Scotland's Economic and Fiscal Forecasts

December 2022 (revised version February 2023)

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Foreword

The Scottish Fiscal Commission is the independent fiscal institution for Scotland. Our statutory duty is to provide the independent and official forecasts of the Scottish economy, devolved taxes and devolved social security spending. Our forecasts represent the collective view of the four Commissioners who take personal responsibility for them.

Professor Graeme Roy and Dr Domenico Lombardi have both joined as Commissioners since our previous forecast report in May 2022, with Professor Roy replacing Dame Susan Rice as Chair of the Commission.

Following the COVID-19 pandemic, global events have continued to move quickly with the Russian invasion of Ukraine and rising energy prices. Closer to home there has been higher inflation, interest rates, and the cost of living crisis. As a result, the near-term outlook for the Scottish and UK economies has weakened significantly over the course of the past year. We now expect Scottish households to see the biggest real-terms fall in their disposable income since Scottish records began in 1998.

Our forecasts have been used to inform the Scottish Government's Budget for 2023-24, also published today. Our protocol for engagement with the Scottish Government has guided our interaction with the Government during the forecasting process.

We would like to thank the committed staff of the Commission as well as officials from the Scottish Government, Revenue Scotland, Social Security Scotland, DWP, HM Treasury, HMRC and the OBR for their support in creating this report.

Professor Graeme Roy

Professor Francis Breedon

Dr Domenico Lombardi

Professor David Ulph

15 December 2022

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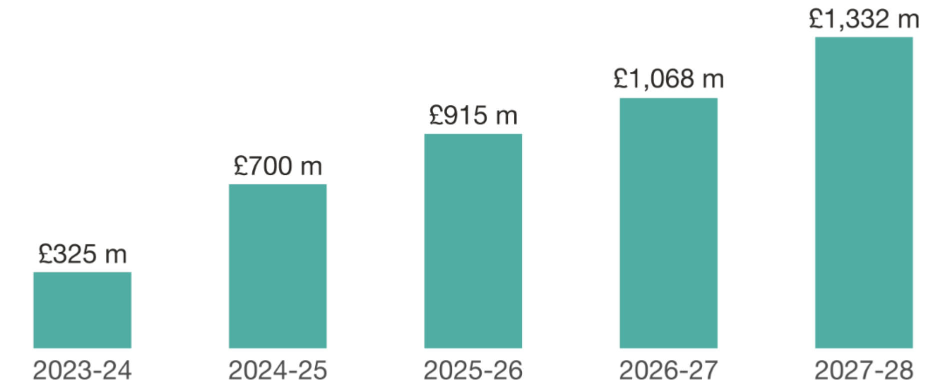
Fiscal Overview

Comparing our forecast with the BGA based on OBR forecasts, an increasingly positive income tax net position is projected, partly as a result of policy changes.

Tax net positions are uncertain, but a higher level could support future resource funding, especially towards the end of the forecast horizon.

Projected income tax net positions



There is almost £1.7 billion more resource funding in 2023-24 than in the latest position for 2022-23 because of increases in the Block Grant and social security funding, as well as improved tax net positions.

However, inflation reduces the spending power of this additional funding. We expect it to be only £279 million more in real terms.

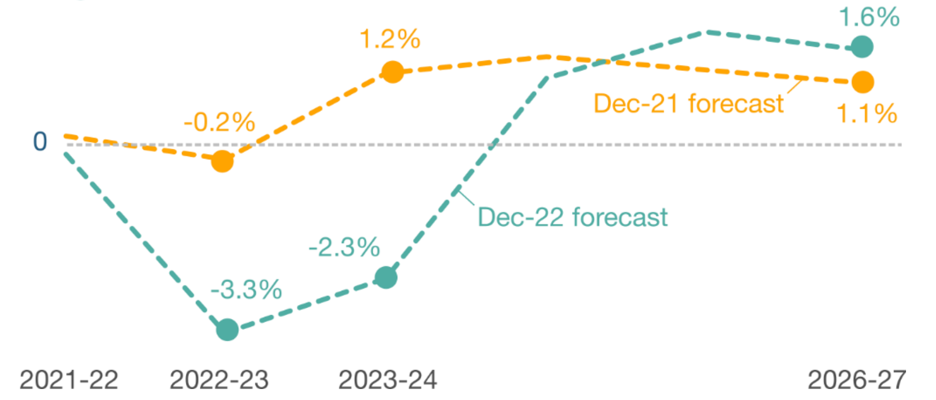
Growth in resource budget from 2022-23 to 2023-24

Economy

High inflation over 2022-23 and 2023-24 results in the greatest fall in the real value of disposable income per person since records began in 1998.

Even once inflation returns to lower levels, real disposable income per person will take time to recover, only reaching its 2021-22 level in 2027-28.

Living standards to fall



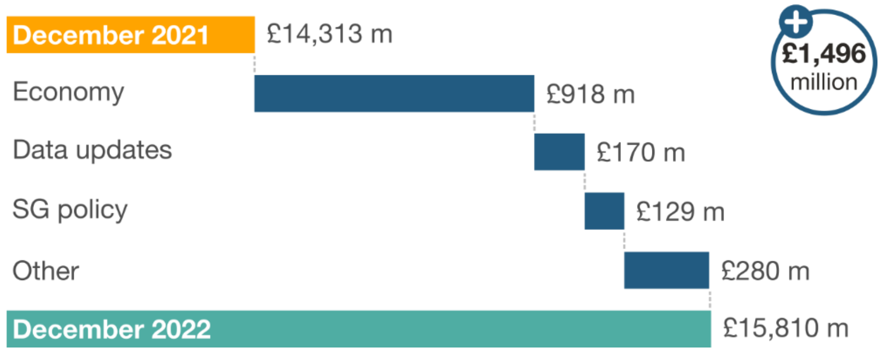
We forecast a shallow recession in the coming year, with a return to the 2022 Q1 pre-recession peak by 2025 Q1.

Following this, GDP does not return to pre-pandemic levels until 2025 Q3.

Recession delays return to pre-pandemic GDP level

Tax

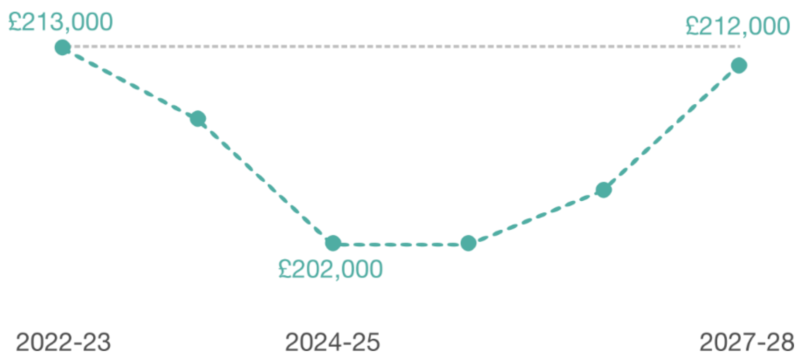
Income tax changes since December 2021 forecast



We expect high inflation leading to increased nominal earnings growth to generate a significant increase in income tax revenue.

The Scottish Government's policy decision to freeze thresholds and increase the higher and top rate of tax will also increase tax revenue.

Fall in house prices over next two years

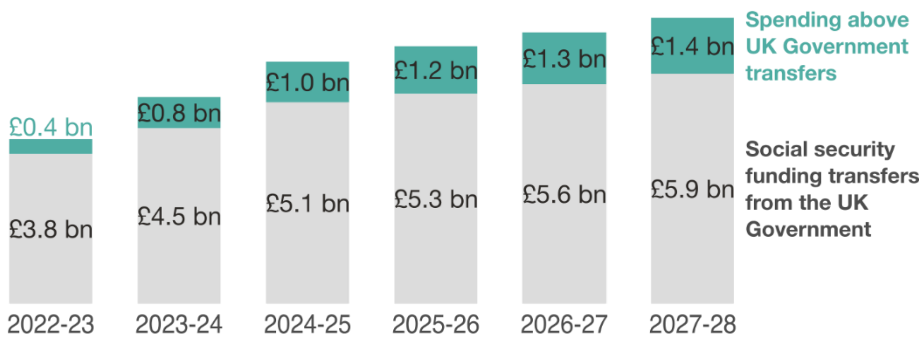


We are forecasting a decrease in house prices over the next two years because of sharp interest rate rises and increased cost of living affecting how much households can afford to spend on moving home.

We expect nominal house prices to return to 2022-23 levels by 2027-28.

Social Security

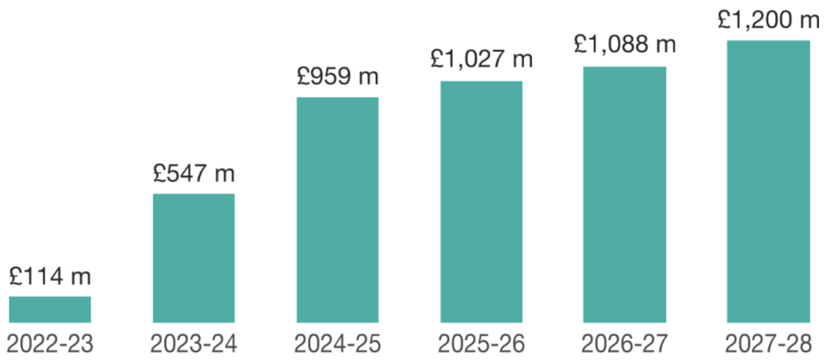
Spending increasing to £7.3 bn by 2027-28



Social Security forecast increases from £4.2 billion in 2022-23 to £7.3 billion in 2027-28.

By 2027-28, we expect the Scottish Government to spend £1.4 billion more on social security than the funding received from the UK Government.

Inflation-linked increases in spending



Most payments are uprated in line with inflation, so high inflation will drive a sharp rise in spending over the next two years.

By 2027-28 uprating increases spending by £1.2 billion.

Budget funding, £ million	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Resource budget (nominal)	43,303	44,991				
Resource budget (2022-23 prices)	43,303	43,582				
Economy, % growth						
Gross Domestic Product	1.7	-1.0	1.2	2.1	1.9	1.5
Consumer Price Index	10.1	5.5	0.0	-1.0	0.8	1.8
Average real earnings	-4.4	-0.8	2.2	2.7	1.7	1.3
Employment	1.7	-0.5	-0.2	0.3	0.5	0.4
Tax, £ million						
Income tax	14,575	15,810	16,633	17,370	18,247	19,437
Non-Domestic Rates	2,818	3,075	3,080	3,135	3,405	3,286
LBTT	850	774	728	794	910	995
Scottish Landfill Tax	101	79	72	58	16	16
Policy announcements						
Income tax	4	129	142	150	162	175
Non-Domestic Rates		-356	-309	-288	-267	-262
LBTT	12	34	28	34	39	40
Social Security, £ million						
All devolved social security	4,187	5,244	6,163	6,554	6,903	7,267

Summary

Introduction

1 Rising prices run through all of our forecasts. Higher energy prices and their consequences for inflation more generally mean that we now think the Scottish economy has entered recession this year, and Scottish households are expected to see the biggest real-terms fall in their disposable income since Scottish records began in 1998.

2 The Scottish Government will also have to deal with the effects of higher prices and demand for higher wages in the public sector.

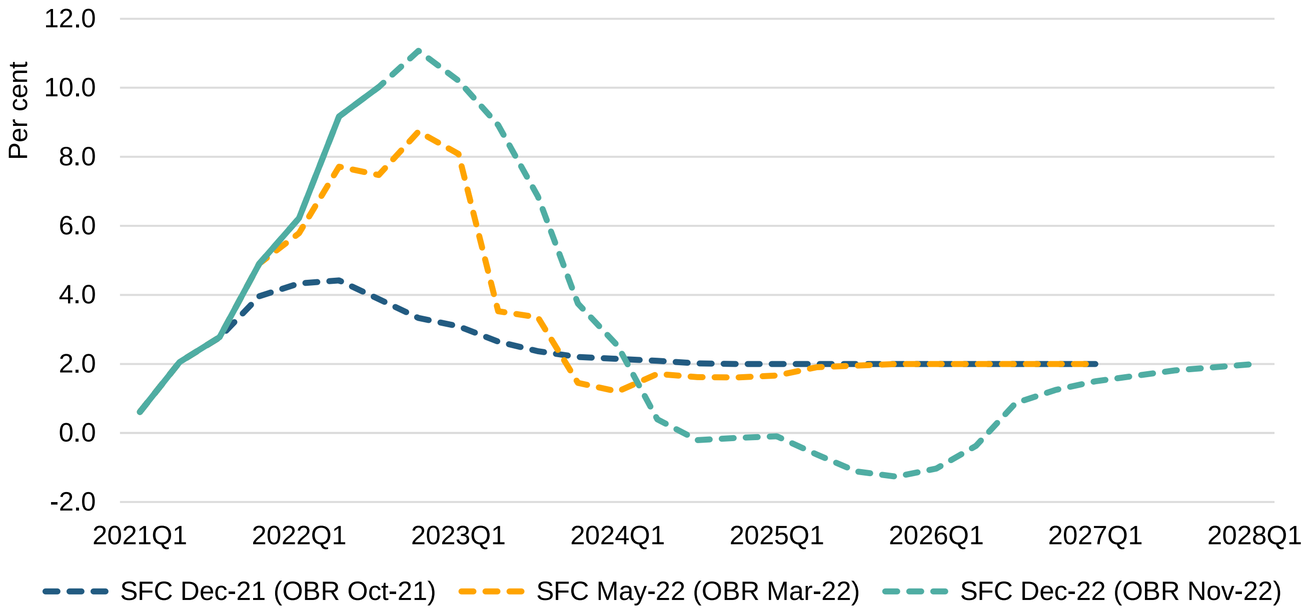
3 Nominal earnings are rising because of higher prices. This has meant upwards revisions to our income tax forecast compared to previous reports. However, as nominal earnings are rising by less than the price of goods and services, the overall effect on households is negative.

Economic outlook

4 The near-term outlook for the Scottish and UK economies has weakened significantly over the course of the year. The rise in energy and traded goods prices being driven by the conflict in Ukraine has been greater than expected earlier in the year, pushing up inflation. Interest rates have risen to levels not seen since before the 2008-09 Global Financial Crisis. All of this has intensified the costs for households and businesses. Falling real incomes mean the coming years are going to be difficult for many households, particularly those with lower incomes.

5 We expect annual Consumer Price Index (CPI) inflation to peak at around 11 per cent in 2022 Q4. The peak is lower than it might have been in the absence of the UK Government's Energy Price Guarantee. Inflation looks set to drop sharply over the course of next year as global energy prices level off and domestic inflationary pressures unwind due to the recession.

Figure 1: Consumer Price Index inflation, year-on-year growth

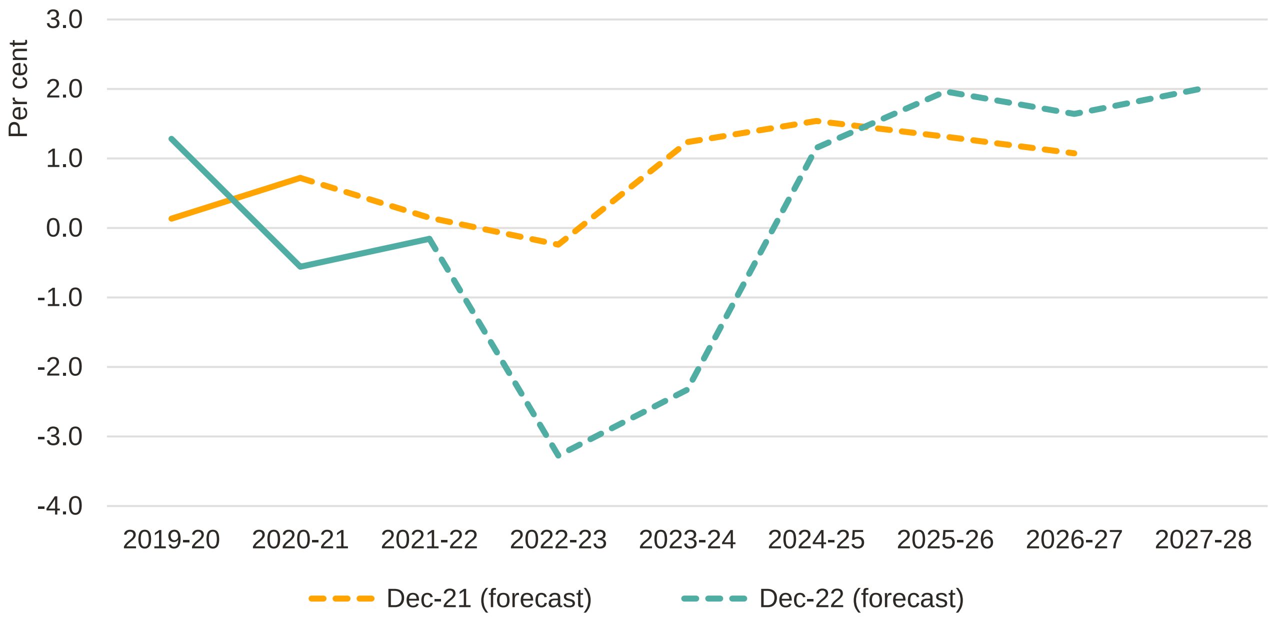


Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2022) Scotland's Economic and Fiscal Forecasts – May 2022 (link), Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – December 2021 (link). Solid lines refer to outturn available at time of publication and dashed lines refer to forecasts.

6 High inflation means that, over this year and next, Scottish households are expected to see the biggest fall in their real disposable income since records began in 1998. Even once inflation returns to lower levels, and real household incomes start to grow again in 2024-25, living standards will take time to recover to the pre-crisis 2021-22 level. Our forecast suggests that, by 2025-26, real disposable income per person will be no higher than its level a decade earlier. The global shock prolongs a period of slow growth in living standards since the Global Financial Crisis, with real disposable income per person growing on average by only 0.4 per cent per year between 2008-09 and 2021-22 compared to around 3 per cent before 2008-09.

7 High inflation and the recession will affect everyone, but there will be particular pressures on lower-income households, as they spend a larger share of income on essentials such as energy and food. Rising interest rates will add to the costs of mortgages and other forms of debt. Compared to the UK as a whole, Scotland has lower average house prices and lower average household debt as a share of income, which means that rising interest rates will tend to have a smaller effect than in the rest of the UK.

Figure 2: Real disposable income per person growth



Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – December 2021 (link), Scottish Government (2022) GDP Quarterly National Accounts (QNA): 2022 Quarter 2 (April to June) (link).
Solid lines refer to outturn available at time of publication and dashed lines refer to forecasts.

8 When the global energy price shock arrived in early 2022, the Scottish economy was still recovering from the impact of health restrictions, labour shortages and supply chain disruptions associated with the global Coronavirus (COVID-19) pandemic. Throughout 2022, the impact of higher energy prices and the acceleration of wage pressures has worsened. The economy has also been adjusting to Brexit as well as the long-term evolution of the oil and gas industry in the North East of Scotland. There is no comparable period in recent economic history when the economy has been hit by two global shocks in immediate succession while adjusting to other significant domestic pressures.

9 The underlying structure of the Scottish economy is undergoing profound shifts. The pandemic has resulted in shifts in demand and changes in labour markets including more people working from home, while some people are suffering from prolonged health effects, in part due to delays in NHS treatment. At the same time, the economy faces higher goods import prices as a result of the continuing COVID-19 restrictions in China. Rising energy prices are a terms of trade shock that the economy has to adapt to by using less energy at a higher cost. This will be a particular issue for energy intensive industries that find it difficult to pass on higher costs to consumers. Brexit is also having an effect on supply chains and on export markets for Scottish business.

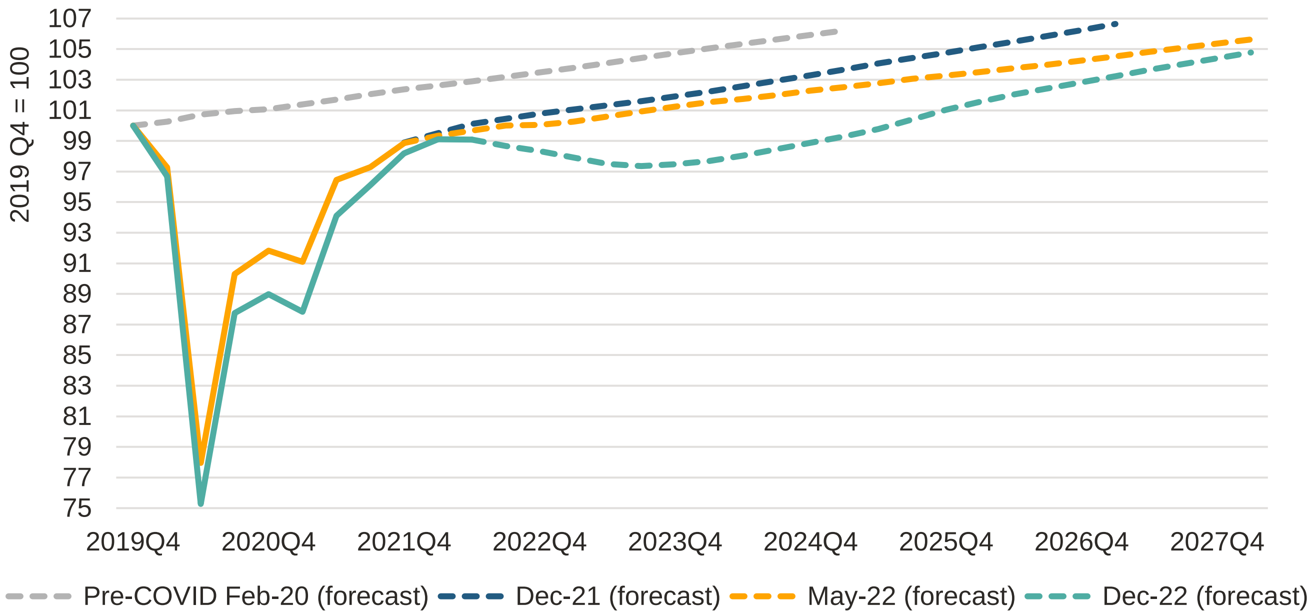
10 Over the longer term, the size of Scotland's economy is determined by its potential output. In the current context, both the underlying capacity of the Scottish economy to produce goods and services – its potential output – and the outlook for productivity growth are uncertain. We have reduced our view of the size of Scotland's potential output in recent forecasts, and are therefore forecasting a lower level and cumulative growth rate of Gross Domestic Product (GDP). This can be seen in Figure 3.

11 In the shorter term, largely reflecting the energy price shock and its inflationary consequences, our judgement is that Scotland has already entered a recession which will last six quarters, with a total peak to trough fall in GDP of 1.8 per cent. Higher prices will mean real incomes fall and put the economy into recession via both a supply and demand side shock. The recession will be dampened by higher nominal pay awards, increased benefits payments and some households running down

savings to support spending. Following the inflation shock, the level of real incomes in Scotland will be lower and expected to take time to recover. Although prolonged, we expect the recession will be shallower than the Global Financial Crisis or the COVID-19 recession.

12 The precise magnitude and duration of the recession are uncertain. While there is a lot of focus on the specific path for growth over the short term, we consider that the level of GDP in Scotland over the longer term is the most important aspect. Despite the relatively shallow nature of the recession, it is important to see it in the context of a prolonged period of slow economic growth. This slow growth is the result of globally slowing productivity growth as well as the shocks outlined at the start of this section. Sustained lower levels of GDP, relative to what we would have expected to be the case without these shocks, will mean ongoing lower incomes and will put pressure on tax receipts and public spending.

Figure 3: Scottish GDP, outturn and forecast



Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2022) Scotland's Economic and Fiscal Forecasts – May 2022 (link), Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – December 2021 (link), Scottish Fiscal Commission (2020) Scotland's Economic and Fiscal Forecasts – February 2020 (link).
Solid lines refer to outturn available at time of publication and dashed lines refer to forecasts.

13 We expect the recession in Scotland to broadly mirror the UK recession forecast by the Office for Budget Responsibility (OBR). Peak to trough, we forecast the Scottish economy to shrink by 1.8 per cent, compared to the OBR's forecast for the UK of 2.1 per cent. We expect the Scottish economy to recover to its pre-recession peak by the first quarter of 2025, one quarter behind the UK.

14 As in all our forecasts, there is significant uncertainty around the economic outlook, in this case arising from global developments. Energy prices and inflation will continue to depend on how the situation in Ukraine evolves. Another important source of uncertainty is how high inflation affects wages. So far, pay awards have remained below inflation, resulting in falling real earnings. However, with unemployment relatively low, it is possible that workers will find they can bargain for stronger pay awards, affecting both the real terms earnings outlook and potentially inflation.

15 Figure 4 shows further detail on our latest economy forecast and compares it to our December 2021 forecast, which pre-dated the Russian invasion of Ukraine.

Figure 4: Headline economy forecasts, growth rates unless otherwise specified

Per cent	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
GDP							
December 2021	10.4	2.2	1.2	1.3	1.4	1.4	
December 2022	14.0	1.7	-1.0	1.2	2.1	1.9	1.5
Consumer Price Index							
December 2021	3.3	3.7	2.3	2.0	2.0	2.0	
December 2022	4.0	10.1	5.5	0.0	-1.0	0.8	1.8
Unemployment rate							
December 2021	4.6	4.5	4.3	4.2	4.2	4.2	
December 2022	3.9	3.4	4.3	4.7	4.6	4.3	4.1

Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – December 2021 (link).
Shaded cells refer to outturn available at time of publication.

Tax

Income tax

16 As shown in Figure 5, we have revised up our income tax forecast significantly since December 2021. High inflation leading to increased nominal earnings growth is the main reason for this increase. The combination of high inflation with fixed tax thresholds leads to more people moving into higher tax bands, known as fiscal drag, and tax revenues rise faster than nominal earnings. Figure 5 summarises changes in our income tax forecast since December 2021.

17 The Scottish Government has announced that in 2023-24 all non-savings, non-dividends (NSND) income tax thresholds will remain frozen at 2022-23 levels, with the exception of the top rate of income tax which will reduce to £125,140 from the current level of £150,000. They have also announced they will be increasing both the higher rate and top rate by 1 pence. From 2023-24, the higher rate will now be 42 pence and the top rate will be 47 pence. These income tax policy changes are expected to raise an additional £129 million of income tax revenue in 2023-24.

18 When creating our five-year forecasts, for years in which there is not an announced Scottish Government policy, we need to make assumptions about future income tax rates and thresholds. In May 2022 we took the decision to freeze the income tax higher rate threshold in that and future forecasts, as we judged this to be the most reasonable assumption to make in our forecasts in line with historical patterns.[1] This means that the freezing of the higher rate threshold is already included in our forecasts and the Scottish Government's decision to freeze the higher rate threshold does not yield additional revenue. We explain this in further detail in in Chapter 4.

[1] Scottish Fiscal Commission (2022) Scotland's Economic and Fiscal Forecasts – May 2022 (link)

Figure 5: Change in income tax from December 2021

£ million	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27
December 2021 forecast	11,938	13,002	13,671	14,313	15,056	15,790	16,445
Economy	-	277	652	918	745	405	345
Policy	-	-	4	129	142	150	162
Other	10	58	248	449	689	1,024	1,295
December 2022 forecast	11,948	13,337	14,575	15,810	16,633	17,370	18,247

Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2021) Scotland's Economic and Fiscal Forecasts – December 2021 (link), Scottish Fiscal Commission (2022), Scotland's Economic and Fiscal Forecasts – May 2022 (link), HMRC (2022) Scottish Income Tax Outturn Statistics: 2020 to 2021(link).
Shaded cells refer to outturn available at time of publication.

The income tax net position

19 Despite a deterioration in the forecasts of the Scottish and UK economies overall, the outlook for the income tax net position has improved significantly. Comparing our forecasts with the OBR's, the net position is expected to be £325 million in 2023-24, compared to the expected value in December 2021 of -£257 million. Relatively small changes in either the OBR or our forecasts can lead to significant changes in the projected net position. This is particularly relevant now with heightened inflation and increased geopolitical risks adding to the uncertainty of the component forecasts.

20 The more positive outlook for the net position is driven in part by Scottish Government policies to raise additional income tax. An additional £129 million of income tax revenue is set to be raised in 2023-24 following policy changes announced at this budget.

21 Since 2017-18, the Scottish Government has increased income tax rates and frozen thresholds to raise additional revenue, relative to what would be raised under UK Government policy. While the higher rate threshold is frozen in both the UK and Scotland, it is frozen at a lower level in Scotland. We estimate that the total divergence in Scottish and UK income tax policy since 2017-18 is contributing around £1 billion to the income tax net position in 2023-24.

22 Another factor is outturn data for 2020-21 published in July 2022 and discussed in our August 2022 publications, which showed Scotland to have a more positive net position than we anticipated in our December 2021 and May 2022 forecasts, driven primarily by lower than expected UK income tax revenues.

23 Changes to the OBR's and our economy forecasts have also affected the outlook for the net position. With inflation rising, both the OBR and the Commission have revised up our forecasts for nominal average earnings growth by around the same amount in 2023-24. However, the OBR have made significant downward revisions to their forecast of employment growth in 2023-24. We think this revision in the OBR's forecast of employment growth in the UK has contributed significantly to the positive shift in the net position in 2023-24.

24 From 2024-25 onwards, the OBR forecasts UK average nominal earnings growth to average 2.0 per cent. This is low by historical standards and compared to our forecast of 2.6 per cent for Scotland, leading to a further improvement in the income tax net position over the forecast horizon.

25 Over the last five years, earnings have been growing more slowly in Scotland than the UK. This has been driven in part by slowing activity in the oil and gas sector in Scotland, and growth in the

earnings in the financial services in the UK. Comparing our forecasts of earnings growth to the OBR's suggests a period of catch-up in Scottish earnings over the next five years. driven by:

- Higher energy prices and an increased emphasis on energy security leading to a more positive outlook for earnings and employment in the oil and gas sector.
- Greater alignment in the outlook for earnings growth in Scottish and UK financial services.
- Scottish households tend to have smaller mortgage debt than households in other parts of the UK, meaning they will be less affected by rising interest rates, supporting economic activity in Scotland.

26 The outlook for earnings growth is uncertain and a range of outcomes is possible. Further revisions to ours or the OBR's forecasts could see this period of catch-up in earnings in Scotland disappearing, and a weakening in the outlook for the income tax net position.

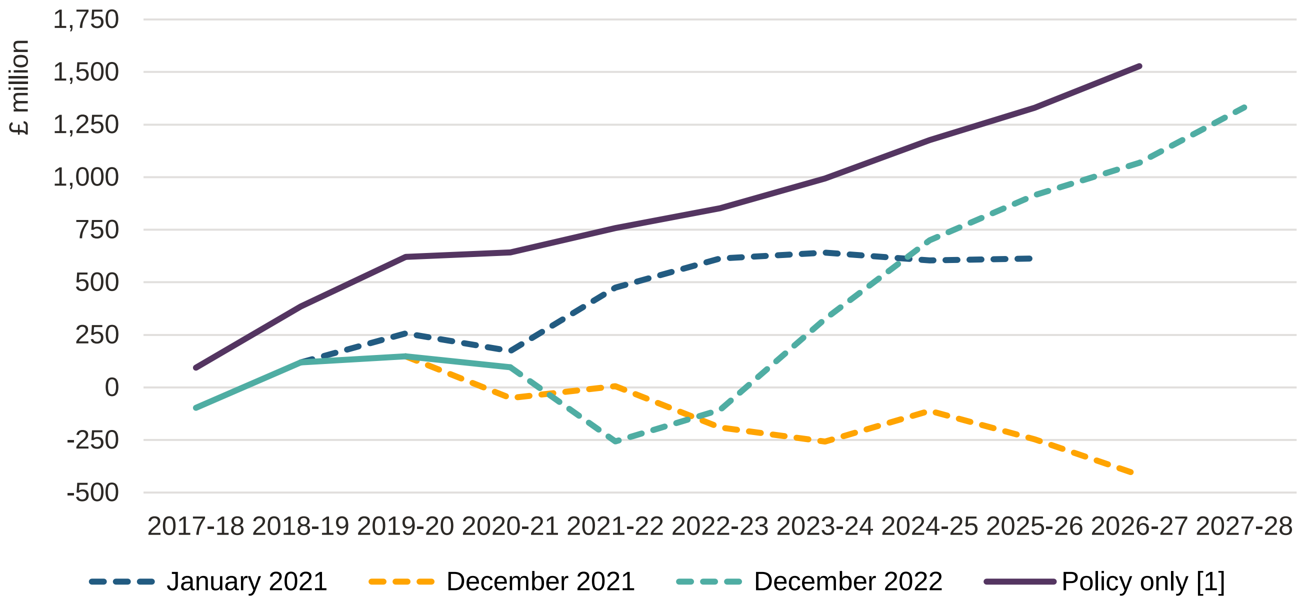
27 In summary, policy changes, revised data, and shifts in the relative economic outlook with the UK have all contributed to improved projections of the income tax net position. However, we strongly caution that the outlook remains very sensitive to changes in our or OBR's forecasts. The income tax net position for 2023-24 has increased by £582 million since our December 2021 forecast. While this is a large amount of money, it represents only 3.7 per cent of Scottish income tax revenues in this year. For context, we estimate that the OBR has an absolute forecast error of around 4.9 per cent in its two-year-ahead income tax forecasts for the UK, and so shifts in the income tax net position of this scale are not unexpected.[2]

28 The net position is the difference between two large forecast values, and there was always an expectation that estimates could move over time. We are now five years into the operation of the fiscal framework, and we can see that estimates of the net position can move year-to-year, and perhaps more than anticipated. As forecast error is an inherent part of forecasting, movement in the outlook of the net position is an inherent part of the fiscal framework, particularly with heightened economic uncertainty, and therefore requires careful budget management.

29 Figure 6 shows the latest projection of the net position compared to other recent projections.

[2] We reference the OBR figure here as a benchmark as they have a longer history of forecasts to compare. Scottish Fiscal Commission (2021) Supplementary Forecast Evaluation Report (link).

Figure 6: The income tax net position comparisons



Source: Scottish Fiscal Commission, Scottish Fiscal Commission (2022) 'Trends in Scotland's population and effects on the economy and income tax' (link).
[1] The policy only line includes the latest policy announcements from the Scottish Government and UK Government. It is estimated on a static policy basis. Including behavioural responses would only have a small effect on the purple line and not change the overall story presented in this figure.

30 In Figure 6 the solid line is outturn data on the income tax net position, and the dashed line shows the outlook given the latest OBR and our forecasts. The net position has been revised up significantly since December 2021 and is now more in line with where it was projected to be in January 2021.

31 The policy only [1] line in Figure 6 shows our approximation of what the income tax net position would be if Scottish economic performance had exactly matched the UK, with the only difference being in income tax policy. The actual net position being below this policy only position is in line with relatively slower earnings and employment growth in Scotland compared to the UK since 2016-17. Even with a period of relative catch-up over the next five years, earnings and employment growth in Scotland still lags the UK compared to the 2016-17 starting year for income tax. Despite upwards revisions, the income tax net position remains below the hypothetical policy differences only position.

Other devolved taxes

Non-Domestic Rates

32 There are several Non-Domestic Rates (NDR) policy changes included in the 2023-24 Budget. The Scottish Government has set the poundage to the same amount as in 2022-23. The Small Business Bonus Scheme (SBBS) has been reformed. There are two transitional reliefs available, one for all properties where rateable value has substantially increased after revaluation and one for small businesses affected by SBBS changes.

33 Our NDR forecast has been affected by the ongoing revaluation of all rateable properties. The final valuation roll will not be available until 1 April 2023. Because of this ongoing revaluation, we have used an imputed roll based on an incomplete draft roll to forecast NDR. Any differences between the imputed roll and the final roll will affect our policy costings and forecasts.

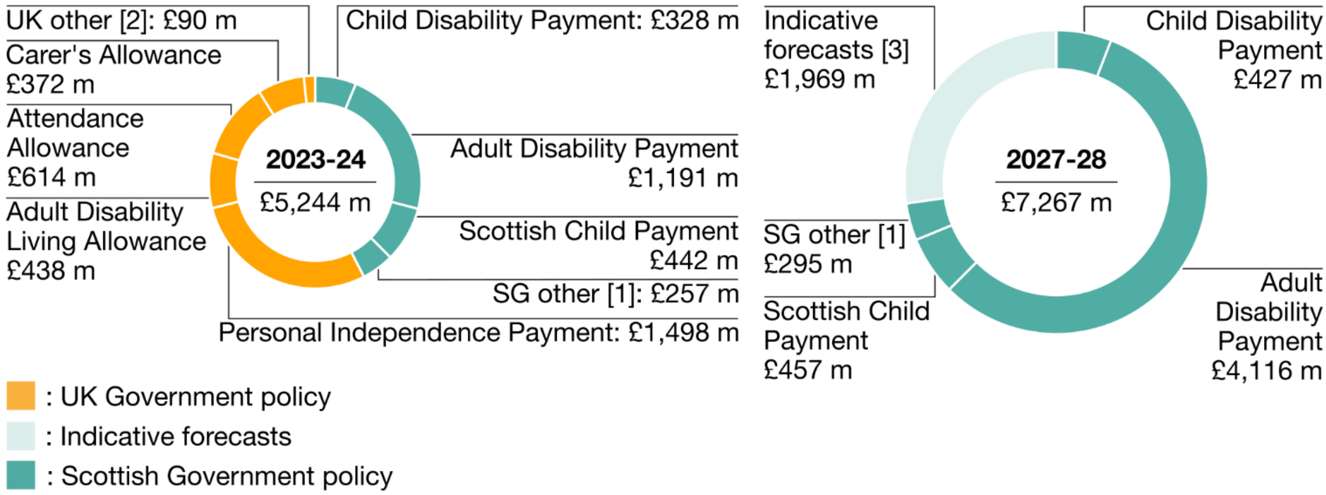
Land and Buildings Transaction Tax

34 House prices have increased further since December 2021, and this is reflected in an increase to our Land and Buildings Transaction Tax (LBTT) forecast for 2022-23. However, we have revised down our forecast from 2023-24 onwards because we expect a drop in house prices and transactions next year and the year after in response to the rapid rise in interest rates and the wider downturn.

Social security

35 We forecast overall social security spending will rise from £5.2 billion in 2023-24 to £7.3 billion in 2027-28. The existing payments administered by the Department for Work and Pensions (DWP) will continue to be replaced by new payments delivered by Social Security Scotland. The increase in expenditure over the forecast is a result of more people receiving the payments and on average people receiving higher payments over time, with inflation being a major factor in this.

Figure 7: Social security spending in 2023-24 and 2027-28



Not included in the visual: £14 million for the replacement of the devolved employability support services as an indicative forecast in 2023-24 and £4 million for Severe Disablement Allowance as UK Government Policy in 2027-28.

[1] SG other includes: Best Start Foods, Best Start Grant, Carer's Allowance Supplement, Child Winter Heating Assistance, Winter Heating Payment, Funeral Support Payment, Discretionary Housing Payments, Fair Start Scotland and Scottish Welfare Fund in 2023-24.

[2] UK other includes: Industrial Injures Disablement Benefit and Severe Disablement Allowance in 2023-24.

[3] Indicative forecasts includes: Scottish Carer's Assistance, Pension Age Disability Payment, Employment Injury Assistance, Pension Age Winter Heating Payment, Scottish Adult DLA, and an estimate for spending on Employability Services to replace the current Fair Start Scotland.

36 Our forecast for spending in 2026-27 has increased by £1.4 billion compared to our December 2021 forecast. The two major drivers of this have been higher inflation leading to payment amounts being increased by more than we forecast in December 2021, and recent increases in the number of people receiving disability payments.

Figure 8: Change in total social security spending forecasts since December 2021

£ million	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
December 2021	3,679	4,065	4,657	4,966	5,230	5,511	
December 2022	3,682	4,187	5,244	6,163	6,554	6,903	7,267
Change since December 2021	3	122	587	1,197	1,324	1,392	

Source: Scottish Fiscal Commission.
Figures may not sum because of rounding. Shaded cells refer to outturn available at time of publication.

37 Social security spending is partly funded by Block Grant Adjustments (BGAs) from the UK Government for taking on the payment of devolved benefits. The level of BGAs is based on spending on the UK payments in England and Wales and they do not include the effect of Scottish Government reforms. Any spending above the funding from the BGAs must be met by the Scottish Government from elsewhere in the budget. The Scottish Government has also introduced new payments which have no UK equivalents. As there are no BGAs these must be funded entirely from the Scottish Government budget.

38 Figure 9 shows forecasts for the difference between social security funding and spending each year. When including new payments introduced by the Scottish Government, we forecast that by 2027-28 the total spending on social security payments will be £1.4 billion more than the corresponding funding received.

Figure 9: Social security net position and new payments

£ million	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Social security net position	- 11	- 194	- 421	- 584	- 689	- 775
New social security payments	- 363	- 582	- 625	- 627	- 636	- 642
Total	- 374	- 776	- 1,046	- 1,212	- 1,325	- 1,416

Source: Scottish Fiscal Commission.
Figures may not sum because of rounding.
[1] Social security net position includes Adult Disability Payment (covered by the Personal Independence Payment BGA), Child Disability Payment and Scottish Adult Disability Living Allowance (covered by the Disability Living Allowance BGA), Pension Age Disability Payment (covered by the Attendance Allowance BGA), Scottish Carer's Assistance and Carer's Additional Person Payment (covered by the Carer's Allowance BGA), Employment Injury Assistance (covered by the Industrial Injuries Disablement Scheme BGA), Winter Heating Payment (covered by the Cold Weather Payment BGA), Pension Age Winter Heating Payment (covered by the Winter Fuel Payment BGA) and Severe Disablement Allowance (covered by Severe Disablement Allowance BGA).
[2] Social security new payments include Scottish Child Payment, Carer's Allowance Supplement, Child Winter Heating Assistance, Best Start Grant Early Learning Payment and Best Start Grant School Age Payment. We also include spending through Discretionary Housing Payments on bedroom tax mitigation and the extra costs of the new commitment to mitigating Benefit Cap deductions.

39 The majority of social security payments are increased each year by inflation. This means the higher forecasts of inflation have led to our forecasts of social security spending increasing. BGAs also increase as a result of inflation, but these only cover part of the spending forecast. UK Government funding transfers will not cover the inflation related increase in spending on the additional cost of the reforms introduced by the Scottish Government.

40 Scottish Child Payment is the most significant new benefit introduced by the Scottish Government, with forecast spending of £442 million in 2023-24. It was originally launched in February 2021 as a

weekly payment for low-income families with children aged under six. On 14 November 2022 Scottish Child Payment was extended to include all children under 16 in low-income families.

41 Adult Disability Payment (ADP) was launched nationally in Scotland in August 2022 to replace Personal Independence Payments (PIP), the existing UK Department for Work and Pensions (DWP) payment. Adult Disability Payment spending accounts for over half of the social security spending forecast for 2023-24.

42 In the period since COVID-19, in advance of the launch of ADP, there has been an increase in the number of adults receiving disability benefits in Scotland. We attribute this increase to the combined impact of the following factors:

- Eligible people considering sources of support as a response to the cost of living crisis.
- People waiting longer for NHS treatment, potentially leading to conditions worsening or treatment being less effective, to such an extent that they become eligible for disability benefits.
- Continuing long-term impacts from COVID-19, including long COVID and wider impacts of the pandemic on mental health.

43 We expect these effects will persist into the future, so have increased our forecasts for spending on disability benefits. There have also been similar increases in people receiving UK disability payments England and Wales, meaning that forecasts for funding received through BGAs have also increased.

44 Compared to PIP, the Scottish Government has made a number of reforms with the introduction of ADP. The reforms include, but are not limited to, changes designed to improve the experience of people applying for the benefit, longer awards, the ambition to increase take-up by those eligible for the payment, and changes to the terminal illness rules. Our assessment is that the implementation of these reforms will lead to more people receiving ADP and higher average payments. We forecast expenditure on ADP will be over £650 million higher than the BGA received for PIP in 2027-28. This additional spending is more uncertain than other parts of the social security expenditure forecasts as it is based on our assumptions and judgements on the impact of the Scottish Government reforms. It is important that we receive the detailed data we need on ADP to ensure we can accurately forecast the overall expenditure and changes introduced by the Scottish Government.

The funding outlook

45 The Scottish Government has set the 2023-24 Budget based on our tax and social security forecasts, UK Government spending plans, plans for using the Scotland Reserve and borrowing, and assumptions on other income sources. We consider the Scottish Government's funding assumptions for the 2023-24 Budget to be reasonable. We discuss in this report the pressures 2023-24 will bring in terms of inflation and increasing social security spending.

46 The Scottish Government has provided indicative assumptions for the years 2024-25 to 2027-28. Our forecast accompanies a one-year budget and we do not comment on the reasonableness of these assumptions. We do note pressures in future years including a large negative income tax reconciliation for 2024-25 and an increasing social security bill.

Resource budget 2023-24

47 We expect resource funding for 2023-24 to increase by £1.7 billion in nominal terms but only £279 million in real terms compared to the latest funding position for 2022-23. Resource funding makes up the majority of the Scottish Budget and is used on public services such as NHS Scotland, goods and services, and social security. The difference of £1.4 billion in the value of the nominal and real 2023-24 Budget compared to the latest 2022-23 position shows the effect higher inflation is having, eroding the spending power of the Scottish Government. We account for inflation using the GDP deflator, but CPI inflation is higher than this and may affect some areas of government spending more than the GDP deflator. Although there have been increases in funding for 2023-24, the Scottish Government is likely to face challenges in balancing its funding and spending plans.

48 Nominal resource funding for 2023-24 has increased due to greater UK Government funding via the Block Grant. There has been an improvement in the tax net position, the difference between Scottish tax revenues and their Block Grant Adjustments (BGAs). In 2022-23 the net tax position was slightly negative, it is positive for 2023-24. This change is partly driven by Scottish Government policy for income tax in freezing income tax thresholds at a lower rate than that set by the UK Government and raising tax rates. In 2022-23 a small negative tax reconciliation is applied but a positive tax reconciliation is expected for 2023-24 based on outturn data. The Scottish Budget is set based on forecasts of Scottish and UK income tax. Reconciliations are funding adjustments applied to the budget after outturn data are available. Compared to the latest position for 2022-23, for 2023-24 the Scottish Government is assuming lower amounts of reserve drawdown, borrowing and assumed other funding.

49 The Scottish Government is profiling £310 million of the proceeds from ScotWind leases in the 2023-24 Budget. In May 2022 we assessed this to be reasonable but noted it may warrant revisiting if other funding materialises. Since then, there has been a real-terms increase of £1.3 billion in the funding position for 2023-24. This is due to increased funding via the Block Grant, the tax net position moving from being forecast at -£265 million to £562 million and the final reconciliation being positive rather than negative. We still assess the profiling of ScotWind in this way to be reasonable as we expect the 2023-24 Budget will be subject to further inflationary pressure throughout the year, but this does constrain what can be deployed in future years from this source.

50 Social security spending on devolved payments is forecast to exceed specific funding from the UK Government by £194 million due to Scottish Government reforms of these payments. Together with new payments introduced by the Scottish Government, there is £776 million of social security spending not funded by BGAs in 2023-24. The gap between the BGAs and social security spending puts pressure on the Scottish Budget as other sources of funding must be used. Most of social security payments are increased each year by CPI, so inflationary pressures may exceed those captured by the GDP deflator.

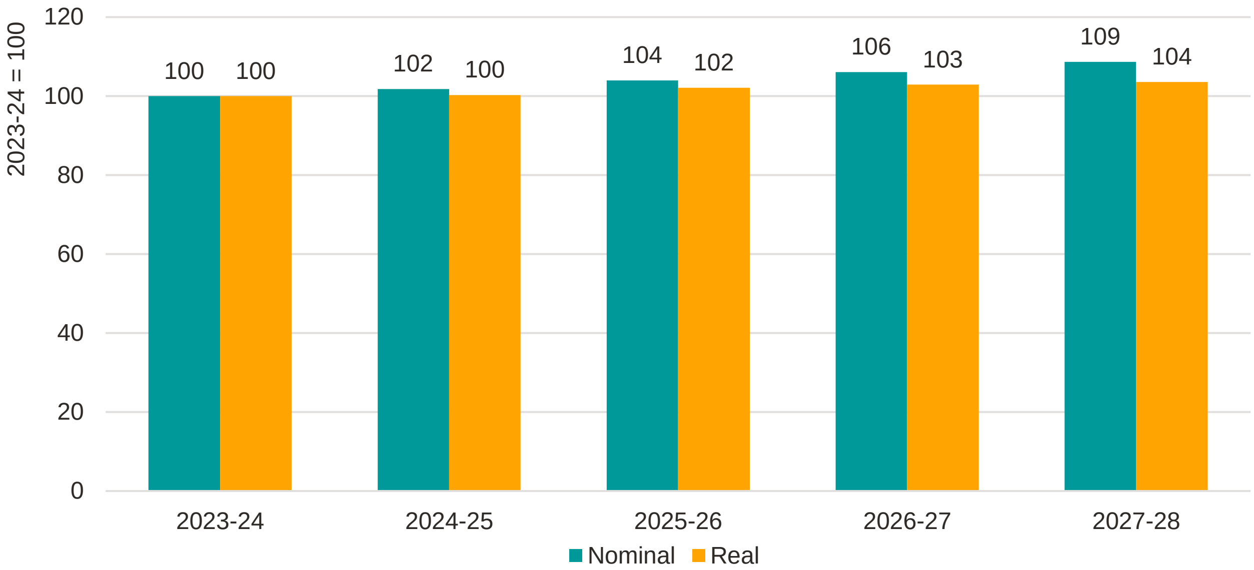
51 The 2023-24 Budget does not include planned resource drawdown from the Scotland Reserve. This is because the available balance is expected to be drawn down to support additional spending in 2022-23. The Scottish Government plans to borrow £41 million within the limit unlocked by negative forecast errors.

Resource funding in the medium term

52 Over the next five years we expect a modest but steady increase in nominal resource funding. Inflation dampens this growth substantially. In 2027-28 we expect the Scottish Government to have 4 per cent more resource funding in real terms than in the 2023-24 Budget. This is shown in

Figure 10. The medium-term funding position is indicative and based on assumptions made by the Scottish Government on the UK Government funding, other sources of income and our forecasts.

Figure 10: Five-year resource funding trends



Source: Scottish Fiscal Commission, Scottish Government.
Amounts indexed so that amount in 2023-24 is equal to 100. Real amounts have been calculated adjusting nominal amounts by the most recent GDP deflators published by the OBR in November 2022 (link).

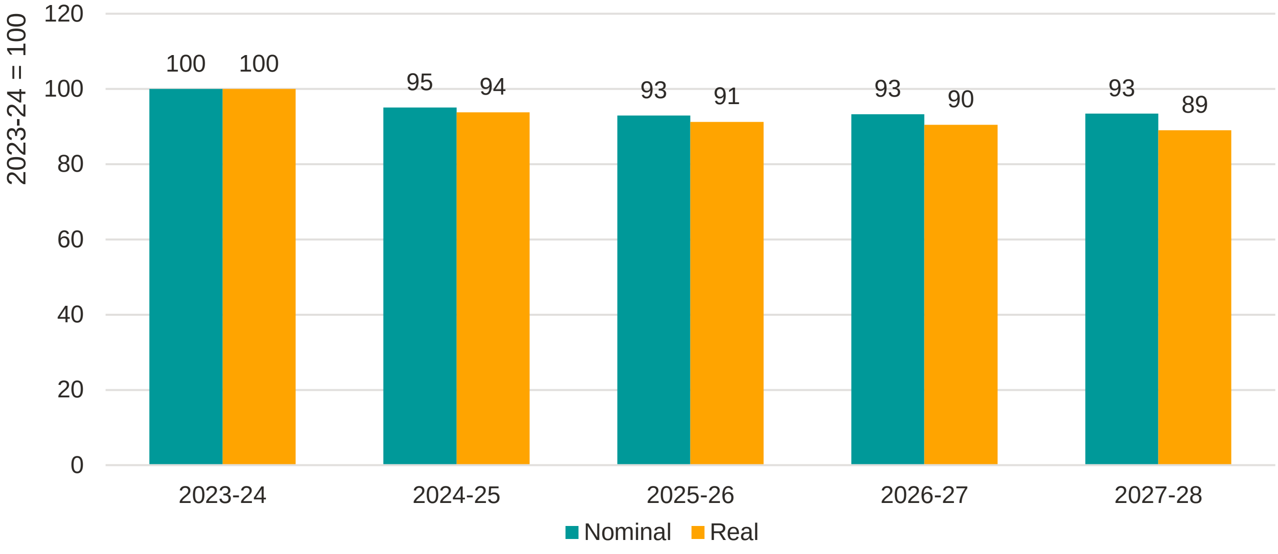
53 Our and the OBR's latest forecasts lead to the projected tax net position being increasingly positive over the medium term. The income tax net position drives this and is forecast to add £1.3 billion to the resource budget in 2027-28. This estimate is illustrative and may change depending on UK and Scottish tax policy and revenues. The large negative income tax reconciliation of £732 million expected in 2024-25 means that the resource budget for 2024-25 is only very slightly higher than for 2023-24 in real terms. This reconciliation will exceed the Scottish Government's resource borrowing limit, reducing resource funding available to portfolios. We expect that spending on devolved social security will increasingly exceed BGA funding because of Scottish Government reforms. Combined devolved and new social security payments are forecast to exceed the BGAs by £1.4 billion in 2027-28. This will reduce funding available to other portfolios.

Capital funding

54 Capital funding accounts for 12 per cent of the Scottish Budget in 2023-24 and is used to fund long-term investments such as infrastructure, hospitals, and research and development. The capital budget is flat in nominal terms between the latest position for 2022-23 and the 2023-24 Budget reflecting a real-terms cut £185 million.

55 As shown in Figure 11, this pressure is expected to continue in the medium term. This reflects less capital funding in nominal terms mainly because of reduced UK Government funding and the impact of inflation. In the 2022 Autumn Statement, the UK Government announced a freeze in capital budgets in cash terms from 2026-27 onwards.

Figure 11: Five-year capital funding trends



Source: Scottish Fiscal Commission, Scottish Government.
Amounts indexed so that amount in 2023-24 is equal to 100. Real amounts have been calculated adjusting nominal amounts by the most recent GDP deflators published by the OBR in November 2022 (link).

Capital reserve and borrowing

56 No reserve drawdowns are assumed to support the capital budget in 2023-24, but the Scottish Government plans to draw down £50 million from the Financial Transactions account. For 2023-24 and subsequent years, the Scottish Government assumes a total of £450 million in funding from borrowing, drawdowns, additional UK consequentials and other sources. The Scottish Government plans to borrow £250 million in 2023-24 and will increase this if the other funding sources do not produce £200 million. We have assessed this borrowing plan to be reasonable. However, we note that it seems unlikely the full £200 million will be available for 2023-24 given UK Government fiscal tightening on capital spending and Scottish Government plans to draw down all reserve funds in 2022-23. The Scottish Government can borrow up to £450 million each year to support capital investment and could increase their borrowing to £450 million in 2023-24. However, successive years of borrowing at that level would move the total debt stock closer to the limit of £3 billion over the next five years.

Additional Information

Abbreviations

ADP	Adult Disability Payment
BGA	Block Grant Adjustment
CPI	Consumer Price Index
DLA	Disability Living Allowance
DWP	Department for Work and Pensions
GDP	Gross Domestic Product
HMRC	His Majesty's Revenue and Customs
HMT	His Majesty's Treasury
LBTT	Land and Buildings Transaction Tax
NDR	Non-Domestic Rates
NHS	National Health Service
NSND	Non-Savings and Non-Dividends
OBR	Office for Budget Responsibility
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
PIP	Personal Independence Payment
QNA	Quarterly National Accounts
SBBS	Small Business Bonus Scheme
SG	The Scottish Government

A full glossary of terms is available on our website:

https://www.fiscalcommission.scot/explainers/glossary/

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The Commission is committed to fulfilling our role as an Independent Fiscal Institution, in line with the principles set out by the Organisation for Economic Cooperation and Development (OECD).[3]

The Commission also seeks to adhere to the highest possible standards for analysis. While we do not produce official statistics, we voluntarily comply as far as possible with the UK Statistic Authority's Code of Practice for Statistics. Further details and our statement of voluntary compliance can be found on our website.[4]

[3] OECD (2014) Recommendation on Principles for Independent Fiscal Institutions (link).
[4] Scottish Fiscal Commission (2018) Compliance with the Code of Practice for Official Statistics (link).

Correspondence and enquiries

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All charts and tables in this publication have also been made available in spreadsheet form on our website. For technical enquiries about the analysis and data presented in this paper please contact the responsible analyst:

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