Finance and Public Administration Committee

33rd Meeting, 2022 (Session 6), Tuesday 13 December 2022

Scrutiny of the Scottish Budget 2023-24: UK context

Purpose

1. The Committee is invited to take evidence from the Office for Budget Responsibility (OBR), on the UK economic and fiscal outlook, to inform its scrutiny of the Scottish Budget 2023-24.

2. This paper provides background information on the Scottish Budget 2023-24, the OBR's latest forecasts, the Chancellor of the Exchequer's Annual Budget Statement, and relevant commentary and recently published papers.

Scottish Budget 2023-24

3. In its Pre-budget Report on Scotland's Public Finances in 2023-24 and the Impact of the Cost of Living and Public Service Reform, published on 3 November 2022, the Committee accepted that the Scottish Government "faces difficult choices" on spending and taxation, against inflationary pressures. It called for "an open and honest debate with the public about how services and priorities are funded, including the role of taxation in funding wider policy benefits to society". The Committee also sought to establish how the Scottish Government plans to progress its preventative agenda and "work with the public sector to minimise the impact of reform and efficiency savings on the quality of public services and the delivery of national outcomes".[1]

4. The Written Agreement between the Committee and the Scottish Government requires the Scottish Budget document to include a summary of how committees' pre-budget reports have influenced preparation of the Budget, and the Parliamentary Bureau to schedule a debate for committees to explore these issues further.

5. The Committee will take evidence on the Scottish Budget 2023-24 document, which is to be published on 15 December, at its meetings on 20 December 2022 and 10 January 2023, before reporting its findings in late January.

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[1] In its Resource Spending Review (RSR) published in May 2022, the Scottish Government notes that its public service reform programme "will be undertaken over the remainder of the Parliament, with initial outcomes to be reported in the 2023-24 Scottish Budget" and that it will also, alongside this Budget, "set out proposals for the future public body landscape". The Committee has agreed to conduct separate scrutiny on the reform proposals.

UK Economic and Fiscal Outlook

6. The OBR produces detailed five-year forecasts for the economy and public finances twice a year, which accompany the UK Government's Budget Statements in the Autumn and Spring. These forecasts incorporate the impact of any tax and spending measures announced in those Budget Statements by the Chancellor. Along with Scottish Fiscal Commission (SFC) forecasts, they also determine the initial size of the Scottish Budget.

7. In its latest [Economic and Fiscal Outlook – November 2022], published on 17 November, the OBR notes that "the medium-term fiscal outlook has materially worsened since our March forecast due to a weaker economy, higher interest rates, and higher inflation (the latter largely due to global factors, so raising public spending much more than it boosts tax bases)". The OBR notes that:

- "CPI inflation in the UK is set to peak at a 40-year high of 11% in the current quarter, driven in particular by higher global energy and food prices. It is expected to fall back sharply over the course of next year, moving into negative territory in the middle of the decade, before returning to its 2% target by the end of the forecast period.
- Rising prices "erode real wages and reduce living standards by 7% in total over the two financial years to 2023-24 (wiping out the previous eight years' growth), despite over £100 billion of additional government support.
- The squeeze on real incomes, rise in interest rates, and fall in house prices all weigh on consumption and investment, tipping the economy into a recession lasting just over a year from the third quarter of 2022, with a peak-to-trough fall in GDP of 2%.
- Unemployment rises by 505,000 from 3.5% to peak at 4.9% in the third quarter of 2024.
- Higher borrowing pushes underlying debt (excluding the Bank of England) up sharply, from 84.3% of GDP last year to a 63-year high of 97.6% in 2025-26."

8. The OBR highlights that the UK Government has announced new fiscal targets: "to get borrowing below 3% of GDP and underlying debt falling in five years' time". It notes however that the near tripling of interest rates since March means the shares of revenues consumed by servicing that debt rises from under 5% in 2019-20 to 8.5% in 2027-28, leaving the public finances more vulnerable to future shocks or swings in market sentiment."

9. It goes on to note that "the main positive risk would stem from a rapid end to Russia's invasion of Ukraine that stabilised energy markets and lowered prices", adding "that could relatively quickly feed through to reduced inflationary pressure, smaller rises in interest rates, and a stronger economic recovery". It suggests that "the main adverse risks relate to a further escalation in the war in Ukraine intensifying pressures on European energy supplies, inflation and interest rates".

10. In the Chair's presentation on the OBR's latest economic and fiscal forecasts on 17 November, Richard Hughes notes that, while the UK's economic position is

largely due to external influences, "fiscal policy here at home has also been a key source of uncertainty since March", when the OBR's previous forecasts were published. Mr Hughes argued that "the past six months have witnessed a series of dramatic swings in the direction of fiscal policy with five major fiscal statements delivered by three successive governments", adding that, "taken together, and including their indirect effects via the economy, the net impact of this series of announcements and reversals has been to add over £40 billion of borrowing by 2027-28".

Block Grant Adjustments

11. The OBR also published on 17 November [Devolved Taxes and Spending Forecasts - November 2022](), which the UK, Scottish and Welsh Governments use as part of their agreed block grant funding mechanisms.

12. [The Deputy First Minister wrote to the Committee on 29 November setting out the Block Grant Adjustments (BGAs) for the Scottish Budget 2023-24]() as informed by the OBR's November forecasts. This letter is attached as an Annexe to this paper and includes the BGAs for income tax, land and buildings transaction tax, Scottish landfill tax, and devolved social security benefits. Current forecasts are showing a BGA for 2023-24 of -£11,741m. This comprises a negative BGA for devolved taxes of -£16,101 million and a positive BGA for devolved social security of £4,360 million. However, the Deputy First Minister explains that "the full impact on Scotland's Budget will not be known until the SFC publish their final forecasts in December". The forecasts will show whether the SFC expects tax receipts and social security spending to be higher or lower than the BGAs in 2023-24.

13. The updated position currently shows a positive reconciliation of £42 million to be added to the 2022-23 Budget in year. However, the Deputy First Minister explains that this is only one side of the equation and "as things stand, the net impact on the financial position for 2022-23 is … expected to be nil" after "adjustments expected to equivalent forecasts for fully devolved Scottish taxes and social security payments [and] changes to resource borrowing capacity (to offset forecast errors)". He states that "a more complete picture of the net budget position will be available on receipt of final SFC revenue forecasts to be published alongside the 2023-24 Scottish Budget", and that "the forecast position will continue to evolve between now and the end of the year".

UK context

14. In his [Autumn Budget Statement,]() published with the OBR Forecasts on 17 November 2022, the Chancellor of the Exchequer, The Rt Hon Jeremy Hunt MP, set out the UK Government's priorities of stability, growth, and public services and its plan to ensure that national debt falls as a proportion of the economy over the medium term. This, he argued, would "reduce debt servicing costs and leave more money to invest in public services; support the Bank of England's action to control inflation, and give businesses the stability and confidence they need to invest and grow in the UK". He went on to state that "the government's approach to delivering

fiscal sustainability is underpinned by fairness, with those on the highest incomes and making the highest profits paying a larger share".

15. To achieve these aims, the Chancellor announced that he would:

- reverse "nearly all the measures in the Growth Plan 2022", announced by the previous Chancellor on 23 September 2022,
- maintain income tax, national insurance, and inheritance tax at current thresholds until April 2028,
- reduce the income tax additional rate threshold from £150,000 to £125,140, increasing taxes for those on higher incomes (not applicable to Scotland),
- raise corporation tax to 25% from April 2023,
- increase the minimum wage for people over 23 from £9.50 to £10.42 an hour from April 2023,
- increase state pension payments and means-tested disability benefits by 10.1%, in line with inflation,
- reduce tax-free allowances for dividend and capital gains tax in 2023 and 2024,
- scale back the household energy price cap. This will now be in place for one year beyond April 2023, with typical bills capped at £3,000 a year rather than £2,500 as announced by the previous Prime Minister,[2]
- increase windfall tax on profits of oil and gas firms from 25% to 35% until March 2028 and introduce a temporary Electricity Generator Levy at 45% from January 2023, and
- increase spending in England on the NHS and schools, which he stated were the UK Government's priority for public spending. This has a positive impact on devolved budgets.

16. The Chancellor explained that "by taking difficult decisions on tax and spending, the Autumn Statement sets out a clear and credible path to get debt falling and deliver the economic stability needed to support long-term prosperity".

17. The Autumn Statement did not reverse all the measures in the former Chancellor's Growth Plan 2022. The reversal of the increase in national insurance contributions rates and cancellation of the health and social care levy has already been legislated for, and cuts to stamp duty land tax were introduced immediately after they were announced on 23 September. The Chancellor intends to proceed with the abolition of the cap on bankers' bonuses and the Office for Tax Simplification confirmed on 17 November that it will formally close when the next Finance Bill received Royal Assent.[3]

Institute for Fiscal Studies

18. In a presentation providing early analysis on the Autumn Statement on 18 November, Paul Johnson, Director of the Institute for Fiscal Studies, suggested that,

[2] Commentary on the impact of the UK Government's revised plans in relation to the Energy Price Guarantee can be found in the FAI blog: Energy Price Guarantee is now less generous but will play a role in fighting inflation.
[3] These announcements were made by the former Chancellor.

"in sum, this is a Chancellor erring on the side of caution in terms of protecting spending and the economy in the short run, rather than erring on the side of prioritising shoring up the public finances". He suggests that borrowing will take the strain in the near-term, with "the great majority of the planned consolidation … due only after the next election", adding "what we are really doing is reaping the costs of a long-term failure to grow the economy, the effects of population ageing, and high levels of past borrowing". He concludes, by saying "we are in for a long, hard, unpleasant journey; a journey that has been made more arduous than might have been by a series of economic own goals".

19. The Committee took evidence on 6 December from the IFS on the wider UK context including the Chancellor of the Exchequer's Annual Budget Statement. Issues discussed included: the need for the Scottish Government, against a backdrop of "squeezed funding", to prioritise particular elements of its spending programme or "up taxes to increase the funding envelope"; the use of CPI or a GDP deflator as a measure of inflation for public finances; the health of the UK population worsening since the Covid pandemic compared to other countries, and the OBR forecasts being "in the middle of the pack" on the length of the recession, while the Bank of England forecasts are a more pessimistic "outlier"[4].

Fraser of Allander Institute

20. The Fraser of Allander Institute (FAI) published its first thoughts on the Autumn Statement and the implications for Scotland on 17 November, noting that the measures in the Statement "are not enough to offset the grimmest outlook for living standards on record". Its analysis indicates that, if the Scottish Government was to follow the UK Government's policy of reducing the threshold for the Additional Rate of Income Tax to £125,140 in Scotland, this "would bring up to as many as 12,000 additional Scottish taxpayers into the 'top rate' in 2023-24, up from 22,000 currently, and raising around £40m in revenue for the Scottish Budget". However, the FAI suggests that, even if the Scottish Government did decide to follow suit, "Scotland is still likely to face a negative net tax position due to this change, as the deduction off the block grant is likely to be larger than additional revenues given the higher earnings in Scotland".

21. Increased departmental spending in devolved areas, including health and social care and schools in England, will lead to Barnett consequentials for the Scottish Government, though there are questions around whether they will fully offset the effect of higher inflation in years 2023-24 and 2024-25. In their podcast on 18 November, David Eiser and Mairi Spowage from the FAI discuss this issue in more detail, explaining that, while it is "good news budgets are being topped up", this "only just" offsets the impact of inflation (using usual measures for calculating inflation"). However, "if inflation is measured in a slightly different way", the Scottish Government's resource spending budget is "a bit less than it thought it would be" during its Spending Review in May 2022.

[4] Bank of England is overly pessimistic about UK economy, claims OBR chief (telegraph.co.uk)

SPICe

22. The SPICe blog on the UK Autumn Budget 2022 – Winter is Coming also explores this point, highlighting the HM Treasury view that the Scottish Government will receive an additional £1.5bn over the next two financial years (2023-24 and 2024-25)[5] while the Deputy First Minister's view is that "inflation is eating away at the Scottish Budget". The Deputy First Minister, in a press statement responding to the Autumn Statement, goes on to note that he is faced with "the difficult task of setting Scotland's Budget for 2023-24 with no hope of financial flexibility to make a real difference in the lives of those who need it most". He also makes the point that, "due to the lack of additional funding in 2022-23 and the financial restrictions of devolution, we have had no choice but to make savings of more than £1 billion".[6] These savings have been used to fund increased pay offers for the public sector to reflect inflation rises, as well as increased support for individuals and businesses during the cost-of-living crisis.[7] These fiscal challenges continue as the Scottish Government's prepares its Budget for 2023-24.

Institute for Public Policy Research Scotland

23. The Institute for Public Policy Research Scotland published a briefing on Funding Social Renewal in November setting out particular steps that could be taken to increase public revenue in Scotland in the year ahead, including short-term steps such as "matching the UK Government's decision to reduce the top tax rate threshold to £125,140 and freezing remaining thresholds, raising £400m". It also calls on the Scottish Government to commit to: (a) "a root and branch review of the tax system ahead of the 2024-25 Scottish budget to examine reforms to rates and bands, and how local tax raising powers could be used to address wealth inequality in Scotland and (b) replacing council tax and non-domestic rates with a new, fairer system that is either property or land value based". It argues that its "modelling shows how, even with 'progressive' increases across bands, the current system remains highly regressive".

Scottish Trades Union Congress

24. In a paper commissioned by the Scottish Trades Union Congress (STUC) on Options for increasing taxes in Scotland to fund investment in public services, published on 5 December, Landman Economics sets out "a proposed package of tax increases to fund an increase in public sector pay and investment in public services, in Scotland". Again, this includes both short and long-term measures which it argues would, combined, raise £3.3 billion.

[5] Autumn Statement 2022 HTML - GOV.UK (www.gov.uk)
[6] Households 'paying a steep price for UK economic mismanagement' - gov.scot (www.gov.scot)
[7] The Deputy First Minister wrote to the Committee first on 7 September 2022 and again on 7 November 2022 setting out identified savings for 2022-23 and which areas these would now fund.

Next steps

25. The Committee will take evidence from the Scottish Government's Expert Economist Panel and the SFC in relation to the Scottish Budget 2022-23 and the SFC's Economic and Fiscal Outlook for Scotland at its next meeting on 20 December.

Committee Clerking Team
December 2022