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Research Report

The medium-term outlook and choices

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IFS Report R296

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The medium-term outlook and choices

3. The medium-term outlook and choices

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This chapter of our second annual Budget Report looks beyond 2024–25 to the medium-term outlook for the Scottish Government’s funding, and the implications of the funding picture for the choices and trade-offs faced when allocating funding between areas of the budget. The Scottish Government had said it would confront those choices alongside the 2024–25 Budget by publishing an update to 2022’s Resource Spending Review. However, with the Deputy First Minister and Finance Minister, Shona Robison, citing the ‘turbulent economic environment’, a decision has been taken to postpone this until the next set of economic and fiscal forecasts from the Scottish Fiscal Commission (SFC) and the publication of the next Scottish Government Medium-Term Financial Strategy (MTFS), expected in the late spring or early summer. Our analysis, presented below and based on current forecasts for UK government funding and devolved tax revenues, suggests that 2025–26 will see a substantial real-terms increase in Scottish Government resource funding. However, 2026–27 onwards is currently forecast to see much smaller increases in resource funding – that could easily be more than entirely absorbed by the NHS and other priority areas, necessitating cutbacks to many other services. A planned cash-terms freeze to capital funding from the UK government, together with Scotland planning to reduce borrowing used for capital purposes (in an attempt to maintain some headroom against its borrowing limits), is set to see capital funding in Scotland fall significantly in real terms over the second half of the 2020s. More funding than is currently pencilled in might be made available by the UK government for both resource and capital purposes, but risks to net revenues from devolved taxes are likely weighed to the downside. The Scottish Government should not bank on significantly more funding becoming available.

Key findings

1. The medium-term outlook for Scottish Government funding will depend on both the funding it receives from the UK government and the net revenue it receives from its own devolved taxes and other income sources. Broadly speaking, current plans imply that UK government funding is set to be highly constrained over the period 2025–26 to 2028–29, as efforts are made to start to bring down the debt-to-GDP ratio. On the other hand, forecasts imply that the net contribution of devolved tax revenues to Scottish Government funding is set to increase substantially, driven by income tax.
2. The UK government has pencilled in 0.8% real-terms increases per year in its overall departmental resource spending limits in the four years from 2025–26 to 2028–29. Capital spending limits are set to be frozen in cash terms, implying real-terms cuts averaging 1.7% a year. The Scottish Government's block grant funding will depend on how the UK government allocates funding between departments responsible fully or largely for services that are devolved in Scotland (such as the NHS, housing and justice), versus those responsible fully or largely for UK-wide services (such as defence). In the absence of this information, the Scottish Government assumes block grant funding will change by the same percentage rates as the overall resource and capital spending plans. But, because of the way the Barnett formula operates, Scotland will only get a 0.8% a year real increase in its block grant if UK departments responsible for services that are devolved in Scotland see their budgets increase at a rate faster than this.
3. SFC forecasts for devolved tax revenues and Office for Budget Responsibility (OBR) forecasts for the associated block grant adjustments imply the net contribution of devolved taxes to the Scottish budget will increase by almost 6% a year in real terms between 2024–25 and 2028–29. This is driven by income tax, which is forecast to contribute a net £2.3 billion in 2028–29, up from a forecast £1.4 billion next year. The higher net contribution of income tax reflects the fact that the SFC is forecasting faster earnings growth for Scotland than the OBR is forecasting for the UK as a whole (explaining around £500 million of this increase), and Scotland's generally higher marginal income tax rates, which mean each additional pound of earnings growth generates more revenue (explaining much of the remaining increase).
4. Despite only small increases in UK government funding, the Scottish Government's overall resource funding is set to increase by 2.9% in real terms in 2025–26, with the amount available for devolved public services (after accounting for forecast spending

on devolved social security benefits) increasing by 2.2% in real terms. In part, this reflects forecast year-on-year growth in the net income tax revenue position. But more important is that the SFC now thinks its initial forecasts for Scottish income tax revenue performance in 2022–23 were pessimistic, so is predicting a positive £732 million forecast reconciliation payment in 2025–26 when final revenue out-turn data are available.

5. The picture for 2026–27 onwards is much tougher, despite a slight uptick in growth in funding from the UK government. In part, this reflects a slight slowdown in the improvement in the net income tax position, which will contribute an average of 0.3 percentage points to funding growth each year, down from 0.7 percentage points in 2025–26. However, more important is the fact that reconciliations for past income tax forecast errors drop out of the system (as forecast errors only arise as forecasts are updated after budgets have already been set). As a result, the growth in resource funding available for public services in 2026–27, 2027–28 and 2028–29 is projected to average just 0.6% per year in real terms. To smooth out growth since 2024–25, the Scottish Government could place some of the £732 million that is expected to be received in 2025–26 into reserves for drawdown in these later years.
6. Capital funding is projected to fall by 16% in real terms between 2024–25 and 2028–29. This is a result of the cash freeze in UK government capital funding and a reduction in capital borrowing by the Scottish Government, as it seeks to retain some modest ‘headroom’ against its total debt limits to respond to unexpected cost overruns. The Scottish Government could make additional capital funding available, but only by reducing the amount available for day-to-day (resource) purposes.
7. There is significant uncertainty around these projections. On the one hand, the spending plans pencilled in by the UK government are very tight and, on reasonable assumptions, could see funding for many unprotected areas cut by over 3% a year in real terms. Given this, and the fact that the run-ups to both the 2015 and 2021 multi-year Spending Reviews saw top-ups to spending plans, it might seem more likely than not that block grant funding from the UK government will be higher than currently assumed. On the other hand, the SFC highlights how risks related to net income tax revenues weigh to the downside. This is because its relatively fast earnings growth forecasts for Scotland are likely to reflect, at least to some extent, a different view about UK-wide earnings growth compared with the OBR’s, rather than any Scotland-specific factor. If so, this will either depress tax revenues (if the OBR is correct) or inflate the BGA (if the SFC is correct), both of which would reduce the contribution of income tax revenues to future budgets.

8. Under the SFC and Scottish Government's existing funding projections, if health funding were increased by an average of 2.3% a year in real terms (the rate assumed as needed to maintain existing service standards in the most recent Medium-Term Financial Strategy) and funding for local government held flat in real terms, funding available for other services would be approximately 1% lower in real terms in 2028–29 than in 2024–25. If health funding were increased by an average of 3.3% a year in real terms (in line with estimates from IFS researchers of the cost of the English NHS's long-term staffing plan) and funding for local government increased by 1% a year in real terms, Scotland would see funding for 'unprotected' services fall by 12% in real terms between 2024–25 and 2028–29.
9. If additional UK government funding is forthcoming, these trade-offs would be eased. For example, if an additional £1 billion in UK government funding were made available in 2028–29, then 2.3% real-terms increases in health funding per year and a flat real settlement for local government would be consistent with a 7.5% increase in funding for other services by 2028–29; under 3.3% and 1% real-terms increases for health and local government respectively, the cut to 'unprotected' services would be reduced to 4%.
10. On the other hand, if the net income tax revenue position increases by £1 billion less than expected, the challenges would be substantially tougher. For example, 2.3% real-terms increases in health funding per year and flat funding for local government would imply real-terms cuts of 9% to unprotected services by 2028–29; 3.3% real-terms increases in health funding and 1% real-terms increases in funding for local government per year would entail cuts of 21% in real terms by 2028–29.

3.1 The funding outlook

The medium-term outlook for Scottish Government funding will depend on both the funding it receives from the UK government and the net revenue it receives from its own devolved taxes and other income sources. Broadly speaking, current plans imply that UK government funding is set to be highly constrained over the period 2025–26 to 2028–29, as efforts are made to start to reduce the debt-to-GDP ratio. On the other hand, forecasts imply that the net contribution of devolved tax revenues to the Scottish Government is set to increase substantially, growing from 3.4% of resource funding in 2024–25 to 4.4% of resource funding in 2028–29 (with non-domestic rates collected by councils and redistributed by the Scottish Government providing about a further 6.5% in both years). And reconciliations for past forecast errors for income tax revenues are now expected to boost funding in 2025–26 and 2026–27.

UK government funding

The UK government has not set out detailed departmental spending allocations beyond 2024–25. Instead, it has set provisional resource and capital spending totals each year until 2028–29. Resource spending is set to grow by 0.8% in real terms each year beyond 2024–25, while capital spending is planned to be held flat in nominal terms, implying real-terms cuts.

The implications of these provisional spending totals for the Scottish Government will depend not only on whether these plans are kept to, but also on how funding is allocated between different UK government departments. Funding for departments to pay for services in England (or England and Wales) that are devolved in the case of Scotland will result in additional funding for the Scottish Government via the Barnett formula, while funding for departments to pay for UK-wide responsibilities will not do so. Each UK government department is assigned a ‘comparability factor’, which reflects the proportion of its responsibilities that in Scotland’s case are devolved, and so the share of the funding they receive that leads to additional funding for Scotland via the Barnett formula. Departments for which all responsibilities are devolved to the Scottish Government have a 100% comparability factor: these include the Department for Education and the Department for Levelling Up, Housing and Communities. Those departments for which all responsibilities are UK-wide, and so cover Scotland, have a comparability factor of 0%, and funding for them does not generate any additional funding for the Scottish Government: these include the Cabinet Office and HM Treasury.

The majority of departments have some responsibilities that are devolved and others that are UK-wide, and therefore have a comparability factor between 0% and 100%. This includes departments for which the vast majority of responsibilities are devolved to the Scottish Government, such as Health and Social Care, for which the comparability factor is 99.5%, and the Home Office, for which the comparability factor is 82.5%. It also includes departments where only a few responsibilities are devolved and most responsibilities are UK-wide, such as the Department for Energy Security and Net Zero, for which the comparability factor is 2.6%, and the Department for Science, Innovation and Technology, for which the comparability factor is 6.9%.

In the absence of information on how funding will be allocated between UK government departments in 2025–26 and beyond, the Scottish Government’s medium-term funding projections assume that the block grant will grow at the same percentage rate as overall UK government resource spending limits (0.8% in real terms per year, on average).¹ This would require the funding for the UK government departments delivering services that in Scotland are

¹ Technically, it assumes that block grant funding will grow in line with the Office for Budget Responsibility’s forecast for ‘public sector current expenditure in resource departmental expenditure limits’.

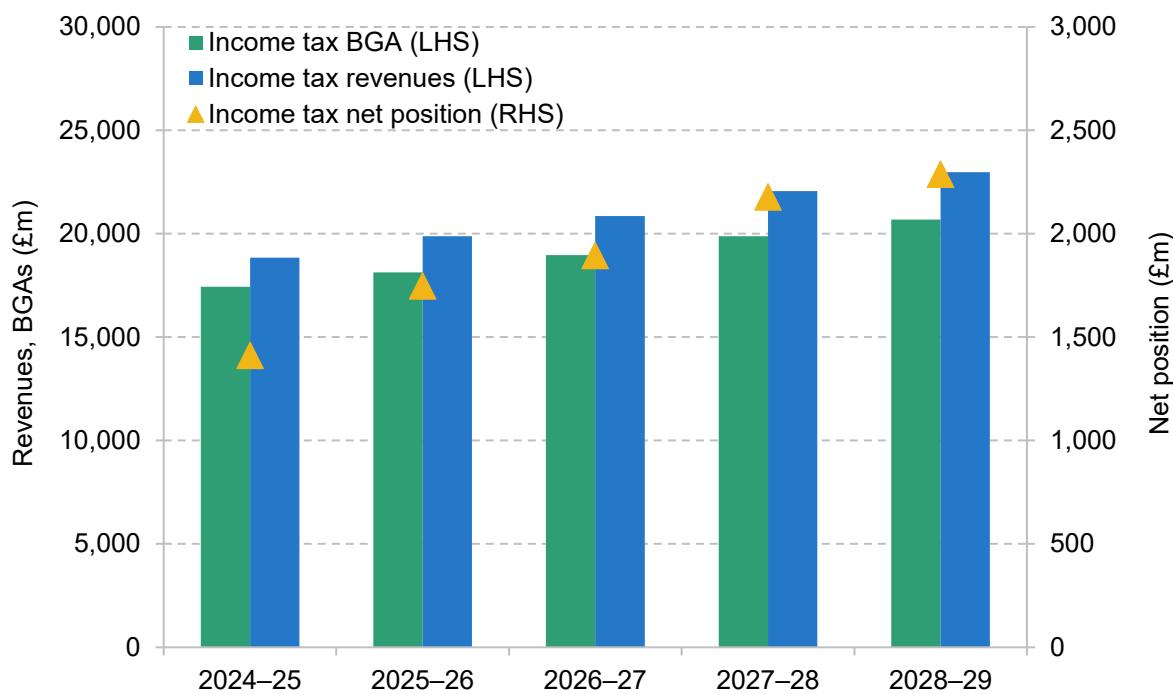
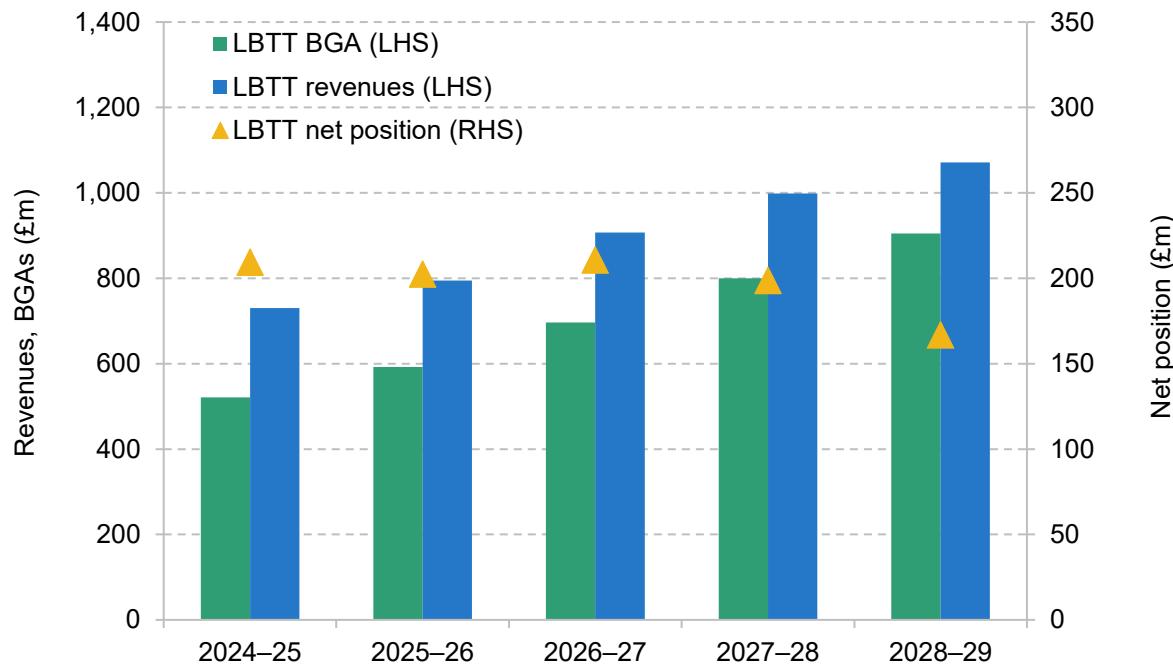
devolved to actually grow at a *faster* percentage rate than overall UK government resource spending. This is because the Barnett formula provides the Scottish Government with the same cash-per-person changes in funding, not the same percentage changes, as are being allocated to departments for England. And with Scottish Government funding per person higher than government funding per person in England, this means an increase in funding of more than 0.8% for England is required to generate a 0.8% increase in the Scottish Government's block grant funding.

As funding for the Department of Health and Social Care is the biggest driver of block grant funding for Scotland, and funding for this department typically grows faster than average, an assumption that 'comparable' funding for England grows faster than overall UK government funding might not seem unreasonable. However, it is far from certain – for example, if cuts are made to other 'comparable' funding for England (such as for policing and justice, or local government) in order to boost health funding. As we discuss further below though, the existing provisional spending totals set out by the UK government are also likely to be revised, introducing further uncertainty into medium-term funding projections; though in this case past behaviour suggests that an upward revision might seem more likely than a downward one.

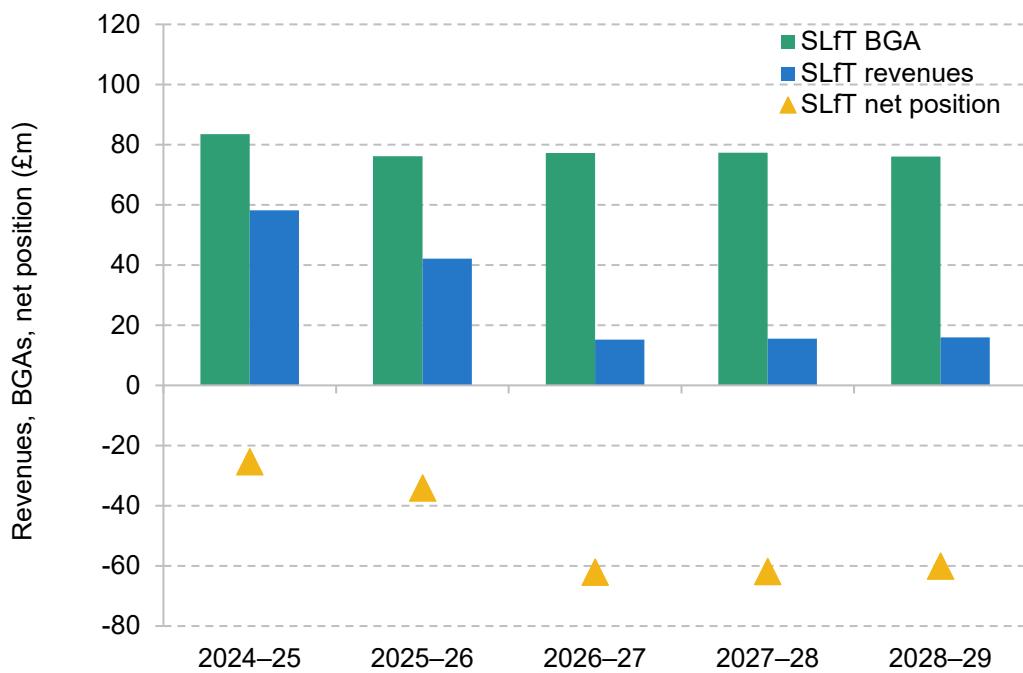
On the capital side of the budget, current UK government plans are for a cash-terms freeze in the four years from 2025–26 to 2028–29, which translates into a real-terms reduction averaging 1.7% per year. Again, block grant funding for capital purposes for the Scottish Government will depend on how funding is allocated between UK government departments, which has not yet been determined. In the absence of this information, the Scottish Government is currently assuming its block grant capital funding will be frozen in cash terms, translating into real-terms reductions averaging 1.7% a year. The Scottish Government also assumes that no more financial transactions capital funding – ring-fenced funding for loan or equity investments in the private sector, such as the Help to Buy scheme – will be provided beyond 2024–25.

Devolved tax revenues

In addition to non-domestic rates, which have been devolved since the creation of the Scottish Parliament in 1999, the Scottish Government now has powers over and retains revenues from income tax, land and buildings transaction tax (LBTT) and Scottish landfill tax (SLfT). The effect of these taxes on funding for the Scottish Budget depends both on the revenues collected within Scotland and on the corresponding block grant adjustments (BGAs) made to the block grant funding received from the UK to account for these new devolved revenues. In turn, these BGAs reflect what would have been raised in Scotland if Scottish revenues per person had grown at the same percentage rate as in the rest of the UK (rUK) since these taxes were first devolved. The 'net position' for each tax captures the difference between the revenues collected and the BGAs, and determines the net contribution of devolved tax revenues to the Scottish Budget (see Figure 3.1).

Figure 3.1. Forecasts for devolved tax BGAs, revenues and net revenue position**Panel A. Income tax****Panel B. Land and buildings transaction tax**

Panel C. Scottish landfill tax



Source: Scottish Fiscal Commission, 2023.

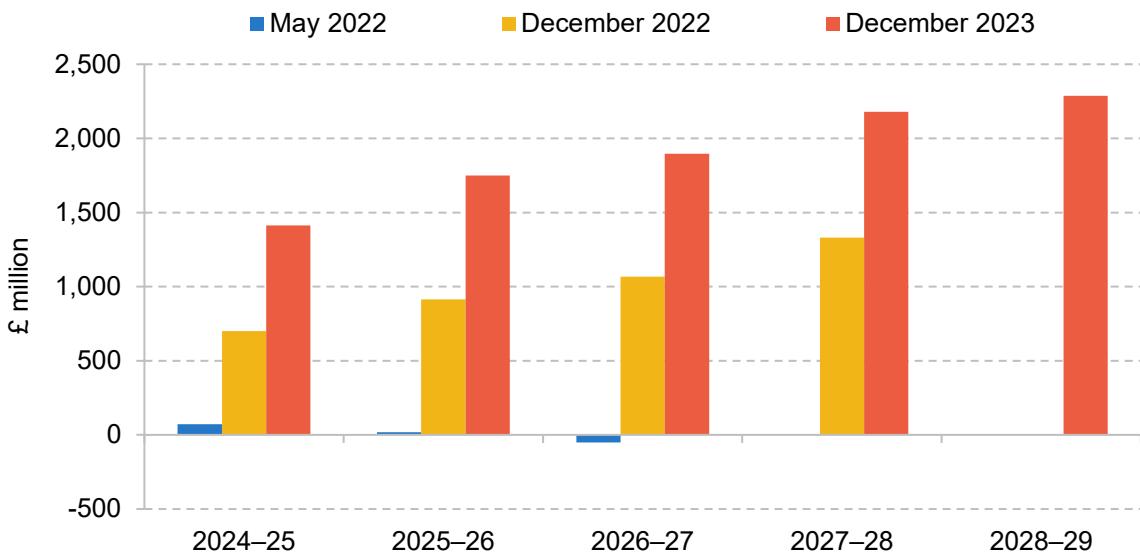
The net position for income tax in particular is set to increase considerably between 2025–26 and 2028–29, growing by 7.5% a year on average in real terms to reach £2.3 billion. Income tax revenues and BGAs are significantly larger than the other taxes devolved to Scotland, so this drives an overall increase in the net tax position of 5.8% in real terms per year, on average, over the period 2025–26 to 2028–29. The growth in the net position for income tax reflects the fact that revenues are forecast to grow by an average of 3.1% in real terms each year, compared with 2.7% for the BGAs. We return to why this is the case below.

The net position for LBTT is set to fall by 7.9% a year on average in real terms between 2025–26 and 2028–29. This is a result of the BGA increasing by more than revenues – although revenues are still forecast to exceed the BGA by almost a fifth (£167 million) in 2028–29. For Scottish landfill tax, the net position is set to further decline to –£60 million in 2028–29, with revenues falling substantially more quickly than the BGA, as the amount of waste sent to landfill falls faster than in England.

Understanding the income tax net position

The income tax net position in particular now looks higher than was expected in either December 2022 or May 2022, as shown in Figure 3.2. For example, the forecast for the net position for 2026–27 was –£50 million as of May 2022, but had been revised upwards to +£1.1 billion by December 2022 and +£1.9 billion as of the latest forecasts published in December 2023.

Figure 3.2. Forecasts for the income tax net position between 2024–25 and 2028–29, made in May 2022, December 2022 and December 2023



Note: In May 2022, there was no forecast income tax net position for 2027–28 or 2028–29. In December 2022, there was no forecast income tax net position for 2028–29.

Source: Authors' calculations using Scottish Fiscal Commission (2022a, 2022b, 2023).

Table 3.1. SFC and OBR forecasts for employment and earnings growth, 2023–24 to 2028–29

Growth rates	2023–24	2024–25	2025–26	2026–27	2027–28	2028–29
Employment						
OBR	0.1%	0.2%	0.7%	1.0%	0.9%	0.7%
SFC	0.5%	–0.1%	0.1%	0.2%	0.3%	0.3%
Average nominal earnings						
OBR	6.2%	3.3%	1.9%	2.2%	2.6%	2.8%
SFC	6.6%	3.6%	3.0%	2.9%	3.0%	3.1%
Implied growth in employment income						
OBR	6.4%	3.6%	2.6%	3.3%	3.5%	3.6%
SFC	7.1%	3.5%	3.0%	3.1%	3.3%	3.3%

Source: Figure 4.16 of Scottish Fiscal Commission (2023).

This upwards revision has taken place for a variety of reasons. As discussed in the previous chapter, out-turn figures for Scottish income tax revenues in 2021–22 were stronger than expected, as were Real Time Information earnings and PAYE tax data during 2022–23 and so far during 2023–24, with earnings growth in Scotland outpacing that in the rUK. Table 3.1

shows that the Scottish Fiscal Commission's (SFC's) forecasts for average earnings growth in each of the next five fiscal years exceed the Office for Budget Responsibility's (OBR's) forecasts for the UK (which underlie forecasts for the income tax BGAs). This was true to a slightly lesser extent in December 2022, and particularly May 2022. The table also shows that SFC's forecasts for employment growth in Scotland are weaker than the OBR's for the UK as a whole, but much of this relates to slower projected population growth in Scotland, which is adjusted for when calculating the BGAs.

The SFC estimates that each 0.1 percentage point increase in Scottish average earnings growth relative to that in rUK boosts the net tax position by £25 million, and overall that its faster earnings growth forecasts between 2024–25 and 2028–29 explain around £500 million of the forecast £876 million improvement in the income tax net position between 2024–25 and 2028–29. Most of the remainder will reflect the fact that Scotland's more progressive income tax system means that each additional pound of earnings is taxed at a higher marginal rate, on average, and so boosts revenues by more. The SFC estimates that each 1 percentage point of earnings growth generates around £25 million more in revenues than it would under the income tax rates and bands in place in the rUK, for example (and total growth in average earnings is forecast by the SFC to amount to just over 12% in cash terms between 2024–25 and 2028–29).

In addition to boosting forecasts of future income tax revenues, the stronger-than-expected performance of Scottish earnings in 2022–23 and so far in 2023–24 means that the SFC now expects the final out-turn for the net income tax position in those years to be stronger than forecast when the budgets for those years were set. Under the Scottish Fiscal Framework, if this is borne out, the Scottish Government will receive positive reconciliation payments in 2025–26 and 2026–27 for these years. Based on the SFC's latest forecasts, these would be £732 million (roughly 1.5% of the Scottish Government's overall resource budget) and £502 million (roughly 1% of the Scottish Government's overall resource budget) for these two years, respectively.

Other funding and factors

Several other factors affect the outlook for the Scottish Government's funding, and in particular the amount available for public services:

- The end of drawdowns of existing ScotWind proceeds, which are providing £460 million of funding in the current financial year and a planned £200 million in 2024–25, but no funding thereafter. A new round of windfarm licences for projects designed to reduce the environmental impact of the oil and gas sector has recently been completed, but the revenue from these (up to £262 million) will be lower than from the previous round currently being utilised for public spending.
- Increases in spending on devolved social security benefits that are forecast to outpace increases in the associated BGAs. A small part of this reflects increasing Scotland's new

benefits, such as the Scottish child payment, in line with inflation. Much more important for the years between 2025–26 and 2028–29, though, is the roll-out of Scotland’s new benefits for disabled adults and those with caring responsibilities. Taken together, these are forecast to cost around £680 million more than the associated BGAs, up from £350 million in 2024–25, contributing around 80% of the overall increase in ‘net spending’ on social security benefits (i.e. spending on top of the amount provided by the social security BGAs) over these four years. Box 3.1 discusses this issue in more detail, focusing in particular on adult disability payment (ADP, the Scottish Government’s reformed disability benefit for working-age adults), for which the net cost on top of the associated BGA (based on personal independence payment – or PIP – spending in rUK) is set to increase, but by less than previously forecast.

Box 3.1. SFC disability benefit forecasts and trends in disability benefit claims

While the eligibility criteria and amounts payable for ADP are the same as for rUK counterpart PIP, differences in the application and review processes mean that spending on ADP per person is expected to be higher. The application process for ADP is designed to lessen the burden on the applicant – for example, by requiring fewer face-to-face medical assessments. This is expected to lead more people to take up the benefit. Those receiving ADP will also have their award reviewed less frequently and in a ‘light touch’ manner, reducing the likelihood that they will lose their benefits. This combination of factors means that spending on ADP is expected to outstrip the BGA funding associated with PIP.

In its latest forecasts, the SFC has revised up its predictions for spending on ADP between 2024–25 and 2027–28 (Scottish Fiscal Commission, 2023). This is due to increases in forecast inflation (raising the amount by which benefits are uprated), and the continued increases in the number of new claims each month, something seen across the UK as we show below. However, the upward revision to ADP spending is less than that to (rUK) PIP spending, meaning that less additional spending is required by the Scottish Government, as the BGA funding covers a greater proportion. Because of this, the difference between devolved social security spending and spending on social security benefits with BGAs is now forecast to be £590 million in 2027–28, down from £775 million forecast last year.

The key reason for this decline relates to the SFC’s view that part of the reason for the bump in PIP/ADP applications is the cost-of-living crisis and resulting pressure on households’ budgets. This has led it to revise down its expectations of the size of the ADP caseload relative to the OBR’s forecast for PIP.

While both the SFC and the OBR account for the effect of the cost-of-living crisis in their modelling of PIP/ADP spending, assuming that as inflation eases the number of applications will ease too, the SFC has informed us that it believes that the cost-of-living crisis will also limit the impact of the introduction of ADP on benefit take-up. Its assumption is that the cost-of-living crisis has reduced the

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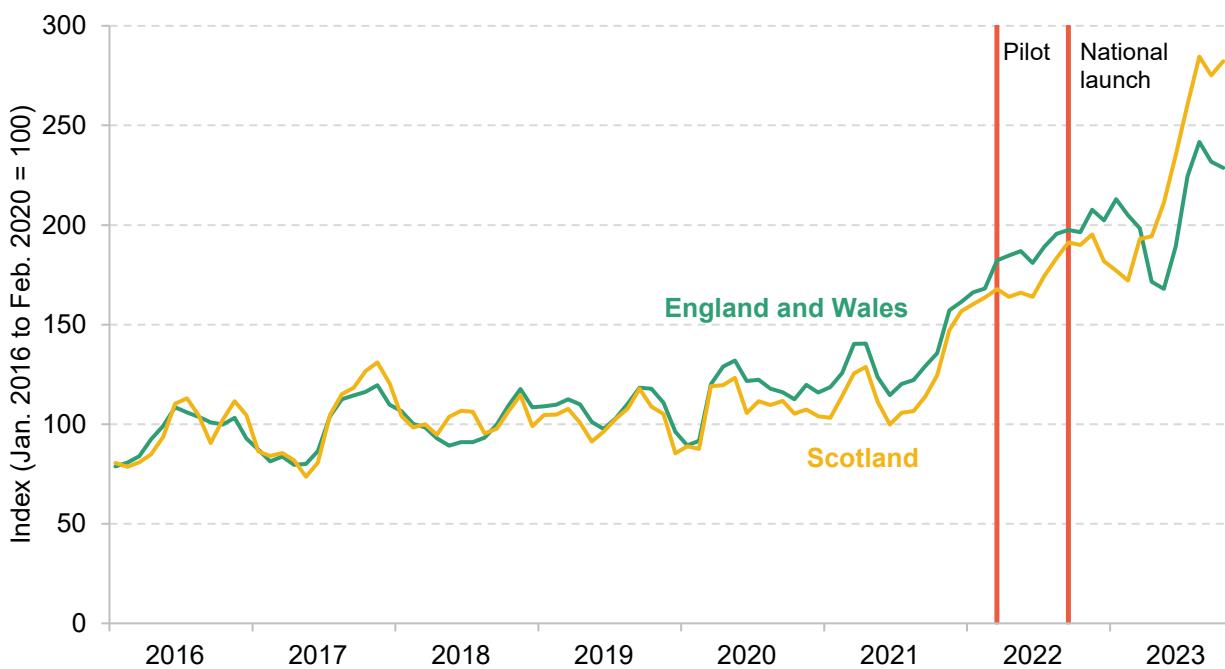
pool of people induced to apply to ADP because of its less onerous approach, since rising prices would have led them to apply to PIP even if ADP were not introduced.

If the SFC is correct, then this will mean less additional spending required. But if instead it was assumed that the effect of the cost-of-living crisis and the easier application process for ADP were independent factors affecting the probability of application, then we might not expect this to reduce the number of additional ADP claimants compared with PIP. This is because, under this assumption, there would be some people induced to apply only because of the combination of ADP's introduction and the cost-of-living crisis. The SFC is assuming that the two effects interact in a way that means this latter group is small.

There is limited evidence with which to assess the validity of this position: it is largely a judgement call. As a result, when combined with uncertainty about just how big a difference Scotland's application, assessment and reassessment systems will make to claim numbers and durations, there remains significant uncertainty about how the cost of ADP will evolve compared with the BGA funding.

However, we can use the evidence on ADP claims so far to offer some insight. Figure 3.3 shows an index of the number of monthly new PIP or ADP awards in Scotland, and in England and Wales.

Figure 3.3. Monthly new PIP or ADP awards (three-month rolling average; index, January 2016 to February 2020 = 100)



Note: Up to October 2023. ADP data only include initial awards, so underestimate the true number of awards. PIP data include new awards from mandatory reassessments or appeals. Neither series includes disability living allowance reassessments.

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

We see that from mid 2021, the number of monthly new awards increased sharply in both Scotland and England and Wales, with the increase in England and Wales slightly greater than the increase in Scotland. This was still the case in February 2022, just before ADP began to be rolled out for new applicants. Since then, the increase in new ADP awards has been much greater, so that by October 2023 new awards in Scotland are 72% higher than in February 2022 (7,100 compared with 4,100), whereas new awards in England and Wales are 36% higher (41,900 compared with 30,800). It is difficult, though, to reach any firm conclusions based on the data currently available. The SFC assumes that there will be an initial spike of ADP awards following the roll-out, which could explain this difference, but it may also be that the reform will lead to a longer-term increase in inflows. The data do not yet allow us to distinguish between the two, highlighting the continued uncertainty around disability benefit spending.

Capital borrowing

On the capital side of its budget, in addition to real-terms falls in block grant funding from the UK government, the Scottish Government currently plans to reduce its own devolved borrowing from £458 million in 2024–25 to £250 million in 2025–26 and beyond. This would lead to a particularly sharp reduction in capital funding in 2025–26.

The Scottish Government will have some modest headroom against its overall capital debt limit which, following a review of Scotland’s Fiscal Framework, is now being increased in line with inflation. For example, under these plans, outstanding borrowing is set to equal 91% of the debt limit in 2025–26 and 93% in 2028–29. However, borrowing the maximum £466 million allowed in 2025–26 would see outstanding borrowing reach 98% of the total debt limit, and borrowing would need to be cut back in 2026–27, meaning cuts to capital spending could only be delayed by a year. Moreover, having some headroom makes sense as it would allow the Scottish Government space to respond to unanticipated cost overruns by borrowing, if necessary.

If the Scottish Government wanted to continue to borrow more for capital purposes, it could choose to borrow for shorter durations than the current 15 years: quicker repayment of outstanding borrowing would allow more new borrowing, although it would mean more resource funding would need to be allocated for debt repayment rather than day-to-day spending on public services or social security benefits. An alternative – but effectively quite similar – approach to support capital funding would be to transfer funding from its resource budget to its capital budget. As we discuss below, this may be an option in 2025–26, but would be much more difficult in 2026–27 to 2028–29, when resource funding looks to be highly constrained.

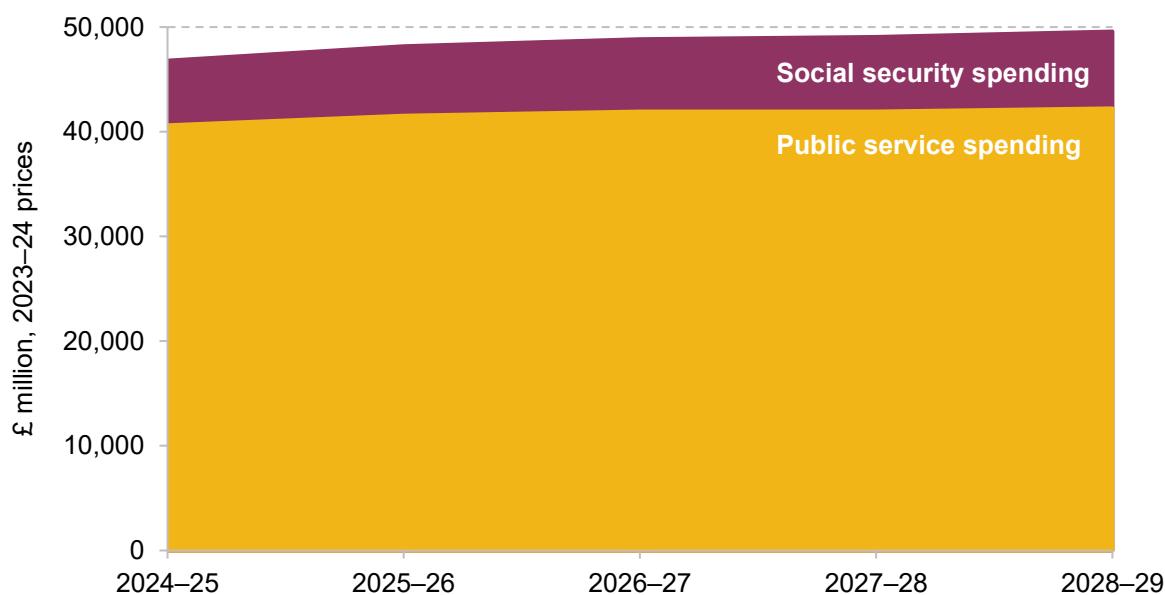
The Budget also confirmed that the Scottish Government is considering borrowing via issuing its own bonds, rather than asking the UK government to borrow on its behalf, from the second half of 2025–26. This bond-financed borrowing will still be subject to the same limits, and is likely to be slightly more expensive due to investors requiring higher interest rates to lend to a new

borrower for bonds that will be less liquid than the UK's established and large public debt market (Scottish Government, 2023b). However, the Scottish Government argues that this approach will raise Scotland's profile with international and institutional investors and help develop Scotland's public finance institutions – which, if true, could be helpful if the current Scottish Government's aim of independence were achieved.

Overall funding projections

Figure 3.4 brings together the various sources of funding for day-to-day (resource) expenditure. It shows the overall amount available, splitting it into the amount allocated to spending on social security benefits (in purple) and the amount available for public services (in yellow), for the next five fiscal years, expressed in 2023–24 prices. It shows relatively large increases in funding in 2025–26, followed by much smaller annual average increases in funding in the subsequent three years.

Figure 3.4. Projected Scottish Government resource funding (2023–24 prices)



Source: Scottish Fiscal Commission (2023); November 2023 GDP deflators.

The resource funding outlook for 2025–26

Overall resource funding is projected to grow by 2.9% in real terms in 2025–26, with the amount available for public service spending increasing by 2.2%. The difference between these two figures reflects bigger increases in devolved social security spending than in the associated BGAs from the UK government, as Scotland's reformed benefits for carers and disabled adults lead to more successful and longer claims.

The 2.2% real-terms increase in the amount available for public services is substantially higher than the real-terms increase in block grant funding assumed by the Scottish Government – which averages 0.8% in real terms in the four years from 2025–26 to 2028–29, but is just 0.5% in real terms in 2025–26. In addition, existing ScotWind proceeds are expected to have been fully drawn down, which will reduce funding by the equivalent of around 0.5%, roughly offsetting the real-terms increase in block grant funding. This means the projected real-terms increase in resource funding in 2025–26 is almost entirely driven by devolved tax revenues, and particularly devolved income tax revenues.

The forecast of year-on-year increases in the net income tax revenue position discussed earlier – driven by the SFC’s assumption of faster earnings growth than the OBR assumes and greater fiscal drag under Scotland’s more progressive income tax system – explains a relatively small part of it: the £300 million real-terms increase in the net income tax position is equivalent to around a 0.7% boost to resource funding for public services. More important, though, is the SFC’s forecast that stronger-than-expected earnings growth and hence income tax revenue growth in Scotland relative to rUK in 2022–23 will lead to a positive reconciliation payment of £732 million in 2025–26. This is equivalent to a 1.8% boost to the amount of resource funding available for public services. The performance of Scottish income tax revenues relative to rUK income tax revenues in 2022–23 will therefore be a key determinant of the Scottish Government’s budget choices and challenges in 2025–26. Even though around eight months had passed between the end of the 2022–23 tax year and the SFC’s latest forecasts for revenues in that year, and hence the size of any reconciliation payments, there is still significant uncertainty, not least because self-assessment tax returns and payments were only due at the end of January 2024. And the reconciliation payment for the previous year, 2021–22 was notably different from the forecast made at the same point: –£390 million as opposed to a forecast –£732 million, a difference equivalent to 0.8% of overall resource funding available for public service spending. As we discuss further below, this means not only future but also past income tax revenue performance creates uncertainty for the Scottish Government’s future budget.

The resource funding outlook for 2026–27 to 2028–29

In 2026–27 and beyond, the outlook for resource funding is much tougher. This is in spite of the fact that UK government block grant funding is currently projected to increase by more (1.0% a year in real terms) than in 2025–26 – although this is still much slower than over the period between 2019–20 and 2024–25 and, as we discuss below, would likely necessitate cuts to a range of service areas.

Overall resource funding is projected to increase by 1.4%, 0.4% and 1.0% in real terms in 2026–27, 2027–28 and 2028–29, respectively. After accounting for growing expenditure on devolved social security benefits (forecast to increase by 3.4% in real terms per year as Scotland’s new

disability and carers' benefits roll out), the amount available for public services is projected to grow by 1.0%, 0.0% and 0.7% in real terms in the same respective years.

The slowdown in funding growth is driven partly by slowdown in the growth of the income tax net revenue position in these years – with the boost to overall resource funding available for public services equivalent to just over 0.3% (down from 0.7% in 2025–26). More important, though, is the decline and then cessation of forecast positive reconciliation payments for past underestimates of Scotland's net income tax revenue position. For example, while the SFC now forecasts that the net income tax position in the current financial year, 2023–24, will be stronger than when this year's budget was set, generating a positive reconciliation payment in 2026–27, it forecasts that this will be smaller (£502 million) than the payment for 2022–23 made in 2025–26 (forecast to be £732 million). This fall in the reconciliation payment is a drag on the growth in overall resource funding.

Any reconciliation payment in 2027–28 would be because of under- or over-forecasting the net income tax revenue position in 2024–25. As the figures assumed in the Scottish Budget for the 2024–25 net income tax position are the SFC's latest forecasts, there is currently no anticipated 'forecast error' and hence the implied reconciliation payment in 2027–28 is zero. The impact of moving from a £502 million reconciliation payment in 2026–27 to zero in 2027–28 is equivalent to a reduction in overall resource funding available for public services of 1.1 percentage points. Alongside growing net expenditure on devolved social security benefits, this would almost exactly offset assumed growth in block grant funding from the UK government and forecast year-on-year increases in the net income tax revenue position in 2027–28.

Based on current projections for block grant funding, forecasts for devolved tax revenues and social security spending, and forecasts for reconciliation payments, 2027–28 therefore looks as if it will be a particularly tough year. But as we show in Section 3.2, each of the years between 2026–27 and 2028–29 will entail very difficult trade-offs between service areas based on current funding projections.

The capital funding outlook

The combination of cash-flat block grant funding from the UK government and a reduction in assumed borrowing (to maintain headroom against overall capital debt limits) means a large fall in capital funding between 2024–25 and 2028–29: around 16% in real terms, including funding for capital transactions (loans or equity investments to the private sector). The biggest year-on-year fall is in 2025–26 (around 11% in real terms), as this is when the Scottish Government assumes capital transactions funding will come to an end, and when it plans to reduce capital borrowing. Cuts on this scale would require significant reductions in investment in infrastructure, facilities and equipment – especially if construction inflation continues to outpace overall economy-wide inflation.

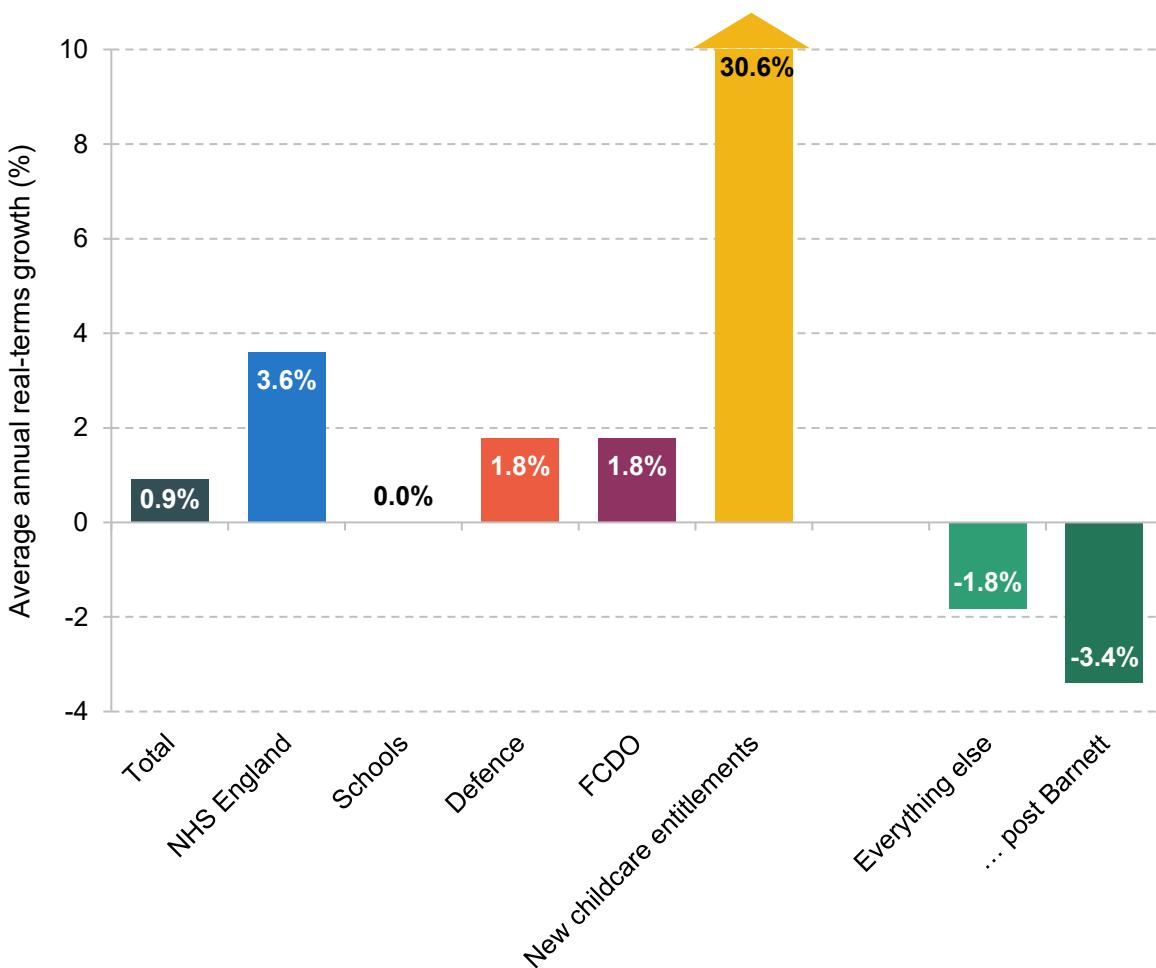
Upside and downside risks

The medium-term funding projections discussed above are subject to significant uncertainty. The two biggest areas of uncertainty – given their scale and importance to the Scottish Government’s overall budget – are the levels of block grant funding that will be received from the UK government, and devolved income tax revenue performance.

Key upside risk: UK government funding

We have already discussed uncertainty related to how the UK government chooses to divide up its funding between departments in the next Spending Review period – which will determine how much Scotland receives via the Barnett formula. A more important source of uncertainty, though, is the total funding envelopes pencilled in by the UK government – which could be changed significantly in future Spending Review(s) – and indeed in subsequent UK Budgets.

Figure 3.5. Illustrative changes in UK government resource funding implied by Autumn Statement 2023 plans, 2024–25 to 2028–29



Source: Figure 5 in Emmerson et al. (2024).

The current envelopes imply difficult trade-offs for the UK government, with tight spending settlements for many areas of UK government spending. This is illustrated in Figure 3.5, which looks at the implications of a range of plausible assumptions for particular services for ‘unprotected’ services. The figure assumes that NHS funding grows at a rate of 3.6% in real terms, which is below its long-run average growth rate, but which is what would be required to deliver the English NHS workforce plan (Warner and Zaranko, 2023). It also assumes that defence and overseas aid spending are maintained as a proportion of national income, and that schools funding is frozen in real terms (allowing small increases per pupil given falling school rolls in England). It also assumes that new English childcare spending is increased in line with commitments made in the Spring Budget 2023 (note that this is a relatively small area of overall spending).

Given these assumptions, funding for all other areas would need to be reduced by an average of 1.8% a year in real terms in the four years 2025–26 to 2028–29. And after accounting for funding for Scotland, Wales and Northern Ireland that is determined by the Barnett formula (and which would be boosted by increases in funding for the NHS and childcare), the cuts to unprotected departments serving England or the UK as a whole would average 3.4% a year.

This ‘unprotected’ category includes funding for local government, criminal courts and prisons, the police and fire services, further and higher education, culture and sport, rural affairs and environmental protection, energy and climate change, and transport. Many of these faced substantial cuts in the last round of austerity in the 2010s and are facing evident strain and cost pressures. When the prospect of laying out these cuts in detail, through setting out departmental spending allocations, is confronted at the next Spending Review, budgets may be topped up. A top-up to overall envelopes at this point would be in line with recent experience: since 2010, at Spending Reviews, departmental spending totals have been topped up by £14.3 billion per year on average (Atkins and Lanskey, 2023).

This means that it is possible (and perhaps probable) that the existing indicative UK government spending limits will be topped up, which would generate more block grant funding for the Scottish Government (and other devolved governments) than is currently assumed. However, high levels of public debt, which is set to rise further over the next few years and barely fall in 2028–29, mean the Chancellor’s fiscal rules are barely being met – indeed, recent IFS research shows that cutting these high levels of debt appears to be harder than at any time since the 1950s on one key measure (Emmerson et al., 2024). As a result, it seems unlikely that spending plans will be increased to such an extent as to avoid difficult budgetary trade-offs both in Westminster and in Edinburgh.

Key downside risk: devolved tax revenues

The second key area of uncertainty for the Scottish Budget is the performance of devolved tax revenues, and in particular income tax. In this case, the risks are weighted to the downside, as highlighted by the SFC in its recent forecasts (Scottish Fiscal Commission, 2023).

This is because the increasingly positive net income tax revenue position forecast reflects to a large extent differences in earnings forecasts between the SFC (which forecasts devolved tax revenues) and the OBR (whose forecasts for rUK revenues underlie forecasts of the BGAs). The SFC highlights that there are factors that might mean the continuation of trends over the last 18 months or so for earnings in Scotland to outpace those in rUK – such as improved North Sea oil and gas activity, and reduced bonuses in the City of London in a higher-interest-rate environment. But the differences in forecasts may also reflect different degrees of overall optimism between the SFC and the OBR, rather than optimism about Scottish earnings specifically. For example, the SFC highlights that its earnings forecasts are more in line with the average of independent forecasters for the UK as a whole than the OBR's are. If it turns out that earnings growth across the UK is more in line with the SFC's more optimistic forecasts, then the income tax BGA will increase by more than currently forecast, meaning less of an improvement in the net income tax position. On the other hand, if it turns out that the OBR's relatively more pessimistic figures are borne out, Scottish revenues will underperform the SFC's forecasts, again reducing the net income tax position. Thus, in both cases, the scale of the improvement in the net income tax position would be less than currently forecast.

If, rather than growing by a cumulative 2.6 percentage points more between 2024–25 and 2028–29 as current SFC and OBR forecasts imply, Scottish earnings instead grew at the same rate as in rUK, the net income tax position in 2028–29 would be around £500 million lower – equivalent to a 1 percentage point reduction in overall resource funding. Each 0.1 percentage point reduction in Scottish earnings growth relative to rUK earnings growth per year would reduce the net income tax position and hence available funding by £100 million in 2028–29.

Other uncertainties – reconciliations and social security forecasts

There is also the potential for final reconciliation payments for 2022–23 and 2023–24 to differ from current forecasts. It is less clear that these risks are weighted to the downside (given that they are based on observed Real Time Information on earnings and PAYE income tax collections). But after positive surprises in relation to reconciliations for 2020–21 and 2021–22, it is important not to discount the risk of negative surprises going forwards.

Another area of uncertainty where it is unclear which way risks are weighted is the net social security spending position. In particular, overall trends in disability benefit claims are uncertain – with the SFC and the OBR seeming to take slightly different views on the extent to which recent big increases in rates of new claims are a permanent or partially temporary issue. And the

extent to which Scotland's reformed system for applying for, assessing and reassessing disability benefit claims will lead to more and longer successful claims is uncertain – and will likely remain so for some time until the system has been in place longer, so that trends in applications, success rates and benefit durations can be observed. This means the next few years could see big upward or downward revisions to net disability benefit spending, with knock-on effects for the amount of funding available for other areas of Scottish Government spending.

3.2 Spending choices and trade-offs

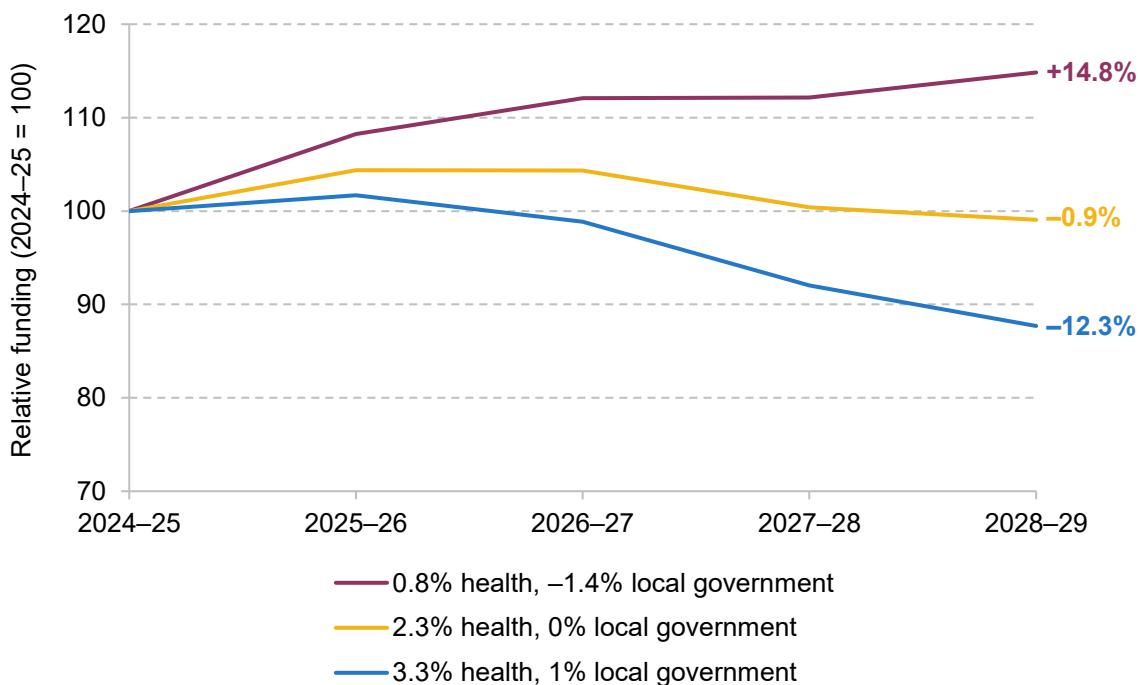
The constrained environment set out above implies difficult budgetary trade-offs for the Scottish Government for both its resource and capital budgets. To illustrate this, we carry out similar analysis to Figure 3.5 for Scotland, by examining the implications for ‘unprotected’ service areas of particular assumptions about health and core local government funding² – the two largest and perhaps most politically salient areas of the Scottish Government’s budget.³ Figure 3.6 shows the implications for these other departments (including funding for the courts, the fire, police and prison services, further and higher education, rural affairs and environmental protection, economic development, transport and actions to tackle climate change), given the SFC’s medium-term funding projections, and three scenarios for health and local government funding:

- 1 Health and core local government funding change in line with the real-terms plans set out for the period 2024–25 to 2026–27 in the May 2022 Resource Spending Review. These were for funding for the then-named Health and Social Care portfolio to increase by an average of 0.8% a year in real terms, and for core funding for local government to be cut by 1.4% a year in real terms.
- 2 Health funding to increase by 2.3% a year in real terms, in line with assumptions underlying spending need projections in the Scottish Government’s May 2023 Medium-Term Financial Strategy, and core funding for local government to be flat in real terms.
- 3 Health funding to increase by 3.3% a year in real terms, which would provide the same increase per person in Scotland as IFS researchers estimate is needed to meet the NHS’s long-term staffing plan in England, and core funding for local government to increase by 1.0% a year in real terms.

² More precisely, we vary assumptions about funding for the NHS Recovery, Health and Social Care portfolio and the funding provided to councils via the Deputy First Minister and Finance portfolio (which provides the main general-purpose grant funding to councils).

³ Moreover, unlike in England, most spending on schools and childcare is paid for from general-purpose local government funding, rather than separate funding streams.

Figure 3.6. Implication of differing degrees of prioritisation of the NHS Recovery, Health & Social Care and Local Government portfolios for other public service spending



Source: Authors' calculations using Scottish Fiscal Commission (2023) and Scottish Government (2023a).

Figure 3.6 shows that under the first scenario, funding for unprotected services could be increased by approximately 15% in real terms over the period between 2024–25 and 2028–29, in contrast to the cuts set out in the May 2022 Resource Spending Review. This reflects the fact that while tight, the projected funding outlook is less dire than the Scottish Government was assuming when it last set out medium-term funding plans. In turn, this is because of substantial upwards revisions to the forecast trajectory for the net income tax position (which SFC and OBR forecasts in May 2022 implied would progressively worsen, but is now set to improve). But it also reflects the fact that whereas in May 2022 the Scottish Government assumed that its UK government block funding would grow by 1% *less* than overall UK government funding resource spending limits in order to be ‘cautious’, it is now assuming its block grant funding will grow in line with those overall limits.

Such small increases in health funding alongside cuts to local government are arguably unrealistic given the evident pressure on the NHS and on adults’ and children’s social care services, in particular. At the very least, they would likely entail a continued worsening of access to and quality of these services.

The second scenario arguably represents a minimum needed to maintain existing health service standards, and would allow for councils’ overall funding to be increased by around 0.8% per year in real terms if council tax were increased by 5% (in cash terms) a year. This would enable

increases in social care spending of about 2.3% per year in real terms (in line with health spending) if increases in other local government spending (including on education) was held roughly flat in real terms. Under this scenario, funding for all other services could increase by 4.4% in real terms in 2025–26 (when, as previously discussed, the Scottish Government’s funding is projected to increase at a reasonable rate). But it would be flat in 2026–27 and fall by 3.8% in real terms in 2027–28 and 1.3% in 2028–29, by which point it would be 0.9% lower in real terms than in 2024–25.

The third scenario would allow for substantial increases in Scottish NHS employment and activity in line with what the English NHS’s long-term workforce plan implies south of the border. Real-terms increases of 1% in Scottish Government funding for councils would, together with council tax increases of 5% a year, provide roughly 1.5% per year overall real-terms increases in council funding. That would enable social care spending to grow by 3.3% per year (in line with health spending) and increases in spending on other council services (including education) averaging around 0.5% per year in real terms. Under this scenario, there would still be sufficient funding for an average increase in funding for other ‘unprotected’ services of 1.7% in 2025–26. But funding for these ‘unprotected’ services would need to be reduced by an average of 2.8%, 6.9% and 4.7% in real terms in 2026–27, 2027–28 and 2028–29, making the second half of the 2020s extremely difficult for a whole raft of Scottish public services. Their funding would be, on average, 12.3% lower in real terms in 2028–29 than in 2024–25.

In reality, if its overall funding followed the path implied by current SFC forecasts and assumptions about block grant funding, the Scottish Government would likely give priority areas, such as the health service, bigger increases in funding in 2025–26 and smaller increases thereafter, so that funding for other services did not rise and then fall in a way that could likely cause inefficiencies in spending and service delivery. But these scenarios illustrate that even simply standing still with healthcare and social care, let alone aiming for improvements, would entail difficult decisions for many other services in the second half of the 2020s.

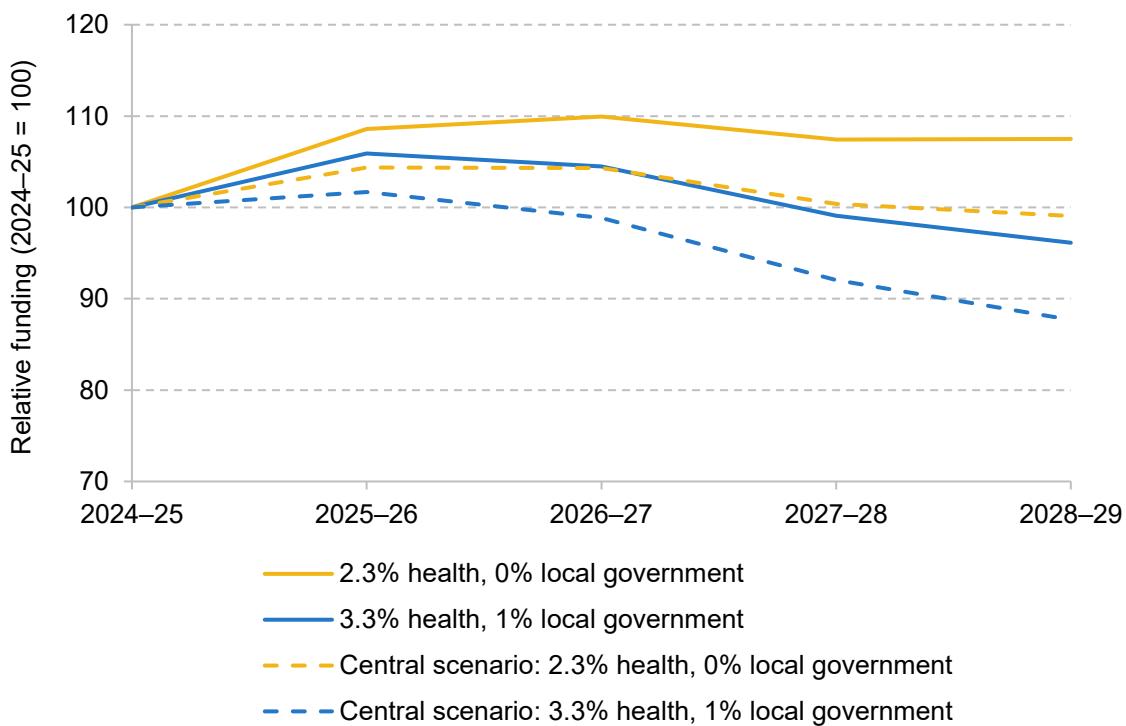
How would trade-offs change if overall funding were higher or lower?

As described earlier, it is likely that funding will not follow the exact path set out in the SFC’s December forecast report. On the one hand, it seems plausible – at least given past behaviour – that whoever is in office in Westminster come the next UK Spending Review will top up spending plans. On the other hand, risks around Scotland’s devolved tax revenues are weighted to the downside. We now turn to what such upside and downside scenarios could mean for the budgetary trade-offs facing the Scottish Government.

Upside scenario: additional funding found by the UK government

In our upside scenario, we assume that UK government resource spending plans are topped up by £15 billion (in real terms) in 2028–29. The precise number is arbitrary, but is chosen to be similar in magnitude to that seen on average across Spending Reviews since 2010 (Atkins and Lanskey (2023) estimate this at £14.3 billion). We assume that real-terms increases are more front-loaded⁴ and amount to £7.5 billion in 2025–26, £10 billion in 2026–27 and £12.5 billion in 2027–28. We also assume that two-thirds of these increases give rise to extra funding for Scotland under the Barnett formula.⁵ The implied increases in block grant funding on top of those assumed in the SFC’s projections are around £480 million in 2025–26, rising to £1 billion by 2028–29.

Figure 3.7. Implication of differing degrees of prioritisation of the NHS Recovery, Health & Social Care and Local Government portfolios for other public service spending: upside scenario



Source: Authors’ calculations using Scottish Fiscal Commission (2023) and Scottish Government (2023a).

⁴ We make this assumption for two reasons. First is because of the evident short-term pressures on services such as the NHS and councils. Second is that current spending envelopes assume that the UK government will allow special non-domestic rates reliefs for the retail, hospitality and leisure sectors to expire at the end of March 2025, which seems unlikely given it has rolled over these ‘temporary’ reliefs each year since the COVID-19 pandemic; a bigger boost to funding that year will allow the reliefs to be rolled over again without significantly squeezing funding for public services in that year.

⁵ Unlike the Scottish Government’s approach for projecting UK government funding, this approach allows us to account for the fact that the Barnett formula provides the same cash-per-person increase in funding as in England rather than the same percentage increase.

Figure 3.7 shows that under this scenario, 2.3% real-terms increases in funding per year for health and a flat real-terms settlement for local government would allow funding for other services to be around 7.5% higher in real terms in 2028–29 than in 2024–25, although all that increase would take place in 2025–26. In reality, as discussed earlier, it is likely that funding increases for all services, including health, would be front-loaded, to avoid this ‘feast’ then ‘famine’ for certain services. Nevertheless, this scenario illustrates that top-ups to block grant funding by the UK government could notably ease the budgetary trade-offs facing the Scottish Government.

However, there will still likely be challenges. For example, 3.3% real-terms increases for the NHS and 1% for local government would see funding for ‘unprotected’ services be 4% lower in real terms in 2028–29 than in 2024–25. In other words, providing funding to the NHS that could help address current performance issues, and modest increases in central government funding for councils, would require cuts to many areas of spending, even if the UK government loosens its purse strings to the tune of £15 billion per year by 2028–29 in real terms.

Downside scenario: a weaker net income tax revenue position

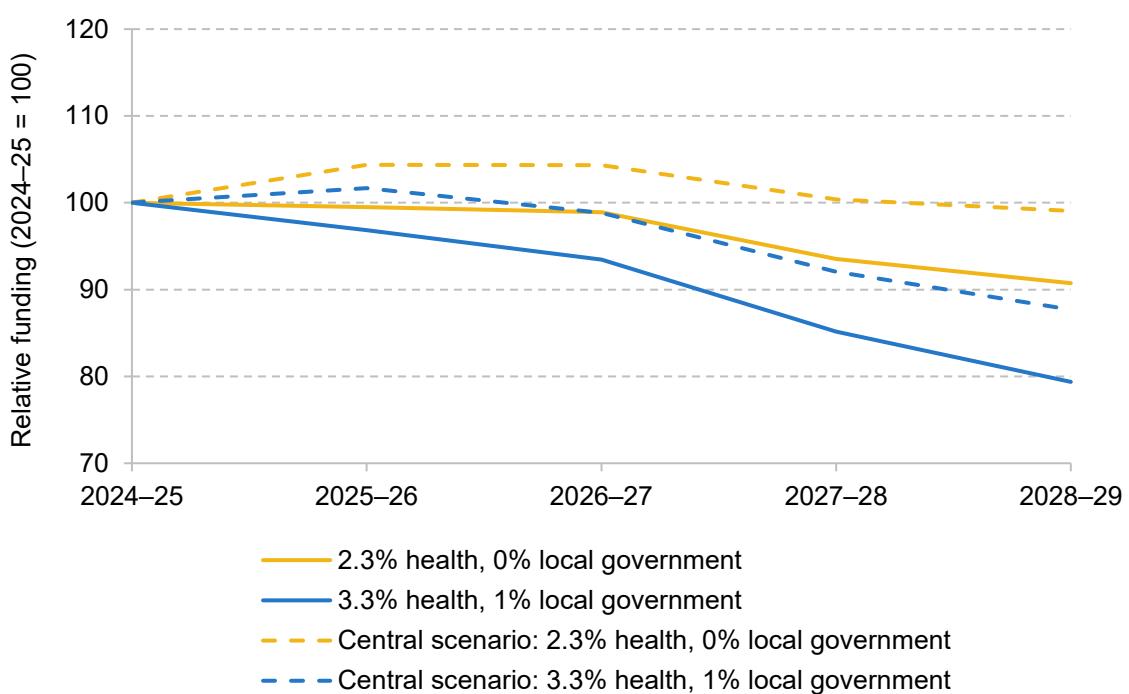
The key downside risk relates to Scotland’s net income tax position – which in turn depends on how strongly Scottish earnings grow in Scotland relative to rUK. As highlighted earlier, the SFC’s forecasts for Scottish earnings are higher than the OBR’s for the UK as a whole – a cumulative 12.5% between 2024–25 and 2028–29, compared with 9.8% – contributing around £500 million to the increased net income tax position in 2028–29. In addition, the SFC reports that each 0.1 percentage point change in earnings growth relative to rUK changes the net tax position by around £25 million.

In our downside funding scenario we therefore assume that not only do Scottish earnings not outpace rUK earnings, but they instead grow by a cumulative 1 percentage point less between 2024–25 and 2028–29. Most obviously, this could arise if Scottish earnings grow by less than the SFC forecast or if rUK earnings grow by more than the OBR’s forecast – but it could also reflect earnings in Scotland and rUK outpacing their associated forecasts, but the latter by more. Based on the SFC’s estimates, this would reduce the net tax position by £750 million in 2028–29. A 1 percentage point decline in earnings growth in Scotland over four years would be a relatively modest change over such a period: over the four years between 2014–15 and 2018–19, the decline was around 4 percentage points, whereas between 2006–07 and 2010–11, the increase was around 3 percentage points. This scenario should therefore not be seen as a ‘lower bound’ on the impact of relative earnings growth on the net tax position.

In addition to these changes to earnings growth assumptions, in our downside scenario we also assume that the positive reconciliations for income tax forecast errors in 2022–23 (affecting the 2025–26 budget) and 2023–24 (affecting the 2026–27 budget) are only half as large as currently

forecast, at £366 million and £251 million, respectively. This scale of change is roughly of the same magnitude (although in the opposite direction) to the ‘positive’ surprise for the 2021–22 reconciliation (which affects the 2024–25 budget). Such a situation could arise if PAYE tax revenues are weaker than suggested by Real Time Information that is already available (which is a good but imperfect guide to PAYE revenues) and/or Scottish self-assessment revenues fall back after particularly strong growth in 2021–22. We also assume that these effects persist, and further reduce the net income tax position in 2027–28 and 2028–29 by £250 million. All told, this means that relative to the projections set out in the SFC’s latest forecast report, resource funding would be around £550 million lower in 2025–26, with the difference growing to £1 billion by 2028–29. In that final year, the net tax position would be around £1.3 billion, compared with £1.2 billion in 2024–25 and £0.6 billion in 2023–24 (after accounting for changes in assumptions about forecast errors and reconciliations discussed above).

Figure 3.8. Implication of differing degrees of prioritisation of the NHS Recovery, Health & Social Care and Local Government portfolios for other public service spending: downside scenario



Source: Authors’ calculations using Scottish Fiscal Commission (2023) and Scottish Government (2023a).

Figure 3.8 shows the implications of this for the budgetary trade-offs facing the Scottish Government. It shows that under spending scenario 2 – with 2.3% real-terms increases in funding for health and flat real-terms funding for local government – and this ‘downside’ scenario for funding, the amount of funding available for ‘unprotected’ services would decline in every year (albeit only slightly in 2025–26) and would be over 9% lower in real terms by 2028–29. This shows that in the absence of an improving net income tax position, even providing the

minimum needed for the NHS and requiring councils to rely on council tax for any real-terms increases in funding would necessitate significant cuts to other service areas.

If health funding were instead increased by 3.3% in real terms per year and local government funding by 1% in real terms per year, the cuts to unprotected services would be even larger – a cumulative 20% in real terms by 2028–29. Such cuts, having come on top of cuts to many such areas in the 2010s, would probably be undeliverable, without stopping certain types of spending and services entirely.

The challenge of medium-term budgeting in Scotland

The differences in the budgetary trade-offs that the Scottish Government would face in the downside, central and upside funding scenarios presented above illustrate the difficulties the Scottish Government has in making medium-term spending plans. Uncertainty about UK government funding, the future net contribution of devolved tax revenues and the impacts of disability and carers' benefits reforms on caseloads and spending, when combined with the limited borrowing powers available to the Scottish Government, mean it is more difficult for the Scottish Government to make firm plans than it is for the UK government.

The Scottish Government has already postponed when it intends to publish updated medium-term spending plans until its next Medium-Term Financial Strategy, expected this summer. Given the potential for substantial changes in UK government spending plans for 2025–26 and beyond, which are unlikely to become clear before the upcoming general election, and the fact that more data on the roll-out of Scotland's reformed benefits will become available during the course of next year, it may make sense to push these plans back again. Going forwards, it may then make sense to align Scottish Spending Reviews with UK Spending Reviews, as is the case in Wales. At the very least, those planning and managing the budgets of particular spending portfolios (and Scottish councils) should treat any spending plans set out in a pre-election Scottish Spending Review as potentially subject to significant revision.

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