

Fraser of Allander Institute Scotland's Budget – 2016



The Fraser of Allander Institute is Scotland's leading economic research institute with over 40 years' experience of researching, analysing and commentating on the Scottish economy. It is widely regarded as Scotland's expert authority on economic policy issues.

The 'Fraser' undertakes a unique blend of cutting-edge academic research, alongside applied commissioned economic consultancy in partnership with business, local and national government and the third sector.

The Fraser of Allander has a unique mix of staff expertise, experiences and backgrounds that enables it to bring together cutting-edge economic methods and techniques with practical policy solutions and business strategies.

For over 40 years, *The Fraser of Allander Institute Economic Commentary* has been the leading publication on the Scottish economy providing authoritative and independent analysis of the Scottish economy.

The Fraser of Allander Institute is a research institute of the Department of Economics and is part of Strathclyde Business School, Scotland's leading business school.



Welcome to this first annual briefing on the Fraser of Allander Institute's Scotland's Budget report.

The delivery of new powers to the Scottish Parliament has coincided with an increasing focus on the role of fiscal policy in supporting economic growth - not least as we reflect on the limits of monetary policy in a post-Brexit world. As a consequence, the forthcoming Scottish Budget is of crucial importance to all key stakeholders in Scotland's economy.

All of us recognise the need for more informed debate around the policy choices and priorities which can best encourage and sustain a thriving Scottish economy and we are delighted to be supporting the Fraser of Allander Institute and Mackay Hannah in facilitating such an important debate.

At Morton Fraser we represent key stakeholders across business, central & local government and the third sector as well as individuals and families. The common thread across all of these stakeholders is a shared interest in helping to deliver a more prosperous Scotland and the recognition that Scotland's Budget can be a key plank in that success.

I have no doubt that the Fraser of Allander Institute's Scotland's Budget report will be a key reference point for all of us with a stake in Scotland's economic future.

Chris Harte
Chief Executive

Foreword

There has never been a greater need than there is today for independent analysis and comment on the fiscal opportunities and challenges facing Scotland.

Arguably there has been such a need for decades, but with the onset of considerably greater tax and welfare powers from next April, and the ongoing debate about Scotland's constitutional and economic future, informed analysis and commentary from an independent source is vital.

Once the 'Smith Commission' powers are fully transferred, the Scottish Parliament will have responsibility for raising around 30% of the total tax revenues raised in Scotland. This will rise to 40% once the proposed partial assignment of Scottish VAT revenues is incorporated. Similarly, around 50% of the Scottish budget will now be funded directly by the revenues raised in Scotland rather than simply relying on a block grant from Westminster. The Scottish Government will also have new borrowing powers which, while relatively modest in terms of the overall size of the Scottish economy, are nevertheless an important new economic tool in the policy-making process.

These new powers will also usher in a radically new framework for how policy is developed, scrutinised and implemented. New arrangements for managing economic risks, delivering the annual budget scrutiny process and determining intergovernmental relations between the UK and Scottish Governments will all be needed.

Fiscal devolution on this scale is largely unprecedented internationally and certainly within the UK.

Delivering these new powers in 'normal' times would be challenging enough. But as today's report highlights, they are being delivered at a time of significant fiscal challenge and economic uncertainty. Ambitious programmes of reform are vital if we are to ensure continued access to high quality public services with much fewer resources. Urgent action is needed to grow our economy – not just in the light of the current Brexit uncertainty and the downturn in Scotland's oil and gas sector – but also to face up to the longer term challenges of an ageing population, rising inequality, technological change and rapid globalisation.

There is now an unprecedented responsibility on the Scottish Parliament and Scottish Government to boldly exercise these new and existing powers with skill and insight to realise the vision of sustainable prosperity in Scotland.

Moreover, it places a significant responsibility on Scottish civic society – its business and academic communities, organisations, the media and, indeed, individuals – to conduct and inform a constructive and thoughtful debate, founded on the best evidence and experience available.

The Fraser of Allander Institute – and this Seminar on the outlook, choices and challenges for the next Scottish budget – aims to take up this responsibility.

Scotland's Budget 2016 provides an objective assessment of the outlook for the Scottish budget. Not everything is known with certainty. It unashamedly poses more questions than answers. The aim is to set out the evidence base for a frank discussion about the choices and challenges the government will face when setting priorities for the new parliamentary term.

Today's publication sets the context for debate. We will follow this up with further analysis once the Scottish Government Draft Budget is published.

In celebrating the Fraser of Allander's 40th anniversary earlier this year, the University of Strathclyde outlined its plans to invest in the long-term future of the Fraser of Allander. We are delighted that others – including the Scottish Funding Council and Asianomics – are working with us to help deliver on our ambition for a rigorously non-aligned body of work that unambiguously seeks to inform the debate on Scotland's fiscal outlook through the highest-quality evidence and analysis.

This will be a lively debate, and I urge everyone whatever your background or interests to work with us in the months and years ahead. Challenge our assumptions and analysis, agree and disagree with our conclusions and help us to inform the debate. Your input in shaping the future work priorities and research agenda of the Fraser of Allander Institute will be crucial.

The coming months and years may turn out to be the most important period of economic and fiscal policy debate Scotland has known; we will do our best to analyse and inform that debate and we invite you to join us in doing so.

Professor Andrew Goudie
Chair, Fraser of Allander Institute Advisory Board

13 September 2016

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Executive Summary

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly. Around 40% of devolved expenditure will soon be funded by tax revenues collected in Scotland – a figure that will rise to 50% once half of VAT revenues are assigned.
- The Scottish Government budget will in the future now depend upon two key elements –
 1. The remaining Scottish block grant as determined by ‘the Barnett Formula’; and,
 2. The growth in devolved tax revenues, most crucially income tax.
- This means that Scotland’s economic performance – or more accurately, Scotland’s *relative* performance – will have a greater bearing on the spending plans of Holyrood than ever before.
- The Scottish Government will also have the opportunity to vary its budget through the specific tax policy choices that it makes. Once new social security powers are devolved, it will be able to determine how much of its budget to dedicate to these areas.
- The Smith Commission’s proposals were intended to introduce both greater risk and greater reward to the Scottish budget. However with additional economic uncertainty following the EU referendum, a weakening UK fiscal position, ongoing UK welfare reform, and a fragile Scottish economy, the devolution of these new tax and social security powers could not have come at a more challenging time. There is a real risk that this new framework will only add strain on Scotland’s public finances at least in the near term.

Outlook for the Scottish economy

- The Scottish economy remains fragile. Growth has lagged behind that in the UK as a whole over the past year with growth of just 0.6%, compared to UK growth of 1.7%.
- Early signs of an improving outlook for 2016 have been dented by the uncertainty caused by the EU referendum. Prospects now look much more challenging than they did at the Scottish elections in May 2016.
- The uncertainty over the impact of Brexit will likely lead to a deterioration in the fiscal positions of both the UK and Scotland. The UK Government has abandoned its target to achieve a budget surplus by 2019-20.
- How the new Chancellor chooses to react will have implications for that part of the Scottish budget that will still be financed by a block grant from Westminster.
- In turn, how Scotland copes with the ‘shock’ of Brexit – on top of the ongoing challenges in the oil and gas sector – will be crucial for determining the outlook for devolved tax revenues.

Outlook for the Scottish Budget: 2016-17 to 2020-21

- The Scottish budget has faced unprecedented cuts since 2010. This year, Scotland's resource budget is around 5% lower in real terms than it was in 2010-11. Capital spending has been hit particularly hard, down 12% in real terms since 2010-11.
- The outlook looks just as – if not more – challenging.
- The new Chancellor has indicated that he is prepared to 'reset' UK fiscal policy. It would be wrong however, to assume that this means an immediate end to fiscal consolidation. With a weaker economic outlook and rising inflation putting pressure on the welfare budget, further departmental spending cuts are now even *more* likely over the medium term.
- Real terms cuts to the Scottish block grant are likely to continue into the next decade, extending the period of fiscal consolidation to over 10 years.
- Under the complex arrangement for determining the Scottish Government's budget under the new fiscal framework, what will be crucial is how the growth in Scottish tax receipts per head compares to the growth in equivalent tax revenues per head in the rest of the UK.
- The balance of evidence suggests that Scotland will do well to match UK economic performance at least in the short-term.
- The Scottish Government has outlined a number of tax increases and tax cuts. On balance, our assessment is that these will increase the Scottish budget, albeit by a modest amount. Overall the uplift is less than 1% of the total budget.
- In this report, we set out a range of possible scenarios for the Scottish budget under alternative outcomes for UK and Scottish fiscal policy.
- Even before the EU referendum outcome, the Scottish budget was facing real terms cuts over the next few years driven largely by the plans set out by the previous Chancellor George Osborne. Our new findings suggest that the Scottish budget could be cut by between 3% – 4% percent in real terms by 2020-21 and up to 6% – around £1.6 billion – under a worst case scenario.
- To put this in context, cuts of that scale are more than the entire budgets for the Finance and Economy; Fair Work, Skills and Training; Culture and External Affairs; and Rural Affairs, Food and Environment portfolios combined.

Spending commitments and priorities: 2016-17 to 2020-21

- These cuts come at a time when the Scottish Government has made a number of high profile – and costly – new spending commitments.
- The Scottish Government plans to increase health spending by £500m more than inflation by the end of the parliament. It has also committed to maintain real terms spending on policing and has a flagship policy of doubling the provision of free childcare.
- Delivering these commitments will require difficult decisions and a serious re-prioritisation of existing spending. As an illustration, to make up the difference between an overall real-terms cut of up to £1.6 billion and to pay for the government's new ambitious spending commitments, other 'unprotected' public services could face an average reduction of between 10% to 17% (2.6% to 4.5% annually) in real terms by 2020-21.
- Alongside these high profile commitments, the Scottish Government has pledged to deliver a number of additional priorities which will also require to be resourced. These include protecting further education places, free higher education tuition, new targets for educational attainment and more generous welfare spending.
- The government is also likely to face additional spending pressures from rising inflation (which will erode the effective value of budgets and make certain commitments such as the real-terms increase in health more expensive), repayments associated with revenue-financed capital investment programmes (including PFI and NPD programmes), demands on the pay-bill, and the costs of delivering the new devolved welfare system.
- Whilst the immediacy of the challenge will clearly fall on the Scottish Government, it is vital that political parties from all sides set out their clear priorities – including how they will fund new commitments and manage the increasing demands on public services.
- Local government will likely be a focal point for debate. As an area of 'unprotected spend', our analysis suggests that the grant to local government could be reduced by around £1 billion on a like-for-like basis by 2020-21 – with increases in business rate and council tax income only partially offsetting these cuts.
- Cuts to local services are likely to become increasingly apparent in the years ahead. This is likely to set the terms for a wider debate about the future of local government in the run up to the local council elections in May next year.
- The scale of the challenges facing the public finances means that bold and radical solutions will be needed. Business-as-usual is not an option.

Choices, challenges and opportunities

- The budget challenge facing the Scottish Government is arguably the toughest since coming to power in 2007.
- But at the same time, the government will have unprecedented autonomy to shape the distribution of incomes, the incentives facing individuals and businesses alike, and the effectiveness by which economic and social policy objectives can be achieved.
- To take this debate forward, we still require greater clarity over the underlying vision for fiscal policy in Scotland in the light of the new tax and welfare powers. What are the primary outcome objectives we are trying to achieve? How much resource is required to deliver these outcomes, and how will they be paid for?
- In this final chapter, we highlight key themes we think should frame the debate in the run up to the publication of the Scottish Draft Budget later in the year.
- First, budget decisions need to be based much more explicitly on intended outcomes rather than funding inputs. There also needs to be greater recognition of the opportunity costs of spending decisions, particularly over the medium to long-term.
- Second, with Scotland's new tax powers the debate can move beyond simply deciding how best to distribute a (tight) overall spending envelope. These powers provide a set of tools to vary revenue but also to achieve wider objectives around re-distribution, growth, efficiency and the overall balance of tax and spend in Scotland. There are important constraints however, and policy needs to be underpinned by explicit recognition of the strategic objectives that are being targeted, and the costs and practical challenges underlying tax policy choices.
- Third, to have an informed debate about Scotland's fiscal future and how best to use these new powers, the role of Parliament and civic Scotland in scrutinising and influencing budgetary plans should be strengthened. A renewed emphasis on multi-year budgeting, long-term strategic planning and transparency will all help assist in preparing Scotland to best meet the challenges and opportunities ahead.
- These three questions will form the basis of the work programme of the Fraser of Allander Institute in the months ahead.

Chapter 1: Outlook for the Scottish economy

- The fiscal responsibilities of the Scottish Parliament are expanding rapidly, with new powers over taxation and welfare.
- Around 40% of devolved expenditure will now be funded by tax revenues collected in Scotland – a figure that will rise to 50% once VAT revenues are assigned.
- Crucially, Scotland's economic performance – or more accurately, Scotland's economic performance *relative* to the UK – will soon have a much greater bearing on public spending in Scotland than ever before.
- Under the new fiscal framework, Scotland's budget will be no better and no worse off relative to the current funding arrangement, provided growth in Scotland's devolved revenues matches the growth of comparable revenues in the rest of the UK (rUK). If Scotland outperforms the UK on this basis then resources will rise, if Scotland underperforms, resources will fall.
- All of which makes the outlook for Scotland's economy presented here key to understanding the outlook for the Scottish budget.
- These new fiscal powers come at a time when the Scottish economy remains fragile. Growth over the past year of just 0.6% has lagged the UK (1.7% on a comparable basis).
- Early signs of an improving outlook for 2016 have been hindered by the EU referendum result. Prospects for the next few years – in both Scotland and the UK – look challenging.
- There are two key reasons for this –
 1. A period of uncertainty as the terms of 'exit' from the EU are negotiated is unavoidable. This carries risks for investment, household incomes and growth; and,
 2. Over time, there is a high probability that trade and investment will be damaged by the decision to become less integrated with the EU. This will have a permanent impact on the economy's long-term prospects.
- Whilst the immediate risks are on the downside, it is important to not over-state them. Exiting the EU is materially different from the financial crisis of 2008-09 when the global systemic effects were more significant.
- The effects of the UK leaving the EU are likely to be long-term with any benefits at best undetermined and highly uncertain.

The Scottish economy remains fragile. Although there is significant uncertainty over the immediate impact of the EU referendum outcome, most economists believe that the outlook has weakened as a result. The future direction of the Scottish and UK economies will have important implications for Scotland's budget. Given recent data trends, Scotland will do well to match the UK's performance in the near-term.

1.1 Introduction

The Scottish Parliament will soon oversee annual public spending of around £40 billion, control all land and property taxation, and be predominantly responsible for income taxation in Scotland.

Around 40% of 'devolved expenditures' will be funded by tax revenues raised in Scotland– a figure that will rise to 50% once half of VAT revenues are assigned to Holyrood¹.

Scotland's budget and public spending outlook will now depend upon two key elements –

- The block grant as determined by the 'the Barnett formula'; and,
- The growth in devolved tax revenues.

Under the Scotland Act (2016) and its new fiscal framework, UK economic performance and spending decisions taken at Westminster will continue to set the overall envelope for Scottish public spending through the Barnett formula.

However from April 2017, Scotland's block grant will be adjusted (i.e. reduced) to take account of the new devolved tax revenues. Whether Scotland is better or worse off as a result of these new powers will entirely depend upon how Scotland's economy performs.

For a given policy stance, the Scottish budget will effectively be no better or no worse off provided that Scotland matches the growth per head in devolved tax receipts (and devolved welfare spending) in the rest of the UK. If Scotland outperforms the rest of the UK economically resources will rise, and if it underperforms resources will fall.

This chapter therefore assesses the economic outlook for both Scotland and the UK.

This is not straightforward. There is significant uncertainty over the immediate economic (and longer-term) prospects following the UK decision to leave the EU.

Over the long-run (i.e. 15+ years), most economists predict that trade, labour mobility, investment and productivity will be damaged by weaker integration with our largest trading partner. Whilst these long-term risks are well evidenced, the short-run dynamics are more complex and uncertain.

¹ **Source:** Government Expenditure and Revenue Scotland (2016) - <http://www.gov.scot/Publications/2016/08/2132>

The near-term economic outlook will impact on Scotland's budget through a number of different channels –

1. The impact of the decision to leave the EU on the UK public finances could have knock-on effects to Scotland's block grant. The IFS estimate a negative shock to the public finances of between £24 billion and £39 billion by 2019-20 compared to pre-referendum forecasts²;
2. The potential policy response of the UK Government to the EU referendum outcome could also have spill-over effects to Scotland's block grant. For example, any stimulus to infrastructure to stave off recession or alternatively, a new round of fiscal consolidation to combat a rising deficit, could change future spending plans in Scotland; and,
3. The outlook for Scotland's economic performance relative to the UK will determine future devolved revenues. In the immediate term, two factors will be crucial – whether or not Scotland is hit more or less significantly by Brexit than the UK as a whole; and, the extent to which the recent divergence in growth between Scotland and the UK continues.

Over the course of Chapter 1 and Chapter 2 we set out a range of scenarios both for the economy and fiscal policy based on these three different channels.

This chapter is structured as follows. Section 1.2 summarises the economic performance of the Scottish economy over the past year. Section 1.3 focusses on the labour market given the significance of developments here for devolved tax revenues. Section 1.4 sets out the key channels through which the outcome of the EU referendum may shape the growth path of the Scottish economy over the next few years. Section 1.5 summarises the outlook for the UK as a whole. Section 1.6 presents our forecasts for growth in Scotland. Section 7 concludes.

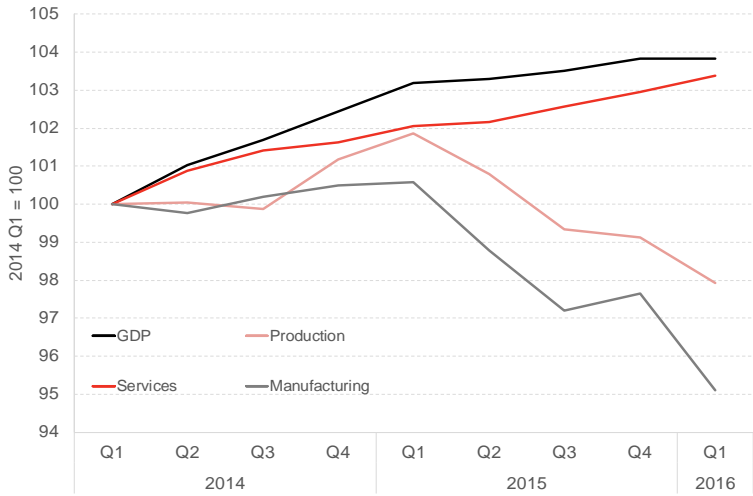
1.2 Scotland's recent economic performance

The Scottish economy continues to be fragile. Over the twelve months to Q1 2016, the Scottish economy grew by 0.6% - below its long-term average³. The data also points to an ongoing divergence between Scotland and the UK where growth was 2.0% (or 1.7% excluding oil and gas). Production and manufacturing in particular have been dragging down overall growth – Chart 1.1.

² See Emmerson et al. (2016) <https://www.ifs.org.uk/publications/8296>

³ It should be noted that the headline Scottish Quarterly GDP figures exclude output from the North Sea. Under UK statistical definitions, the North Sea is classified as part of the 'extra-regio' territory. The decline in the sector will however, through both the supply chain which services the North Sea and by lowering incomes, still have a significant impact on the Scottish Quarterly GDP statistics – see Box 1.1.

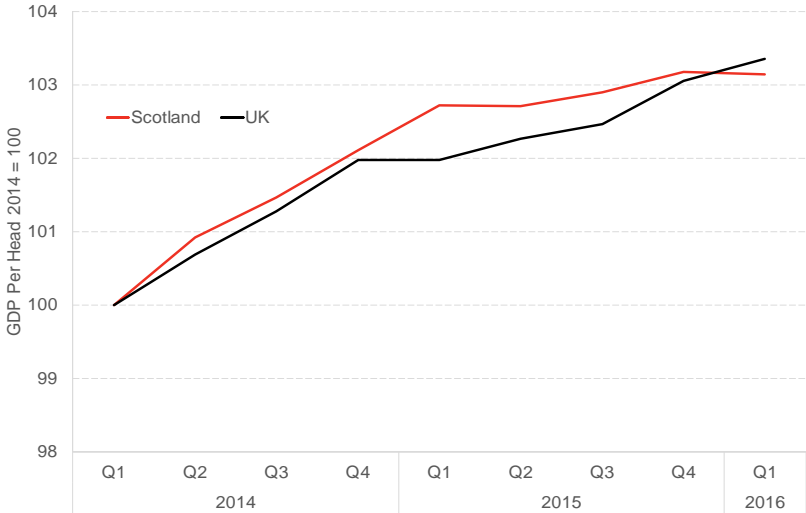
Chart 1.1: Scottish GDP sector performance: 2014–2016 (excluding construction – Chart 1.4)



Source: Scottish Government, Q1 GDP Statistics

When measured in terms of output per head – arguably the more relevant indicator of performance given the focus of the fiscal framework on tax receipts per capita – a similar story emerges. Scotland grew more strongly in 2014 but since then the UK has grown more quickly (Chart 1.2) – with growth in Scotland of 0.4% compared to the UK’s 1.4% over the past year.

Chart 1.2: Scottish & UK GDP per head: 2014-2016



Source: Scottish Government, Q1 GDP Statistics

The pace of growth in Scotland had been weakening further immediately prior to the EU referendum. In the first three months of the year, growth was flat (i.e. 0.0%) with the production (largely manufacturing) and construction sectors both contracting. Growth in the services sector was relatively strong though slower than the UK as a whole – Table 1.1.

Table 1.1: Scottish GDP growth (%) by sector, Q1 2016

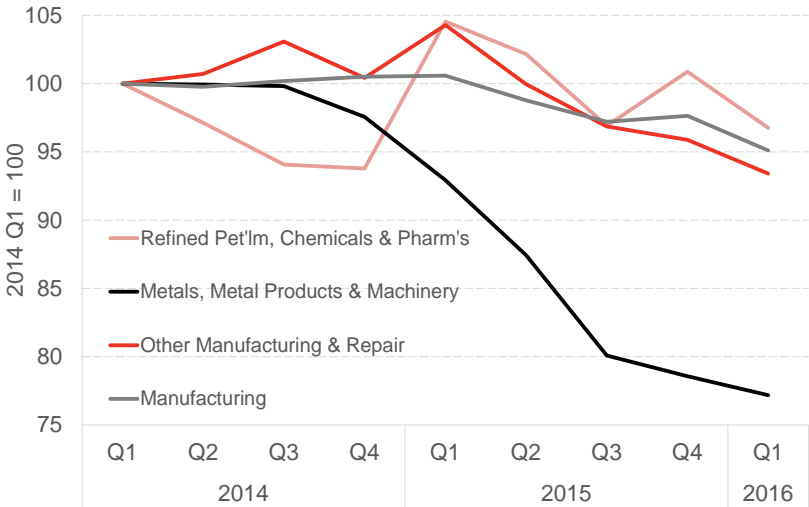
	GDP	Agriculture	Production	Construction	Services
Quarterly Growth	0.0	-0.2	-1.2	-1.5	+0.4
<i>UK</i>	<i>+0.4</i>	<i>0.0</i>	<i>-0.2</i>	<i>-0.3</i>	<i>+0.6</i>
Annual Growth	+0.6	+2.2	-3.9	+4.8	+1.3
<i>UK</i>	<i>+2.0</i>	<i>+1.4</i>	<i>+0.3</i>	<i>+0.2</i>	<i>+2.5</i>

Source: Scottish Government, Q1 GDP Statistics

There have been three key drivers of the recent performance in the Scottish economy.

Firstly, the ongoing impact of the downturn in the North Sea continues to have a significant impact on the domestic oil and gas supply chain. Manufacturing is down nearly 5.5% over the year with the Metals, Metal Products and Machinery sub-sector falling nearly 23% since 2014, in part due to the challenges facing the oil and gas sector, but also wider structural weaknesses including a number of large plant closures – Chart 1.3.

Chart 1.3: Challenges in manufacturing linked to the North Sea: 2014-2016

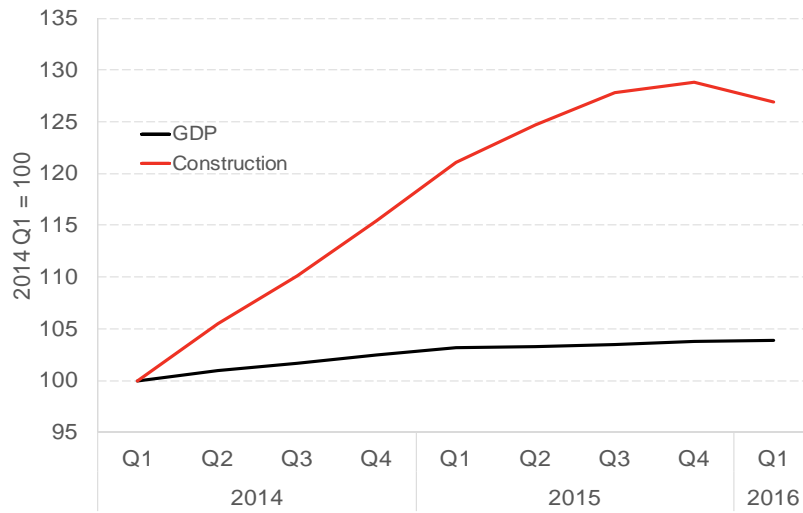


Source: Scottish Government, Q1 GDP Statistics

Secondly, growth in recent quarters had been boosted by a sharp rise in construction, driven primarily by public infrastructure spending. This pace of growth could only be expected for so long. As it has tailed-off, so has overall growth – Chart 1.4.

At the same time, growth in the services sector, whilst growing relatively robustly, has been slower than for the UK as a whole. Over the year, activity in the services sector is up 1.3% in Scotland vs. 2.5% in the UK.

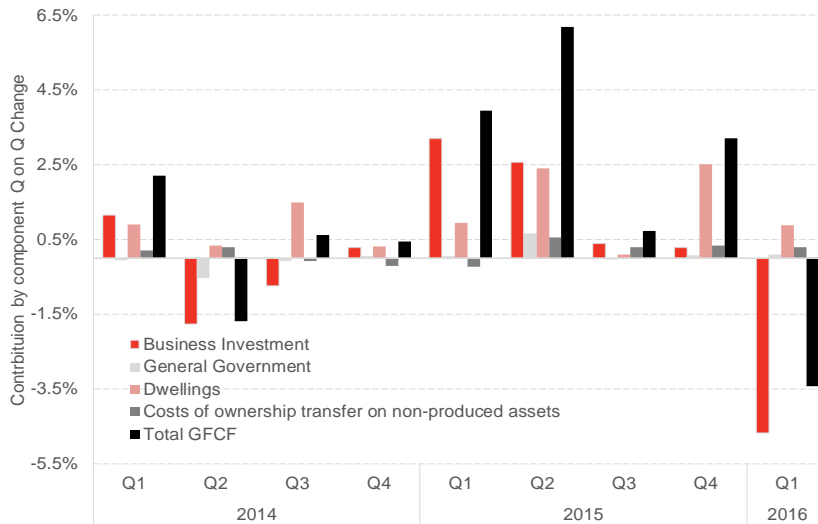
Chart 1.4: Strong rise in construction appears to be tailing-off: 2014-2016



Source: Scottish Government, Q1 GDP Statistics

Thirdly, the weak growth in business investment witnessed over the past couple of years has further decelerated. New experimental statistics covering the first quarter of 2016 show a sharp fall in business investment in Scotland, particularly linked to construction of new plant – Chart 1.5. Scotland's net trade position also acted as drag on growth over the past year.

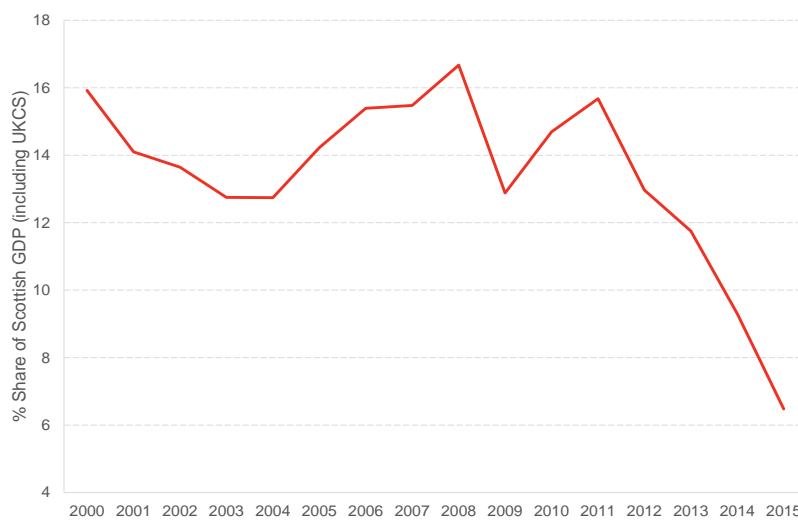
Chart 1.5: Fall in investment Q1 2016: QonQ %change in aggregate Gross Fixed Capital Formation (GFCF), by components



Source: Scottish Government, Quarterly National Accounts, August, 2016

Box 1.1: The impact of oil and gas slowdown on the Scottish economy

Under the UK statistics classification, the Continental Shelf is classified as part of the 'extra-regio' territory and any economic activity here – including oil and gas extraction – does not typically appear in Scotland's headline GDP measures. The Scottish Government however, publishes supplementary data which includes North Sea output as part of its Quarterly National Accounts series⁴. This shows that oil and gas remains a significant component of the total Scottish economy (based on a geographical share of the UK Continental Shelf), although its contribution has declined sharply in recent years.

Chart 1.6: North Sea output as a share of total Scottish GDP: 2000-2015

Source: Scottish Government, Quarterly National Accounts, August, 2016

Indeed, total Scottish GDP in current prices including a geographical share of North Sea output actually fell by 1.2% on a 4Q-on-4Q basis during 2015.

Tracing the economic impact of developments in oil and gas markets in Scotland is not straightforward. The vast majority of investment in the sector is driven by international energy markets far beyond Scotland. Furthermore, profits are typically dispersed across multi-national conglomerates and many offshore employees live outside of Scotland.

Official statistics⁵ show that around 30,000 people in Scotland were employed in 'extraction of crude petroleum and natural gas and mining support service activities' in 2014. This excludes the jobs supported by the spending power of the industry (e.g. with local businesses). These wider activities are significant – for example, international sales from Scotland's oil and gas supply chain were around £11.2 billion in 2013-14. Oil and Gas UK estimate that the industry supports approximately 375,000 jobs in the UK when all such elements are included⁶.

⁴ See <http://www.gov.scot/Topics/Statistics/Browse/Economy/SNAP/QNAS>

⁵ <http://www.gov.scot/Topics/Statistics/Browse/Business/Publications/GrowthSectors/Database>

⁶ Oil and Gas UK Economic Report 2015: <http://oilandgasuk.co.uk/economic-report-2015.cfm>

Since the sharp fall in the oil price toward the end of 2014, on and off-shore activity has been reduced. Operating expenditures fell 15% in 2015 and are expected to fall further in 2016. Investment is down 20% and exploration is at its lowest level since 1965 with just 13 exploration wells drilled in 2015.

This has hit employment and earnings. Over the year to July 2016, the Claimant Count rose by 56% in Aberdeen City and 92% in Aberdeenshire. Whilst actual levels of unemployment remain below the Scottish average, such increases are indicative of the scale of the challenge across the North East including in hotel occupancy rates, retail footfall and business services.

The decline in the North Sea has two key implications for Scotland's budget.

First, the North Sea has been a major source of revenue for the UK Exchequer over the years – over £100 billion in tax revenues between 1998 and 2014. As a result of falling revenues and tax concessions, the UK Office for Budget Responsibility (OBR) has forecast that North Sea revenues will be in the low hundreds of millions at best over each year of the 5-year forecast horizon (and were around £50m in 2015-16). To the extent that the sharp fall in North Sea revenues weakens the UK public finances, this will have an impact on Scotland's block-grant via reduced UK public spending.

Second, and of much greater significance in this context are the potential implications for devolved tax revenues including income tax. Through both direct employment and jobs in the wider supply chain, the North Sea has been a major contributor to earnings and employment growth in Scotland for over four decades, not least from the above average wages and spending power of those who work in the sector. If earnings and employment continue to fall, this will weaken the outlook for Scottish income tax, VAT revenues and property taxes.

The early indications are that growth remained relatively weak in the second quarter of 2016, even prior to the EU referendum result being announced. Growth is forecast to remain weak⁷.

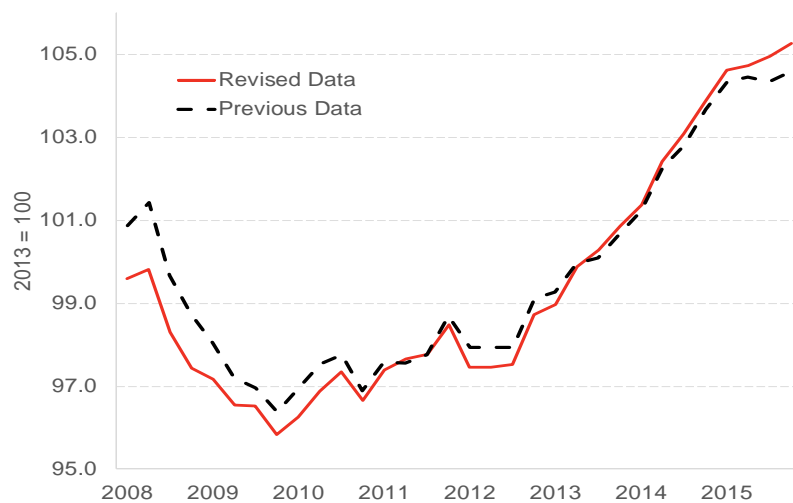
Pre-EU referendum business surveys reported challenging trading conditions, but there was also tentative evidence of a more positive outlook for the second half of 2016.

The Royal Bank of Scotland Scottish Business Monitor – produced by the Fraser of Allander Institute (FAI) and published just before the referendum – reported a net +12% of firms expecting business volumes to rise over the next six months, with rising optimism across most sectors and parts of the country⁸. This positivity was seriously dented by the EU referendum outcome – see Box 1.3.

One (slightly) positive note has been the recent upward revision to 2015's performance with the economy now estimated to have been more resilient than first thought. 2015 annual growth (4Q on 4Q) is estimated to have been +2.1% up from the +1.9% published earlier this year.

⁷ Moreover, a one off statistical 'event' is likely to have a major bearing on Scottish Q2 GDP figures. The closure of Longannet power station at the end of March could take anything up to 0.4 percentage points off the headline number for Scotland.

⁸ Royal Bank of Scotland Business Monitor: <http://www.rbs.com/news/2016/june/scottish-businesses-optimistic-about-growth-prospects-.html>

Chart 1.7: Revisions to Scottish GDP make 2015 better than previously thought

Source: Scottish Government, Q1 GDP Statistics

Box 1.2: Scotland's recent economic performance – implications for the new fiscal regime

It is clear that 2015 was challenging for Scotland's economy and 2016 is likely to be just as tough. The balance of probability is that – even before accounting for Brexit – the Scottish economy is likely to grow more slowly than the UK over the near-term.

This performance has two important implications under the new fiscal framework.

Firstly, 2016-17 represents the 'base-year' for the devolution of income tax revenues (by far the largest power being transferred). All else being equal, a weaker performance in 2016-17 will lead to a smaller deduction in Scotland's block grant than would otherwise have been the case. This is because the initial deduction is designed to be revenue neutral (i.e. 'no-detriment').

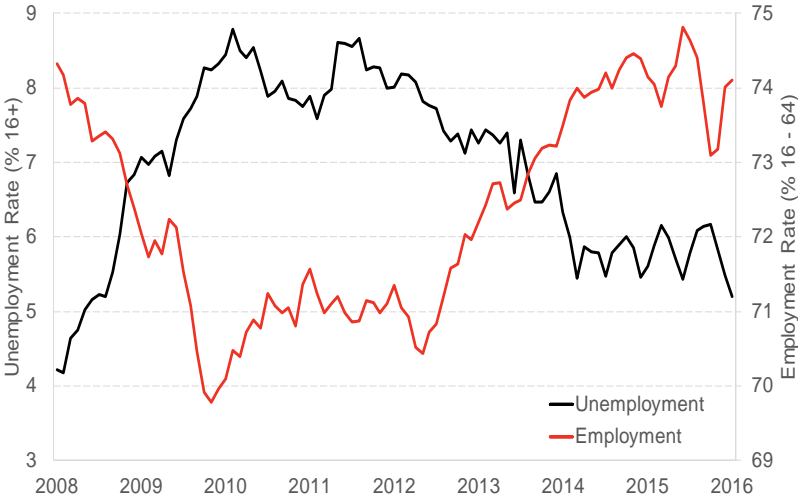
Secondly, it is far from clear that Scotland's relatively weaker performance has been driven by temporary factors. If the recent slowdown in the North Sea is part of a more sustained trend then the potential risks to the Scottish budget could be significant. Indeed, the lack of fiscal support mechanisms to counteract an asymmetric structural decline in a sector that Scotland is more heavily concentrated in is a key weakness embedded within the new fiscal framework. Whilst there are protections to guard against temporary divergences in economic performance, and slowdowns common to both Scotland and the UK, there are no new mechanisms to protect devolved services during sustained structural slowdowns. As a result Scotland's budget is now much more exposed to risks that the Scottish Government has limited ability to mitigate.

1.3 Recent labour market trends

Consistent with the wider economy, Scotland's labour market performance has been mixed. Developments in the labour market will be crucial for future tax revenues under the new fiscal framework. The key drivers of income tax and VAT are employment and earnings.

Since the global financial crisis and the peak in unemployment in late 2009 and early 2010, employment has recovered strongly albeit to a slightly lesser extent than in the UK as a whole.

Chart 1.8: Unemployment has remained flat between 5.5% and 6% for the last two years



Source: ONS LFS, August, 2016

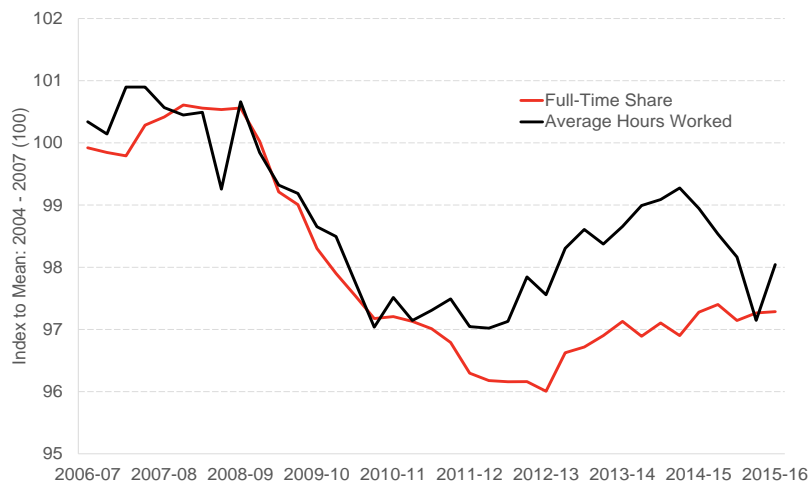
Whilst Scotland currently has a higher unemployment rate and lower employment rate than the UK as a whole, unemployment is now back at levels last witnessed in 2009.

Table 1.2: The UK labour market, Apr-Jun 2016

	Employment (16-64)	Unemployment (16+)	Inactivity (16-64)
Scotland	74.1%	5.2%	21.7%
England	74.8%	4.9%	21.2%
Wales	72.2%	4.3%	24.4%
N. Ireland	69.0%	6.0%	26.4%
UK	74.5%	4.9%	21.6%

Source: ONS, LFS August, 2016

Below the headline figures however, the data are slightly less positive. Whilst employment levels and rates are at near record levels, hours worked have fallen whilst the number of people working part-time has increased. Chart 1.9 tracks the performance of both average hours worked and the share of total employment that is full-time since 2006-07. On both measures, the labour market remains weaker than it was prior to the financial crisis.

Chart 1.9: Hours worked and full-time employment lower than pre-recession average in Scotland

Source: ONS, APS August 2016 and FAI calculations

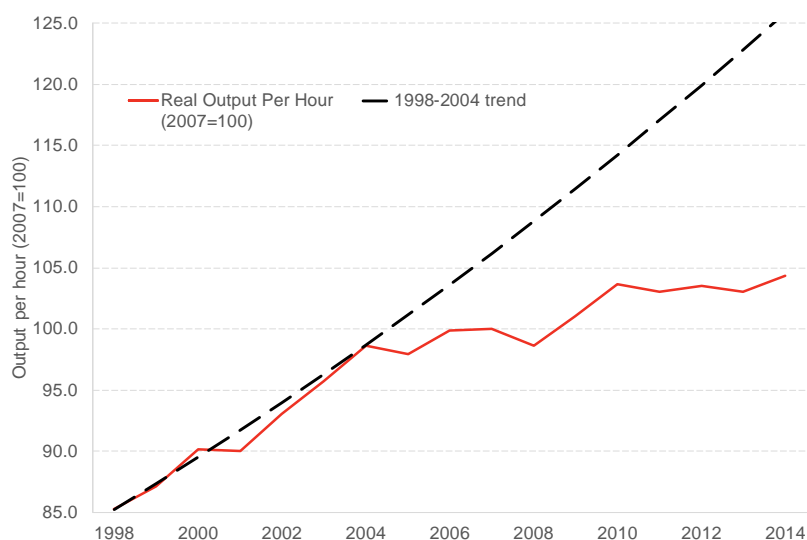
On earnings, the data is also mixed. After a period of significant falls in household incomes as a result of low (or fixed) nominal wages being eroded by rising inflation, across the UK there have been signs of a degree of recovery in real wages – at least in the private sector – although earnings remain well below previous levels. Job insecurity has also increased.

The strong performance in the labour market belies a significant worsening of labour productivity growth in recent years. Productivity is a measure of the value of output produced per hour worked in the economy. In the UK, productivity growth averaged 2% per year until the mid-2000s, but has slowed significantly since.

Scotland has seen a similar slowing trend – Chart 1.10 – although Scotland has fared better than the UK as a whole with the gap between the two narrowing in recent years.

The recent trend of weak productivity growth is not unique to Scotland or the UK, but is evident worldwide. The precise causes of this productivity puzzle remain a mystery, although there have been plenty of explanations proposed – including low levels of investment in the public and private sectors, limited investment in R&D and innovation, poor access to finance, inhibited ‘creative destruction’ processes as a result of financial sector restructuring, and the nature of recent technological developments.

If Scotland is to grow its revenues through faster growth then tackling relatively weak performance – and the drivers of this performance, a lower propensity to export and internationalise, weak business investment, lower innovation etc – will be key.

Chart 1.10: Productivity growth in ScotlandSource: Scottish Government productivity statistics⁹

1.4 The impact of Brexit on the Scottish economic outlook

Over the long-run (i.e. 15+ years), most economists predict that the decision to leave the EU will damage trade, labour mobility and investment. Any economic benefits that Brexit might bring are as yet unclear and by no means certain.

Whether or not the decision to leave the EU leads to a permanent reduction in the *rate of growth* or the *level of output* is as yet unclear. On the one hand once the economy adjusts to life outside of the EU, output could simply be a permanent step below the level it otherwise would have been in each and every year. By permanently reducing the capacity of the economy, one consequence is that the amount of resources that can be devoted to public spending will fall.

There is the potential however, for a more damaging impact if it were to confine both Scotland and the UK to a lower long-term growth rate (perhaps via a hit to productivity growth). Productivity – the key to long-term prosperity – may be weaker if leaving the Single Market reduces some combination of competition, product specialisation, skilled migration, inward investment and financial integration.

Whilst the long-term risks are pretty clear and well-evidenced, the short-run dynamics are more complex and uncertain.

There are two key channels through which the decision to leave the EU is expected to drive growth in the near future.

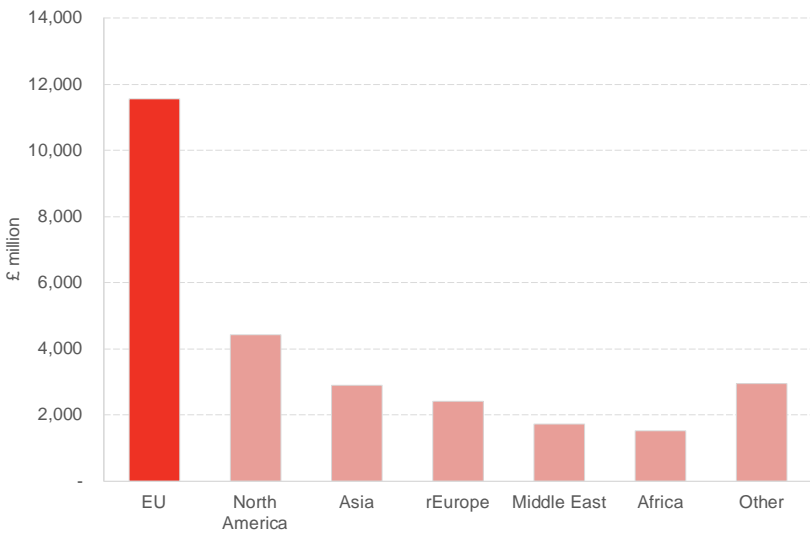
⁹ <http://www.gov.scot/Topics/Statistics/Browse/Economy/PROD2014>

Transition effects

As highlighted above, the decision to leave the EU is forecast to have a detrimental impact on long-term economic prospects. Investment, household incomes, employment and the long-run supply potential of the economy could all be lower although any effects may take time to emerge.

Trade could be hit particularly hard. The EU accounts for just over 40% of all of Scotland's international exports (i.e. excluding exports to rUK) – more than North America, Asia, South America, the Middle East and Australasia combined. Many companies in Scotland (and the UK) are also part of complex international supply chains. This means that it is not just access to export markets but also EU imports which are important.

Chart 1.11: The importance of EU exports – Scottish international exports by destination: 2014



Source: Scottish Government, Export Statistics Scotland

In recent years, Scotland has performed well in international investment – rivalling the South East of England as the second biggest location for FDI projects after London – driven, in part, by a skilled workforce but also the UK as an access point to the Single Market. FDI has strong links to productivity through the transfer of knowledge, skills, best practice, technology, and innovation. To the extent that FDI flows could be at risk from Brexit, growth will be slower than would otherwise have been the case.

Table 1.3: EU and foreign-owned enterprises in Scotland: 2015

	Number of Enterprises	Employment in Scotland	Total Scottish Turnover (£m)
EU-Owned	970	115,890	34,006
Other foreign-owned	1,340	198,170	55,254
All foreign-owned	2,310	314,060	89,260

Source: Scottish Government, ONS, IDBR

However, businesses will not, and cannot, adjust their plans overnight. Plant and machinery are immobile in the short-run. Moreover, for the time being Scotland and the UK remain within the EU. In terms of trade, regulation and free movement, nothing has changed thus far.

It is likely to be only a matter of time however, before expectations of reduced integration feed through to day-to-day investment, production operations, R&D activities, employment and household spending decisions.

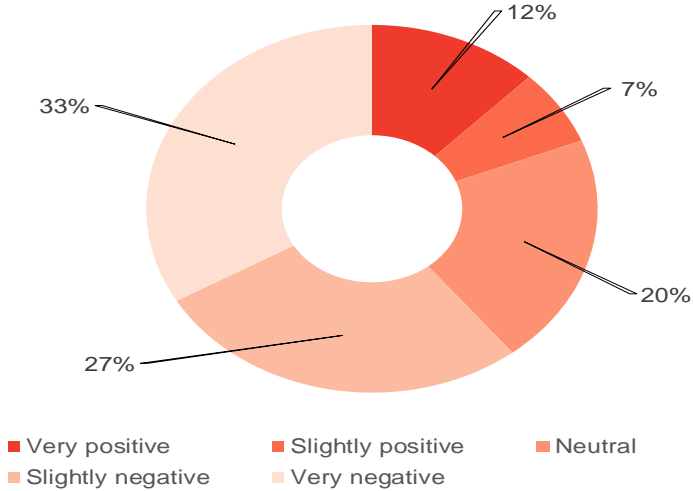
Our Brexit survey of businesses published earlier this summer, 60% of respondents believed that Brexit would either have a 'slightly negative' or 'very negative' impact on their investment plans – see Box 1.3.

Box 1.3: Initial Scottish business reaction to EU referendum outcome

To help obtain a picture of how businesses are reacting to the decision to leave the EU, we undertook a survey of Scottish companies shortly after the referendum¹⁰.

The key conclusion was that of the firms surveyed, just over 60% said Brexit will have a negative impact on their business and only 19% believe that it will have a positive impact. One third said the impact would be 'very negative'.

Chart 1.12: Do you think that the result of the referendum will be positive or negative for your business?



Source: Fraser of Allander post-Brexit Survey (04-12 July)

We followed this up by asking firms about their future investment and recruitment plans.

Around 40% said that it could have a negative impact on investment with a further 40% responding that it was unlikely to lead to any change. Less than 10% said it was likely to have a positive impact. The responses were similar for both investment and recruitment.

¹⁰ <https://www.sbs.strath.ac.uk/feeds/news.aspx?id=1014>

Table 1.4: “To what extent do you believe that the referendum result will have an impact on your business plans?”

	Investment	Recruitment
Significantly positive	4%	2%
Slightly positive	4%	3%
No Change	40%	55%
Slightly negative	19%	22%
Significantly negative	19%	12%
Don't know	13%	7%

Source: Fraser of Allander post-Brexit Survey (04-12 July)

One particularly striking result from the survey was the lack of preparation for the UK exiting the EU. More than 85% of firms reported ‘no preparation’ – or ‘very little’ – had been undertaken. This is consistent with evidence for the UK as a whole.

The lower exchange rate will help dampen some of these effects. Since the referendum, the sterling effective exchange rate has fallen nearly 10%, and 15% since its peak in November 2015, although it has bounced back slightly in recent weeks. A fall in sterling boosts the competitiveness of exporters and the tourism sector, although as costs rise this ‘advantage’ will disappear over time.

At the same time, sectors including retail, which rely on imports will see costs rising. The lower value of sterling cuts the real incomes of Scottish households as imports – particularly food and fuel – become more expensive.

Macroeconomic stability

At the UK level, the decision to leave the EU was clear. However, the exact terms of exit are unknown and are likely to remain so for the foreseeable future.

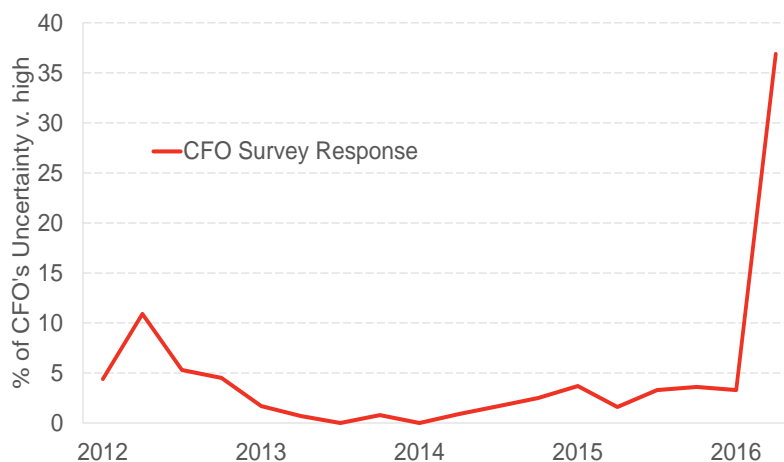
Consequently, the referendum result has ushered in a period of significant economic uncertainty – Chart 1.13. In response, businesses and households tend to postpone spending and investment.

Macroeconomic uncertainty is not uncommon, but when it does occur it can act as a significant headwind to growth.

However more often than not, once the uncertainty is resolved the macroeconomic impacts turn out to be temporary. Decisions that have been postponed can be implemented at a future date. However, the longer uncertainty continues the greater the risk of permanent damage.

The current economic uncertainties are exacerbated by *policy* uncertainty – such as the shape of any EU trade deal. This creates a lack of clarity around the fundamental structure of the economic and political environment that businesses will operate within.

Chart 1.13: Sharp rise in external financial and economic uncertainty Deloitte CFO Survey – “% uncertainty very high”



Source: Thomson Reuters Datastream

On balance, the expectation is that the UK-EU negotiations will not be straightforward and neither will the associated financial market dynamics. Exchange rates and stock prices could deviate substantially from 'fundamentals' for periods of time. This instability could itself act as its own drag on growth. It implies a less productive use of resources than would otherwise have been the case. It could also lead to higher risk premiums on lending to businesses and households, increasing the cost of capital. This, coupled with a weakening housing market, could depress wealth holdings and curtail household spending.

Government policy can help offset such uncertainty, albeit partially and temporarily, and there is much speculation about what the Chancellor may do in the forthcoming Autumn Statement. The Bank of England has already intervened by cutting interest rates to 0.25%, increasing its Quantitative Easing programme and introducing a new Term Funding Scheme to ensure that interest rate cuts are passed-through to the real economy¹¹.

Relative impact between Scotland and the UK

At this stage, it is not clear the extent to which any consequences from leaving the EU will be more or less significant for Scotland than for the rest of the UK.

On the one hand, and as highlighted in Box 1.4, some factors suggest that the long-term 'shock' may be more significant in other parts of the UK than in Scotland.

For example, from the relatively limited data that we have, the UK appears more closely integrated with the EU in terms of trade than Scotland. Some industries – for example the City of London and the major UK car manufacturing plants in the North of England and the Midlands – depend on access to EU markets for a significant proportion of their activity. Close proximity to

¹¹ <http://www.bankofengland.co.uk/publications/Pages/news/2016/008.aspx>

potential export customers is a factor for many businesses in England and increasing this 'distance' through trade barriers and restrictions will hurt firms.

Box 1.4: Modelling the long-term impact of Brexit on the Scottish economy

Following a commission by the Scottish Parliament, the Fraser of Allander Institute has modelled the effects of Brexit on the Scottish economy. We used the FAI's multi-regional, multi-sectoral model of Scotland and the rest of the UK, AMOSUK. This enables us to differentiate Scotland-specific effects of Brexit, compare them with the situation in the rest of the UK, and observe the sectoral distribution of the effects.

Due to uncertainty about the precise form of Brexit we distinguish several potential post-Brexit scenarios – “Norway”, “Switzerland” and “WTO”.

In this projection we accounted for the following potential effects of Brexit:

- reduction of exports to EU countries due to reduced integration, divergence in regulation and increase in non-tariff barriers;
- no contributions to the EU budget (in WTO scenario);
- tariffs on exports to EU countries (in WTO scenario).

Our forthcoming results are similar to analyses done by other organisations on the impact of Brexit in the UK in that – based on the modelling assumptions in our analysis – we find a significant negative effect of Brexit on Scottish and UK economies. Overall we find that over the next 10 years the level of GDP in Scotland could be between 2% and 5% (depending on the scenario) lower than it would otherwise have been.

What is new in our analysis is that we can compare the potential impact on Scotland and the rest of the UK and identify its sectoral distribution. Our results suggest that the shock to Scotland from Brexit – whilst substantial – may be slightly less than for the rest of the UK, due to a lower level of trade integration with the EU. This is a significant finding in the context of the new fiscal framework.

It is also possible that previous UK-wide research that was carried out in highly aggregated models underestimated the negative impact of Brexit. The reason for that is that the sectors that are most exposed to EU trade – and consequently suffer as a result of Brexit – also tend to have higher level of value added.

However as a smaller economy, Scotland is always likely to be more susceptible to one or two major investment or recruitment decisions having a significant impact on overall growth and employment. Scotland's productivity may also suffer disproportionately if the decision to leave the EU has a relatively greater negative impact on international investment. As highlighted above, this is an area where Scotland has been relatively successful in recent years helping to close the gap in productivity with the rest of the UK.

Levels of uncertainty may increase in Scotland if the possibility of a second independence referendum rises, although it is too early to measure the potential economic implications of different constitutional settlements, particularly given the lack of clarity over the UK's position with the EU.

1.5 The outlook for the UK

The outlook for the UK remains – as for Scotland – highly uncertain. UK growth was better than expected in the run-up to the referendum and the labour market continues to operate at near record levels.

However, in the first official assessment of the impact of Brexit on the economy post-referendum, the Bank of England's August 2016 Inflation Report acknowledged that the outlook for UK growth in the short to medium term had now 'weakened markedly'.

The central forecast in the Bank's August report shows real GDP to be 2.3 percentage points lower in 2018 compared to its pre-referendum forecast in May. Nominal earnings are expected to be 1.6 percentage points lower, which combined with a higher forecast for inflation implies real earnings being 2.8 percentage points lower.

Employment is forecast to be lower by around 320,000 and the unemployment rate forecast is expected to rise from 4.9% (in the May Inflation Report) to 5.5%.

Box 1.5: The global economic environment

Overall, economic conditions internationally remain finely balanced. Uncertainty over the global outlook had been a key source of concern, even prior to the EU referendum.

In a number of countries, growth is close to trend but elsewhere, particularly in the largest emerging economies and some key advanced economies, growth has been subdued. This has weakened global trade and increased financial market volatility.

The Euro Area continues to recover with growth at its healthiest since the financial crisis – at 2.2% (annualised) in the first quarter of 2016.

However, the uncertainty around Brexit and the depreciation in Sterling has weakened the outlook for Euro Area exports (around 15% of which are to the UK), whilst business and consumer confidence has also taken a hit. The referendum has also fuelled concerns over political and economic stability in some European countries including heightened questions over the strength of the banking system, particularly in Italy and Portugal.

The US economy remains relatively strong, although 2016 has been a weaker year to date than 2015. Growth is expected to pick-up in the coming months however, driven by higher real wages, employment growth and higher investment.

Table 1.5: Outlook for global growth: 2016-2017

Year on Year	2014	2015	Projections	
			2016	2017
World Output	3.4	3.1	3.1	3.4
Advanced Economies	1.9	1.9	1.8	1.8
US	2.4	2.4	2.2	2.5
Euro Area	0.9	1.7	1.6	1.4
Emerging Market and Developing Economies	4.6	4.0	4.1	4.6

Source: IMF World Economic Outlook, July 2016

In 2015, China's economy experienced its slowest year of growth (6.9%) since 1990, reflecting weaker investment and manufacturing activity as it rebalances towards consumption and service-led growth. China's slowing growth has been a key factor behind the weakening outlook for emerging economies with Asian economies particularly affected.

Concerns remain however, over emerging markets near-term prospects. Most economists predict a gradual recovery over the next few years but for growth to remain below trend. The balance of risks remains on the downside. The greatest risk continues to be the potential impact of a sharp reversal of capital inflows should monetary policy in advanced economies tighten. With high levels of indebtedness, many emerging economies remain highly exposed.

Alongside the Bank of England, most forecasters have significantly revised down their projections for UK growth. The biggest 'hit' is forecast for 2017 as the full effects of investor uncertainty feed through to the real economy.

Table 1.6: Independent forecasters tracked by HM Treasury – rapidly revising near-term outlook

% growth in 2017	GDP	Consumption	Investment	Net Trade*
Av. forecast (June 16)	+2.1	+2.2	+4.3	-0.5
Av. 'new' forecast (since Brexit)	+0.7	+1.0	-3.8	+0.5

Source: HM Treasury

* net trade contribution (% of GDP)

Within the forecasts there is a substantial degree of variability. Some economists are even predicting a modest UK recession in 2017. Predictions of a fall in output over an entire year however appear too pessimistic.

Table 1.7: Latest economic growth forecasts for the UK economy – forecasts post-referendum

	2016	2017
Barclays Capital	+1.5	-0.5
Capital Economics	+1.5	+1.5
Credit Suisse	+1.0	-1.0
Fathom	+1.6	+0.6
Oxford Economics	+1.8	+1.1
CEBR	+1.6	+0.4
Experian	+1.4	+0.4
NIESR	+1.7	+1.0
IMF	+1.7	+1.3
ITEM Club	+1.9	+0.4
<i>Average of post referendum forecasts</i>	<i>+1.6</i>	<i>+0.7</i>

Source: HM Treasury

It is too early to assess the impact on the real economy. Most official data for the post-referendum period will not be available until late autumn. Even then, with the UK not actually leaving the EU until 2019 at the earliest, and with uncertainty surrounding the specifics of the post-EU economic relationships, we may not see major shifts in economic data for some time yet. One consequence is that the Chancellor may wait until next year before deciding whether to act or not.

The greatest movements have been in the housing and commercial property sectors, where indicators point to noticeable falls in activity.

The most keenly watched economy-wide statistic has been the Purchasing Managers Index (PMI) which measures whether a balance of firms report that their activities have grown or fallen.

The PMI is typically seen as a relatively robust indicator. However, it should also be used with caution, particularly during times of volatility. Responses can be driven by the views of the individuals surveyed rather than actual changes in activity and can – on certain occasions – ‘overreact’ up or down.

Table 1.8: UK PMI points to flat growth (i.e. zero)* in Q3 2016

	Services	Manufacturing	Construction
August	52.9	53.3	49.2
July	47.4	48.3	45.9
June	52.3	52.1	46.0
May	53.5	50.1	51.2

Source: Markit

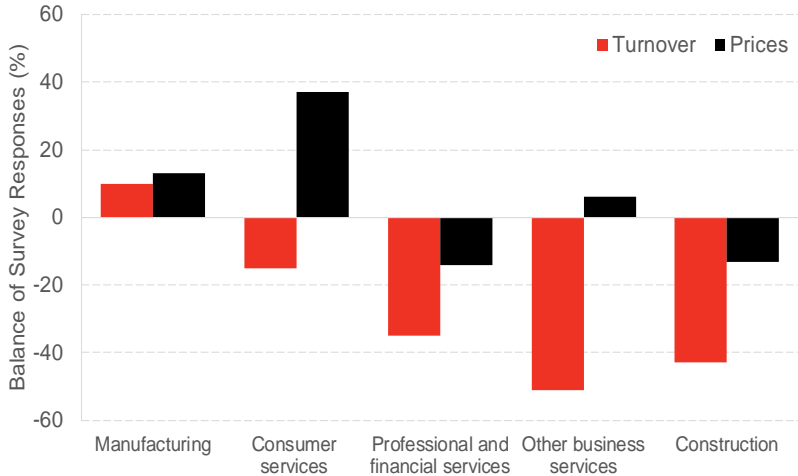
* Above 50 suggests an expansion of activity, below 50 a contraction.

Noting these caveats, the UK PMI for both services and manufacturing fell sharply in July. Within that, regions such as London and the South East saw their PMI's fall to lows not seen since the

financial crisis. But it has since bounced back in August, suggesting that activity remained broadly flat over the two month period with decisions postponed in July coming back on stream.

In its August Inflation Report, the Bank of England reported the results from its own survey undertaken by its Regional Agents which shed some further light on sentiment within business by asking whether or not turnover and prices were forecast to rise or fall – Chart 1.14.

Chart 1.14: Balance of Bank of England survey responses for turnover and prices by sector



Source: Bank of England, August 2016

The expected effects on turnover were mostly negative, with the outlook particularly pessimistic for business services and construction. In contrast, manufacturing turnover was expected to rise, following an expected boost to export demand from the depreciation in sterling.

1.6 Forecasts for the Scottish economy

All of this takes us to the outlook for Scotland. Forecasting short-term growth in an environment where there is a considerable degree of uncertainty is challenging.

Data on the impact on Scotland to date of the EU Referendum decision is scarce. The Bank of Scotland Purchasing Managers' Index (PMI) survey registered a four-month low of 49.2 in July. Interestingly, relative to the rest of the UK, the Scottish PMI held up well – the fall of 1.3 points compared to a UK average of 5 points. However 'new business' activity, often seen as a leading indicator of output, fell by the greatest degree for nearly four years.

To provide an up to date assessment of economic activity in Scotland, the FAI produces monthly 'nowcasts' of Scottish quarterly growth – www.fraserofallander.org.

The advantage of a 'nowcast' is that it provides an indication of economic performance far in advance of official data. Our latest nowcast estimates growth of 0.2% in Q2 and offers little optimism for anything approaching a return to trend during the first half of 2016.

The Institute's central forecast for Scotland is for growth to slow to 0.9% in 2016 (down from our 1.4% forecast in June) followed by an even sharper downward revision in 2017 and 2018 to just 0.5% and 0.7% respectively (down from 1.9% and 2.0% respectively).

These forecasts are on the cautious side. There are two reasons for this. Firstly, they do not include any stimulus via a significant 'resetting' of fiscal policy by the UK Government. It is simply too early to make a definitive judgement over the possible action that the Chancellor may take in late autumn.

Secondly, the forecasts include an expectation that the slowdown in the North Sea continues to act as a drag on growth well into 2017.

Table 1.9: FAI revised forecast Scottish GVA growth (%) by sector: 2016-2018

	2016	2017	2018
GVA	0.9	0.5	0.7
Production	1.3	0.7	0.8
Construction	0.4	0.3	0.4
Services	0.9	0.5	0.7

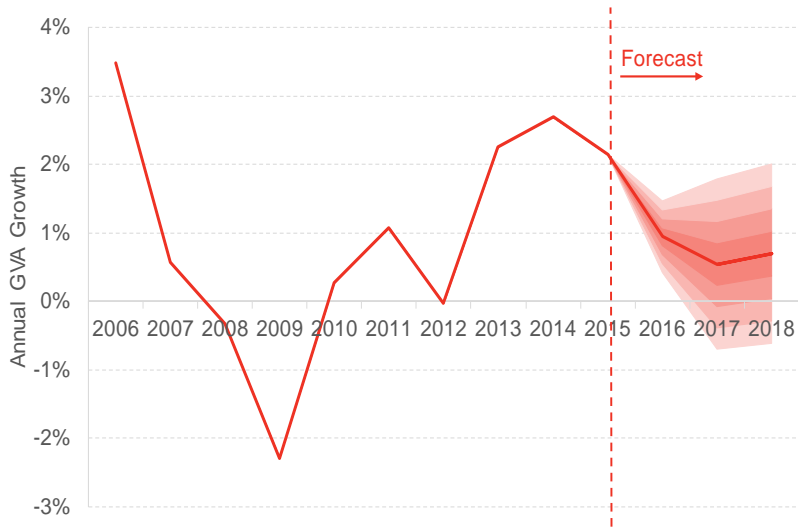
Source: Fraser of Allander Institute, July 2016

These forecasts suggest that whilst there will be a slowdown in the rate of growth, the Scottish economy will avoid an annual recession (i.e. a full calendar year where output falls). However, growth will be close to zero in individual quarters and a short 'technical recession' in Scotland – defined as two consecutive quarters of falling output – is possible. There is a distinct possibility that growth will be slower than for the UK as a whole.

Growth in all sectors will slow significantly. Construction will see close to zero growth in 2017, in part due to the impact of the EU referendum outcome, but also from a return to trend output following the strong growth through 2014 and 2015.

Of the components of demand, the expectation is that short-term uncertainty will hit investment and consumption over the next few years.

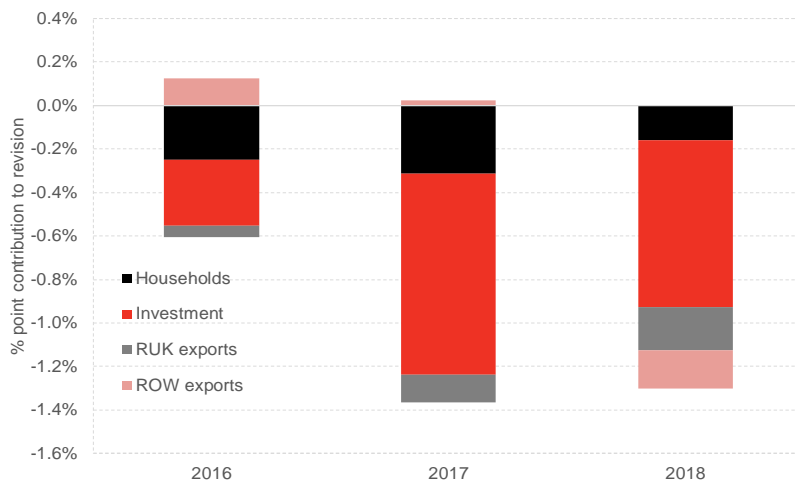
Chart 1.15: FAI forecasts for GVA growth: 2016-2018*



Source: Fraser of Allander Institute, July 2016

* Actual data up to 2015, central forecast with forecast error for 2016 – 2018

Chart 1.16: Decomposition of revisions to FAI's pre-referendum forecasts – sharp decline in investment leading the way: 2016-2018



Source: Fraser of Allander Institute, July 2016

Whilst the boost to net exports from the depreciation in the pound will support external demand in the short-run, it is unlikely to be sufficient to offset the wider slowdown in the economy. Indeed, part of the revision to growth in 2016 and 2017 is through weaker exports to the rest of the UK.

The labour market will slow. We now predict that unemployment will rise to 7.0% in 2017.

Table 1.10: FAI forecast of Scottish unemployment in central forecasts: 2016-2018

	2016	2017	2018
ILO unemployment	173,500	188,250	183,050
Rate (%) ¹	6.5	7.0	6.8

Note: Rounded to the nearest 50. ¹ = Rate calculated as total ILO unemployment by total economically active population 16+.

Source: Fraser of Allander Institute, July 2016

1.7 Conclusions

The new fiscal framework for Scotland will mean that developments in the Scottish economy will now have a much greater impact on future budgets than ever before.

This chapter has shown that the potential paths for the economies of both Scotland and the UK – and the implications for fiscal policy – are highly uncertain.

Overall however, the economic outlook for the UK has undoubtedly weakened over the short-term. This is likely to increase the level of fiscal consolidation in the long-run. The Chancellor faces a careful balancing act between continuing to reduce the deficit and protecting the real economy. In the short-term, this may lead to a modest stimulus although the knock-on impact to the day-to-day Scottish budget may be marginal if it is concentrated on unemployment benefits, a boost to the UK's trade capacity or higher capital investment.

With the devolution of new powers, the outlook for Scotland's economy will be crucial in determining the future path of the Scottish budget. Recent trends present a challenging backdrop.

On balance, the immediate outlook for the Scottish economy appears to be more challenging than for the UK as a whole and Scotland will do well to match UK economic performance in the near-term.

Chapter 2: Outlook for the Scottish budget

- In 2016-17, Scotland's resource budget is 5% lower in real terms than 2010-11. The capital budget has been hit particularly hard, down 12% in real terms since 2010-11.
- The outlook looks just as – if not more – challenging.
- The UK Government's objective of achieving a budget surplus in 2019-20 had promised to deliver at least a further 3 years of cuts beyond this year, with the Scottish budget projected to fall a further 3.5% between 2016-17 and 2019-20.
- The outlook is now a little more uncertain following the EU referendum, with the Chancellor promising to 'reset' UK fiscal policy. It would be wrong however, to automatically assume that this means an end to fiscal consolidation.
- Whilst there may be a short-term uplift to individual budget lines, the weaker economic outlook will lower tax revenues and increase the budget deficit. At the same time, higher inflation will reduce the real-terms value of spending. Further cuts are therefore now *more* likely over the medium term.
- The transfer of new fiscal powers means that the outlook for the Scottish budget is now crucially dependent upon Scotland's relative economic performance. The evidence suggests that, particularly with the ongoing challenges in the North Sea, Scotland will do well to grow its devolved revenues in line with those in the rest of the UK.
- The Scottish Government has outlined a series of new tax policies. Some of these will raise revenue whilst others will lower it. On balance the net increase is marginal, adding less than 1% to the Scottish Government's resource budget.
- This chapter sets out a range of possible scenarios for the Scottish budget based upon what may happen both to UK fiscal policy and Scottish devolved revenues.
- Overall, the Scottish Government should prepare for possible real-terms cuts of up to 6% by 2020-21 – or around £1.6 billion over the course of the parliament.
- Coming on the back of six years of cuts, this suggests a full decade of fiscal consolidation in the Scottish budget.

The Scottish Government faces a challenging budget outlook and will require considerable skill to navigate Scotland's public services over the course of the next parliament. On any realistic scenario, real-terms resources for public spending are likely to be highly constrained and the government should plan for a worst case scenario of a fall in resource of up to £1.6 billion by 2020-21.

2.1 Introduction

What level of resource is the Scottish Government likely to have to invest in day-to-day public services over the course of this parliament? And how much will it be able to invest in capital spending? These are the questions considered in this chapter.

As set out in Chapter 1, Scotland's resource budget will now depend upon two important elements –

1. The Block Grant as determined by 'the Barnett formula'; and,
2. The growth in devolved tax revenues, relative to the growth in equivalent revenues in rUK (which determines the 'block grant adjustment').

For clarity on the first of these, we await the Chancellor's response to the EU referendum and the UK's weakened economic prospects in his Autumn Statement (23rd November 2016).

The plan by George Osborne to achieve a surplus by 2019-20 has been abandoned. But this by no means signals an end to fiscal consolidation. By reducing the long-term capacity of the economy, leaving the EU is likely to prolong real-terms cuts in day-to-day public spending into the next decade.

From April 2017, growth in devolved tax revenues will have a significant impact on the Scottish budget. Future growth in the Scottish budget will increasingly depend upon Scotland's relative economic performance and tax decisions taken at Holyrood.

Based on an assessment of the most likely scenarios for both the evolution of policy and the economy, the conclusion we reach is that the outlook for public spending in Scotland is likely to remain highly challenging over the course of this parliament.

Between 2016-17 and 2020-21, the Scottish budget could fall by between 2.8% and 6.2% in real terms, equivalent to between £800 million and £1.6 billion.

Tough choices in terms of priorities and reform will be required not just in their making but also in their implementation. Coming on the back of six years of real terms cuts, it is unlikely that short-term stop gaps will be sufficient. More fundamental decisions are needed over the future direction of public spending and how public services are delivered and financed.

This chapter is structured as follows. Section 2.2 sets out past trends in the Scottish budget whilst Section 2.3 summarises the new fiscal framework. Section 2.4 considers the outlook for Scotland's block grant. Section 2.5 outlines the likely path for both the all-important block grant

adjustment (BGA) and devolved tax revenues in Scotland. Section 2.6 brings all of these elements together to provide an overall outlook for the Scottish budget.

Section 2.7 assesses the revenue implications of the tax policies set out to date by the Scottish Government. Section 2.8 summarises the outlook for capital spending. Section 2.9 concludes.

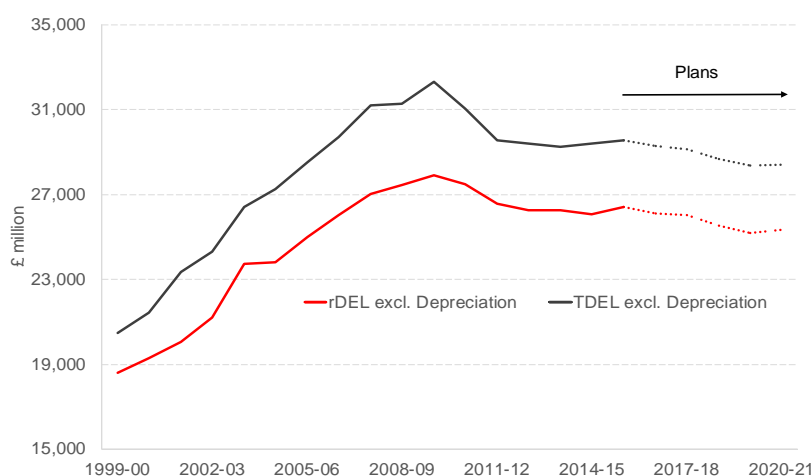
2.2 Past trends in the Scottish Government budget

The challenging budget outlook anticipated for the course of this parliament comes on the back of a sustained period of fiscal consolidation.

Over the first decade of devolution, Scotland's block grant grew year on year both in cash and real terms. This growth went into reverse in 2010. During the financial crisis, the UK fiscal position deteriorated rapidly. Net borrowing peaked at £155 billion (over 10% of GDP) in 2009-10.

Alistair Darling's final Budget as Labour Chancellor set out plans to cut UK departmental spending by £56 billion by 2014-15. The incoming Coalition Government's 'Emergency Budget' in June that year increased the scale of the planned consolidation, aiming to cut £66 billion from departmental spending by 2014-15¹².

Chart 2.1: Scottish Government Budget, 1999-00 to 2020-21



Source: Public Expenditure Statistical Analysis, various years; FAI analysis of Budget documents
TDEL includes RDEL (resource spending) and CDEL (capital spending)

After 2011-12, the pace of austerity was scaled back somewhat. However by 2016-17, the Scottish Government resource budget (see Chart 2.1) is still around 5% lower in real-terms than in 2010-11.

¹² Emmerson and Tetlow (2015) 'Public finances under the coalition'. https://www.ifs.org.uk/uploads/gb/gb2015/ch1_gb2015.pdf

Under the plans set out by George Osborne in his March 2016 Budget, Scotland's block grant – even before any changes in devolved revenues – was expected to fall further in real terms with cuts of around 3.5% in real terms by 2019-20.

These plans would have taken real terms spending in Scotland back to 2005-06 levels.

As a result of the EU referendum decision, there is now greater uncertainty around the future outlook for the Scottish budget. How the Scottish budget will evolve will depend on the response of the UK Government, and the new Chancellor, to revised economic forecasts. We consider likely scenarios in Section 2.4.

Box 2.1: The Scottish budget

Each year the Scottish Government publishes a Draft Budget with their plans for the year ahead.

Every five years or so, the UK Government undertakes a Spending Review which sets fixed expenditure limits for departments – including the Scottish Government – for a multi-year period.

Scottish administrations have typically followed suit. The last UK Spending Review took place in November 2015 with detailed plans up to 2019-20 and a broad outline of spending priorities for 2020-21. The Scottish Government has however, so far resisted undertaking a multi-year Spending Review choosing to set only an annual budget for 2016-17.

Giving evidence to the Finance Committee in June this year, Cabinet Secretary for Finance Derek Mackay said¹³: 'With the degree of uncertainty and volatility that exists right now, it would be unwise to publish a three-year spending review. Therefore, we propose a one-year budget [in 2017-18] and will not deliver a three-year spending review at this time.'

The total amount of money that the Scottish Government spends is known as Total Managed Expenditure (TME).

TME is split into two components –

- Department Expenditure Limit spending (DEL) – the amount that government departments have been allocated to spend; and,
- Annually Managed Expenditure (AME) – spending that is not controlled directly by a department but instead varies year-on-year (such as public sector pensions).

In practice, the Scottish Government has virtually no discretion – except for the allocation of Non-Domestic Rate Income – over AME spending. It is the DEL element which constitutes discretionary spending and that which is spent on services such as the NHS, education and economic development.

Within DEL, spending is further divided into Resource DEL (RDEL) and Capital DEL (CDEL).

¹³ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=10486&mode=pdf>

RDEL is money that is spent on day to day resources and administration such as staff costs. CDEL is money that is spent on investment – such as a new road or hospital. The Scottish Government is permitted to move RDEL spending into CDEL but not vice versa.

Finally, RDEL contains an allocation for 'non-cash' elements – largely an accounting adjustment for depreciation. Whilst incorporated into the accounts, it is not money that can actually be spent by the government. Excluding these non-cash elements provides a figure known as Fiscal RDEL. It is this, which provides the best assessment of the discretionary day-to-day spending power of the government, although the Scottish Government do not routinely publish Fiscal RDEL at a portfolio level.

2.3 The new fiscal framework

The Scottish Government has traditionally relied on a block grant from Westminster to finance virtually all of its expenditure¹⁴.

This block grant has been determined by the Barnett formula. Barnett allocates to Scotland a population share of changes in 'comparable spending' in England. This change is added to the block grant in the previous year.

Following the Scotland Act 2012 and Scotland Act 2016, a number of tax revenues are being devolved and assigned to the Scottish budget as part of a new fiscal framework– see Box 2.4.

The Scottish block grant for resource spending will continue to be calculated initially by the 'Barnett formula'. But the block grant will then be adjusted (i.e. reduced) to take account of these new taxes being transferred to the Scottish Government.

The mechanism is complex, and is described in Section 2.5.

In terms of capital spending, the amount the Scottish Government will be able to invest will still largely depend on a block grant from Westminster but also be supplemented by its new borrowing powers¹⁵.

Box 2.2: Scotland's new fiscal framework

The fiscal framework was the most controversial part of the agreement to implement the Smith Commission's recommendations. In the end, only a temporary deal was reached and it will be reviewed in 2021.

In addition to setting out the mechanism for how the block grant adjustment (BGA) will operate – see Box 2.5 – the new framework will have other important implications.

¹⁴ Council Tax and Non-Domestic Rates are set and collected in Scotland, but the revenue from these taxes is used to fund Local Government.

¹⁵ Technically, the Scottish Government could also shift resource spending into capital; although it is unlikely to do so in the future given the constraints facing its resource budget.

Firstly, for the first time the Scottish Government will take responsibility for significant elements of welfare – see Chapter 3 for a discussion.

Secondly, the Scottish Government's capital borrowing powers will increase. The overall limit on borrowing will rise to £3 billion, with an annual limit of 15% of the overall borrowing cap (equivalent to £450 million a year).

Thirdly, the Scottish Government will gain increased revenue borrowing powers of up to £600 million per annum, subject to a combined overall limit of £1.75 billion, for in-year cash management, forecast error and Scottish-specific economic shocks.

Fourthly, the institutional arrangements for managing the public finances are being overhauled. The independent Scottish Fiscal Commission will assume responsibility for forecasting economic growth and devolved tax revenues.

Fifthly, the processes for managing cash flow and variations in tax revenues between years will change. A new Scotland Reserve is being established. The Scottish Government will be able to deposit up to £700 million and draw down monies – subject to limits of £250 million for resource and £100 million for capital – should they need to.

Finally, the inter-governmental relations between the Scottish and UK Governments will be reformed with greater equality between the two administrations in decision making, expanded dispute resolution mechanisms, and new arrangements for information sharing.

To calculate Scotland's budget under this new framework, three key elements need to be measured –

- The 'baseline' block grant for resource spending from Westminster;
- The interaction between the adjustment to the block grant for the taxes that are devolved to Scotland and the revenues raised from those devolved taxes in Scotland; and
- The revenue implications of any tax-policy changes that the Scottish Government decides to implement.

We take each of these three elements in turn.

2.4 The block grant from Westminster

Although substantial revenues are being devolved, the overall Scottish Budget will remain closely tied to the fiscal decisions of the UK Government via the block grant. In this section, we therefore comment on the outlook for Scotland's block grant up to the end of the parliamentary term.

In its March 2016 Budget, the UK Government set out its spending plans and the implication for the Scottish block grant until 2019-20 – Table 2.1. Scotland's resource block grant was expected to fall by 3.5% in real terms between 2016-17 and 2019-20.

The Budget did not provide an estimate for 2020-21, although it did provide a forecast for overall UK departmental spending in that year. On that basis, and an assumption about how much the Barnett consequential could turn out to be, we have estimated the Scottish resource block grant for 2020-21. The assumption of the UK Government in March was for departmental spending to remain constant in real terms after 2019-20, once the target for surplus had been achieved.

Table 2.1: The Scottish Government's RDEL block grant before tax adjustments, £m

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Nominal terms	26,033	26,115	26,489	26,552	26,677	27,200
Real terms (2016-17 prices)	26,423	26,115	26,021	25,546	25,188	25,178

Source: FAI calculations

Of course these numbers were produced before the vote to leave the EU. To what extent might Scotland's block grant now change? Essentially, the answer depends on the outlook for the UK fiscal position and how the UK Government decides to respond.

At the time of the March 2016 Budget, the Office for Budget Responsibility (OBR) forecast that in 2019-20 there would be a fiscal surplus of £10.4 billion in the UK (0.5% of GDP). George Osborne was able to say that he was on course to eliminate the deficit before the next UK election.

As discussed in Chapter 1, the vote to leave the EU has undoubtedly weakened the economic – and fiscal – outlook. Slower growth implies reduced tax revenues, whilst higher unemployment implies greater pressures on public spending. Higher inflation – which has been forecast by the Bank of England – is likely to put further pressure on the government's welfare bill. On the positive side, the UK may benefit from the part or full repatriation of its £7–8 billion annual net contribution to the EU, but this is unlikely to offset the fall in revenues arising from the deterioration in the economic outlook (see Box 2.3).

Box 2.3: UK net contributions to the EU

Much was made in the referendum debate about the UK's fiscal contribution to the EU. Here we assess the extent to which leaving the EU could have a positive or negative impact on the public finances.

The UK's gross contribution in 2014 to the EU was £19.1 billion. This was the source of the Leave campaign's claim that the UK "sends" £350 million per week to Europe. However, there are a number of problems with this figure¹⁶.

First, this ignores the UK rebate – the amount automatically deducted from the UK's gross contribution.

¹⁶ For a discussion see official correspondence from Sir Andrew Dilnot, Chair of the UK Statistics Authority, to Norman Lamb MP, 21st April 2016. <https://www.statisticsauthority.gov.uk/wp-content/uploads/2016/04/Letter-from-Sir-Andrew-Dilnot-to-Norman-Lamb-MP-210416.pdf>

Second, both the UK and Scotland benefit from income received from the EU through CAP, structural funds and research funding. ONS estimate that once accounted for, the UK's net contribution between 2010 and 2014 averaged around £7 billion, although more recent figures put it closer to £8 billion.

Third, should the UK wish to retain some of the economic benefits of the EU – e.g. the Single Market – then some form of payment will continue. European Economic Area (such as Norway) members make fiscal contributions although they have no say over how such funds are used.

Finally, and most significantly, the IFS estimate that the UK could face a much larger fiscal deficit as a result of the weakened economic outlook – even accounting for no longer making a financial contribution to the EU budget¹⁷.

Following the vote to leave the EU, Chancellor Phillip Hammond has said that he will seek to “reset” fiscal policy. But what might he mean by a fiscal policy reset?

In setting out a range of scenarios for the Scottish block grant, our starting point has been to assume that the government's core objective over the medium term is to continue to reduce the fiscal deficit, in order that debt as a percentage of national income falls from its post-war high of 80%.

In re-setting fiscal policy, the government may change the focus of its fiscal target somewhat – perhaps aiming for a surplus on current spending rather than on total spending – and may change the period over which it hopes to achieve whatever target it sets. But fiscal consolidation and sustainability is likely to remain the government's overarching objective.

It has to be recognised that, even if it were to leave its plans for departmental spending unchanged, the government will run a larger deficit (and thus borrow more) than it was planning, given the forecast economic deterioration. In this context, and assuming that fiscal consolidation remains a key plank of government fiscal policy, the scope for a substantial loosening of fiscal policy – certainly a large increase in departmental resource spending that would generate consequential for the Scottish block grant – seems unlikely.

In the short-term, the UK Government may decide to counteract a temporary weakening of economic activity through one or more temporary tax cuts. Tax cuts are more effective at increasing consumer confidence than increasing departmental spending. At the height of the 2008-09 recession, the UK Government announced substantial fiscal loosening on the tax side, including a temporary cut to VAT, a holiday on stamp duty, and a rise in the income tax personal allowance, but increases in spending were much more limited.

If there is any fiscal loosening on the spending side in 2017-18 relative to March plans, it is perhaps most likely to come in the form of an increase in capital spending by the UK Government, as this is likely to be the most effective response to medium-term decline in the economic outlook. An increase in capital spending by the UK Government would increase the Scottish Government's block grant for capita spending, via Barnett consequential.

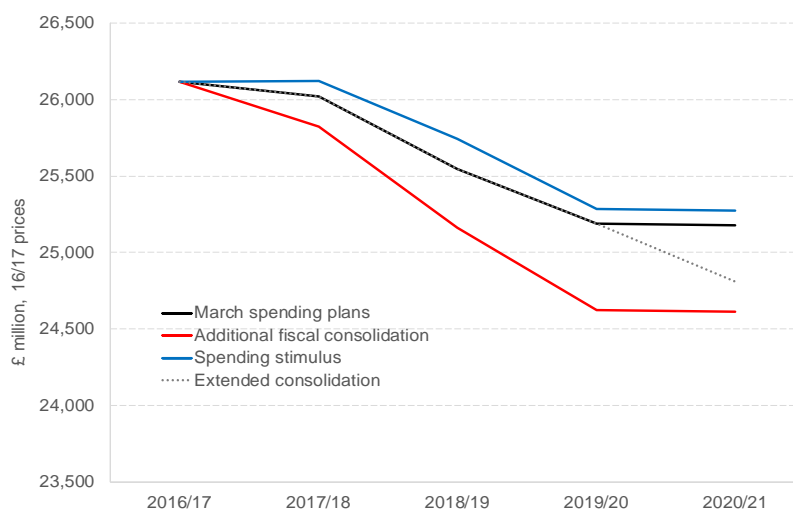
¹⁷ See Emmerson et al. (2016) <https://www.ifs.org.uk/publications/8296>

In this context we model four scenarios for the Scottish resource block grant over the course of this parliament:–

- *'March spending plans'* – this scenario is based on the departmental spending plans set out by the UK Government in the March 2016 Budget. This scenario is however, consistent with the idea of a 'fiscal policy' reset as – given deteriorating revenue forecasts following the EU Referendum – the 2019-20 surplus is unlikely to be achieved. Moreover, it could be combined with some fiscal loosening on the tax side, such as a temporary cut in VAT;
- *'Fiscal stimulus on spending'* – in addition to a stimulus on the tax side, the UK Chancellor may pencil in some additional departmental spending increases. It seems unlikely that we will see significant real terms departmental spending increases, given the government's commitment to fiscal sustainability, combined with the deterioration in the revenue outlook following the EU referendum. But for completeness we include a scenario that assumes the Chancellor embarks on a fiscal loosening which includes an additional £1.5 billion of UK departmental resource spending in 2017-18 (equating to an increase in the block grant of around £100m) and 2018-19 compared to March plans, with some of this stimulus recouped in later years.
- *'Extended consolidation'* – this assumes the Chancellor maintains the existing departmental spending plans over the period to 2019-20, but continues the pace of fiscal consolidation in subsequent years, within the context of an objective to reduce the deficit over the medium term.
- *'Additional fiscal tightening'* – this assumes the Chancellor revises his plans for departmental spending relative to those set out in March. Specifically, we assume the Chancellor aims to take £9bn out of departmental spending over a three year period. Whilst this may sound like a particularly tight settlement, it should be seen within the context of modelling by the IFS which forecast that Brexit would worsen the UK fiscal position by somewhere between £23- £38 billion in 2019-20¹⁸.

The implications of these scenarios for the evolution of the Scottish Government's resource block grant – prior to any adjustment for devolved taxes – is shown in Chart 2.2. By 2020-21, there is around a £700 million real terms difference across the range of scenarios.

¹⁸ See Emmerson et al. (2016) <https://www.ifs.org.uk/publications/8411>

Chart 2.2: Scenarios for the Scottish resource block grant, £m (2016-17 prices)

Source: FAI calculations

2.5 Tax devolution and the block grant adjustments

The next element in the calculation of Scotland's budget is the interaction between the block grant adjustment mechanism and devolved tax revenues.

As set out in Box 2.4, by 2016-17 Land and Buildings Transactions Tax (LBTT), Landfill Tax, and almost half of revenues from income tax raised in Scotland had been devolved.

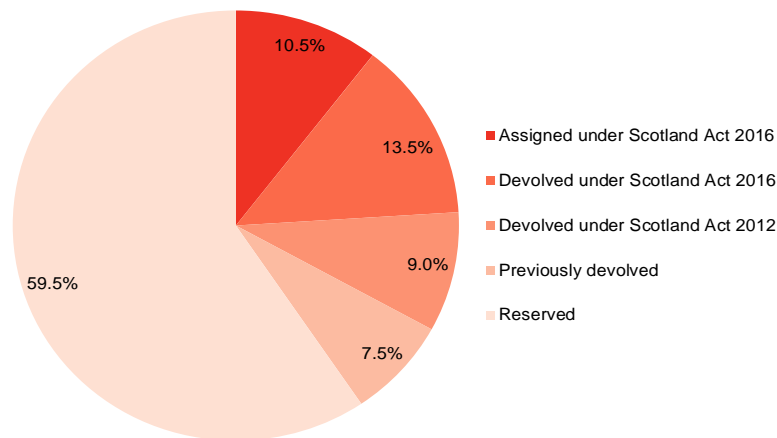
By 2017-18, the setting of rates and bands for Non-Savings, Non-Dividend income tax revenues will be fully devolved (although the Personal Allowance will continue to be set at Westminster); Air Passenger Duty will be devolved in 2018-19, and a proportion of the receipts from VAT raised in Scotland will be assigned to the Scottish budget from 2019-20.

Box 2.4: Scotland's new tax powers

From 1999 to 2015, the Scottish Government had little in the way of tax autonomy, while having responsibility for about 60% of public spending in Scotland. This was seen as a highly asymmetric model of devolution.

Initially, the only two devolved tax powers were business rates and council tax – raising £1.9 billion and £2.1 billion (net) respectively in 2015-16.

Following the Scotland Act 2012, two new devolved taxes were created – Scottish Landfill Tax and Land and Buildings Transaction Tax (both from 2015-16) – with the equivalent UK taxes switched off. These two new taxes raised £147 million and £425 million respectively in 2015-16. From 2016-17, a Scottish Rate of Income Tax was established with UK income tax reduced by 10 pence across all bands (raising around £4.3 billion in 2015/16).

Chart 2.3: Evolution of Scotland's tax powers

Source: GERS and FAI calculations

Following the Smith Commission, these income tax powers have been extended to cover all non-savings and non-dividend income (NSND). Greater flexibility over rates and bands has also been granted. Scottish NSND income tax is estimated to raise around £11.2 billion.

Air Passenger Duty will be devolved in 2018-19, with the existing UK tax currently raising around £275 million in Scotland. Aggregates levy is also to be devolved – at a date to be agreed by both governments – with the current UK tax raising around £50 million. In time, devolved tax revenues will be equivalent to around 30% of total Scottish tax revenues.

From 2019-20, receipts from the first 10p of the standard VAT rate and the first 2.5p of the reduced rate of VAT will be assigned to the Scottish budget – currently around £5 billion for 2015-16. This will take devolved and assigned revenue as a percentage of Scottish revenue to 40%.

After tax devolution, the Scottish block grant will continue to be calculated in the first instance by the Barnett formula. But the devolution of tax powers requires this to be adjusted to reflect that some of the budget will be replaced by tax revenues.

For each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) will be calculated. An overview of how the BGAs will be calculated is provided in Box 2.5¹⁹.

The key point to bear in mind is that the BGAs can be interpreted as counterfactual estimates of the revenues that the UK Government is likely to have foregone – in any given year – as a result of transferring each tax to Scotland. The BGA for income tax for example, is an estimate of the revenues that the UK Government would have raised from income tax in Scotland, if tax policy was the same in Scotland as in the rest of the UK (rUK) and if revenues *per capita* had grown at the same rate in Scotland as in rUK since the tax was devolved.

¹⁹ <https://www.gov.uk/government/publications/the-agreement-between-the-scottish-government-and-the-united-kingdom-government-on-the-scottish-governments-fiscal-framework>

The way that the BGAs are calculated means that what is critical for the Scottish budget is the growth rate of per capita revenues in Scotland relative to the growth rate of per capita revenues from the equivalent taxes in rUK. In short, how does the amount now being taken out – i.e. via the BGA – compare to how much is being added back in – i.e. via the new devolved taxes?

If devolved Scottish revenues turn out to be higher than the BGAs, then the Scottish budget is better off than it would have been without tax devolution, and vice versa.

The fact that what matters here is relative growth in tax revenues has important implications for considering the impact of Brexit on the Scottish budget. The decision to leave the EU is expected to reduce UK Government tax revenues over the next few years. As a result the BGAs will also fall, offsetting any decrease in the Scottish Government's devolved revenues following any post-Brexit slowdown in Scotland.

Box 2.5: Adjusting the block grant to reflect Scotland's new tax responsibilities

The Smith Commission made clear that Scotland's block grant should continue to be determined by the Barnett formula. But it also recognised that Barnett would have to be adjusted to reflect the new tax powers.

To do this, for each of the devolved (and assigned) taxes, a 'block grant adjustment' (BGA) will be calculated.

The BGA is calculated for each tax separately, and consists of two elements – an initial deduction and an indexation mechanism.

The initial deduction is simply equal to the tax revenues collected in Scotland in the year immediately prior to the devolution of the tax power. For example, if income tax is devolved in 2017-18, the initial deduction is equal to income tax receipts in Scotland in 2016-17.

But what should the BGA be in 2017-18 and any year thereafter? This is where the indexation mechanism comes in. Its purpose is to provide a measure of the rate at which 'comparable revenues' have grown in the rest of the UK.

In negotiating the fiscal framework on which the Scotland Act 2016 financial arrangements depended, the Scottish and UK Governments could not agree on the appropriate methodology to adopt. This mattered. Depending upon your interpretation, the Scottish budget could have lost (or gained) billions of pounds over a relatively short period of time.

In the end a compromise was reached. The indexation of the BGA will be calculated using two methods. The first – preferred by the UK Government – is known as the 'Comparable Model'. The second – preferred by the Scottish Government - is known as 'Indexed Per Capita' (IPC). However, although the BGAs will be calculated according to both methods, over the period until 2020-21 it is the IPC method which will be used. To keep the analysis straightforward, we simply calculate Scotland's BGA according to the IPC approach.

The IPC approach assumes that Scottish revenues grow at the same per capita rate as those in rUK, and adjusts the BGA accordingly. This is easiest to illustrate with an example – see Table 2.2.

Table 2.2: Calculation of the Block Grant Adjustment

	2016-17	2017-18
Scottish revenues 2016-17: the 'initial deduction'	£12,175m	
Scottish population	5.38m	5.40m
Scottish revenues per capita (2016-17)	£2,263	
growth rUK revenues per capita (2016-17 & 2017-18)		5.6%
Assumed Scottish revenues per capita 2017-18 (based on rUK growth)		£2,263 x 105.6% = £2,390
<i>BGA (£m). Scottish revenues per capita multiplied by Scottish population in 2017-18</i>		£2,390 x 5.4m = £12,908m

Let us suppose that the question is what Scotland's BGA for income tax should be in 2017-18, the first year that income tax will be fully devolved. In this hypothetical example, income tax revenues from Scotland in 2016-17 (i.e. 'year 0', the year immediately prior to devolution) are £12.175 billion. So the 'initial deduction' is £12.175 billion.

Between 2016-17 and 2017-18, income tax revenues per capita in rUK grow by 5.6%. This means that the initial deduction for income tax (£12.175 billion) is multiplied by 5.6%, and multiplied further by the growth in Scottish population – to arrive at a BGA estimate of £12.9 billion.

This process continues year on year.

The implication of the IPC method is that the IPC method protects the Scottish budget from the risk that Scotland's population grows more slowly than the rUK population – what matters is growth in tax revenues *per capita*. The Scottish budget is still exposed to the risk that tax revenues per capita grow more slowly than in rUK but also will receive the benefit if they grow more quickly.

Table 2.3 sets out an estimate of the BGAs for each tax over the years from 2015-16 to 2020-21.

Initial BGAs for 2015-16 and 2016-17 have been set. The Scottish and UK Governments agreed a temporary combined BGA for LBTT and Landfill Tax in both 2015-16 and 2016-17 (£494 million and £600 million respectively)²⁰. The BGAs for 2016-17 will be reconciled to outturn, and any necessary adjustments made to the block grant, when the relevant outturn data becomes available.

²⁰ Paragraph 36 of the Fourth Annual Report on the implementation and operation of Part 3 (financial provisions) of the Scotland Act 2012; <http://www.gov.scot/Publications/2016/03/4517/5>

In future years, the BGAs for LBTT will be calculated using the IPC indexation method outlined above, with the initial deduction based on outturn figures for 2014-15 (not on the agreed BGA in 2016-17)²¹.

The UK and Scottish Governments also agreed a one-off BGA of £4.9 billion in 2016-17 for the Scottish Rate of Income Tax – the partial devolution of income tax to be superseded in 2017-18 by the full devolution of NSND Income Tax.

For all other taxes (i.e. those to be devolved or assigned in 2017-18 or afterwards), we estimate the initial 'year 0' block grant deduction based on the OBR's March 2016 forecasts of the revenue raised in Scotland the year before the tax is devolved. We then use OBR forecasts of per capita growth in revenues from that tax in rUK to calculate the BGA in future years.

The total block grant adjustment grows over each year of the forecast period, partly as more revenues are transferred to the Scottish Government, and partly due to forecast growth in per capita revenues in rUK. Based on the forecasts in the OBR's March 2016 outlook, by 2020-21 the total BGA is forecast at £21 billion. This is the amount deducted from the Barnett-determined block grant.

Table 2.3: Estimates of the Block Grant Adjustments, £m (cash terms)

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Combined LBTT/ Landfill Tax	494	600				
SRIT (one-off adjustment)		4,900				
LBTT			642	684	731	777
Landfill Tax			103	102	104	105
NSND Income Tax			12,321	12,904	13,393	14,058
Air Passenger Duty				307	323	339
VAT					5,754	5,992
Aggregates Levy					54	54
Total BGA	494	5,500	13,065	13,997	20,359	21,326

Source: FAI calculations

Post-EU referendum, the forecasts for rUK revenues – and therefore the BGAs – will almost certainly now be revised down. But if Scottish devolved tax revenues are revised down by a similar amount then the net effective will be to cancel one another out.

To reiterate, whilst the rate of growth in equivalent tax revenues in rUK is crucial for the calculation of the BGA, what is critical for the Scottish budget overall is whether or not this growth is faster or slower than the growth in Scottish devolved taxes. It is this combination – what is taken out from Scotland's block grant via the BGA versus what is added back in via devolved tax revenues – which determines Scotland's net budget position.

²¹ The outturn figures will be adjusted for forestalling effects, see p.3 of the Fiscal Framework Technical Annex

This highlights how crucial it is to assess Scotland's relative performance. Growth of 5% per capita of a devolved tax in Scotland is all well in good, but Scotland would still be worse off if growth in the equivalent tax per capita in rUK was 6%.

Of course the Scottish Government could achieve faster growth in revenues by increasing tax rates in Scotland – see Section 2.7.

But first let's assume that there are no tax policy changes between Scotland and rUK, and that the only thing that can vary is the relative rate of revenue growth. How different might the Scottish Government's budget be?

Between 2001-02 and 2014-15, Scottish income tax revenues per capita grew at 3.4% per annum, compared to 3.2% in the UK as a whole²². Scottish VAT revenues per person also grew faster in Scotland than in the UK: 4.7% v. 4.4%. So for our first scenario therefore, we assume that Scottish per capita revenue growth continues to maintain this positive differential relative to the revenue growth rates for the UK as a whole, not just for income tax, but for all devolved taxes and assigned VAT, from the date that they are devolved.

Our second scenario is the mirror opposite – i.e. Scottish per capita revenues grow more slowly (by the same magnitude) than the rate projected for the UK as a whole.

Table 2.4 summarises the implication of these assumptions. If Scottish per capita revenue growth maintains this positive differential relative to rUK, the Scottish budget could be around £130 million better off by the end of the parliament. In other words, revenues from devolved and assigned taxes would be £130 million higher than the BGA for those taxes. If however Scottish revenues per capita grow more slowly, the Scottish budget could be £130 million worse off.

Note that the effects of differential tax revenue growth in this parliament are not as significant as they could be in future parliaments. This is because some taxes – notably VAT – will not be devolved until 2019-20, and so the length of time over which differential revenue growth can occur is relatively limited.

Table 2.4: The effects of faster or slower relative per capita tax revenue growth on the Scottish budget, £m (cash terms)

	2017-18	2018-19	2019-20	2020-21
Faster Scottish growth	25	51	90	132
Slower Scottish growth	-24	-50	-88	-130

Source: FAI calculations

²² Source: Government Expenditure and Revenues Scotland, 2015-16

2.6 Bringing this all together – the outlook for the Scottish Budget

It is now possible to bring together the determinants of the Scottish resource budget – the block grant, the BGA and devolved revenues – to set out the estimated level of resource that the Scottish Government will have access to over the period to 2020-21.

The purpose of this analysis is to set out a range of scenarios rather than one central scenario. In Section 2.7, we consider the scope for variation in Scottish tax policy.

We consider the four scenarios for the evolution of the Scottish block grant described in Section 2.4.

For each of these block grant scenarios, we overlap the two scenarios – set out in Section 2.5 – for relative growth of Scottish revenues: the optimistic scenario, where Scottish per capita revenues grow relatively faster than those in rUK, and the pessimistic scenario, where the reverse happens.

For comparative purposes, we also show the evolution of the Scottish budget under the March 2016 UK Budget spending plans assuming Scottish and rUK tax growth is identical.

Under this scenario with the block grant as set out in March, and identical revenue growth in Scotland as rUK, the Scottish budget could be expected to fall by around £900 million in real terms, or 3.6%, by 2020-21 (Table 2.5).

Our alternative scenarios, which vary assumptions about the Scottish block grant and the growth of relative tax revenues, lie around that range.

Even a relatively optimistic scenario – one where Scotland outperforms the UK and the UK Government increases its resource spending plans compared to those set out in March – is still projected to lead to a real terms cut in the Scottish budget of around 2.8% or £700 million.

For other outcomes the range of cuts is around 3% to 4%, although under the most pessimistic scenario the Scottish budget may face cuts of up to 6.2% - or up to around £1.6 billion – over the course of this parliament.

Table 2.5: Scenarios for the outlook of the Scottish budget, £m (2016-17 prices)

	2016-17 £million	2020-21 £million	Change 16-17 to 20-21	Annual change 16- 17 to 20-21
March spending plans (same revenue growth as rUK)	26,115	25,178	-3.6%	-0.9%
March spending plans (faster revenue growth)	26,115	25,300	-3.1%	-0.8%
March spending plans (slower revenue growth)	26,115	25,058	-4.0%	-1.0%
Additional fiscal consolidation (faster revenue growth)	26,115	24,734	-5.3%	-1.3%
Additional fiscal consolidation (slower revenue growth)	26,115	24,492	-6.2%	-1.6%
Spending stimulus (faster revenue growth)	26,115	25,394	-2.8%	-0.7%
Spending stimulus (slower revenue growth)	26,115	25,152	-3.7%	-0.9%
Extended consolidation (faster revenue growth)	26,115	24,930	-4.5%	-1.2%
Extended consolidation (slower revenue growth)	26,115	24,688	-5.5%	-1.4%

Source: FAI calculations

This range of outcomes may seem – at first glance – to be relatively large (Chart 2.4). However, each scenario contains plausible outcomes and it is their combination which determines the overall range. For example, a scenario where the UK Government presses ahead with consolidation and Scotland was to grow more slowly than the rest of the UK would imply a relatively sharp real-terms fall in the Scottish budget.

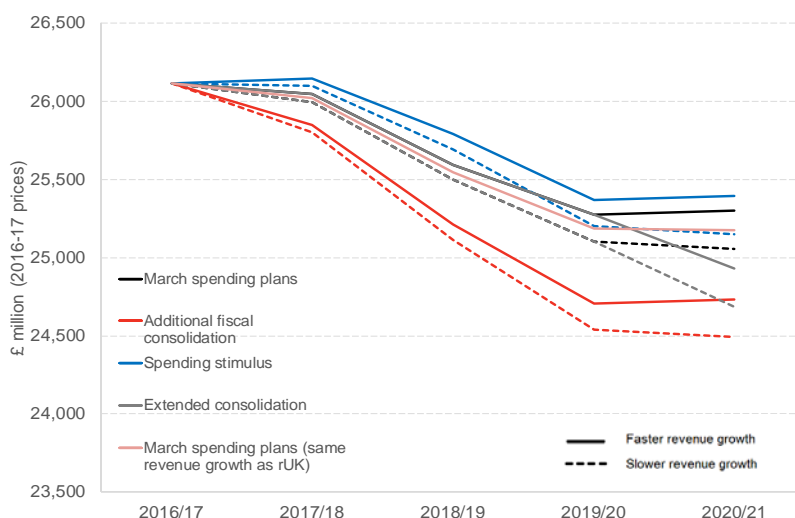
In contrast, if Scotland was to outperform the UK and the UK Government was to ease the pace of consolidation, then Scotland's budget would perform better. However, it should be noted that even on this scenario, the Scottish budget is still projected to fall in real-terms - marking a full decade of cuts.

Coupled with the spending commitments and pressures we set out in Chapter 3, it is clear that the Scottish budget faces a period of significant ongoing constraint.

What this suggests is that the Scottish Government needs to plan for a range of possible scenarios from 2017-18 onwards. It does not have the discretion that the UK has of increasing borrowing to manage spending pressures – effectively it has to run a balanced budget based on the block grant, BGAs, and tax revenues. Crucially, the Scottish Government will need to work on contingency plans should the pressure on budgets intensify.

Up until now we have assumed that Scottish tax policy does not diverge from UK policy. But devolved tax revenues might not only grow faster or slower as a result of differential tax growth – the Scottish Government may also vary its budget by making explicit tax policy choices.

Chart 2.4: Scenarios for the Scottish resource budget, £m (real terms, 2016-17 prices)



Source: FAI calculations

2.7 Tax policy commitments

In what follows, we assume that the tax policies set out in the SNP 2016 manifesto become Scottish Government commitments.

The Scottish Government has two headline policy positions on income tax -

- Increase the Personal Allowance to £12,750 by the end of the parliament.
- Freeze the Higher Rate threshold in 2017-18 and ensure that it will rise by a maximum of inflation until 2021-22.

It is also committed to halve the burden of Air Passenger Duty by the end of the parliament²³.

We consider the revenue implications of each of these policies below.

Increase the Income Tax Personal Allowance to £12,750

Although the ability to vary the Income Tax Personal Allowance is not devolved, the Scottish Government can effectively set a higher Personal Allowance by setting a zero rate on top of the UK allowance.

²³ In relation to Scottish Government spending commitments, by the 'end of this parliament', we generally mean 2021-22. The parliament will technically 'end' in Spring 2021, but the budget for the 2021-22 financial year will be set in this parliamentary term. We similarly assume that tax commitments to be achieved 'by the end of the parliament' are to be achieved in full by 2021-22.

Above inflation increases in the Personal Allowance represent tax cuts, as they increase the amount of income that is not subject to tax. How much of a tax cut a rise in the Personal Allowance to £12,750 represents depends on the timescale over which it is implemented.

The UK Government has set out an intention to raise the Personal Allowance to £12,500 by the end of the UK parliament. Whilst the interpretation of 'end of' is open to debate, we take it as 2020-21.

The Scottish Government aspiration is to raise the Personal Allowance to £12,750 by the end of the Scottish parliamentary term which instead relates to 2021-22. An increase in the Personal Allowance from £12,500 in 2020-21 to £12,750 in 2021-22 is equivalent to a 2% increase – i.e. in line with inflation and, more than likely, what will happen at the UK level anyway.

The Scottish Government policy might be seen as little more than indexing the Personal Allowance to inflation. If the UK follows suit, the policy will be revenue neutral.

To date however, the UK Government has only legislated to increase the Personal Allowance to £11,500 in 2017-18, and then to index it to inflation from then on. This implies (based on current inflation forecasts), that the UK Personal Allowance will reach £12,000 in 2019-20 and £12,200 in 2020-21.

In making its forecasts, the OBR is mandated to reflect *actual* government policy (not intentions or ambitions). Manifesto 'commitments' that have not yet been legislated for are noted as a source of risk but are not explicitly incorporated into the forecasts. Therefore, consistent with the approach taken by the OBR – with analysis based on current legislation *rather than* political aspiration – it is these forecasts which underpin our estimates of the income tax BGA in Table 2.3.

The revenue impact of the Scottish Government setting a Personal Allowance of £12,750, relative to one of £12,200 (which currently underpins OBR tax forecasts) would be fairly substantial. Based on our modelling, we estimate that this would cost around £225 million by 2021-22.

However, our projections only run until 2020-21, and we thus exclude this policy commitment from our analysis²⁴.

Freeze the Income Tax Higher Rate threshold in 2017-18 and raise it by inflation thereafter

The second income tax commitment of the Scottish Government is to freeze the Higher Rate threshold in 2017-18 and ensure that it rises by no more than inflation until 2021-22.

This policy has been expressed as a revenue raising policy, on the basis that the UK Government has committed to increase the Higher Rate threshold by faster than inflation, from £43,000 in 2016-17 to £50,000 by the end of the UK parliament²⁵.

But how much additional revenue will the policy raise relative to the estimates in Table 2.5?

²⁴ If the Scottish Government decided to achieve a graduated increase in the Personal Allowance to £12,750 in 2021/22, then relative to a Personal Allowance that was indexed to inflation, this would cost the Scottish budget around £36m, £76m, and £113m respectively in 2018-19, 2019-20 and 2020-21.

²⁵ See <http://news.scotland.gov.uk/News/Income-tax-rates-to-be-frozen-2479.aspx>

This again depends critically on the assumptions and baseline used. As above, the forecasts in Table 2.5 were based on the assumption that Scottish income tax policy mirrors policy *legislated* for in the UK, not the Conservative manifesto.

The March 2016 UK Budget set out provisions for the Higher Rate threshold to rise to £45,000 in 2017-18. Beyond this however, the current legislation is for the Higher Rate threshold to rise by inflation. Given forecasts for inflation at that time²⁶ this implies a Higher Rate threshold of £48,000 (not the £50,000 in the Conservative manifesto) in 2020-21.

This gives two possible scenarios.

Firstly, if the Scottish Government freezes the Higher Rate threshold at £43,387 in 2017-18, for it to then increase according to CPI inflation, the Higher Rate threshold in Scotland would reach £46,000 by 2020-21. This lower threshold – compared to the UK rate of £48,000 – would according to our modelling raise around an additional £176 million²⁷.

Secondly, if the UK Government delivered on the Conservative manifesto commitment to raise the Higher Rate threshold to £50,000 by 2020-21, this would have the added effect of reducing UK income tax revenues, and therefore the BGA for Scotland (fifth row of Table 2.6). This would cut the BGA by around £194 million by 2020-21.

In summary by 2020-21, if the Scottish Government implements the SNP manifesto pledge, it will raise around £180 million annually in tax, whilst if the UK Government implements the Conservative manifesto pledge, the Scottish BGA will fall by around £190 million in 2020-21, relative to the estimate shown in Table 2.3 above.

Table 2.6: Scenarios for the Higher Rate threshold, £m (cash terms) – revenue impacts

	2017-18	2018-19	2019-20	2020-21
UK Higher Rate threshold (Budget 2016)	£45,000	£45,945	£46,864	£47,801
Scottish Higher Rate threshold (manifesto commitment)	£43,387	£44,298	£45,184	£46,088
<i>Additional Scottish revenues as a result of these thresholds (£million)</i>	£130	£160	£166	£176
UK Higher Rate threshold (manifesto commitment)	£45,000	£46,667	£48,333	£50,000
<i>Reduction in BGA as a result of these thresholds (£million)</i>	£0	-£60	-£124	-£194
Total Revenue Gain (£million)	£130	£220	£290	£370

Source: FAI calculations

The net impact of UK Government and SNP Manifesto Commitments would be to boost the Scottish budget by around £370 million annually by 2020-21.

²⁶ Table 4.1 of the March 2016 Economic and Fiscal Outlook.

²⁷ Our modelling takes no account of potential behavioural effects and therefore can be viewed as an upper estimate.

Reduce Air Passenger Duty

The Draft Budget 2016-17 confirmed that the Scottish Government intends to reduce APD by 50%, with the reduction beginning in April 2018 and delivered in full by the end of the parliament.

The costs of this policy will depend on the extent to which the tax cut stimulates greater passenger numbers. In the absence of any full economic modelling of this policy by the Scottish Government however, we assume that a halving of the tax burden will equate to a revenue fall of 50%, which we phase in between 2018-19 and 2021-22. This policy costs the Scottish Government £42m, £87m and £138m in 2018-19, 2019-20 and 2020-21 respectively (Table 2.7).

Table 2.7: Air Passenger Duty, £m (cash terms) – revenue impacts

	2017-18	2018-19	2019-20	2020-21
APD forecast 'no policy change'	-	307	323	339
APD revenues, SNP manifesto Commitment	-	268	242	212
Revenue Cost	-	-38	-81	-127

Source: FAI calculations

Reduce waste to landfill

The Scottish Government has set an ambition to reduce total waste generated to 85% of the 2011 level by 2025, and to reduce total disposals to landfill to 5% of total waste generated. Although not a tax policy per se, if the target is achieved it will result in a reduction in the tax base.

The Scottish Government's forecasts for Landfill Tax take account the revenue costs of meeting the policy objective. Relative to the baseline scenario, the policy is expected to result in Scottish revenues being lower by £6m, £18m and £30m in 2018-19, 2019-20 and 2020-21 respectively.

Of course, if similar reductions in waste to landfill were made in rUK, and these reduced Landfill Tax receipts in rUK, then the effect of lower tax revenues in Scotland might be offset by a lower block grant adjustment.

Summary of tax policy commitments

The combined revenue effects of the Scottish policy measures (including the effect of an increase in the UK Higher Rate threshold on the Scottish block grant) are shown in Table 2.8.

If all commitments are followed through, and if the Scottish Government is successful in reducing levels of waste to landfill, the aggregate effect of these tax measures is to raise the Scottish budget by £130 million in 2017-18, rising to around £213 million in 2020-21.

In the context of the scenarios outlined in Table 2.5 – which showed the Scottish budget varying between £24.5 billion and £25.3 billion depending on assumptions about UK fiscal policy and relative Scottish tax revenue growth – the revenue implication of existing tax policy proposals is marginal. Revenues of £213 million equate to less than 1% of the Scottish resource budget.

Table 2.8: Revenue effects of Scottish tax policy measures, £m

	2017-18	2018-19	2019-20	2020-21
Scottish Higher Rate: freeze then CPI index	£130	£160	£166	£176
UK Higher Rate: increase to £50k		£60	£124	£194
Reduce APD	-	-38	-81	-127
Reduce waste to landfill		-6	-18	-30
Net effect	£130	£176	£191	£213

Source: FAI calculations
Note: (+ = revenue raising; - = revenue cut)

2.8 The outlook for capital spending

The final piece of the jigsaw is the outlook for capital spending. Under the new fiscal framework, the decision to devolve tax powers and the complex arrangements for adjusting the block grant will not apply to capital spending. The Scottish Government will still largely just receive a grant for capital spending from the UK Government.

The Scottish Government's capital grant is expected to be £2.7 billion in 2016-17 (excluding Financial Transactions). The March 2016 UK Budget forecast that this would increase to £3.3 billion by 2020-21 (Table 2.9).

There is a possibility that the Chancellor may announce a boost to capital spending in his Autumn Statement. The implications for Scotland will depend upon the extent to which spending is targeted at areas with high Barnett consequentials. Roughly speaking, a 10% increase in UK capital spending that is comparable in terms of the Barnett formula equates to £300 million.

Table 2.9: The Scottish Government's Capital Grant and Capital Borrowing Limits, £m

	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
cDEL block grant	2,692	2,846	2,908	3,038	3,202	3,300
cDEL block grant (real)	2,733	2,846	2,856	2,923	3,024	3,055
Capital borrowing limits (Scotland Act 2012)	306	316				
Capital borrowing limits (Scotland Act 2016)			450	450	450	450
Total	2,998	3,162	3,358	3,488	3,652	3,750

Source: FAI calculations

One new addition in the fiscal framework is the power to borrow for additional expenditure beyond this cDEL allocation.

The Scottish Government is now able to invest an additional £450 million by borrowing from the National Loans Fund or the private sector (loans or bonds²⁸).

The Scottish Government has announced a further £100 million of capital investment in 2016-17. This is largely un-spent resource monies from 2015-16 being drawn down this financial year.

2.9 Conclusions

The end of fiscal consolidation is by no means in sight, with further real terms reductions likely over the course of this parliament. A decade of cuts is now a distinct possibility.

Real-terms cuts had already been planned prior to the EU referendum. The decision to leave the EU has made the outlook a little more uncertain. That being said, we can still make important judgements about the likely path of the Scottish budget under a range of plausible scenarios.

Firstly, it is unlikely that the UK Government will depart from its policy of tackling the fiscal deficit in the medium term. Whilst there might be a modest stimulus in the short-term – perhaps to investment and/or cut in taxation – a substantial increase in day-to-day public spending appears unlikely.

Secondly, under the new fiscal framework what is crucial is how well the Scottish economy copes with Brexit relative to the rest of the UK. The new Block Grant Adjustment (BGA) mechanism will cut the Scottish budget each year by the growth in comparable tax revenues in rUK. If Scottish devolved tax revenues per head can grow more quickly, then this will more than offset the BGA - Scotland will be better off compared to Barnett. But if they grow more slowly, Scotland will be worse off.

We have set out a range of possible outcomes. In short, which ever scenario is r, the Scottish budget will remain highly constrained. Even under a relatively optimistic scenario where Scotland outperforms rUK and the UK Government implements an increase in departmental spending relative to its March plans, the Scottish budget is still likely to be lower in 2020-21 than in 2016-17 – a cut of around 2.8% in real terms. Under a scenario where the UK Government loosens fiscal policy through tax cuts rather than spending increases, and retains a medium term focus on reducing the deficit, the Scottish budget is likely to fall by 3-4% in real terms.

On more challenging scenarios, for example where the UK Government continues with its aim of tackling the deficit – albeit over a longer time horizon – and Scotland underperforms relative to the rest of the UK, the decline in the Budget could be larger – a cut of nearly 6.2%.

The Scottish Government now has of course the opportunity to raise revenues through devolved tax rates. To date, the policies announced will collectively only have a marginal impact on revenue, making a less than 1% difference to the Scottish Government's resource budget.

As we outline in the next chapter, this outlook will mean that the government will have to carefully prioritise their commitments over the course of the parliament.

²⁸ Clearly, any borrowing must be repaid. Borrowing for capital spending today thus implies a spending commitment on the Scottish Government's future resource spending. We consider spending commitments in more detail in Chapter 3.

Chapter 3: Spending commitments and constraints

- The Scottish Government has set out a number of high profile spending priorities for the new parliament.
- It plans to increase health spending by £500m more than inflation by the end of the parliament. It has also committed to maintain real terms spending on policing and has a flagship policy to double the provision of free childcare.
- Delivering these commitments will require a serious re-prioritisation of spend. In the context of a declining resource budget, some unprotected areas of the budget could face cuts of between 10% to 17% (2.6% to 4.5% annually) over the period to 2020-21, depending on scenarios for the Scottish block grant and relative growth of Scotland's new tax revenues.
- Alongside these high profile commitments, the Scottish Government has outlined a number of additional costly policies. These include protecting further education places, and free higher education tuition.
- The Scottish budget also faces a number of spending risks –
 - Inflation is anticipated to increase in the near-term, reducing the real terms value of budgets whilst making spending commitments expressed in real terms more expensive;
 - It is forecast that the Scottish Government will spend around £1.2 billion each year over the course of this parliament on PFI/NPD repayments;
 - The public sector payroll accounts for around 55% of the Scottish budget and after years of pay freezes and below inflation increases, the pressure for more generous awards is likely to increase; and,
 - The delivery of Scotland's new welfare powers will be a major priority. The cost of delivering the new system could be much higher than the £200 million secured from HM Treasury to cover the administration costs for *all* new powers.
- Local government faced a particularly challenging settlement in 2016-17, with its revenue grant cut by 5% in real terms. At the same time, an increasing number of conditions have been attached to budget allocations, opening up a wider debate around the future of local government. As an area of 'unprotected spend', the grant to local government could be cut by around £1 billion on a like-for-like basis by 2020-21 – with increases in business rate and council tax income only partially offsetting these cuts.

The Scottish Government will set out a series of spending commitments for the new parliamentary term in its Budget to be published later this year. In a time of tight resources, this will imply a tough re-prioritisation of spend with some portfolios facing substantial real terms reductions over the course of this parliament. Following six years of austerity this will not be easy, with some portfolios facing the prospect of a decade of real-terms cuts. Unprotected portfolios could face cuts of between 10% and 17% by 2020-21.

3.1 Introduction

The previous chapter considered how the Scottish Government's budget might evolve over the course of the new parliament.

How might it decide to distribute this budget across a multitude of spending priorities? This is the question we consider in this chapter.

In the previous parliament, the Scottish Government had to take a series of difficult decisions about how to distribute resources across portfolios. To help support this, they embarked upon a programme of public service reform - most recently the integration of health and social care – coupled with efficiency targets and restraint in public sector pay.

Resource spending on health was increased in real terms. But other budgets faced substantial cuts. In particular, whilst insulated somewhat – at least initially – from the scale of cuts in England, Scottish local authorities have still seen their block grant fall by around 11% in real terms between 2010-11 and 2016-17²⁹.

Within portfolios there have also been significant cutbacks. For example, Scotland's enterprise budgets have fallen by over 20%³⁰ in real terms since 2009-10.

As Chapter 2 made clear, the balance of probability is that the Scottish Government's budget is likely to remain at least as constrained over the course of this parliament even after the devolution of new tax powers.

The Scottish Government will need to decide how to allocate these scarce resources to their immediate policy – and political – commitments as well as their longer-term aspirations set out in the National Performance Framework³¹.

The SNP's 2016 manifesto provides some indication as to where priorities lie.

²⁹ Source: <http://www.audit-scotland.gov.uk/report/an-overview-of-local-government-in-scotland-2016>

³⁰ See Annex H of Draft Scottish Budget 2017-17

³¹ See <http://www.gov.scot/About/Performance/purposestratobis>

A number of key spending pledges have been set out including increases in the Health budget – totalling over 3% in real terms by 2020-21. With inflation expected to rise, the cost of delivering such commitments will increase.

At the same time, the government will also face a number of constraints that will limit the degree of flexibility, including repayment costs on Private Finance Initiative (PFI) and Non-Profit Distribution (NPD) schemes, increased demand for public services from an ageing population, and pressure on the public sector pay bill after years of restraint.

This chapter is structured as follows. In Section 3.2, we discuss the core spending pledges outlined so far by the Scottish Government and consider the implications for the distribution of the budget.

In Section 3.3, we extend this discussion to include a broader set of policy commitments, before Section 3.4 discusses the spending outlook for the 'non-protected' areas.

It is important however, to view the discussion of policy priorities and the corresponding cuts in the round. Health accounts for around 44% of the Scottish budget in 2016-17 and it follows that any prioritisation of the health budget will have serious implications for other portfolios. Critics of cuts in particular portfolios will need to set out where money should be saved or what taxes should rise.

Section 3.5 focuses on the capital outlook.

Our analysis leads us to conclude that irrespective of the particular scenario adopted, and given the commitments and constraints we outline, a central focus of the debate in the coming months will be the settlement for local government and the potential implications of around a £1 billion cut to local authority resource funding on a like-for-like basis. This is the focus of Section 3.6. Section 3.7 concludes.

3.2 Explicit spending commitments

The Scottish Government has set out a number of high profile spending commitments for the new parliament. As in Chapter 2, we take the view that commitments contained in the 2016 SNP manifesto are now Scottish Government priorities.

Three of the most significant are expressed explicitly in funding terms. In our view, we see these as totemic policy priorities for the Scottish Government, both in terms of scale and political profile.

These three relate to health, policing, and the expansion of childcare.

Health spending

Since 2007, the Scottish Government has prioritised health spending. It is clear that this will continue.

The SNP Manifesto set out a pledge to increase the NHS revenue budget by £500 million more than inflation by the end of the parliament. This commitment implies an increase in the health

resource budget from £12.4 billion in 2016-17 to £14.1 billion by 2021-22, equivalent to a 3.7% real terms funding increase.

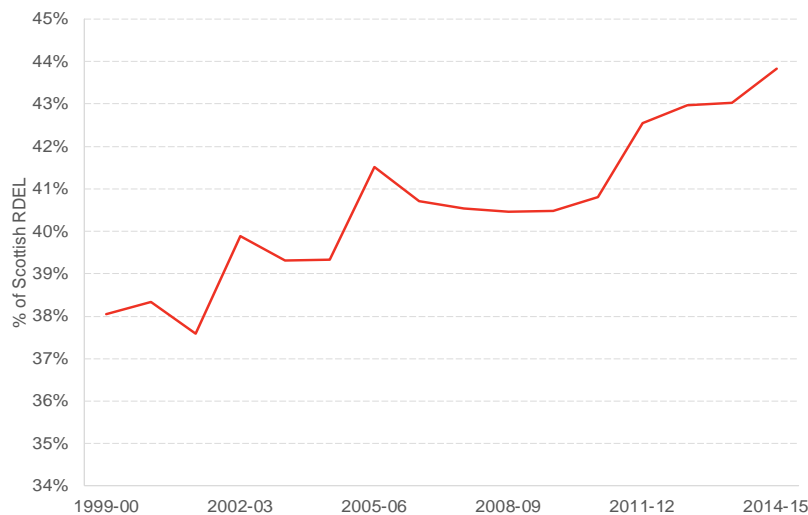
Exact profiling of this investment has yet to be set out. For simplicity, we assume that the increase is phased equally over our forecast period, so that health spending reaches £13.8 billion (a 3.1% real terms increase) by 2020-21³².

Box 3.1 puts the health spending commitment in some context.

Box 3.1: Health spending pressures

Spending on health has been rising in real terms since 1999. Resource spending on health rose from 38% of the Scottish Government's RDEL in 1999-2000 to 44% in 2014-15 (Chart 3.1).

Chart 3.1: Health spend as a percentage of Scottish resource spending



Source: Public expenditure statistical analysis, various years

This increase has – in contrast to other areas of the public sector – led to an expansion in the numbers employed in the NHS. In Jan-Mar 2016, there were 161,700 people employed by NHS Scotland, up from 147,500 over the same period in 2006 – a rise of nearly 10%.

The Scottish Government has made clear that it will continue to invest in the health resource budget in real-terms. A series of new capital investments will also be undertaken, including six new diagnostic treatment centres costing around £200 million.

However, with a continuation of increasing demand expected, the pressure on health services will continue to rise. Despite increased budgets, key challenges have emerged including in A&E Waiting Times and delayed discharges. In response, and alongside new investment the

³² The commitment 'by the end of this parliament' in our view means 2021-22, which is the last Budget to be set in this parliamentary session (with elections May 2021). By NHS we mean all health spending – and not just territorial and Special NHS Boards. This commitment results in additional health spending of £1.8 billion by 2021-22, which is broadly consistent with the Scottish Government's figure of 'around £2 billion'.

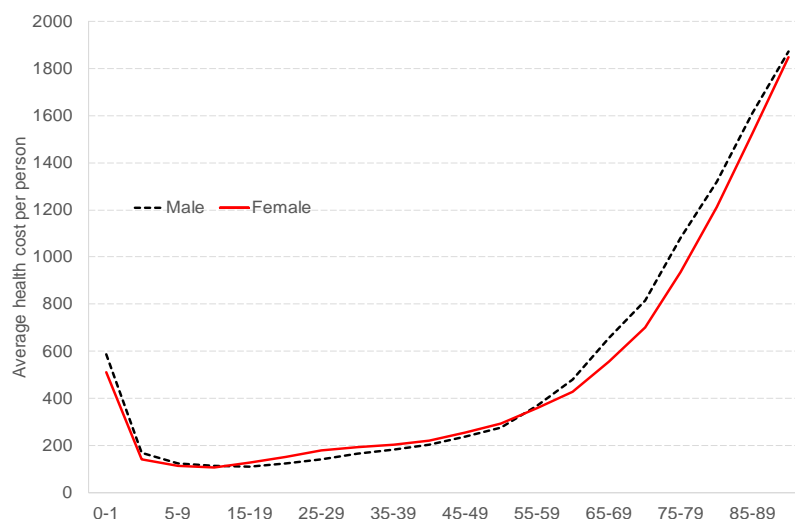
government has embarked on a series of reforms as it aims to focus on prevention and delivery of more home-based care.

This will not be easy. The health budget faces a number of unique spending pressures with demand for healthcare increasing over time and at a faster rate than other public services.

One reason for this is demographics. Scotland's population is ageing. Between 1999 and 2014, the proportion of Scotland's population aged over 65 increased from 15.7% to 18.3%. By the end of this parliament, this will have reached almost 20%, according to ONS Principal population projections.

Older populations tend to demand more healthcare. Chart 3.2 below shows the implied NHS costs per person and year of age in Scotland³³. If the ratio of health care costs to age remains the same, then based on demographic projections we forecast that the Scottish health budget would need to rise by 2.3% in real terms by 2020-21 simply to keep up with demographic change³⁴. This puts the projected real terms increase in the Scottish health budget of 3.1% over the same period in context.

Chart 3.2: Per capita health costs, by gender and age



Source: Derived from NHS Scotland Resource Allocation Formula

The health service also faces rising costs as a result of high-cost drugs and new technologies.

One factor that has eased the burden has been that pay increases have been modest.

However, continuing public sector restraint alongside private sector pay acceleration will make it difficult to recruit and retain high quality motivated workers.

³³ These costs are derived from the NHS Scotland Resource Allocation Formula, which estimated age-cost profiles in 2007. See <http://www.isdscotland.org/Health-Topics/Finance/Resource-Allocation-Formula/>

³⁴ There is however a debate as to whether what matters in determining health costs is not age, but time to death. In other words, an ageing population might not necessarily imply additional health expenditure, if the majority of health expenditures are demanded in the last few years of life, rather than being associated with a specific age.

Police spending

Since 2007, the Scottish Government has delivered a commitment to support 1,000 extra police officers. The government has argued that this has been an important factor behind a fall in recorded crime, which is now at a 41-year low. The sustainability of the commitment has however, been questioned by the Scottish Police Authority (SPA) and trade unions.

The Scottish Government appears to have moved away from this policy beyond 2016-17. It now intends to give Police Scotland the *“flexibility to be able to adapt the numbers to reflect the changing nature of crime”*³⁵ with the recognition that other skills may be required to cope with new pressures including cybercrime and heightened terrorist threats.

The transition from eight regional police forces to Police Scotland has not been without its challenges. Audit Scotland has been critical of the lack of a long-term financial strategy. A report in December 2015, estimated that the force could face a funding gap of around £85 million by 2018-19 based upon current plans³⁶.

In part due to the pressures on Police Scotland budgets, the Scottish Government has committed to protect the police resource budget in real terms over the course of the new parliament. This implies an increase in funding for the Scottish Police Authority from £1.07 billion in 2016-17 to £1.16 billion in 2020-21³⁷.

Childcare

The Scottish Government has committed to doubling the number of hours of free early years education and childcare to 30 hours a week for vulnerable 2 year olds and all 3 and 4 year olds by 2021. It is estimated that this will include 600 new childcare centres and require 20,000 more qualified staff.

According to the SNP manifesto, this policy will cost an additional £500 million per year by the end of the parliament (from £439m in 2015-16 to £939m in 2020-21).

The government has yet to set out the detail of how this commitment will be delivered. A number of different approaches are to be piloted with a view to rolling out best practice, particularly in terms of quality and flexibility.

It is anticipated that the expansion will be delivered by local authorities, and as such the Scottish Government will negotiate with COSLA how much additional funding will be transferred to the local government revenue grant. Some council leaders have, however, expressed doubts over whether or not the new investment can be delivered within planned timescales citing staff and accommodation shortages.

³⁵ See - www.holyrood.com/articles/news/snp-drops-1000-extra-police-officers-target-party-promises-give-police-scotland

³⁶ See - www.audit-scotland.gov.uk/news/auditor-general-reports-for-a-second-time-on-issues-with-scottish-police-authority-accounts

³⁷ Page 71 – Scottish Draft Budget 2016-17.

The Scottish Government may choose a different delivery mechanism, including passing the funding directly to parents (e.g. vouchers). Irrespective of the mechanism, from a public finance perspective this is a new commitment that will require resource.

Cost of the commitments

Taken together, these three policy initiatives represent a significant financial investment by the Scottish Government. The upper part of Table 3.1 shows the implications of these commitments for spending on health, police and childcare by 2020-21. Taken together, spending on these three areas will increase by £1.9 billion over the period to 2020-21.

We have followed Scottish Government practice of expressing spending plans and commitments at a portfolio level to include 'non-cash' DEL³⁸.

Table 3.1: Spending commitments and implications for the Scottish Government resource budget: 2016-17 prices

	Expenditure in 2020-21 (£m)	Change, 2016-17- 2020-21	Annualised change, 2016-17- 2020-21
Spending on commitments			
NHS - spend £500m more than inflation by end of parliament	£12,767	3.1%	0.8%
Police Scotland - protect in real terms	£1,070	0.0%	0.0%
Childcare - double provision	£869	58.3%	12.2%
Total spend on committed areas	£14,706	5.0%	1.2%
Remainder for unprotected portfolios			
March spending plan (same revenue growth)	11,622	-11.6%	-3.0%
March spending plan (faster revenue growth)	11,744	-10.6%	-2.8%
March spending plan (slower revenue growth)	11,502	-12.5%	-3.3%
Additional fiscal consolidation (faster revenue growth)	11,178	-14.9%	-4.0%
Additional fiscal consolidation (slower revenue growth)	10,936	-16.8%	-4.5%
Spending stimulus (faster revenue growth)	11,839	-9.9%	-2.6%
Spending stimulus (slower revenue growth)	11,596	-11.8%	-3.1%
Extended consolidation (faster revenue growth)	11,374	-13.5%	-3.5%
Extended consolidation (slower revenue growth)	11,132	-15.3%	-4.1%

Source: FAI calculations

Delivering these commitments in a time of overall resource constraint will require substantial re-prioritisation within other portfolios.

Table 3.1 sets out the implications of these spending commitments in real terms for unprotected portfolios, under a variety of budget scenarios. The scenarios in Table 3.1 build on those outlined in Chapter 2. There are four scenarios for the Scottish block grant; for each of these block grant

³⁸ 'Non-cash' DEL covers depreciation and impairments and does not represent actual spending power. Non-cash DEL accounts for just over £1 billion in the 2016-17 Draft Budget. Consistent with that publication, we assume that Non-cash DEL remains constant over the Spending Review period.

scenarios we then consider the implication for the Scottish budget if devolved revenues grow relatively faster or slower than the comparable rUK revenues. All scenarios further assume that the Scottish and UK Governments implement their respective tax policy commitments, and this – as described in Chapter 2 – raises the Scottish budget by around £200m in 2020-21, relative to a 'no policy change' scenario.

Deducting the expected costs of the policy commitments outlined above provides an illustration of the scale of the re-prioritisation from 'unprotected' areas of the budget.

Under the budget plans laid out by George Osborne in the March Budget, and assuming that Scottish devolved revenues grow at the same rate as those in rUK, the implication of these three spending commitments is that the Scottish Government's resource budget for all other portfolios would fall by 11.6% in real terms by 2020-21.

Even under a more optimistic scenario where the UK Government increases departmental spending relative to its March plans, and where devolved revenues grow relatively faster than the equivalent revenues in rUK, unprotected portfolios could see their budgets fall by almost 10% in real terms.

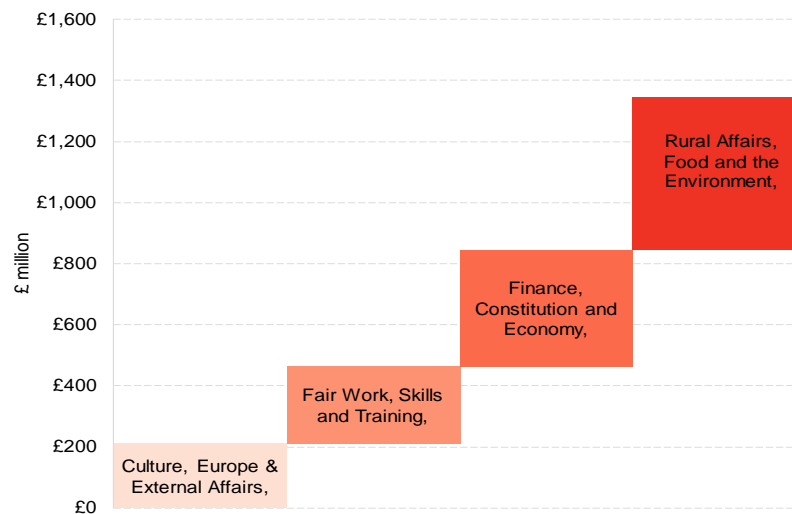
Under a pessimistic scenario, where the UK Government undertakes further fiscal consolidation and Scottish devolved revenues grow relatively more slowly, the budget for unprotected areas could fall by up to 16.8%.

In line with the discussion in Chapter 2, we expect fiscal prudence and consolidation to remain as the underpinning principles of UK fiscal policy in the medium term, even if there is some fiscal loosening in the short-term to counter any post-EU referendum slowdown. In the remainder of this chapter therefore, we focus on the 'extended consolidation' scenario. Under this scenario for the block grant, unprotected portfolios could see cuts in their resource budgets of between 13.5% and 15.3%, depending on whether the growth of Scottish devolved revenues is faster or slower than the growth of equivalent revenues in rUK.

Clearly, these cuts are unlikely to be distributed evenly across unprotected areas and services but the average cut is clearly substantial.

Delivering cuts of this scale will be a significant challenge. To put this in context, a cut of 13.5% to the unprotected areas of the Scottish budget is equivalent to around £1.8 billion in real terms. This is more than the Scottish Government's entire spending in Rural Affairs, Food and Environment, Finance, Constitution and Economy, Fair Work, Skills and Training, and Culture, Europe and External Affairs portfolios (Chart 3.3).

An added challenge is that some of these areas of 'unprotected' spend have borne a significant share of the burden of fiscal consolidation since 2010-11. One might reasonably assume that any cuts that were easy to identify and deliver have already been made, so any further cuts may be harder to make.

Chart 3.3: Scale of the challenge - £1.8 billion in context, by portfolio spend 2016-17

Source: Scottish Government draft budget 2016-17

3.3 Additional policy priorities

Alongside the explicit high profile spending commitments set out above, the Scottish Government has outlined a number of additional policy pledges. Some are not necessarily expressed in funding terms as yet, but will clearly carry a significant price tag. It will thus be up to the government to determine how to allocate the budget in order to meet these policy pledges.

Further & higher education funding

The Scottish Government has committed to maintaining the number of college FTE places at 116,000 per annum.

Conservatively, it might be assumed that this implies (at the very least) maintenance of 2016-17 cash-terms resource spending on college services. Even if delivered, this would be equivalent to a 7% real terms fall between 2016-17 and 2020-21.

On university funding, the outlook is more uncertain. In the 2016-17 Draft Budget, the Scottish Government pledged to continue with funding in excess of £1 billion but only for that year. Beyond that, the government indicated that they will “*seek to ensure that over the period of the spending review to 2019-20, the allocation for higher education from the Scottish Government’s budget will support the continued success of our world-class, research-excellent and internationally competitive universities*”³⁹. Given the resource constraints outlined above real-terms reductions in funding seem likely.

The commitment to free higher education tuition, at a cost of some £300 million per year, is retained. In addition, the Scottish Government has pledged to boost the number of students from Scotland’s most disadvantaged backgrounds.

³⁹ Page 50, 2016-17 Scottish Government Draft Budget.

Educational attainment

The Scottish Government has made improving Scotland's attainment record in education – both in terms of overall performance and closing the gap between those from the poorest and most affluent backgrounds – a key objective.

To support this, it has earmarked a total of £750 million through the Scottish Attainment Fund. Each year, approximately £100 million will be allocated directly to schools, on the basis of the numbers of children who meet the eligibility criteria for free school meals, financed from the planned reforms to Council Tax (see below). £50 million will be allocated from within existing budgets through the Challenge Authorities.

In addition to this, it seems likely that the Scottish Government will be under pressure to find some mechanism to maintain – at least in some form – the overall level of investment in school education outside of these attainment commitments (e.g. to maintain teacher numbers). This is likely to be particularly important as new initiatives such as the new National Improvement Framework are implemented. All of this will require negotiation with COSLA.

Concessionary travel

The Scottish Government has made a strong case for its concessionary travel policy. This policy cost £208 million in 2016-17. In the Programme for Government they announced that they will “examine with stakeholders options to safeguard the longer-term sustainability of the concessionary travel scheme”.

It might be reasonable to assume that spending on the existing concessionary travel scheme will increase in line with inflation, (this is a fairly conservative assumption, given the projected growth in the over-60 population).

The Scottish Government will also implement a new scheme to provide free bus travel to all young people under 21 who are undertaking an apprenticeship.

Welfare spending

It is also reasonable to assume that the Scottish Government will continue the 2016-17 cash terms allocations – at the very least – to the Scottish Welfare Fund (£38 million in 2016-17) and that mitigating the effects of the 'bedroom tax' (£35 million per year currently), will rise with inflation.

Taking these other commitments into account – a cash-terms freeze in college funding, real terms increase in spending on concessionary travel, and cash or real terms freezes on existing welfare policies – could imply real terms cuts to remaining portfolios of 14-16%⁴⁰. This cut of 14-16% needs to accommodate whatever additional funding the Government decides to allocate to achieve its objectives for educational attainment.

⁴⁰ As above, this is based on the extended fiscal consolidation scenario

Other commitments

Finally, there are a number of commitments we anticipate will be borne within individual portfolios but will nevertheless represent an important draw on resources and will limit flexibility.

Within the Health portfolio for example, the government is committed to ensuring that prescriptions and eye tests remain free, retaining the nursing and midwifery bursary, and to spending an additional £150 million on mental health over the parliament. The number of Modern Apprenticeships will rise to 30,000 a year by 2020, whilst the Education Maintenance Allowance will be retained. A cost to the public sector will be its contribution to the Apprenticeships Levy, possibly around £70 million per annum⁴¹.

To reiterate, the Scottish Government might decide that – at least some of – these commitments can be met with less resource, in which case its ‘remaining’ budget would see smaller cuts over the parliament. But, given the relatively conservative nature of our assumptions, it is difficult to see how savings of this scale can be achieved without significant re-prioritisation.

Finally, the Scottish Government has announced a new £500 million Growth Scheme comprising investment guarantees, and some loans, up to a value of £5 million. The scheme requires approval by the UK Government and will form part of AME and therefore has no direct (immediate implications) for the Scottish resource DEL budget.

Once again it is important that these changes are viewed in the round. The significant cutbacks estimated to occur are the direct consequence of the decision to prioritise other areas of spending such as health. Critics of these cuts must explain what they would cut instead or by how much taxes would rise.

3.4 Additional constraints on spending

In addition to the revenue risks discussed in Section 3.2, the Scottish budget also faces a number of risks on the spending side. There are four key reasons why the above discussion may *understate* the challenge facing some portfolios.

Inflation

Earlier in 2016, inflation was forecast at around 2% per annum. The recent fall in sterling, together with lower interest rates, is expected to lead to higher inflation. In its August Inflation Report, the Bank of England forecast inflation could rise by around 0.4 percentage points in 2017 and 2018. Similarly, the National Institute for Economic and Social Research estimate that inflation may increase by 0.5 percentage points each year.

Inflation has two implications.

Most obviously, it reduces the real terms value of a given level of cash spending.

⁴¹ It should be noted of course that Scotland will be receiving – through Barnett consequentials – a share of £500 million to be allocated between the Scottish, Welsh and Northern Irish Governments.

The revisions to inflation forecast by the Bank of England and the National Institute for Economic and Social Research imply that the Scottish budget could be around 1.6% - or £390 million – less in real terms in 2020-21 than if the inflation forecast had not been revised.

The second implication is what it means for spending commitments expressed in real terms.

For example, under the Bank of England's inflation forecast revisions, the commitment to protect the police budget in real terms could cost around £15 million per year more by 2020-21 than initially planned. Similarly the commitment on health could cost £175 million more per year in 2020-21.

Financing of capital investment

Both the current Scottish Government and previous administrations have used a variety of revenue financed mechanisms to boost capital investment.

These included the Public-Private Partnership (PPP)/Private Finance Initiative (PFI) schemes – up to 2007 – and then subsequently the Non-Profit Distributing (NPD) programme.

Under these initiatives, the private sector finances the upfront capital costs of a project and, once operational, the public sector agrees to pay fees to cover capital costs, interest repayments and maintenance/service charges (usually for 25-30 years).

The mechanisms are controversial in terms of value for money, the off-balance sheet nature of the commitments and the potential build-up of long-term debt and service obligations. However, successive administrations have argued that this is offset by the additional economic activity that is created, the enhancement of the asset base and the outcomes benefits that flow from infrastructure improvements.

The outlook for such schemes is now a little uncertain. A recent ruling by the Office for National Statistics following recent changes in EU guidance classified a high-profile NPD project – the Aberdeen Western Periphery Route – as 'public sector' meaning that for accounting purposes the project is treated as being on balance sheet. Other projects, including the 'Hub' model have been unaffected⁴².

Irrespective of the future of these initiatives, existing PPP/PFI and NPD commitments will make up a significant proportion of the Scottish budget – with the government forecast to spend around £1.2⁴³ billion each year over the course of this parliament on repayments.

The allocation of such commitments is not uniform across portfolios. In 2016-17 for example, £350 million of the Education portfolio and £250 million of the Health portfolio was allocated for operational PPP repayments alone. Whilst this represents only 2% of the Health resource budget, it represents almost 11% of the Education budget.

⁴² It is possible that there will be further changes in future to EU guidance on statistical classification and the Scottish Government and other administrations across Europe will need to take this into account in due course.

⁴³ See Hudson (2016), Section 4 of www.parliament.scot/parliamentarybusiness/99386.aspx

In addition, the Scottish Government is itself now able to borrow directly to fund capital investment. From April, the government can borrow up to £450 million in any given year⁴⁴.

The Scottish Government has committed to spending no more than 5% of its DEL budget on repayments from revenue financing and its new capital borrowing. On the basis of current projects and plans, the government will spend around 4% of its budget on such payments in 2017-18, rising to just over 4.2% in 2019-20 and 2020-21⁴⁵. It therefore has some 'headroom' to invest further, although this requires committing more resources toward repayments over the medium term.

Public sector payroll

Public sector pay is one of the largest day-to-day elements within the Scottish budget.

Surprisingly, the Scottish Government do not routinely publish information on public sector pay costs. This makes tracking issues such as pay growth over time difficult to discern.

The latest available estimate is for 2013-14, with Scottish public sector pay estimated at £14.5 billion – just over half (55%) of the Scottish resource budget⁴⁶.

It would be wrong to think of pay solely as a spending constraint. Public services are fundamentally delivered by people, particularly in 'frontline' services such as the NHS, education and policing. Thus a commitment to improve public service outcomes is almost inevitably going to require increases in either the numbers employed or pay and progression structures.

That being said, given its size, the public sector payroll can act as a significant pressure on budgets particularly in the short-run. More generous pay awards can lead to funding pressures, whilst any attempt to reduce the pay-bill without compulsory redundancies – something that the Scottish Government has strongly resisted – can only happen over time.

The public sector pay-bill has increased in recent years as a result of UK tax and pension reform. Changes to Employer NICs cost the public sector in Scotland £250 million in 2016-17. Whilst in 2019-20, a change in the discount rate used for valuing public service pensions is likely to add a further £200 million to costs.

In practice, the Scottish Government determines pay for a fraction of the public sector, principally the devolved civil service and agencies. This is around 35,000 employees – 6% of devolved public sector employment – with an estimated bill of around £1.4 billion in 2016-17.

The government does however, have influence over pay awards within the wider public sector either through joint negotiation, interaction with UK-wide review bodies, or the allocation of budgets.

The Scottish Government has adopted a twin-track approach to pay in recent years.

⁴⁴ Borrowing £450 million for ten years at a 5% interest rate would imply annual repayments of approximately £60 million.

⁴⁵ See Hudson (2016) referenced previously.

⁴⁶ www.parliament.scot/FinancialScrutiny/Affordability.pdf

The first strand has been a policy of no-compulsory redundancies, maintenance of 'progression' and increases for those on the lowest incomes. These are not without cost. Progression for example is estimated to cost around £120 million across the devolved public sector.

One significant new commitment is for all social care workers to receive the Living Wage by October 2016. This is above the new National Living Wage – which on its own the Resolution Foundation estimate will cost the public sector in the UK around £2.3 billion⁴⁷ (with likely costs in Scotland of £200 million).

The second strand has been pay restraint with modest (below inflation) pay awards.

Even then, such commitments can be significant, particularly at a time of overall budget constraint. For example, a 1.5% award within the Scottish Government's areas of responsibility is estimated to cost around £20 million. If replicated across the NHS, police and fire and rescue, a 1.5% pay increase will cost over £150 million.

Continued pay restraint will be challenging. Pay awards have largely been frozen or grown at around 1% since 2010 and 2011. Coupled with increased employee NICs, the take-home pay of many public sector workers has fallen sharply.

The implications of devolved welfare powers

Under the Scotland Act 2016, powers over a number of social security benefits are being devolved –

- Six of these benefits relate to people who are either carers, disabled, or ill (Disability Living Allowance, Attendance Allowance, Carer's Allowance, Personal Independence Payment, Industrial Injuries Disablement Benefit, and Severe Disablement Allowance)⁴⁸.
- Four of the benefits are currently part of the Regulated Social Fund (Winter Fuel Payment, Cold Weather Payment, Funeral Payment, and Sure Start Maternity Grant).
- Discretionary Housing Payments (DHPs, which are used to help those struggling with their rent payments) are also to be devolved.

Expenditure on these totalled £2.8 billion in 2015-16 in Scotland (Table 3.2). It has not yet been agreed when the social security benefits will be devolved.

Additionally, the Scottish Government will gain the power to 'top-up' reserved benefits, and to create new benefits in devolved areas. There will also be new powers over employability programmes (i.e. the Work Programme and Work Choice).

There has been much discussion about how the government could use these new powers. In terms of disability benefits for example, there could be scope to reform the way that assessments

⁴⁷ www.resolutionfoundation.org/publications/care-to-pay-meeting-the-challenge-of-paying-the-national-living-wage-in-social-care/

⁴⁸ For further details on each benefit, see <http://www.parliament.scot/parliamentarybusiness/99697.aspx>

are made, who makes them, and how often they are carried out; there might also be scope to integrate these benefits with the work of the integrated health and social care boards.

Some (including the government's Poverty Adviser Naomi Eisenstadt) have questioned whether it makes sense to pay Winter Fuel payments to all pensioners, or whether it should be adjusted to take account of income.

Table 3.2: Newly Devolved Benefits

	Spend 2015-16 £m	Caseload 2015
Disability Living Allowance	1,399	325,000
Attendance Allowance	487	128,000
Carer's Allowance	224	64,000
Personal Independence Payment	315	56,000
Industrial Injuries Disablement Benefit	91	27,000
Severe Disablement Allowance	49	13,000
Winter Fuel Payment	180	1,077,000
Cold Weather Payment	3	n/a
Funeral Payment	4	n/a
Sure Start Maternity Grant	3	n/a
Discretionary Housing Payments	13	118,000
Total	2,768	

Source: Government Expenditure and Revenue Scotland: 2015-16 and Scottish Government⁴⁹

It is clear that the Scottish Government is likely to come under pressure to reverse – at least in part – key elements of the UK Government's welfare reform agenda. A likely area of focus is Personal Independence Payments (PIP). However, under the BGA for welfare, any policy that is more generous in Scotland relative to comparable spending in rUK will carry a financial cost⁵⁰.

Aside from these pressures two other issues are worth highlighting.

First, welfare benefits are more demand-driven than day-to-day departmental spending. This is why they typically form part of AME rather than DEL. However, once transferred to Scotland they will form part of DEL and will be managed in the same way as all other expenditure programmes. This poses a risk. Once qualifying criteria are set and to ensure payments can always be met, the Scottish Government may wish to build some form of reserve which they can draw on in times of need. This will of course come at the opportunity cost of spending elsewhere.

Second, a key challenge for the Scottish Government will be to actually deliver these new welfare powers. A new delivery agency is planned. At the same time, the UK Government will make a

⁴⁹ See Scottish Government Social Security Statistics <http://www.gov.scot/Topics/Statistics/Browse/Social-Welfare/SocialSecurityforScotland>

⁵⁰ Under the planned mechanism, the growth in the block grant will change in line with the corresponding social security spend per person in the rest of the UK – up until 2021. This will protect Scotland from differential population growth and a higher starting base of welfare expenditure.

one-off transfer of £200 million, plus an annual transfer of £66 million, to assist with the implementation and administrative costs associated with *all* the new powers (and not just welfare).

It is not clear whether this funding will fully cover the costs of delivery. As an illustration, the National Audit Office reported in 2014 that the investment cost of Universal Credit (over the 12 years to 2022-23) was around £1.7 billion⁵¹. Scaling that to the equivalent caseload for devolved benefits implies an implementation cost of around £400 million. Running costs are also likely to be tight.

Clearly there are substantial differences in the schemes. However it provides an illustration – at the very least – of the importance of careful consideration of delivery methods. There may be a trade-off between the level of ambition a radically new set of benefit structures may allow for and an alternative less risky option which more closely resembles the existing UK scheme.

3.5 Capital spending

The Scottish Government's capital budget allocation across portfolios is shown in Table 3.3 below.

The Social Justice and Communities portfolio has a budget of £1.1 billion; £600 million of which is local government and £430 million housing – principally the construction of affordable homes.

Table 3.3: Scottish capital budget allocation, £m

	2015-16	2016-17
Health, Wellbeing & Sport	226.5	489.5
Finance, Constitution and Economy	226.6	220.8
Education and Lifelong Learning	103	85.5
Fair Work, Skills and Training	-	-
Justice	111	74.8
Social Justice, Communities & Pen. Rights	1,221.60	1,064.00
<i>of which Local Government</i>	<i>861.3</i>	<i>606.9</i>
Rural Affairs, Food and the Environment	52.1	57.4
Culture, Europe & External Affairs	28.7	26.7
Infrastructure, Investment & Cities	1,066.30	1,120.20
Administration		
Crown Office and Procurator Fiscal	3.6	3.6
Total	3,039.4	3,142.5

Notes: excludes financial transactions. Source: Scottish Draft Budget 2016-17

⁵¹ <http://www.parliament.uk/documents/commons-committees/public-accounts/Universal-Credit-progress-update.pdf>

The Infrastructure, Investment and Cities portfolio has an allocation of £1.1 billion – with unsurprisingly, motorways and trunk roads (£513 million) and rail (£483 million) the largest elements.

In 2015-16, the Scottish Government gained powers to borrow up to 10% of its CDEL budget – around £300 million that year – to fund capital investment. The allocations for 2015-16 shown in Table 3.3 are based upon these powers being utilised in full.

In the end, an accounting adjustment agreed with HM Treasury to address the re-classification of the Aberdeen Western Periphery Route NPD project, meant that the additional cover required effectively counted against the annual borrowing limit.

The Scottish Government has not so far used its capital borrowing powers in 2016-17. Any borrowing is likely to occur at the end of the financial year once the full CDEL allocation has been used up.

In August, the First Minister announced a funding package of £100 million for capital investment, made available from underspend in previous years. Details on allocations were set out in the Scottish Government's 2016 Programme for Government⁵².

3.6 Local Government

Local government faced a particularly challenging settlement in 2016-17. With the Scottish resource budget falling by 1.5% in real terms, combined with spending on health increasing above inflation, large cuts were inevitable in other areas. In the end, the revenue grant to councils was cut by around 5% in real terms between 2015-16 and 2016-17.

Of course, the cut to local government could be interpreted as being substantially less if the £250 million funding for Health and Social Care partnerships announced in the Budget is included in the calculation. However, this was allocated to the integrated Health and Social Care Boards via the health portfolio and was not 'new money' for local government to spend.

At the same time, to receive their full grant allocation, councils had to agree to freeze council tax for the ninth successive year, maintain a pupil/teacher ratio at the same level as 2015, and pay the Living Wage to social care workers. Failure to deliver on any of these elements would result in a financial penalty. Furthermore, it has since been confirmed that additional funding for the Scottish Attainment Fund will bypass local authorities and be allocated direct to schools.

Tensions remain therefore in two areas: disagreement over the scale of the funding squeeze on councils; and increasing concerns about the extent to which conditions attached to funding settlements to deliver 'national' priorities impinge on councils' policy autonomy.

The outlook for local government over the parliament looks just as challenging, if not more so.

As outlined above, once the Scottish Government's policy commitments are considered, unprotected areas will face significant real terms cuts. Councils are part of this 'unprotected'

⁵² Page 30 - <http://www.gov.scot/Resource/0050/00505210.pdf>

element. Having faced real terms cuts since 2010-11 of around 11% on a like-for-like basis⁵³, without reform – either within councils or more widely – the room to manoeuvre is limited.

Yet it is likely that a number of the Scottish Government's key policy pledges will need to be delivered in whole or in part by councils. With elections in 2017, local government resourcing will come under the spotlight. For these reasons, we focus attention in this section on issues around local government finance.

Local government resource spending is a function of:

- The revenue grant from the Scottish Government (around 40% of resource income);
- Revenues from Council Tax (just over 10%);
- Non-Domestic Rates Income/Business Rates (around 25%);
- Service income, fees and charges, including specific grants from the Scottish Government and NHS (around 25%); and
- Housing rents (around 5%), although these revenues are ring-fenced for housing purposes;

The revenue grant

Each year, the Scottish Government negotiates a settlement for the revenue grant with COSLA, the organisation representing local government in Scotland⁵⁴. The settlement typically takes into account the Scottish Government's total resource budget (in the past, COSLA has sought to maintain local government revenue as a share of total spending), and any policy commitments the Scottish Government expects local government to deliver.

What is the outlook for the local authority revenue grant in 2017-18 and beyond?

Taking the scenario of extended fiscal consolidation set out above, we have already seen that the outlook for 'unprotected' parts of the Scottish budget is of real terms cuts of 13-16% over the course of this parliament.

On an annualised basis, this would imply an average cut of 3.5% to 4.1% between 2016-17 and 2020-21 – or a cut of around £1 billion to the local government resource grant over the course of the parliament based upon the scenarios set out above.

At the same time however, some of the Scottish Government's policy commitments will have delivery implications for local government which could add to or ease the funding pressures.

Most obvious is childcare. COSLA will begin budget negotiations with the government in early September. Local authorities will no doubt seek the full transfer of the £500 million earmarked for the expansion in childcare.

⁵³ Audit Scotland: Overview of Local Government in Scotland 2016 <http://www.audit-scotland.gov.uk/report/an-overview-of-local-government-in-scotland-2016>

⁵⁴ This includes all local authorities in Scotland, excluding Aberdeen, Glasgow, Renfrewshire and South Lanarkshire.

It remains to be seen however, what proportion of the estimated costs of the childcare policy – outlined in Section 3.2 – will actually be passed on to local government. In order to ensure that provision is both flexible and high quality, the Scottish Government may seek to implement the policy in a variety of ways. Even if delivery responsibility does fall largely to councils, the extent to which councils might be expected to deliver at least part of the commitment from existing budgets will undoubtedly be a key aspect of the upcoming budget negotiations.

On the assumption that the revenue grant to local government is cut by around 13.5% over the course of the parliament on a like for like basis, but that the costs associated with delivering the childcare commitment are rolled into the revenue grant, then the forecast for the local government revenue is a real terms cut of around 7-8% between 2016-17 and 2020-21.

Non-domestic rates

NDR are set by the Scottish Government, collected by local government and paid into the Scottish Government's NDR 'pool'. They are then distributed to local authorities. The Scottish Government guarantees to local government the combined general revenue grant and the distributable NDR income figure.

In recent years, NDR income has risen in real terms as a result of increases in the tax rate and growth of the tax base (the number of properties on which the tax is levied). At the same time however, the Scottish Government has expanded the availability of various relief schemes – including the Small Business Bonus (which is estimated to cost around £170 million per annum).

The medium-term outlook for NDR income is somewhat uncertain given the Barclay Review of Business Rates. The Scottish Government has also indicated that the rate of growth in NDR income has slowed, perhaps leading to a deficit in the NDR income pool which will have to be funded in due course.

For simplicity, we assume that NDR revenues in Scotland will follow trend growth of NDR in the UK as a whole (as forecast by the OBR at the time of the March 2016 Budget). This implies a 0.6% real terms fall in revenues over the period to 2020-21. This assumption is not unreasonable, given the SNP's manifesto commitment to 'expand the Small Business Bonus, and increase the number of small businesses that pay no rates'.

Council tax

Domestic properties in Scotland are assigned to one of eight council tax bands (A to H). Individual councils set the 'tax rate' – the amount paid annually by a property in Band D – but the Scottish Government sets the ratios between the bands⁵⁵.

Since 2008-09, the Scottish Government and local authorities have agreed to freeze the council tax. As a result, revenues have grown relatively slowly (reflecting some growth in the number of properties liable to tax). For each year the freeze has been maintained, the government has transferred an additional £70 million to local authorities to compensate for the loss in revenue.

The Scottish Government has made two major new commitments on council tax.

⁵⁵ For example, Band H properties are charged 2.1 times a Band D property, so if a Council sets the Band D tax rate at £1,100, then Band H properties in that area will be charged £2,200.

The first is that it will allow councils to increase council tax rates by up to a maximum of 3% from 2017-18. In many ways, this puts local authorities in a tricky position. In a period of tight budget constraints, to choose not to increase council tax would seem counterintuitive. On the other hand, council tax accounts for only 15% of income on average (so a 3% increase results in a less than ½% increase in local authorities' overall budget). Politically, councils may have a difficult job in explaining to residents why bills are going up at the same time that services are being reduced. The most likely outcome is perhaps that COSLA will seek agreement that all councils will raise council tax by the full 3% cap – although this is not necessarily a guaranteed outcome, especially in an election year. On the assumption that 3% increases are implemented in subsequent years, council tax revenues will rise to around £2.3 billion by 2020-21.

The second commitment is to attempt to make council tax “fairer” by increasing the multipliers for Bands E, F, G and H. Low-income households living in higher banded properties will be exempted from the increases, and there will also be some additional support for low-income households with children, regardless of council tax band.

The net revenue impact of this policy is around £100 million per year. However, rather than flowing to local authorities, the Scottish Government has indicated that this money will be allocated directly to schools to boost attainment.

Capital spending by Councils

Local authorities also receive a capital grant from the Scottish Government. In 2016-17, this totalled £481 million, on top of which they received £110 million in specific capital grants.

Local authorities can also fund capital investment by borrowing (via a prudential regime). In 2014-15, around 42% of councils' capital investment came from the general capital grant, one third from borrowing, and the remainder from specific grants and asset sales.

In recent years, local government have also made substantial use of PPP/PFI and NPD mechanisms, particularly to fund investment in new schools. Local authorities annual payments under these projects are expected to total £500 million in 2016-17 rising to £550 million by the end of the parliament.

Summary

Table 3.4 shows forecasts for the possible evolution of local government resources from the resource grant, NDR income, and council tax over the course of the parliament.

Under the scenario of extended consolidation that we outline here, the resource grant is expected to fall by around 13.5% in real terms on a like-for-like basis between 2016-17 and 2020-21. Depending on the negotiations around delivery of childcare (and potentially any commitment to retain teacher numbers), the final grant settlement may end up looking more generous (or at least, less challenging).

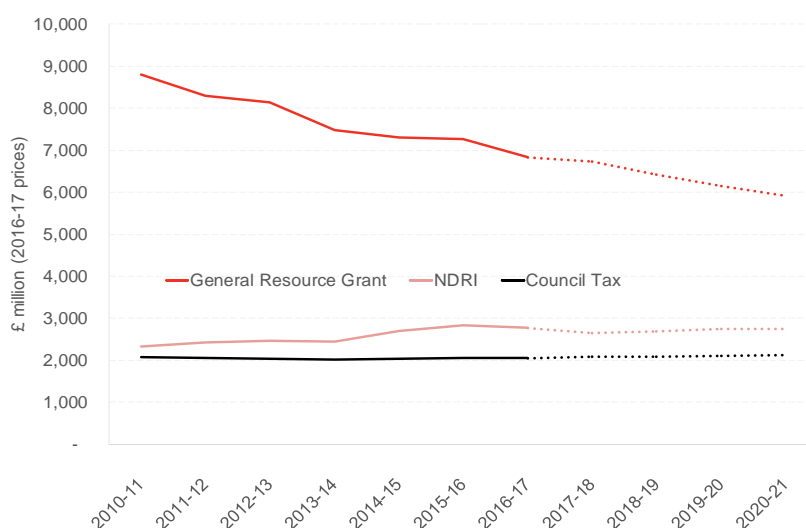
Remember however that our estimates from earlier in this chapter were that the Scottish Government's resources for unprotected areas could fall by up to 17% under a scenario where devolved Scottish revenues grow relatively more slowly.

Table 3.4: Local Government income from general grant and tax, £m and forecast real terms change to 2020-21⁵⁶

	2016-17 £m	Change, 2016-17- 2020-21	Annualised change, 2016-17- 2020-21
General Resource Grant	6,834	-13.5%	-3.5%
NDRI	2,769	-0.6%	-0.1%
Council Tax	2,053	3.7%	0.9%
Total resource	11,656	-7.4%	-1.9%

Source: FAI calculations

NDR income is forecast to fall by 0.6% in real terms. Council Tax is forecast to increase by 4% in real terms, assuming that the council tax rate increases by 3% in each year. Chart 3.4 puts these forecasts in a historical context.

Chart 3.4: Local government resource from General Resource Grant, Council Tax and NDR, outturn and forecast, £m (2016-17 prices)

Source: Local Government Finance Circulars, various years; GERS; FAI calculations

Note: the relatively large fall in the resource grant in 2013-14 was due to the transfer of police and fire services from local authorities to new national agencies

Local government will clearly face a challenging budget settlement in this parliament.

Spending on all service areas (with the exception of social work) declined between 2010-11 and 2014-15⁵⁷. Faced with such spending pressures, it might be expected that councils would cut spending on non-statutory areas, but the counterweight to this is that elected members have been reluctant to cut non-statutory services for fear of the political ramifications.

Councils have managed to make efficiency savings in several areas without impacting on the quality of service delivery (at least not directly). Management structures have been streamlined, non-operational assets have been rationalised, back-office functions have been restructured, and

⁵⁶ Note the 2016-17 figure excludes the £250 million allocated to health and social care integration authorities.

⁵⁷ Audit Scotland (2016) as referenced previously.

there is a greater emphasis on shared services. However, cuts to services are likely to become increasingly apparent as budgets are further reduced.

Despite real terms cuts, councils have also developed a number of coping mechanisms in response to reduced budgets. They have become more reliant on charges as a source of income (although larger, city authorities have greater flexibility in this respect than smaller, rural authorities).

Some councils have been building up reserves in recent years in anticipation of using them to bridge a gap between incomes and spending commitments. At 1st April 2016, local authorities estimated general fund reserves were £1.046 billion⁵⁸. This may help deal with budgetary pressures in 2017-18, but it clearly can only be a temporary solution; and over half of these reserves have already been earmarked. Moreover, the amount of usable reserves varies substantially across councils, and for some, the option of using reserves to deal with shortfalls in 2017-18 and beyond simply does not exist.

3.7 Conclusions

There is clearly some uncertainty around exactly how the Scottish Government's budget will evolve over the lifetime of the parliament. Even before the vote to leave the EU, the Scottish budget was expected to fall by 3-4% over the period to 2020-21. If the UK Government extends its consolidation plans as a result of the referendum, real terms resource budget falls for the Scottish Government of 4-6% are possible.

The Scottish Government has committed to increase real terms spending on health. This continues a trend of real terms increases in health spending since 1999.

Perhaps the Scottish Government's most high profile commitment in this parliament is to double the provision of childcare, with the aim to achieve a transformational step-change in attainment and a reduction in educational inequalities.

The commitments to health and childcare, combined with a commitment to maintain real terms spending on the police, imply that unprotected areas of the Scottish resource budget will face cuts of between 13.5% and 15.3% on average by 2020-21, under our 'extended consolidation' scenario. Even among 'unprotected' portfolios however, funds have been earmarked for a number of within-portfolio commitments.

Further policy opportunities – but also funding constraints – are coming down the line when new welfare powers are devolved later in the parliament.

One area where the Scottish Government is less constrained is in capital spending. The potential to offer an accelerated programme of capital spending in future may prove a useful bargaining tool for the Scottish Government in negotiating the scale of resource budget cuts for some portfolios.

⁵⁸ Provisional Outturn 2015-16 and Budget Estimates 2016-17 - <http://www.gov.scot/Publications/2016/06/9117/downloads>

Negotiations over the local government settlement are likely to be particularly challenging. Based on the scenarios set out above, local government could face a budget squeeze of around £1 billion by 2020-21.

The local authority funding settlement is thus likely to be a focus of political debate, not just over the level of resource but the future of local government more generally and the relative balance of central government accountability and local autonomy.

The room for manoeuvre is likely to be highly constrained. Careful budgeting will be required if the Scottish Government is to deliver on its policy priorities whilst still delivering outcomes in other areas. This is likely to require bold and creative thinking both in terms of the options for revenue raising, and hard decisions on spending that go beyond simple salami-slicing approaches. We turn to these broader issues in Chapter 4.

Chapter 4: Choices, challenges and opportunities

- The clear conclusion of this report is that Scotland's budget faces a challenging and uncertain outlook over the course of this parliament.
- The Scottish Government will soon have greater power than ever before to vary that budget, but it will also be exposed to new risks. The government will also have new responsibilities, including the delivery of complex welfare powers, and potentially an even wider remit if certain powers currently controlled at the EU level are passed to Holyrood.
- With the uncertainty of Brexit, a weakening UK fiscal position, ongoing UK welfare reform, and a fragile Scottish economy, the implementation of Scotland's new fiscal powers over the next few years could not have come at a more challenging time.
- In this environment, the importance of effective fiscal policy development, governance and scrutiny is more crucial than ever.
- In this final chapter, we discuss some of the choices, challenges and opportunities facing Scottish policymakers. We deliberately avoid specifying individual policy solutions but instead highlight key themes we think should frame the debate in the run up to the publication of the Scottish Draft Budget later in the year.
- This agenda will set the scene for the work of the Institute in the months (and years) ahead.
- Firstly, it is clear that – despite significant improvements in recent years – budget decisions need to be based much more explicitly on intended outcomes rather than funding inputs. There also needs to be greater recognition of the opportunity costs of spending decisions, particularly over the medium to long-term.
- Secondly, with Scotland's new tax powers the debate can move beyond simply deciding how best to distribute a block grant. The powers provide a set of tools to vary revenue but also to achieve wider objectives around re-distribution, growth, efficiency and the balance of tax and spend in Scotland. There are important constraints on these powers however, and policy needs to be underpinned by recognition of the costs and practical challenges in different tax policy choices.
- Thirdly, to have an informed debate about Scotland's fiscal future and how best to use these new powers, some key reforms to the role of Parliament and civic Scotland in scrutinising and influencing budgetary plans are needed. A renewed emphasis on multi-year budgeting, long-term strategic planning and transparency will all help assist in preparing Scotland to best meet the challenges and opportunities ahead.

The budget challenge facing the Scottish Government is arguably the toughest since coming to power in 2007. Following over five years of real-terms cuts, the combination of an uncertain economic outlook and the complexity and risks inherent in the new fiscal framework means that tough choices will be required. The processes through which these choices are made will influence how effective they are.

4.1 Introduction

These are uncertain times for Scottish policy makers. New powers bring new opportunities, but also new risks. Constraints are tighter than ever, and room for manoeuvre is limited.

Whilst the immediacy of the challenge will fall on the Scottish Government, it is vital that political parties from all sides set out their priorities, including how they will fund new commitments, deprioritise others, and manage increasing demand on public services.

At the centre of all this are fundamental questions about the underlying vision for Scottish fiscal policy in the light of the new tax and welfare powers - what are the primary economic and social objectives we are trying to achieve? Does the way we are implementing spending and tax policy promote and help secure these?

These basic questions of rationale and objective-setting are crucial for effective fiscal policy and deciding how to use it as a tool to deliver better economic, equity and sustainability outcomes. This agenda lies at the heart of our work programme over the coming years.

This chapter sets out three key themes we believe should underpin the debate as the government prepares its Draft Budget. In a world where the economic (and fiscal) outlook is highly uncertain, it is vital that policymakers –

- Make securing outcomes the driving force for determining the allocation of resources;
- Take a strategic approach to efficient tax policy design, recognising the need to balance objectives around revenue raising with the goal of promoting economic growth; and,
- Conduct the debate in an open and constructive manner which has good economic and financial governance at its core.

4.2 Why this is important

This report has highlighted some of the key macroeconomic drivers that will set the backdrop for the delivery of the Scottish Draft Budget later this year.

Chapter 1 described the fragile and uncertain economic outlook, whilst Chapter 2 showed how this weakening outlook will pose a fiscal challenge both for Scotland and the UK.

Although we may see some stimulus measures from the UK Government in the next few months – perhaps a temporary tax cut or a boost to capital spending – the balance of probability is for the Scottish budget to continue to face a squeeze (and possibly quite a substantial squeeze) over the course of the new parliament.

The importance of effective fiscal policy in such an environment is crucial.

To help, the Scottish Government will soon have greater power than ever before to vary its budget, whether through tax policy, borrowing, or encouraging faster economic growth. But it faces risks too that its new devolved revenues might grow more slowly. A weakening offshore economy, or a buoyant housing market in the south east of England are the types of risks that pose a threat to the Scottish budget, but that the Scottish Government can do little about.

The Scottish Government will have the opportunity to use the full spectrum of its spending resources (around 2/3rds of total public spending in Scotland) to respond to the challenge. Chapter 3 showed how choices already made about how to allocate the Scottish budget – including new commitments and long-term constraints – will already dictate key trends in spending allocations.

Layered on top of all of this are the new administrative responsibilities being devolved. Most importantly, nearly £3 billion of welfare. This brings enormous opportunities to pursue a distinctive Scottish model of social security and to better link up currently devolved responsibilities in health, education and skills with these new powers. But effective delivery is not straightforward – as recent experiences with farm payments have shown – and comes with its own pressures.

A final consideration is the potential administrative implications of Brexit. Might Scotland take responsibility for designing a system of agricultural support and allocating funds for regeneration and scientific research? How much funding will be transferred? Will becoming free of EU rules on 'sales taxes' such as VAT enable even further devolution of tax powers than had been envisaged by the Smith Commission?

In such a complex world of economic and fiscal uncertainty, constitutional reform and administrative complexity, there has never been a clearer need for government and civic society to engage in a robust debate on the fundamental role of fiscal policy in Scotland.

What are the overriding economic and social objectives we are trying to pursue? How can Scotland's full suite of fiscal powers – both new and old – be deployed to most effectively deliver them?

These are clearly big challenges. We do not seek to suggest specific solutions in this report. Instead we outline some of the key issues, and highlight the change needed to the way budget debates take place if we are to successfully address some of these challenges.

4.3 Securing outcomes

The first theme is the focus on outcomes and ensuring that, above all else, this is the driving force for determining the allocation of resources in the future.

This will not be easy. It requires a fundamental re-shaping of the way in which the debate is conducted. It will require a much stronger evidence base and level of analysis which is focussed on finding out what actually delivers results and the fiscal effort required.

It may also increase the spending pressures in some areas as plans adjust, but it is vital that longer-term strategies increasingly feed through to short-medium term actions. Much of this is about managing demand into the future rather than reducing immediate costs.

If an outcomes focus approach is delivered, it will clearly have implications for the way in which certain public services are managed and delivered which will in turn require careful workforce planning and investment.

Outcomes delivery

Policymakers are generally good at setting out how they will allocate funding. But they tend to be less clear about the factors that underpin those decisions – what outcomes are we anticipating and how will the resource allocated help to deliver those outcomes?

Important strides have been made in recent years to boost the recognition of outcomes in delivering public services, most visibly captured through the government's National Performance Framework⁵⁹. Particular initiatives such as the Early Years Collaborative have worked well but success is patchy. Explicit links to the budget process remain largely undeveloped.

Indeed, the Scottish Parliament elections earlier this year laid bare the nature of the way that budgetary promises are still often made.

Policy commitments are invariably made in relation to spending inputs – *“£150 million extra on priority X; protection of portfolio Y; 1,000 more staff for service Z”*.

In this process, consideration of the outcomes that we want to achieve, and how the commitments and promises might support their delivery, can often get crowded out.

In times of budget constraint, understanding the rationale for spending decisions takes on even greater importance. Rather than making spending pledges based on inputs, we should be thinking about the impacts of policy over the medium to longer term, and how these will support the delivery of key performance objectives.

For example, rather than referring to 'health' simply as the totality of the spend within the current portfolio allocation, how can we view 'health' in a broader context to include investments in community programmes on mental wellbeing, work to reduce re-offending or addiction and efforts to boost employment prospects in communities with poor social and health track records?

The issue of outcome focussed public services has been discussed for a number of years. A full outcomes based approach to the budget – that is where individual budget allocations are presented in terms of how they contribute to outcomes rather than according to traditional portfolios – is clearly a challenge. But if the intensity of the drive in Scotland toward outcomes is to be increased, now is surely the time for a much deeper look at how this could be achieved.

⁵⁹ See <http://www.gov.scot/About/Performance/purposestratobis>

Initial first steps could include parliament and/or government mapping current spend to a small set of outcomes and tracing the interdependencies between portfolios.

Opportunity costs

Greater awareness is also needed about the opportunity costs of budget choices, particularly over the longer-term. In the context of declining resources, protecting a given service is all well and good, but there is a need for strategic choices in unprotected areas too.

There is rarely, if ever, consideration of the opportunity costs of commitments (i.e. the impact of cuts in other areas).

Since 2009-10, there have been substantial changes to the way that the Scottish budget is allocated. The total health budget (TME) has increased by 6% in real terms. In contrast, Enterprise, Energy and Tourism has fallen 23%, Further and Higher Education is down 21%, as are Rural Affairs and the Environment (down 7%) and Culture and External Affairs (down 12%).

Such comparisons are often misleading as definitions change and most of the historic comparative data that is publicly available includes demand-driven expenditures such as pension costs.

But setting aside issues of exact comparability for the moment, whilst there may well be clear rationales for these policy trends - demographics and rising costs of medical technologies in health for example – do we have a clear sense of the likely medium and longer-term strategies and impacts of these decisions? Most often, the answer is probably not.

As a result, it is often easy too for past policy decisions to become 'locked in'. Policy commitments are easy to make in the good times when budgets are rising. But once implemented they become difficult to reverse – especially where they have become totemic in political terms – even if the current financial or economic environment makes them harder to justify.

Budget planning and allocations should not just be forward-looking, but consider questions such as how well has money been spent previously, and what has it achieved. A more strategic budgetary process may help to overcome this 'path-dependence' in policy making.

Prevention and delivery

The call for a more outcomes based approach to budgeting is closely linked to the notion of 'preventative spending' and prevention policies. The Christie Commission on Public Service Reform found that approximately 40 per cent of all public spending went to 'clean up messes that could have been prevented' at a lower financial and human cost⁶⁰.

Clear progress has been made with greater collaboration and partnership working than in the past. But the pace is well short of what is needed.

Politicians from all sides recognise the clear need and budgetary advantage in targeting early intervention, but a multitude of factors – budgetary cycles, classification of spending by department or portfolio rather than outcome; challenges in identifying impact of intervention, and

⁶⁰ See <http://www.gov.scot/resource/doc/352649/0118638.pdf>

so on – limit the extent to which prevention policies are pursued. As a result, many targets remain reactive (e.g. reducing waiting times rather than reducing the number of people in the queue).

The final element which is crucial in this debate is the issue of how and who should deliver public services. The right solutions for people may differ across communities.

Local delivery of services that is responsive to local needs can often result in better outcomes. Communities and individuals that are genuinely engaged in decisions on how public services are delivered perform better and can lead to more cost effective delivery. Improving the capacity within communities to engage in such a way can be challenging but even then, too often barriers can exist that prevent community-based solutions.

This is not surprising as a move to a world where services are shaped around the needs of individuals and their families is a radical departure from the traditional top-down approach of central and/or local government delivery. It requires a shift in culture and approach to collaboration that is not easy. It is also likely to require an acceptance that there will be much greater diversity and divergence in the provision of public services between communities. Considerable work will be required to prepare, empower and support public services and their wider workforce to help deliver reform. Doing so however, will be a key avenue to help protect outcomes in the face of cuts to public services.

4.4 The size of the spending envelope

Having set out the core outcomes that are being sought, tough choices then have to be made about how they are paid for.

In the past, the Scottish Government had no real scope to vary the size of its budget. In future, the government will now be able to vary its spending envelope in three ways:

- Borrowing to fund capital investment;
- Changing tax policy for the taxes that are devolved; and,
- Implementing policies that grow its tax base and thus grow revenues.

Borrowing

It is important to note that the Scottish Government will not have the autonomy to alter the fiscal stance at a macroeconomic level, even after the new tax and welfare powers are transferred. Any increase in expenditure – devolved public services or welfare – must be matched by a corresponding increase in tax.

The one exception is in capital expenditure with the Scottish Government now able to add to existing capital programmes by borrowing up to £450 million in any given year.

As noted in Chapter 3, the Scottish Government has yet to draw down borrowing in 2016-17.

Borrowing costs for the public sector are lower now than they have ever been. There is also a general acceptance that greater levels of investment is needed. In recent years, growth has been hampered by weak productivity. Investment in infrastructure – transport, communications, schools

and universities etc. – not only provides a short-term boost to construction, but may be one of the most effective ways of raising productivity in the medium/longer term.

At the same time borrowing comes with a cost that will have to be paid for out of future budgets. We have seen the financial constraints that PFI schemes from the past can place on day-to-day budgets years down the line. This makes a clearer strategy for borrowing and debt accumulation vital - how will the powers be used, and what will they be used to support?

Devolved taxation

The most important avenue through which the Scottish Government will now be able to determine the size of its spending envelope is through its newly expanded tax powers.

It is important to note at the outset that taxation serves purposes beyond revenue raising. It can for example, be used to achieve objectives relating to redistribution. It can also be used to discourage less desirable behaviours (for example, activities that cause environmental harm). Tax policy also has a key role in encouraging and incentivising economic growth and economic development.

But taxation can also influence behaviours in undesirable ways (for example, incentivising people to work less, or move house less often than they otherwise would), and it reduces the welfare of those who face the burden of the tax. A good tax system should achieve its aims whilst minimising undesirable behavioural effects.

The scope for unintended behavioural effects of tax policy can be accentuated when they are operated by a devolved government which is part of a wider single market, and where it is responsible for some tax levers but not others – see Box 4.1.

We illustrate some of these issues below by thinking in terms of the two core tax groups the Scottish Government is now responsible for - first in terms of income tax, and second in terms of taxes on land and property.

Income tax is a highly visible tax; people tend to know fairly accurately how much they pay. It also has a broad base – income from employment, self-employment, and pensions is liable for 'Non-Savings, Non-Dividend' income tax that will be devolved to the Scottish Government.

Of all the taxes that the Scottish Government has at its disposal, income tax is the one where marginal changes in policy could have the greatest revenue impact. 1 pence on the basic rate of income tax is forecast to raise around £400 million in any given year. It is also the devolved tax that can shape the distribution of income the most effectively. Given the visibility of income tax, the scale of revenues, and the role of the tax in redistribution, it is not surprising that debates around income tax were at the heart of the 2016 Holyrood election.

In general, the design of the UK income tax system that Scotland will retain, works in a way that accords reasonably well with what theory says an income tax system should look like. It is relatively simple and transparent, with a progressive rate schedule. To the extent that there are

weaknesses in the design, they will generally remain out with the control of the Scottish Government⁶¹.

The question of how income tax bands and rates should be set in Scotland is therefore a political question around how much revenue the government wants to raise, and how it wants to raise it. Policymakers need to be explicit about how they intend to strike the balance between revenue raising, redistribution, and behavioural incentives, in setting out their tax plans. Thus far, most of the debate has centred upon only the first of these.

Box 4.1: Spill-overs between devolved and reserved taxes

There is a strong case for devolving some taxes on accountability and economic efficiency grounds.

However, devolving tax powers can create issues relating to the interaction of devolved and reserved policies. And tax devolution within a single market, where people are relatively mobile, can increase the behavioural response of taxpayers to tax policy changes. Both these factors may constrain the extent to which any Scottish administration is able to exercise its tax levers.

In relation to behavioural effects, there was substantial debate during the Scottish elections about whether it would make sense to raise the Additional Rate of tax (paid by those earning over £150,000) if that tax increase was not implemented in rUK – i.e. re-instate a 50p top rate.

What is clear is that, even at the UK level, the responses of Additional Rate taxpayers to tax changes are difficult to quantify precisely, but can be reasonably significant. In a devolved context, it is entirely possible – though by no means certain – that given the level of integration between the two economies, the potential behavioural responses could be even greater. There is therefore the risk that actual revenue outcomes may differ quite significantly (and may be qualitatively and not just quantitatively different) from what policy intended.

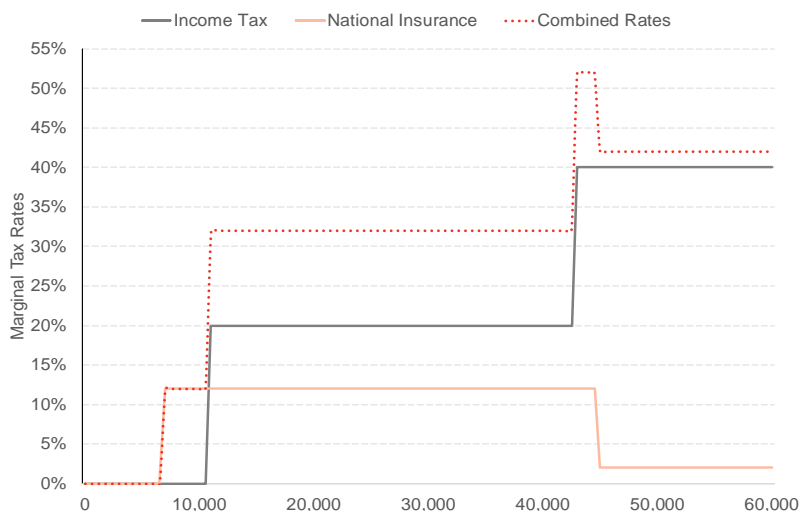
The key point is that any change to income tax is likely to have behavioural implications – whether these implications involve migration between Scotland and rUK or, more likely, more nuanced implications for working and earning. Whilst there will always be some uncertainty about these effects, policy design should seek to mitigate and minimise these impacts as much as possible.

In relation to the interaction effects between devolved and reserved taxes, one example of the spill-overs that can occur relates to the interaction between income tax and National Insurance Contributions (NICs). In recent years the UK Upper Earnings Limit (UEL) for employee national insurance contributions has tracked the higher rate threshold for income tax. The UEL employee NICs are paid at 12% of earnings but above UEL they drop to 2%. This means that

⁶¹ Technically Scotland's new income tax powers are not a devolved tax but a shared tax. The definition of income and the tax base is still determined by the UK Government. Criticisms of the income tax system that relate to the way that the tax base is defined (for example, the fact that pension contributions are subject to tax relief, but a substantial proportion of pension income can be taken as a tax-free lump sum on retirement) are out with the power of the Scottish Government to address.

the combined UK income tax and national insurance rate just below the higher rate threshold (or UEL) is 32% (20% + 12%) while just above the threshold it is 42% (40% + 2%).

Chart 4.1: Income tax and national insurance interactions – Scotland and the UK



Source: FAI calculations

If the UK and Scottish governments choose to set different policies for the higher rate threshold as is now planned, an anomaly will emerge where some individuals in Scotland could be paying a marginal rate of 52% (40% income tax and 12% NICs) – the dotted red line in Chart 4.1 – at the point between the Scottish higher rate threshold and the UK equivalent threshold.

This interaction between devolved and reserved taxes might accentuate the behavioural implications of devolved policy change.

In contrast to income tax, the system of land and property taxation – which Scotland will virtually control in entirety – is a long-way removed from what theory says a good tax system should look like. In that regard, it does not accord with the Scottish Government's own principles for taxation⁶².

Council Tax is regressive with respect to property value (i.e. the tax liability is lower as a percentage of property value for high value properties relative to low value properties) and with respect to income. The issue is exacerbated by the fact that there has been no property revaluation since the early 1990s⁶³. Whilst the Scottish Government has announced a series of reforms to raise income, including around £70 million per annum from the removal of the freeze and £100 million from increasing the charges on properties in the highest valued bands, they stopped short of a radical overhaul of the tax.

The Land and Buildings Transactions Tax (LBTT) is a tax on property transactions, and as such dissuades people from making beneficial transactions. For example, it may dissuade an older

⁶² See <https://www.revenue.scot/about-us/scottish-approach-tax>

⁶³ See <http://localtaxcommission.scot/download-our-final-report/>

couple from downsizing, contributing to a shortage of properties for families. From an economic theory point of view, it is therefore an inefficient tax.

Finally, Non-Domestic Rates (business rates) also have a number of design weaknesses that limit its efficiency – see Box 4.2.

Box 4.2: Issues in the design of non-domestic rates

There is an extensive set of rates reliefs underpinning the system of business rates. Whilst each of these reliefs has a rationale, the reliefs also have potential unintended side effects.

To take just one example, the 'Small Business Bonus Scheme' provides rates relief for businesses occupying low-value properties. The relief cost the Scottish Government £171million in 2014-15⁶⁴. Around 100,000 business properties benefit from the scheme.

Despite its name, the Small Bonus Scheme is not specifically targeted at small businesses, but at businesses occupying low-value properties. The relief therefore has the potential to distort economic activity in favour of more low-value properties and fewer high value properties. There may of course be a case for the relief, for example if it helps to support competition and variety in town centres. But the policy may at the same time have negative consequences for productivity and growth, if it dissuades relatively successful, growing businesses from upscaling to better premises that would better support their growth objectives.

Perhaps more fundamentally, the evidence suggests that in the long-run, the impact of business rates reliefs is passed on to the owners of property via higher rents⁶⁵. Thus the ultimate beneficiaries are likely to be property owners rather than the 'small businesses' that the scheme is intended to support.

So although the Small Business Scheme is underpinned by an objective to support 'small businesses', it may nonetheless have a range of unintended consequences. Similar arguments can be made about other business rates reliefs, for example the relief for unoccupied properties. This reiterates the need for tax policy to be explicit about its objectives in the broadest sense.

So there is scope for further reform of how we tax land and property in Scotland.

Incumbent governments tend to respond to calls for tax reform by making cautious, incremental change. This is to an extent inevitable. But we need a clearer sense of what we are trying to achieve through our system of land and property taxation, and taxation in general.

More generally, whilst it is vitally important to discuss the impacts of changes in tax policy to assess 'winners and losers', the debate needs to be broadened to consider wider issues such as the overall balance of tax and spend in the economy; and the impact on incentives and

⁶⁴ Scottish Local Government Financial Statistics, 2014-15 <http://www.gov.scot/Resource/0049/00494790.pdf>

⁶⁵ For a more in-depth analysis of these issues, see Adam and Miller (2014) https://www.ifs.org.uk/budgets/gb2014/gb2014_ch11.pdf

behaviours. This is particularly important in a system which is still tied to the UK in many important ways.

Proposals to reduce the burden of APD are justified on economic development grounds, for example. But there does not yet appear to be a clear economic business case from the Scottish Government which sets out what these economic benefits might realistically be, who might benefit, nor what the opportunity costs might be – both in terms of revenue loss or impacts on pollution and climate change.

The message from this section is that – whilst existing and new devolved tax powers bring substantial opportunities – there is scope to be clearer about the objectives of Scotland's devolved tax policy in the round. Once the objectives are clearer, political consensus for reform may be easier to achieve.

Economic growth

The third avenue through which the overall spending envelope will be determined is through economic growth.

As we saw in Chapter 2, the Scottish budget will from now on depend increasingly on the revenues from devolved (and assigned) taxes in Scotland, and in particular, how their growth compares to comparable taxes in rUK.

Thus the Scottish Government now faces strong incentives (if it did not already) to stimulate economic growth. Over the longer-term, it will be the rate of growth that is by far the most significant determinant of the overall spending envelope, much higher than any individual tax policy measure. How can growth be boosted in Scotland and what are the key channels through which the Scottish Government can deliver it?

It is important to note that it is harder for governments to stimulate economic growth than is often assumed. Growth prospects for individual countries are increasingly shaped by global macroeconomic conditions and the sentiments of businesses and consumers.

That being said, there is still much that government can do. Two issues are important.

Firstly, there is a consensus that the theoretical underpinnings of the Government's Economic Strategy are sound⁶⁶. Indeed, it has been an evolution of a consistent approach first set out in the early 2000's.

Turning the strategy into concrete policy actions that deliver results is much harder. The key issues that have held back Scotland historically – including weak productivity growth, low export intensity, weak management structures etc. – remain the key factors today. A much greater focus on 'how' to deliver the Economic Strategy is required.

⁶⁶ See <http://www.gov.scot/Topics/Economy/EconomicStrategy>

Official figures show that Scotland spends over £100 per head more each year on 'Enterprise and Economic Development' than in the UK as a whole – with around £1 billion spent in Scotland each year on 'economic support and development'⁶⁷.

Are we getting value for money? Why – despite this investment– does Scotland have a lower business start-up and R&D rate than the UK? To what extent is there duplication in provision of business support? What programmes are more efficient than others? What programmes might be more/less effective post-Brexit?

Secondly, alongside a focus on boosting growth in the economy more broadly, the Scottish Government could also try to raise revenues by supporting the growth in the tax base of the devolved taxes more directly.

Income tax revenues for example, are a function of employment and wages. Higher employment rates and higher wages should lead to faster income tax growth. But the picture is also more nuanced than this.

One of the success stories of the Scottish economy since the mid-2000s is that median wages and employment rates have converged to those of the UK (Chart 4.2). However, Scottish income tax revenues per capita have only converged to a limited extent, and remain around 12% below tax revenues per capita in the UK as a whole.

The key reason is that there are relatively fewer high income earners in Scotland relative to rUK, and wages at the 90th percentile have not converged to the same extent as wages at the median (Chart 4.2). Scotland's share of UK income tax revenues paid on incomes up to £30,000 is proportionate to its share of UK population (8.3%). But Scottish taxpayers account for only 6.2% of UK income tax paid on incomes between £150,000 and £200,000, and just 3.8% on incomes above £200,000⁶⁸.

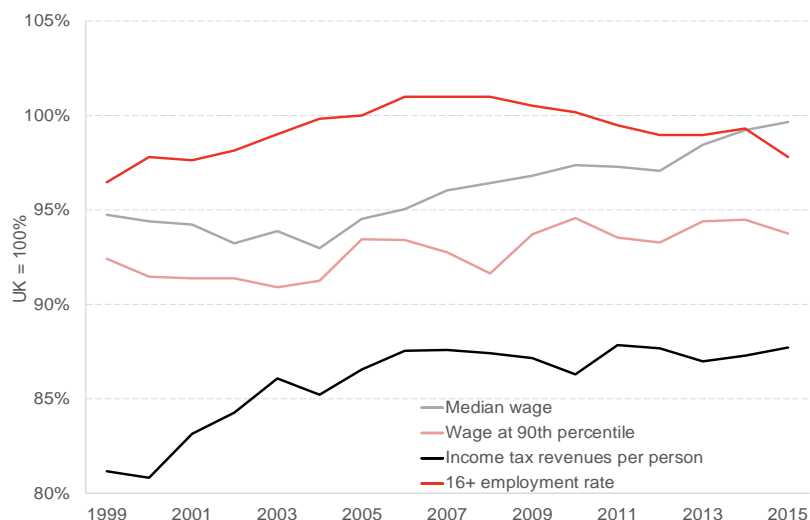
Income tax liabilities have become increasingly concentrated on higher earners over the past 20 years. This is in part due to a greater concentration of income at the top end of the distribution, but since 2007-08 it is a trend that has largely come about as a result of policy⁶⁹.

Consecutive UK governments have pursued a policy of raising the Personal Allowance in real terms. The result is that the proportion of the adult population who pay income tax has fallen from 66% in 2007-8 to 56% in 2015-16. At the same time, the threshold for paying Higher Rate tax has fallen in real terms and a new Additional Rate of tax was introduced in 2010. As a result, the proportion of income tax paid by the top 1% of taxpayers increased from 21.3% to 27.5% between 1999-2000 and 2015-16 with the proportion paid by the top 10% up from 50.3% to 58.9%.

⁶⁷ For a discussion see - <https://fraserofallander.org/2016/07/08/brexit-what-next-for-scotlands-economic-strategy/>

⁶⁸ Berthier (2015) http://www.parliament.scot/ResearchBriefingsAndFactsheets/S4/SB_15-72_Income_Tax_in_Scotland.pdf

⁶⁹ Miller and Pope (2016) https://www.ifs.org.uk/uploads/publications/bns/BN_182.pdf

Chart 4.2: Wages, employment rate and tax revenues per capita, Scotland as percentage of UK

Source: ONS labour market statistics; Government Expenditure and Revenues Scotland; Annual Survey of Hours and Earnings

There are at least two implications for the Scottish Government. First, its existing tax policy commitments (to increase the Personal Allowance above inflation but to increase the Higher Rate by no more than inflation) will tend to increase the proportion of Scottish income tax revenue liabilities from higher earners.

Second, the reliance on high earners as a source of devolved revenues means that the Scottish Government has an implicit incentive to attract and retain high income earners. In practical terms, this means promoting opportunities for employment within high-skilled, high-paying occupations. Whether this incentive creates any tension with the Scottish Government's objectives to promote inclusivity and equality remains to be seen.

These challenges certainly emphasise the importance of establishing clear budgetary priorities, and a clear medium-term strategy on taxation. Budgets should be clear about what are the basic objectives underlying the principle tax choices. There should also be recognition of the key drivers of tax revenue growth over time, and how policy will stimulate these.

4.5 How the debate happens

This report has highlighted the scale of the challenge facing the Scottish budget over the course of this parliament. A focus on securing outcomes and being clear about the purpose and aims of taxation will be key. There are no easy answers.

But if we are to have an informed debate, how the debate itself happens will also be crucial. In this section we discuss three issues which will influence the conduct of the debate.

Scrutiny

The Draft Scottish Budget is typically produced in September, allowing three months of parliamentary scrutiny before the Budget Bill is published.

The OECD emphasises the importance of allowing sufficient time for budgetary scrutiny by parliaments, and the Scottish Parliament is seen as an example of best practice⁷⁰.

During the scrutiny period, the Scottish Parliament has the opportunity to suggest both alternative tax and alternative spending policies, and whilst the government is not obliged to accept the suggestions, it is required to provide a response before asking parliament to approve the budget. This contrasts with arrangements at Westminster, where parliament's role is simply to approve the government's financial decisions with no real time for formal scrutiny.

In 2015-16, the time available for budget scrutiny was substantially curtailed. This was because the newly elected UK Government was due to set its spending plans at the Autumn Statement. It was argued that publishing a Draft Scottish Budget before the Autumn Statement would be unwise given that the UK's spending plans (and hence Scotland's block grant) would not be known with any certainty beforehand. With the Draft Budget published on 16 December, Subject Committees had only four weeks – which included the Christmas period – to report back to the Finance Committee.

In 2016-17, the Scottish Government is again making the case to delay publication of the Draft Budget until after the Autumn Statement. The rationale is a combination of uncertainties relating to the estimation of the Block Grant Adjustments for devolved taxes, uncertainties surrounding the potential implications of the UK Government's 'reset' of fiscal policy, and the potential for early announcement of possible tax changes to impact on behaviour⁷¹.

There is clearly a difficult balancing act here. Publishing forecasts and plans that are then subject to significant change can clearly be damaging. But at the same time it is vital to protect parliament's and civic Scotland's role in budgetary scrutiny.

Multi-year budgeting

A single year budget is difficult to reconcile with medium term plans and priorities for government. Multi-year budgets can provide greater transparency around how the government's objectives and goals will be achieved. They also provide greater certainty for departments and non-departmental bodies alike, allowing them to plan more effectively.

Scottish Budgets have traditionally covered multiple years. The 2016-17 Budget was an exception; as the last year of the Scottish Parliamentary session, it was seen as inappropriate for the government to set a multi-year budget.

2017-18 will also be an exception.

Giving evidence to the Finance Committee in June, Cabinet Secretary for Finance Derek Mackay said⁷²: 'With the degree of uncertainty and volatility that exists right now, it would be unwise to publish a three-year spending review. Therefore, we propose a one-year budget [in 2017-18] and will not deliver a three-year spending review at this time.'

⁷⁰ Burnside (2016) http://www.parliament.scot/2016.08.17_SPICe_Comparative_Budget_processes_FINAL.pdf

⁷¹ A Budget Review Group has been established involving parliament officials and civil servants to consider issues around the timing of the Scottish budget in future years.

⁷² <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=10486&mode=pdf>

It will be essential to return to multi-year budgeting as early as possible, in order that budgetary changes can be seen in light of the government's medium term objectives and goals, and that public services can be planned for on a sustainable basis – see Box 4.3.

Box 4.3: Non-government service providers: the challenge of one-year budgets

Over recent years, there have been moves to put the funding of key service deliverers in the non-government sector on to a sustainable footing, and to match the horizons of funding with the long-term, often preventative, nature of the services provided.

Any regression from the progress toward multi-year settlements of 3-5 years – as appears to be increasingly common – poses a risk to the outcomes that government and service provider seek. A balance between avoiding funding settlements that are too long and those that are too short is of critical importance, not least to the beneficiaries of the service.

Several crucial elements are worth highlighting. In each case, the challenge that is imposed by only funding bodies for a year or less can be acute –

- Long term strategic thinking: Deep-seated societal challenges inherently need to be addressed over the long term through a coherent and sustained approach. Actions need to be grounded in evidence, experience, strategy and implementation excellence. The insecurity and uncertainty that short term funding brings can only diminish this;
- Critical human capital: The delivery of high quality public services is inextricably linked to the quality and skill of the service provider's staff. The shorter the term of the funding settlement, the greater the challenge in recruiting and retaining valuable staff which in turn risks undermining outcomes;
- Delivery partners: Maintaining excellent – and developing new – working relationships and partnerships with other service providers is critical. Commitment and partnership will struggle if the funding pattern generates insecurity and the potential for high levels of staff turnover and the loss of the institutional knowledge and experience;
- Late Determination of Settlements: The implications of short term funding settlements can be exacerbated by the late confirmation of settlements, often in the final quarter of the preceding financial year, and weeks prior to staff contracts coming to an end. This brings additional serious challenges for planning and staff retention;
- Inefficiencies: There will be inefficiencies in renegotiating contracts on an annual or short term basis, both for the funding department and recipients. For small organisations, these costs may often be disproportionate; and,
- Securing longer term income sources: Organisations can sometimes be placed at a serious disadvantage in their efforts to secure alternative and longer term funding where matched resources to secure this funding are required.

In essence, if outcome objectives, founded on key services, are paramount in the mind of government – and they should be – then there is a risk that this is inadvertently undermined by

the process taken to manage the budget. The adverse impact will typically include delays and discontinuities in activities, delays in the delivery of outcomes, and dips in individual and collective productivity.

Transparency

Over time the government has made substantial improvements in the level and quality of budgetary and financial information that is provided and is publicly accessible.

The provision of level 4 budgetary data shortly after publication of the Draft Budget for example, allows more detailed scrutiny than was previously possible. However, there remains significant scope to improve the availability and transparency of publicly available budget data.

Even within a given Draft Budget document, figures in different sections are not comparable because of what they do (and do not include) – e.g. some include only cash but others include non-cash items, some figures include financial transactions whilst others do not.

Comparisons of spend over time rarely exist in a comparable manner. This is a challenge at the UK level but particularly so in Scotland.

Even the format of the presentation of budgetary data can be problematic; Budgets tend to be produced in pdf format, with no corresponding publication of data in excel.

There is also a more fundamental issue in that the budget should not be seen simply as a set of spending allocations, but as the end point in a process of strategic planning. This should include – where possible – much greater emphasis on outcomes budgeting.

With the new fiscal framework exceptionally complex and opaque – see Box 4.4 – and as the Scottish Government's fiscal powers expand to include borrowing, cash reserves, tax forecasts and outturn, the urgent need for transparency and accessibility to budgetary data will increase.

Box 4.4: Complexity of the new arrangements

The new fiscal framework to manage the Scottish budget is inherently complex. It is without precedent internationally.

The consequence however, will be a budget process that does not lend itself to transparency. As we have seen in Chapter 2, assessing the overall path for Scottish public spending in the future will require a complex mix of forecasts of UK public spending, UK taxation and Scottish devolved taxes.

In addition to that however, forecast error, the use of borrowing powers and the new Scotland Reserve will also have to be factored in.

To take just one example – the practical implementation of the Block Grant Adjustment and its reconciliation with actual tax receipts will involve years of estimates, revised forecasts, reconciliations and adjustment that will build on top of each other each year.

The first stage in the process will be to calculate the baseline Barnett block grant. This will then be adjusted, firstly by the UK Government's favoured approach of 'Comparable Deduction' for the BGA and then reconciled with the Scottish Government's favoured methodology, 'Index Deduction Per Capita'. This will be based upon a forecast for comparable rUK tax receipts by the OBR. Around the same time, the Scottish Fiscal Commission will forecast future devolved tax revenues in Scotland, including for income tax perhaps using a different model, assumptions and data to the OBR.

On top of this, actual tax receipts might not be known with certainty until a much later date – in the context of income tax 18 months after the end of the financial year!

If revenues turn out to be lower than forecast, the BGA for the next year (i.e. two years after the year in question) will be adjusted to make up the difference between planned and forecast revenues. The Scottish Government will then have the opportunity to borrow or use its reserves to pay off the difference. Any borrowing can be repaid over five years.

This will occur each and every year, so very quickly changes in budget lines will become inherently more complicated on a scale not yet witnessed. Any one-year's budget figures will be influenced by a multitude of different repayment and reconciliations. Finding a way to make this accessible to promote scrutiny and accountability will be crucial.

The Scottish Government could also do more to improve the information on the long-term financial costs and benefits of policy decisions. There is little assessment of the risks around future spending plans, and how these risks are being managed. Relatively little information is provided on Government's assets and liabilities.

The Auditor General has repeatedly underlined the need for better information on long-term public sector spending commitments, including in areas such as aggregate pension liabilities. At the same time, information on NPD/PPP commitments, whilst it exists, is not always presented in a very transparent way – particularly in relation to which portfolio budgets will bear future costs.

As the Scottish Government's fiscal powers expand – to include borrowing, cash reserves, tax forecasts and outturn – the need for transparency and accessibility to budgetary data increases.

4.6 Conclusions

With the Scottish Government facing a tough and uncertain fiscal outlook, it is more essential than ever that budgetary plans are made on a strategic basis.

This means a more explicit focus on the outcomes that policymakers expect their policies to achieve, and how the resources allocated will help support their delivery.

The Budget process should place less emphasis on policy commitments expressed in terms of inputs. And the budget process should be about looking back at effectiveness as much as it is about looking forward.

The Scottish Government now has much greater scope than in the past to vary its budget.

Decisions around borrowing involve trading off the benefits of increased capital investment today against repayment costs in future. Tax policy decisions involve even greater trade-offs. Achieving an appropriate balance between revenue raising, redistribution, and incentives for growth will be challenging – and potentially even more so once behavioural responses and the scope for policy spill-overs are taken into account.

In this complex and uncertain environment, it is more important than ever that the budget process is undertaken in a transparent and open way. Opportunity for scrutiny is essential, as is a willingness to challenge existing and past assumptions and commitments. Greater transparency around existing and planned spending decisions and commitments is a critical in informing the scrutiny process.

Underpinning this all is a need for an overall strategy outlining the role that fiscal policy will play in achieving the government's core economic and social objectives. The links between the core vision of government, the overall fiscal strategy, and its budget should be clear and explicit.

Here at the Fraser of Allander Institute, we look forward to contributing to this debate in the months and years to come.

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