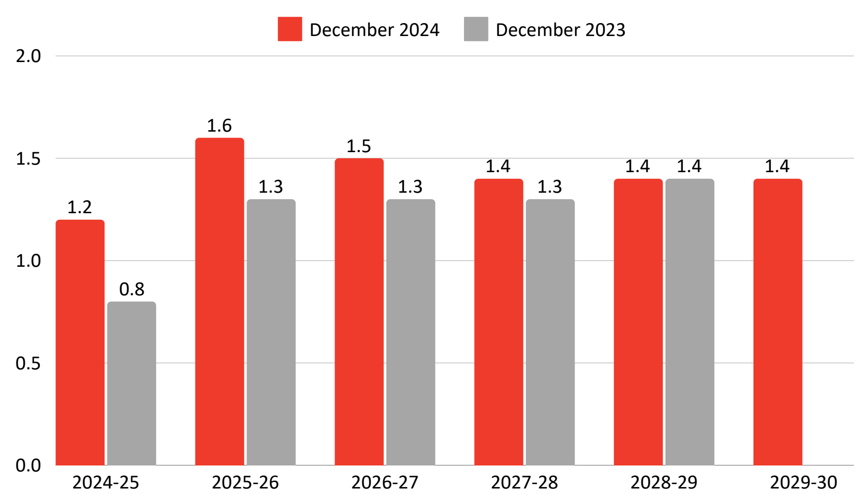
Scottish Monthly Change in GDP



The latest forecasts from the SFC show a significant upward revision for 2024, with GDP growth now projected at 1.0%, up from 0.7% in December 2023.

The outlook for 2025 and 2026 has also been revised upwards to 1.5% and 1.6%, respectively, compared to 1.1% and 1.3% previously. This suggests growing confidence in medium-term economic recovery.

Scottish GDP Growth Forecasts



Scottish GDP Growth Forecasts

	2024	2025	2026
FAI *September 2024*	0.9%	1.1%	1.2%
FAI *December 2024*	0.9%	1.3%	1.2%
SFC *December 2023*	0.7%	1.1%	1.3%
SFC *December 2024*	1.0%	1.5%	1.6%

The FAI forecasts of GDP growth in 2024 and 2026 remain unchanged from September's at 0.9% and 1.2%, respectively, but it has revised its 2025 estimate up 0.2% to 1.3%, reflecting near-term optimism followed by a slightly more cautious outlook from 2026.

Source: Scottish Government, SFC, FAI Analysis

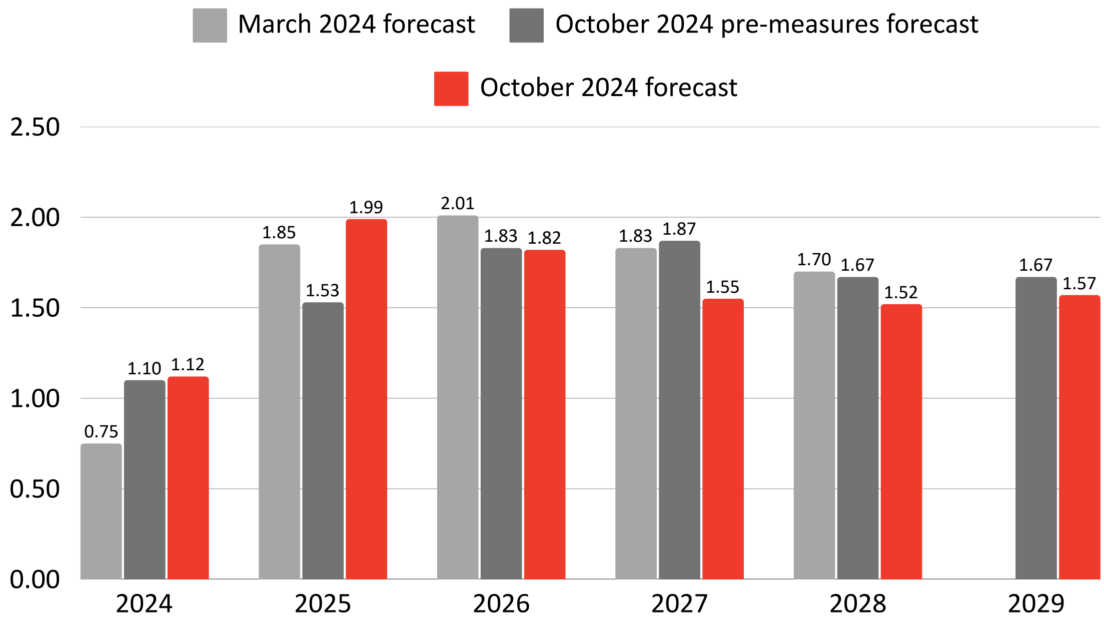
THE SCOTTISH ECONOMY

UK Budget Impacts GDP Growth Forecast

Despite a short-term uplift from the Chancellor's announcements on 30th October, the Office for Budget Responsibility (OBR) has lowered its expectations for medium-term real growth.

The OBR cite supply side impacts from the employer NICs rise along with crowding out impacts from spending as contributing to a broadly unchanged forecast for 2029.

Real GDP Growth



The OBR and SFC largely agree on the underlying fundamentals of GDP growth.

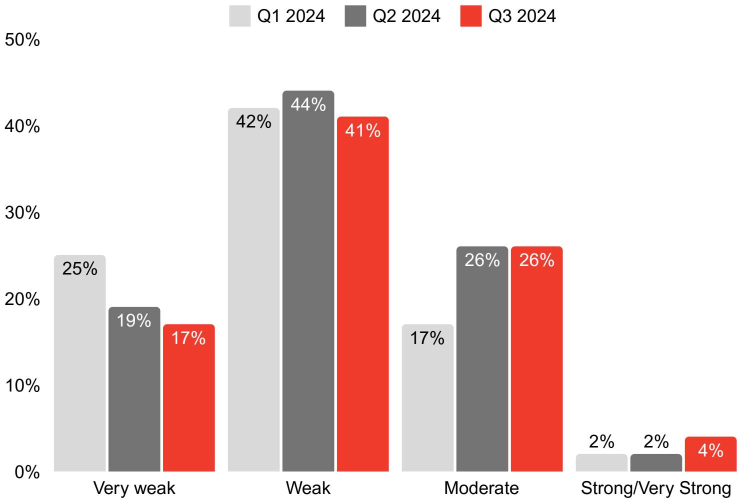
Much of the variance in expectations relates to slower population growth in Scotland - driving additional tightness in the Scottish labour market.

The gap narrows significantly when considering growth on a per person basis.

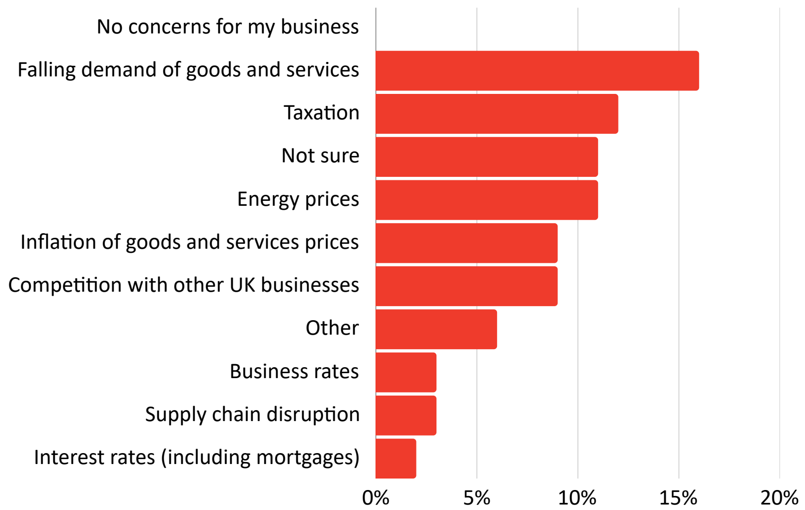
Findings from our Q3 Scottish Business Monitor reveal that 1 in 4 firms anticipate moderate economic growth in Scotland over the next year. Encouragingly, optimism about growth has strengthened throughout 2024, suggesting a gradual improvement in business sentiment.

However, challenges persist, with nearly 60% of firms expecting growth to remain weak or very weak.

Firms' Outlook for Growth



Business Concerns in December



In December, the most commonly cited concern among businesses was falling demand for goods and services, reported by 16% of respondents, followed by taxation at 11.9%.

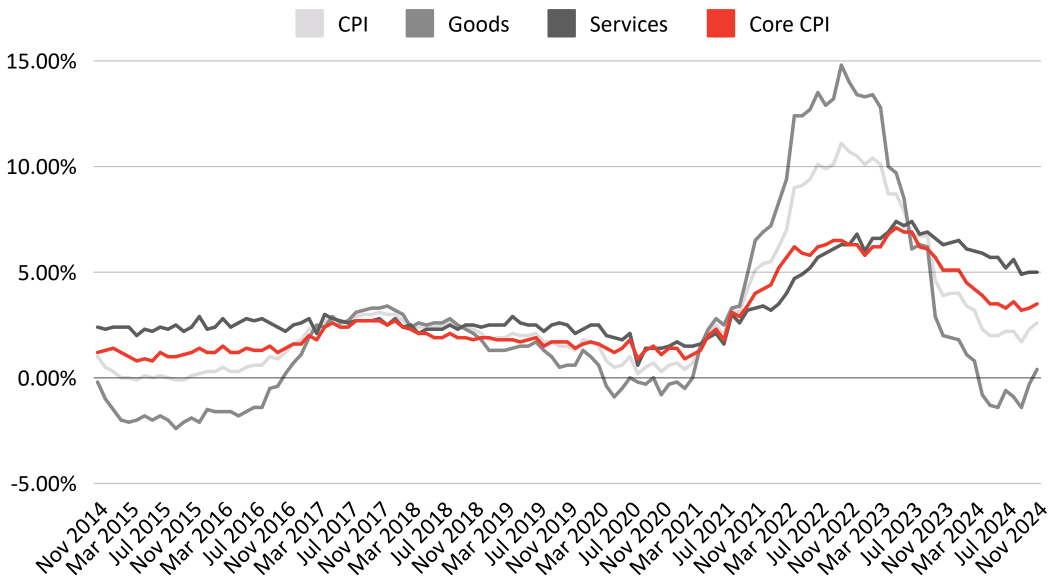
While concerns over energy prices have decreased significantly compared to the same period last year, there has been a noticeable uptick in recent months. The share of businesses citing energy prices as a primary concern rose from 6.3% in August to 10.3% in December.

Source: OBR, SG (BICS), FAI

INFLATION

In the 12 months to November 2024, Consumer Price Inflation was 2.6%, up from 2.3% in October. The latest two data points show the challenge of holding inflation near the 2% target. The increase in November was largely driven by transport and housing and household services.

CPI Inflation



Meanwhile, core inflation, which excludes volatile components such as food and energy, rose to 3.5%, up from 3.3% in October.

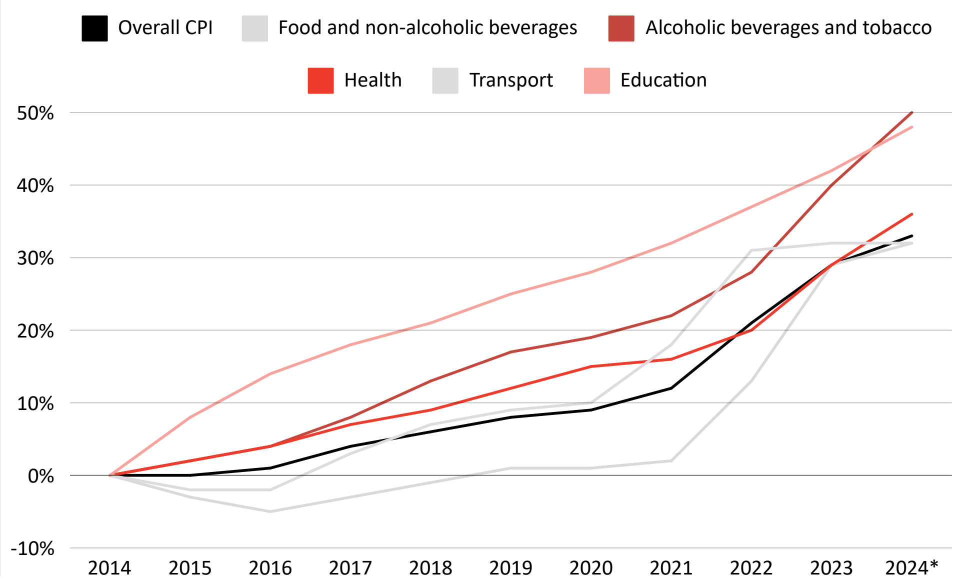
This uptick in core inflation underscores persistent underlying price pressures and is likely to weigh heavily on the Bank of England's upcoming decision regarding interest rates.

Cumulative Price Increases Highlight Long-Term Inflationary Pressures

Since 2014, some components of CPIH have experienced substantial cumulative price increases, with Alcohol and Tobacco leading the way at 50%, followed by Education (48%) and Restaurants and Hotels (47%).

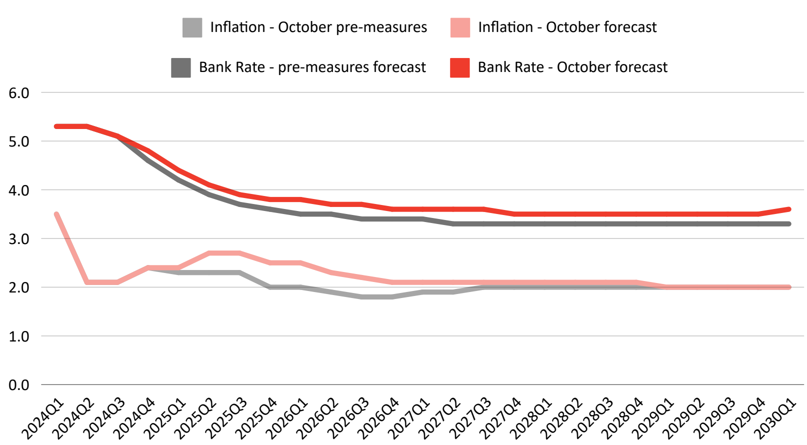
In comparison, overall CPI has risen by 33% over the last decade - 10% higher than target inflation over the period.

Cumulative CPI 2014-2024



*Average from January to October 2024

Post Budget Inflation and Rate Expectations



The Bank of England's Monetary Policy Committee (MPC) has responded to lower and more stable inflation by implementing cautious reductions in the Bank Rate. This measured approach reflects the MPC's commitment to balancing economic growth with inflationary risks.

The October forecast from the Office for Budget Responsibility (OBR), following measures announced by the Chancellor in late October, projects that inflation will remain higher for longer. This outlook suggests a slower pace of further reductions in the Bank Rate, as the MPC navigates persistent price pressures.

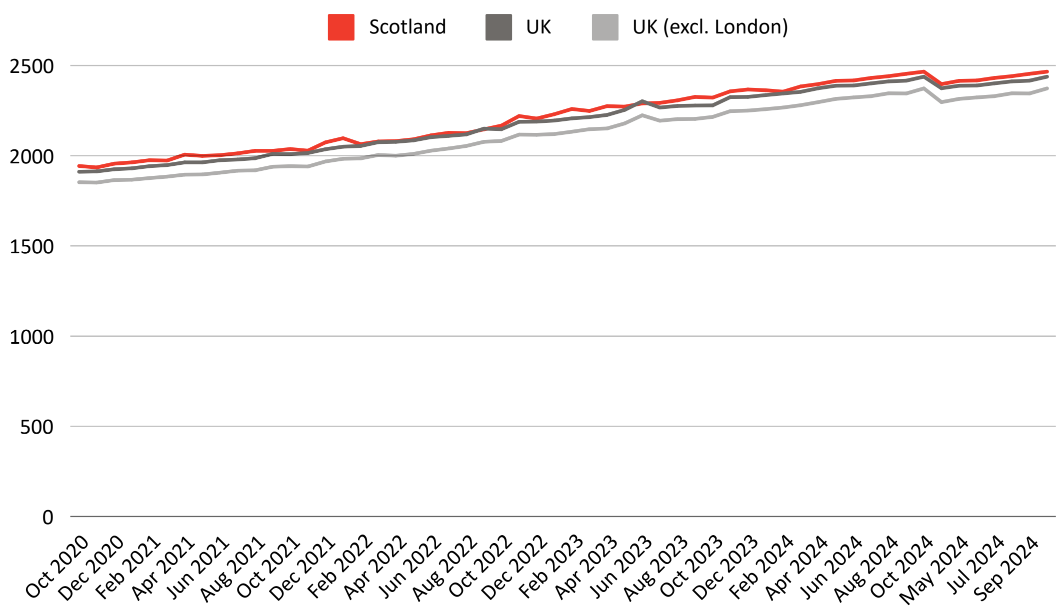
Source: ONS, OBR

EARNINGS

Mixed Expectations for Earnings Growth

The latest SFC and OBR forecasts show mixed earnings growth trajectories, with upward revisions for 2024-25 and 2025-26 but downward adjustments thereafter. These revisions likely reflect their interpretations of measures in the Scottish and UK Budgets, with the OBR's real earnings growth forecasts particularly influenced by inflation expectations.

Scottish vs UK Median Monthly Earnings



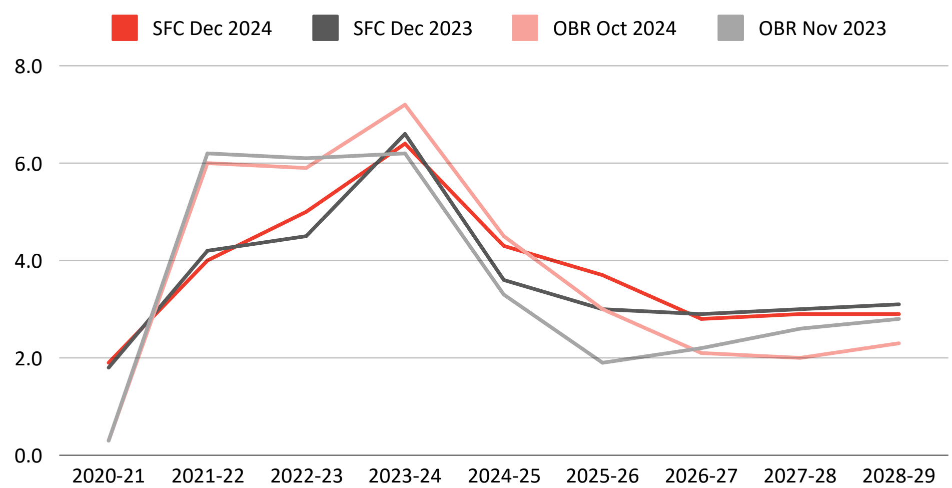
Scotland continues to perform well in relation to the rest of the UK in terms of average earnings. As of September 2024, median monthly earnings were over £100 higher than in the rest of the UK (excluding London).

Earnings in Scotland and the UK have risen steadily, at a comparable rate, since October 2020.

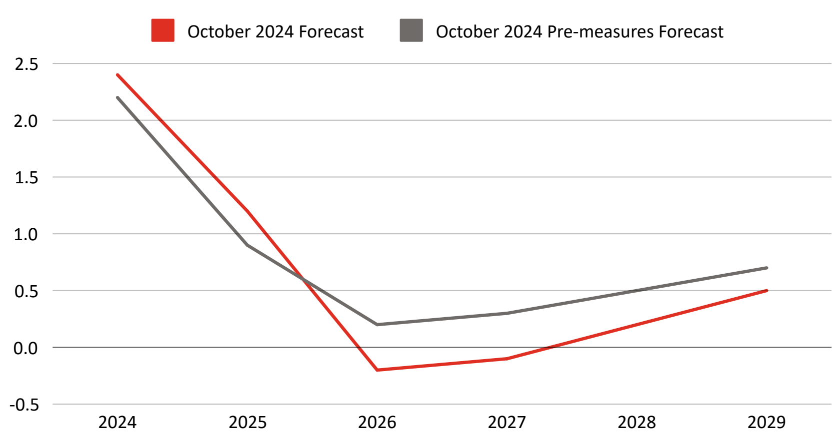
Earnings Growth Forecasts

The latest earnings growth forecasts from the SFC and the OBR produced upward revisions from the respective 2023 estimates in the near term.

From 2026-27, though, the revised forecasts reflect dampened expectations of earnings growth, with updated forecasts below the previous forecasts. The SFC partially attributes this to employers passing the announced NIC rise onto employees via higher prices, reducing real and future nominal wages.



Real Earnings Growth Forecasts



The OBR's post-measures forecast revisions reflect the impact of fiscal measures and higher inflation expectations; most notably the announced NICs increase from April 2025. Real earnings growth is expected to decline sharply, turning negative by 2026 as inflation erodes purchasing power.

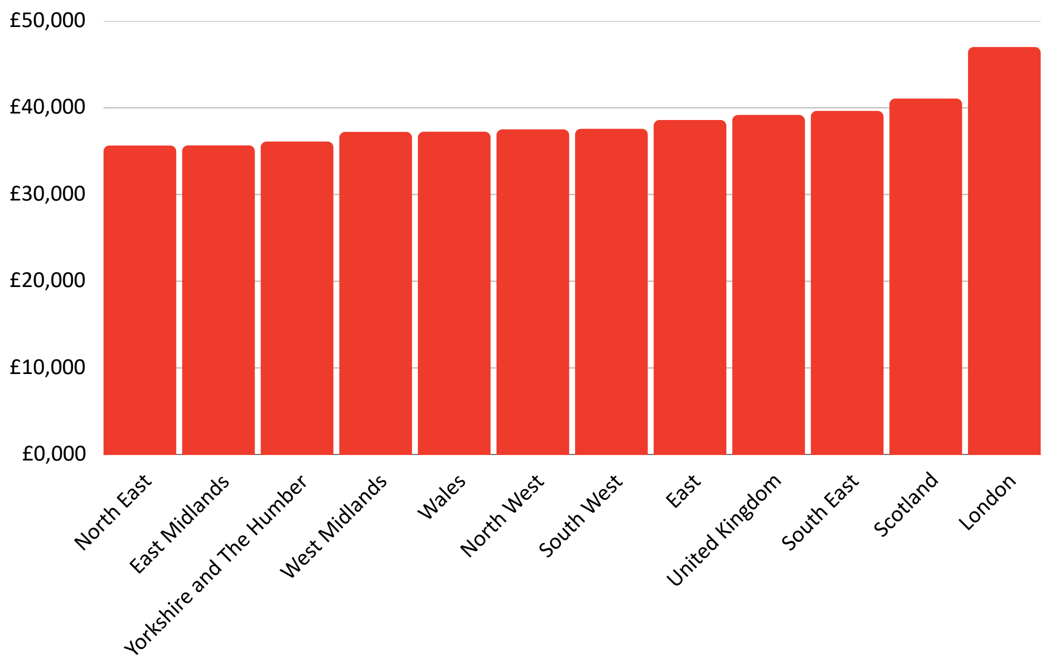
The post-measures forecast (red line) is lower than the pre-measures projection, suggesting that 2024 fiscal measures may constrain disposable incomes or wage growth. While growth recovers after 2026, the expected rebound following the Chancellor's announcement remains slower.

Source: ONS, SFC, OBR

THE SCOTTISH PUBLIC SECTOR

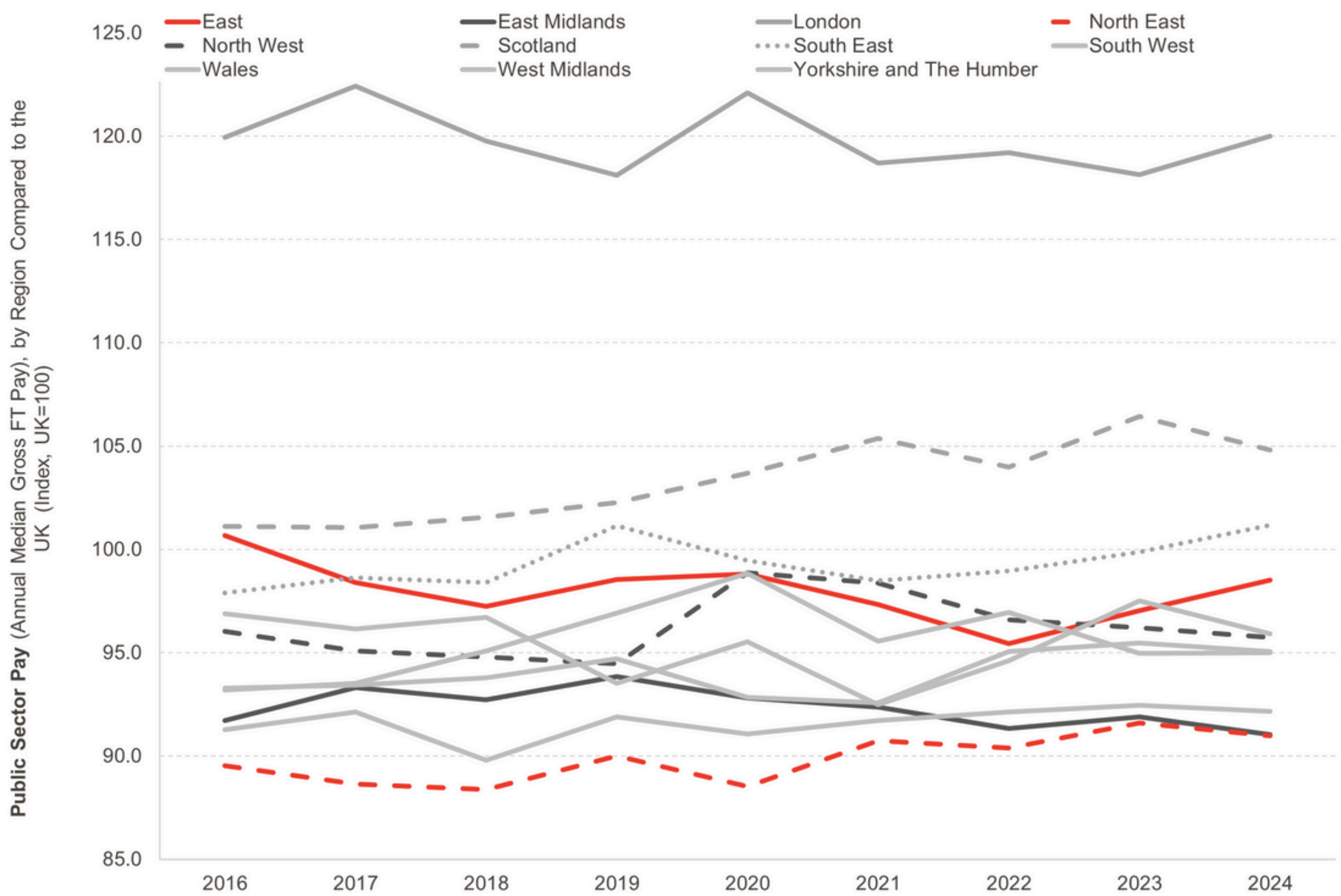
In our last commentary, we analysed the nature of the public sector in Scotland, highlighting that the average wage of a public sector worker in Scotland is higher than the UK average, and that the proportion of employees who are in the public sector in Scotland is also higher. This is a crucial issue for fiscal sustainability, as public sector pay is around half of the resource budget, and the issue is further exacerbated by the increases to employer national insurance contributions, which further increase differentials in the cost of employment.

Public Sector Pay, Annual Gross FT by Region, 2024



New data for 2024 was published at the end of October which now shows that the average full-time salary for a public sector worker in Scotland is £41,065, still significantly above the UK average. Scottish pay in the public sector has been increasing more quickly than in other regions.

Public Sector Pay by Region (Compared to UK)



Source: ONS

A Summary of Measures

Shona Robison presented her Draft Budget to parliament on 4th December.

The Scottish Government will be hoping for many of the headlines to focus on the mitigation of the effect of the two-child limit from 2026-27. The Finance Secretary left this until last in the order to ensure maximum impact. This appears to be a highly political announcement, given its timing ahead of the election, and one that has no money attached to it (as far as we can tell) in the 2025-26 financial year – the year this Budget actually refers to. Further details are discussed below.

There were also significant announcements on health spending, with a forecasted real-terms increase of 3.6%—a significant rise, though, as we've often highlighted, how and where it is spent matters just as much as the envelope itself. There were also increases to the Affordable Housing Supply Programme, which was cut by a quarter last year but is now only 2.5% below 2023-24 in real terms.

We welcome the change in the presentation of the Scottish Government's plans, which are now compared with their best estimate of the position for the current financial year. This has helped us meaningfully scrutinise plans, though some wrinkles remain to be ironed out such as in-year transfers to local government, which we hope will be baselined in the future.

Two-child limit

The biggest surprise in the budget (although social media had gotten wind of it slightly ahead of time) was the promise to 'mitigate, as far as possible, the impacts of the two-child limit from 2026.'

This appears to have been a last-minute addition to the budget. The Scottish Fiscal Commission (SFC) stated that it received the measure too late to include in its figures or for any analysis to be incorporated into the budget document or the Equality and Fairer Scotland Budget Statement. The SFC has since estimated a cost of £155m for 2025-26. While there are too many unknowns to draw conclusive insights about its impact, it is clear that the measure would contribute to efforts towards meeting statutory child poverty targets - though not sufficiently to achieve them on its own.

How will the Scottish Government fund this? Well, it may be hoping that it won't have to, relying instead on the widely anticipated possibility that the UK Government will abolish the policy UK-wide before the Scottish Government is required to implement it.

Although early 2026 is the target date, the statement heavily caveated this timeline, making it conditional on the UK Government providing the necessary data for operationalisation. Given the delays experienced with the rollout of the Scottish Child Payment, which took years, there are valid concerns that implementation could exceed the stated timescales. In the meantime, however, the Scottish Government can position itself as taking the moral high ground on this issue.

THE SCOTTISH BUDGET

Relief for hospitality businesses

The Finance Secretary announced a 40% relief for small hospitality businesses, which at first glance appears similar to the 40% relief offered by Rachel Reeves for retail, hospitality, and leisure (RHL) businesses in England. However, Scotland's measure is much more limited, applying only to hospitality businesses with a rateable value under £51,000.

To illustrate the difference in scale, the SFC estimates this relief will cost £22m—far less than the £147m of Barnett funding generated by the broader measure in England.

ScotWind funding (partially) restored

Early in her statement, the Finance Secretary announced that some of the ScotWind funding, previously drawn down to fill gaps in spending in the statement in September has not been used for day-to-day spending and will instead be retained for capital spending in 2025-26 - "for exactly the kind of long-term investment it should be spent on."

ScotWind revenues are generated from the sale of offshore wind licences to energy companies. As one-off windfall payments from the exploitation of Scotland's resources, they should ideally be invested in infrastructure to ensure that Scotland's economy benefits on an ongoing basis from such sales. Specifically, they should focus on capital spending that supports the energy transition.

However, some of the ScotWind funding has still been used to address gaps in day-to-day spending, even though some funds have now been redirected. The Scottish Government allocated £160 million for resource funding in 2024-25. For 2025-26, it plans to use the majority of ScotWind revenues - £326 million - for capital spending, with £10 million still allocated to resource funding.

This leaves a remaining balance of £219 million for future capital or resource spending. Ideally, this should be explicitly reserved for investment purposes to maximise long-term benefits.

Lessons learned?

A surprising decision was the failure to account for the certain rise in employment costs due to the employer National Insurance Contributions increase, set to take effect on 1 April. As noted recently, we expect this to cost around £500m annually, as the increase is permanent.

This approach is highly risky, and could potentially require further emergency measures during the next financial year. It raises questions about whether lessons have been learned from previous instances of entering a new year without adequate budget cover for known costs, as highlighted by the recent Audit Scotland report.

Affordable Housing

Shona Robison announced an affordable housing budget of £768 million for 2025-26, restoring it to a level higher than two years ago, before 2024-25's steep cut. However, it's not immediately clear from the Budget documents how this figure is derived. The closest match is the Housing and Building Standards Level 2 budget within the Social Justice portfolio, listed as £766 million for 2025-26 - a minor discrepancy, perhaps.

This budget includes diverse spending lines, such as Fuel Poverty, Housing Quality, Building Standards, Discretionary Housing Payments, and Housing Support. These are important ways of supporting people in difficult circumstances, of course, and much-needed ones - but they are not what we'd consider targeted affordable housing supply investment.

For a clearer view, we focus on the More Homes Level 3 budget, which is dedicated to affordable housing supply. This budget totals £590 million, with £583 million allocated for capital spending (including direct capital and financial transactions). This represents a 4.5% increase since 2023-24 in nominal terms, although it is still around 0.5% lower in real terms.

Capital spending on the Level 4 line for the Affordable Housing Supply Programme - effectively funding additions to affordable housing stock, excluding receipts from sales and repayments - is up 2.4% in cash terms compared to 2023-24 but remains 2.5% lower in real terms. Notably, there has been a shift in the allocation of funds, with direct capital spending increasing by 16% in real terms and a reduced reliance on financial transactions.

This shift is positive, as direct investment ensures projects are either built by the Scottish Government or funded through grants, offering greater transparency and accountability compared to lending schemes that are more detached from public sector oversight.

THE SCOTTISH BUDGET

A New Tax Strategy

Alongside the Scottish Budget, the Tax Strategy has also been published. This had been delayed and ultimately cancelled in draft form alongside the Medium-Term Financial Strategy (MTFS) but has now been released in its final form.

A key positive is the commitment to evaluate the effects of income tax changes in 2023-24 and 2024-25. This is particularly important given HMRC's evaluation of the 2018-19 changes and the lingering uncertainty around the longevity of their impact.

The publication of research priorities, particularly on the behavioural effects of tax policy changes, is another positive step. As income tax policy continues to diverge between Scotland and the rest of the UK, building a robust evidence base will be critical for informed debate and effective policy. Publishing these research questions is a step in the right direction and a prerequisite for a higher quality of debate in Scotland.

Some of the commitments relating to the path forward are also welcome, and provide greater clarity on income tax thresholds through to 2027-28, although annual reassessments will still occur at the Budget. However, other areas of the strategy lack detail. For example, council tax and non-domestic rates reforms have been relegated to commitments to consider responses and working groups that are likely to take a long time to report, delaying progress.

Aims such as growing the tax base and understanding the economic impact of taxes are difficult to disagree with - who wouldn't want to grow the tax base and the economy? However, they remain broad aspirations. The challenge will be turning these goals into actionable policies, which will require significantly more detail and direction.