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UKRI Economic and Social Research Council

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Preface

The authors gratefully acknowledge the support of the ESRC Centre for the Microeconomic Analysis of Public Policy (ES/T014334/1) and the IFS's ESRC Impact Acceleration Account.

We also gratefully acknowledge comments on earlier drafts of the chapters of this report by Carl Emmerson. In addition, we thank officials from the Scottish Government and Scottish Fiscal Commission for clarification of a number of issues related to the overall funding outlook, and officials from the Scottish Parliament Information Centre for comments on initial drafts of our chapter on local government funding and spending.

Note on additional funding for teachers' pay

On the evening of 14 February 2023, after we had finalised this report, the Scottish Government announced that £156 million of additional funding would be provided to councils in 2022–23 and 2023–24 to improve the pay offer for teachers.[1] Some news outlets, including the BBC, reported that this was part of a broader £300 million package of funding to support the pay award for other council staff in 2023–24 too.[2]

The implications of this for our analysis of the outlook for overall funding for non-benefit spending and the outlook for local government specifically depend on the source of this new funding and how it is allocated over time. For example, if this is funding reallocated from other services in-year, our estimates for overall funding in 2022–23 and 2023–24 would still hold. However, if it were paid for using additional funding that has become available since the Budget bill was presented, our estimates of the real-terms change in funding between 2022–23 and 2023–24 would be biased downwards. Finally, if it has been found from expected underspends in 2022–23 that will be carried forward to 2023–24 via the Scotland Reserve, this would mean that our estimates of the year-on-year change in funding are further downwardly biased; this is because not only would funding in 2023–24 be higher than in the current Budget bill (and our analysis), but also funding actually utilised in 2022–23 will be lower than assumed.

Unfortunately, at the time of publication, the Scottish Government has not provided information on the source of this funding, or its allocation across years. We have therefore been unable to update our analysis of the overall and local government funding outlook in Chapters 2 and 4. The presentation of our findings delivered at our Scottish Budget event[3] does illustrate how our estimates would be affected by different scenarios for the source of this extra funding (assuming the total is the £300 million reported by the BBC). Broadly speaking, this shows that rather than there being a modest real-terms reduction in overall and local government funding in 2023–24 relative to 2022–23, the additional funding for pay may mean that there could be a small increase, especially if it has been funded by underspends in 2022–23. However, this would still pose challenges for service delivery. Moreover, the medium-term outlook is largely unaffected by this one-off funding announcement: funding would fall back in 2024–25 and then follow the path set out in this report.

1 https://www.gov.scot/news/improved-pay-offer-for-teachers/.
2 https://www.bbc.co.uk/news/uk-scotland-64642699.
3 https://ifs.org.uk/events/scottish-budget-2023-24-ifs-analysis.

Contents

1. Introduction

The Scottish Government's Budget for 2023–24 takes place at a difficult time for households, businesses and public services. High inflation, driven by energy and food price increases, is reflected in a forecast UK-wide 7% fall in household disposable income over the two calendar years, 2022 and 2023 (Office for Budget Responsibility, 2022). The resulting fall in demand, and tighter financial conditions following increases in interest rates is leading to an increase in businesses going under (Insolvency Service, 2023). And increases in the costs of purchases, higher-than-planned-for wage increases and labour unrest are putting public services – already struggling to recover from the COVID-19 pandemic – under strain.

Given all this, the headline increase in spending set out in the Scottish Government's Budget for 2023–24 may seem comforting: 3.9% in real terms compared with the current financial year. However, spending on recently devolved and new social security benefits, such as the Adult Disability Payment and Scottish Child Payment, is set to absorb over half this increase. Recipients of these payments will see a boost to their incomes, but it also means tighter budgets elsewhere. Comparing the Budget for 2023–24 to the initial Budget for 2022–23 for non-benefit spending only, the increase is 1.6% – and this ignores in-year top-ups to the Scottish Government's Budget during the course of 2022–23, with extra funding provided to the NHS, local government, and to cover police and fire service pension costs, among other things. Taking account of these top-ups, the budget for non-benefit spending in 2023–24 is currently set to be 1.6% lower than in 2022–23; or 0.8% lower, after stripping out the effect of one-off policies such as the council tax rebate. Even this is likely to understate the financial pressures that Scottish public services will face, as the measure of inflation used to calculate real changes in public spending does not fully account for rising energy and food prices (as it excludes the cost of imported goods and services).

Even so, the budget for the coming year is still more generous than what was expected at the time of the Scottish Government's Resource Spending Review in May 2022. Additional funding from the UK government of £800 million, following top-ups to planned spending in England, as well as an improvement to the forecast net funding contribution from Scotland's devolved taxes of a similar magnitude, mean an additional £1.5 billion is available from April compared with the indicative plans set out in the Resource Spending Review.

Nearly all services have seen a boost to planned spending compared with the indicative plans set out in that Review. Health, and the 'net zero, energy and transport' portfolios are notable winners, with funding for local government (including schools) still set to fall in real terms after

adjusting for in-year top-ups in the current financial year and changes in councils' responsibilities.

The Budget also continues a trend of increases in taxes on higher-earning Scots to help fund more generous social security benefits and public service spending – although the high levels of spending (and the resulting greater levels of service provision) relative to England remain largely down to extra funding received from the UK government via the block grant.

The aim of this report, the IFS's first in-depth analysis of the Scottish Government Budget, is to look at some of the key implications for the coming year, and for the longer term. We do not attempt to cover all of the different services that the Scottish Government is responsible for, or all revenue streams, but instead look at those issues most pertinent to current political and public debates. We therefore focus on the overall funding outlook, income tax revenue performance, local government funding, and the distributional effects of tax and benefit reforms.

The rest of this report proceeds as follows.

In Section 2, we look at the overall funding outlook for the Scottish Government, considering the short, medium and long term in turn. We find that a forecast improvement in the performance of Scotland's devolved tax revenues relative to the rest of the UK will, if it materialises bolster funding over the next few years. However, significant growth in spending on devolved social security benefits will absorb a large part of this, and funding for non-benefit spending is set to fall over the next two years and then grow only modestly in the period to 2027–28. The Barnett formula is also likely to deliver smaller percentage increases in funding for Scotland than will be provided to England, making it increasingly difficult to maintain the higher levels of public service provision that Scotland currently enjoys.

Section 3 looks in more detail at devolved income tax revenue performance, highlighting the importance of past and forecast changes in employment and earnings in Scotland relative to the rest of the UK.

Section 4 considers funding for Scottish councils and schools, which overall fell by less during the 2010s than in England, but is set to increase by significantly less in the coming year than south of the border.

Section 5 presents our analysis of the distributional effects of the Scottish Government's income tax and social security benefit policies – looking at both changes over time and comparisons to the rest of the UK.

Section 6 offers some brief concluding remarks.

As discussed in the note at the start of this report, we have been unable to account for additional funding for teachers' pay announced on 14 February 2023. This reflects both the late announcement of this funding and a lack of detail on the source of this funding and how it is being distributed across years.

References

Insolvency Service (2023), 'Commentary – monthly insolvency statistics December 2022', https://www.gov.uk/government/statistics/monthly-insolvency-statistics-december-2022/commentary-monthly-insolvency-statistics-december-2022.

Office for Budget Responsibility (2022), 'Economic and fiscal outlook – November 2022', https://obr.uk/efo/economic-and-fiscal-outlook-november-2022/.

2. The overall funding outlook

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The Scottish Government's overall budget depends both on funding from the UK government, which is determined largely via the Barnett formula, and on its own devolved revenues, borrowing and reserves, which are governed by the Fiscal Framework. This chapter of the report looks at the funding outlook in the short term (2022–23 and 2023–24), medium term (2024–25 to 2027–28) and beyond, drawing on Scottish Government and Scottish Fiscal Commission (SFC) figures.

Key findings

1. The funding available to the Scottish Government in 2023–24 for day-to-day non-benefits spending is around £1.5 billion higher than forecast in May 2022 at the time of the Resource Spending Review. Of this, just over £0.8 billion reflects higher funding from the UK government via the Barnett formula, and another £0.8 billion reflects a forecast improvement in net revenues from devolved taxes, only a small part of which is due to new tax raising measures. This cash-terms increase is partially, but not fully, offset by higher forecast inflation.

2. The Scottish Budget for 2023–24 shows day-to-day non-benefits spending increasing by 1.6% in real terms, on average, compared to what was originally budgeted to be spent this year, which is more generous than the 1% fall expected at the time of the Resource Spending Review. However, these comparisons exclude in-year top-ups to the funding available to the Scottish Government this year, which SFC forecasts suggest amount to around £1.1 billion. Taking account of this additional funding would suggest the amount available for non-benefits spending will actually fall by 1.6% next year compared to this, or 0.8% after adjusting for major one-off costs such as council tax rebates. The Scottish Government formally allocated some of this additional funding in the Autumn Budget Revision in November 2022, but the SFC's forecasts suggest there may be another £400–600 million available for allocation in the Spring Budget revision in February 2023.

3. Medium-term funding projections by the Scottish Government suggest an improved outlook for the next four years compared to what was expected at the time of the Resource Spending Review in May 2022. However, the outlook remains difficult, with funding for day-to-day non-benefit spending set to be almost 2% lower in 2027–28 than in 2022–23. This is despite forecasts for a significant increase in net revenues from Scotland's devolved income tax revenues over the next few years: if this did not materialise, the reduction could be closer to 5% over the same period. This reflects several factors including planned spending restraint by the UK government, significant forecast growth in Scotland's devolved benefit spending as a result of policy reforms (reducing the amount available for public services), and the plan to draw down reserves fully this year (boosting funding this year, and thereby depressing growth in spending going forwards).

4. These cuts to overall funding would imply difficult trade-offs for the Scottish Government as it allocates funding between different services. For example, if health spending were increased by 2.9% a year in real terms each year between 2023–24 and 2027–28 (the increase planned for 2023–24 and roughly in line with estimates of what might be needed in the long term) and spending on the net zero, energy and transport portfolio were increased by 4% a year (slightly less than planned, on average, in the Resource Spending Review), the amount available for all other service areas would fall by around 6% between 2023–24 and 2024–25, and by 13% by 2027–28. Without the forecast improvement in the net income tax position, the implied falls would be almost 10% and 19%, respectively, for those two years.

5. The Scottish Government's medium-term projections were purposefully cautious, and based on the indicative spending totals set out by the UK government in the Autumn Statement, a reasonable central projection for 2027–28 would be for funding to be around 1% higher in that year than projected by the Scottish Government. This would be a useful sum of money but would not significantly ameliorate the difficult trade-offs the Scottish Government would face. The indicative spending totals pencilled in by the UK government would imply difficult trade-offs between public services in England too, and it would not be surprising if they were revised up in future UK Budgets or Spending Reviews. This would provide additional funding for the Scottish Government, but uncertainty about UK government spending decisions beyond 2024–25 and constraints on Scottish Government borrowing mean it is not unreasonable to make long-term plans on a cautious basis.

6. The long-term funding outlook beyond 2027–28 will also be largely determined by UK government spending decisions and the performance of Scotland's devolved tax

revenues relative to equivalent revenues in the rest of the UK (rUK).[4] The Barnett formula determines how much the Scottish Government's budget increases when UK government spending in England increases. It provides Scotland with a population-share of the change in spending planned for England, which means the same cash per-person increase in Scotland as in England before considering the impact of differential population growth. Because spending is currently higher per-person in Scotland than England, the same cash per-person increase represents a smaller *percentage* increase in Scotland. When cash spending per person grows in England, this reduces the percentage by which spending in Scotland exceeds that in England, making it more difficult for the Scottish Government to maintain higher levels of service provision than in England, such as free personal care and free university education, and to meet rising spending pressures.

7. The speed of this 'Barnett squeeze' depends on the rate of growth in spending in England (both real-terms growth and to offset inflation), and the rate of population growth in Scotland relative to England. Using long-term projections for inflation and GDP growth from the Office for Budget Responsibility – assuming public spending is held constant as a share of GDP – and taking into account population projections from the Office for National Statistics, we project Scottish Government funding would increase by an average of 1.2% per year in real terms over the 30 years between 2027–28 and 2057–58. This compares to an average of 1.4% per year in England over the same period, with bigger gaps in earlier years and smaller gaps in later years. Under this scenario, spending per person in Scotland would fall from 124% of English levels in 2027–28, to 121.4% in 2032–33, and to 115% in 2057–58.

8. Faster real-terms spending growth in England to meet the rising costs of health and social care (which are expected to grow faster than GDP) would result in bigger absolute increases in funding for the Scottish Government, making it easier for it to meet these costs itself. However, it would increase the Barnett squeeze on funding levels relative to England – although funding per person in Scotland would remain higher than in England. Boosting Scottish population growth would reduce both the relative and absolute levels of funding per person received via the Barnett formula, potentially making it more difficult to meet these rising costs. This is because the Barnett formula only partially accounts for population growth when allocating funding.

[4] Strictly speaking, the comparator has switched to England and Northern Ireland, following the devolution of tax powers to Wales in 2018–19 (Stamp Duty Land Tax and landfill tax) and 2020–21 (income tax). We use the term rUK throughout for ease of reference.

2.1 The short term: 2022–23 and 2023–24

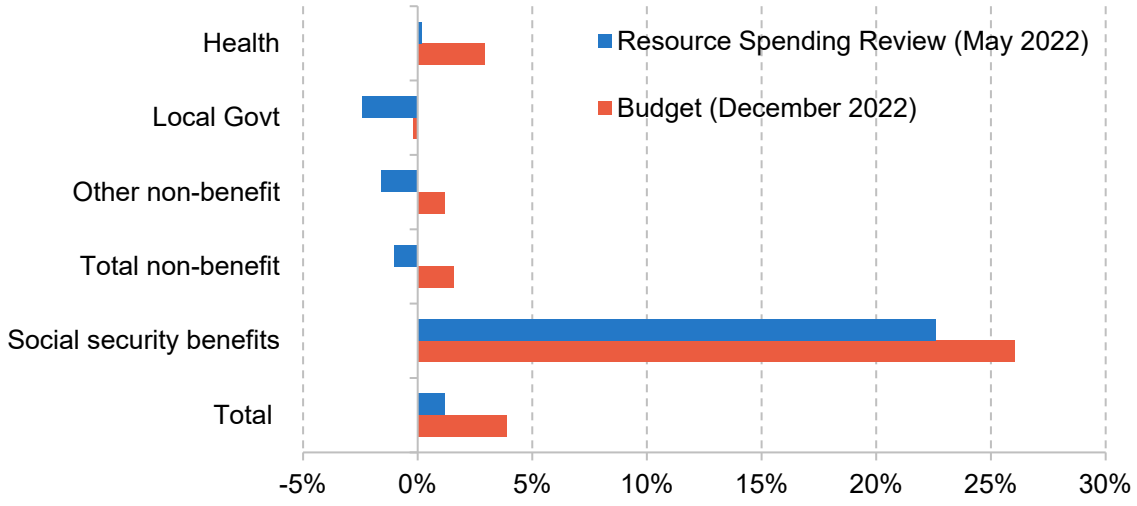
The Scottish Government set out its initial plans for spending in 2023–24 (and the following three years) in its Resource Spending Review in May 2022. The blue bars in Figure 2.1 show that these plans implied real-terms cuts to most services compared to what was initially budgeted to be spent in the current financial year, 2022–23. Overall, Scottish Government figures suggested that excluding spending on social security benefits (which was due to increase by 22.6%), spending was set to fall by 1.0% in real terms. Figures from the Scottish Fiscal Commission (2022a), published alongside the Resource Spending Review, showed a bigger year-on-year real-terms cut of 2.8% to non-benefits spending, because these figures take into account the in-year top-ups to spending in 2022–23 whereas the Scottish Government's practice of comparing to initial budgets does not (a higher baseline increases the size of subsequent cut).

The 2023–24 Budget published in December 2022 shows a significantly different picture. Spending plans for 2023–24 have been topped up by around £1.5 billion compared to those set out in May. Updated figures from the Scottish Government, shown by the red bars, therefore show most service areas seeing real-terms increases in funding, with total non-benefits spending set to increase by 1.6% in real terms compared to what was originally budgeted for spending this year, despite an increase in forecast inflation. We discuss plans for local government (including schools) in more detail in Chapter 4.

It is important to note that all of these real-terms figures are based on the GDP deflator measure of inflation, which measures the change in price of goods and services produced in the UK. As a result, these figures exclude increases in the costs of imported energy and food. This means that they are likely to understate the true rate of cost growth facing public services, and in turn, to understate the real-terms planned spending cuts as of the Resource Spending Review and to overstate the planned real-terms increases in spending as of the Budget. However, it is still highly likely to be the case that the outlook has improved somewhat since the Resource Spending Review in May.

Several factors explain the improved funding outlook for next year, as shown in Figure 2.2. First, in the Autumn Statement, the UK government announced additional spending on public services – in particular, the NHS, schools and local government – and business rates reliefs in England, which has generated just under £1.1 billion in additional funding for the Scottish Government via the Barnett formula. The Resource Spending Review had already assumed £250 million would be forthcoming, so the net effect is an additional £0.8 billion for the Scottish Budget.

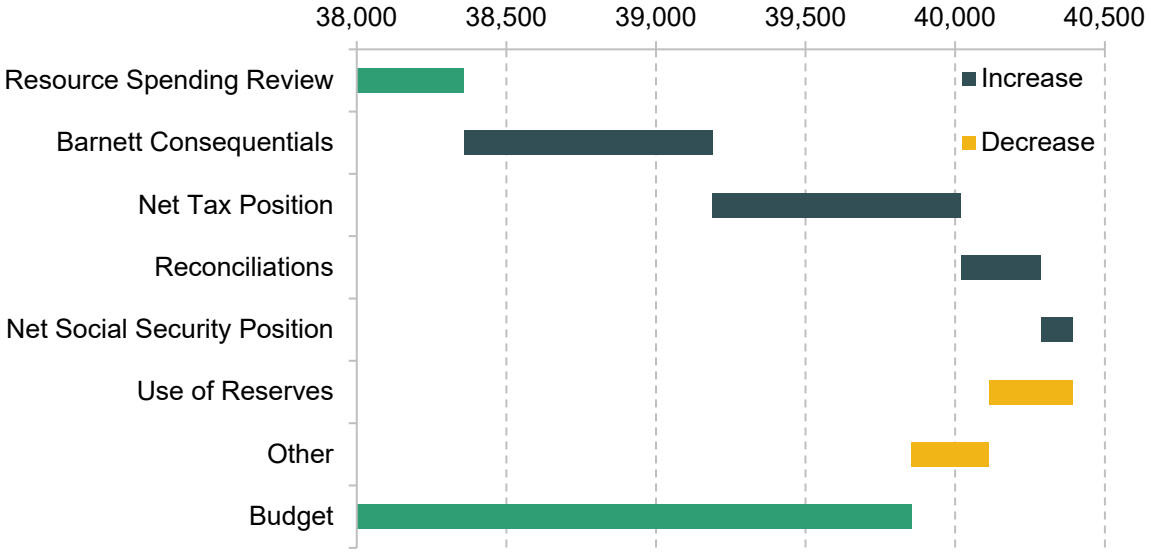
Figure 2.1. Planned real-terms changes in spending, 2022–23 to 2023–24



Note: Other non-benefit spending includes all other Scottish Government portfolios, as well as funding for the Scottish Parliament and Audit Scotland. The vast majority of total non-benefit spending relates to spending on public services but this also includes some spending on cash transfers to households such as Discretionary Housing Payments. Figures adjusted for inflation using Office for Budget Responsibility GDP deflator forecasts (March 2022 forecasts for the Resource Spending Review and November 2022 forecasts for the Budget).

Source: Authors' calculations using Scottish Government (2022a, b).

Figure 2.2. Contributions to change in funding for 2023–24 for non-benefit spending between the Resource Spending Review and the Budget, £ million



Source: Authors' calculations using Scottish Fiscal Commission (2022b).

Increases in the amount forecast to be raised from devolved taxes, relative to the amount subtracted from the Scottish Government's block grant funding to account for tax devolution (the block grant adjustments or BGAs), also generate about £0.8 billion compared with previous forecasts. This amount mostly relates to income tax (where the forecast net position has improved by almost £0.7 billion), only a small part of which (£130 million) is as a result of income tax policy changes. Instead, most of the improvement in the net tax position relates to a forecast improvement in the growth of the underlying tax base relative to rUK. We discuss this further in Chapter 3.

There are also several smaller changes, which largely offset each other. First, final outturn income tax revenues in 2020–21 were better than previously forecast, generating a positive reconciliation payment for the Scottish Budget in that year. Second, compared with previous forecasts, there has been an improvement in the net position on devolved benefit spending next year (although the forecasts still imply that spending will exceed funding by almost £0.8 billion, reducing the amount available for non-benefit spending). However, the planned drawdown of all reserves this year means that there will be no funding available to draw down next year, as previously planned. Also, a number of other forecast changes will reduce funding.

The implications of in-year increases in funding in 2022–23

The year-on-year changes in spending published by the Scottish Government in its 2023–24 Budget overstate the true year-on-year changes in spending power though. This is because by using the original 2022–23 Budget as the baseline for comparison, the figures ignore in-year top-ups to spending this year.[5]

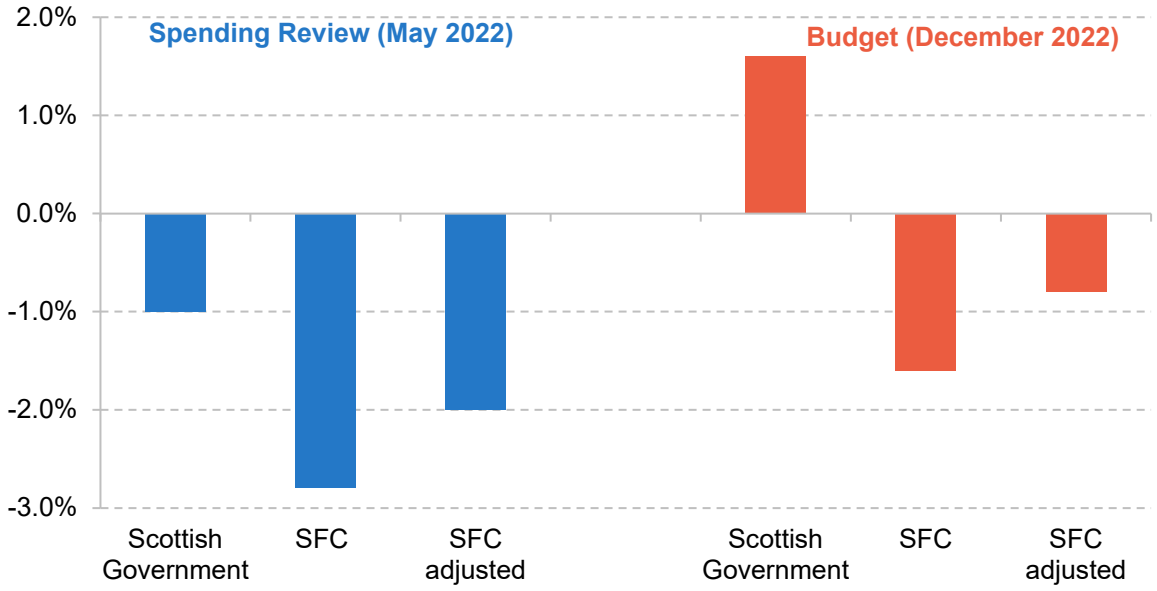
The SFC's forecasts imply that the total amount available for non-benefit spending in 2022–23 will be approximately £1.2 billion higher than initially budgeted for. Just under £0.1 billion of this relates to transfers of responsibility from the UK government to the Scottish Government ('Machinery of Government' changes), meaning just over £1.1 billion of genuine additional funding. Of this, the largest components are extra UK government funding via the Barnett formula (£450 million), largely as a result of measures to help address the cost-of-living crisis, and additional drawdown of reserves (£605 million as opposed to £120 million), following bigger than expected payments into reserves in 2021–22. Borrowing is also set to be somewhat higher (£100 million as opposed to £20 million) than originally planned.

[5] The Scottish Government argues that Budget-to-Budget comparisons are most meaningful because in-year top-ups to the base year may reflect one-off spending items (such as this year's council tax rebates), and top-ups may be made to the subsequent year, which cannot be taken into account. In addition, in-year top-ups are uncertain until confirmed by the UK government's Supplementary Estimates process. However, to the extent that in-year top-ups are being used to pay for recurrent costs (such as higher local government pay settlements), ignoring them will overstate current expectations of the increase in funding available to pay for recurrent costs.

Part of this funding was allocated in the Autumn Budget Revision – largely to pay for cost-of-living support, such as council tax rebates (£280 million) and higher funding for councils to pay for pay rises (£140 million). However, comparing this revised Budget to the latest SFC forecasts suggests that around £0.4–0.6 billion has yet to be formally allocated to specific service lines, equivalent to just over 1%–1.5% of the Scottish Government's funding for non-benefit resource spending. It is likely that part – and perhaps even all – of this has been earmarked internally by the Scottish Government, and the allocation of these remaining funds could be announced in the Spring Budget Revision in February.

If all this extra funding is allocated in the current year – and the Scottish Government has said it plans to draw down its Reserves in full – rather than increasing in real terms, then non-benefit spending will fall by 1.6% in real terms next year. This is illustrated in the second red column of Figure 2.3. Stripping out confirmed spending on council tax rebates and 'bridging payments' for families with children (which is not officially part of Scotland's social security benefit spending but is more akin to this than spending on public services), the amount available to spend is set to fall by 0.8%, as shown in the third red column of Figure 2.3.

Figure 2.3. Comparison of Scottish Government and SFC figures for real-terms changes in funding for non-benefit spending, 2022–23 to 2023–24



Note: The 'Scottish Government' columns show Budget-derived figures, using Budget-to-Budget comparisons. The 'SFC' columns show figures derived from the SFC's Economic and Fiscal Forecasts, comparing the latest funding position for 2022–23 with the Budget for 2023–24. The 'SFC adjusted' columns subtract spending on council tax rebates and bridging payments for low-income families from the SFC's 2022–23 baseline, reducing the size of the subsequent cut.

Source: Authors' calculations using Scottish Government (2022a, b).and Scottish Fiscal Commission (2022a, b).

Therefore, while the Budget documentation accurately reflects the amount available to spend next year, it overstates the true *increase* in available resources relative to this year. Nevertheless, the additional funding available in 2023–24, as a result of additional UK government funding and a forecast improvement in the net tax position, means that, despite higher inflation, the picture next year looks a little less difficult than it did when the Resource Spending Review was published in May 2022. And if the Scottish Government does not utilise all of the additional funding available this year, it will be able to carry it forward as Reserves, allowing it to top up spending in 2023–24 or subsequent years.

2.2 Medium term: 2024–25 to 2027–28

The funding available in subsequent years has also increased relative to what was set out in the Resource Spending Review. In 2024–25, this reflects both additional UK government funding via the Barnett formula and a forecast improvement in the net tax position by the SFC. From 2025–26 onwards, the net tax position is forecast to continue to improve, but this is partially offset by pencilled-in plans by the UK government to hold down the rate of growth in departmental spending to 1% in real terms: if kept to, over time this would act to reduce the funding provided via the Barnett formula compared with previous expectations.

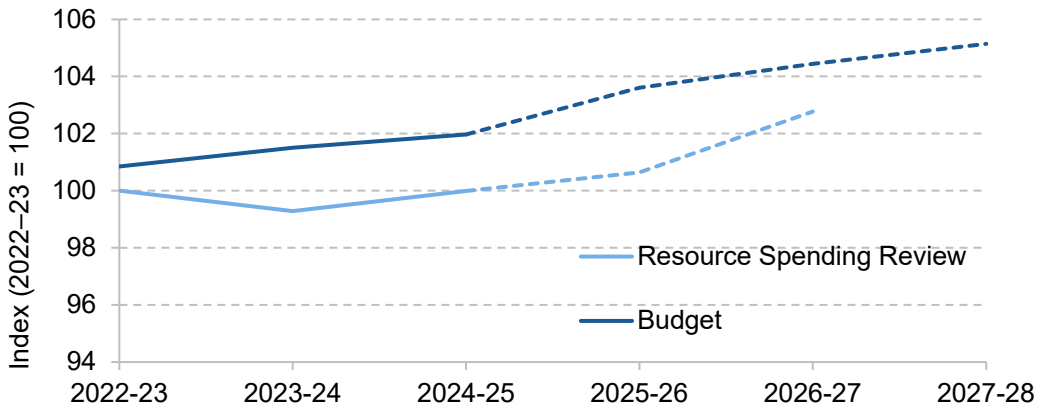
Figure 2.4 shows real-terms projections for Scottish Government funding for 2022–23 to 2027–28, based on figures reported by the SFC as of the Resource Spending Review (the dashed lines) in May 2022 and the Budget in December 2022, again using the GDP deflator to adjust for inflation.[6] Panel A shows total resource funding, including for social security benefits. Panel B shows funding for non-benefit spending. Panel C shows funding for non-benefit spending, stripping out the forecast change in the net tax position from 2023–24 onwards, except that part which relates to new revenue-raising policy measures. Figures are normalised to 100 in 2022–23 as of the Resource Spending Review in May 2022, to make it easier to see how the overall projections have changed since then, and how the projected funding available changes over time.

It is worth noting that the Scottish Government has been deliberately ‘cautious’ when making these projections, assuming a slower rate of growth in its block grant funding than it would receive if funding for comparable services in England (which determines how much the Scottish Government receives via the Barnett formula) were to increase by 1% a year in real terms, in line with the overall average. If it did, then funding would be around 1% higher than assumed by the Scottish Government by 2027–28; this is a useful amount, but does not significantly change

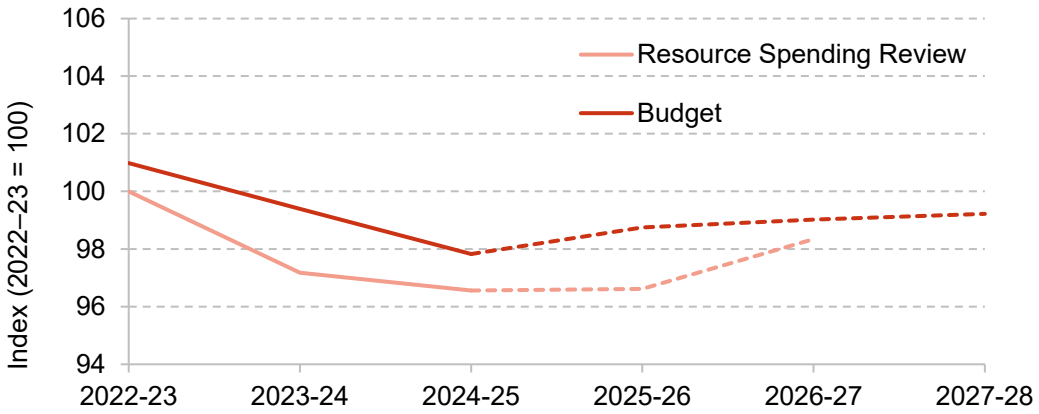
[6] Note that forecast falls in energy and food prices mean that it is less likely that this measure of inflation will underestimate inflation facing public services in the medium term than in the short term (indeed, it may overestimate costs).

Figure 2.4. Real-terms resource funding (2022–23 = 100), 2022–23 to 2027–28

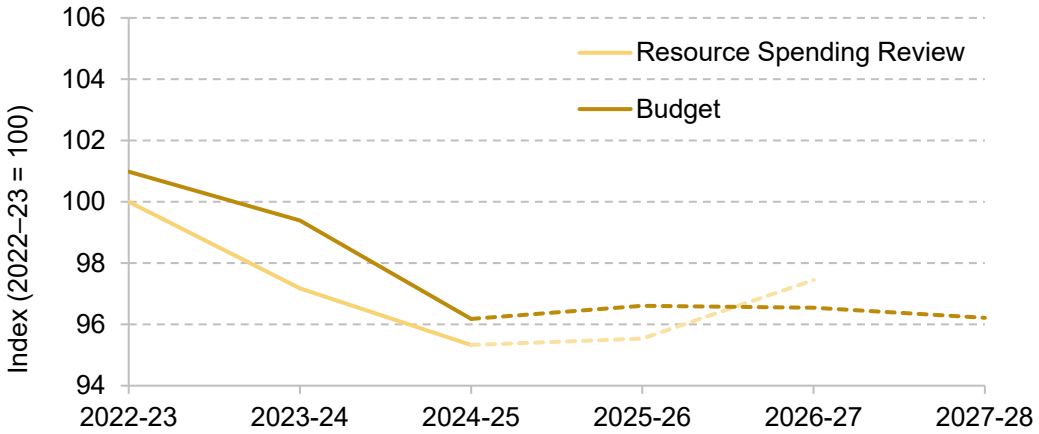
Panel A. Total



Panel B. Excludes benefit spending



Panel C. Illustrative scenario for spending excluding benefit spending and the forecast boost to funding from a strengthening net tax position



Source: Authors' calculations using Scottish Fiscal Commission (2022a, b).

the picture presented by their more 'cautious' assumptions. In addition, the spending totals pencilled in by the UK government would require it to make difficult choices when allocating spending between services in England. The Office for Budget Responsibility (2022a) shows that if spending on health services increased by 3.1% a year in real terms between 2024–25 and 2027–28, alongside commitments on defence and aid spending, then this would imply cuts averaging almost 1% to other public service spending. Therefore, it would not be a surprise if these totals were to be revised up in future UK Budgets or Spending Reviews. This would provide additional funding for the Scottish Government, but uncertainty about UK government spending decisions beyond 2024–25. So, constraints on Scottish Government borrowing mean it is not unreasonable to make long-term plans on a cautious basis.

Bearing this in mind, and using the Scottish Government's projections, panel A of Figure 2.4 shows that the total available for total resource spending has increased for every year compared to those figures published alongside the Resource Spending Review in May 2022 (the dark blue line is above the light blue line in every year). There is around 1% more available to spend in the current financial year, around 2% more over the next two years, and almost 3% more in 2025–26, with the gap then shrinking in 2026–27. The panel also shows that the amount of funding is set to increase each year in real terms, according to the projections published by the SFC, amounting to a 5% real-terms increase overall by 2027–28. While this is an increase, it is relatively small, reflecting in large part the tight spending plans pencilled in by the UK government in the November 2022 Autumn Statement.

Panel B shows a somewhat different pattern for non-benefit spending. As for total spending, the amount available to spend is projected to be higher in real terms in each year than in the Resource Spending Review in May 2022 (the dark red line is above the light red line in every year). However, the increase relative to these previous projections is generally a little smaller than for total spending, reflecting the fact that future benefit spending is expected to be higher as a result of higher inflation and higher disability benefit caseloads, absorbing some of the increase in planned spending between May and December.

More significantly, panel B shows that the funding available for non-benefit spending is set to fall in 2023–24 and 2024–25 relative to the current financial year and then increase only modestly. As a result, it would still be around 2% lower than in 2022–23. The fall and subsequent very slow growth reflect several factors. First, as shown in Section 2.1, additional reserve drawdown and extra funding from the UK government in the current financial year mean that rather than increase, as suggested in Scottish Government Budget documentation, the amount available for non-benefit spending is set to fall in 2023–24. Second, forecasts suggest that the Scottish Government will have to repay over £800 million to the UK government in 2024–25 to offset what now appear to be optimistic forecasts of Scotland's net tax revenue position when the 2021–22 Budget was set. Third, the aforementioned tight spending plans for

2025–26 onwards pencilled in by the UK government will affect how much the Scottish Government receives via the Barnett formula. Fourth, benefit spending is forecast to grow substantially (see Table 2.1), partly reflecting new benefits and reforms to disability benefits being rolled out by the Scottish Government, which will reduce the amount available for public service spending and other spending. We show below that the resulting funding squeeze implies difficult trade-offs when allocating funding between service areas.

Panel C shows projections of the amount that would be available for non-benefit spending, stripping out changes in funding resulting from changes in the net tax position for income tax (with the exception of changes driven by newly announced tax policies).[7] Because the net income tax position (and the overall net tax position shown in Table 2.1) is now forecast to improve significantly over the next few years (an issue discussed in more detail in Chapter 3), stripping these changes out would significantly reduce the amount of funding available to the Scottish Government. For example, funding for non-benefit spending would fall by around 5% in real terms between 2022–23 and 2024–25, and then be little changed over the following three years. If the forecast improvement in the net income tax position does not materialise, the bigger funding squeeze implied would therefore make the already difficult trade-offs between service areas even more challenging.

Table 2.1 shows just how much forecasts for the overall net tax position have changed since those published in May 2022 and used as part of the Resource Spending Review. At that time, net revenues from Scotland's devolved taxes were forecast to be around −£300 million for the current financial year (2022–23), and −£30 million in 2026–27. The latest forecasts show net revenues of £24 million for this year, and almost £1.2 billion in 2026–27, rising to £1.4 billion the year after. This amounts to around 3% of the projected amount available for non-benefit spending by the Scottish Government in that year. The table also shows that the latest forecasts imply that net spending on benefits – on top of the funding provided by the UK government through associated BGAs – will be largely or fully covered by net revenues from Scotland's devolved taxes. This was not the case at the time of the Resource Spending Review in May 2022, when tax revenues and benefit spending forecasts implied that around £1.3 billion of general funding from the UK government would have to be used to help fund devolved Scottish benefits.

[7] In particular, increases in revenues associated with increases in income tax rates and freezes or reductions in income tax thresholds announced as part of the 2023–24 Budget are not stripped out of future forecasts. All other changes in the net income tax position are stripped out. In doing so, we account for the fact that the forecasts published alongside the Budget in December will be used to determine the net amount of income tax revenue available for spending in 2023–24. If these forecasts are proved wrong, a reconciliation payment would be required in 2026–27 after outturns data are available, and the Scottish Government could borrow to pay for this payment in full or in part. Full underlying calculations are available from the authors on request.

Table 2.1. Net social security and net tax position (cash terms), 2022–23 to 2027–28, £s million

	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28
Resource Spending Review (May 2022)						
Tax revenues	15,304	16,058	16,897	17,716	18,433	
Tax BGAs	15,610	16,324	16,730	17,612	18,464	
Net tax position	*−306*	*−265*	*167*	*103*	*−31*	
Benefit spending	4,063	4,963	5,615	5,998	6,380	
Benefit BGAs	3,602	4,082	4,574	4,825	5,103	
Net benefit position	*−462*	*−881*	*−1,042*	*−1,173*	*−1,277*	
Budget (December 2022)						
Tax revenues	15,525	16,663	17,433	18,222	19,173	20,448
Tax BGAs	15,501	16,101	16,535	17,146	18,006	19,028
Net tax position	*24*	*562*	*898*	*1,076*	*1,167*	*1,419*
Benefit spending	4,077	5,136	6,051	6,442	6,791	7,155
Benefit BGAs	3,703	4,360	5,006	5,231	5,467	5,739
Net benefit position	*−374*	*−776*	*−1,046*	*−1,212*	*−1,325*	*−1,416*

Source: Authors' calculations using Scottish Fiscal Commission (2022a, b).

Scenarios for different public services

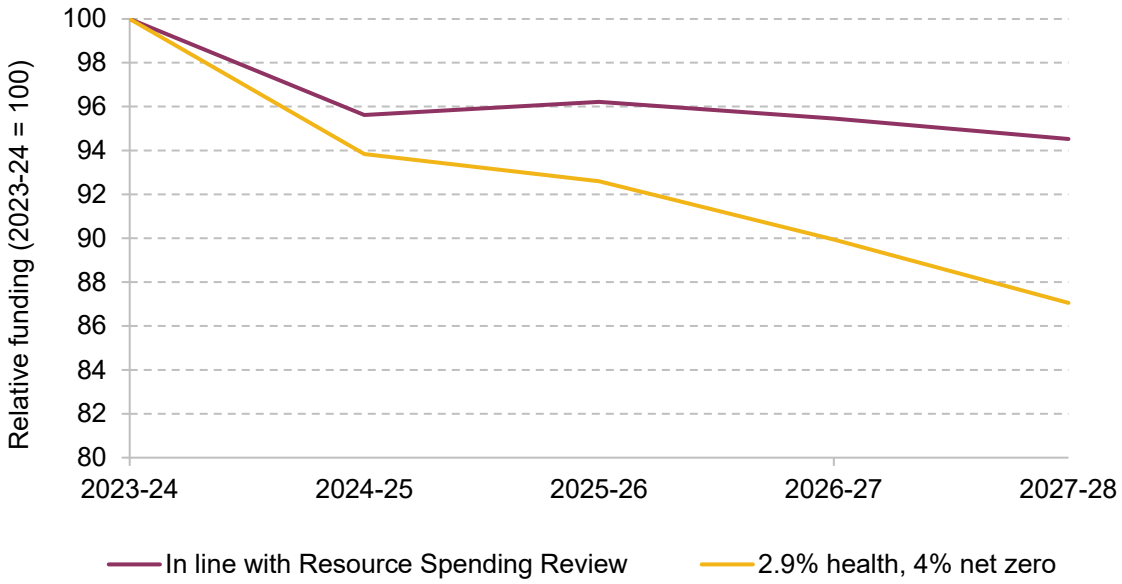
As already mentioned, the projections of the amount of funding available for non-benefit spending over the next four years imply difficult trade-offs in the amount provided to different public services. Figure 2.5 illustrates this by showing the implications for other service areas of different scenarios for the 'health and social care', and the 'net zero, energy and transport' portfolios, which were prioritised for additional funding in the Resource Spending Review. Figures are normalised so that the amount available is equal to 100 in 2023–24, making the real-terms changes that would be required in future budgets easy to observe.

The purple line in Figure 2.5 shows the total funding for other portfolios (such as local government, education and justice) if the health and social care and net zero, energy and transport portfolios were allocated the same real-terms increases planned in the May 2022 Resource Spending Review, which averaged 0.8% and 5.7% per year, respectively. As shown, the (relative) prioritisation of these budgets would mean that other portfolios are squeezed even further, falling in real terms by 5.5% between 2023–24 and 2027–28. In order to restore the funding levels of these portfolios to their 2023–24 levels in real terms in 2027–28, more than

£1.1 billion would be required in that year, equivalent to raising Scottish income tax by around 2p on the pound in that year.

The yellow line shows the funding that would be available for other portfolios if health and social care funding were instead increased by 2.9% in real terms per year, the same as is planned between 2022–23 and 2023–24 in the Budget; this is arguably a more realistic depiction of what will be needed to meet rising costs and demands. In addition, the net zero, energy and transport portfolio is assumed to receive an additional 4% in real terms each year, again the same as planned between 2022–23 and 2023–24. As shown, this would make the outlook for other services substantially more challenging, with available funding falling almost 13% in real terms between 2023–24 and 2027–28, or an average of 3.4% each year. To restore these funding levels to their 2023–24 levels would require £2.7 billion, or approximately the equivalent of an additional 4–5p on the pound on income tax rates.

Figure 2.5. The impact of differing degrees of prioritisation of the 'health and social care' and 'net zero, energy and transport' portfolios for other non-benefit spending

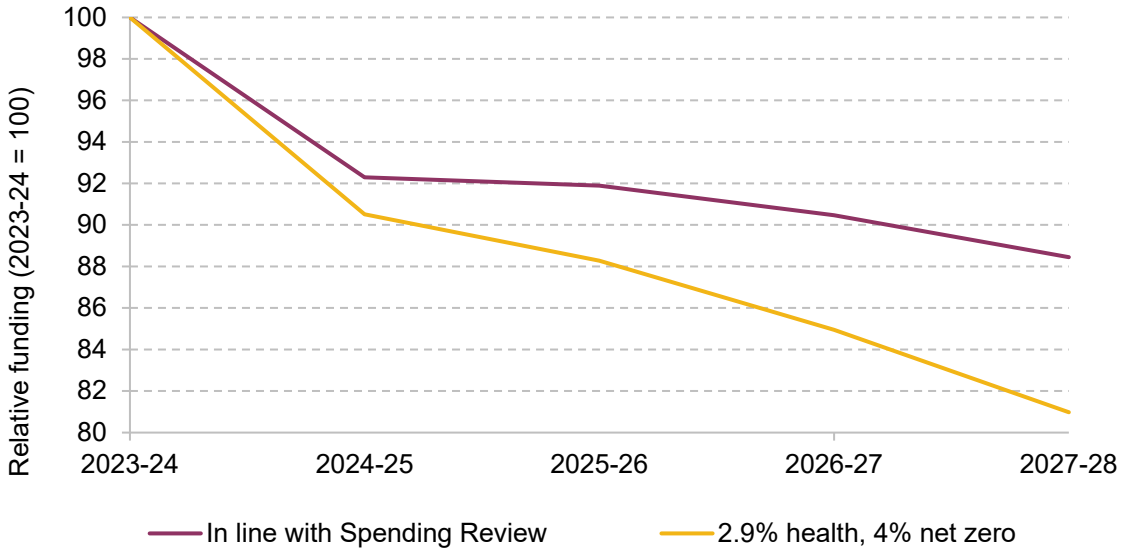


Source: Authors' calculations using Scottish Government (2022a) and Scottish Fiscal Commission (2022b).

Figure 2.6 shows the outlook for other portfolios under the same assumptions if the forecast improvement in Scotland's net income tax position is not borne out. In both cases, other portfolios would be considerably squeezed. In order for health and social care to grow at 0.8% in real terms each year between 2023–24 and 2027–28, and net zero, energy and transport at 5.7%, funding for other portfolios would have to be cut by around 3% a year in real terms, with a particularly large cut of 8% in 2024–25. If these two portfolios were increased at the same rate

as between 2022–23 and 2023–24, shown by the yellow line, funding for other portfolios would need to fall by an average of 5% a year, and almost 10% in 2024–25. This would be unlikely to materialise (in that either health, net zero or benefits would be increased less quickly and/or taxes increased), but further illustrates the importance of the forecast improvement in Scotland's net income tax position to its future funding outlook.

Figure 2.6. The impact of differing degrees of prioritisation of the 'health and social care' and 'net zero, energy and transport' portfolios for other non-benefit spending, excluding funding from the forecast improvement in net tax position



Source: Authors' calculations using Scottish Government (2022a) and Scottish Fiscal Commission (2022b).

2.3 Longer term: the Barnett squeeze

We now consider the longer-term outlook for the Scottish Government's funding, which the SFC will be considering in its first Fiscal Sustainability Report in March 2023.

As in the short and medium term, the amount available to spend in the longer term will depend on funding from the UK government, largely via the Barnett formula, and devolved tax revenues. Focusing on the first of these, the design of the Barnett formula is likely to squeeze the amount of funding the Scottish Government receives per person related to England, which, all else equal, will increasingly make it harder for the Scottish Government to continue to provide more generous public services and social security benefits than south of the border. In particular, the Barnett formula provides the Scottish Government with a population share of the change in spending on comparable services in England. And because spending per person in Scotland is currently higher than in England – on average, 26% higher between 2022–23 and 2024–25,

according to HM Treasury (2021) estimates – and therefore it currently receives a share of spending that is much higher than its population share, these population-based increments translate into smaller percentage changes in funding than in England. When spending is being increased, this tends to lead to the initial gap in spending narrowing over time – a process of convergence termed the Barnett squeeze.

The speed and extent of this process depends on two main factors.

- The rate of increase in spending on comparable services in England. The higher this rate, the greater is the increase in funding for the Scottish Government. However, with bigger cash-terms increases in spending, the gap between the percentage increase in England and Scotland is larger, increasing the rate and extent of convergence in spending levels between those two parts of the UK.
- The difference between Scotland's and England's rates of population growth. When Scotland's population grows less than that of England, the increases in spending in Scotland have to be spread among fewer additional people than in England. This slows the rate and extent of convergence in spending levels per person.

Historically, the large increases in spending during the 2000s were associated with a significant convergence in spending between Scotland and England. This was due to the relatively generous spending increases in England – and despite slower growth in the population in Scotland than England. In contrast, Phillips (2022) has shown that the austerity of the 2010s, combined with a flaw in the way the Barnett formula treated cuts to local government funding in England, saw divergence in funding, as spending in Scotland was cut by less in percentage terms than in England.

Future trends are uncertain, but with spending highly likely to grow in cash terms in the longer term, convergence is set to resume. Figure 2.7 illustrates the potential implications using different scenarios for spending and relative population growth. Panel A shows how differences in the rate of real-terms spending growth in England would affect the Scottish Government's funding in absolute terms and relative to England. Panel B shows how differences in the rate of inflation would affect the Scottish Government's absolute and relative funding levels. Panel C shows how differences in the rate of population growth would affect the Scottish Government's absolute and relative funding levels.

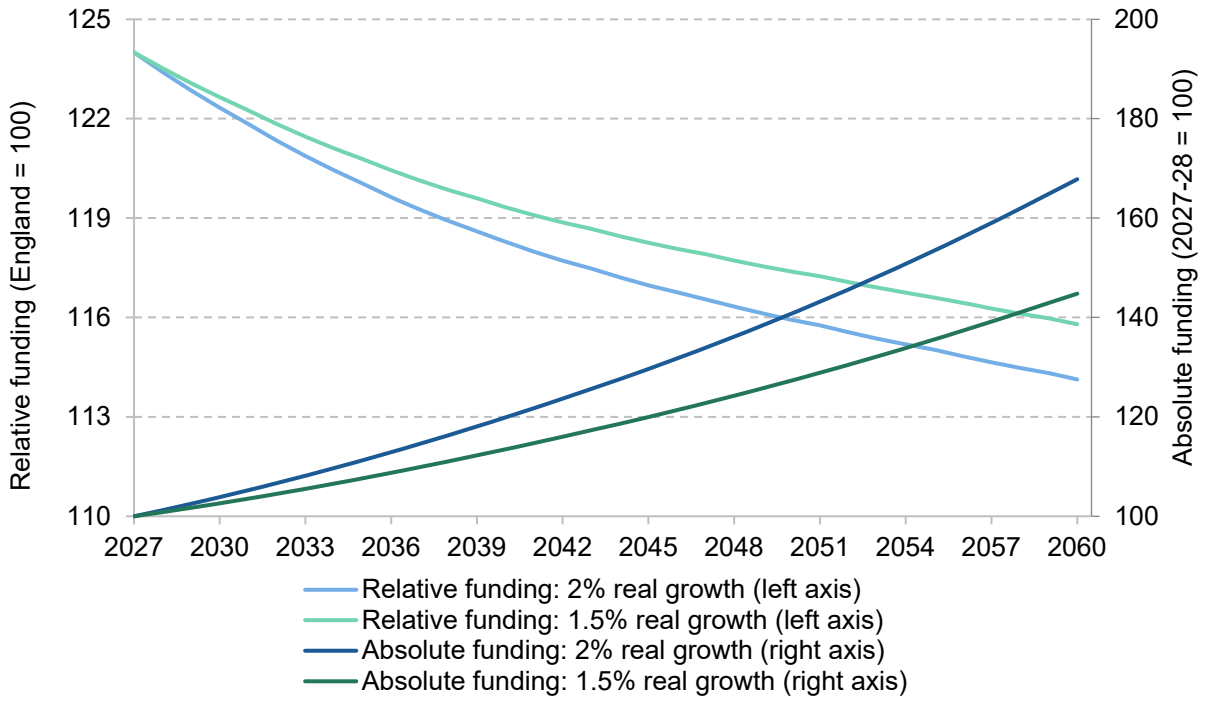
Looking first at panel A, the dark blue and dark green lines show clearly that bigger real-terms increases in spending in England will lead to bigger real-terms increases in Scotland. For instance, based on current central population projections and 2% inflation per year, 1.5% per year real-terms increases in spending in England would mean that Scottish funding per person would increase by 16% in real terms between 2027–28 and 2042–43, and by 39% by 2057–58.

In contrast, 2% per year increases in spending would mean 24% and 59% increases in total by the same years. However, faster real-terms increases in spending in England would lead Scottish funding per person *as a share of English funding per person* to fall more quickly. It would fall from around 124% in 2027–28 to around 116.3% by 2057–58 if English spending increased by 1.5% a year, but to 114.6% if English spending increased by 2% a year. Faster spending growth in England, while making it easier for the Scottish Government to maintain and potentially improve the range and quality of services provides, would make it more challenging to continue to offer a higher level of service provision than England.

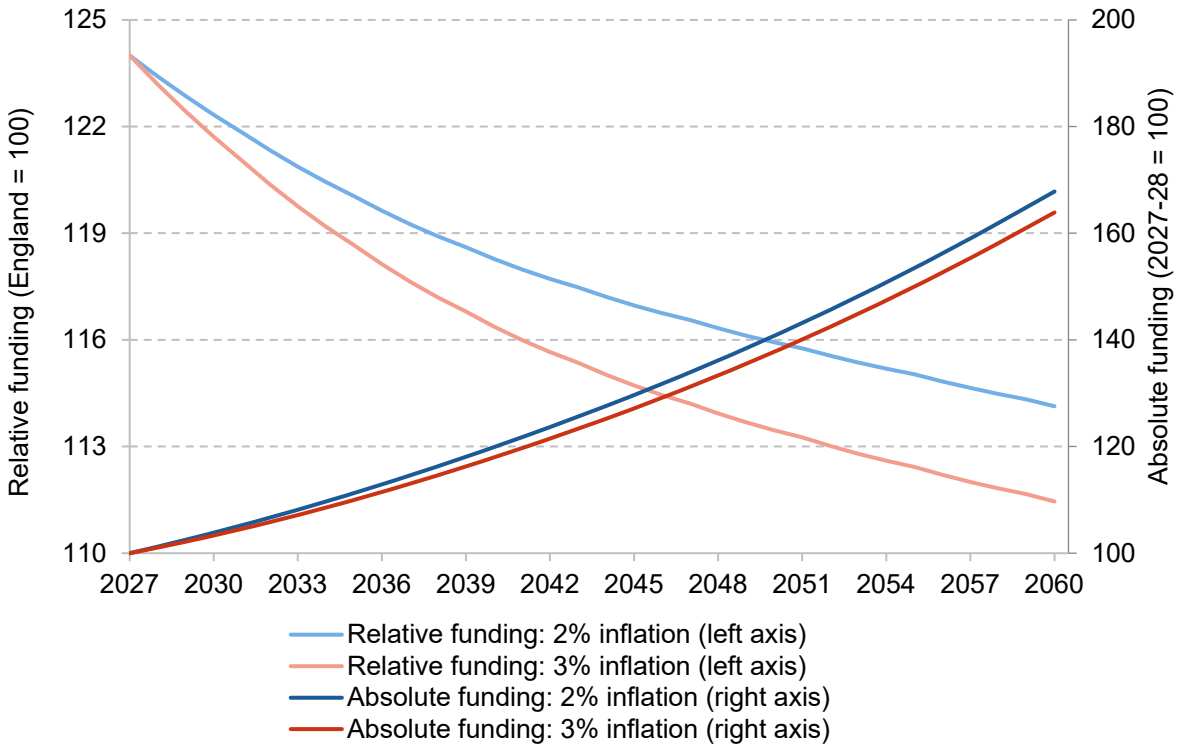
Panel B shows that holding real-terms growth in spending in England fixed at 2%, higher inflation would reduce both the absolute and relative funding of the Scottish Government over time. For example, with 2% real spending increases in England and 2% inflation, Scottish Government funding per person would increase by 59% in real terms by 2057–58, as already highlighted. But with 2% real spending increases in England and 3% inflation, Scottish Government funding per person would increase by 55% by 2057–58. Relative funding would fall to 114.6% of England's levels with 2% inflation by the same date, but 112% with 3% inflation. Both the slower absolute growth and bigger relative squeeze reflect the fact that higher inflation would increase the total cash-terms increase in funding to which the Barnett formula is applied, allowing more of a squeeze to occur.

Figure 2.7. Scenarios showing the potential impact of the Barnett squeeze on the Scottish Government's funding, 2027–28 to 2060–61

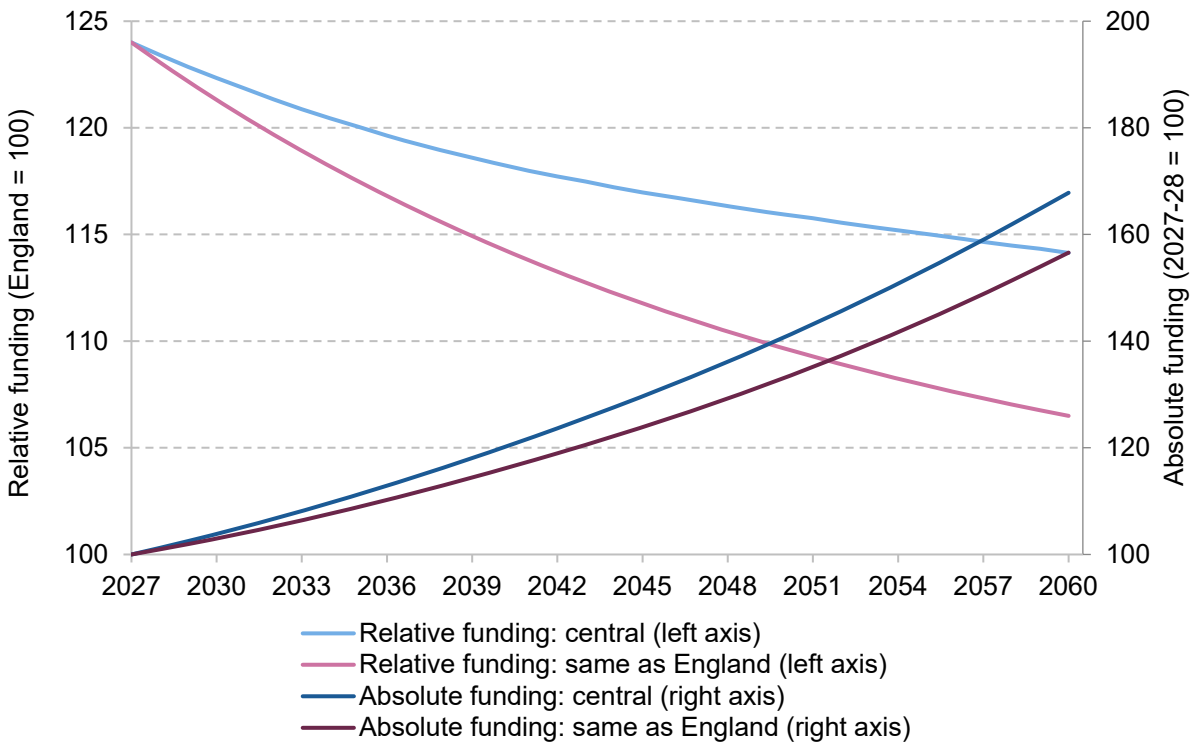
Panel A. Varying real rate of growth



Panel B. Varying inflation



Panel C. Varying population growth



Source: Authors' calculations using HM Treasury (2021) and Office for National Statistics (2022).

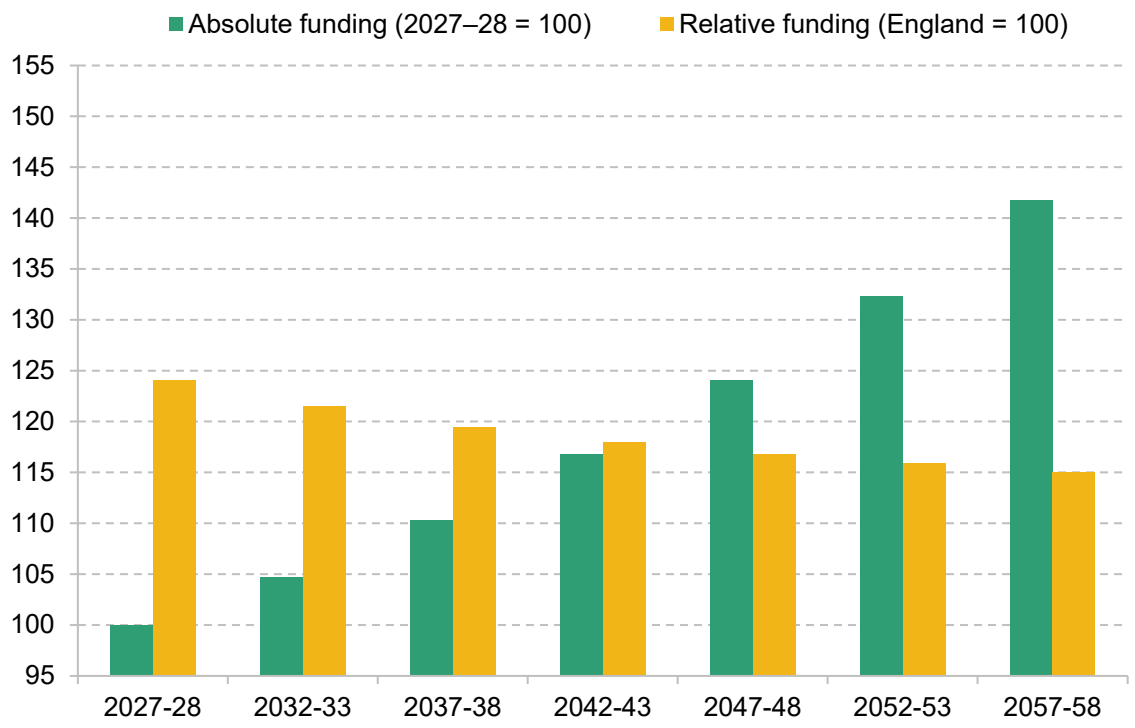
Finally, panel C shows that holding real-terms growth in spending and inflation fixed at 2%, faster population growth in Scotland reduces both absolute and relative funding per person and therefore increases the rate of convergence in spending per person. For example, if the Scottish population were to grow as fast as the English population is projected to, funding per person would increase by 49% (not 59%) by 2057–58, and relative funding fall to 107.3% (not 114.6%) of English levels. This reflects Scottish Government funding having to be spread across more people in this scenario (Phillips (2022) discusses this issue further).

While future trends in real-terms spending, inflation and population growth are uncertain, we do have projections for each of these from the OBR and Office for National Statistics (ONS). In Figure 2.8 we assume that real-terms spending in England on items subject to the Barnett Formula increases in line with OBR long-term assumptions for GDP per person and ONS central projections for population growth, inflation increases in line with OBR long-term assumptions for inflation, and population increases in line with ONS central projections for population. This would hold spending on items subject to the Barnett Formula constant as a share of GDP; as discussed by the Office for Budget Responsibility (2022b), this would likely be insufficient to meet the rising cost of healthcare and social care spending. However, meeting those pressures would likely require substantial increases in taxation, whereas increases in line with GDP would not, which is why we choose this for our main projection.

These assumptions imply real-terms spending growth in England of 1.6% per year, inflation of 2.3% a year, and population growth averaging approximately 0.2% and −0.2% per year, on average, in England and Scotland in the 30 years from 2027–28. Given these assumptions, the Figure shows that real-terms funding per person in Scotland would grow by an average of 1.2% per year per person compared to 1.4% per year per person in England. As a result, relative funding per person would fall from 124% of English levels in 2027–28 to 121.4% in 2032–33, 117.9% in 2042–43 and 115% in 2057–58.

Therefore, under a scenario where spending on public services in England is increased in line with GDP growth, rather than increasing in line with (higher) projected demand and cost growth, the Scottish Government would face a notable additional pressure because the Barnett formula would deliver even smaller percentage increases to its funding. Counteracting this additional squeeze (let alone the full increases in costs and demands facing Scottish Government spending) would require some combination of significant increases in taxes and cuts to certain services, unless there was stronger growth in the Scottish economy and devolved tax bases than in rUK. The SFC is expected to look further at this issue – including the potential increases in costs and demands facing the Scottish Government – in its forthcoming Fiscal Sustainability Report.

Figure 2.8. Main projection for Scottish Government's absolute and relative funding per person, 2027–28 to 2057–58



Source: Authors' calculations using Office for Budget Responsibility (2022b) and Office for National Statistics (2022).

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3. Income tax performance

Bee Boileau and David Phillips

Since the partial devolution of income tax to Scotland, revenues have disappointed. For example, whereas increases in tax rates and changes to tax bands are – before accounting for behavioural responses – estimated to have generated over £600 million in 2020–21, revenues were only £96 million more than the amount subtracted from the Scottish Government's block grant funding (the block grant adjustment, or BGA) to account for devolution. This is because the underlying tax base grew less quickly in Scotland than in the rest of the UK (rUK),[8] offsetting most of the revenue generated by the Scottish Government's tax changes.

Forecasts suggest that this trend has continued into the current year. In particular, the Scottish Fiscal Commission (SFC) has forecast that the Scottish Government's tax changes will raise the equivalent of £850 million this year (again before accounting for behavioural responses), yet revenues will be around £100 million lower than the BGA. In other words, slower tax base growth is expected to more than offset Scotland's higher tax rates.

In both December 2021 and May 2022, the SFC was forecasting the trend to continue in the medium term. However, the forecasts published last month are for a significant reversal of this trend, with revenues set to exceed the BGA by £1.1 billion by 2026–27, and £1.3 billion by 2027–28. This is an important change, providing a notable boost to the Scottish Budget (see Chapter 2).

This chapter of the report therefore looks at what we know about why Scotland's tax base has grown more slowly so far since devolution, and discusses the SFC's explanation for the partial catch-up expected over the next few years.

[8] Strictly speaking, the comparator has switched to England and Northern Ireland, following the devolution of tax powers to Wales in 2018–19 (Stamp Duty Land Tax and landfill tax) and 2020–21 (income tax). We use the term rUK throughout for ease of reference.

Key findings

1. Scottish Government policy measures – which include reducing the higher rate threshold, moving to a five-band system of income tax, and increasing the higher and top rates of tax – have raised significant amounts of revenue relative to if it had followed UK government tax policy that applies in rUK. The SFC estimates that, before accounting for any behavioural responses, these changes boosted revenues by £385 million in 2018–19 and will boost revenues by £852 million in the current financial year, 2022–23.

2. However, slow growth in Scotland's underlying tax base compared with rUK has exerted downwards pressure on Scottish income tax revenues, despite these reforms to Scottish income tax policy. In 2018–19, revenues from income tax were only £127 million higher than the BGA subtracted from Scotland's block grant funding to account for tax devolution (which is updated each year in line with growth in revenues in rUK), and in the current financial year, 2022–23, revenues are forecast to be £107 million lower than the BGA. In other words, slow growth in the underlying tax base is forecast to more than offset the additional revenues from Scotland's higher tax rates this year.

3. Relatively slow employment growth in Scotland, compared with rUK, has been one factor behind this poor net tax position. Scotland's population is ageing more rapidly than the population of rUK, and there have been falls in economic participation rates within age groups. For adults aged 35–49, the labour force participation rate in 2014–15 was comparable in Scotland to that in the UK as a whole (86.8% versus 86.9%), but by 2021–22, a 3.5 percentage point gap had emerged (84.5% versus 88.0%), with participation falling in Scotland and rising in rUK. This depresses tax revenues per person in Scotland relative to rUK, worsening Scotland's net position.

4. Scottish earnings growth has also been weak compared with earnings growth in rUK over the period in which income tax has been devolved. Scottish Government analysis suggests that this primarily reflects two factors. The first is strong growth in earnings in London and its surrounding regions, related to growth in the finance and insurance sector in particular. In the period between 2016–17 and 2021–22, changes in London, the South East and the East of England can account for more than half of the shortfall in growth in average earnings in Scotland relative to rUK. The second factor is the weak performance of the oil and gas sectors and associated industries, particularly affecting earnings – and so income tax revenues – in North Eastern Scotland.

5. As recently as May 2022, the SFC was expecting this slow growth in the Scottish tax base to continue in 2023–24 onwards, with negative impacts on forecast net income tax revenue in Scotland. This was largely as a result of its forecast for continued slower employment growth in Scotland compared with rUK.

6. In its latest forecasts, however, the net income tax position for 2023–24 onwards is much stronger. Forecasts for Scottish revenues were revised upwards from their May levels in each year between 2023–24 and 2026–27, while the BGA forecasts by the Office for Budget Responsibility (OBR) were revised downwards (apart from a slight upwards revision in 2024–25). Only a small part of this net improvement is as a result of income tax policy changes announced in the December 2022 Scottish Budget, which include increasing the higher rate of tax (from 41% to 42%) and the top rate (from 46% to 47%).

7. The most important factor causing the improvement in the forecast net position from 2023–24 between May and December 2022 is the change in underlying economic forecasts. Employment forecasts have been revised downwards by the OBR in the UK for 2023–24 and 2024–25, but the SFC has not done the same. The OBR also forecasts that earnings will grow much more slowly (at an average of 2% per year between 2024–25 and 2027–28) in the UK than is forecast for Scotland by the SFC (2.6% on average).

8. To some extent, these differences are likely to reflect Scotland-specific factors: much elevated energy prices are likely to boost employment and earnings in the oil and gas sectors in North Eastern Scotland, and a recession and rising interest rates may slow earnings growth in the large financial sector in rUK. But part of the differences are also likely to reflect different judgements about the economic outlook for the UK as a whole. If the SFC's more 'optimistic' position is borne out, the OBR's revenue forecasts will be too low, and the BGAs will be revised upwards. If the OBR's forecasts are more accurate, Scottish revenues will be lower than is forecast. In both cases, Scotland's net income tax position would be weaker than currently forecast. Risks to Scotland's net income tax position are therefore likely to be weighted to the downside.

9. Despite the improved outlook for the income tax net position from 2023–24, forecasts are still lower than would be expected as a result of income tax policy alone. In 2026–27, for example, the latest forecast for the net position is £1,068 million, but the effect of tax policy alone, according to SFC analysis, would be a net position of £1,528 million. This reflects the fact that the stronger forecast growth in the tax base over the next few years is only expected partly to undo the slower growth in the tax base during the first few years of income tax devolution.

3.1 Income tax performance to 2022–23

The power to vary income tax rates and bands charged on income other than interest and dividend income (termed non-savings, non-dividends or NSND income) was devolved to the Scottish Government in 2017–18. At the same time as these powers and associated revenues were devolved, the block grant funding provided by the UK government to the Scottish Government was reduced. This block grant adjustment (BGA) was initially set equal to estimates of the tax revenues to be devolved to the Scottish Government. In subsequent years, it is changed in line with the percentage growth in income tax revenues per person in the rUK and with growth in the change in the Scottish population. This means that there would be a net increase in funding (from the devolved revenues and offsetting BGAs) if income tax revenues per person were to grow at a faster rate in Scotland than in rUK since the point of devolution, and a net decrease if they were to grow at a slower rate.

Two main factors could affect the relative growth rate in revenues per person in Scotland compared with rUK:

- first, changes in income tax policy in Scotland and rUK (for example, if the Scottish Government were to increase tax rates relative to those in rUK, all else equal, we would expect revenues per person to grow more quickly than in rUK);
- second, changes in the underlying tax base (the amount of income subject to tax) as a result of different trends in demographics, employment, earnings and other economic variables.

The Scottish Government has in fact used its tax powers to make a series of changes to income tax policy relative to rUK that would be expected to lead to a bigger increase in revenues per person since devolution. In the current financial year, these changes include:

- a reduction in the higher rate tax threshold relative to that set in rUK (£43,662 compared to £50,270 as of 2022–23), meaning that more income is taxed at the higher rate of tax;
- the introduction of a five-band system of income tax by splitting the basic rate (20% in rUK) into three bands, which are a starter rate of 19% applying on a small band of income between £12,571 and £14,732, a basic rate of 20% applying between £14,733 and £25,688, and an intermediate rate of 21% applying between £25,689 and £43,662;
- an increase in the higher and additional rate of tax to 41% and 46% (compared to 40% and 45% in rUK), with a further increase – to 42% and 47% – to come in April 2023.

The distributional effects of these reforms are discussed in Chapter 5. In terms of revenue, the SFC estimates that these reforms would be expected to raise approximately £850 million this year, before accounting for any behavioural response to them, relative to following income tax policy in rUK.

However, slower growth in the underlying tax base has offset the impact of higher tax rates, as can be seen in Table 3.1. Part 1 shows the forecasts for income tax revenues and for the associated BGAs at the time the Scottish Budget was initially set each year, along with the resulting net revenue position, in each year between 2017–18 and 2022–23. These are the amounts that were used to determine how much funding the Scottish Government has to spend each year. The forecasts for revenues were made by the SFC, while the forecasts for the BGA are based on OBR forecasts for revenues in rUK. Part 2 shows the final figures for revenues, BGAs and the net position once the amounts actually collected in Scotland and rUK were known. Part 3 shows how much the outturn net position differed from the initial forecasts for each year: negative figures mean the Scottish Government has to pay back funding to the UK government as the forecast net position was optimistic, while positive figures mean the UK government has to provide additional funding to the Scottish Government as the forecast net position was pessimistic. These 'reconciliation' payments are made three years following the tax year in question (for example, the reconciliation payment for 2017–18 took place in 2020–21, and any reconciliation payment for 2022–23 will take place in 2025–26). Finally, part 4 shows the SFC's aforementioned estimates of the effects of changes in income tax policy compared with rUK, before accounting for any anticipated behavioural changes.

Looking first at part 1, we can see that initial forecasts were for Scottish income tax revenues to exceed the BGA by £107 million and £428 million in 2017–18 and 2018–19, respectively. Part 4 shows that this was mostly explained by tax policy changes relative to rUK, which were expected to raise £94 million and £385 million in these years. However, part 2 shows that the outturn net position was much weaker than forecast: −£91 million in 2017–18 and £127 million in 2018–19. This resulted in a need for negative reconciliation payments (whereby the Scottish Government pays back funding to the UK government) of £198 million and £302 million for these two years, which were applied in the 2020–21 and 2021–22 Budgets, respectively.

The weaker-than-expected relative performance of Scottish revenues had become evident by the time the Scottish Budget for 2019–20 was set, and the initial net position (£182 million) was much lower than SFC estimates of the effects of changes in tax policy (£621 million) and much closer to final outturn figures (£155 million) than in previous years, meaning a much smaller reconciliation payment (£50 million), which was applied in the current financial year.

This pattern has been repeated since then, with the exception of 2021–22, for which the SFC's forecasts of Scottish revenues (made in January 2021) could account for the relatively rapid roll-out of the COVID-19 vaccines boosting the economy and revenues, but the OBR's forecasts of rUK revenues and the BGAs (made in November 2020) could not. In particular, the initial forecast for the net position has been close to the outturn figures (or the latest forecasts where outturns are not yet available); however, the net position has fallen further and further behind what would have been expected based on income tax policy alone. In particular, for the current

financial year, 2022–23, the SFC estimates that the effect of tax policy has been to boost revenues by £852 million. However, the latest SFC forecast is for revenues to be £107 million *lower* than the BGA. This means that the direct effects of Scotland's higher income tax rates are forecast to have been more than offset by slower growth in the underlying tax base.

Table 3.1. Income tax revenue and BGA forecasts, outturns and reconciliations, and SFC estimates of impact of policy changes (£ millions)

	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23
1. Forecast						
Revenue	11,857	12,177	11,684	12,365	12,263	13,671
BGA	11,750	11,749	11,501	12,319	11,788	13,861
Net position	107	428	182	46	475	−190
2. Outturn						
Revenue	10,908	11,549	11,825	11,948	13,337	14,575
BGA	10,999	11,423	11,670	11,852	13,594	14,681
Net position	−91	127	155	96	−256	−107
3. Reconciliation (1c minus 2c)	−198	−302	−28	50	−732	83
4. SFC estimate of impact of policy change only	94	385	621	642	757	852

Note: Reconciliation payments for a given year are applied to the Scottish Budget three years later. The SFC's estimates of the impact of policy changes on revenues are prior to any behavioural responses.

Source: Authors' calculations using Scottish Fiscal Commission (2022b). Shaded cells are the latest forecasts for outturns (made in December 2022), rather than outturns themselves.

Part of the slower growth in Scotland's tax base may reflect a behavioural response to Scotland's higher income tax rates. For example, when higher and additional rates of tax were increased from 40% to 41% and from 45% to 46%, respectively, in 2018–19, the SFC forecast that behavioural response would reduce the revenue raised from the higher rate in 2022–23 by 15% (from £156 million to £132 million), and from the top rate by over half (from £69 million to £29 million). Therefore, if these assessments of behavioural effects are broadly accurate, then these responses can only explain a small part of the slower growth in Scotland's tax revenues.

Analysis by the SFC and Scottish Government has highlighted a number of other factors that together, are likely to explain the deteriorating underlying net tax position – the following draws heavily on Scottish Fiscal Commission (2022c) and Scottish Government (2022).

The number of people in employment in Scotland has grown less quickly than in rUK since income tax was devolved. For example, between 2016–17 and 2021–22, employment in the UK as a whole is estimated to have increased by around 2%, whereas employment in Scotland is estimated to have fallen by 0.9%. This partly reflects slower population growth in Scotland than in rUK (which, because of the way the BGAs are calculated, using growth in revenues per person in rUK and growth in the Scottish population, should not affect the net tax position) but not fully. Scotland's population has also been ageing, but the SFC suggests that while this has contributed to the absolute decline in employment, the ageing of the rUK population would, all else equal, have led to a similar decline in employment there. Instead, the differences relative to rUK are a result of declining participation rates for given age groups. For example, whereas the labour force participation rate for adults aged 35–49 was 0.1 percentage points lower in Scotland (86.8%) than in the UK as a whole (86.9%) in 2014–15, it was 3.5 percentage points lower (84.5% versus 88.0%) as of 2021–22. For adults aged 16–64 as a whole, the participation rate went from being 0.3 percentage points lower in 2014–15 to 2.7 percentage points lower in 2021–22. The relative fall in employment in Scotland would depress income tax revenues relative to rUK.

Scottish earnings growth has also been weaker than in rUK over the period in which income tax has been devolved. For example, while average earnings are estimated to have grown by 17.7% between 2016–17 and 2021–22 in Scotland, they are estimated to have increased by 20.3% across rUK: 2.6 percentage points or 14% more. The SFC estimates that this contributed more to the deterioration in the underlying income tax position than slower employment growth, reflecting the fact that the tax-free allowance and progressive income tax rate structure means a 1% increase in earnings raises more revenues than a 1% increase in employment.

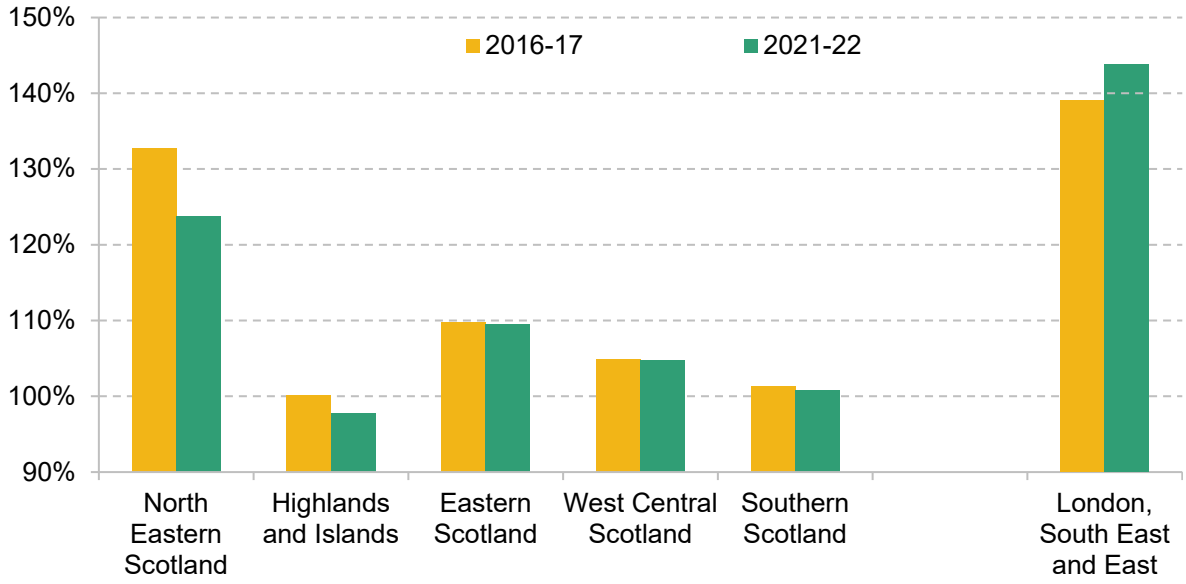
Analysis by the Scottish Government (2022) suggests that two factors explain much, if not all, of the slower growth in Scottish earnings.

- There was strong growth in earnings and, in turn, income tax payments in London, the South East and East of England. In particular, the shortfall in growth in average earnings in Scotland relative to rUK *excluding* London, the South East and East of England between 2016–17 and 2021–22 is estimated to be less than half the shortfall relative to rUK as a whole. Analysis of earnings by industry suggest that, particularly in 2021–22, a significant part of this relates to strong earnings growth in the finance and insurance sector in London, the South East and East of England. Because many people working in this sector in London, in particular, are highly paid and subject to a high marginal rate of income tax, the strong earnings growth for this group would have a disproportionate effect on rUK income tax revenues and hence the BGA.
- Additionally, the performance of the oil and gas sectors and associated supply chain industries deteriorated from 2015–16 onwards, probably reflecting falls in oil and gas prices,

and particularly affecting North Eastern Scotland. Analysis by the Scottish Government suggests that average earnings in Scotland excluding the North East nearly kept pace with average earnings in rUK excluding London, the South and East of England between 2016–17 and 2021–22. Again, the high average earnings among those working in the oil and gas (and related) sectors mean that the subsequent poor performance of earnings in these sectors is likely to have had a disproportionate effect on Scottish revenues, contributing to the deterioration in the net income tax position.

Analysis of earnings data based on real-time tax information reported to the HMRC by employers suggests that mean earnings have grown by less in recent years in most parts of Scotland than in rUK. When excluding London, the South East and East of England from the comparisons, the differences are only notable in North Eastern Scotland and the Highlands and Islands though. This is illustrated in Figure 3.1, which shows mean earnings for the different NUTS2 regions of Scotland, as a share of mean earnings in England and Northern Ireland (E&NI) excluding London, the South East and East of England. It shows that whereas mean earnings in North Eastern Scotland fell from 132.7% to 123.7% of mean earnings in E&NI excluding London, the South East and East of England between 2016–17 and 2021–22, and those in the Highlands and Islands fell from 100.2% to 97.8%, there was little change in the relative earnings of Eastern, West Central and Southern Scotland. The figure also shows that in all regions of Scotland except for the Highlands and Islands, mean earnings are higher than mean earnings in E&NI outside of London, the South East and East of England.

Figure 3.1. Mean earnings as a percentage of mean earnings for England and Northern Ireland excluding London, South East and East of England



South: Authors' calculations using Office for National Statistics (2022).

However, what matters for the net income tax position is how trends in income tax revenues per person across the whole of Scotland compare with trends across rUK as a whole. And slower growth in employment and earnings in Scotland has contributed to slower growth in the underlying tax base, offsetting the effects of Scotland's higher income tax rates.

3.2 Forecasts for 2023–24 to 2027–28

As of May 2022, in its forecasts published alongside the Resource Spending Review, the SFC was expecting this trend of slower growth in the underlying tax base to continue, driven largely by an expectation of a continued fall in employment in Scotland relative to rUK (the SFC was forecasting that earnings growth in Scotland would largely keep pace with that in rUK).

Part 1 of Table 3.2 shows the SFC's May forecasts for revenues, forecasts for the associated BGAs and the implied net income tax position, as well as SFC estimates of the impact of policy changes relative to rUK on the net position, before any behavioural response. It shows an improvement in the forecast net position between 2023–24 and 2024–25 (from −£359 million to £71 million), and then a slow worsening over the subsequent years (to −£50 million in 2026–27) as the forecast slower growth in employment takes its toll on the relative growth in Scotland's income tax base. The forecast improvement between 2023–24 and 2024–25 was the result of the then planned cut in the basic rate of income tax in rUK to 19% from April 2024: the resulting lower tax revenues would have reduced the BGA, and hence improved the net position. Stripping out that policy-driven effect, the SFC's forecasts imply that the underlying change in the tax base, and hence the net income tax position, was negative in that year too.

A comparison of the third and fourth rows of part 1 of Table 3.2 shows just how stark an impact Scotland's relatively slow growth in the tax base was expected to have on the net income tax position back in May 2022. For example, whereas the net position was forecast to be −£50 million in 2026–27, the direct effect of changes in policy relative to rUK were expected to raise £1.8 billion. This means slower growth in the underlying tax base was expected to have cost the equivalent of more than 10% of forecast income tax revenues in that year and, essentially, all the net income tax raising measures were essentially 'running to stand still' in terms of income tax revenues.

Table 3.2. Income tax revenue and BGA forecasts, outturns, and reconciliations between 2023–24 and 2027–28 (£ millions)

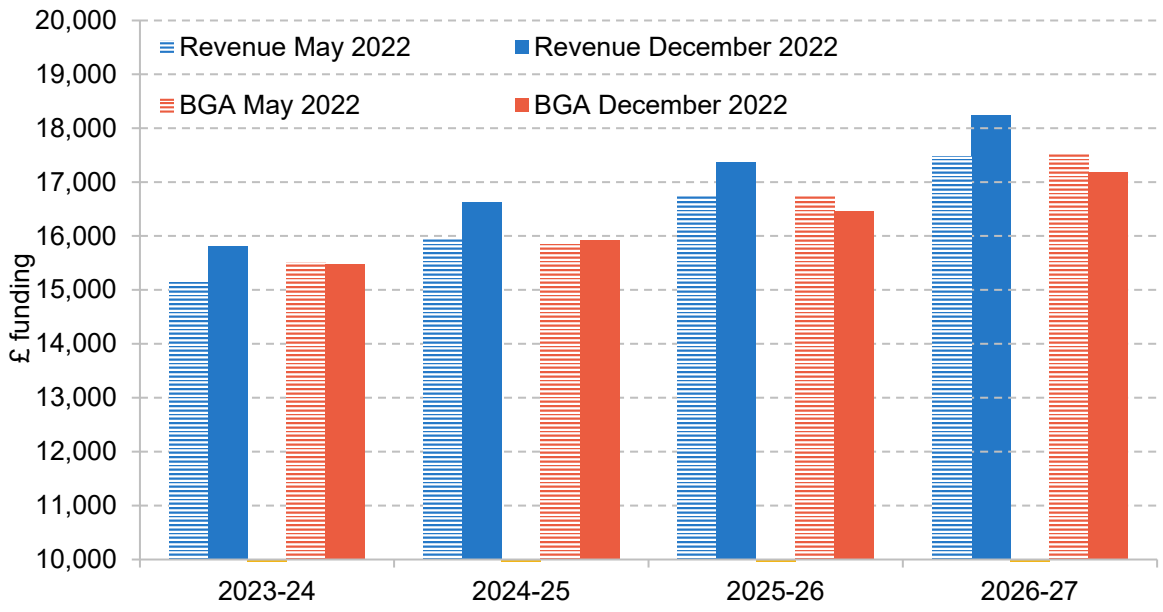
	2023–24	2024–25	2025–26	2026–27	2027–28
1. May 2022 forecasts					
Revenue	15,143	15,954	16,754	17,484	n/a
BGA	15,502	15,883	16,737	17,534	n/a
Net position	−359	71	18	−50	n/a
SFC estimate of impact of policy change only (December 2022)	895	1,459	1,613	1,810	n/a
2. December 2022 forecasts					
Revenue	15,810	16,633	17,370	18,247	19,437
BGA	15,485	15,932	16,455	17,179	18,105
Net position	325	700	915	1,068	1,332
SFC estimate of impact of policy change only (December 2022)	994	1,177	1,330	1,528	n/a

Note: Figures may not sum due to rounding.

Source: Authors' calculations using Scottish Fiscal Commission (2022a, b, c).

Part 2 of the table shows the same information as part 1, but for the December 2022 forecasts. It shows a significant change, with the net income tax position now forecast to be far stronger. For example, while in May 2022 Scottish income tax revenues were expected to be around £350 million lower than the BGA in 2023–24, the forecast position has now reversed with revenues expected to be around £325 million *higher*. The difference is similar for the 2024–25 net position, which was forecast to be £71 million in May but £700 million in December. In the following two years, the net position has improved by still more: by almost £900 million in 2025–26, and by more than £1.1 billion in 2026–27. This is despite the cancellation of the planned cut in the basic rate of income tax in rUK, which, all else equal, would have been expected to increase revenues in rUK and hence the BGA, worsening the net position by around £0.4 to £0.5 billion.

Figure 3.2. Comparison of income tax and BGA forecasts, May 2022 and December 2022



Note: Shaded bars represent May forecasts, while solid bars represent December forecasts.

Source: Scottish Fiscal Commission (2022a, 2022b).

Figure 3.2 illustrates visually how the forecasted revenues and BGAs have changed in each year to produce these improvements in the net position. As can be seen, the December forecasts for revenues have been revised considerably upwards from their May levels in each financial year between 2023–24 and 2026–27. The BGA forecasts have been revised downwards, adding to this improvement in the forecast net position, in each of these years apart from 2024–25, where they have been revised slightly upwards (from just under to just over £15.9 billion), likely reflecting the cancellation of the previously planned cut in the basic rate of income tax in rUK that year.

The largest driver of these substantial revisions has been the changes to the Scottish tax revenue forecast. The SFC's revenue forecasts for each of the next four years was increased by around £700 million between May 2022 and December 2022.

To some extent, this is the result of changes in income tax announced in the Scottish Budget in December 2022. This includes an increase in the higher rate of tax from 41% to 42%, and in the top rate from 46% to 47%, as well as confirming a freeze in most tax bands – although it was worth noting that the SFC had already assumed the higher rate threshold would be frozen in its May forecasts. Together, these changes are forecast to raise £121 million in revenue in 2023–24, increasing to £160 million in 2027–28, contributing modestly to the improvement in the net income tax position. In addition, the Scottish Government matched the UK government's change to the top rate threshold, which was reduced from £150,000 to £125,140. This is forecast to raise £8 million in the coming year, rising to £16 million by 2027–28. However, the combined effect

of the reduction in the top rate threshold in Scotland and rUK is actually to worsen slightly the net income tax position because the greater share of individuals affected in rUK means revenues there, and hence the BGA, will increase by more than Scottish revenues.

Much more important to the improvement in the net position are changes in underlying economic forecasts. For example, since May 2022, the OBR has revised employment growth forecasts down in the UK for 2023–24 and 2024–25, as a result of the expected recession following the energy price increases. Employment is then forecast to grow more quickly but not return to previous forecast levels until 2027–28. This would act to depress revenues in rUK and hence reduce the BGA. However, the SFC has not revised down employment in 2023–24 for Scotland, and has in fact revised up employment for future years. This would increase revenues in Scotland, further improving the net income tax position.

Updated forecasts for earnings growth also contribute to improved forecasts for Scottish tax revenues relative to rUK. The OBR's latest forecasts are for UK earnings to grow in nominal terms by an average of 2% per year between 2024–25 and 2027–28 (and just 1.6% and 1.7% in 2024–25 and 2025–26, respectively), while the SFC has forecast earnings in Scotland to grow by an average of 2.6% per year (and by 2.5% and 2.1% in 2024–25 and 2025–26). Relatively faster earnings growth in Scotland would again contribute to an improvement in the net positions by boosting Scottish revenues relative to rUK revenues (and hence the BGA).

The differential changes in the employment and earnings forecasts by the SFC and OBR may reflect both Scotland-specific factors and more general differences in modelling approaches and forecast judgements.

Focusing first on Scotland-specific factors, the slower growth in earnings in Scotland between 2016–17 and 2021–22 relative to rUK was, as discussed earlier, to a significant extent driven by slowing activity in the oil and gas sector (causing a fall in earnings in North Eastern Scotland and, to a lesser extent, the Highlands and Islands), and strong growth in earnings in the financial services in rUK (and particularly London and its environs). Higher energy prices – which, although expected to fall back somewhat, are forecast to remain substantially above previous levels, especially for gas – are likely to boost employment and earnings in the oil and gas sector in Scotland. And the economic slowdown and rising interest rates may reduce earnings growth in the financial sector in rUK (and especially London) by more than Scotland, reducing the likelihood of further divergence (and potentially even allowing catch-up). It is worth noting, however, that there is so far little sign of such a turnaround. For example, there was, if anything, a further decline in relative earnings in North Eastern Scotland in the Summer and early Autumn of 2022 (following the energy price rise), with mean earnings falling to 21% above the mean in England and Northern Ireland (excluding London, the South East and East of England) between

July and October 2022, compared to 22% during the same period in 2021, before the rise in energy prices. The same is true for all other regions of Scotland to a greater or lesser extent.

The Scottish Fiscal Commission (2022b) also suggests that the smaller mortgage debts of Scottish households relative to those in rUK means that they will be less affected by rising interest rates, supporting consumption and, in turn, employment and earnings in Scotland.

However, to some extent, the differences in forecasts for earnings and employment growth, and hence income tax revenues, made by the OBR and SFC are likely to reflect different judgements about the economic outlook for the UK as a whole. For example, underpinning the OBR's earnings forecasts are assumptions about the share of overall economic output (GDP) that is captured by workers via wages. While wages are falling behind inflation, they are outstripping output per worker currently. This has pushed the wage share above its average long-run share of output. If wages were to move back towards their long-run share of output, there would therefore be a period of wages growing by less than output per worker. This may contribute to the slow increase in earnings forecast by the OBR in 2024–25 and 2025–26, in particular. In contrast, the SFC does not make assumptions about wages as a share of output, and instead is guided more by past relationships between wage growth and economic growth.

To the extent that part of the difference between the SFC's forecasts for Scottish revenues and the OBR's forecasts for rUK revenues (and hence the BGA) reflect different judgements about the UK as a whole, this represents a downside risk to Scotland's net income tax position. This is because if the more 'optimistic' implicit SFC position for the UK as a whole is borne out, the OBR will have been overly pessimistic about rUK revenues, and the BGA would be revised upwards. This would worsen the net income tax position compared to current forecasts. Conversely, if the more 'pessimistic' OBR position is borne out, Scottish tax revenues would be lower than currently forecast. This would again lead to a worse net income tax position than currently forecast.

It is entirely possible, of course, that differences in economic, employment and earnings growth are even stronger in Scotland relative to rUK than the December forecasts imply. There is a lot of uncertainty. But the potential for differences in judgements about the UK as a whole to be driving part of the current improvement in the net tax position represents a notable downside risk to the Scottish Budget. As we showed in Chapter 2, if the income tax position does not improve as forecast, the outlook for funding for public services would be significantly more challenging for the Scottish Government. The importance of the net income tax position – and hence differences between the SFC's forecasts and judgements for Scotland, and the OBR's for the UK – for the Scottish Budget mean that it would be worthwhile for the SFC and OBR to invest more time in understanding the factors leading to differences in their forecasts, and the extent to which they are Scotland-specific.

Finally, it is worth noting that while the latest forecasts show a much-improved net income tax position compared to those in May 2022, there is still a shortfall compared with what would be expected given changes in income tax policy alone. For example, the SFC forecasts that the net position will be just under +£1.1 billion in 2026–27, but the effect of tax policy alone would be to raise over £1.5 billion in revenues. This means that slower growth in the tax base (partly due to behavioural responses to tax changes, but mostly other factors) so far will be partly but not fully undone. This likely reflects the fact that the relative improvement in future employment forecasts would prevent a further fall in employment in Scotland relative to rUK, but would not significantly undo the falls seen between 2016–17 and 2021–22. It will therefore remain the case that part of the higher tax rates paid by Scottish residents will be offset by slower underlying growth in the tax base since income tax devolution.

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4. Council and school funding

Kate Ogden, David Phillips and Luke Sibieta

After health, funding for Scottish councils is the second largest item in the Scottish Government's Budget. In the original 2022–23 budget as passed by the Scottish Parliament, the Scottish Government allocated £10.6 billion to councils as part of the main local government portfolio, with further funding from other portfolios increasing the amount initially provided in the annual local government finance settlement for resource (i.e. non-capital) spending to £12.0 billion.

This funding supports a range of service areas including schools, early-years education and childcare, adults' and children's social care, environmental and regulatory services, local transport, leisure and cultural services, planning and local economic development, and housing advice and regulation. Additional funding is raised by councils themselves through council tax and sales, fees and charges, and via contributions from public sector bodies such as the National Health Service (NHS).

The 2010s saw cuts to councils' funding and spending, but more recently funding has been increasing again. This chapter of the report therefore first looks at how Scottish councils' spending on local services changed during the 2010s, splitting spending into spending on schools and spending on other services to allow for easier comparisons of trends in England (although differences in data and responsibilities mean these comparisons are somewhat rougher for the 'other services' category). It then looks forward to 2023–24 and 2024–25, looking at the outlook for overall council funding including for schools, and how this compares with England.

Key findings

1. Changes in the responsibilities of Scottish councils over time mean that it is not possible to carry out a fully like-for-like comparison of their funding over time. However, it is possible to adjust for some of the main changes in councils' responsibilities, such as the centralisation of police and fire services. After doing this, we estimate that Scottish councils saw a real-terms reduction in funding from grants from the Scottish Government and council tax of around 9%–10% between 2009–10 and 2018–19, equivalent to a fall of around 13% per person.

2. Funding for Scottish councils has increased since 2018–19, and as of 2022–23 is around 2% lower in real terms than in 2009–10, which is equivalent to a fall of around 5% per person. However, part of the recent increases in funding relate to new responsibilities and, most notably, to the expansion of free childcare for children aged 2, 3 and 4. Stripping out ring-fenced funding for this particular 'new burden', council funding remains around 5% lower in aggregate and 8% lower per person than in 2009–10.

3. Scottish councils received approximately £1.8 billion in COVID-19 grants during 2020–21 and 2021–22 to address pandemic-related pressures. Net expenditure did increase for a range of services, often reflecting the fact that additional grant funding had to make up for the loss of income from sales, fees and charges (such as parking charges). But councils also increased their general fund reserves by around £1.3 billion over the same two years, which suggests that the additional funding they received exceeded the short-term financial pressures they faced, or that they struggled to spend funds well. Councils may now be drawing down these reserves, given unexpectedly high inflation, with further drawdowns likely in future in light of a challenging funding outlook.

4. Within the overall cuts to councils' funding, some services have seen spending increase. For example, after initially falling, real-terms spending on early-years childcare and schools is likely to be around 19% above 2009–10 levels by 2021–22. This partly reflects a big boost to teachers' pay in Scotland in 2019–20, as well as the aforementioned expansion of free early-years childcare.

5. As a result of these spending increases, school spending per pupil aged 3–18 is estimated to have been 17% higher in Scotland in 2021–22 than in 2009–10. This is in stark contrast to England where it is estimated to have been 2.5% lower than in 2009–10. Spending per pupil in 2021–22 is estimated to be 25% higher in Scotland (£8,800) than in England (£7,100), up from 4% higher in 2009–10.

6. Scottish councils' spending on social work and social care also increased in real terms during the 2010s: by 8% on a net basis between 2009–10 and 2019–20, or 15% on a gross basis, also accounting for client charges and contributions from other organisations such as the NHS. But spending on other council services fell substantially during the 2010s: central administrative services (−55% net and −39% gross), planning and development (−52% net and −23% gross), housing (−38% net and −27% gross), roads and transport (−29% net and −9% gross), and culture (−29% net and −29% gross). This pattern is similar to England although the overall cut to non-schools spending is somewhat lower in Scotland, especially after accounting for its

slower population growth (which means spending has to provide for fewer additional people).

7. Turning to the future, it appears that after several years of real-terms increases, Scottish councils' funding may fall again in real terms. For example, after adjusting for in-year top-ups to councils funding in 2022–23 and stripping out funding for new burdens next year, grant funding for Scottish councils is set to fall by around 1% in real terms. Even 5% council tax increases would not be enough to fully offset this, and would still leave funding around 0.3% lower in real terms in 2023–24 than in 2022–23.

8. The outlook for 2024–25 is uncertain but is likely to be even tougher, given that overall funding for Scottish Government non-benefit spending is set to fall by 1.6% in real terms. If grant funding for Scottish councils were to change in line with this, 5% council tax increases would still see a further real-terms cut to overall funding of 0.5% on top of that seen in 2023–24. The cuts to councils' funding in 2024–25 would be substantially larger – potentially 4% – if the Scottish Government were to increase funding for health services and 'net zero' by the same percentage as in the Budget for 2023–24, and reduce grant funding for councils in line with the rest of the Budget.

9. The contrast with England over the next two years is therefore striking. Big increases in grant funding for councils announced in the November 2022 Autumn Statement mean that funding for English councils and schools (which is a separate budget line in England) is set to increase by 3% in real terms in 2023–24 and 2% in 2024–25, even if council tax rates are frozen in cash terms; with 5% increases in council tax rates, the real-terms increases would be 4.5% and 3.7%, respectively, for these two years. Given current plans and forecasts, the next few years are therefore likely to see something of a reversal of fortunes for Scottish and English councils and schools.

4.1 Recent trends in council funding and spending

Analysis of how Scottish councils' funding has changed over time is not straightforward because of changes to the way in which funding is allocated from central to local government, shifts in responsibilities between central and local government, and entirely new responsibilities. For example, 2013–14 saw the UK-wide council tax benefit replaced with local schemes to assist

low-income households to pay council tax,[9] and the shifting of police and fire services to new Scotland-wide bodies funded outside of the local government finance settlement in the same year. Recent years have also seen expansions of childcare, and free personal care for adults under 65, for instance, with funding for these provided as part of the local government finance settlement. Also, a growing proportion of councils' funding takes the form of 'ring-fenced' grants that must be spent on particular types of services, rather than as general funding, which councils have discretion over how to spend.

It is not possible to adjust perfectly for all of these factors – and, in particular, for all of the new responsibilities that councils have. It is therefore not possible to construct a fully consistent series of council funding for the same set of responsibilities over time. Approximate adjustments for the shift in responsibility for funding police and fire services and means-tested support for council tax are possible but the former, in particular, means that comparing periods pre- and post-April 2013 must be treated with a degree of caution.

Bearing this in mind, Figure 4.1 shows estimates of Scottish councils' resource funding for the period between 2009–10 and 2022–23 based on the updated local government finance settlements for these years (published alongside the initial settlements for the following years), and councils' reported council tax revenues.[10] Funding is separated into four streams: general grant funding plus business rates revenues; specific grant funding; pandemic-related grant funding; and council tax revenues, as reported in councils' revenue outturns (up to 2021–22) or budgets (2022–23). All values are in 2022–23 prices using the GDP deflator to adjust for inflation.

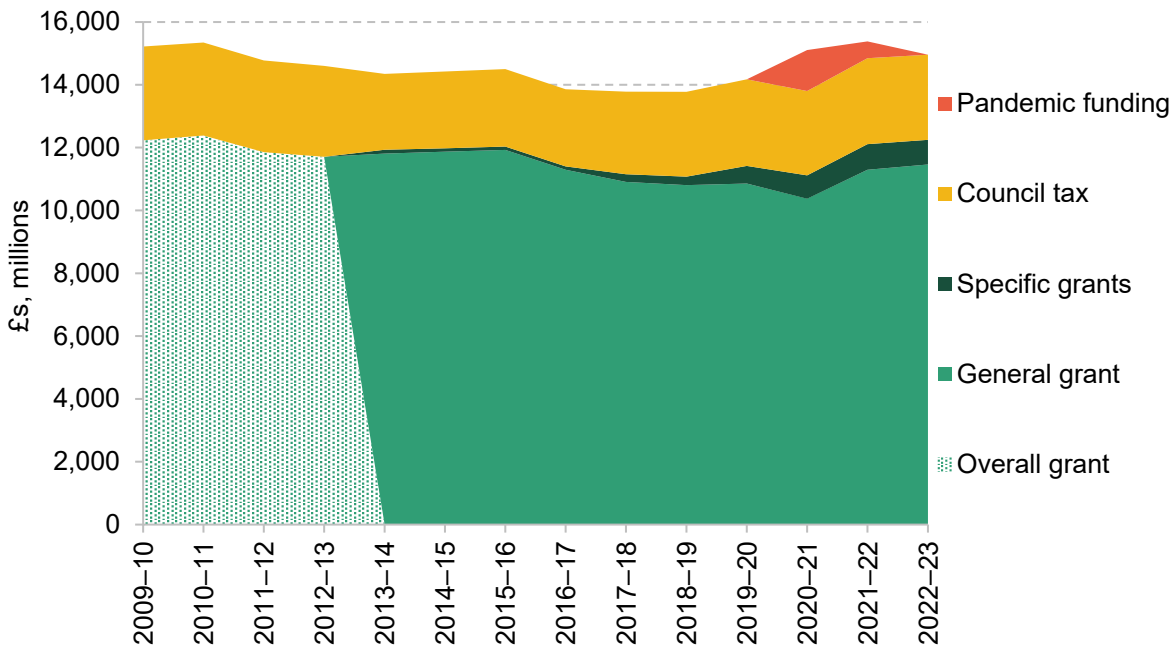
The figure shows that overall council funding from general and specific grants and council tax fell by an estimated £1.4 to £1.5 billion in real terms between 2009–10 and 2018–19, or 9.5%. After accounting for population growth, this is equivalent to a fall of just over 13% per person. Most of the fall took place in two periods: between 2010–11 and 2013–14 (and especially in 2011–12); and then in 2016–17. This trend reflects both a fall in grant funding from the Scottish Government and a real-terms reduction in council tax revenues as a result of the council tax freeze in place during most of this period and the localisation of means-tested support for paying council tax.

[9] Councils in Scotland apply a common set of rules specified by the Scottish Government but are responsible for delivering this support using the general grant funding provided to them.

[10] Estimates for years prior to 2013–14 are adjusted to remove an estimate of police and fire funding, assuming that the share of funding for police and fire was the average of the share subtracted in 2013–14 and 2014–15 (11.5%) when police and fire responsibilities were centralised, and should be treated as less precise. An alternative adjustment based on police and fire spending, and funding allocated for police and fire pensions, prior to 2013–14 produces similar results. See Fraser of Allander Institute (2017) for further discussion.

Since 2018–19, funding for Scottish councils has been increasing, mostly as a result of increases in grant funding from the Scottish Government. This includes around £1.3 billion of funding specifically to address pressures related to the COVID-19 pandemic in 2020–21, with a further £0.5 billion provided in 2021–22 (both figures are reported in 2022–23 prices). The substantial increases in councils' reserves in both of these years suggest that this additional funding exceeded the net additional pressures on their budgets (or, if not, that councils had difficulty spending the funding well). Indeed, councils' general fund reserves increased by around £1.3 billion over these two years, approximately doubling their value. This may be providing some support to councils' budgets this year and over the next couple of years, to address the ongoing longer-term impacts of the pandemic and much elevated inflation.

Figure 4.1. Scottish council resource funding, 2009–10 to 2022–23 (2022–23 prices)



Source: Authors' calculations using Scottish Government (2022a, b) and earlier versions, and Scottish Government (2022c).

Total grant funding this financial year, 2022–23, is estimated to be £1.2 billion higher in real terms than in 2018–19. This increase is split roughly 50/50 between general and specific grant funding. Council tax revenues have been broadly flat in real terms as increases in bills have broadly matched inflation (as measured by the GDP deflator). On this basis, council funding in 2022–23 is estimated to have almost returned to its 2009–10 levels in aggregate (just under 2% lower), although it remains notably lower after adjusting for population growth (just over 5% lower per person).

However, two factors are worth noting. First, as discussed in Chapter 2, the GDP deflator is likely to be underestimating inflation this year in particular, as it excludes the significantly increased costs of imported energy and food. Second, as discussed earlier in this chapter, part of the additional funding that councils have received is associated with new responsibilities. This includes the expansion of free early-years childcare, for which £522 million of ring-fenced funding has been provided in 2022–23. Stripping out this element of funding, real-terms funding is around 4% to 5% lower in aggregate and almost 8% lower per person this year than in 2009–10.[11]

How much of the overall funding provided by the Scottish Government to councils is for such 'new burdens' and how much is earmarked for particular services, as opposed to being subject to councils' discretion, are both highly contentious issues though.

For example, the Convention of Scottish Local Authorities (COSLA) produces what it calls a 'Budget Reality' document that adjusts the headline cash change in Scottish Government funding for councils to strip out funding it estimates are required to meet Scottish Government policy commitments. For example, its iteration for 2022–23 (COSLA, 2021) argued that Scottish Government commitments and other policy pressures would cost councils almost £0.9 billion, which at that stage exceeded the additional funding being provided to councils by £0.1 billion. Some of the items represent genuine 'new burdens' (such as for bridging payments for low-income families, prior to the expansion of the Scottish Child Payment) but others represent additional funding for existing responsibilities (such as the Pupil Equity Fund, designed to boost attainment of children from deprived backgrounds). It therefore seems likely that the Scottish Government's figures overstate the increase in funding for existing service responsibilities in recent years, but that COSLA's figures understate the increase.

Turning to the issue of councils' spending discretion, in both 2021–22 and 2022–23, £0.8 billion is ring-fenced (including the aforementioned funding for expansion of free childcare). However, the Accounts Commission (2023) calculates that, in 2021–22, an additional £2 billion in real terms was 'directed funding': not officially ring-fenced but provided with the expectation that it would be spent on specific services (equivalent figures are not yet available for 2022–23). Together with formally ring-fenced funding, this means 'earmarked' funding was equivalent to 23% of funding in 2021–22. Statutory duties and other agreed service standards may further reduce the discretion councils have to allocate funding between services. COSLA (2019), for instance, argues that over 60% of councils' budgets are subject to Scottish Government earmarking and commitments.

[11] There was an earlier, smaller, expansion of free early-years childcare provision in 2014–15 but it is not possible to similarly strip out the funding for this expansion.

Partly as a result of this, the funding cuts that councils faced during the 2010s did not fall evenly across service areas. In the next two subsections, we therefore look separately at spending on schools and on councils' non-education services. This also allows for easier comparisons with England, where funding for schools is increasingly separated from other council funding.

Spending on Scotland's schools

The largest single element of council spending in Scotland is spending on schools. Including spending allocated to schools and pre-school providers, as well as council spending on support services,[12] this amounted to £5.9 billion in today's prices in 2009–10, accounting for all grant funding and contributions from other public sector bodies. This measure of spending had increased to £6.5 billion in today's prices by 2020–21, an increase of around 10% in real terms. Figures for the current financial year, 2022–23, are not yet available but we estimate total spending increased further to about £7.0 billion in 2021–22, around 19% higher than in 2009–10.

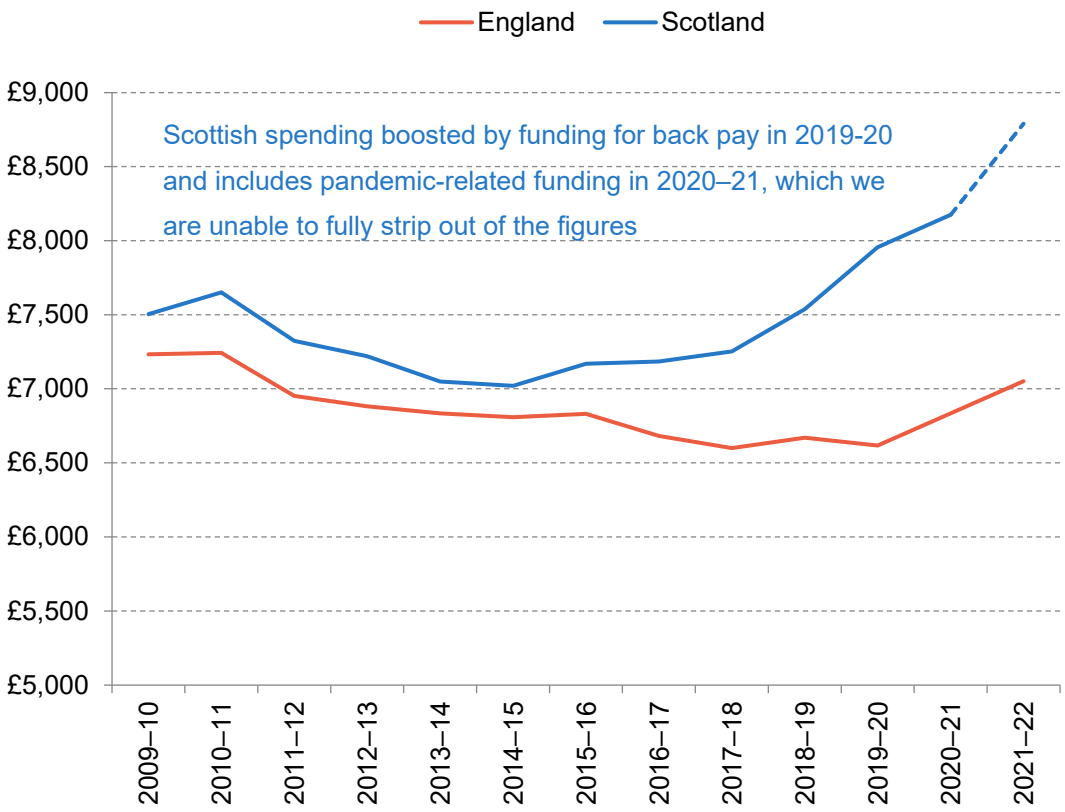
Figure 4.2 compares the level and trends in this measure of school spending *per pupil* across Scotland and England over time between 2009–10 and 2021–22. It includes all day-to-day spending on schools in both nations, including spending by individual schools and councils, as well as funding for school-based post-16 education, and funding for pre-school education.

In 2009–10, spending per pupil in Scotland was about £7,500 in 2022–23 prices, about £270 or 4% higher than the figure of £7,230 per pupil in England in 2009–10. By 2021–22, we estimate that school spending per pupil in Scotland grew to about £8,800 per pupil, approximately £1,700 or 25% higher than in England. This increasing divergence has been shaped by differing policy choices and trends over time.

Starting with England as a benchmark, spending per pupil fell by 9% between 2009–10 and 2019–20. Following extra funding allocated at recent spending reviews, it has since begun to grow again. As a result, we estimate that spending per pupil in England will return to at least 2010 levels by 2024–25 (Drayton et al., 2022).

[12] In Scotland, councils play a considerable role in shaping school spending levels, budgets and expenditure decisions: they are directly responsible for about one-third of school spending, with about two-thirds devolved to individual schools, albeit subject to oversight from their council (Jerrim and Sibieta, 2021). Scottish councils also have considerable freedom to determine how much funding is allocated to individual schools. This contrasts with England, where over 90% of school spending is devolved to individual schools. The ability of councils in England to determine the distribution of funding to schools in their area is also gradually being reduced, and will be removed altogether when a 'hard' National Funding Formula is introduced.

Figure 4.2. School spending per pupil in Scotland and England, 2022–23 prices



Note: Planned/provisional spending levels are indicated by the dashed line.

Source: Figures for England are taken from figure 5.1 in Drayton et al. (2022). Total school spending for Scotland is based on net revenue spending on schools plus all education-related specific grants from central government (specific grant figures relate to schools in 2009–10 and 2010–11, but also include the relatively small number of non-schools education-specific grants from 2011–12 onwards). These figures were kindly supplied by the Scottish Government on a consistent basis from the underlying data for the Scottish Local Government Financial Statistics, 2009–10 to 2019–20 (https://www.gov.scot/collections/local-government-finance-statistics/). Figures for revenue education spending and specific grants for 2020–21 were taken from Scottish Local Government Financial Statistics, 2020–21 (https://www.gov.scot/collections/local-government-finance-statistics/). Figure for 2021–22 was taken from 'Local government provisional outturn and budget estimates' (https://www2.gov.scot/Topics/Statistics/Browse/Local-Government-Finance/POBEStats). Specific grants for 2021–22 are based on 'Local government finance circular 5/2021: settlement for 2021–2022', (https://www.gov.scot/publications/local-government-finance-circular-5-2021-settlement-for-2021-2022/) together with a assumed cash-terms freeze in other central government grants. Full-time-equivalent pupil numbers are calculated as the sum of pupils in state-funded schools and early education centres (https://www.gov.scot/collections/school-education-statistics/). HM Treasury GDP deflators, January 2023 (https://www.gov.uk/government/collections/gdp-deflators-at-market-prices-and-money-gdp).

In Scotland, spending per pupil fell by 6% in real terms between 2009–10 and 2014–15. This is mostly in line with cuts seen in England. These cuts then began to be unwound in Scotland, with spending per pupil growing by 7% in real terms between 2014–15 and 2018–19. As such, the second half of the 2010s shows the start of a divergence in spending between Scotland and England, where spending per pupil continued to decline.

In 2019–20, there was a large increase of 6% in real terms or an extra £400 per pupil in Scotland. This increase largely reflects the Scottish Government's decision to increase teacher pay scales by 7% from April 2019 (with a further increase of 3% backdated to April 2018). This led to an unusually high level of spending per pupil in 2019–20. The increases in more recent years also reflect the initial ramping up of funding for the expansion of free childcare for children aged 3 and 4 and for disadvantaged children aged 2, who are now entitled to 30 hours free childcare per week during term time (up from 16 hours previously).

This expansion of free childcare was funded by a ring-fenced grant. The latter half of the 2010s also saw a more general expansion of ring-fenced grants for schools, including the Pupil Equity Fund, which, like the Pupil Premium in England, provides extra funding to schools with greater numbers of disadvantaged pupils. The total amount of specific grants provided for schools and pre-schools grew from just under £50 million in 2014–15 (less than 1% of total school spending) to reach over £500 million in 2019–20 (nearly 10% of total school spending).

This further increased to £800 million in 2020–21 with the ramping up of funding for the childcare expansion and, at least, £80m in ring-fenced pandemic-related grants. We estimate that total specific grant then remained at around £800 million for 2021–22.

This increase in ring-fenced funding contributed to a further increase in spending per pupil in 2020–21 and 2021–22, when it amounted to £8,200 and £8,800, respectively, in today's prices. This means that, by 2021–22, spending per pupil in Scotland was about 17% higher in real terms than in 2009–10. This contrasts with England, where – remarkably – spending per pupil was still lower than 2010 levels in real terms. As a result, school spending per pupil aged 3–18 in Scotland was an estimated £1,700 or 25% higher than in England in 2021–22, a much more significant gap than in 2009–10.

It is difficult to project spending per pupil in Scotland for 2022–23. Councils are likely to have budgeted for at least £6.6 billion in total spending in 2022–23. Given high levels of inflation, this would equate to a real-terms cut to spending per pupil. However, the final level of spending on schools in Scotland is likely to be higher once teachers and employers reach an agreement on salary increases for the current financial year. Once this is agreed, extra funding is likely to be provided to pay for this increase and back pay, either within 2022–23 or the next financial year.

Spending on Scotland's other council services

Spending on the other services that councils provide fell in real terms during the 2010s, with most of the fall in the early part of the decade and then in 2016–17. This is illustrated in Figure 4.3, which shows the trends in non-education service spending between 2009–10 and 2020–21. The green line shows an adjusted version of net expenditure, which is the amount that councils pay for from their general purpose and ring-fenced grant funding, provided as part of the local government finance settlement, and their own council tax revenues.[13] The blue line shows an adjusted version of gross expenditure, which also includes spending funded by other grants and contributions to council services by the government and other public sector bodies (adjusted to strip out transfers to and from Social Care Integration Boards in 2019–20 and 2020–21, and grants from the UK government to pay for housing benefit), as well as income from sales, fees and charges (including rents).[14] The latter shows the extent to which income from clients and from other public sector bodies has offset reductions in councils' core grant funding and council tax revenues.

The figure shows that adjusted net expenditure on non-education services was approximately £1.2 billion lower in real terms in 2019–20 than in 2009–10: a fall of approximately 15%. After adjusting for population growth, this is equivalent to a reduction in spending of 18% per person. The reduction in adjusted gross expenditure during the 2010s was rather smaller: 8% in aggregate or 10% per person. This reflects an increased contribution to the cost of delivering council services by grants and other contributions from public sector bodies (such as the NHS) outside of the local government finance settlement; income from clients via sales, fees and charges has also declined in real terms.

This is a somewhat smaller cut than faced by English councils' non-education services, for which net service spending fell by 17% in real terms on an aggregate basis, and by 23% per person, between 2009–10 and 2019–20, after accounting for shifts in responsibility and funding from the NHS to councils. The smaller overall cut to non-education services may reflect the smaller overall cuts faced by the Scottish Government (Phillips, 2014, 2021), and the fact that spending on the NHS was prioritised somewhat less than in England (Farquharson, Phillips and Zaranko, 2021). Offsetting this is the fact that most of the additional funding this has enabled the

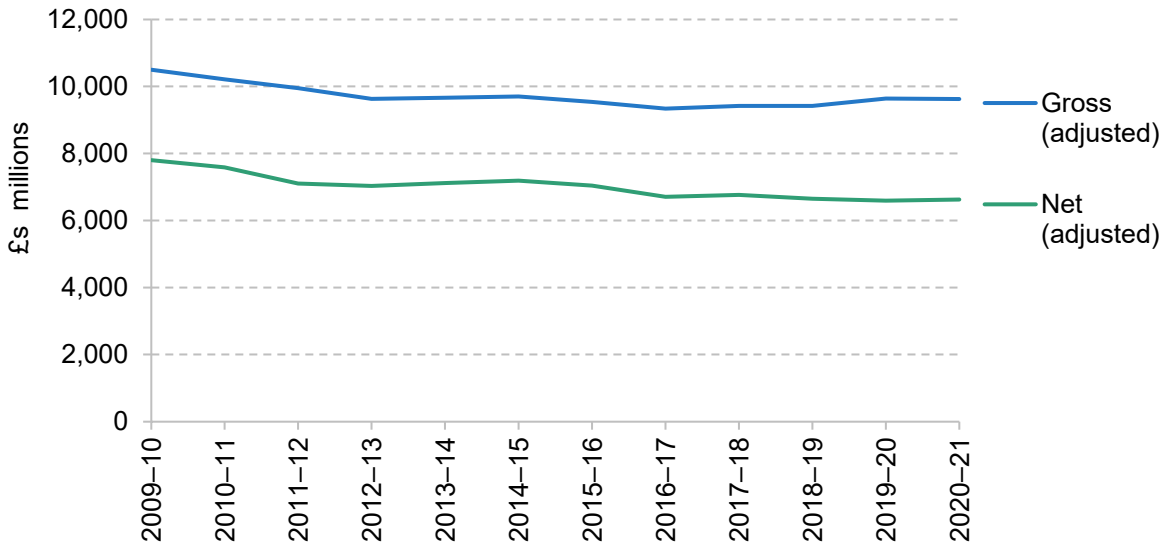
[13] Since 2011–12, ring-fenced grants provided via the local government finance settlement have been netted off Scottish councils' spending in official estimates of net service expenditure. We add this grant funding back in to make figures from before and after 2011–12 consistent and to make Scottish figures more comparable to spending figures in England, where they are not netted off when calculating net service expenditure.

[14] As part of plans to better integrate health and social care services, starting in 2019–20, Integration Boards have routed large sums of funding via Scottish councils. This has led to a big increase in offsetting transfers to and from the Integration Boards, which substantially increase both gross expenditure and other income. We strip both of these out to make figures from 2019–20 onwards consistent with earlier years. We strip out grants to cover spending in housing benefit as this is a demand-led payment to households that for most working-age claimants is being replaced by universal credit (which is paid directly by the UK government's Department for Work and Pensions), making figures incomparable over time.

Scottish Government to provide to councils during the 2010s was targeted at schools and the initial phase of the expansion of free childcare. Slower population growth in Scotland has also meant that their funding has had to be spread over fewer additional people than is the case in England.

The figure also shows remarkably little change in the real-terms value of councils' gross or net spending in 2020–21, despite the COVID-19 pandemic. As highlighted above, while councils were provided with £1.3 billion additional pandemic-related funding in that year, a significant proportion of this was put into reserves rather than spent in-year. This may reflect, in part, the fact that a significant part of this funding was only paid over to councils in March 2021, just prior to the end of the financial year. Councils in England and Wales also saw a smaller-than-expected increase in their spending in 2020–21, and also paid significant sums into reserves in that year (Ogden and Phillips, 2022).

Figure 4.3. Scottish council resource spending on non-education services, 2009–10 to 2020–21 (2022–23 prices)



Note: Gross and net expenditure are adjusted to account for the removal of the district courts and the police and fire services from local government in 2010–11 and 2013–14, respectively. In the latter case, this includes adjusting central services spending for estimates of how much central services spending related to police and fire activities between 2009–10 and 2012–13. In addition, the 2014–15 Scottish Local Government Finance Statistics publication revised net spending on other services down in each of the preceding four years (2010–11 to 2013–14). We apply these revisions to each of these years and revise down reported figures for 2009–10 by the same amount as the Scottish Government revised down 2010–11 figures (£45 million in cash terms). We also apply the same revision to gross as to net spending. The figures have also been adjusted to remove spending by Glasgow city council on settling a large equal-pay claim in 2019–20 to ensure greater consistency over time. Full details for the revisions we apply, including breakdowns by service area, are available on request.

Source: Authors' calculations using Scottish Government (2022b) and earlier versions.

It is also worth noting that councils' net and gross spending did increase in cash terms in 2020–21, by around 7% and 6%, respectively. The increase in gross spending was smaller than for net spending because while transfers from other public sector bodies (such as the NHS) to help cover the costs of council services increased, this was offset by a decline in income from sales, fees and charges from service users – especially for parking, leisure and cultural facilities, and planning and economic development services. The fact that these cash-terms increases did not translate into real-terms increases reflects the high measured inflation according to the GDP deflator in 2020–21. This reflects an estimated increase in the cost of delivering many public services, where expenditure increased but measured output sometimes fell, such as when schools and other facilities were closed.

Figures on net and gross spending are not available for other council services in 2021–22 and 2022–23. However, provisional outturns data for 2021–22 suggest that net spending on non-education services increased by around 3% in real terms compared with 2020–21.

Trends by service

Trends in spending have varied across the different non-education services that councils provide, as shown in Table 4.1: the top panel shows (adjusted) net expenditure and the bottom panel (adjusted) gross expenditure. In particular, in contrast to councils' overall non-education spending, spending on social care services increased during the 2010s (+4% net and +11% gross), with most of this increase taking place in the second half of the decade. The larger increase in adjusted gross spending mostly reflects an increase in contributions to the cost of social care services by the Scottish NHS.

However, spending on central administrative services (−55% net and −39% gross), planning and development (−52% net and −23% gross), housing (−38% net and −27% gross), roads and transport (−29% net and −9% gross), and culture (−29% net and −29% gross) all fell by significantly more than the average cut to councils' spending (−15% net and −8% gross) between 2009–10 and 2019–20. The generally smaller falls in adjusted gross spending than adjusted net spending reflect an increase in contributions to the cost of some of these services from government grants provided outside of the local government finance settlement and from other public and private sector organisations.

The pattern of changes in spending across services reflects councils prioritising those services with particularly significant growth in demand, and where statutory duties limit the ability to cut back service provision, forcing them instead to make cuts to more discretionary areas of expenditure. This is similar to the pattern in England where, after accounting for shifts in responsibility between councils and the NHS, net spending on social care services increased by 7% in real terms between 2009–10 and 2019–20, but net spending on roads and transport,

Table 4.1 Council resource spending by service area, £s millions, 2022–23 prices

Service area	2009–10	2014–15	2019–20	2020–21
(Adjusted) net spending				
Culture and related	865	777	612	606
Social work and social care	3,782	3,830	3,940	3,796
Roads and transport	615	507	435	489
Environmental	855	804	757	756
Planning and development	429	336	208	259
Central services	789	530	354	418
Housing	469	404	289	299
(Adjusted) gross spending				
Culture and related	1,005	891	717	662
Social work and social care	4,745	4,838	5,247	5,387
Roads and transport	895	794	816	702
Environmental	1,029	954	902	884
Planning and development	668	558	513	526
Central services	1,124	794	688	683
Housing	1,034	870	754	782

Note: See notes to Figure 4.3. In addition, reported housing and social care spending figures have been adjusted downwards by £60 million and upwards by £60 million in cash terms, respectively, in 2009–10 and 2014–15 to reflect classification changes that took effect in 2019–20. The 2019–20 Local Government Finance Statistics Publication revised net spending on these services for years back to 2015–16 and we apply the same changes to earlier years' net and gross spending for these services.

Source: Authors' calculations using Scottish Government (2022b) and earlier versions.

housing services, culture and leisure service, and planning and development fell by around 50% in real terms over the same period.

As already mentioned, figures for 2020–21 are affected not only by additional costs associated with the COVID-19 pandemic but also by changes in income from sales, fees and charges, and contributions from the wider Scottish public sector. Increases in contributions from the NHS, for example, may explain the fall in net spending but increase in gross spending on social care services. Falls in parking income may explain the increase in net spending but the fall in gross spending on transport.

Final outturn data are not yet available for 2021–22 but provisional estimates suggest that changes in net spending differed significantly between services. For example, net spending on

social work and social care is estimated to have increased by 8%, which may in part reflect a reduction in transfers from the NHS from their elevated levels in 2020–21. In contrast, net spending on roads and transport is estimated to have fallen by 7%, while net spending on central services is estimated to have fallen by 19%. The former may reflect a rebound in income from parking charges, while the latter may reflect the end of some pandemic-related costs that had been charged to councils' central services budgets in 2020–21.

4.2 Future outlook for council funding

The story so far then is that Scottish councils, and the services they fund, generally saw cuts during the 2010s, albeit ones that were smaller than those in England, especially on a per person basis. This is particularly true for schools, where, after initially falling, funding per pupil aged 3–18 had increased by the end of the decade in Scotland, but had fallen in England. Among the other services they are responsible for, councils in Scotland and England made similar prioritisation decisions, with spending on social care services increasing, and spending on other services decreasing substantially.

The pandemic years saw councils in Scotland and England receive substantial additional funding, a significant part of which they have paid into reserves. School spending per pupil started to increase again in England, but not as much as in Scotland, further widening the gap in spending per pupil.

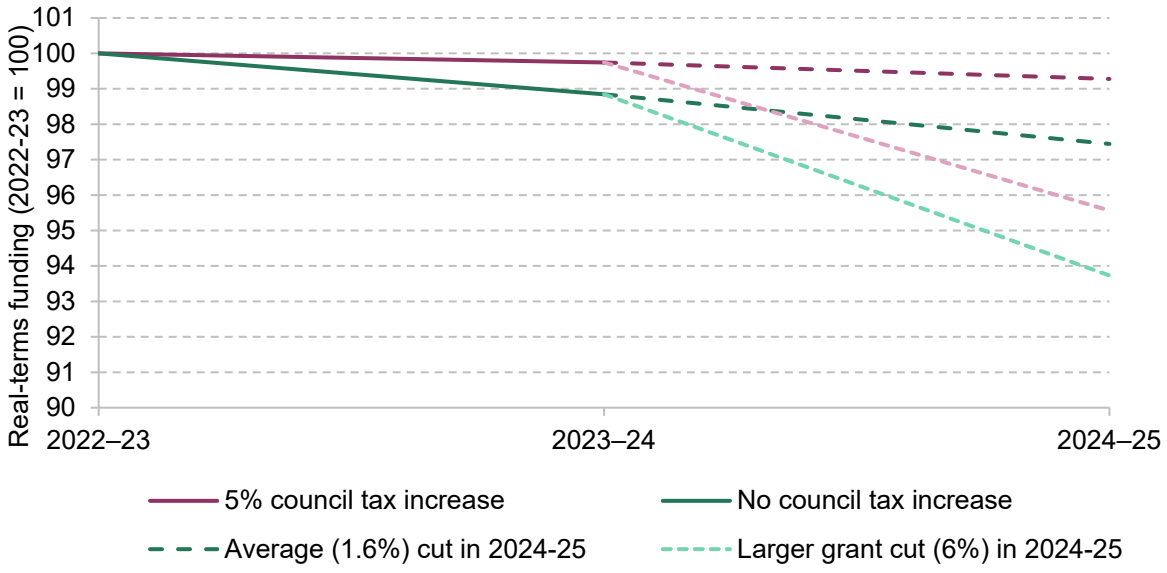
Looking ahead, the picture is different: Scottish councils and schools look set to see smaller increases in funding between 2022–23 and 2024–25 than their English counterparts. This reflects the substantial increase in funding for English councils announced in the Autumn Statement in November 2022, but a much tighter settlement for Scottish councils in the Scottish Budget for 2023–24 and a projected fall in the overall amount of funding available for Scottish Government non-benefit spending in 2024–25 (see Chapter 2).

The Scottish Budget for 2023–24 shows grant funding for councils' resource spending increasing by 0.9% in real terms in the coming financial year compared to this. As highlighted in Chapter 2, Scottish Budget figures ignore a number of in-year top-ups to funding in 2022–23, and do not adjust for changes in responsibilities and 'new burdens'. Using estimates by COSLA and our own judgement about what is and what isn't a genuine new burden (as opposed to changes in funding linked to existing responsibilities), we estimate that after accounting for

these issues, grant funding for Scottish councils is set to *fall* by around 0.8% in real terms based on known allocations for 2022–23 and current plans for 2023–24.[15]

Councils' overall funding will also depend on what happens to their other income sources, the most significant of which is council tax. The Scottish Budget confirmed that no limits would be placed on how much councils can increase their council tax rates. If they implemented a cash-terms freeze, we estimate that combined revenues from grant funding (adjusted for our estimates of in-year funding changes and new burdens) would fall by around 1.1% in real terms in 2023–24.[16] This is illustrated in the dark green line in Figure 4.4. With a 5% cash-terms increase in council tax rates, the cut to overall funding would be 0.3% in real terms, as shown by the dark purple line.

Figure 4.4. Scenarios for Scottish councils' funding from grants and council tax, 2022–23 prices



Source: Authors' calculations using Scottish Government (2022a, d), Scottish Fiscal Commission (2022) and COSLA (2022).

[15] We adjust the 2022–23 funding baselines to account for in-year top-ups to part-fund higher-than-expected pay settlements (+£140 million) and to account for one-off expenditures such as Bridging Payments for families with children (–£188 million). We adjust 2023–24 funding to account for new burdens related to Whole Family Wellbeing Support (–£32 million), Free School Meal expansion (–£17.5 million), the expansion of Free Personal and Nursing Care (–£15 million) and the cost of covering business rates' empty property relief (–£90 million) (the £105 million provided for this is expected to slightly exceed the cost of matching the existing relief). It is not clear from the documentation published alongside the Spring Budget Revision (Scottish Government, 2022e) whether an additional £33 million provided for 2022–23 to cover the cost of the teachers' 2021–22 delayed pay deal was for one-off back-pay costs (which is what we have assumed), or ongoing costs. If this was to cover ongoing costs, the adjusted real-terms cut to grants to Scottish councils would be 1% not 0.8% as reported in the main text.

[16] This assumes that the Scottish council tax base (i.e. the number of properties subject to tax, weighted by the amount of tax they are liable for) will grow by 0.6% a year.

Unlike in a number of previous years when the Scottish Government announced a top-up to its initial plans for council funding at the time of the Stage 1 debate on the Scottish Budget, no such top-ups were announced for 2023–24 in this year's Stage 1 debate (on 2 February). The Scottish Government may announce changes to its plans for local government funding and funding for other services at the time of the Stage 2 debate (on 7 February), although its room for manoeuvre may be limited as it has previously said it planned to draw down its reserves in full in 2022–23, preventing any carry-forwards.

The picture for 2024–25 is less clear, as the Scottish Government has yet to set its Budget for that year and the plans set out in the Resource Spending Review last May are now somewhat out of date, given changes to the outlook for overall Scottish Government funding seen since then. However, as shown in Chapter 2, official projections by the Scottish Government and the Scottish Fiscal Commission (SFC) imply that overall funding for non-benefits spending will fall by 1.6% in real terms in 2024–25. If we assume that grants to Scottish councils are cut in line with this, and councils themselves increase council tax by 5% in that year, then their overall funding would fall by a further 0.5% in real terms, as illustrated in the dashed dark purple line. But it is unlikely that the Scottish Government would cut all spending by the same percentage in 2024–25. If we instead assume that the Scottish Government increases spending on its health and 'net zero' portfolios by the same amount as in the 2023–24 Budget, then grants funding for councils could fall by 6% in real terms. Under this scenario, even with 5% increases in council tax rates, overall funding for Scottish councils would fall by around 4% in real terms in 2024–25. This is illustrated by the dashed light purple line. And without council tax increases, the cuts in 2024–25 would be even starker, as illustrated by the dashed dark and light green lines.

Even the small cut to overall funding that Scottish councils would face in 2024–25 if their grant funding is cut in line with the overall Budget rather than 'unprotected' services and if they were to increase council tax rates by 5% a year would require difficult choices. Costs associated with social care reform and rising demand for social care services, and a planned moratorium on reducing the number of teachers and school hours, mean that the pressure would likely be particularly keenly felt in the one-third of councils' budgets that is allocated to other services. This is in the context of councils' culture, environmental, housing, planning and economic development, and transport services being cut back the most during the 2010s.

In contrast, large increases in grant funding for English councils were announced in the Autumn Statement for both 2023–24 and 2024–25, targeted at social care services. On their own, these would be sufficient to increase English councils' funding for non-education services by around 3% a year in real terms in both of these years, even if council tax rates were frozen in cash terms. If all English councils were to increase their council tax rates by the maximum amount they can, without having to call and win a referendum (generally 5% per year), the real-terms increases would be closer to 6% per year. English schools also saw a top-up to their funding in the

Autumn Statement but one that was less generous than for councils. Combined funding for English councils and schools is therefore set to increase by 4.5% in real terms in 2023–24 and by 3.7% in 2024–25, if all councils make full use of their powers to raise council tax. Even if they were to freeze council tax rates, funding for schools and councils' non-education services would increase by 3% and 2.2% in these two years, respectively.

Box 4.1 Scotland's National Care Service and council funding

One of the ways the UK government has freed up funding for English councils' existing responsibilities has been to postpone planned reforms to adult social care (including a less stringent financial means test and a lifetime cap on personal care costs). This has provided over £3 billion of funding over the next two years to meet rising costs and improve services within the existing means-test and charging rules. However, this means English care recipients will continue to face stringent means-tests for at least two further years, and potentially longer: the funding environment for English councils currently looks likely to be much tougher from 2025–26 (Ogden, 2022).

The Scottish adult social care system is significantly more generous to recipients than the English system – personal care is provided free to all who are assessed to need it (although these assessments are still stringent). The main reform planned in Scotland is for the establishment of a National Care Service covering adults' and children's social care services, with care boards directly accountable to Ministers taking over responsibility for commissioning services from councils. The Scottish Government (2022f) has estimated that set-up costs will amount to between £63 million and £95 million in 2023–24 and between £84 million and £126 million in 2024–25, although the Scottish Parliament Finance and Public Accounts Committee (2022) has expressed concern that the assumptions underlying these figures are opaque and costs could be higher. Once the system is up and running, the Scottish Government estimates that costs will amount to up to £500 million per year – although over half of this reflects planned improvements to pay and conditions, and enhanced training and professional development. Again, the Finance and Public Accounts Committee has expressed concerns that costs could be higher, not least because, unlike councils, Scottish Government bodies cannot generally reclaim VAT paid on their purchases.

The aim of the planned National Care Service is to improve the quality and consistency of social care services across Scotland. However, centralised, directly funded provision may not necessarily lead to more consistent standards of care across the country if the formulas used to allocate funding do not properly reflect differences in needs across the country (Phillips, 2022). Whereas councils can offset these errors by shifting funding between services or varying their council tax, this option will not be available to the new care boards. More generally, the transfer of social care services from councils to the new care boards will require careful consideration of how to unwind the local discretion councils have had to allocate funding between services and raise more or less via council tax.

These issues are potentially addressable, and if they are, a National Care Service could provide more consistent services across Scotland, and potentially allow for further integration with health services. But if these issues are not well addressed, the centralisation of care services could in fact lead to less consistent provision across Scotland, and unfairness between council taxpayers in different council areas. Careful consideration of whether the set-up and operational costs of the new National Care Service represents good-value-for-money is therefore important. If plans were shelved and funding redeployed to local government, it would be sufficient to boost funding by around 0.6%–1% in 2024–25: the equivalent of what could be raised from council tax increases of 3%–5%.

Some caution is needed in comparing English figures directly to those for Scottish councils due to differences in responsibilities and funding arrangements. However, the differences are stark enough that we can be confident that the funding outlook over the next two years is likely to be much tougher for Scottish councils than for English councils. In particular, it looks likely that even with significant increases in council tax, funding for Scottish councils is at best likely to be little changed in real terms over the next two years, given the 2023–24 Budget and current official projections for Scottish Government funding in 2024–25. If the Scottish Government felt the need to continue to boost funding for the health service and its 'net zero' priorities in 2024–25, then councils could be facing substantial cuts that year. In contrast, even without increases in council tax, funding for English councils (including schools) is set to increase in real terms at a reasonable rate over the next two years.

The next two years are therefore set to see a bit of a reversal in fortunes for Scottish and English councils. The reserves that Scottish councils built up during the COVID-19 pandemic may therefore need to be put to use quickly – although once used, they cannot be used again.

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5. Analysis of Scottish tax and benefit reforms

Tom Waters and Tom Wernham

In recent years, powers to change the tax and benefit system have been devolved to the Scottish Government. These powers have been used to make the system overall more progressive, with more generous benefits boosting the incomes of poorer households, and higher taxes reducing the incomes of richer households.

With regards to income tax, the Scottish Government has the ability to set income tax rates and bands on income other than from dividend or interest payments, with the exception of the personal allowance. It has used these powers to introduce a new system with more bands and different rates compared with that used in the rest of Great Britain (rGB, i.e. England and Wales),[17] with the consequence that lower earners pay a little less in tax, whilst higher earners pay quite a bit more. All income tax liabilities were increased by the measures announced in the Scottish Budget published in December 2022.

Changes to benefits include the introduction of several new benefits, including the Scottish child payment (which was increased to £25 per week from November 2022, and expanded to cover low-income families with children under 16), and the Best Start grants (providing support for low-income families with babies and young children). Other UK-wide benefits policies are adjusted, for example by topping up carer's allowance and undoing the effects of the benefits cap and under-occupancy charge ('bedroom tax'). Overall these changes will deliver a big increase to the incomes of, in particular, low-income families with children. A new system of disability benefits is also being brought in, which will see claims assessed and managed differently, though the rates will be the same.

In this chapter, we first analyse the impact of changes to devolved income tax rates and bands and benefits, taking effect between April 2022 and April 2023, on Scottish households' take-home incomes, both on average and across the income distribution. We then show the total impact of the changes to income tax and the benefits system since powers were devolved to

[17] The comparison system we focus on here is rGB, rather than the entirety of the rest of the UK, because there are some minor differences in benefit policy in Northern Ireland.

Scotland. Finally, we focus on disability benefits, which are set to become an area of increasing divergence between Scotland and rGB, and which have seen a recent sharp uptick in applicants across the UK.

Key findings

1. Scottish child payments were increased and extended to more families in November 2022. In addition, the Scottish Budget announced an increase in the top two rates of income tax, and freezes or reductions to income tax thresholds, from April 2023. The combined effect of these reforms is to reduce the average net income of Scottish households by £110 per year, or 0.3%.

2. The effects of these reforms differ significantly across the income distribution. Households towards the top of the distribution will be net losers as a result of the income tax changes, which will cost the richest tenth of Scottish households almost £1,400 per year on average (1.2% of their income). In contrast, poorer households have gained from the increase and big expansion of the Scottish child payment. The poorest tenth of Scottish households will gain the equivalent of almost £260 per year, or 2% of their incomes, on average, from the combined effect of the benefits and income tax changes. Households with children in approximately the bottom third of the income distribution will gain, on average, around £1,200 per year – around 4%–5% of their incomes.

3. These reforms continue a trend of the Scottish Government using its devolved income tax and benefit powers to increase the progressivity of the tax and benefit system. Taken together, reforms to Scotland's income tax rates and bands and devolved benefits will have reduced the average income of Scottish households by £210 (or 0.5%) per year by 2023–24, compared to what their incomes would be in England and Wales. However, the poorest tenth of households will, on average, have benefited to the tune of £580 (4.6%) per year as a result of higher benefit entitlements, whilst the richest tenth will be £2,590 (2.1%) worse off as a result of higher income tax payments.

4. There has been a sharp increase in the number of people successfully claiming disability benefits over the last 18 months, in both Scotland and the rest of Great Britain: the number of people starting disability benefits was 90% above its 2016–20 average in October 2022 in Scotland, and 96% higher in England and Wales. This does not appear to be due to eligibility tests becoming less stringent as there has been a similar increase in the number of people applying and being found ineligible.

5. The Scottish Government has begun to roll out a new devolved disability benefit, adult disability payment, to replace the UK's pre-existing personal independence payment. The expectation is that changes to the assessment and re-appraisal process will result in more people being found eligible for support. If this occurs, this will boost the incomes of a group that tend to have low living standards (half of the most materially deprived individuals living in Scotland report being disabled). However, especially in the context of an uptick in claims, this will put further pressure on Scotland's benefits budget.

5.1 Tax and benefit reforms since April 2022

This section looks at the effect of recent tax and benefit reforms by the Scottish Government on Scottish households' incomes. Specifically, the changes we model are:[18]

- freezing the basic, intermediate and higher rate income tax thresholds, at £14,733, £25,689 and £43,663, respectively;
- cutting the additional rate threshold to £125,140;
- increasing the higher and additional rates of income tax by 1p to 42% and 47%, respectively;
- increasing the Scottish child payment to £25 per week, and expanding eligibility from children aged up to 5 to those aged up to 16.

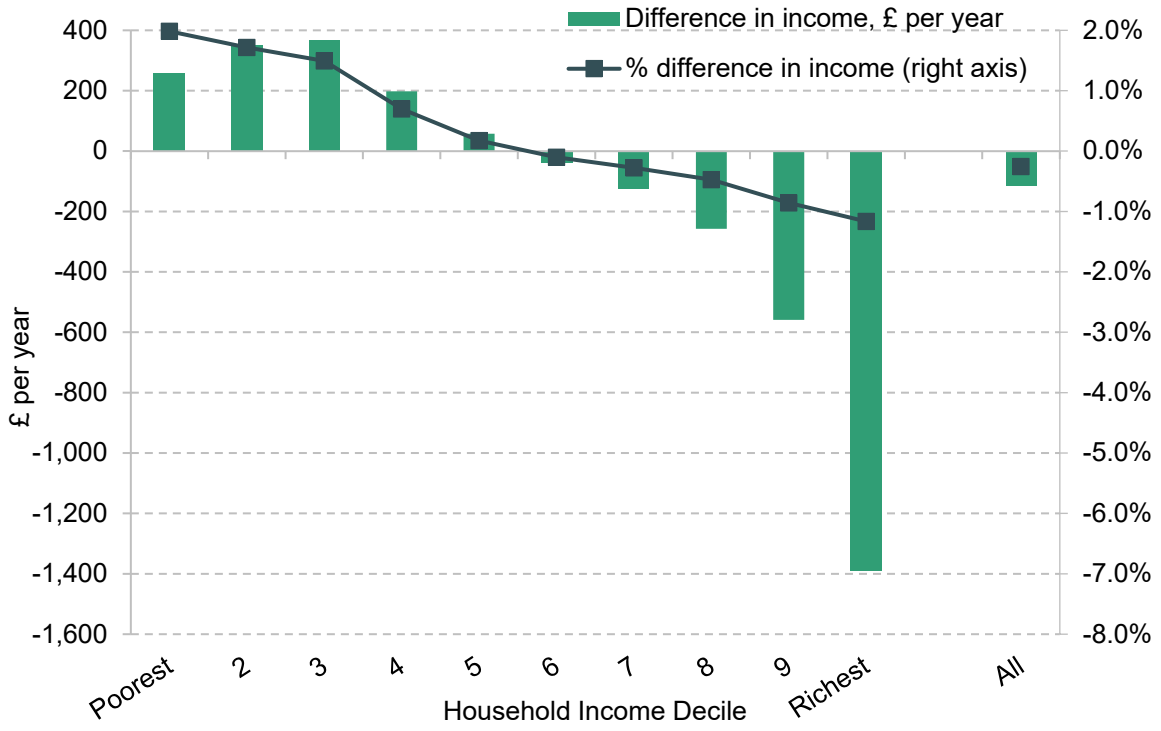
The combined impact of these measures is to reduce Scottish households' incomes by an average of £110 per year, or 0.3%, as shown in Figure 5.1. But the effects differ markedly across the income distribution: the reforms reduce the incomes of the richest 10% of households by 1.2% (almost £1,400), and increase the income of the poorest 10% by 2% (£260 per year).

The freeze to the higher rate threshold of income tax is driving most of the additional revenue for the Scottish Government (and therefore income losses for Scottish households). This will raise around £390 million (Scottish Government, 2022a). By comparison, the 1p increases in the higher and additional rates generate additional revenue of £95 million, whilst the additional rate threshold reduction will raise a further £8 million (Scottish Fiscal Commission, 2022b).[19]

[18] Scottish tax policies that are not modelled include changes to land and buildings transaction tax (LBTT) and business rates, which will not directly reduce household incomes but which will indirectly reduce them.

[19] These estimates account for behavioural responses. In the absence of behavioural changes, the policies would raise £160 million and £33 million, respectively.

Figure 5.1. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022



Note: Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migration out of Scotland).

Source: Authors' calculations using the Family Resources Survey (FRS) 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

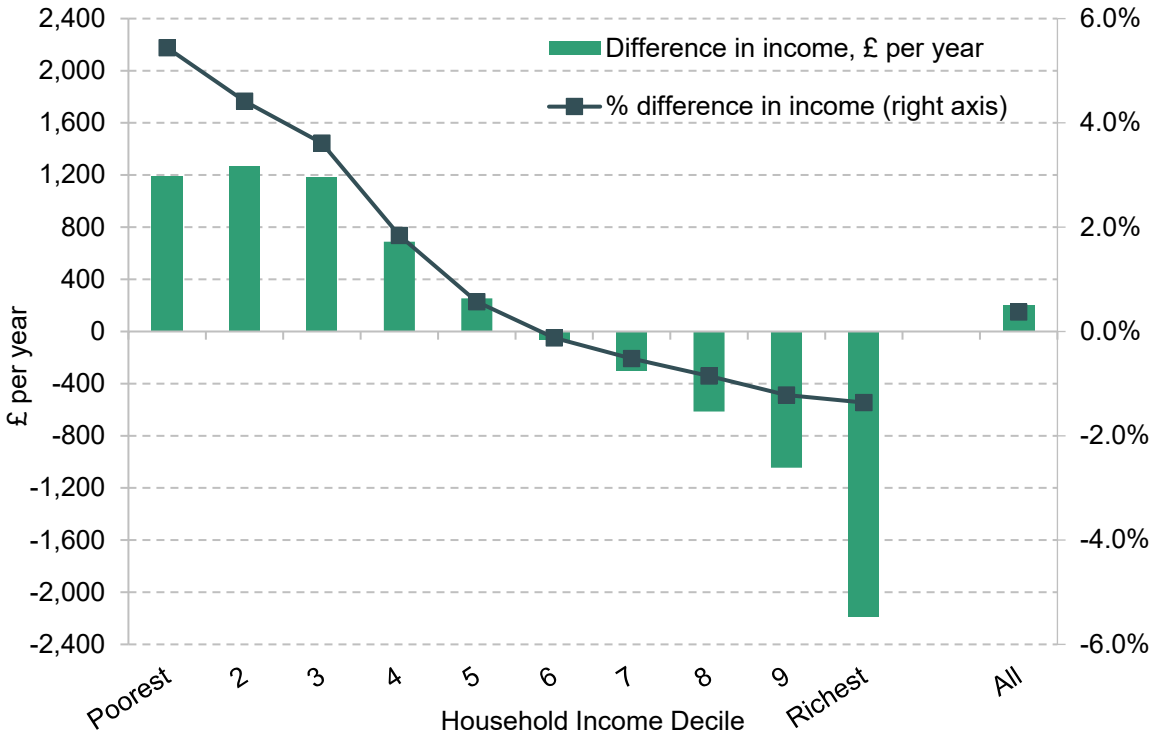
The freeze to the income tax personal allowance by the UK government is also significantly increasing the income tax paid by Scottish households, and will affect lower earners as well as higher earners. Scottish households will lose £330 per year on average as a result of this freeze, whilst over £800 million of revenue will be raised for the UK government.[20] Figure 5.1 does not include this impact, as our focus here is on the Scottish Government rather than UK government policy, and the Scottish Government does not control the personal allowance. The figure shows the impact of reforms that are the result of Scottish Government policy (whether or not this policy is the same as the UK government's) coming into effect in the period after April 2022 and up to and including April 2023.

[20] Strictly speaking, the freeze in the personal allowance will increase the income tax revenues raised in Scotland, but because it will also raise revenues by a similar proportionate amount in rGB, this will be offset by a larger adjustment to the Scottish Government's block grant funding to account for tax devolution (the 'block grant adjustment'). This means that the revenues will flow to the UK government.

The big expansion of eligibility for the Scottish child payment in November 2022 is estimated to have quadrupled the number of eligible children to around 400,000 (Scottish Government, 2022b). The increase in the payment amount from £20 to £25 a week is sufficient – on average – to offset the increase in tax for those in the bottom half of the income distribution. The payment is targeted at poorer families as eligibility is dependent upon receiving a means-tested benefit.

Naturally, the Scottish child payment reforms only affect households with children. Figure 5.2 highlights this point by repeating the exercise of Figure 5.1 but for households with children only. This shows even bigger increase among lower-income households: the poorest 30% see, on average, an increase in income of £1,200 a year. Indeed, following these reforms, the Scottish child payments will boost some households' incomes very substantially. For example, a non-working lone parent with two children aged 3 and 5 would see their income after housing costs increased by 19% as a result of the payments. In contrast, poorer households without children

Figure 5.2. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022: households with children



Note: Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland). Household income deciles are defined with respect to the whole population.

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

see virtually no change in their incomes as a result of recent policy changes (see Figure A.1 in the Appendix) – they neither gain from the expansion of child payments nor lose much from Scottish Government income tax reforms (as their incomes are too low to be affected).

5.2 Comparison with England and Wales

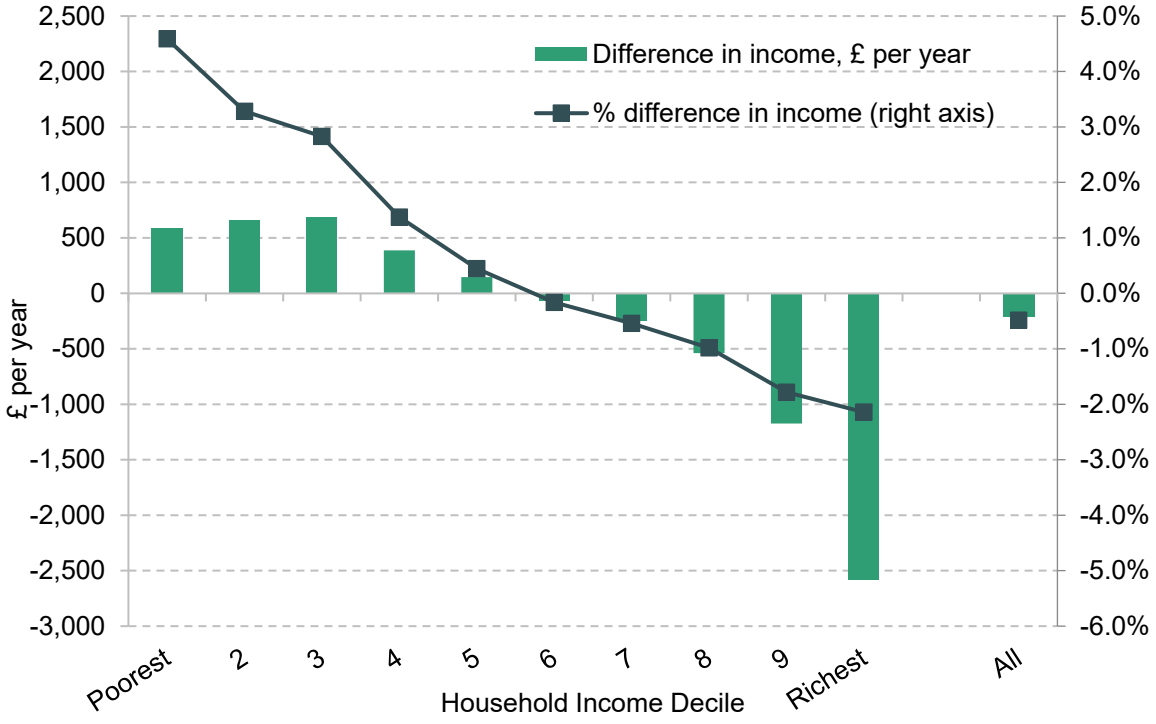
Whilst some of the changes announced in December's budget are in line with UK government policy – both governments have frozen the higher rate threshold and reduced the additional rate threshold – the other policies announced represent a further divergence between the tax and benefit system in Scotland and that in rGB. Figure 5.3 illustrates the total effect on Scottish households' incomes of the differences in income tax and benefits policy in Scotland compared with policy in rGB. The benefit changes include not only the Scottish child payment, but also Best Start payments (which support low-income families with babies and very young children), the supplement for the carer's allowance, and mitigation of the under-occupancy charge ('bedroom tax') and the benefit cap, which affects around 4,000 households (Department for Work and Pensions, 2022). The figure shows that, overall, average household incomes in 2023–24 will be slightly reduced by Scottish income tax and benefits policy measures: by £215 or 0.5%.

But again, there is significant variation across the household income distribution. Poorer households benefit from new benefits and top-ups, as well as slightly lower rates of income tax for low-earning taxpayers. The poorest 10% will be £580 per year better off as a result of the Scottish policies we model, or 4.6% of what their incomes would be under UK government policy. Overall, the Scottish Fiscal Commission (SFC) estimates the cost of these policies to be £596 million (Scottish Fiscal Commission, 2022b).

Again, it is almost entirely benefits for families with children that explain the additional income for the poorest households. This is illustrated by Figures A.2 and A.3 in the Appendix, which show the differences for households with and without children, respectively. Amongst the poorest 30% of households, those with children will see their incomes boosted by around a sizeable £2,000 a year on average, driven by higher benefits for families with children.

In contrast to poorer households, the fact that earnings above £28,000 are taxed more heavily in Scotland means that those further up the income distribution generally have lower incomes as a result of Scottish policy. For example, someone on £50,000 will pay £1,550 more tax in Scotland than rGB, and someone on £150,000 will pay £3,900 more, in the coming tax year. The richest tenth will be £2,590 per year worse off under the Scottish income tax and benefit system (2.1%) on average in 2023–24. In total, the SFC estimates that, before accounting for behavioural response, Scottish income tax policy will raise £1 billion in the coming financial year (Scottish Fiscal Commission, 2022b).

Figure 5.3. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

5.3 Disability benefit claims and reforms

Working-age adults with disabilities are supported by two types of payment. Incapacity benefits (either employment and support allowance or an additional element in universal credit) are paid to those who are deemed unable to work because of their condition. Disability benefits – our focus here – aim to support those who have higher living costs due to their disability, and eligibility is not contingent on being unable to undertake paid work and the payments are not means-tested. The main disability payment in the rGB (and Northern Ireland) is the personal independence payment (PIP). Entitlements range from £1,271 to £8,159 per year depending on the severity of the condition. 8.4% of working-age adults in Scotland receive PIP (or its predecessor, disability living allowance).

Scotland has recently begun replacing PIP with the adult disability payment (ADP). ADP has the same rates as PIP, but the assessment process will differ. There will be fewer face-to-face

assessments and, perhaps because of this, the ADP form that applicants must fill out is more detailed than the PIP form. Reassessments that do take place will be carried out by Social Security Scotland rather than private contractors. Whereas most PIP awards have a specified length, at the end of which claimants must reapply for PIP or see their payments end, ADP awards are all indefinite – though, like PIP, usually ADP claimants do still have to go for occasional reassessments to check that they are still eligible. The Scottish Government has promised to tailor the time to these reassessments more to individual circumstances. Those who are deemed to be unlikely to see significant changes in their condition will be reassessed no more than once every five years.[21] The Scottish Government is also replacing the disability benefit for children, though here we focus on the adult payments.

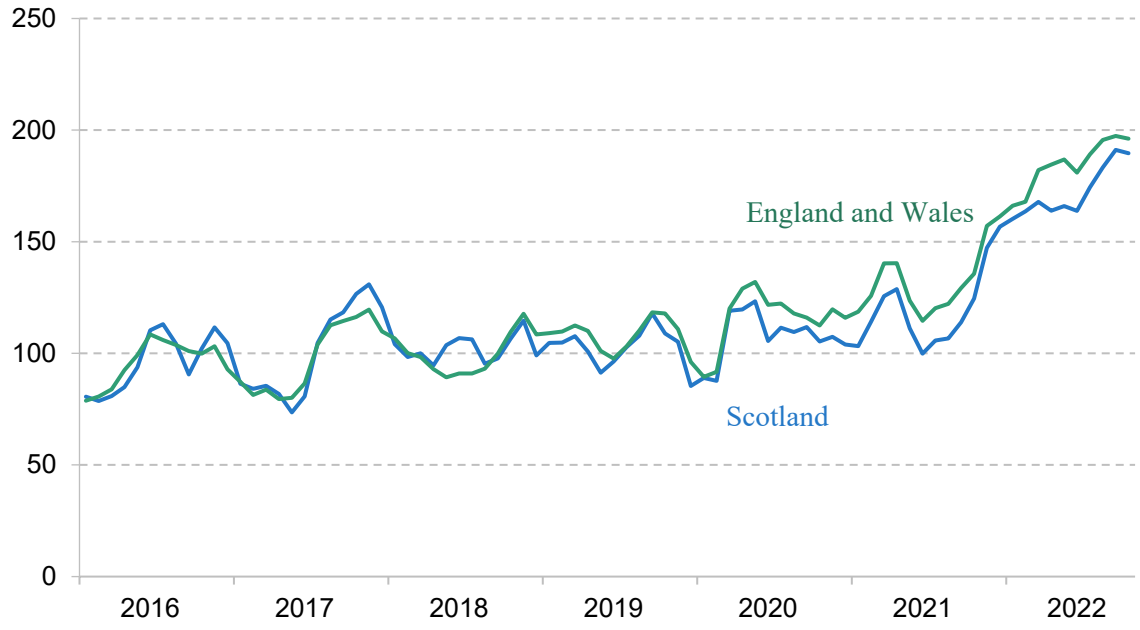
Importantly, these changes are forecast to lead to more people successfully claiming, and spending longer on the benefit. As a result, the SFC expects that, by 2027–28, ADP will cost £650 million per year more than PIP (Scottish Fiscal Commission, 2022b), a 19% increase and equivalent to £260 per year per Scottish household.

A key piece of background here is that across Great Britain we have recently seen a sharp rise in the number of people being awarded disability benefits. Figure 5.4 shows an index of the number of new PIP or ADP awards in Scotland, and in England and Wales. In the several years up to the pandemic, there was little change in monthly claims. 2020 and the first half of 2021 saw a noticeable rise, especially in England and Wales, but this was then eclipsed by a much bigger increase (for England and Wales, and Scotland alike) from the middle of 2021 to the end of 2022. In the latest few months of data (up to October 2022), the number of people flowing on to disability benefits each month was a little under double its pre-pandemic average (90% higher in Scotland and 96% higher in England and Wales). Because this sharp rise almost entirely pre-dates ADP (which only began to be rolled out in a small way in March 2022), and because it is mirrored in England and Wales, ADP is not the driving factor.

Precisely what is behind this increase is unclear (see Joyce, Ray-Chaudhuri and Waters, 2022). It does not appear to be that the system has become more lenient, as the number of applications has seen a similarly meteoric rise, leaving the share of applicants who are successful broadly unchanged. If this is a permanent change in trajectory, it implies significantly more disability spending going forward – and indeed both the SFC and the UK's Office for Budget Responsibility have significantly upped their forecast for disability benefit expenditure accordingly.

[21] See Adam and Phillips (2021) for a more detailed discussion of this reform.

Figure 5.4. Monthly new PIP or ADP awards (three-month rolling average; index, January 2016 to February 2020 = 100)



Note: Up to October 2022. Includes new awards from mandatory reassessments or appeals. Does not include Disability Living Allowance reassessments.

Source: Authors' calculations using Stat-Xplore, Department for Work and Pensions.

The implications for the Scottish Budget are complicated by the operation of the Fiscal Framework. Each year, this updates the amount provided to the Scottish Government to pay for devolved benefits (the block grant adjustment) by the increase in spending on equivalent benefits in England and Wales. If spending per person increases more quickly in percentage terms in Scotland, money from elsewhere in the Scottish Government's Budget needs to be found to top up this funding; conversely, if spending per person increases less quickly in percentage terms in Scotland, some of the money provided for devolved benefit spending can be used for other things instead.

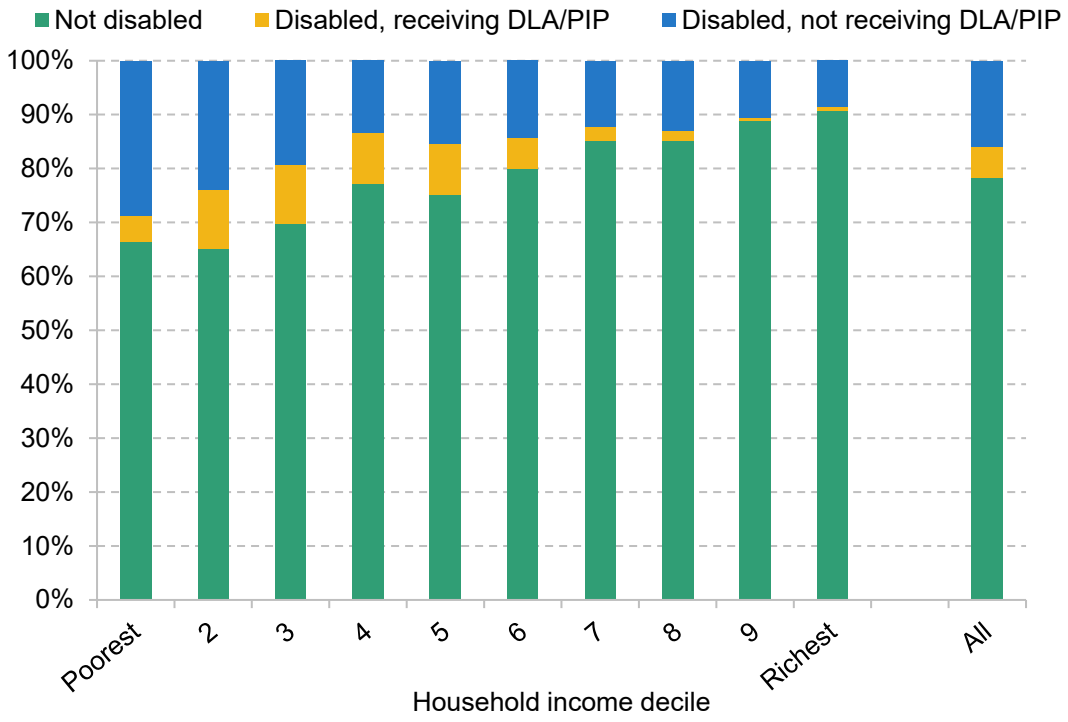
As discussed above, the Scottish Government is changing the assessment and re-appraisal processes for its disability benefits in ways that are expected to increase the fraction of people deemed eligible for support, and to increase the length of time they receive support. If more people are applying for support, then the cost of this more lenient system is likely to be greater. Unless offset by some other factor, this would further push up the rate of growth of disability benefit spending in Scotland relative to England and Wales, putting the Scottish Government's benefits budget under further pressure. The SFC revised up its forecasts of the cost of ADP relative to the forecasts for the block grant adjustment funding the Scottish Government will receive in its December forecast. But there is significant uncertainty about just how much more these costs will be, given the uncertainty about both how the number of people applying for

disability benefits will evolve, and how the fraction deemed eligible (and the average time they are deemed eligible for) will change in Scotland compared with England and Wales.

But given that it looks like more people are going to end up on disability benefits in Scotland – both because of the rise in applications, and because ADP is expected to lead to more of these applications being successful – it is worth briefly reviewing who receives these benefits. Figure 5.5 shows where disabled people in Scotland are in the household income distribution (where disability is defined as having a long-term health condition that affects their ability to carry out day-to-day activities). We split those who are disabled into those who do and do not receive a disability benefit.

The figure shows that disabled people are more likely to be located in the bottom half of the income distribution. This is particularly true for those on disability benefits, although those who are disabled but *not* in receipt of disability benefits are more likely to be at the very bottom of the income distribution.

Figure 5.5. Disability status, by household disposable income decile, 2017–18 to 2019–20

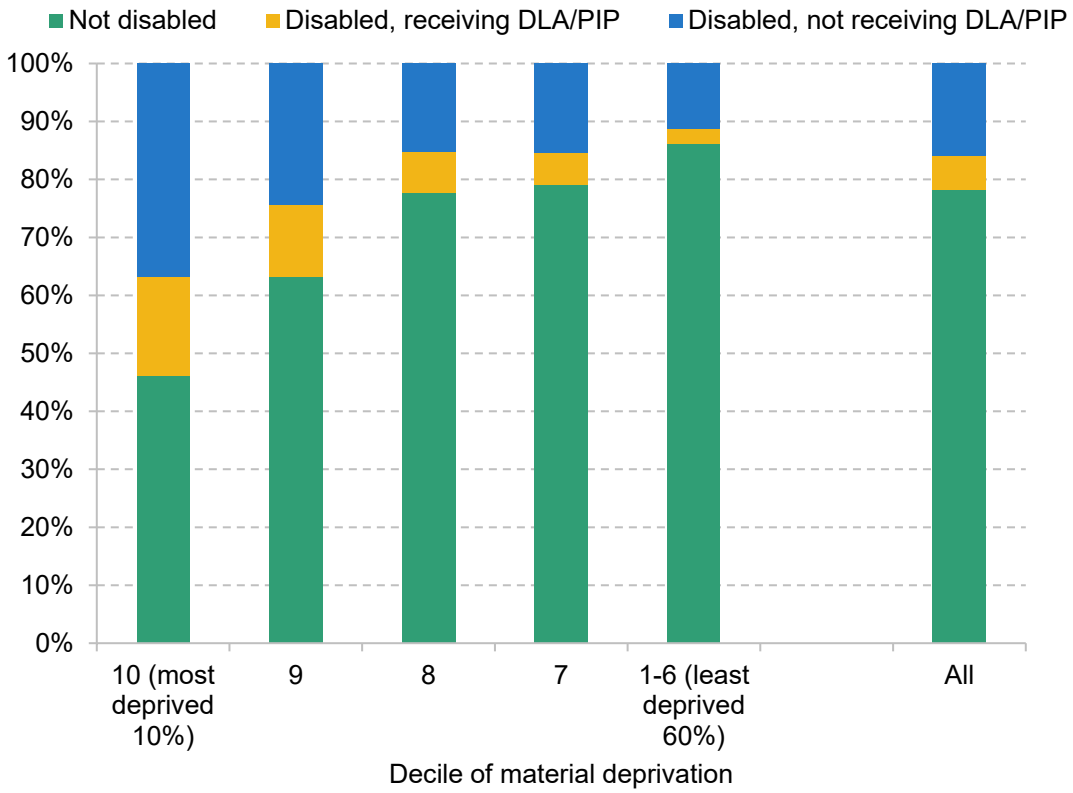


Note: The sample is adults in Scotland below state pension age. We use reported receipt of DLA/PIP in the survey. Because some people receive DLA/PIP but do not report it in the survey, the fraction labelled as receiving DLA/PIP is slightly lower than the actual share of adults who receive it.

Source: Authors' calculations using the FRS 2017–19.

However, even this is likely to overstate the living standards of those in receipt of disability benefits. Many disabled people face higher living costs because of their disability – and in fact this is the key justification for PIP and ADP in the first place[22] – but this is not captured when we simply compare differences in household income. Put simply, receipt of a disability benefit will push a household up the income distribution whereas the rationale for the payment is to compensate for costs that non-disabled households do not face. An alternative way to measure living standards that avoids this problem is to examine the material deprivation faced by different households. Material deprivation scores are based on whether a household reports being unable to afford some basic items, such as the ability to keep the house warm, to replace worn out furniture, and to go on holiday once a year. Figure 5.6 shows where disabled individuals are located in the material deprivation distribution. Here we see even more clearly

Figure 5.6. Disability status, by decile of material deprivation, 2017–18 to 2019–20



Note: The sample is adults in Scotland below state pension age. We use reported receipt of DLA/PIP in the survey. Because some people receive DLA/PIP but do not report it in the survey, the fraction labelled as receiving DLA/PIP is slightly lower than the actual share of adults who receive it.

Source: Authors' calculations using the FRS 2017–19.

[22] These benefits are designed to reflect the extra costs associated with being disabled rather than to make up for lost income (which is the role of universal credit and its predecessor benefits).

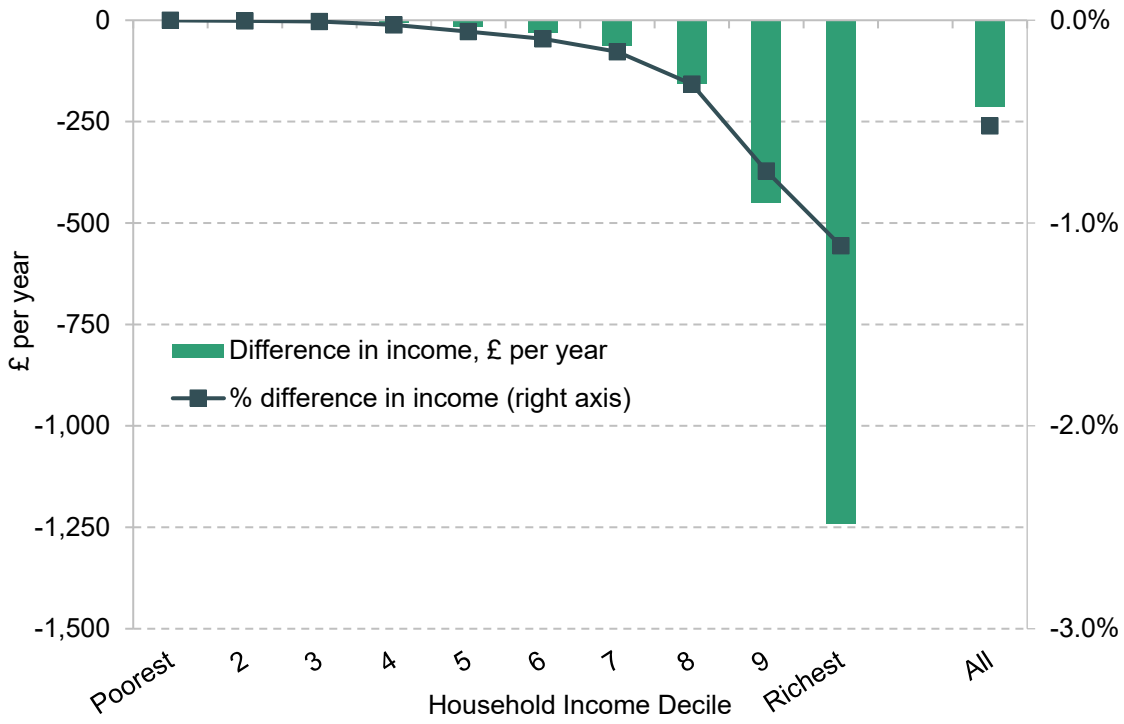
that disabled people are likely to have lower living standards than the wider population. More than half of the most deprived tenth of the population are disabled, though even most of this group do not receive disability benefits.

Together, this suggests that an increased leniency in disability benefits (if that is indeed what ADP ends up delivering) will be broadly targeted at households with low living standards. This means that the gap in progressivity between Scotland, and England and Wales is likely to eventually be even larger than we show in Figure 5.3, which does not incorporate the ADP reforms (which are only just rolling out).

However, the reduced stringency of Scotland's disability benefits is coming at the same time as what seems to be a worsening in the health of the Scottish and wider UK population. Together, these factors are likely to put significant increased upward pressure on Scotland's disability benefit spending.

Appendix

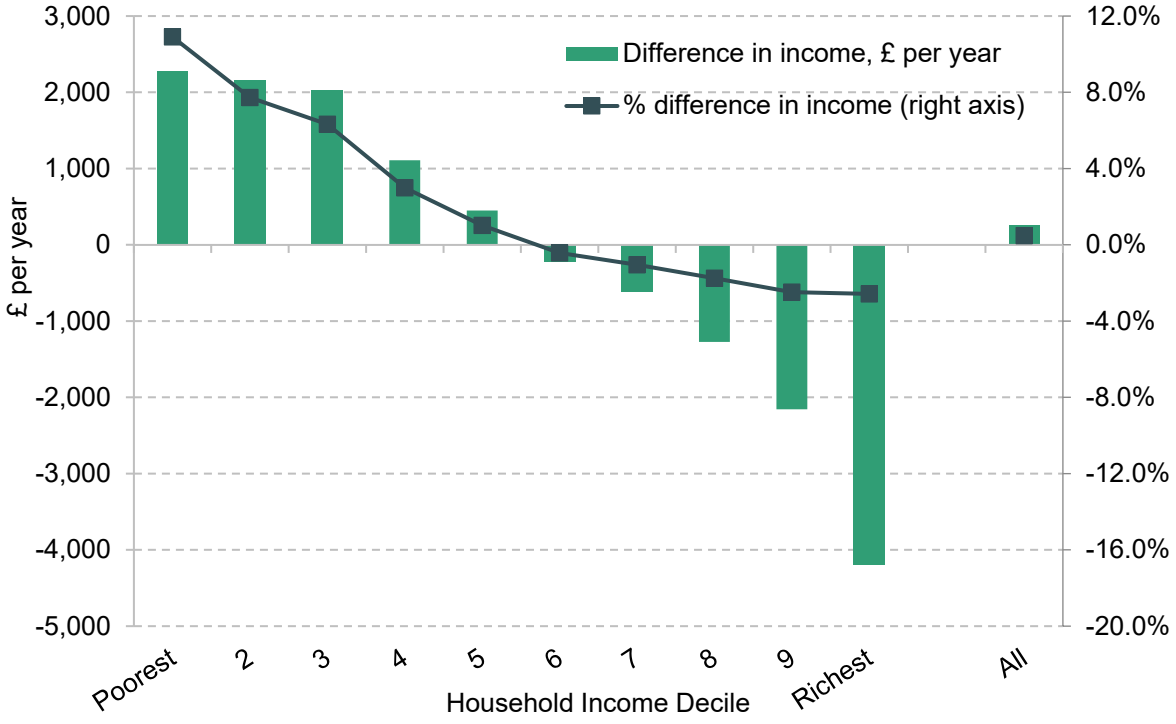
Figure A.1. Household disposable income under the April 2023 Scottish tax and benefit system, compared with April 2022: households without children



Note: Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland). Household income deciles are defined with respect to the whole population.

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

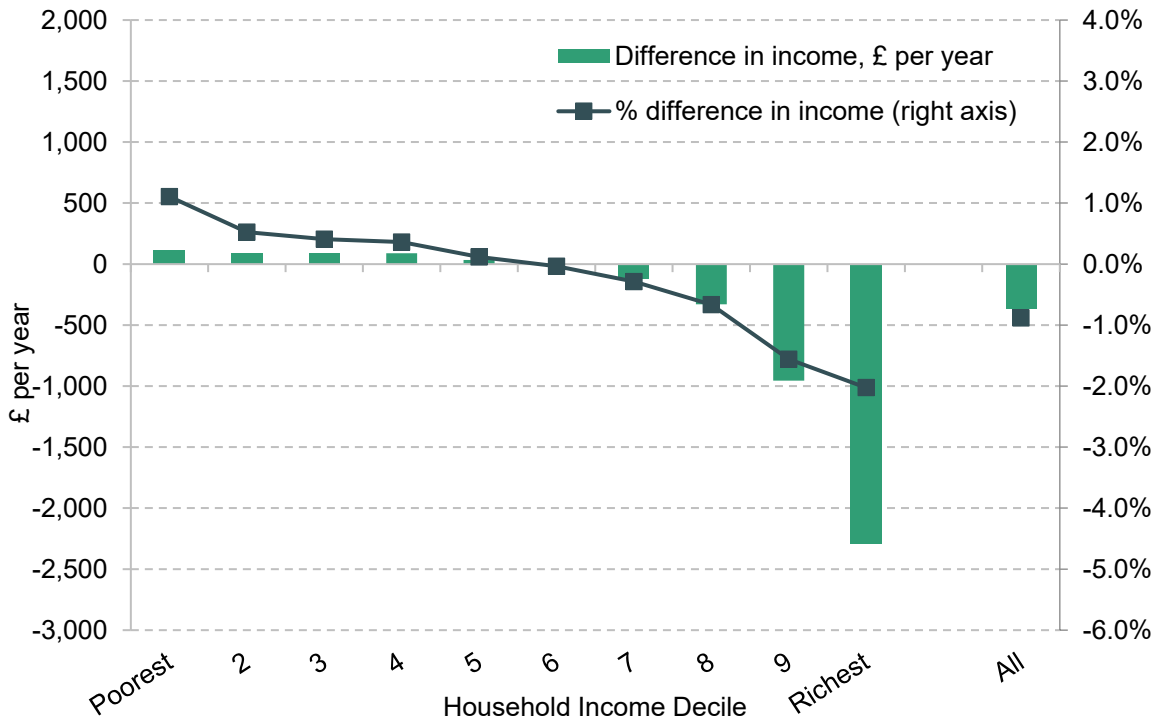
Figure A.2. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023: households with children



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

Figure A.3. Household disposable income under the Scottish tax and benefit system, compared with the system in England and Wales, April 2023: households without children



Note: Scottish policies modelled include the Scottish income tax system, Scottish child payment and Best Start payments, the carer's allowance supplement, and mitigation of the under-occupancy charge and benefit cap. Differences between the Scottish and rGB council tax systems are not modelled. Income changes shown are before any behavioural response from households. This is especially important for the increase in the additional rate of income tax, which the SFC expects to generate significant behavioural response (e.g. reducing income or migrating out of Scotland).

Source: Authors' calculations using the FRS 2017–19 and TAXBEN, the IFS tax and benefit microsimulation model.

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6. Conclusions

This report has looked at a number of key fiscal issues for the Scottish Government for the 2023–24 financial year and beyond.

The funding available for non-benefit spending is set to fall over the next two years and then only grow modestly; indeed, official projections imply that it will be lower in 2027–28 in real terms than in the current financial year, even given a forecast substantial improvement in income tax revenue performance relative to rUK. While revenues could perform even better than expected, the fact that some of the forecast improvement may reflect differences in judgement about the overall economic outlook (rather than any Scotland-specific factors) between the SFC and OBR represents an important downside risk to Scottish revenue forecasts and therefore the Scottish Government's overall budgetary position. Given the role that differences in the economic judgements of the SFC and OBR can play in determining the forecast net tax revenue positions used when setting Scottish budgets – in turn, affecting subsequent reconciliation payments when outturns revenue data become available – the two forecasting bodies should be clearer about how and why their judgements differ.

One of the factors underlying the challenging funding outlook is the operation of the Barnett formula. Both over the next five years and in the longer term, it is set to deliver smaller percentage increases in funding per person for the services the Scottish Government is responsible for than is provided for comparable services in England. While funding will remain substantially above English levels, it will make it increasingly difficult for the Scottish Government to maintain the higher levels of service provision that its historic relatively generous levels of funding (close to 30% more per person than in England in 2019–20, for example) have enabled.

Our analysis has also shown how the Scottish Government has used its powers to make different tax and spending decisions compared with the UK government. For example, during the 2010s, the Scottish Government cut local government funding by substantially less than the UK government did in England, with schools and early-year childcare provision being the main beneficiaries of this. Looking ahead though, funding for Scottish councils and schools looks set to be squeezed, while funding in England is set to be boosted.

Even more notable are changes made to income tax and benefits policy, where the Scottish Government has forged a notably higher-tax and more redistributive policy. The introduction of a 21% intermediate rate, a lower higher-rate threshold, and higher and additional rates of 42%

and 47% (versus 40% and 45% in rUK) mean Scottish households in the top half of the income distribution lose from these changes, on average. Households in the top 10% of the income distribution, for example, are around £2,600 per year worse off relative to the income tax and benefit system in place in England and Wales. In contrast, poorer households with children are substantially better off than they would be under the system elsewhere in the UK: over £2,000 per year, on average, for those in the bottom 30% of the income distribution. These are big differences.

As well as affecting incomes, such changes in tax and benefits policy will also affect incentives: to work in Scotland and to engage in tax avoidance and evasion. At the lower end of the income distribution, the unfortunate 'cliff edge' in the design of the Scottish Child Payment will disincentivise some from taking on extra hours or a pay rise, especially if they have several children. It could also encourage families of relatively modest means with children to stay in, or perhaps to move to, Scotland. At the top of the income distribution, higher taxes could further encourage a trend towards people setting up limited companies so that they can take their income in the form of dividends – which are taxed at the UK government's lower rates of tax. It could also reduce inflows and/or increase outflows of people with very high earnings. Indeed, the SFC assumes that around 90% of the mechanical revenue effect of raising the top rate of income tax is offset by such behavioural effects; that is, the 47p top rate will raise £3 million a year, rather than the £32–40 million it would raise if behaviour did not change. This suggests that the Scottish Government should consider other taxes – such as further reform of the outdated and still-regressive council tax – if it wants to raise more revenue from better-off Scots for redistribution or to fund public service spending.

Given that the starting point for this report is the Scottish Government's Budget for 2023–24, our analysis has considered the funding outlook, and policy options, under current constitutional and funding arrangements. However, it is hard to avoid the constitutional debate in Scotland – with proponents and opponents of independence making bold claims off the back of our analysis of the funding outlook and policy choices and constraints.

In earlier work, we have considered the scope for reforms to the Scottish Government's funding arrangements within the UK (Bell, Eiser and Phillips, 2021). There is a strong case for modest increases in the Scottish Government's powers to borrow and hold reserves, although more fundamental changes to funding arrangements would require careful consideration of the role of the Union as a mechanism for coordination, insurance and redistribution, and fairness to England (which does not have its own devolved government).

We have also analysed the fiscal situation that an independent Scotland could expect to begin its life in – most recently in Phillips (2022). While there is significant uncertainty about the long-term economic and fiscal impacts of Scottish independence – and hence room for debate

between 'Yes' and 'No' groups – the short-term picture is reasonably clear: unless oil and gas output significantly rebounds and/or prices return to extremely high levels similar to those seen in the second half of 2022, an independent Scotland would face a bigger budget deficit than the UK as a whole. Independence, while providing more flexibility over policy design and priorities, would therefore likely increase rather than reduce the need for tax rises or spending cuts at least in the short and medium term, especially in a context of higher interest rates on government borrowing.

Irrespective of what happens to the constitutional status of Scotland in future, the next couple of years will see the Scottish Government having to make some very difficult decisions over which areas of spending to prioritise and which to cut back. Budgets for the coming year, 2023–24, are less generous than they would appear from reading budget documentation, with the costs of public-sector pay deals a notable risk. And updated plans for 2024–25 will see significant cuts to many services outside the health service, especially if the Scottish Government is to meet its pledge to fully pass on funding received as a result of increases in English NHS spending to the Scottish NHS. In this context, the Scottish Government should carefully assess each area of spending, including new areas of spending such as the planned National Care Service, to see if they represent the best use of limited funding. It also needs to be honest to the Scottish people about the scale of the challenges it faces – and the factors underlying them, some of which relate to UK government decisions, but some of which are homegrown (including past poor income tax revenue performance, and decisions to prioritise a more generous social security benefit system).

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