Finance and Public Administration Committee

13th meeting 2021 (Session 6), Tuesday 7 December 2021

Scrutiny of the Scottish Budget 2022-23: UK context

Purpose

1. This paper invites the Committee to take evidence from the following two panels of witnesses in relation to the UK economic and fiscal outlook:

Panel 1: Richard Hughes, Chairman, and Professor Sir Charlie Bean, and Andy King, Budget Responsibility Committee Members, Office for Budget Responsibility, and

Panel 2: Carl Emmerson, Deputy Director, Institute for Fiscal Studies.

2. The two evidence sessions will provide background on the UK context ahead of the Scottish Budget 2022-23 and the Scottish Fiscal Commission's latest economic and fiscal forecasts being published on 9 December. The Committee is then due to take evidence on these and related documents[1] on 14 and 21 December, and to report to Parliament in mid-January.

Scottish Budget 2022-23

3. The Committee published its pre-budget report on 'Scotland's public finances in 2022-23 and the impact of Covid-19'[2] on 5 November. A key theme in the report was the need to balance the short-term demands from the response to, and recovery from, Covid-19, with continuing longer-term pressures such as demography, poverty and inequality. The report also made a number of recommendations aimed at achieving future fiscal sustainability.

4. Under the Written Agreement between the Committee and the Scottish Government[3], the Scottish Budget should include a summary of how committees' pre-budget reports have influenced the preparation of the Budget. Relevant Ministers are thereafter required to provide a more detailed response to each committee, and a debate expected to be arranged for late January provides further opportunity to discuss these issues.

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[1] The Committee has agreed to use the Medium-Term Financial Strategy also being published on 9 December to inform its budget scrutiny. The Scottish Government's framework for a resource spending review will also be published on the same date.

[2] Pre-Budget Scrutiny 2022-23: Scotland's Public Finances in 2022-23 and the Impact of COVID-19 (azureedge.net)

[3] Budget Process Session 6 Agreement (parliament.scot)

5. The Budget Bill is also being introduced on 9 December, with a Stage 1 deadline expected to be towards the end of January, when a debate on the general principles of the Bill will take place. Stages 2 and 3, where only Ministers can lodge amendments, will follow thereafter.

UK economic and fiscal outlook

6. The Office for Budget Responsibility (OBR) produces five-year forecasts for the economy and public finances twice a year, which accompany the UK Government's Spring and Autumn Budget Statements. Its forecasts, along with those of the Scottish Fiscal Commission, determine the size of future reconciliations to the Scottish Budget.

7. In a joint report[4] on the fiscal framework, the Committee's predecessor highlighted some of the risks inherent in forecasting, including:

- the extent of the underlying uncertainty about the economy,
- the availability of relevant and robust data,
- the robustness of the OBR and SFC's respective methodologies and judgments,
- differences in the methodologies used by the OBR and SFC, and
- forecast horizons, i.e. the length of time into the future for which forecasts are prepared.

8. These risks are more acute during periods of economic uncertainty such as the pandemic. In its pre-budget report, this Committee agreed with its predecessor that "the two governments should consider the extent of the risk arising from potential divergence in forecast error between the SFC and the OBR, learning any lessons from the experience of an economic shock being triggered due to a quirk in timings".

9. In its latest UK forecasts[5], published alongside the UK Autumn Budget 2022-23 on 27 October 2021, the OBR revised up its expectations for growth over the next five years, following stronger than expected growth in the first half of 2021, supported by the vaccine roll-out. It expects the UK to reach pre-pandemic levels at the turn of 2022. However, while economic scarring and unemployment is forecast to be lower than was anticipated at the start of this year, inflation has risen sharply. As noted in the Committee's pre-budget report, the OBR explains this is "due to supply issues, migration and trading regimes following Brexit, soaring energy prices, labour shortages in some occupations, and blockages in some supply chains".[6] On 17 November, the ONS announced that Consumer Price Inflation (CPI) rose to 4.2% in the 12 months to October 2021, up from 3.1% in September. The Bank of England, in its Monetary Policy Report[7] of November 2021, set out its expectation that inflation would continue to rise, to 5% by Spring 2022.

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[4] A joint report with the Social Security Committee and Cabinet Secretary for Finance: Report(2).pdf (parliament.scot)
[5] OBR forecasts 27 October 2021: CCS1021486854-001_OBR-EFO-October-2021_CS_Web-Accessible_v2 (1).pdf
[6] Pre-Budget Scrutiny 2022-23: Scotland's Public Finances in 2022-23 and the Impact of COVID-19 (azureedge.net)
[7] Monetary Policy Report - November 2021 | Bank of England

10. Further background can be found in the OBR's overview of its October 2021 Economic and Fiscal Outlook reproduced at Annexe A. Each month the OBR also produces a brief analysis of data, contained in an Office for National Statistics (ONS) and HM Treasury joint statistical bulletin on public sector finances, and compares it with its most recent forecast. The OBR published its latest analysis of public sector finances on 19 November, highlighting that UK Government borrowing this year to date was down £103.4 billion (44.3%) on the same period last year, reflecting both higher receipts and lower spending.

11. Another issues to note is an observation made by the Institute for Fiscal Studies (IFS)[8] on 30 September 2021 that "the number of vacancies in Scotland was over two-fold greater than last summer – the fastest growing in the UK" Although this was seen to be a positive sign for Scotland's recovery, there were "growing concerns of a mismatch between the skills demanded for vacancies and the skillsets of those searching for jobs".

12. In its analysis of the Autumn Budget and Spending Review 2021[9], the IFS highlighted the Chancellor of the Exchequer's decision not to reverse the significant tax rises (through national insurance contributions) which were announced in March when the economic forecasts were less positive. Paul Johnson, Director, commented that the Chancellor instead chose "to bank them, raise spending, and bring borrowing in below pre-pandemic forecasts", adding "this gives him some cushion against the OBR becoming more pessimistic again". In an 'observation on the cost of living crisis' published on 17 November, the IFS concluded that "while the current rates of average price increases are very similar for households of different income levels, as gas prices continue to rise we may expect lower income households to be hit more".[10]

13. The emergence of a new Covid-19 variant, Omicron, brings uncertainty as to whether a change in government response will be required and what, if any, impact this will have on economic performance. The Fraser of Allander Institute explained to the Committee during pre-budget scrutiny that Covid-19 has to date largely had similar health and economic impacts across the UK, a scenario which sees little or no impact on how the fiscal framework operates. However, if these impacts were to disproportionately affect some parts of the UK more than others, the fiscal framework could come under greater strain.

14. The OBR is due to publish its annual Forecast Evaluation Report on the morning of 9 December, which will look at the impact of the pandemic on its forecasts over 2020-21 and compare them against subsequent outturn data.

Next steps

15. The Committee will take evidence on the Scottish Budget 2022-23 on 14 and 21 December 2021.

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[8] Employment and the end of the furlough scheme - Institute For Fiscal Studies - IFS
[9] Autumn Budget and Spending Review 2021 - Institute For Fiscal Studies - IFS
[10] The cost of living crisis – who is hit by recent price increases? - Institute For Fiscal Studies - IFS

Committee clerks
December 2021

ANNEXE A

Office for Budget Responsibility: Overview of the October 2021 Economic and fiscal outlook

October 27th, 2021

The successful vaccine rollout has allowed the economy to reopen largely on schedule, despite continuing high numbers of coronavirus cases. The vaccines' high degree of effectiveness, combined with consumers' and businesses' surprising degree of adaptability to public health restrictions, has meant that output this year has recovered faster than we expected in March, boosting tax revenues in the process.

The stronger economic recovery has also helped to reduce the fiscal cost of pandemic-related support to below our March forecast. The economy is now expected to grow by 6.5 per cent in 2021 (2.4 percentage points faster than we predicted in March), and unemployment to rise only modestly to 5¼ per cent this winter (1¼ percentage points lower than March), which helps the budget deficit to almost halve to £183 billion in 2021-22 (£51 billion lower than March).

But the strength of the rebound in demand in the UK and internationally has led it to bump up against supply constraints in several markets. In the UK, these supply bottlenecks have been exacerbated by changes in the migration and trading regimes following Brexit. Energy prices have soared, labour shortages have emerged in some occupations, and there have been blockages in some supply chains. These can be expected to hold back output growth in the coming quarters, while raising prices and putting pressure on wages. We expect CPI inflation to reach 4.4 per cent next year, with the risks around that tilted to the upside. News since we closed our forecast would be consistent with inflation peaking at close to 5 per cent next year. And it could hit the highest rate seen in the UK for three decades.

Over the medium term, we have revised up real GDP as we now expect post-pandemic scarring of potential output to be 2 per cent – rather than the 3 per cent we assumed in March. Uncertainty around this judgement remains large, however, with limited evidence as yet regarding how smoothly furloughed workers will be reabsorbed into employment, whether those workers who became inactive or left the country during the pandemic will re-enter the labour force, and how fully shortfalls in capital investment, innovation, and the acquisition of skills will be made up. With inflation also higher and more persistent, we have revised up nominal GDP – the key driver of tax revenues – by 4.1 per cent in 2025-26 relative to March, boosting our pre-measures revenue forecast by 4.5 per cent in that year. While higher inflation also boosts public spending, overall our pre-measures forecast for borrowing is lower by £38 billion a year on average relative to our March forecast.

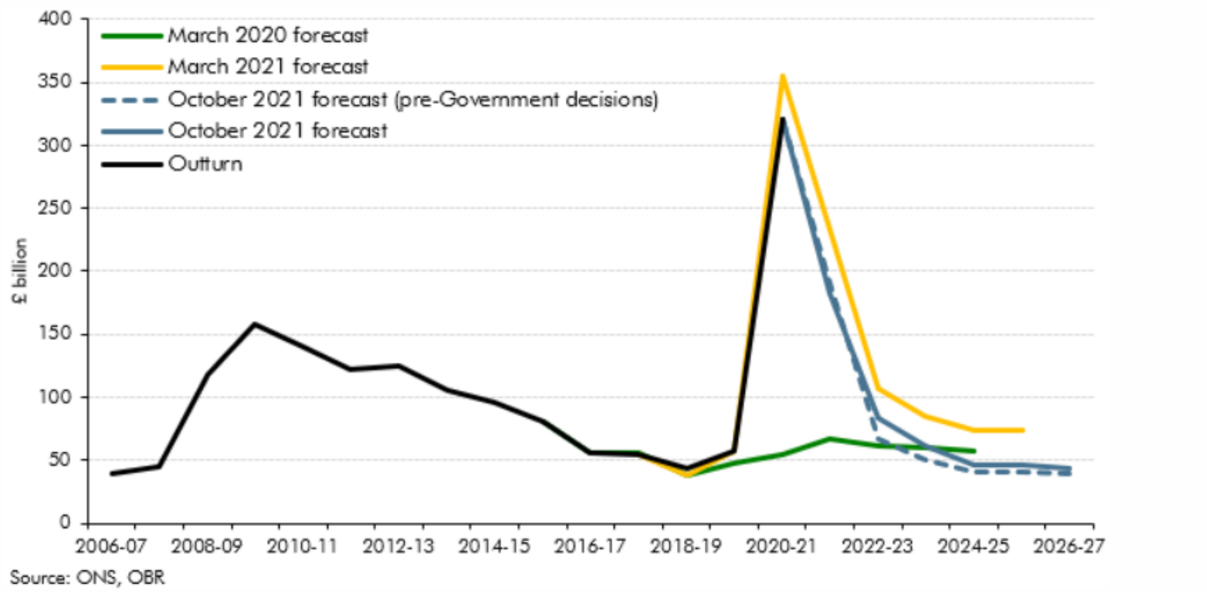
Against the backdrop of an improved underlying fiscal outlook, the Government has announced a significant discretionary increase in both the tax burden and the size of the post-pandemic state. In particular, the October 2021 Budget and Spending Review delivers

- A further net tax rise amounting to £16.7 billion a year by 2026-27, more than explained by the introduction of a health and social care levy of 1.25 per cent on employees, employers and the self-employed, which raises £18.2 billion by 2026-27, and is only partly offset by tax cuts, principally the freezing of fuel duty for the twelfth year in succession at a cost of £1.6 billion a year. Together with the £31.5 billion in corporate and personal tax increases announced in the March 2021 Budget, and the improved underlying fiscal outlook, these measures raise the tax burden from 33.5 per cent of GDP before the pandemic to 36.2 per cent of GDP by 2026-27, its highest since the early 1950s. Taking his March and October Budgets together, the Chancellor has raised taxes by more this year than in any single year since Norman Lamont and Ken Clarke’s two 1993 Budgets in the aftermath of Black Wednesday.

- A large and sustained increase in public spending amounting to £22.9 billion a year in 2026-27, comprising a £25.0 billion increase in departmental resource spending and a £3.0 billion boost to universal credit, which is only partly offset by £6.7 billion saved by the temporary move from a triple to double lock for the state pension. Of the roughly £30 billion on average added to departmental budgets in each year of the Spending Review, around half goes directly from the new levy to health and social care with the other half undoing the £18 billion of unspecified cuts to pre-pandemic spending totals made in the last two fiscal events. Together with underlying forecast changes, these discretionary increases take public spending from 39.8 per cent of GDP before the pandemic to 41.6 per cent of GDP in 2026-27, the largest sustained share of GDP since the late 1970s.

Taking account of both forecast and policy changes announced since March, borrowing falls back below £100 billion next year, declining more slowly thereafter to stabilise at around £44 billion (1.5 per cent of GDP) in the medium term. This leaves borrowing lower in every year than we forecast in March, and down £27 billion in 2025-26 thanks to the £33 billion improvement in the pre-measures fiscal outlook being only partly offset by a net fiscal loosening that declines to £6 billion by that point (Chart 1).

Chart 1: Public sector net borrowing



The improvement in the fiscal outlook is sufficient to enable the Chancellor to meet his fiscal target of getting underlying debt falling as a share of GDP by the third year of our forecast (2024-25 in this one). This new fiscal mandate is codified in a revised draft Charter for Budget Responsibility published alongside the Budget, which also includes supplementary targets for balancing the current budget within three years and capping public investment and welfare spending over different periods. All these new targets are set to be met too.

Finally, the Charter identifies additional measures of debt affordability and public sector balance sheet performance that will guide the Chancellor's management of fiscal policy. In our central forecast, underlying debt falls by 0.6 per cent of GDP in 2024-25, the current budget is in surplus by 0.9 per cent of GDP, public investment averages 0.3 per cent of GDP below its cap, and welfare spending is £2.8 billion below its effective cap. These margins are all well below the historical average three-year ahead forecast error for the current balance of 2.3 per cent of GDP and for the change in debt of 3.8 per cent of GDP.