Scotland's Fiscal Outlook

The Scottish Government's Medium-Term Financial Strategy

May 2022

Scottish Government
Riaghaltas na h-Alba
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Contents

Foreword by the Cabinet Secretary for Finance and the Economy

This is the fifth edition of the Medium-Term Financial Strategy (MTFS) and the second of this Parliament. It is being published today as part of a suite of fiscal publications including the Resource Spending Review (RSR) and an update to the Capital Spending Review (CSR). The RSR is also accompanied by an Equalities and Fairer Scotland Statement and Consultation Analysis Report. The MTFS provides a medium-term perspective on the public finances, supporting a forward-looking approach to budget evaluation. It ensures that both Parliament and Government have foresight of the financial challenges that lie ahead.

This publication of the MTFS is first of its kind in that it provides the fiscal context for the RSR; the first time in over a decade that this has been undertaken. It does so at a time of significant uncertainty.

Since the last MTFS was published, global events have had a significant impact on the economic outlook and heightened fiscal risks. While, back in December, inflation was forecast to reach 4% for the period April – June 2022 before gradually returning to 2% by the second half of 2024, the situation in Ukraine coupled with soaring energy prices and supply chain disruption has meant that inflation is now at a 40 year high and forecast to rise further[1] . As a result, the Office for Budget Responsibility (OBR) and Scottish Fiscal Commission (SFC) are both forecasting that Scotland and the UK will experience the biggest annual fall in living standards since equivalent Scottish and UK records began[2].[3]

Rising inflation is having a severe impact across the country, with many households facing significant challenges. This is particularly true for lower income households who tend to spend proportionately more of their income on areas such as energy bills, where price rises have been particularly severe. Rising inflation, and the consecutive increases in the Bank of England Interest Rate[4], are also increasing budgetary pressures on the Scottish Government and public bodies, and will put pressure on our public services in real terms.

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[1] Office for National Statistics (2022), Consumer price inflation, UK - Office for National Statistics – May 2022
[2] Scottish Fiscal Commission (2022), Scotland's Economic and Fiscal Forecasts – May 2022
[3] Office for Budget Responsibility (2022), Developments in the outlook for household living standards - Office for Budget Responsibility (obr.uk) - March 2022
4 Bank of England (2022), Monetary Policy Report - May 2022 | Bank of England – May 2022

Within this challenging context, I want to provide as much clarity and certainty as I can. The RSR sets out the high-level parameters for resource spend within future Scottish Budgets up to 2026–27, offering a strategic funding framework for the Scottish Government and our many partners to plan for the future. It sets out a renewed vision for public services in Scotland, bringing together a focus on key outcomes and the need for a sustainable approach to public finances.

At the same time, the Scottish Government remains committed to meeting the requirements of the Budget Process Review Group[5] and will continue to protect public finances through diligent management of fiscal risks. The MTFS provides an assessment of key fiscal risks the Scottish Government faces and how the Government will manage them. It also sets out the principles for how the Scottish Government will exercise its limited resource, borrowing and reserve powers, whose real term effectiveness is being eroded each year. We will continue to work within the framework, and work to improve on it, until such a time as the people of Scotland choose a different constitutional path. However, given the increasing levels of risk we now face, the Fiscal Framework Review must properly consider the need for more powers and fiscal flexibilities to fully manage these.

Through the MTFS we are being open and transparent with the public on the risks to the funding and spending outlook. The RSR will pivot resources so that we can deliver our core priorities over this Parliament in the tight budgetary envelope that we operate in. But it is our job as a mature fiscally responsible government to deliver these priorities and ensure that public services remain robust now and for future generations despite the huge uncertainties that are out of our control.

Kate Forbes MSP

Cabinet Secretary for Finance and the Economy

[5] Budget Process Review Group (2017), *Final Report* – June 2017

Executive summary

This is the fifth edition of the Medium-Term Financial Strategy (MTFS) and has been published alongside the Resource Spending Review (RSR) and Capital Spending Review (CSR). It sets out the medium-term economic and fiscal outlook and provides the context for the Scottish Government's spending decisions.

Chapter 1 - Scotland's Economic Outlook

This chapter provides an update on the latest state of the Scottish economy; a summary of the latest economic forecasts from the Scottish Fiscal Commission (SFC) and Office for Budget Responsibility (OBR), and what these imply for the Scottish Budget; how the Scottish Government is acting to promote economic recovery from the COVID-19 pandemic; supporting households and businesses following the UK's exit from the EU and during the cost of living crisis; all whilst continuing progress towards the delivery of the Scottish Government's priorities and the National Outcomes.

Chapter 2 - Scotland's Fiscal Outlook

This chapter sets out the Scottish Government's expectations for its funding position over the next five years. It includes the assumptions that underpin the Scottish Government's central funding scenario, supporting spending plans for 2023-24 to 2026-27 as published in the accompanying RSR. It also includes the assumptions that support the funding envelope for capital, with the update to the CSR also published alongside this MTFS.

Chapter 3 overview - Scotland's Spending Outlook

The purpose of this chapter is to provide an update on the overall spending outlook and its component parts, including:

- The Resource Spending Outlook;
- The Capital Spending Outlook; and,
- Key drivers of spend such as pay and demand-led social security

Chapter 4 overview - Managing Fiscal Risks

Building on the analysis about both funding and spending, this chapter analyses the different sources of fiscal risk that need to be managed as well as the available fiscal tools to manage those risks.

Conclusion

The conclusion reiterates the importance of the MTFS, RSR and CSR for robust medium-term financial planning to ensure long term sustainability of public finances. It also highlights the progress we have made in implementing the recommendations from the Finance and Public Administration Committee to further improve the MTFS and our intention to continue to collaborate with the Committee and other stakeholders such as the SFC on improvements going forwards.

Annexes

The annexes provide technical analysis on regional and sectoral trends across the Scottish and rest of the UK (rUK) Income Tax bases (Annex A) as well as key data on the components of the Fiscal Framework (Annex B).

1. Scotland's Economic Outlook

This chapter provides an update on the latest state of the Scottish economy; a summary of the latest economic forecasts from the SFC and OBR and what these imply for the Scottish Budget; how the Scottish Government is acting to promote economic recovery from the COVID-19 pandemic; supporting households and businesses following the UK's exit from the EU and during the cost of living crisis; all whilst continuing progress towards the delivery of the Scottish Government's National Outcomes[6].

1.1 State of the Economy

The Scottish economy is facing new challenges, with rising inflation placing significant pressure on households, businesses and public services. The economy has shown resilience at the start of 2022 with GDP growing 1.1% and 0.4% in January and February respectively, having rebounded sharply from the fall in output in December at the start of the Omicron wave and is now 1.3% above its pre-pandemic level in February 2020. The removal of remaining COVID-19 restrictions in April marked an important stage in the domestic recovery although risks to the recovery are heightening, with the latest data showing the UK economy shrinking by 0.1% in March as higher prices started to weigh on trade in the wholesale and retail sector.[7]

Scotland's labour market continues to perform strongly with unemployment falling to 3.2% in the period December to February, while the payroll employee level[8] has risen sharply and is now 29,000 above its pre-pandemic level. High vacancy rates and recruitment challenges also continue to persist, creating upward pressure on starting salaries and average earnings growth.

However, over the first quarter of 2022 inflationary pressures that began in 2021 have continued to strengthen with consumer price inflation (CPI) rising to a 40-year high of 9.0% in the 12 months to April and forecast to rise further. These pressures are beginning to be reflected in the latest economic data, such as the Scottish Consumer Indicator[9], which fell sharply across early 2022 due to the weakening sentiment regarding household finances, spending, and the outlook for the economy.

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[6] Scottish Government (2022), National Outcomes | National Performance Framework – May 2022

[7] The figures in this chapter are the latest available as of the 18th of May, which was the cut-off point for new economic data releases.

[8] Sourced from the jointly published ONS – HMRC Real Time Information Database, covering employees on the PAYE system.

[9] Scottish Government (2022), Scottish Consumer Sentiment Indicator: 2022 Quarter 1 - gov.scot (www.gov.scot) - April 2022

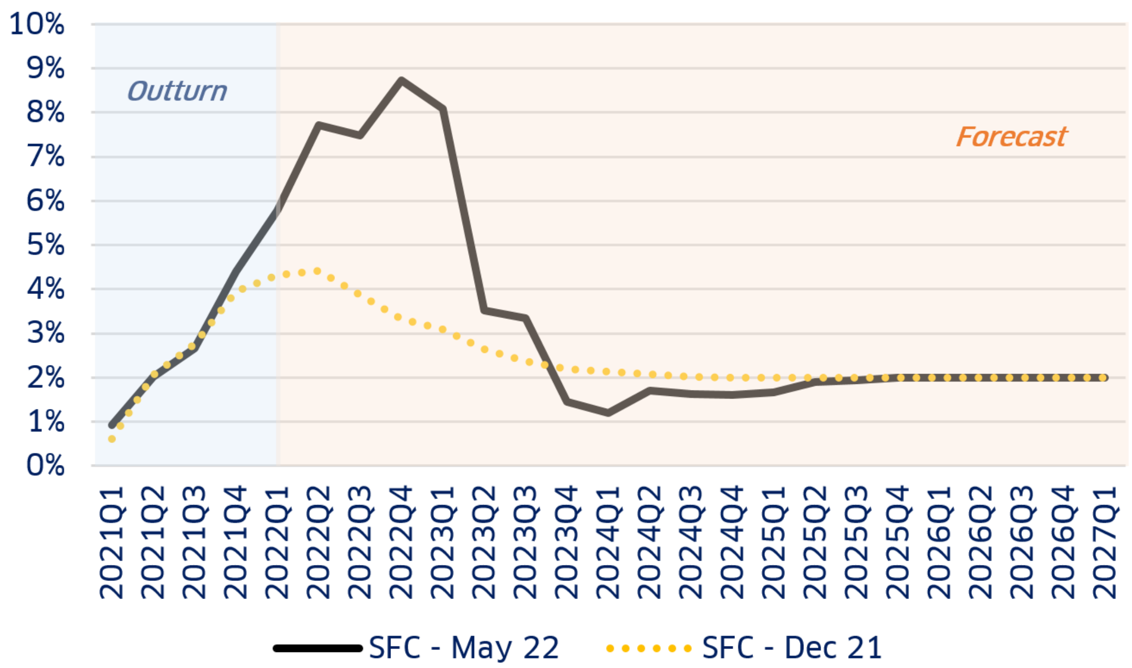
The economic impact of inflation is also disproportionately affecting those on lower incomes who tend to spend more of their income on energy bills where price increases have been particularly intense. The Institute for Fiscal Studies (IFS) estimates that the poorest 10% of households are facing a real inflation rate of just under 11%, relative to a real inflation rate of just under 8% for the richest 10% of households.[10]

Inflationary pressures have been exacerbated by the situation in Ukraine. Scotland's direct trade links with Russia and Ukraine are limited, and as such the direct impacts of the situation are expected to be small. However, the surge and volatility in the price of global commodities such as oil and gas, grains, and metals in which Russia and Ukraine are key global producers, means the indirect impact of higher inflationary pressures will affect all importing economies, including Scotland.

1.1.1 Latest Economic Forecasts of the Scottish and UK Economies

The latest forecasts for the Scottish economy reflect the economic developments that have occurred over the past 6 months. The SFC's forecasts mirror the latest inflation outlook of the OBR which sees the Consumer Price Index (CPI) growing at an average rate of 8% across 2022-23 which is double the rate of inflation forecast at the time of the Scottish Budget in December 2021.

Figure 1: Outlook for Inflation



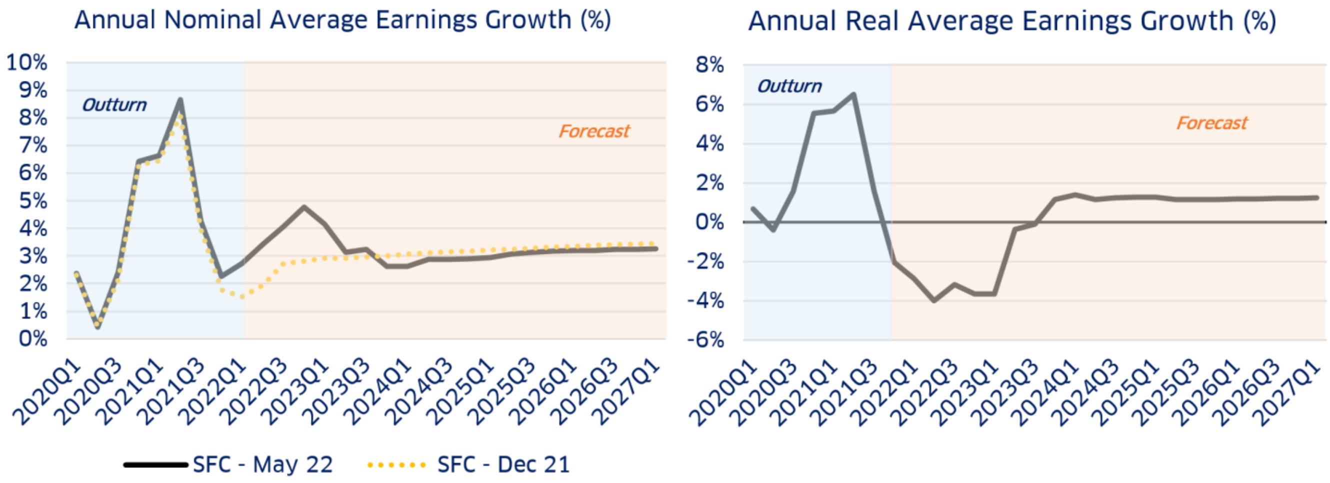
Source: Scottish Fiscal Commission; Office for Budget Responsibility

[10] Institute for Fiscal Studies (2022), [Inflation hits 9% with poorest households facing even higher rates]() - May 2022

The SFC continues to forecast a relatively robust labour market, with tight competition for workers keeping unemployment low by historic standards and staying close to 4% across the forecast horizon. However, over the medium term, forecasts of employment in Scotland will begin to decline reflecting the SFC's forecast reduction in the working age population in Scotland.

The SFC have also revised up their outlook for average earnings growth in 2022 as a tight labour market and higher levels of inflation increase employee bargaining power for further wage rises. However, the SFC do not expect average earnings growth to match the higher rates of inflation in the economy, resulting in real earnings, or the true purchasing power of earnings, falling sharply by an average of -2.7% across 2022-23.

Figure 2: Outlook for Earnings



Source: Scottish Fiscal Commission

As a result of the worsening employment and real earnings outlook, the SFC are now forecasting the largest fall in real household disposable income since records began in Scotland. The SFC have now downgraded their forecast for GDP growth in Scotland over the forecast horizon by an average of around 0.3 percentage points each year relative to their last GDP growth forecast in December 2021.

1.1.2 Fiscal Implications for the Economic Outlook

As set out in further detail in Chapter 2, the Scottish Budget is influenced by the relative performance of devolved tax revenues and social security expenditure. Consequently, differences between the Scottish and UK economic forecasts can have a material impact on the funding outlook for the Scottish Government.

As Table 1 shows, there are some significant differences in the economic outlook forecast by the SFC and OBR. Whilst both institutions have a very similar outlook on unemployment and a relatively similar outlook for earnings, the forecasters have a greater degree of disparity on the outlook for GDP and employment growth at the Scottish and UK level.

Table 1: Headline Economy Forecasts

		2022-23	2023-24	2024-25	2025-26	2026-27
GDP growth (%)	SFC May-22	2.1	1.1	1.0	1.0	1.0
	OBR Mar-22	2.2	1.9	2.1	1.7	1.7
Employment growth (%)	SFC May-22	1.5	-0.2	-0.2	-0.2	-0.3
	OBR Mar-22	0.8	0.6	0.5	0.4	0.4
Unemployment rate (%)	SFC May-22	3.9	4.0	4.0	4.0	4.1
	OBR Mar-22	4.1	4.2	4.1	4.1	4.1
Consumer Price Inflation (%)	SFC May-22	8.0	2.4	1.7	2.0	2.0
	OBR Mar-22	8.0	2.4	1.7	2.0	2.0
Nominal average earnings growth (%)	SFC May-22	4.1	2.9	2.9	3.1	3.2
	OBR Mar-22	5.1	2.4	2.7	3.0	3.3
Real average earnings growth* (%)	SFC May-22	-2.7	0.4	1.2	1.1	1.2
	OBR Mar-22	-1.1	-0.1	1.0	1.0	1.2

*Please note that, in a similar methodology as the OBR, the SFC's real earnings forecast is calculated using their forecast of the Consumer Expenditure Deflator (CED) to deflate their nominal earnings forecast. CED is strongly correlated to, but slightly different than, their forecast of Consumer Price Inflation (CPI).

Source: Scottish Fiscal Commission; Office for Budget Responsibility

The SFC are forecasting rising productivity growth in Scotland, which is a key driver of living standards in the economy, citing Scotland as having one of the most educated workforces in the OECD and an internationally competitive level of research and development spend.

However, the SFC are forecasting that longer term demographic trends, for which key levers such as migration policy remain reserved, could dampen growth over the medium term. For example, the SFC forecast that low levels of net international migration will continue to contribute towards a shrinking working age population in Scotland. This falling working age population, combined with falling participation rates, in turn drives most of the gap in their forecasts of both employment and the potential size of the overall economy relative to the OBR's forecasts for the UK.

The SFC also raise the importance of sectoral risks. Since the devolution of significant tax powers to the Scottish Parliament, the Scottish Budget is now affected by the relative growth of tax revenue per person in Scotland and the rest of the UK. This is in turn determined by both economic factors and policy choices in both countries.

Chapter 2 goes into more detail on the latest funding outlook, however, there is some evidence that average earnings growth has been diverging between Scotland and the rest of the UK in recent years, driven in part by strong earnings growth in London. This is discussed in detail in Annex A, but is also a view shared by the SFC. They note that average pay in Scotland has been similar to that of most UK regions since tax devolution occurred but highlighted that London, and its significantly stronger earnings growth performance in sectors such as finance, has been a significant factor in the emerging average earnings gap between Scotland and the UK as a whole.

1.2 Delivering economic prosperity

One of the best ways to protect the Scottish Budget and support living standards across Scotland, is by growing the Scottish economy. The ambition of the Scottish Government's new 10-year National Strategy for Economic Transformation[11] is to build a wellbeing economy – one that is thriving across economic, social and environmental dimensions.

1.2.1 10-Year National Strategy for Economic Transformation (NSET)

The National Strategy for Economic Transformation contains a range of actions – within the powers currently available to the Scottish Government - to deliver economic prosperity for all of Scotland's people and places. It was informed by the Advisory Council for Economic Transformation[12], as well as by wide ranging engagement with businesses, unions and other stakeholders across Scotland.

The strategy offers a route to a stronger economy with good, secure and well-paid jobs and growing businesses; maximising Scotland's strengths and natural assets to increase prosperity, productivity and international competitiveness. It will build on Scotland's strengths in sectors like energy, financial services and life sciences, and carve out new strengths in technology, space and decarbonisation.

Five policy programmes have been chosen, based on rigorous analysis of evidence, to transform our economic model and drive improvement in Scotland's economy:

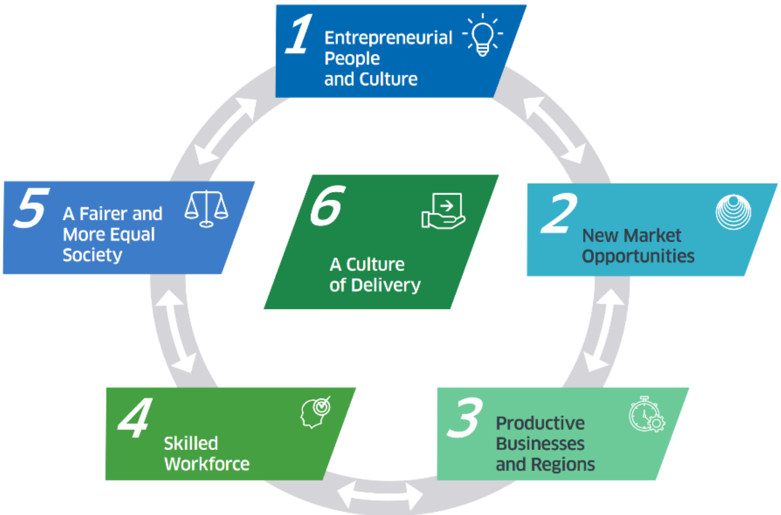
1. Creating a culture in which entrepreneurship is encouraged in every sector of the economy;
2. Capitalising on new market opportunities, such as the transition to net zero;
3. Improving productivity by boosting traditional and digital infrastructure and targeting regional inequalities;
4. Supporting and incentivising access to lifelong learning and training to ensure Scotland continues to have a skilled, competitive workforce; and,

[11] Scottish Government (2022), Scotland's National Strategy for Economic Transformation - gov.scot (www.gov.scot) - March 2022
[12] Scottish Government (2021), Advisory Council for Economic Transformation - gov.scot (www.gov.scot) – July 2021

5. Reducing inequality and poverty, and eradicating structural barriers that prevent participation in the labour market.

Since the launch of NSET in March 2022, we have been laying the foundations for delivering the Economic Transformation Plan as well as addressing some of the most immediate challenges. Successful delivery of the strategy will involve working together with people and organisations from all sectors of the economy. A robust governance structure, co-led by businesses, will hold the public sector and industry to account for delivery, strengthening accountability and transparency and ensuring that the right frameworks are in place to deliver on the actions and to measure success.

Figure 3: The five key policy programmes of action with a sixth programme on delivery



Source: Scottish Government - National Strategy for Economic Transformation

The strategy's programmes are interconnected and are a mutually reinforcing cycle, which will ultimately lead to higher living standards and a reduction in poverty. A higher wage, higher participation economy will also generate greater tax revenues, enhancing Scotland's financial sustainability

Overall, the National Strategy for Economic Transformation will help protect the Scottish Budget and improve Scotland's longer term fiscal sustainability by improving economic performance for Scotland. The strategy will help tackle long-term structural challenges and remove barriers to participation in the labour market so that everyone is enabled and empowered to participate in economic success.

2. Scotland's Fiscal Outlook

2.1 How Scotland's fiscal outlook is determined

This chapter sets out the Scottish Government's expectations for its funding position over the next five years. It includes the assumptions that underpin the Scottish Government's central funding scenario, supporting resource spending plans for 2023-24 to 2026-27 as published in the accompanying RSR. It also includes the assumptions that support the funding envelope for capital, with the update to the CSR also published alongside this MTFS.

The Scottish Government's funding outlook is determined by combining forecasts and risk based assumptions from multiple sources, and is affected by decisions of both the UK and Scottish Governments. This results in a funding outlook with a high degree of uncertainty and volatility. The funding position described in this chapter is our view of a 'central' outlook, with some analysis of the downside and upside risks. As part of its remit, the SFC are tasked with independently assessing the reasonableness of our funding assumptions, and have independently confirmed that our central funding scenario is reasonable.

The remainder of this chapter describes:

- The aggregate funding outlook that informs the Scottish Government's spending plans;
- The anticipated outlook for each component of the Scottish Government's fiscal position;
- The assumptions underpinning the central outlook that supports the spending plans; and
- The risks and uncertainties associated with this central outlook.

The Scottish Government is committed to being open and transparent with the public on the risks to the funding outlook. We intend to replicate the structure of this chapter in future iterations of the MTFS, in order to allow readers to track how each component of our funding position evolves over time

2.2 Summary of Scotland's fiscal outlook

Table 2 below describes the anticipated resource funding position, broken into five high level categories, each discussed in detail in this chapter:

- The Block Grant – the single largest source of funding for the Scottish Government. It is determined by the Barnett Formula, based on the spending plans of the UK Government.
- Devolved taxes – the Scottish Government receives the revenue from these, the largest of which is Scottish Income Tax. However, the Budget is also reduced based on how quickly revenues of the corresponding tax have grown in rUK (adjusted for population).

- Non-domestic rates – this revenue is raised by Local Authorities from non-domestic rates. All revenue raised is ultimately returned to Local Government.
- Social Security Block Grant adjustments – this is revenue provided by the UK Government for devolved social security payments, based on the growth in expenditure on the corresponding payment in the rest of the UK.
- Other income and expenses – assorted revenue and costs that do not fit into one of the above categories.

Overall, we expect the funding available to the Scottish Government to grow steadily over the next four years, with slightly higher growth from 2025-26. Relative to 2022-23 levels, the funding envelope grows by 14% by 2026-27. In real terms the growth is only 5% in aggregate over the next 4 years, largely due to the growth in Block Grant not keeping pace with inflation. However, a significant part of this growth relates to the devolution of social security benefits and so is directly associated with similar demand-led increases in social security in Scotland. Stripping out this growth implies real terms growth of just 2% across the whole four year period.

Table 2: Central outlook for Scotland's funding sources

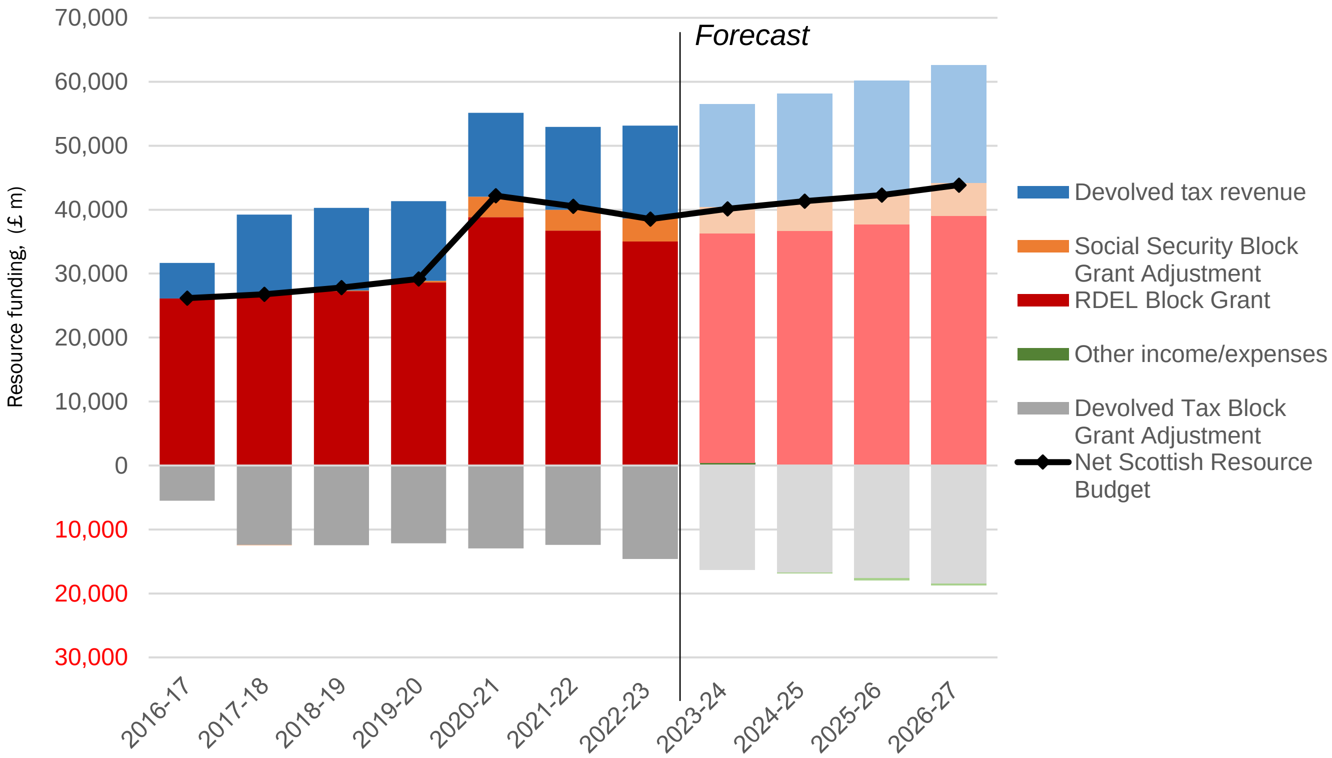
All figures in £million, current prices		*Forecast*			
Resource Funding	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**
Block Grant	35,026	35,908	36,691	37,674	39,048
Net tax position	-86	-265	167	103	-31
Of which:					
Devolved tax revenue	14,521	16,058	16,897	17,716	18,433
Block Grant Adjustment	-14,607	-16,324	-16,730	-17,612	-18,464
Non-domestic rates distributable amount	2,766	3,190	3,134	3,323	3,651
Social Security Block Grant Adjustment	3,587	4,082	4,574	4,825	5,103
Non-tax income & block grant adjustments	-8	-9	-8	-8	-8
Other income/expenses	549	416	-119	-317	-265

TOTAL RESOURCE FUNDING, inc NDR income	**41,836**	**43,321**	**44,439**	**45,600**	**47,498**

Based on funding position as set at Budget 2022/23
Totals may not sum due to rounding

Looking over a longer time horizon, as shown in Figure 4 below, the forecast growth in the funding envelope is marginally below the growth seen in the years prior to COVID-19, at an average of 2.4% per annum (compared to 2.7% in the four years prior to 2019-20). However, as noted above, a large part of the persistent increase in the funding envelope from 2020-21 and into the future reflects the devolution of additional Social Security powers. These increase the funding via the Social Security BGA (in orange below), but are fully utilised by additional costs of the newly devolved benefits.

Figure 4: Historic and forecast composition of funding envelope (current prices), excluding NDR income



2.3 Components of Scotland's fiscal outlook

This section describes the source of our assumptions for each of the sources components of funding. This is summarised in Table 3.

Table 3: Central funding assumptions

Funding Component	Source of Central funding assumption
Block Grant	October 2021 Spending Review Settlement[13], updated with March 2022 OBR forecasts and Scottish Government risk-based assumptions
Net tax position:	
Devolved tax revenue	May 2022 SFC forecasts
Block Grant Adjustment	March 2022 OBR forecasts
Social Security Block Grant Adjustment	March 2022 OBR forecasts
Other income	Risk-based judgement by Scottish Government.

The approach to these funding assumptions has not changed substantially from that taken in the last MTFS published alongside the Scottish Budget in December 2021. However, some assumptions have been revisited in light of new policy announcements made by the UK Government, or the need to make longer-term judgments on the funding position to support the Resource Spending Review. Where there have been significant changes since the December MTFS, these are noted below.

2.4 Block Grant

The Block Grant is the amount of revenue funding that Scottish Government receives from the UK Government. It is determined by the Barnett formula, which is applied to the UK Government's spending decisions. Higher (or lower) UK Government spending on devolved policy areas results in more (or less) funding being available to the Scottish Government. The Block Grant is the largest single determinant of the Scottish Government's funding.

The UK Government's Autumn Budget in 2021 set out an expected funding Settlement for the Scottish Government, based on the UK Government's spending plans over the UK Spending Review period of 2022-23 to 2025-26.

This forms the starting point of the projected forecast Block Grant over the next five years. Three judgement-based adjustments have been applied to this outlook, shown in Table 4:

- As the UK Spending Review settlement only extends to 2024-25, an assumption for the Block Grant must be made beyond this point. This assumes that the Block Grant in future years grows at around 4% per

[13] UK Government (2021) – Autumn Budget and Spending Review – October 2021

annum, based on the OBR's March 2022 forecast of RDEL expenditure in these years;

- A small upward adjustment is made to the expected Block Grant received in the two remaining years of the UK Spending Review settlement. This is due to the historic tendency of the UK Government to exceed Spending Review settlements, discussed further below; and,
- Ring-fenced funding sources outside the usual Block Grant, such as the Rail Resource Grant and replacements for EU funding, remain fixed in nominal terms based on our current working assumptions.

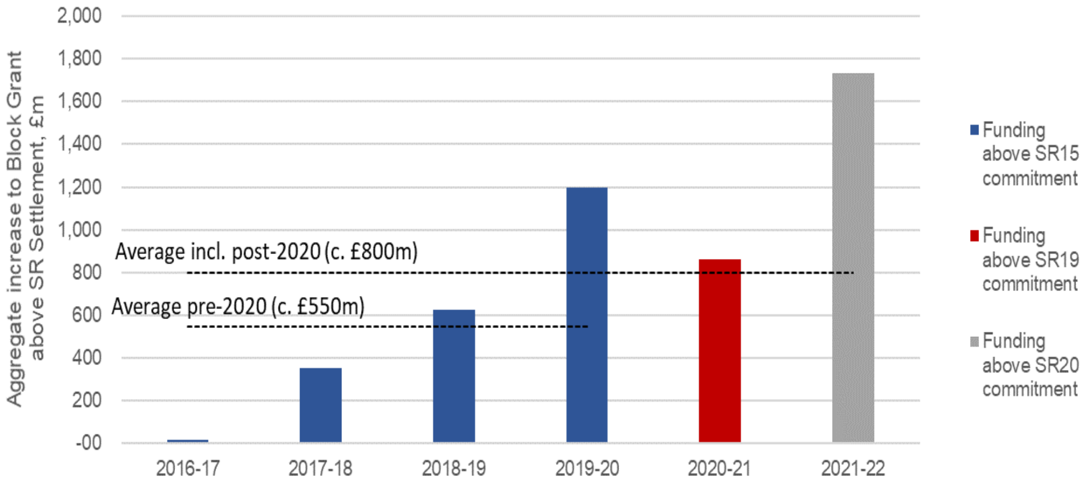
Table 4: assumed resource Block Grant funding

All figures in £million, current prices		*Forecast*			
Resource Funding	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**
RDEL Block Grant as at SR21	34,322	34,943	35,577	N/A	N/A
Assumed Block Grant outside SR period				36,959	38,333
Assumed future consequentials		250	400		
Non-Barnett ringfenced funding	704	715	715	715	715
TOTAL RDEL BLOCK GRANT	35,026	35,908	36,691	37,674	39,048

The assumption of future Barnett consequentials beyond the core Block Grant is based on analysis of historic data. Figure 5 shows the additional funding received by the Scottish Government via the Block Grant in addition to the original Spending Review settlements set in 2015, 2019 and 2020. As this shows, the UK Government's historic tendency has been to increase the available funding envelope at each Budget, with greater increases in future years of the Spending Review. While the years of the COVID-19 pandemic are clearly exceptional in the degree of spending increases seen, our assumptions are well within with the degree of additional spending increases seen over the Spending Review 2015 period.

Overall, we view these funding assumptions as reasonable and prudent. However, as the Scottish Government has no direct control over the UK Government's spending decisions, changes in UK Government policy present a high degree of risk to the funding outlook.

Figure 5: Increases announced at past Fiscal events above previous Spending Review/Round Settlements (2015, 2019 & 2020)



2.5 Net impact of devolved tax revenue & Block Grant Adjustments

The Scottish Government receives the revenue from partially and fully devolved taxes – namely Scottish Income Tax (SIT), Land and Building Transactions Tax (LBTT) and Scottish Landfill Tax (SLfT).

Each of these taxes has a corresponding 'Block Grant Adjustment' (BGA). This is the amount deducted from the Scottish Government's Block Grant based, in simple terms, on how much revenue the corresponding tax has grown in the rest of the UK since 2016-17.

The difference between these two figures determines the net impact of devolved tax on the Scottish Budget, otherwise known as the 'net tax position'. A consequence of the Fiscal Framework[14] BGA mechanism means that the Scottish Budget only benefits from faster tax revenue growth when revenue per person grows faster in Scotland than the rest of the UK.

The central funding outlook uses the SFC's forecasts of devolved tax revenue, as published in *Scotland's Economic and Fiscal Forecast May 2022*.[15] These are based on the SFC's latest assessment of the Scottish economy and incorporate the impact of Scottish Government policy decisions to date.

The Block Grant Adjustments used in the central funding outlook are based on the OBR's forecasts published at the Spring Statement in March 2022[16]. They are calculated based on a method stipulated in the Fiscal Framework.

Table 5 summarises the revenue and BGA forecasts for each devolved tax.

[14] Scottish Government (2021), Fiscal Framework Factsheet – Dec 2021.
[15] Scottish Fiscal Commission (2022)– Scotland's Economic and Fiscal Forecast – May 2022
[16] Office for Budget Responsibility (2022), Economic and fiscal outlook - March 2022 - Office for Budget Responsibility (obr.uk) – March 2022

Table 5: impact of devolved taxes on the Scottish Budget

All figures in £million, current prices		*Forecast*			
Resource Funding	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**
Income Tax					
Revenue	13,671	15,143	15,954	16,754	17,484
Block Grant Adjustment	-13,861	-15,502	-15,883	-16,737	-17,534
Net Income Tax position	**-190**	**-359**	**71**	**18**	**-50**
Land and Buildings Transaction Tax					
Revenue	749	821	849	886	932
Block Grant Adjustment	-664	-741	-772	-807	-854
Net LBTT tax position	**86**	**80**	**77**	**79**	**78**
Scottish Landfill Tax					
Revenue	101	95	94	75	16
Block Grant Adjustment	-82	-81	-75	-69	-76
Net SLfT position	**18**	**14**	**19**	**6**	**-59**
TOTAL NET TAX IMPACT	**-86**	**-265**	**167**	**103**	**-31**

*Figures shown for 2022/23 are based on the SFC and OBR forecasts as at the Scottish 2022/23 Budget, published in December 2021. The latest SFC and OBR forecasts for 2022 will affect the Scottish funding position through reconciliations.
*Some figures may not sum due to roundings

The net tax position – as reflected in final outturn data – will be determined by the relative growth of tax revenue per person between Scotland and the rest of the UK. This will in turn be determined by both economic factors and policy choices made by the two governments.

Where economic or policy factors affect both tax bases equally, the net tax position would be largely unaffected. This provides a degree of insulation from economic shocks, both positive and negative.

However, there is some evidence that tax revenue growth (primarily for Income Tax) has been diverging between Scotland and the rest of the UK in recent years, driven in part by strong earnings growth in London. This is discussed in detail in Annex A. Under the Fiscal Framework, Scotland's Budget depends on what happens both in the Scotland and rUK, and as a result our Budget can be reduced even if tax revenue is growing strongly in Scotland, due to factors out of the Scottish Government's control in the rest of the UK. There are alternative Fiscal Framework mechanisms that can reduce these effects. For example, the Welsh Fiscal Framework includes a 'by band' mechanism that reduces the impact of tax growth among higher earners on the Budget position.

Further divergence in revenue growth presents a major risk for the Scottish Government's funding position and is currently the main driver of the negative net Income Tax position forecast in 2022-23 and 2023-24.

The Income Tax forecasts for this MTFS are also affected by a change to the SFC's assumptions for forecasting Income Tax policy. The Scottish Government confirms Income Tax rates and thresholds annually at each Budget in line with economic forecasts and conditions at the time. To inform the forecasts for future years, assumptions about future policy have to be built into the forecasts.

Those assumptions are informed by a range of factors, including past policy decisions of the Scottish Government and, for example, the UK Government's decision to freeze the Higher Rate Threshold to 2025-26. The SFC forecasts are based on the assumption that the Scottish Higher Rate Threshold will be frozen across the forecast horizon, rather than increasing with CPI. This approach has been discussed with and agreed by the Scottish Government. Consistent with past forecasts, the Top Rate threshold remains frozen, and the Starter and Basic Rate Bands are indexed to inflation. The impacts of this on the forecasts are discussed further in the *Scottish Economic and Fiscal Forecast* document.[17]

This assumption does not represent a policy decision on the part of the Scottish Government. The Scottish Government will continue to make decisions on Income Tax thresholds at each Budget and retain the flexibility to change thresholds in future. However, any future increase in thresholds would reduce available funding relative to the funding envelope presented in this document. This remains a risk to the funding position.

The net tax position also incorporates the current position regarding UK Government tax policy, including the stated intention to reduce the Basic Rate to 19p in 2024-25. By reducing rUK tax revenue growth, this improves the Scottish Government's Budget position from that year onward. As stated above, the Scottish Government takes tax policy decisions at each annual Budget. The current SFC forecasts include no policy changes. Any future reductions in Scottish tax rates would reduce the funding envelope from that shown in this document.

In addition to economic and policy risks, the net tax position remains subject to forecast variation and error. This is typical for revenue sources affected by economic fluctuations. In the case of the Scottish Budget, the risk of forecast error is heightened by the reliance on two different forecast institutions. This is discussed further in Box 1.

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

Box 1: Impact of differences in the net tax position

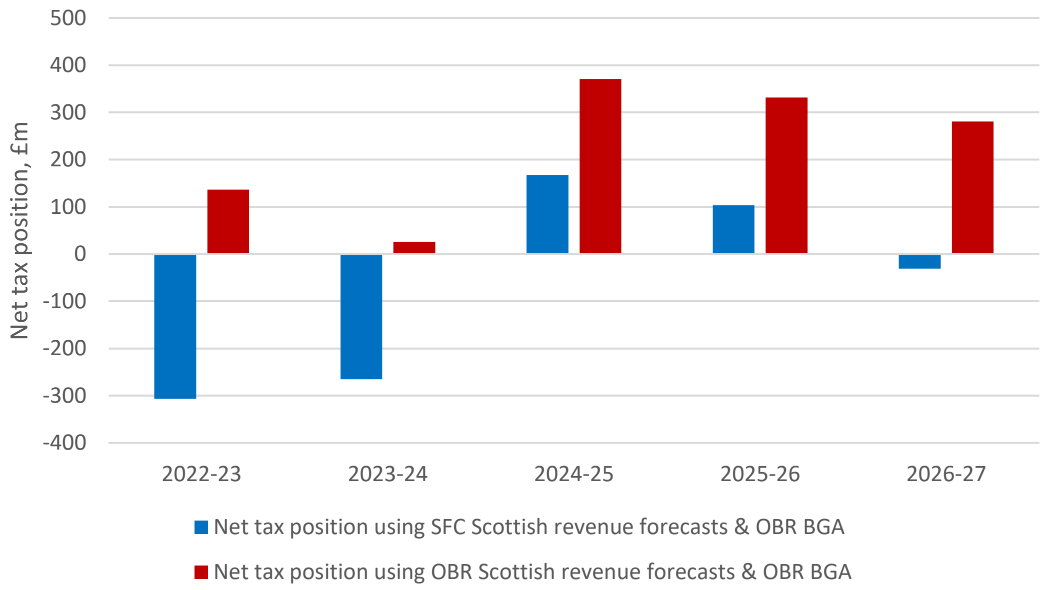
The net tax position, which is a critical component of our funding position, is derived by comparing the SFC's forecasts of the three devolved Scottish taxes to the OBR's forecasts of the corresponding Block Grant Adjustments. Comparing two different forecasts can introduce a source of risk in relation to the funding available to allocate in each Budget. These potential differences include:

- Timing – the OBR typically produce forecasts in March and October of each year to align with UKG fiscal events, while the SFC produce forecasts in May and December alongside Scottish fiscal events, as determined by the Scottish Government. If new statistics or figures are published in the gap between forecasts, this can potentially lead to forecasts being based on different sets of data.
- Judgement – even when using the same set of data, the two forecasting institutions may – reasonably and with good justification – make different judgements on the economic outlook. For example, the SFC have typically forecast lower population growth in Scotland than the OBR, which in turn affects their respective tax forecasts.
- Methodology – the two forecasters use different approaches to forecasting the tax base or wider economy. For example, the OBR's Scottish Income Tax forecast is 'top-down' and calculated as a percentage of the OBR's UK wide income tax forecast. In contrast, the SFC's forecast is 'bottom-up', and calculated using Scotland specific economy and tax data and then forecasting tax liabilities at the individual taxpayer level.

These differences generally have a small impact in the context of total devolved tax revenue and would be within what would be considered normal forecast error. However, they can have a significant impact on the forecast Scottish Budget position. For example, Figure 6 below shows the forecast net tax position under two possible combinations of forecasts:

- Comparing the SFC's May 2022 tax revenue forecasts to the OBR's March 2022 BGA forecasts. This is the approach used in the central funding outlook.
- Comparing the OBR's March 2022 Scottish forecasts of devolved tax revenue to the OBR's March 2022 BGA forecasts.

Figure 6: Net tax position under latest OBR and SFC forecasts



The latter approach removes any differences in timing, judgement, or methodology from the net tax position with the resulting forecast reflecting the OBR's judgement of the relative tax growth between Scotland and rUK. This results in an improvement in the forecast funding position averaging around £300m in each year of the forecast. The extent of the difference indicates how forecasters can vary in their results despite both making use of their best professional judgement and access to similar data. It is also important to note that there may be times when an illustration like this would show a deterioration in the forecast funding position.

The purpose is to demonstrate the scale of this particular element of volatility, which can arise as a result of the operation of the Fiscal Framework. This further demonstrates the inadequacy of the tools available to the Scottish Government to manage and smooth volatility over the medium term.

Any differences between forecasters will ultimately be resolved in reconciliations, which are determined by the final outturn data. However, divergence in forecasts affects the funding available to the Scottish Government to allocate when budgets are set, and large differences between the forecasters can lead to greater volatility in future years when the reconciliations apply.

Having official independent forecasts is intrinsically beneficial, as it removes bias and improves overall fiscal transparency. However, the differences in timing, judgement and methodology between the OBR and SFC continues to present a risk for the Scottish Government's funding outlook and contributes to continuing volatility in the fiscal outlook, as noted in more detail in Chapter 4. The tools the Scottish Government currently has to manage and smooth risks of this nature are inadequate and must be addressed in the upcoming Fiscal Framework Review.

2.6 Block Grant Adjustments for devolved Social Security benefits

The central funding trajectory uses the Social Security Block Grant Adjustments forecast by the OBR, based on their March 2022 forecasts.

These BGAs are based on OBR forecasts of benefit expenditure in England and Wales as of March 2022. The growth in social security BGAs over time will be affected by both economic factors and the policy decisions made by the UK government. This can include technical changes to the eligibility of certain benefits, changes to the generosity of certain payments or decisions around the rate at which payments are increased or uprated over time.

The Social Security BGAs that inform the funding envelope are set out in Table 6 below. These are based on the OBR forecasts, with the exception of the BGA for the Winter Fuel Payment. As this is a newly devolved benefit, the OBR has not yet produced a forecast to inform the BGA. For the purposes of the MTFS, the Scottish Government have forecast the expected BGA. This will be updated following publication of OBR forecasts of Winter Fuel Payment expenditure, broken down by territory, when available.

Table 6: impact of Social Security Block Grant Adjustments on the Scottish Budget

		Forecast			
	2022-23*	**2023-24**	**2024-25**	**2025-26**	**2026-27**
Carer's Allowance	323	362	393	423	459
Attendance Allowance	545	594	626	649	672
Adult Disability Payment *(replacement for Personal Independence Payment)*	1,933	2,298	2,566	2,799	3,014
Disability Living Allowance	687	732	713	677	682
Industrial Injuries Disablement Scheme	79	83	82	80	79
Severe Disablement Allowance	6	6	5	5	4
Low Income Winter Heating Assistance *(replacement for Cold Weather Payment)*	14	8	7	7	7
Winter Fuel Payment	N/A	N/A	181	184	185
TOTAL SOCIAL SECURITY BGA	**3,587**	**4,082**	**4,574**	**4,825**	**5,103**

*Based on OBR forecasts, with the exception of the BGA for the Winter Fuel Payment, at the point the 2022-23 Scottish Budget was set.

The BGAs are also subject to in-year reconciliations, with a final reconciliation made once outturn data is available. If outturn expenditure in England and Wales is higher than forecast, a positive BGA reconciliation (i.e. an addition) will be made to the Scottish Budget to reflect these changes, and vice versa. For example, social security expenditure in England and

Wales in 2020-21 was higher than had been forecast, resulting in a final BGA which was £22m higher than forecast. This was reconciled by adding £22m to the Scottish Budget in 2022-23.

2.7 Other income

Other income is a relatively small component (net less than 1%) of the total funding position, and relies on risk-based assumptions by the Scottish Government. It captures a number of funding sources (and deductions to funding). The material elements are described below:

- Income Tax Reconciliations. These relate to OBR and SFC forecast error in past years. They occur after tax outturn data becomes available, and affect the financial year three years after the tax year to which they relate (i.e. the reconciliation that affects the 2023-24 Scottish Budget relates to the 2020-21 tax year). Estimates of future reconciliations are based on the latest SFC and OBR forecasts, compared to the forecasts used at the relevant Budget. Future reconciliations are currently forecast to be negative but could feasibly be positive or negative in future years. As reconciliations are caused by error in forecasts, they are (by definition) challenging to forecast or predict. This adds an additional degree of volatility to the Scottish Budget position.
- Income Tax Spillovers. The Fiscal Framework allows for transfers from the UK Government to the Scottish Government (or vice versa) to allow for impacts of tax policy changes that are not accounted for by the BGA mechanism which have a disproportionate effect on Scottish Income Tax receipts. We have included an assumption concerning transfers related to a spillover effect linked to increases in the Personal Allowance. We are currently in dispute over the handling of the spillover, and expect this to be considered as part of the Fiscal Framework Review, if not addressed in advance of that.
- Resource Borrowing. This provides funding to offset the impact of adverse income tax reconciliations in future years. Plans and policies regarding borrowing are discussed in chapter 4.
- Projected Resource Costs associated with Capital and Resource Borrowing. These costs are now included as deductions to funding rather than in the portfolio budgets. This reflects both the operational impact of how these payments are deducted from the Scottish Consolidated Fund and the manner in which they are managed in line with the policies outlined in Chapter 4.
- Scotland Reserve Drawdowns. These are anticipated funds available based on fiscal framework aggregates applying to each year and historical average of funds carried forward between years. Scotland Reserve policies are discussed further in chapter 4.

- ScotWind Revenue. This is income from option fees from ScotWind leasing and assumes that the income will be drawn down over the first two years of the forecast period. This will be re-invested in action to tackle the twin challenges of climate change and biodiversity loss over the spending review period, as described in the Resource Spending Review.
- Migrant Surcharge is demand led income collected by the UK Home Office and redistributed to Devolved Governments on a Barnett basis. This differs from Barnett Consequentials which are derived from spending allocations to UK departments on areas of devolved competence.

Table 7 'other income' assumptions used in the central funding estimate

	Forecast			
	2023-24	**2024-25**	**2025-26**	**2026-27**
Reconciliations	-221	-817	-238	0
Resource Borrowing	110	300	119	0
Resource Borrowing Costs	-110	-124	-169	-191
Capital Borrowing Costs	-100	-122	-144	-166
ScotWind	310	350	0	0
Scotland Reserve	279	250	113	87
Migrant Surcharge	120	120	120	120
QLTR	5	5	5	5
Other*	100	52	30	32
Spillover**	-77	-133	-154	-152
Total other income	**416**	**-119**	**-317**	**-265**

*Other includes a risk-based assumption reflecting the uncertainty in all elements of funding in this table
** Numbers and approach currently subject to dispute.

2.8 Non-Domestic Rates

Non-Domestic Rates (NDR) are, unlike most other sources of funding, ring-fenced in what they can be used for. All NDR revenue raised is ultimately distributed back to Local Authorities. It is therefore usually considered separately from the Scottish Budget as a whole, but still forms an important component of the overall funding available to the Scottish Government.

The central funding envelope uses the SFC's forecasts of NDR revenues. Informed by past policy decisions of the Scottish Government, the SFC have assumed the next revaluation on 1 April 2023 will be revenue-neutral in real terms. This approach has been discussed with and agreed by the Scottish Government. However, due to relief provided through the pandemic support and other factors including higher-than-expected levels of NDR income lost to write-offs, bad debts following COVID-19 and emerging 2017 revaluation appeals losses, the NDR deficit has increased.

For the next revaluation to be revenue-neutral in 2023-24, based on current expectations about the tax base, an increase in the poundage would be required. Decisions on tax rates are set at each Budget, and any changes in the poundage – or the amount of NDR funding available for allocation - will be based on the forecasts available at that time.

Table 8 : forecast of NDR income

All figures in £million, current prices	2022-23	2023-24	2024-25	2025-26	2026-27
Non-domestic rates distributable amount	2,766	3,190	3,134	3,323	3,651

2.9 Capital Funding

Capital funding is primarily provided by the Block Grant and Financial Transactions (FT) allocations, both determined by the UK Government's capital spending plans. The remaining sums arise from: income and receipts; deployment of Scottish capital borrowing and reserve powers; innovative financial and revenue finance models; and recycling repayments from earlier FT loans.

Section 3.2 shows the funding outlook for the capital Block Grant and discusses the changes since the last MTFS in more depth. As with the resource outlook, the UK Government's Spending Review settlement provides a degree of certainty over the next three financial years. In 2025-26 and 2026-27, the capital grant funding available to the Scottish Government is assumed to grow at around 4% per year, in line with the OBR's forecasts for UK wide public sector investment[18].

2.10 Risks and uncertainties for resource funding

As noted above, all sources of the funding envelope are subject to uncertainty. These risks are difficult to quantify and ascribe specific probabilities to. However, the Scottish Government needs to anticipate the degree of likely volatility in the funding envelope in order to plan and manage spending over time.

[18] Office for Budget Responsibility (2022), Economic and fiscal outlook - March 2022 - Office for Budget Responsibility (obr.uk) – March 2022

Figure 7: Illustrative upside and downside scenarios for the resource funding envelope

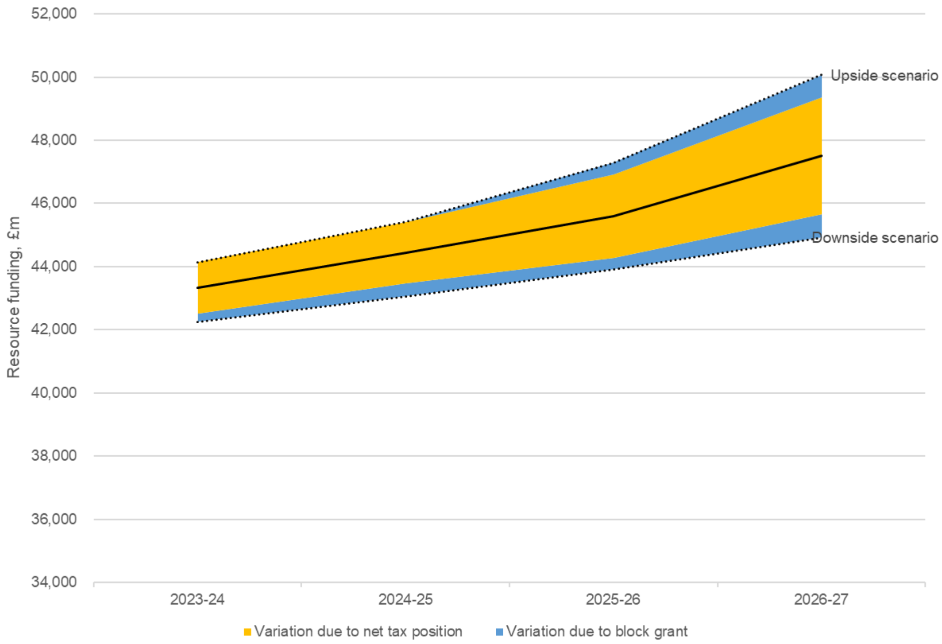


Table 9 : Illustrative upside and downside scenarios for the resource funding envelope

	2023-24	2024-25	2025-26	2026-27
Central funding envelope	**43,321**	**44,439**	**45,600**	**47,498**
Upside scenario	44,144	45,419	47,285	50,069
% variation	*1.9%*	*2.2%*	*3.7%*	*5.4%*
Downside scenario	42,248	43,059	43,914	44,927
% variation	*-2.5%*	*-3.1%*	*-3.7%*	*-5.4%*

Figure 7 and Table 9 above present an illustrative upside and downside scenario for the funding envelope based on some of these risks. These do not relate to a specific economic scenario, and the probability of either scenario cannot be easily quantified. However, they are based on the range of feasible outcomes for major components of the funding envelope. It allows for two principal sources of variation in the funding position:

- Changes in the UK Government Block Grant. As noted above, UK policy changes have a major impact on the overall funding position. In the downside scenario the UK Government adheres closely to the Spending Review settlement in the next two years, and the additional consequentials assumed in the central scenario do not materialise. The subsequent two years reflect a wider range of possible outcomes for UKG fiscal policy and assume the Block Grant growing at 1 percentage point higher or lower than the c. 4% annual growth assumed in the central scenario.

- Forecast variation in tax revenue. Both tax revenue and Block Grant Adjustment forecasts are subject to forecast movements reflecting changes in policy, economic conditions, and forecast error. Based on SFC and OBR forecasts to date, on average, forecasts of tax revenue and BGAs produced today will differ by around 5% from the forecasts applied in the upcoming 2023-24 Budget. This forecast variation increases over a longer time horizon, reaching around 10% over a 5-year period. Much of this variation will be out of the control of the forecasting institutions, and will include the impact of unforeseeable economic shocks such as the COVID-19 pandemic. The figures cited above also reflect the forecast variation in the early stages of both institutions forecasting newly devolved taxes, which we would expect to reduce over time. Nevertheless, these figures are useful to set parameters on how much tax and BGA forecasts could change in future.

  The upside and downside scenario are modelled on the basis of varying forecast tax revenue based on this average forecast variation. This results in a widening range between the upside and downside funding envelopes across the forecast, reflecting the greater uncertainty further in the future.

  In practice, forecasts of the BGA and tax revenue will often vary in the same direction – for example, economic shocks such as COVID-19 that reduce both tax revenue in Scotland rUK, so the overall impact on the net position will often be smaller.

Other sources of funding could also vary substantially. In particular, the components of the ‘other income’ line as described in Section 2.7 are especially volatile, and components of this could vary between being reductions or increases to the funding envelope. However, these variations have not been included in the scenarios above, which are intended to portray the potential variation of the most significant drivers of variation around the central funding envelope.

3. Scotland's Spending Outlook

The purpose of this chapter is to provide an update on the overall spending outlook and its component parts, including:

- The Resource Spending Outlook;
- The Capital Spending Outlook; and,
- Key drivers of spend such as pay and demand-led social security

3.1 Resource Spending Outlook

The MTFS sets out the economic and fiscal outlook for the next five years, providing the necessary context for spending plans. The RSR, published alongside this MTFS, sets out the full detail of our plans and the multi-year portfolio spending envelopes that will enable public bodies and other delivery partners to work with the Scottish Government to plan effectively for the future.

The RSR sets out the high-level parameters for resource spend within future Scottish Budgets up to 2026-27. It offers a strategic funding framework for the Scottish Government and our many partners to plan for the future. It is planned on the basis of the central funding scenario set out in chapter 2; a reasonable estimate of the funding likely to be available over the next five years. The RSR examined all areas of the Scottish Government's spending programmes within the challenging and volatile economic and fiscal context outlined above. The result is a set of multi-year spending envelopes which are set out in Table 10.

Table 10 : Resource Spending Envelopes

	2022-23 £m	2023-24 £m	2024-25 £m	2025-26 £m	2026-27 £m
Constitution, External Affairs and Culture	294	314	294	294	294
Crown Office and Procurator Fiscal Service	170	170	170	170	170
Deputy First Minister and Covid Recovery	43	43	43	43	73
Education & Skills	2,927	2,943	2,943	2,963	3,472
Finance & Economy	553	556	561	566	629
Health and Social Care	17,106	17,550	17,995	18,536	19,029
Justice and Veterans	2,839	2,839	2,839	2,954	2,969

Net Zero, Energy and Transport	1,633	1,669	1,704	1,793	2,088
Rural Affairs and Islands	881	879	879	884	885
Social Justice, Housing and Local Government	15,235	16,237	16,890	17,274	17,769
Scottish Parliament and Audit Scotland	122	122	122	122	122
Total	**41,802**	**43,322**	**44,440**	**45,599**	**47,500**

The drivers of public spending identified in section 3.3 illustrate the variable and growing demands on funding over the spending review period. The December 2021 MTFS compared the Scottish Government's central funding scenario with a mid-spending projection. This suggested a growing gap between funding and spending which could reach approximately £3.5 billion in 2026-27. At the extremes, the low funding compared with the high spending trajectory illustrated an estimated gap of approximately £10.3 billion in 2026-27, while a high funding combined with a low spending trajectory gave a £3.7 billion surplus.

The Resource Spending Review responds to this challenge, which has been exacerbated by rising inflation and the cost of living crisis, and sets out the parameters for the Government's spending plans to 2026-27. The RSR shows how the Government will direct spend to its strategic outcomes, supported by a focus on efficiency and reform in public services.

3.2 Capital Spending Outlook

3.2.1 National Infrastructure Mission

The National Infrastructure Mission (NIM), announced as part of the 2018 Programme for Government, is a commitment to increase annual investment by 1% of 2017 Scottish GDP, £1.5 billion, by the end of this Parliament.

The NIM was introduced with an aim of raising Scottish infrastructure investment to internationally competitive levels; boosting broadband, transport, and low-carbon energy; and supporting inclusive economic growth. This level of investment in vital economic and social infrastructure will protect and create jobs in the short term, and support growth and productivity in the long term.

3.2.2 Capital Spending Review

The Scottish Government has published a refresh to the CSR originally published in February 2021, in light of a lower than expected capital settlement from the UK Government curtailing its spending plans, the cost of living crisis and the ongoing pressure facing the construction sector relating to market conditions and the establishment of the new Scottish Government in 2021 with an increased commitment to tackle global climate and nature emergencies.

The refreshed CSR demonstrates that the Scottish Government remains committed to the principles and themes set out in the Infrastructure Investment Plan, enabling the transition to net zero and environmental sustainability, boosting inclusive economic growth, and building resilient and sustainable places, as well as taking forward the recommendations of the Infrastructure Commission for Scotland.

The refresh also provides the opportunity to ensure that Capital and Resource budgets are well aligned behind projects and programmes, enabling successful delivery against the Scottish Government's priorities set out in the RSR.

Table 11 shows high-level funding and financing plans over the CSR period. This demonstrates that the Scottish Government is on target to successfully deliver against the National Infrastructure Mission (NIM), with £34 billion of investment over the 5-year spending review period.

The NIM previously assumed between £250 million and £450 million of capital borrowing would be required annually to ensure sufficient investment to support economic growth. In light of the increasing volatility in the construction sector as well as uncertainty arising from late consequentials we have amended our capital borrowing policy, as set out in section 4.2.3. This will take account of additional consequentials and changes to the phasing of capital programmes as a result of market conditions and supply chain impacts, which are anticipated to continue to impact on the construction industry. The revised policy has allowed additional capital to be allocated across 2023-24 to 2025-26. This will allow extra funding for key commitments which drive forward climate change ambitions, support economic recovery and tackle child poverty.

The refreshed CSR now sets out Financial Transaction (FTs) allocations for both 2023-24 and 2024-25, following confirmation of these allocations in the UK Spending Review in October 2021. Approximately £400m of further FTs is anticipated following an adjustment from prior years, with the profile still to be agreed with HM Treasury.

Table 11 : National Infrastructure Mission Baseline (£ million)

	2019-20 NIM Baseline	2020-21[1]	2021-22	2022-23	2023-24	2024-25	2025-26	5 Year (2021-22 - 2025-26) Total
Capital Grant [2]	4,105	4,909	5,582	5,329	5,574	5,498	5,718[3]	27,701
Capital borrowing [4] / Consequentials	450	200	150	450[5]	450	450	450	1,950
Financial Transactions [6,7]	652	400	552	582	521	513	130[8]	2,298
Revenue Finance	90	65	55	335	520	690	609	2,209
Total Investment	**5,297**	**5,574**	**6,339**	**6,696**	**7,065**	**7,151**	**6,907**	**34,158**
Audit Scotland modelled NIM trajectory (rounded)		5,500	5,700	6,000	6,200	6,500	6,800	31,200

[1] Outturn figures
[2] Capital grant figure includes UK Capital Allocation, Additional Whitehall Transfers, Estimated Capital Receipts, Fossil Fuel Levy in 2022-23 only.
[3] Modelled figure
[4] Capital borrowing policy assumes £450 million of annual funding will be available through borrowing, the Scotland Reserve and Barnett consequentials of which £250 million will initially be assumed to be capital borrowing.
[5] Excludes £118 million of carry forward from 2021-22 to avoid overstating as outturn figures for 2021-22 are not available yet.
[6] Includes FT Consequentials and FTs Recycled and excludes Reserve drawdown.
[7] Includes additional £400m of FTs with 200m in 2023-24 and £200m in 2024-15, with profile to be agreed with HMT.
[8] There is currently no UK FT Allocation for 2025-26. Therefore figure is solely FTs recycled

The revenue-financed investment noted in the table above includes Growth Accelerators, Green Growth Accelerators the Learning Estates Investment Programme and the potential deployment of the Mutual Investment Model, which are described in detail in the previous MTFS published in December 2021[19]. In light of the current construction market volatility and the knock on impacts on project timelines, the figures have been revised to reflect the latest estimates. Although there has been a decrease in the forecast deployment of revenue finance over the CSR period, the updated Capital

[19] Scottish Government (2021), The Scottish Government's Medium Term Financial Strategy - gov.scot (www.gov.scot) – December 2021

Borrowing policy and the increased deployment of Financial Transactions, at a lower servicing cost than Revenue Finance, ensure the Scottish Government is still on target to successfully deliver against the National Infrastructure Mission.

The Scottish Government is committed to sustainable deployment of revenue financed investment and capital borrowing to ensure there is no undue financial burden on future policy choices. That is why the Scottish Government has a self-imposed revenue finance investment limit of 5% of the Scottish Government resource budget excluding social security. The latest modelling suggests that over the remaining capital spending review period these costs peak in 2025-26 with planned and committed projects and borrowing costs estimated to be 2.61% of the resource budget excluding social security.

3.3 Risks to the spending outlook

Chapter 4 sets out the range of risks to the spending outlook that we face such as increasing social security expenditure, increased demand on the health service due to an ageing population, public sector pay, and inflationary pressures which would have to be funded entirely from the Scottish Budget envelope. This presents a significant risk given the Scottish Government's limited ability to borrow and transfer resources between years. The section below provides an analysis of the biggest drivers of expenditure to illustrate the pressures on the spending outlook.

3.3.1 Demand-led social security spend volatility

Social Security expenditure is the third biggest spending area in the Scottish Budget, following health and local government. Expenditure on social security benefits is variable, as it is determined by the number of eligible people who apply for support, all of whom must be paid at the rate set in the respective policy. Budget allocations are based on SFC forecasts rather than spending limits, and the Scottish Government will have to meet social security expenditure as it arises, even if it differs from the SFC forecast used to set the initial Budget.

The demand-led nature of payment introduces in-year volatility and uncertainty to the Scottish Budget. The SFC reported a 3% variation from their original forecast for 2020-21[20], which, if replicated in 2022-23, would amount to over £125 million, as the SFC's updated forecasts expect that social security expenditure will be almost £4.2 billion in 2022-23[21]. Social security expenditure is forecast to rise progressively to £6.5 billion by 2026-27.

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[20] Scottish Fiscal Commission (2021), *Forecast Evaluation Report* – July 2021

[21] Scottish Fiscal Commission (2022), *Scotland's Economic and Fiscal Forecasts* – May 2022

The Social Security BGAs should also be considered alongside the forecasts of social security expenditure. In 2022-23 approximately 86% of social security benefits expenditure will be funded through BGAs. Social Security expenditure exceeding the BGAs over the RSR period reflects both divergent policy choices of the Scottish and UK governments, as well as economic differences which impact certain benefits. Changes in either UK Government policy relating to benefits, or the OBR's forecasts of benefit demand in the rest of the UK will affect the funding available to the Scottish Government through the Social Security BGAs.

Changes between actual and forecast Scottish expenditure, and the BGA reconciliations, are managed by the Scottish Government's budget management processes, in line with the principles and policies on the use of borrowing and reserve powers as set out in Chapter 4. Further information on the BGAs and reconciliations is set out in Annex B.

The continuing economic and social impacts of COVID-19 recovery and the cost of living crisis adds to the volatility risk associated with benefits expenditure. Disability benefits, which make up the majority of benefits expenditure, have been affected by COVID-19 but are expected to be less impacted by the wider macroeconomic environment except through the uprating of benefit amounts. Any additional expenditure arising as a result of volatility will have to be managed within the limits of the Scottish Government's existing fiscal powers. In Scotland, all benefits expenditure is funded through the overall Resource budget, as opposed to AME (Annually Managed Expenditure), which is the case in England and Wales.

Existing borrowing powers can help manage in-year volatility risk for social security and tax, however these powers have strict annual and overall borrowing limits. As part of the 2021-22 Budget, the Scottish Government had to manage reconciliations which exceeded its borrowing limits, with analysis suggesting that this could happen again. The Scottish Government is committed to building a social security system with dignity, fairness and respect at its heart. Social security is a key part of the Scottish Government's national mission to tackle child poverty and provides vital financial support to households, including those struggling as a result of the cost of living crisis. To support the real terms value of Scottish Benefits, the Scottish Government has uprated eight Scottish benefits by 6% from 1 April 2022 – almost double the September 2021 CPI rate of 3.1%. In addition, to specifically support low-income families with children, the Scottish Child Payment has been doubled from £10 per week per eligible child to £20 – and will further increase to £25 per week when the benefit is rolled out to eligible children under 16 by the end of 2022.

As a result of Scottish Government policy choices, such as delivering the Scottish Child Payment[22]– which is not funded through any additional adjustments from the UK Government – and the launch of new benefits to replace corresponding Department of Work and Pensions (DWP) benefits in Scotland, there is expected to be a growing divergence between the level of funding received from the UK Government (UKG) and the SFC's forecasts of devolved social security expenditure in Scotland. This additional investment will need to be funded entirely from the Scottish Budget envelope.

3.3.2 Public Sector Pay

Pay accounts for over £22 billion of resource expenditure across the devolved public sector (including Local Government). The Scottish Government pay and reward policies[23] apply directly to 50 public bodies and act as a reference point to other devolved public sector workforces (including Health, Teachers, Police, Fire and Further Education Colleges), albeit they have no formal locus in respect of setting Local Government pay. Over the coming years, certain public services will continue to expand, including new Social Security functions and the response to social care demand. As a result, we anticipate that parts of the public sector in Scotland will continue to grow.

The Scottish Government is committed to exploring with Trade Unions and employers further opportunities for developing non-pay benefits. Work has been ongoing to consider standardising the 35 hour working week across public bodies where the pay policy directly applies, to introduce the right to disconnect and where possible to explore a 4-day working week. In the longer term, this could be an opportunity to limit the cost burden of pay awards to employers, act as a lever to improve productivity, and optimise the role of automation and digitalisation of services, all while creating high value job opportunities and contributing to the wellbeing economy.

In designing pay policy, the Scottish Government must balance economic, fiscal and social factors, including:

- The changes to the cost of living – CPI inflation reached 9% in April 2022, and the Bank of England in its latest Monetary Policy Report estimate it could reach 10% later in 2022;
- The effect of the recent 1.25 percentage points increase to National Insurance Contributions for employees and employers;
- The fact that average pay in the public sector has been higher than in the private sector in recent years, with the ONS estimating that the modelled average public sector earnings premium was 7% in 2019; and,

[22] Scottish Government (2022), Scottish Child Payment – February 2021
[23] Scottish Government (2022), Public Sector Pay Policy – December 2021

- The continued improvement in labour market conditions . The number of payrolled employees is now above pre-pandemic levels, having fallen around 3% during 2021.

The affordability of pay uplifts, and recognition of performance across public services, contribute to a fair but fiscally sustainable approach to public sector pay. This is crucial given it is equivalent to half of the Scottish Government resource budget.

The 2022-23 Public Sector Pay Policy continues the progressive principles of recent years. Specifically, it outlined a cash uplift of £775 for public sector workers earning up to £25,000, £700 for workers earning between £25,000 and £40,000, and £500 for those who earn above £40,000 alongside the adoption of a new £10.50 public sector wage floor – building on the impact of the real Living Wage.

In addition to the main single-year pay deal option, the 2022-23 Policy offers the option for public sector bodies to choose a multi-year approach, connected to public service reform and broader changes to terms and conditions.

To illustrate the potential future paybill costs across the devolved public sector, we have modelled three theoretical public sector pay award scenarios – which exclude pension costs (see Table 12)

Table 12 : illustrative pay award scenarios (£ billion)

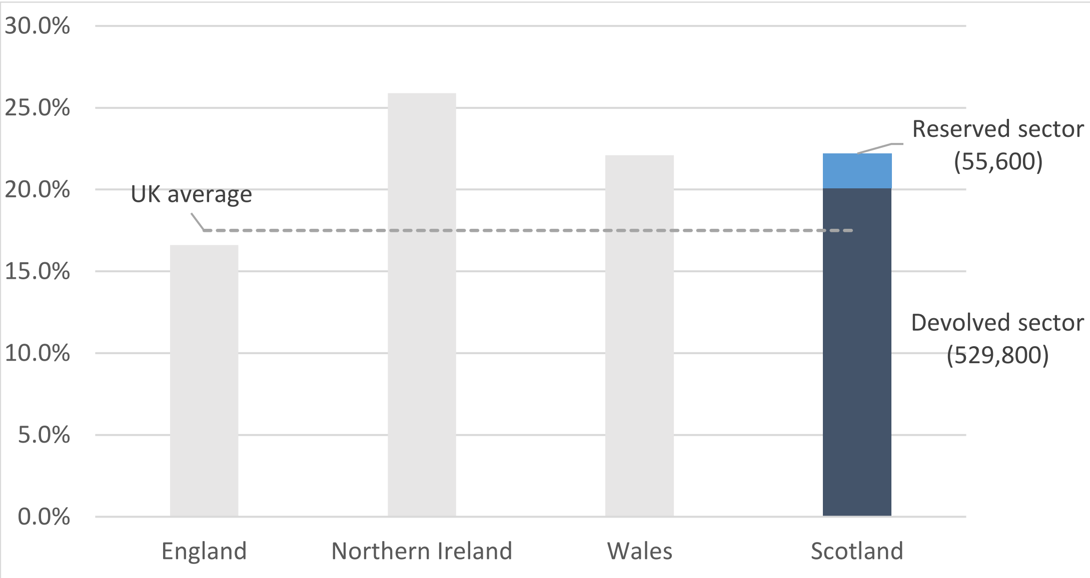
	Baseline (2022-23)	2023-24	2024-25	2025-26	2026-27
Illustration of 1% pay award					
Total	22.1	22.3	22.5	22.8	23.0
Additional cost including Basic Award		0.2	0.2	0.2	0.2
Illustration of 2% pay award					
Total	22.1	22.5	23.0	23.5	23.9
Additional cost including Basic Award		0.4	0.5	0.5	0.5
Illustration of 3% pay award					
Total	22.1	22.8	23.4	24.1	24.9
Additional cost including Basic Award		0.7	0.7	0.7	0.7

Note: This is the cost of the basic award including employer pension contributions and National Insurance costs. The paybill costs include all bodies within the Scottish Devolved public sector.

3.3.3 Growth in the public sector workforce

The size and distribution of the workforce in the devolved public sector directly influences the Scottish Budget position. As of 2021 Q3, 585,400 individuals worked in the public sector, representing around 22.2% of all Scottish workers. Around 47% of these public-sector workers are in Local Government and 33% in the NHS. The Scottish public sector is proportionally larger than the UK average of 18% of the total workforce.

Figure 8 : Proportion of people employed by the public sector: UK nations headcount (2021 Q3)



Public Sector Employment (Office for National Statistics); Public Sector Employment in Scotland (Scottish Government)

Over the last five years the number of workers in the devolved public sector has increased by around 1% per year on average. Over the coming years, we anticipate that parts of the devolved public sector in Scotland will continue to grow, alongside other parts that may shrink. But overall, we expect that without control measures in place, there would be a growing workforce carrying with it an increasing fiscal risk to the Scottish Budget.

To illustrate the potential future costs, based solely on historical trends on growth, we have modelled three scenarios based on assumptions around the pay award and future workforce growth.

Table 13: Illustrative cumulative pay award and workforce costs (£ billion)

	Baseline (2022-23)	2023-24	2024-25	2025-26	2026-27
Low Scenario - 1% pay award, - 0.5% workforce growth					
Total	22.1	22.2	22.4	22.7	22.9
Difference from Central Scenario		-0.6	-0.8	-1.0	-1.3
Central scenario - 2% pay award, 1% workforce growth					
Total	22.1	22.8	23.2	23.7	24.2
High Scenario - 3% pay award, 2.5% workforce growth					
Total	22.1	23.1	24.0	24.8	25.5
Difference from Central Scenario		0.6	0.8	1.1	1.3

Note: This is the cost of the basic award including employer pension contributions and National Insurance costs. The paybill costs include all bodies within the Scottish Devolved public sector. The central scenario of 1% workforce growth is based on the average previous five-year growth of the Scottish Devolved public sector.

In order to mitigate workforce pressures in the current fiscal and economic climate, all public sector employers will need to innovate further and take robust decisions about priorities and service design.

The RSR has introduced measures to reset the pay and workforce expectations, by announcing a broad aim to freeze total paybill costs – as opposed to pay levels - at 2022-23 levels, and a pathway to return the overall size of the public sector workforce to around pre-Covid levels, while supporting expansion in key areas of service delivery.

3.3.4 Public Service Pensions – a mandatory workforce cost

Within the UK, policy is largely reserved to Westminster in respect of public sector pensions and wholly reserved in respect of state pensions, private sector pensions, and pensions taxation policy. Public sector pensions are an important element of current and future obligations for the Scottish Budget. Pension scheme membership is provided as part of public servants' terms and conditions, and the Scottish Government remain committed to public service pensions that are affordable, sustainable and fair to Scotland's public servants and the communities they serve.

Pension scheme expenditure is demand-led and volatile, in that it is more difficult to control than other types of expenditure. For instance if more scheme members retire in a given year than forecasted, the amount of cash flow top-up required can increase, thereby creating an additional budget pressure that needs to be funded. While the cash flow risk for the NHS and Teachers' schemes rests with HM Treasury (scoring as annually managed expenditure in the Scottish Budget), the risk for the Police and Firefighters' schemes rests with the Scottish Government as it is funded through the discretionary Resource budget.

UK Government decisions on overarching policies, such as the discount rate used to value scheme liabilities as part of quadrennial scheme valuations, affect the cost of Scottish public service pension schemes. In the medium term, the upcoming round of public service pension scheme valuations – the 2020 scheme valuations – is the next event that could change pension costs for employers participating in the Scottish NHS, Teachers', Firefighters' and Police pensions schemes, and those in Scotland participating in the reserved Civil Service and Judicial pension schemes.

The employer pension contribution rates set by the 2016 valuations and implemented in 2019-20 will remain in effect for these schemes until new rates are set and implemented from 1 April 2024, providing a level of certainty in the meantime, with costs ultimately being determined by workforce demographics and pay awards. Given the potential for a new discount rate to be used in the 2020 scheme valuations, to be set by HM Treasury in due course, there is a risk that the new contribution rates will be higher than the current rates, with potentially significant budget implications for employers and portfolios that might need to be met without additional funding from the UK Government. Given the contingency of this budget management risk on UK Government decisions, the Scottish Government continues to engage closely with HM Treasury and others to inform our on-going risk management and related planning.

4. Managing Fiscal Risks

Building on the analysis about both funding and spending, this chapter analyses the different sources of fiscal risk that need to be managed as well as the available fiscal tools to manage those risks.

4.1 Fiscal Risks

Section 4.1.1 sets out a detailed assessment of the structural and cyclical risks to funding and spending and includes: an estimation of the impact of each risk on the Scottish Budget; the current levers available to deal with each risk; and, the budget management tools available to the Scottish Government to support managing the risk.

The section considers risks on the funding and spending sides separately, as the levers and strategies to deal with such risks can be significantly different. The implementation of the fiscal powers devolved to Scotland are governed by the Fiscal Framework in place between the Scottish Government and the UK Government.[24]

[24] Scottish Government (2021), Fiscal framework: factsheet - gov.scot (www.gov.scot) – December 2021

4.1.1 Structural and Cyclical Funding Risks

Table 14 : Summary of structural risks to the Funding Outlook

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Forecast error and reconciliation payments Errors in the budget forecasts are captured as reconciliation payments, which can either be positive or negative. This risk can be exacerbated by having two sets of forecasts, made by two separate forecasters at different times in the year and using different judgements about the economic outlook.	Negative reconciliations from Income Tax alone for the 2017-18 to 2019-20 budgets have cumulatively been worth over half a billion pounds across three years.	• Resource Borrowing Powers • Scotland Reserve • Spending reprioritisation	The Scottish Government can use the limited powers available on resource borrowing and the Scotland Reserve to manage any negative reconciliation repayments that occur as a result of forecast error. However, historical negative reconciliations have exceeded the annual £300 million borrowing limit to deal with forecast error, and this is likely to occur more regularly in the future as the current borrowing and reserve powers are not protected in real terms. There is a clear and reasonable case to revise the current borrowing and reserve powers, ensuring the Scottish Government has appropriate and sufficient budget management tools needed. The forthcoming review of the Fiscal Framework provides an opportunity to facilitate adequate risk

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
			management for forecast error over the medium-term.
Asymmetrical economic performance between Scotland and rUK. The Scottish Budget is directly exposed to the relative performance of the Scottish and rUK economies. For example, when devolved tax receipts per person grow quicker in Scotland than in the rUK, the Scottish budget improves and vice versa.	There is limited protection to the Scottish Budget when the Scottish economy or tax base performs more poorly than the rUK. Even relatively short periods of slower growth can add or subtract hundreds of millions of pounds from the Scottish Budget over time.	• Long-term Economic, Social and Health Policy • Spending reprioritisation	The Scottish Government has substantial powers to influence the long-term trajectory of the economy via policies in areas such as education, housing, transport and economic development. However, other areas critical to the economy remain reserved such as immigration and trade policy which constrains the Scottish Government's ability to manage longer-term demographic risks, including differential rates of population growth. The Scottish Government also has less control over medium-term sectoral risks, such as fluctuations in the performance of the oil and gas sector in Scotland, or the financial sector in London (see Annex A). The Scottish Government's ability to respond to short-term economic shocks, by smoothing out business

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
			cycle fluctuations in the short term, is further constrained by limits on discretionary resource borrowing and limits on the size of the Scottish Reserve. The Scottish Government invests in long-term policies, such as the newly published National Strategy for Economic Transformation, as well as in Education, Health Care, Fair work and other devolved areas to support Scotland's economic growth and performance relative to the rUK over the medium-term.
Compositional differences in the Scottish and rUK Tax bases. The current Block Grant Adjustment mechanism used for Devolved Income Tax and LBTT does not take into account the difference in	As shown in the December 2021 MTFS (Annex A), the cumulative impact of the compositional differences for Income Tax alone from 2017-18 to 2019-20 reduced funding to the Scottish Budget by £230 million.	• Limited levers available	Levers to address a risk of this nature, such as the "By-Band" Block Grant Adjustment mechanism currently in operation in Wales, are a possible solution and should be considered as part of the Fiscal Framework Review.

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
the composition of the relative Scottish and rUK tax bases.			

Table 15: Summary of cyclical risks to the Funding Outlook

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Changes to UK Government spending There remains a continued risk of the Scottish facing significant in-year changes, resulting from changes to UK Government Fiscal Policy.	Adjustments to Barnett consequentials at any point in the financial year can change the Scottish funding outlook by hundreds of millions of pounds and can have a material impact on the funding outlook.	• Scotland Reserve • Spending reprioritisation	The Scottish Government can only use draw-downs and carry-forwards through the Scotland Reserve as well as reprioritising spending to manage this risk. It is not possible to use resource borrowing to manage this risk and the limits on the available powers (particularly the Scotland Reserve) are set well below the level of change that could occur to the funding outlook within the financial year.

4.1.2 Structural and Cyclical Spending Risks

Table 16 : Summary of risks to the Spending Outlook

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Spending pressure from increased demand from an ageing population The fiscal pressures of an ageing population are most apparent in our health and social care system and puts additional pressure on the NHS and social care over time.	An ageing population puts additional pressure on the NHS and Social Care over the medium to long term, and would also result in additional expenditure on social security payments, which is demand led. A decrease to the working population will impact both the funding and spending outlooks as this increased spend would need to be funded from a smaller active economy.	• Spending reprioritisation • Policy interventions	Policy interventions are required early in order to maintain the affordability of health care over the long term. In order to maintain funding growth for health and social care at comparatively high levels, spending reprioritisation could also be needed to manage this risk. It should also be noted that changes in the structure of the population will result in some areas of Scottish Government expenditure decreasing. Managing these shifts in expenditure will be a feature in coming years.
Demand-led nature of social security expenditure	The SFC reported a 3% variation from their original forecast for 2020-21, which, if replicated in	• Spending reprioritisation • Scotland Reserve	In Scotland, all benefits expenditure is funded through the overall Resource budget, as opposed to a dedicated AME (Annually Managed

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Social security expenditure is forecast to rise gradually to £6.5 billion by 2026-27, and any additional expenditure from changes to that estimate will have to be managed within the limits of the Scottish Government's existing fiscal powers. Forecast errors are expected to be larger for new payments as there is limited information for the SFC to produce their forecasts.	2022-23, would amount to over £125 million, as the SFC's updated forecasts expect that social security expenditure will be almost £4.2 billion in 2022-23.	• Resource Borrowing	Expenditure) budget that would be better suited to funding demand-led expenditure on this scale, which is the case in England and Wales. Any additional investment will need to be funded entirely from the Scottish Budget envelope and will require prioritisation across other spending areas. The Fiscal Framework Review provides an opportunity to revisit the need for the powers and fiscal flexibilities necessary to manage unexpected increases in social security spending.
Divergence of demand-led expenditure from UK Government funding The Scottish Government is committed to building a new social security	As a result of policy choices, such as delivering the Scottish Child Payment – which is not funded through any additional adjustments from the UK Government – and	• Spending prioritisation	This additional investment will need to be funded entirely from the Scottish Budget envelope and will need to be prioritised relative to other areas of public spending

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
system with dignity, fairness and respect at its heart. Any additional devolved benefits, increases in payments or uptake, need to be funded out of the wider budget.	launching new benefits which replace the corresponding Department of Work and Pensions (DWP) benefits in Scotland there is expected to be a growing divergence between the level of funding received from the UK Government and the SFC's forecasts of devolved social security expenditure in Scotland.		

The Fiscal Framework broadly protects the Scottish funding outlook from economic shocks (such as higher levels of inflation) that affect the Scottish and rUK economies to a similar degree. For example, inflation can result in higher Income Tax revenue growth if the higher rate of inflation incentivises faster earnings growth in the economy and earnings growth turns out to be greater than any equivalent increase in the relevant tax thresholds. However, as long as the impact on the Scottish and rUK tax base is broadly equivalent in scale, then the Scottish funding position would be relatively unchanged as any boost to Scottish Tax revenues would be broadly offset by a similar increase in the corresponding tax Block Grant Adjustment.

However, the risk of higher levels of inflation is more likely to act as a risk to the stability of the spending outlook. For example, higher levels of inflation reduces the real term spending power of nominal cash envelopes across the forecast period. Given the minimal additional spending announcements made by the UK Government in the March

Spring Statement, this means that the cash envelopes settled at the UK Spending Review in October 2021 (and the subsequent future Block Grant funding for the Scottish Government) cannot purchase the same quantity of goods and services as originally forecast.

4.1.3 Inflation Risks

Table 17: Summary of inflation risks

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Pay agreements are a key driver of public sector costs and spending exacerbated by inflationary pressures. Pay is a key driver of public expenditure and makes up over half of the Scottish resource budget Inflationary pressures will further exacerbate public sector pay pressures.	Table 13 models three scenarios based on assumptions around the pay award and future workforce growth to illustrate the possible impact on the Budget. For example, a pay deal that is 1% higher than the UK Government across the devolved public sector would add an additional £200 million into public spending	• Resource Spending Review • Public Sector Pay Policy	The RSR sets out a range of measures on pay and workforce. In addition the 2022-23 Pay Policy sets out the greater flexibilities available to employers who wish to seek a multi-year reform-based approach to pay. This aims to deliver better services for the public by driving further innovation, increasing value for money for Scottish taxpayers and ensuring the public sector is effectively equipped for the future.
Increased cost of living and inflationary pressures	Whilst it is difficult to quantify, there will be significant impacts on the purchasing power of	• Spending prioritisation	Inflation is already at a 40 year high, and expected to climb further. Higher fuel and food costs driven by the situation in Ukraine will

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
Fiscal impacts driven by wider economic factors – heightened and sustained inflation - will create additional pressure on the Scottish Budget and compound existing pressures from the pandemic.	budgets as well as demand for services and support.		exacerbate the cost of living crisis and disproportionately affect lower income households, making the Scottish Government's child poverty targets harder to achieve. Programmes will need to be targeted as far as possible to support low-income households and the Scottish Government will continue to do everything within our powers and fixed budgets to ensure our people, communities and businesses are supported as far as possible. Meeting child poverty targets will also require investment and the Resource Spending Review provides the overall spending envelopes in which this will happen.
Fiscal powers being eroded by inflation over time. Key borrowing powers and reserve limits within the Fiscal Framework are set in	As illustrated in section 4.2, the real term effectiveness of the borrowing powers over 5 years from 2017-18	• Limited levers available	The Fiscal Framework review is an opportune moment to consider the challenges faced by fixed nominal limits on current borrowing and reserve powers. These powers do

Risk	Estimated possible impact	Levers available to manage risk	Budget Management Strategy
nominal cash values and hence are not protected in real terms from inflation or the growing size of the Scottish Budget / Tax base over time.	to 2022-23 could already have been eroded by as much as 24%.		not adjust for the growth of the Scottish budget over recent years (including due to the pandemic response), and due to the lack of indexation their real term effectiveness deteriorates over time. At a minimum, these limits need to be indexed in some form. For example, limits on the Reserve could grow in line with size of the Scottish Budget.

4.2 Current levers for managing volatility and risk

The Fiscal Framework provides the Scottish Government with limited reserve and borrowing powers to manage volatility and risk.

The Scotland Reserve allows the Scottish Government to smooth spending within and between years, carry forward underspend and assist in the management of tax volatility, within set limits. Within its normal limits, the Scotland Reserve is capped in aggregate at £700 million, with an annual drawdown limit of £250 million for resource and £100 million for capital. However, the triggering of the 'Scotland-specific economic shock' provision in 2021-22, largely as a result of timing differences between the OBR's November 2020 and the SFC's January 2021 forecasts[25], means that there is no drawdown limit for the Reserve in 2021-22 through to 2023-24.

The Scottish Government can borrow to support day-to-day (resource) spending only in very specific circumstances, primarily to address forecast error in relation to devolved tax receipts and social security spending and the corresponding BGAs. For example, where there is a shortfall forecast in tax receipts or an increase in demand-led social security spending; it cannot borrow to support discretionary resource spending.

The total limit for resource borrowing is £1.75 billion and the normal annual limit for forecast error is £300 million per year. Due to the triggering of the 'Scotland-specific economic shock' provision of the Fiscal Framework, the annual borrowing limit has been raised to £600 million until 2023-24.

As set out in the January 2021 and December 2021 MTFS, there is a growing body of evidence that the scale and magnitude of potential forecast error under the Fiscal Framework exceeds the level of flexibility provided by the existing borrowing powers.

Scottish Government analysis in the December 2021 MTFS outlined that there was between a 8% and 24% probability of total cumulative negative reconciliations across the various devolved social security benefits and tax revenues breaching the £300 million annual borrowing powers for forecast error.

This has already come to pass in the 2021-22 Budget when historical reconciliations exceeded the annual £300 million borrowing limit to deal with forecast error, and this is likely to occur more regularly in the future as the current borrowing and reserve powers are not protected in real terms.

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[25] See paragraphs 78-82 of the Scotland Act 2012 and 2016: annual implementation report 2021

This reflects the inclusion of the additional fully devolved taxes (LBTT and SLfT) and social security benefits with a BGA mechanism (although Income Tax remains by far the largest driver of the overall risk). SLfT revenues are also forecast to fall sharply in 2026-27 due to the implementation of the ban on landfilling of bio-degradable municipal waste which poses an additional issue for the Budget to manage.

The total limit for capital borrowing to support investment in infrastructure is £3 billion, with annual borrowing limited to £450 million.

The Scotland Reserve is the only mechanism for the Scottish Government to retain underspent funds for future years. The limitations on the use of the Reserve and the volatility relating to forecasts mean that it is neither feasible nor desirable for the Scottish Government to build up substantial balances in the Reserve. If the Scottish Government intentionally underspent its budget to carry forward funds to future years, there is a significant risk that the Reserve limit would be breached and therefore these funds would be returned to the UK Government and lost permanently.

A key constraint faced by the Scottish Government is that all of these limits are set in nominal terms even though the size of the Scottish economy, budget, devolved tax revenues and social security benefit expenditure rises over time. Consequently, over time the Scottish Government's current levers for managing volatility and risk are being effectively eroded in their real term capacity.

For example, since 2017-18 when the limits were initially implemented, they would have been around 14% larger by 2022-23 had they grown in line with inflation. Had they grown in line with the forecast cumulative size of devolved tax revenues they would have been around 18% higher and had they grown in line with the size of the total Scottish Government fiscal resource budget the limits would have been around 24% higher.

There are various arguments around how such limits could be indexed, however it is clear that even over a relatively short period of time, the real term effectiveness of the Scottish Government's levers to manage the risks and volatility within the Fiscal Framework has been eroded. The Fiscal Framework review is an opportune moment to index any nominal limits within the Fiscal Framework in real terms

In the meantime, whilst it is operating within these limitations, the Scottish Government uses the following guidelines when managing the budget.

4.2.1 Scotland Reserve policy

We will prioritise use of the Scotland Reserve to carry forward any forecast underspends for use in the subsequent financial year. This retains sufficient capacity in the reserve to be able to also carry forward any additional underspend that emerges later in the budget process (i.e., at provisional and final outturn stages) and mitigates the risk of funds being lost to the Scottish Government.

From 2017-18 to 2020-21, average reserves have been in excess of £350m, with a proportion of this being driven by consequentials provided later in the financial year to support COVID-19 actions. By prioritising use of the Reserve for this purpose, we ensure that sufficient capacity remains, so that, where excess tax receipts or additional underspends emerge from the Provisional Outturn and Final Outturn Processes, these can be added to the Scotland Reserve for use in future years.

4.2.2 Resource borrowing policy

The use of resource borrowing is complementary to the use of the Scotland Reserve. The Scottish Government must balance the need for flexibility against the additional costs of borrowing compared to the Reserve to find a solution that is most appropriate to the circumstances.

Resource borrowing powers will be used in a way that balances the principles of flexibility, stability and value for money, as set out in the 2019 Medium-Term Financial Strategy:

- Resource borrowing is an important tool to help achieve stable funding and spending trajectories, in order to ensure macroeconomic stability. Repayment terms would be as short as possible, to minimise servicing costs, subject to the need to smooth resource spending over time.
- In the context of the constraints outlined above, the scope for reductions in spending and/or use of any funds held in the Scotland Reserve would generally be considered first, before any decision is taken on resource borrowing.

The Scottish Government will assess all planned resource borrowing decisions to smooth the funding trajectory over five years. Scottish Government budgets have previously assumed full borrowing against known and/or forecast tax and social security reconciliations as the optimum approach to achieving this outcome.

To minimise volatility over the medium-term the equivalent analysis in Annex B now implies we should plan to borrow c. 50% of the full income tax reconciliation in 2023-24, in order to soften the impact of the even larger reconciliation in 2024-25.

This situation arises as a result of the current circumstances, namely:

- Scotland specific shock rules expiring in the year before the largest forecast reconciliation in 2024-25.
- The scale of the reconciliation in 2024-25.

As noted, other than to respond to changes in demand for social security spending, resource borrowing cannot be used to respond to emerging spending pressures, for example, to respond to the impacts of COVID-19.

Given the restrictions on resource borrowing under the existing Fiscal Framework, the only risks created by borrowing are those on future years' resource budgets resulting from borrowing repayments. It is therefore prudent to consider the medium-term impact on the Scottish Budget of reconciliations, borrowing and borrowing repayments in totality. Given the annual limits and short repayment periods, there is no risk of breaching the cumulative limit, and there is also no re-financing risk.

Conversely, there are considerable risks related to forecast error, economic shocks and funding outlooks, depending on UK Government decisions. The resource borrowing powers do not address these sufficiently. The annual cap of just £300 million against forecast errors is insufficient to fully mitigate large movements as evidenced with the situation in 2024-25. As the Scotland Specific Shock rules do not apply we are only able to borrow £300 million to offset the £817 million tax reconciliation. This also leaves no borrowing capacity to manage the risk of in-year forecasting movements.

The Fiscal Framework review is an opportune moment to consider the challenges faced by fixed nominal limits on current borrowing and reserve powers.

4.2.3 Capital borrowing policy

The two key considerations for the medium-term with respect to capital borrowing decisions are the headroom against the cumulative Fiscal Framework limits and affordability of ongoing borrowing repayments.

Capital borrowing powers will be used in a way that balances the principles of flexibility, stability, value for money and intergenerational fairness, alongside supporting the delivery of the NIM.

While the Scottish Government can borrow commercially or issue bonds for capital investment purposes, the National Loans Fund currently remains the preferred source of capital borrowing. Given the medium-term impact on resource costs, this remains the optimum compromise between value for money, resource cost impact and maximising the use of the Fiscal Framework limits.

The term-structure of borrowing will be chosen to strike the right balance between flexibility (requiring shorter-term lengths); value for money (requiring shorter-term lengths); stability (suggesting longer-term lengths); and intergenerational fairness (term length corresponds to asset life).

The previous policy set out in the December 2021 MTFS was to borrow between £250 million and £450 million annually over the period of the NIM to ensure that there is sufficient investment planned to support economic growth, and that investment increases overall year-on-year.

The Scottish Government also planned borrowing over the medium term to ensure that a minimum of £300m capital borrowing headroom will be available to be drawn down in the year following the period covered by the NIM (2026-27).

As we approach the half way point of the NIM we have reviewed the capital borrowing policy to ensure it continues to support the NIM while also providing long- term fiscal sustainability.

The analysis in Annex B shows that the Scottish Government can borrow £250 million annually over a 15 year tenor and sustain this policy (almost) indefinitely even within the existing cumulative limit of £3 billion imposed by the Fiscal Framework. Historic trends have shown there is a high likelihood of material movements on capital projects as well as additional capital consequentials arising in year.

We are therefore amending the policy to assume £450 million of annual funding will be available through borrowing, the Scotland Reserve and Barnett consequentials of which £250 million will initially be assumed to be capital borrowing. Where further capital borrowing is required to support funding the terms of any borrowing will be amended to balance the resource cost impact and longer term fiscal sustainability

All borrowing drawdown decisions will take into account the in-year budget management position, the interest rate environment and the impact over the five-year term versus the assumptions made in the Scottish Budget.

4.2.4 Tax policy

Scotland's first Framework for Tax[26] was published in December 2021. It details how we approach tax policy and make decisions on tax, as well as setting out priorities for this Parliament. It provides a solid foundation for the design and delivery of tax policies that support our national outcomes and pursuit of a fairer and more prosperous Scotland.

The decision-making matrix in the Framework ensures that tax policy is developed in a consistent and coherent manner. The Framework also helps us to respond to the medium-term risks and opportunities for devolved taxes, so that sustainable revenues can be generated, supporting the delivery of priorities across the whole of government and the funding of public services in Scotland.

[26] Scottish Government (2022) – Framework for Tax 2021 – December 2021

4.2.5 Resource Spending Review

Within the limitations of the current Fiscal Framework, controlling expenditure remains the primary lever to ensure the fiscal sustainability of Scotland's public finances.

As set out previously, the RSR sets out spending envelopes for the remainder of this parliamentary term which support the Government's ambitions and provide the parameters within which medium term plans can be developed. The RSR emphasises the importance of excellent public services, ensuring we achieve the best value possible from public spending for the Scottish public while living within our means.

4.2.6 The need for a robust and comprehensive review of the Fiscal Framework

The 2016 Fiscal Framework Agreement described arrangements for the devolution of further tax and social security powers to Scotland. The Scottish Government will continue to work within the framework, and work to improve on it, until such a time as the people of Scotland choose a different constitutional path.

The Fiscal Framework Agreement states that a review of the Fiscal Framework should be undertaken by the Scottish and UK Governments after Parliamentary elections in 2021. This will be informed by an independent report that will be presented to both governments in advance of the review commencing.

In October 2021, the Scottish and UK Governments agreed to commission an independent report focusing on the Block Grant Adjustments, including a call for stakeholder input, prior to a broader review of the Fiscal Framework. The arrangements for the independent report are subject to joint agreement between the Scottish and UK Governments. At the time of writing, the arrangements are being finalised and the report will be launched as soon as possible.

Both governments are working towards agreeing the scope for the Review, with the review aiming to begin in autumn 2022. Views from stakeholders, other than the two Governments, will be sought as part of the process.

As set out in the 2021 MTFS, as well as the Programme for Government in September 2021, the Scottish Government will use the Fiscal Framework review to push to strengthen the fiscal power of the Scottish Parliament including borrowing and reserve powers as outlined above, to allow more effective management of our key risks over the medium-term.

In the recent publication by the Independent Fiscal Commission for Northern Ireland[27] the need for the right balance of risks and rewards, which devolution can bring, has been clearly demonstrated. They recommend that the devolved administrations have the appropriate suite of policy levers and are not unduly exposed to risks outside devolved policy maker's control, which is something we will be focusing on as part of the Fiscal Framework Review later this year.

The Scottish Government continues to seek a resolution on the outstanding dispute concerning the disproportionate impact of personal allowances increases on Scottish revenues, and the appropriate application of the spillover provision in the current Fiscal Framework Agreement. While the scale of the financial impact is disputed, both parties accept that a direct spillover effect arises from the UK Government's changes to the Personal Allowance and that the Scottish Government is due a transfer of funding. Longer-term issues relating to the spillover provisions should be considered in more detail as part of the forthcoming review of the Fiscal Framework.

[27] Fiscal Commission NI (2022) FCNI Final Report - More fiscal devolution for Northern Ireland? | Fiscal Commission NI –May 2022

Conclusion

This is the fifth edition of the Scottish Government's Medium-Term Financial Strategy. The role of the MTFS is to set out Scotland's fiscal outlook over the next five years, including the risks that may impact on the Scottish Government's fiscal position. It is not intended to set out detailed spending plans or explain how prioritisation decisions will be made to meet policy objectives, in line with the recommendations of the Budget Process Review Group. However, as this edition is being published alongside the Resource Spending Review this MTFS also includes an overview of the Scottish Government's resource spending plans until the end of the parliamentary term. It also includes an update on the Scottish Government's Capital Spending Review, also published alongside this MTFS.

Despite the fourth edition of the MTFS only being published in December 2021, the Scottish Government now faces additional volatility to the spending outlook due to the significant increase in inflation since the December publication. There are also additional risks that the Scottish Government faces in managing the uncertainty and volatility in the Budget arising from the need to respond to emerging needs, emergencies and events that arise in year which were not foreseen such as the rapidly increasing energy prices, the current cost of living crisis and other consequences of the situation in Ukraine. The Scottish Government's financial management needs to be agile to respond to this volatility, using the limited budget management tools available.

The challenges highlighted in this MTFS reinforce the importance of medium-term financial planning, to ensure the long-term sustainability of the public finances, sustainable delivery of the Government's priorities and ultimately progress towards the National Outcomes. The MTFS demonstrates how the Scottish Government continues to proactively utilise the powers that are available across taxation, borrowing and the Reserve to manage fiscal risks over the medium-term. In addition to this, the Resource Spending Review sets out a clear direction on how spending can be used more effectively to support the delivery of Government's core missions.

The Scottish Government welcomes the recommendations on improvements to the MTFS made by the Finance and Public Administration Committee and has considered each of these recommendations in detail. This publication of the MTFS now includes greater detail on the funding assumptions and the risks and uncertainties associated with these. It also sets out greater detail on the risks to both funding and spending, including estimated possible impact, the current levers available to the Scottish Government to manage these risks and the budget management strategy. The Scottish Government will continue to work collaboratively with the Committee and other stakeholders such as the SFC on improvements going forwards.

List of Acronyms

AGER	Advisory Group on Economic Recovery
AME	Annually Managed Expenditure
BPRG	Budget Process Review Group
BGA	Block Grant Adjustment
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CSR	Capital Spending Review
EU	European Union
FFFP	Fines, Forfeitures and Fixed Penalties
FT	Financial Transaction
GDP	Gross Domestic Product
HM	Her Majesty's
HMRC	Her Majesty’s Revenue and Customs
HMT	Her Majesty’s Treasury
IIP	Infrastructure Investment Plan
IPC	Indexed Per Capita
IT	Income Tax
LBTT	Land and Buildings Transaction Tax
MSP	Member of the Scottish Parliament
MTFS	Medium-Term Financial Strategy
NDR	Non-Domestic Rates
NHS	National Health Service
NIM	National Investment Mission
NLF	National Loans Fund
NPF	National Performance Framework
NSET	[10-Year] National Strategy for Economic Transformation

NSND	Non-savings, and non-dividend
OBR	Office for Budget Responsibility
OECD	Organisation for Economic Co-operation and Development
ONS	Office for National Statistics
PAYE	Pay As You Earn
PfG	Programme for Government
PIP	Personal Independence Payment
RPI	Retail Price Index
REP	Regional Economic Partnership
RSR	Resource Spending Review
rUK	Rest of the United Kingdom (i.e. England, Wales and Northern Ireland)
SDA	Severe Disablement Allowance
SFC	Scottish Fiscal Commission
SIT	Scottish Income Tax
SLfT	Scottish Landfill Tax
UK	United Kingdom
UKG	UK Government
VAT	Value Added Tax
YOY	Year on Year

Glossary

Barnett Formula	a formula used by HM Treasury to calculate consequentials which form the Block Grant to devolved governments in Scotland, Wales and Northern Ireland. The Barnett formula gives these governments a proportion (or consequential) of increases or decreases in UK expenditure on devolved policy.
Budget	a document prepared by the government to present its anticipated tax revenues and proposed spending/expenditure for the coming financial year.
Block Grant	the grant received by the Scottish Government made up consequentials of UK expenditure, calculated by the Barnett Formula.
Block Grant Adjustment (BGA)	deductions or additions to the Scottish Government's total Block Grant to reflect devolved tax receipts or social security expenditure.
Capital Borrowing	money borrowed specifically for the purpose of Capital Expenditure.
Capital Expenditure	money spent on providing or improving non-current assets, which include land, buildings and equipment, which will be of use or benefit in providing services for more than one financial year.
Consequentials or Barnett Consequentials:	a Barnett Consequential is the change to a devolved administration's assigned budget as a consequence of changes in spending in devolved areas by the UK Government.
Deficit	occurs when a government spends more money than it takes in.
Demand-led	refers to expenditure which can be predicted at the beginning of the year e.g. the payment of benefits but which will ultimately depend on the number of eligible claimants.

Financial Transactions (FTs)	results primarily from a range of UK Government housing-related equity and loan finance schemes, such as ‘Help to Buy.’ When the UK Government invests in such schemes in areas that are devolved to the Scottish Parliament, the Scottish Government receives a proportional share of the UK Government’s investment.
Fiscal Framework	the Fiscal Framework agreement was published alongside the Scotland Act 2016 setting out the new funding arrangements, fiscal rules and borrowing powers for the Scottish Government.
Fiscal Framework Review	the Fiscal Framework is due to be reviewed in 2022. The review will be preceded by an independent report, on the Block Grant Adjustment arrangements.
Funding Outlook	projection of future funding built up by forecasting separate elements of funding and then aggregating these to produce a path for the total level of potential funding.
Gross domestic product	a measure of the size of a country’s economy over a period of time (usually one quarter or one year).
Income Distribution	covers how a country's aggregate income is distributed amongst its population.
Inflation	the increase in prices of a representative basket of goods and services over time. How quickly those prices go up is the rate of inflation.
National Outcome	outcomes for Scotland determined by the Scottish Government in consultation with the communities in Scotland and the Scottish Parliament, which are reviewed at least every 5 years.
Non-Domestic Rates (NDR)	Non-domestic rates, often described as business rates, are a tax on non-domestic properties to help pay for local council services. These include services like education, social care and waste management.

Net zero	achieving an overall balance between emissions produced and emissions taken out of the atmosphere.
Outturn Data	official published statistics about actual revenues and expenditure.
Omicron	variant of the COVID-19 virus which became dominant in the UK in December 2021.
Poundage	Non-Domestic rates are levied on the basis of a national poundage multiplied by the Rateable Value of the property you occupy. If you are the ratepayer for a property with a rateable value in excess of £51,000 then you will be required to pay a supplement on the poundage. The poundage is set annually by the Scottish Government and covers the period 1 April to 31 March.
Public sector enabling infrastructure	investment in public sector assets to stimulate private sector investment e.g., road junctions and train station improvements, not investment in the private sector directly.
Reconciliations	adjustments to address historical budgets' forecast errors.
Resource Borrowing	money borrowed specifically for the purpose of Resource Expenditure.
Resource Expenditure	money that is spent on day-to-day resources and administration costs.
Resource Spending Review	a review to balance the spending ambitions of the Scottish Government within its fiscal constraints.
Scotland Reserve	a cash management facility, allowing the carry-forward of a limited amount of funding from financial year to financial year.
Social Security	A Government support system to provide people in need with financial support (such as people on low incomes or who have health related costs)

UK Spending Review	allocation of funding to UK government departments.
Volatility	the tendency to change rapidly and unpredictably.
Wellbeing economy	an economy that is inclusive and that promotes sustainability, prosperity and resilience, where businesses can thrive and innovate, and that supports all of our communities across Scotland to access opportunities that deliver local growth and wellbeing.

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List of Figures, Tables, and Boxes

Annexes

The Scottish Government's Medium-Term Financial Strategy 2022-23 to 2026-27

Annex A: Regional and Sectoral trends across the Scottish and rUK Income Tax bases

Income Tax devolution in Scotland has only been in operation since 2017-18. During that time, several policy changes have been made, most notably in 2018-19 with the introduction of a five-band system and changes to the rates and thresholds that Income Tax is paid at.

The Scottish Income Tax Policy Evaluation published in December 2021 showed clear evidence that these policy changes have boosted overall Scottish Income Tax revenues.

However, the overall impact on Scotland's Budget is determined by the growth rate of non-savings non dividend (NSND) Income Tax revenue per person relative to the rest of the UK since 2016-17. If tax revenue per person grows faster in Scotland than in the rUK then the Scottish Budget position improves. Conversely, if revenue per person grows faster in the rUK than in Scotland, the Scottish Budget position worsens.

The latest outturn data, which covers 2019-20, shows that Income Tax devolution has benefited the Scottish Budget to date, in large part because of revenue raising policy reforms introduced since 2017-18. However, based on the latest forecasts from the SFC and OBR, future Income Tax revenue per capita is expected to grow faster in the rUK than in Scotland, to the detriment of the Scottish Budget. This annex explores the reasons behind this slower tax revenue growth in Scotland, building on analysis in previous MTFS documents.[28]

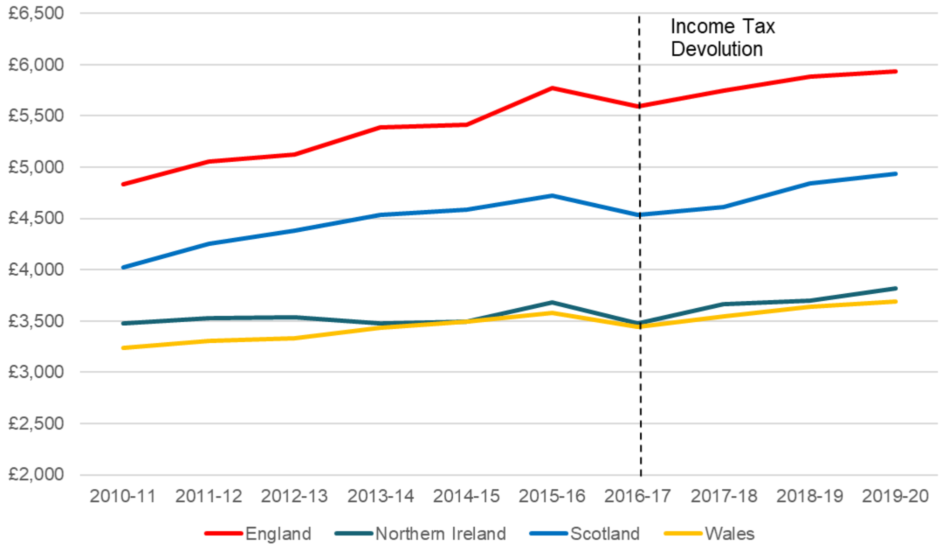
Though many factors will influence the relative growth in tax revenue, the evidence available suggests that recent faster growth of tax revenues and earnings in rUK relative to Scotland appears to be at least partially driven by strong earnings growth in London and the South East of England, particularly amongst high earning taxpayers in the Financial and Insurance services sector. There is also evidence that the relative position is also impacted by slower tax and earnings growth in the North East of Scotland – historically one of Scotland's most tax-rich regions – since 2015-16, linked to changes in oil and gas price.

[28] The Scottish Government (2021) The Scottish Government's Medium Term Financial Strategy - gov.scot (www.gov.scot); 4. Broad spending outlook - Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy - gov.scot (www.gov.scot) – December 2021

Trends in tax revenue per taxpayer across UK nations & regions

As shown in figure A1 below, the average level of Income Tax revenue raised per taxpayer (including on savings and dividends)[29] has been consistently higher in England than in Scotland, Wales and Northern Ireland.

Figure A. 1 : Average Income Tax Revenue per taxpayer across the UK

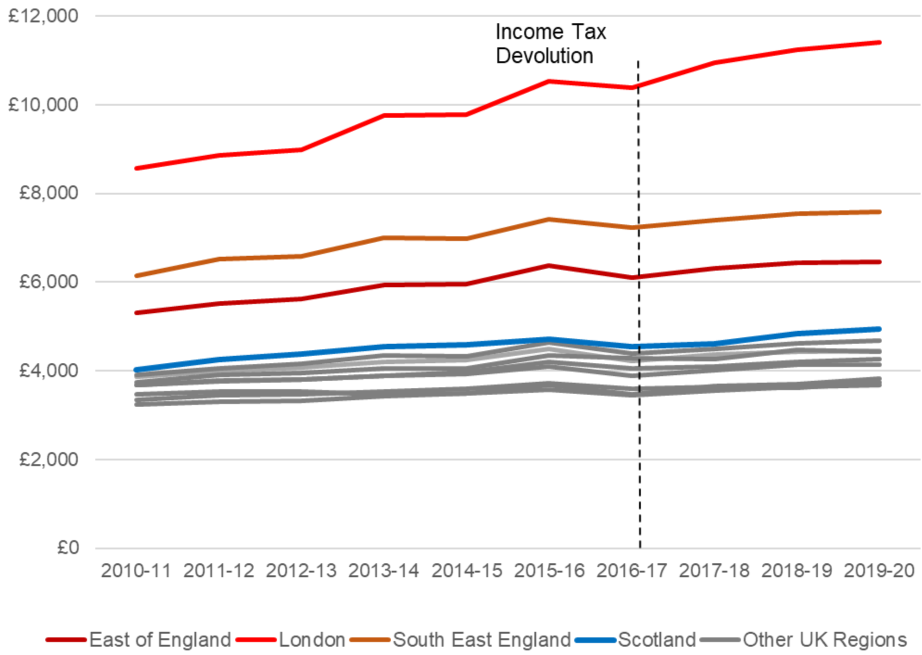


Source: SG analysis of Survey of Personal Income Statistics

However, this aggregated picture masks significant regional variation within England. In particular, London and the surrounding areas of the South East and East of England (which cumulatively account for around a third of the UK population) have significantly higher average levels of Income Tax revenue per taxpayer relative to elsewhere in the UK. When London and surrounding regions are excluded, Scotland has consistently raised more income tax revenue per taxpayer than other regions of the UK.

[29] The publicly available SPI tables from HMRC show estimates of regional Income Tax revenues (including savings and dividends) which is different from Non-Savings Non-Dividend Income Tax Liabilities that is currently devolved to the Scottish Parliament. However, both are likely to be highly correlated and influenced to similar degrees by factors such as economic performance and changes in policy. Consequently, analysing historic Income Tax revenues can still prove informative for the Scottish context. The latest available SPI data covers 2010-11 to 2019-20 and can be found here.

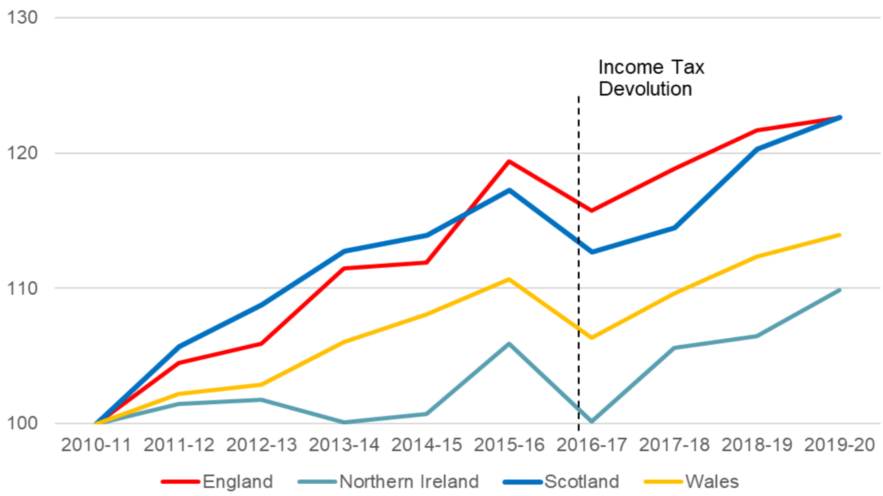
Figure A. 2 Average Income Tax Revenue per taxpayer by NUTS 1 Region



Source: SG analysis of Survey of Personal Income Statistics

As noted previously, it is the relative growth, rather than the relative level of tax raised that determines the Scottish Budget position. The Scottish Budget is affected by the relative growth in per person revenue since income tax powers were devolved in 2016-17. Figure A3 below shows that Scotland initially grew its tax revenues per taxpayer faster than the rUK, before experiencing weaker growth in 2015-16 to 2017-18. Scotland then had a relatively strong year in 2018-19 (when significant revenue raising policies were introduced).

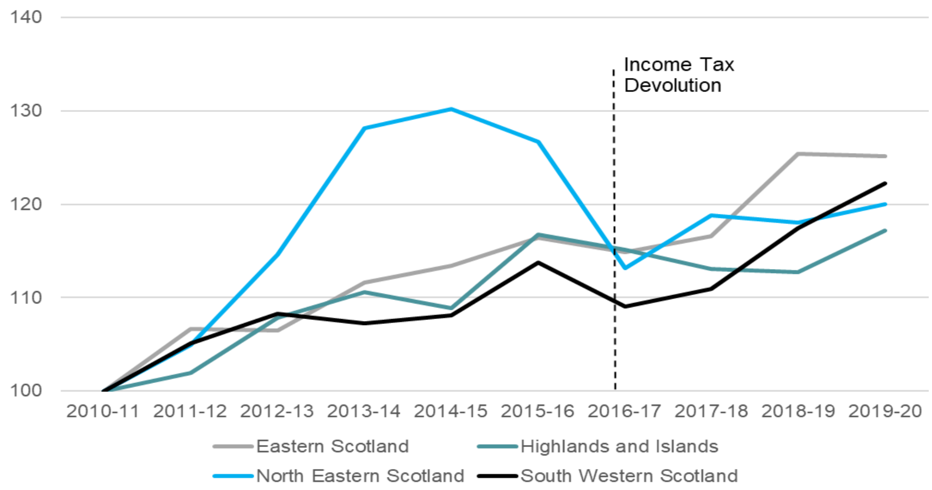
Figure A. 3 Index of Income Tax revenue per taxpayer by UK nation (2010-11 = 100)



Source: SG analysis of Survey of Personal Income Statistics

Looking at a further regional breakdown of the data in Scotland can help identify whether any particular trends over time are relatively widespread across the Scottish economy, or instead if there is evidence that one specific region has had a disproportionate impact on the national performance. As can be seen in Figure A4 below, there is evidence that most of the Scottish regions followed a broadly similar trend over time, with the exception of the North East which was a clear outlier in the early half of the decade.

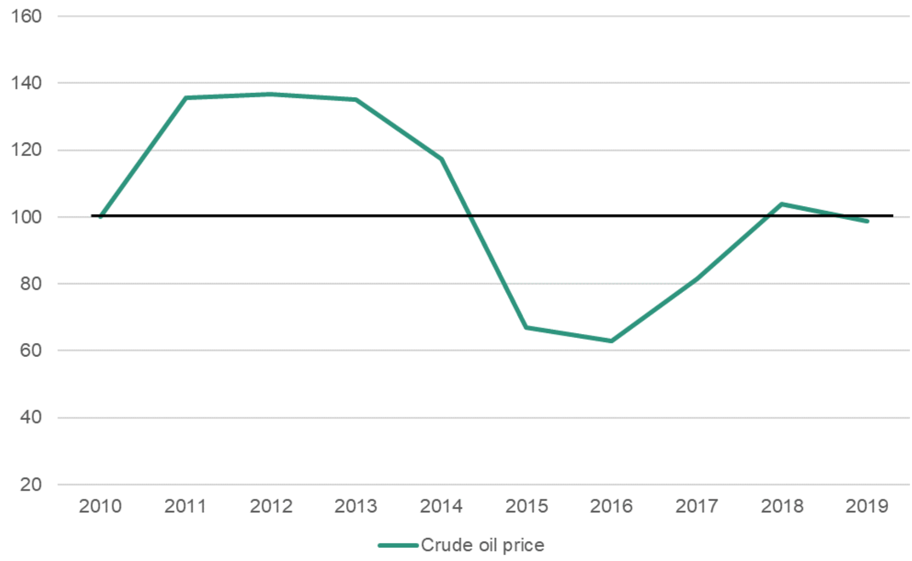
Figure A.4 Index of Income Tax revenue per taxpayer by Scottish NUTS 2 region (2010-11 = 100)



Source: SG analysis of Survey of Personal Income Statistics

The economic performance of the North East is heavily linked to the oil and gas sector in terms of firms working directly in the North Sea, but also via the significant onshore manufacturing and production supply chains and the wider economic spillovers into the regional economy. It is likely that the North East's strong performance before 2015-16 and then weaker performance after this is linked to oil and gas price fluctuations across the last decade, as can be seen in Figure A5.

Figure A.5 Index of Global Oil Price (2010- = 100)



Source: Oil and Petroleum Products Monthly Statistics, UK Gov [30]

Despite accounting for a relatively small proportion of overall taxpayers, there is evidence that the exceptional tax revenue growth witnessed in the region during the periods of high oil price, had a disproportionate effect on the Scottish tax base. In total, from 2010-11 to 2014-15, the North East of Scotland boosted the cumulative tax revenue per taxpayer growth in Scotland by around 3%.

Although relative changes in tax growth prior to 2016-17 do not impact the Scottish Budget position today, they demonstrate how fluctuations in a tax rich region such as the North East can disproportionately affect Income Tax receipt growth for Scotland as a whole.

The Survey of Personal Incomes (SPI) data referred to above provides evidence of the drivers of Scotland's Income Tax performance relative to the rUK, but a limitation is that it only covers up to 2019-20. It therefore excludes more recent performance, including the impact of the COVID-19 pandemic.

More recent evidence can be seen in the Real Time Information (RTI) Earnings and Employment data jointly published by HMRC and the ONS, based on earnings for employees who pay tax via the pay-as-you-earn (PAYE) system across the UK.[31] Although this data covers earnings, rather than Income Tax

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[30] UK Government (2022) Monthly and annual prices of road fuels and petroleum products - GOV.UK (www.gov.uk) – April 2022

[31] Note that PAYE RTI statistics do not cover other sources of income such as from pensions, self-employment or investments.

revenues or liabilities, it is much more timely, being released monthly, with the latest release at the time of writing covering March 2022.

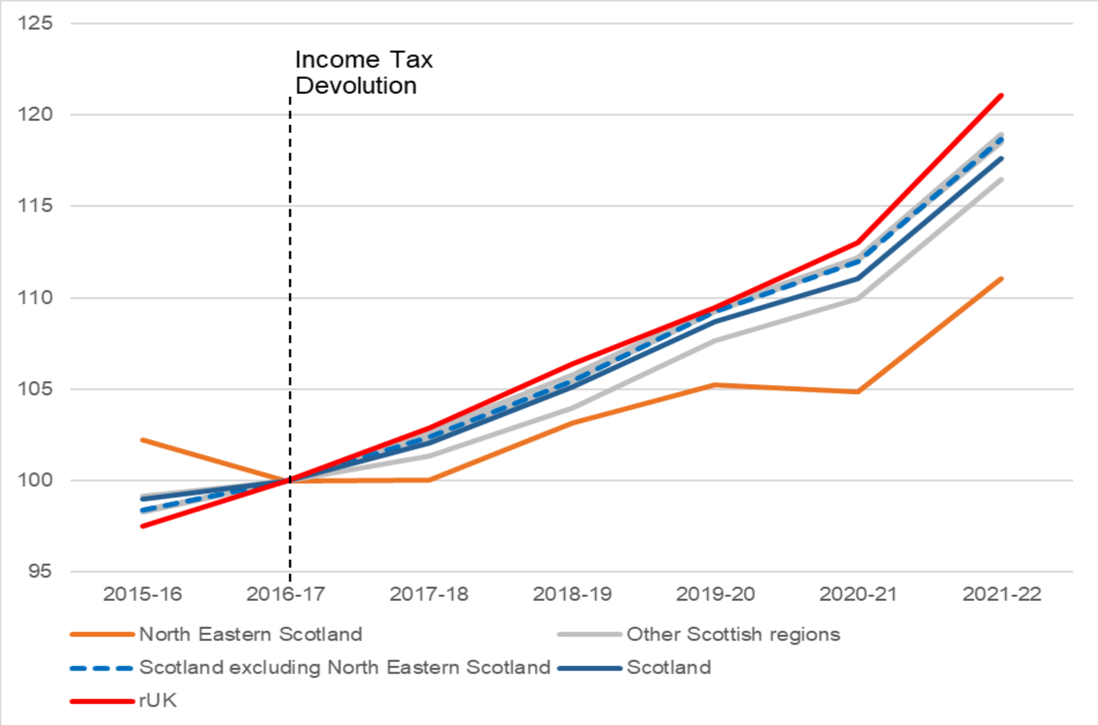
This data also heavily informs the SFC's Income Tax forecasts. Although average earnings growth isn't a perfect predictor of Income Tax receipt growth (due to the progressive nature of the tax system, and the disproportionate impact a relative small number of taxpayers at the very top of the income distribution can have) it is generally still an important factor in how the overall tax base is performing.

As can be seen in Figure A6 below, the RTI data shows that the level of average earnings has grown slower in Scotland relative to rUK since Income Tax devolution in 2016-17. However, the data also suggests that the continued impact of slower earnings growth in the North East accounts for a significant part of this.

For example, since July 2014, the North East of Scotland alone – which accounts for 9.4% of employees in the whole of Scotland–was responsible for around a third of the average earnings gap between Scotland and the rUK.

However, since December 2019, the North East has only explained 20% of the cumulative gap in average earnings growth between Scotland and rUK.

Figure A. 6 Index of the level of average earnings across areas of Scotland (2016/17 = 100)[32]

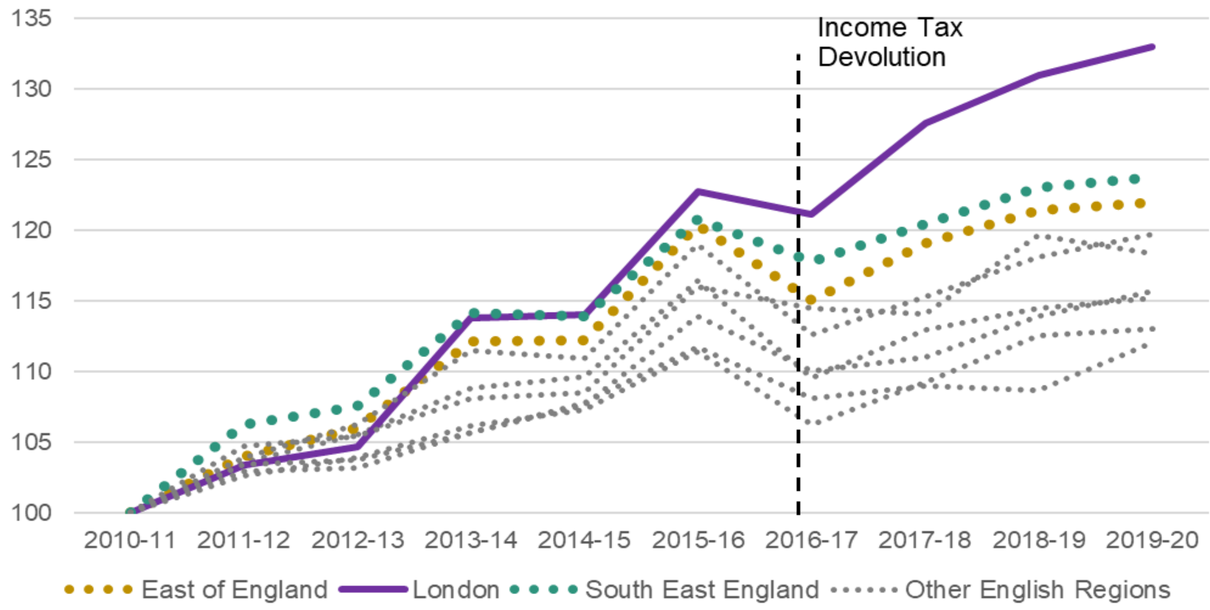


Source: SG analysis of earnings and employment from PAYE RTI

[32] The Scottish Government analysis of the RTI average pay data has been generated on a financial year basis from the monthly estimates. These results have been calculated as the total aggregate pay relative to the total number of employees for a given UK country, region or sector for each financial year.

The performance of the North East is therefore important, but only offers a partial explanation of the gap in relative average earnings performance between Scottish and rUK earnings over time. Figure A.7 below shows that amongst the English regions, Income Tax revenue per taxpayer growth in London (and the key London commuter belt in the East and South East) has been significantly higher across the past decade, particularly since 2016-17 when Income Tax devolution occurred.

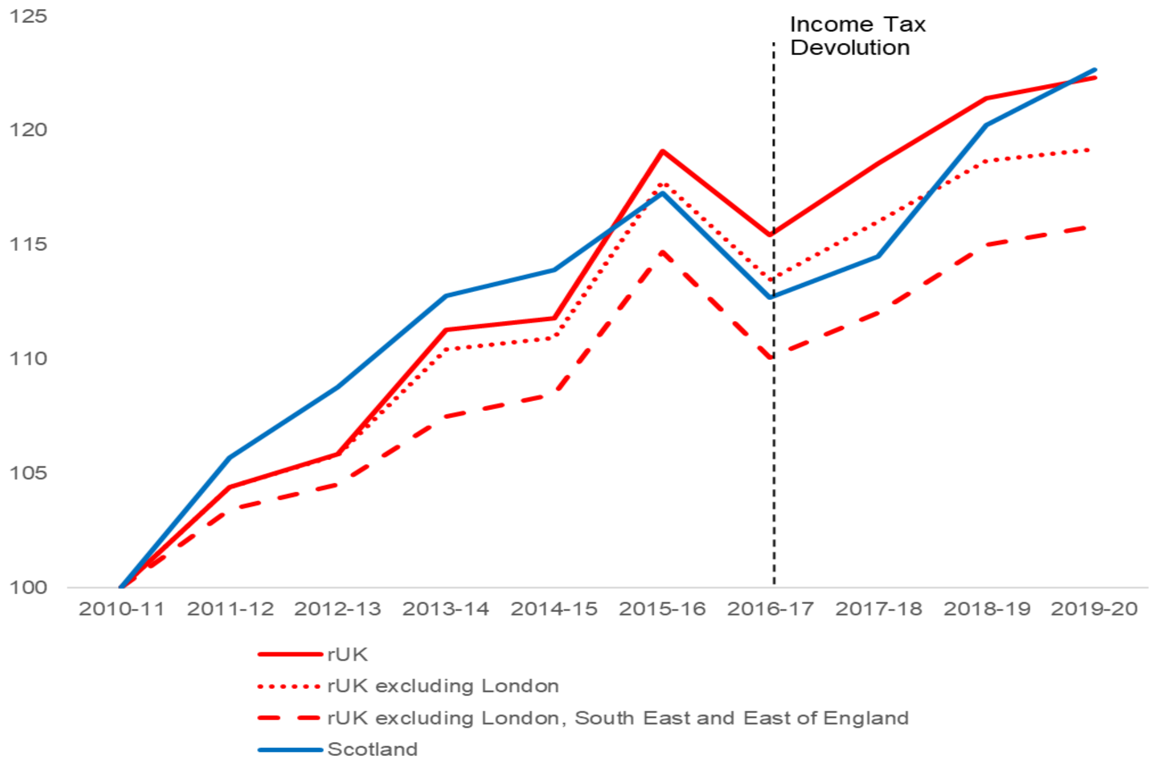
Figure A. 7 Index of Income Tax per taxpayer by region in England (2010-11 = 100)



Source: SG analysis Survey of Personal Income Statistics 2019-20

When comparing to the rUK, there is evidence that Scotland's average level of tax per taxpayer across the decade has cumulatively grown faster than that of the rUK by 2019-20 (albeit only by 0.3%, and likely significantly aided in the policy decisions made by the Scottish Government in 2018-19). However, the cumulative gap in tax raised per taxpayer relative to the rUK would have been higher at 3.5% excluding London; and 6.8% excluding London and the East and South East of England.

Figure A. 8 Tax revenue per taxpayer by UK nations (2010-11 = 100)

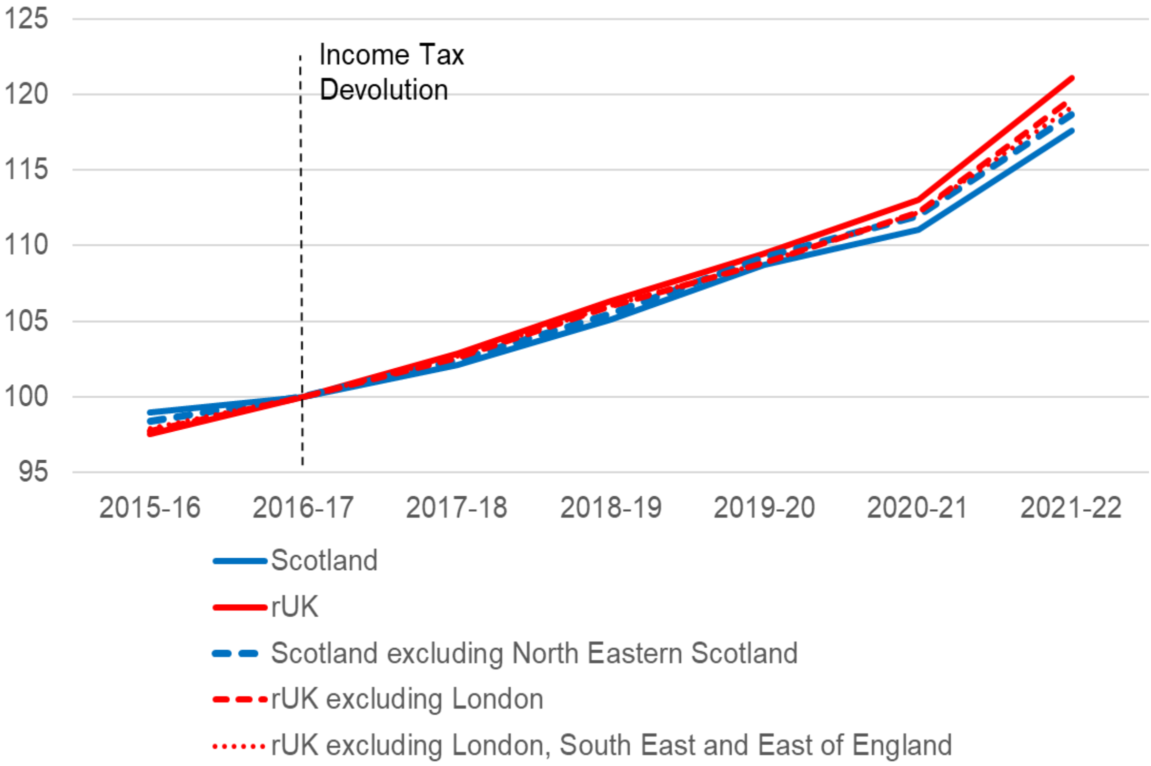


Source: SG analysis Survey of Personal Income Statistics 2019-20

This evidence suggests that London and the surrounding regions are having a major impact on rUK revenue growth, comparable to the disproportionate influence the North East has had on Scottish revenue growth.

There is also further evidence using the RTI earnings data. When London and the surrounding regions are excluded from the rUK, and the North east is excluded from Scotland, this eliminates most of the gap in average earnings growth between Scotland and rUK since 2016-17. This suggests that post-income tax devolution earnings growth has been similar across most of Scotland and rUK, with the North East of Scotland and London explaining the majority of the earnings divergence seen in the data.

Figure A. 9 Average earnings growth by UK nations 2016-2021 (2016-17=100)



Source: SG analysis of ONS earnings and employment from PAYE RTI

Understanding the link between inequality and tax revenue performance

Due to the progressive nature of the tax system, a relatively small number of taxpayers at the very top of the income distribution can have a disproportionate impact on both the amount of tax revenue raised in any one year and how overall tax revenue can grow from year to year.

The Institute for Fiscal Studies (IFS) has published various pieces of research exploring this dynamic. A recent study noted that 34% of total Income tax revenue across the UK in 2018-19 was paid for by the top earning 1% of taxpayers, with a further 34% paid for by those in the top 10% to 2% earning percentiles. [33]

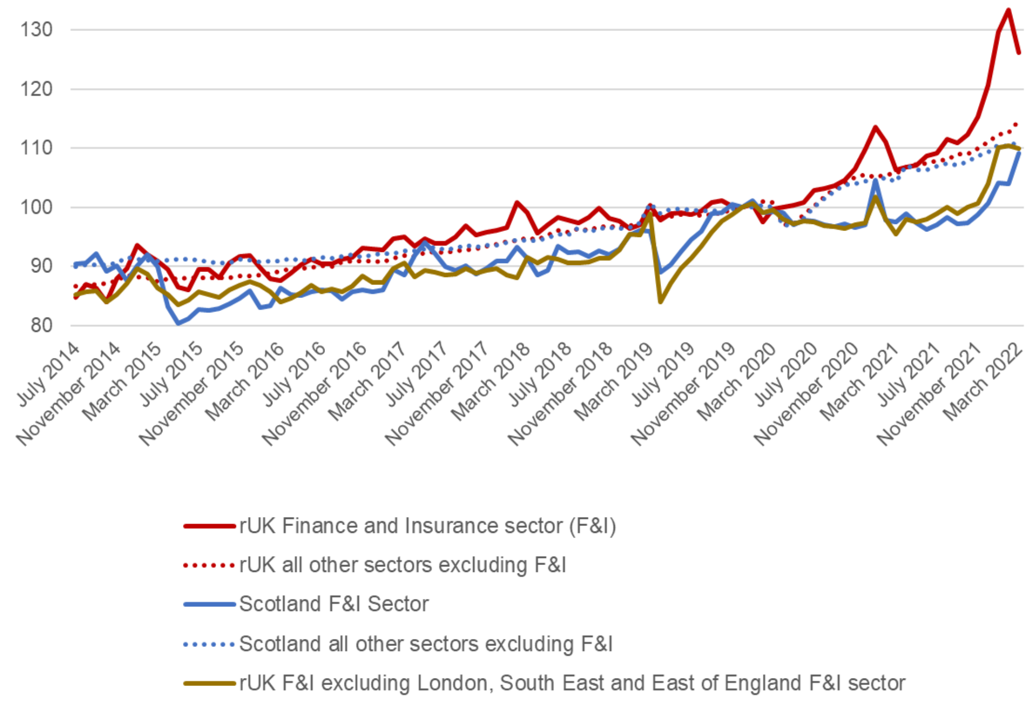
It also found that the top 1% of wage earners disproportionately work in the financial sector and are heavily geographically concentrated in London (which has around 40% of the UK's top 1% taxpayers), with a separate paper[34] by the IFS also noting that this geographical clustering in London has increased in intensity since 2000-01. They also found that in Scotland, only Aberdeen had the same density of top 1% taxpayers as some of the areas of London and the South East.

[33] IFS (2022), Top income inequality and tax policy (ifs.org.uk) – April 2022
[34] IFS(2019), BN253-Characteristics-and-Incomes-Of-The-Top-1%.pdf (ifs.org.uk) – August 2019

The RTI earnings data we have available also allows us to explore London's strong earnings performance. Analysing the sectoral trends in the London data suggests that the Finance and Insurance sector has had significantly higher earnings growth than other sectors in both Scotland and the rUK. This is particularly the case in the 2021 calendar year, where – as observed recently by the IFS[35] – Financial and Insurance sector pay growth has substantially outstripped the average of all other sectors, with much of that growth disproportionately concentrated in London.

For example, by the end of 2021, average earnings had grown by 14.8 percentage points more in the rUK Finance and Insurance sector than in the Scottish Finance and Insurance sector since December 2019. However, this is again almost entirely driven by London, the East and South East of England. As can be seen in Figure A.10 below, when they are excluded, the difference between average earnings growth in the Scottish and rUK Financial and Insurance sectors largely disappears.

Figure A10: Average nominal monthly pay for PAYE employees indexed to December 2019=100, Finance and Insurance (F&I) Sector and all sectors by rest of the UK and Scotland



Source: SG analysis of earnings and employment from PAYE RTI

There is also evidence that the London Finance and Insurance sector has a disproportionate impact on the average earnings growth across the entire rUK economy. For example, since the beginning of Income Tax devolution in April 2016, the Finance and Insurance sector in London, the South East and

[35] IFS (2022) Return of bumper pay growth in finance fuels new rise in earnings inequality - Institute For Fiscal Studies - IFS – May 2022

East of England alone – which accounts for only 2.1% of employees in the whole of the rUK – was responsible for 10% of the average earnings gap between Scotland and the rUK. The effect of this sector has been even stronger in past two years, explaining 29% of the average earnings gap between Scotland and rUK since December 2019.

As shown in figure A.9 previously, taken together the average earnings growth in the North East of Scotland and London and its surrounding regions appears to explain most of the recent gap in Scottish and rUK average earnings growth. Since income tax devolution in April 2016, the growth in these regions explains around two thirds of the gap that has emerged in average earnings growth. In more recent data, the impact is even greater, at just over two-fifths of the gap since December 2019. As noted above, there is evidence that a significant amount of this has been driven by the Finance and Insurance sector alone.

When tax data becomes available, we could see the strong growth in the Financial and Insurance sector earnings having a disproportionate impact on rUK tax revenues. Due to the progressive nature of the income tax system, higher paid individuals pay a greater share of their total income in tax. Given the evidence examined in this annex, there is a risk that strong earnings growth in highly paid professions in London and the South East and East of England could disproportionately drive strong growth in per capita rUK tax revenue, which would in turn hurt Scotland's budget position via the current fiscal framework.

Conclusion

This annex has used publicly available tax and earnings data over the last decade to examine regional and sectoral trends in Scotland and the rUK.

Although there are various factors that influence the relative growth in income tax revenue between Scotland and rUK, there is evidence that the influence of individual sectors and regions of the Scottish and rUK economies have had, and could continue to have, a disproportionate impact on the performance of the relative tax bases over time.

There is also increasing evidence that, due to the progressive nature of the tax system and the disproportionate influence a relatively small number of taxpayers in Scotland and the rUK can have, understanding and monitoring particularly high earning sectors such as the Oil and Gas industry, or Finance, is important in explaining the relative performance of the Scottish and rUK tax bases.

There is evidence that post-Income Tax devolution differences in the growth rates of income tax paid per taxpayer (up to 2019-20) and average PAYE earnings growth (up to 2022) between Scotland and rUK can be attributed to a relative weakness in the North East of Scotland, contrasted with a strong earnings performance in London and the East and South East of England. This evidence is corroborated by the Scottish Fiscal Commission analysis in Box 3.2 of the May 2022 Forecast Evaluation Report, which will be published alongside this MTFS.

Annex B: Fiscal Framework

This Annex sets out the implications of the Fiscal Framework for the Scottish Budget. The Fiscal Framework Technical Note sets out more detail on how the Fiscal Framework operates including the evolution of the fiscal powers of the Scottish Parliament, the timelines for reconciliations and how they affect the Scottish Budget, the limits of the borrowing powers and Scotland Reserve, and the Fiscal Framework Review.[36]

This Annex details the latest BGAs published alongside the UK Spring Statement 2022. The latest SFC revenue and expenditure forecasts have been published alongside this Medium-Term Financial Strategy.

Tax

Table B.1 shows the latest forecasts for tax revenues from the SFC and the latest BGA estimates following the UK Spring Statement 2022.

Table B. 1 : Forecasts of tax revenues and Block Grant adjustments (£ million)

		2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Income Tax	Revenue	12,118	13,342	14,386	15,143	15,954	16,754	17,484	18,298
	BGA[1]	-12,293	-13,684	-14,813	-15,502	-15,883	-16,737	-17,534	N/A
	Difference	**-175**	**-342**	**-428**	**-359**	**71**	**18**	**-50**	**N/A**
LBTT[2]	Revenue	517	799	797	821	849	886	932	987
	BGA[1]	-397	-651	-716	-741	-772	-807	-854	N/A
	Difference	**121**	**148**	**81**	**80**	**77**	**79**	**78**	**N/A**
SLfT[2]	Revenue	107	128	121	95	94	75	16	17
	BGA[1]	-87	-86	-81	-81	-75	-69	-76	N/A
	Difference	**20**	**41**	**41**	**14**	**19**	**6**	**-59**	**N/A**
Total	Revenue	12,742	14,269	15,304	16,058	16,897	17,716	18,433	19,303
	BGA[1]	-12,776	-14,421	-15,610	-16,324	-16,730	-17,612	-18,464	N/A
	Difference	**-35**	**-153**	**-306**	**-265**	**167**	**103**	**-31**	**N/A**

Note 1: The BGAs shown are calculated using the Indexed Per Capita (IPC) indexation method. This method in practice determines the BGAs applied to the budget.

Note 2: The 2020-21 LBTT and SLfT revenue and Block Grant Adjustment are outturn figures.

Figures may not sum due to rounding.

[36] Scottish Government (2021), Fiscal framework: factsheet - November 2021

Forecasts of future years provide an indication of the level of revenues that the SFC anticipates, but these figures will not be used to set future budgets, which will draw upon updated SFC forecasts.

Social Security

Table B.2 shows the SFC's latest expenditure forecasts for social security benefits and the latest BGA estimates following the UK Spring Statement 2022 with the exception of the BGA for the Winter Fuel Payment. As executive competence for this is benefit is yet to be transferred to the Scottish Government, the OBR has not yet produced a forecast to inform the BGA. For the purposes of the MTFS, the Scottish Government have forecast the expected BGA. This will be updated following publication of OBR forecasts of Winter Fuel Payment expenditure, broken down by territory, when available

Table B. 2: forecasts of social security expenditure and block grant adjustments (£ million)

		2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Attendance Allowance	Expenditure	-521	-539	-591	-642	-691	-728	-764
	BGA[1]	515	539	594	626	649	672	N/A
	Difference	**-6**	**-1**	**3**	**-17**	**-41**	**-56**	**N/A**
Adult Disability Payment [2]	Expenditure	-1,754	-2,044	-2,579	-2,921	-3,196	-3,484	-3,783
	BGA[1]	1,726	1,953	2,298	2,566	2,799	3,014	N/A
	Difference	**-28**	**-90**	**-280**	**-355**	**-396**	**-469**	**N/A**
Disability Living Allowance	Expenditure	-701	-714	-744	-738	-720	-705	-684
	BGA[1]	701	698	732	713	677	682	N/A
	Difference	**0**	**-16**	**-12**	**-25**	**-43**	**-22**	**N/A**
Carer's Allowance [3]	Expenditure	-300	-321	-366	-424	-486	-540	-571
	BGA[1]	293	318	362	393	423	459	N/A
	Difference	**-7**	**-3**	**-4**	**-31**	**-63**	**-80**	**N/A**
Industrial Injuries Disablement Scheme	Expenditure	-80	-80	-83	-84	-83	-83	-83
	BGA[1]	79	79	83	82	80	79	N/A
	Difference	**-1**	**-1**	**-1**	**-1**	**-2**	**-5**	**N/A**
Severe Disablement Allowance	Expenditure	-7	-6	-6	-5	-5	-4	-4
	BGA[1]	7	6	6	5	5	4	N/A
	Difference	**0**	**0**	**0**	**0**	**0**	**0**	**N/A**
	Expenditure	N/A	-20	-20	-20	-20	-20	-20
	BGA[1]	N/A	8	8	7	7	7	N/A

Cold Weather Payment	**Difference**	**N/A**	**-13**	**-13**	**-13**	**-13**	**-13**	**N/A**
Winter Fuel Payment	Expenditure	N/A	N/A	N/A	-184	-189	-191	-190
	BGA[1]	N/A	N/A	N/A	181	184	185	N/A
	Difference	**N/A**	**N/A**	**N/A**	**-3**	**-5**	**-6**	**N/A**
TOTAL SS	Expenditure	-3,363	-3,725	-4,389	-5,019	-5,388	-5,754	-6,100
	BGA[1]	3,320	3,602	4,082	4,574	4,825	5,103	N/A
	Difference	**-42**	**-123**	**-307**	**-446**	**-563**	**-651**	**N/A**

Note 1: The BGAs shown are calculated using the Indexed Per Capita (IPC) indexation method. This method in practice determines the BGAs applied to the budget.
Note 2: Adult Disability Payment and Low Income Winter Heating Assistance are the replacement benefits for Personal Independence Payment and Cold Weather Payment respectively.
Note 3: Carer's Allowance Expenditure Forecast does not include Carer's Allowance Supplement (CAS) expenditure, whereas the Scottish Fiscal Commission includes CAS as part of Carer's Allowance expenditure.
Note 4: There are minor differences in the methodology used to calculate the SFC's spending forecasts and the BGA forecasts, which are based on expenditure outturn and OBR forecasts, so comparisons should be interpreted with caution.
Figures may not sum due to rounding.

Benefits Yet to Commence

Responsibility for Winter Fuel Payment has yet to be transferred to the Scottish Government and therefore these payments will not be funded from within the Scottish Budget until executive competence is transferred. The Department for Work and Pensions will continue to make these payments to people in Scotland for winter 2022-23.

Reconciliations and implications for the Scottish Budget

The forecasts for Scottish tax revenues and social security expenditure, and the corresponding BGAs, are based on the latest available information at the time of the Budget. Once outturn data are available, reconciliations are made to the Scottish Budget to ensure that the funding available ultimately corresponds to actual revenues and the BGAs based on the outturn data.

Reconciliations are made for both the revenues and the BGA for Income Tax. For Fully Devolved Taxes (LBTT and Scottish Landfill Tax), Social Security, and Non-Tax Revenues (Fines, Forfeitures and Fixed Penalties - FFFP), reconciliations are only made to the BGA element of funding.

In relation to Income Tax, a reconciliation for both revenues and the BGA for the 2020-21 financial year will be calculated when outturn data are available in summer 2022 and applied to the Scottish Budget 2023-24. The updated forecasts for 2020-21, 2021-22 and 2022-23 do not have any immediate impact on the Scottish Budget. Under the Fiscal Framework, a single reconciliation takes place three years after the original Budget was set and the updated forecasts in the interim have no direct impact.

In relation to the Fully Devolved Taxes, Social Security benefits and FFFP, final reconciliations for the BGAs for the 2021-22 financial year will be calculated when outturn is available later this year and applied to the Scottish Budget 2023-24.

The Fully Devolved Taxes and Social Security BGAs are also subject to an additional in-year reconciliation which takes place within each financial year, based on the OBR forecasts produced alongside a UK Government fiscal event in the autumn. There is no in-year reconciliation for FFFP.

Income Tax

For Scottish Income Tax, outturn data are normally available around 16 months after the end of the financial year. Given this long lag of availability of outturn data, the Income Tax revenue and BGA are fixed for three years from the time the Budget is set. A single reconciliation is then applied to the Budget three financial years after the Budget is set, e.g the reconciliation for 2019-20 Income Tax was applied to the 2022-23 budget. Outturn data for 2020-21 Income Tax is due to be published in Summer 2022, which will allow the Scottish and UK Governments to calculate and agree the final 2020-21 Income Tax reconciliation, which will be applied to the Scottish Budget 2023-24.

Table B.3 shows the latest forecast 2020-21 Income Tax reconciliation is negative £221 million. The final position will not be known until outturn receipts are available in summer 2022.

Table B. 3: Forecast income tax reconciliation applying to 2023-24 budget (£ million)

2020-21 Income Tax	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2020-21	12,365	-12,319	+46	
Outturn	12,118	-12,293	-175	-221
Outturn against forecast	-247	+26		

Figures may not sum due to rounding.

The potential scale of the reconciliations applying to the 2024-25 and 2025-26 Budgets are shown in tables B.4 and B.5 using the latest forecasts.

Table B. 4: Forecast income tax reconciliation applying to 2024-25 budget (£ million)

2021-22 Income Tax	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2021-22	12,263	-11,788	+475	
Latest forecast	13,342	-13,684	-342	-817
Change	**+1,078**	**-1,896**		

Figures may not sum due to rounding.

Table B. 5: forecast income tax reconciliation applying to 2025-26 budget (£ million)

2022-23 Income Tax	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2022-23	13,671	-13,861	-190	
Latest forecast	14,386	-14,813	-428	-238
Change	+715	-952		

Figures may not sum due to rounding.

Based on the latest forecasts, the reconciliation to the Scottish Budget 2024-25 for 2021-22 Income Tax is forecast to be negative £817 million.. A reconciliation of negative £238 million is expected to apply to the Scottish Budget 2025-26 to account for 2022-23 Income Tax.

However, these forecasts are not certain and the final position will not be known for sure until outturn receipts are available for 2021-22 in summer 2023, and for 2022-23 in summer 2024.

Fully Devolved Taxes

Revenue Scotland manages and collects Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) and these revenue streams feed in to the Scottish Budget as they are collected. There is no reconciliation required for these revenues; the Scottish Government manages any variance between what was forecast and actual revenues as part of its in-year budget management process. The latest 2022-23 revenue forecasts for LBTT and SLfT and the previous revenue forecasts are shown in table B.6.

Table B. 6: 2022-23 Revenue Forecast (£ million)

LBTT	SFC Revenue Forecast – Budget 2022-23	749
	SFC Revenue Forecast – MTFS 2022	797
	Change	**+48**
SLfT	SFC Revenue Forecast – Budget 2022-23	101
	SFC Revenue Forecast – MTFS 2022	121
	Change	**+21**

Figures may not sum due to rounding.

The BGAs for these taxes are reconciled in two stages. An in-year reconciliation is made within the same financial year. This is usually on the basis of OBR forecasts produced alongside the UK Autumn Budget. The forecast in-year reconciliations for 2022-23 LBTT and SLfT are shown in table B.7.

Table B. 7: 2022-23 forecast in-year BGA reconciliations (£ million)

LBTT	Forecast BGA – UK Budget October 2021	-664
	Forecast BGA – UK Spring Statement 2022	-716
	Forecast In-year reconciliation to 2022-23 Budget	**-53**
SLfT	Forecast BGA – UK Budget October 2021	-82
	Forecast BGA – UK Spring Statement 2022	-81
	Forecast In-year reconciliation to 2022-23 Budget	**+2**

Figures may not sum due to rounding.

As set out in table B.8, the forecast net effect on the Scottish Budget 2022-23 of the latest fully devolved revenue forecasts, when compared to the forecast in-year BGA reconciliations, is positive £17 million, (comprising negative £5 million for LBTT and positive £22 million for SLfT).

Table B. 8: change in net position for 2022-23 Scottish Budget (£ million)

Fully Devolved Tax	Forecast In-Year BGA Reconciliation	Change in SFC revenue forecast from Scottish Budget 2022-23	Forecast Net Position
LBTT	-53	48	-5
SLfT	2	21	+22
TOTAL	**-51**	**+68**	**+17**

Figures may not sum due to rounding

Outturn data becomes available in the autumn following the end of each financial year. Using these outturn figures, a final reconciliation will be applied to the Block Grant in the financial year two years after the Budget was set. Table B.9 shows the forecast final reconciliations for 2021-22 LBTT and SLfT BGAs applying to the 2023-24 Scottish Budget.

Table B. 9: 2021-22 forecast final BGA reconciliation (£ million)

LBTT	Forecast BGA – UK Budget October 2021	-620
	Forecast BGA – UK Spring Statement 2022	-651
	Forecast Reconciliation to 2023-24 Budget	**-32**
SLfT	Forecast BGA – UK Budget October 2021	-90
	Forecast BGA – UK Spring Statement 2022	-86
	Forecast Reconciliation to 2023-24 Budget	**+3**

Note 1: Ultimately, the final BGA reconciliation will calculate the difference between the in-year forecast of the BGA (used to calculate the in-year reconciliation) and the outturn data (when available).
Figures may not sum due to rounding.

Table B.10 shows the forecast net effect on the budget for 2021-22 LBTT and SLfT by comparing the latest forecast revenues and BGAs to the forecast revenues and BGAs set at the time of the Scottish Budget 2021-22. The final net position will not be confirmed until final outturn is published later in the year.

Table B. 10: Latest forecast net position for 2021-22 LBTT and SLFT (£ million)

		Revenues	BGA	Net Position
LBTT	Forecast as of Budget 2021-22	586	-515	+71
	Latest Forecast – MTFS 2022	799	-651	+148
	Latest Forecast Net Position	**213**	**-136**	**+77**
SLfT	Forecast as of Budget 2021-22	88	-95	-7
	Latest Forecast – MTFS 2022	128	-86	+41
	Latest Forecast Net Position	**+40**	**+9**	**+48**

Figures may not sum due to rounding.

Social Security

The latest 2022-23 expenditure forecasts for Social Security and the previous expenditure forecasts are shown in table B.11.

Table B. 11: 2022-23 Expenditure Forecast (£ million)

Attendance Allowance	SFC Expenditure Forecast – Budget 2022-23	-545
	SFC Expenditure Forecast – MTFS 2022	-539
	Change	**+5**
Adult Disability Payment	SFC Expenditure Forecast – Budget 2022-23	-1948
	SFC Expenditure Forecast – MTFS 2022	-2044
	Change	**-95**
Disability Living Allowance	SFC Expenditure Forecast – Budget 2022-23	-710
	SFC Expenditure Forecast – MTFS 2022	-714
	Change	**-4**
Carer's Allowance[1]	SFC Expenditure Forecast – Budget 2022-23	-315
	SFC Expenditure Forecast – MTFS 2022	-321
	Change	**-6**
Industrial Injuries Disablement Scheme	SFC Expenditure Forecast – Budget 2022-23	-81
	SFC Expenditure Forecast – MTFS 2022	-80
	Change	**+0**
Severe Disablement Allowance	SFC Expenditure Forecast – Budget 2022-23	-6
	SFC Expenditure Forecast – MTFS 2022	-6
	Change	**+0**
Low Income Winter Heating Assistance	SFC Expenditure Forecast – Budget 2022-23	-21
	SFC Expenditure Forecast – MTFS 2022	-20
	Change	**+1**
Total Social Security	SFC Expenditure Forecast – Budget 2022-23	-3,626
	SFC Expenditure Forecast – MTFS 2022	-3,725
	Change	**-99**

Note 1: Carer's Allowance Expenditure Forecasts do not include Carer's Allowance Supplement (CAS) expenditure, whereas the Scottish Fiscal Commission includes CAS as part of Carer's Allowance Expenditure.
Note 2: Adult Disability Payment and Low Income Winter Heating Assistance are the replacement benefits for Personal Independence Payment and Cold Weather Payment respectively.
Figures may not sum due to rounding.

As with the fully devolved taxes, the BGAs for benefits are reconciled in two stages. An in-year reconciliation is made within the same financial year. This is usually on the basis of OBR forecasts produced alongside the UK Autumn Budget. The forecast in-year reconciliations to the 2022-23 Social Security BGAs are shown in table B.12.

Table B. 12: 2022-23 forecast in-year BGA reconciliation (£ million)

Attendance Allowance	Forecast BGA – UK Budget October 2021	545
	Forecast BGA – UK Spring Statement 2022	539
	Forecast In-year reconciliation to 2022-23 Budget	**-6**
Personal Independence Payment	Forecast BGA – UK Budget October 2021	1,933
	Forecast BGA – UK Spring Statement 2022	1,953
	Forecast In-year reconciliation to 2022-23 Budget	**+20**
Disability Living Allowance	Forecast BGA – UK Budget October 2021	687
	Forecast BGA – UK Spring Statement 2022	698
	Forecast In-year reconciliation to 2022-23 Budget	**+11**
Carer's Allowance[1]	Forecast BGA – UK Budget October 2021	323
	Forecast BGA – UK Spring Statement 2022	318
	Forecast In-year reconciliation to 2022-23 Budget	**-5**
Industrial Injuries Disablement Scheme	Forecast BGA – UK Budget October 2021	79
	Forecast BGA – UK Spring Statement 2022	79
	Forecast In-year reconciliation to 2022-23 Budget	**+0**
Severe Disablement Allowance	Forecast BGA – UK Budget October 2021	6
	Forecast BGA – UK Spring Statement 2022	6
	Forecast In-year reconciliation to 2022-23 Budget	**+0**
Low Income Winter Heating Assistance	Forecast BGA – UK Budget October 2021	14
	Forecast BGA – UK Spring Statement 2022	8
	Forecast In-year reconciliation to 2022-23 Budget	**-7**
Total social security	Forecast BGA – UK Budget October 2021	3,587
	Forecast BGA – UK Spring Statement 2022	3,602
	Forecast In-year reconciliation to 2022-23 Budget	**+14**

Note 1: Carer's Allowance Expenditure Forecasts do not include Carer's Allowance Supplement (CAS) expenditure, whereas the Scottish Fiscal Commission includes CAS as part of Carer's Allowance Expenditure.
Note 2: Adult Disability Payment and Low Income Winter Heating Assistance are the replacement benefits for Personal Independence Payment and Cold Weather Payment respectively.
Figures may not sum due to rounding.

Table B.13 sets out the net effect on the Scottish Budget 2022-23 of the latest total devolved social security expenditure forecasts when compared to the total forecast in-year BGA reconciliations, is negative £85 million.

Table B. 13: change in net position for 2022-23 Scottish Budget (£ million)

	Forecast In-Year BGA Reconciliation	Change in SFC expenditure forecast from 2022-23 Scottish Budget	Net Position
Total social security benefits with a BGA[1]	+14	-99	-85

1) Carer's Allowance, Attendance Allowance, Child Disability Payment, Disability Living Allowance, Adult Disability Payment, Industrial Injuries Disablement Allowance, Severe Disability Allowance, Cold Weather Payment
Figures may not sum due to rounding

Outturn data becomes available in the autumn following the end of each financial year. Using these outturn figures, a final reconciliation is applied to the Block Grant in the financial year two years after the Budget was set. Table B.14 shows the forecast final reconciliation for the 2021-22 Social Security BGAs applying to the 2023-24 Scottish Budget.

Table B. 14: Forecast social security 2021-22 final BGA reconciliation (£ million)

Attendance Allowance	Forecast BGA – UK Budget October 2021	521
	Forecast BGA – UK Spring Statement 2022	515
	Forecast Reconciliation to 2023-24 Budget[1]	**-7**
Adult Disability Payment	Forecast BGA – UK Budget October 2021	1,723
	Forecast BGA – UK Spring Statement 2022	1,726
	Forecast Reconciliation to 2023-24 Budget	**+2**
Disability Living Allowance	Forecast BGA – UK Budget October 2021	687
	Forecast BGA – UK Spring Statement 2022	701
	Forecast Reconciliation to 2023-24 Budget	**+14**
Carer's Allowance[1]	Forecast BGA – UK Budget October 2021	295
	Forecast BGA – UK Spring Statement 2022	293
	Forecast Reconciliation to 2023-24 Budget	**-2**
Industrial Injuries	Forecast BGA – UK Budget October 2021	79

Disablement Scheme		
	Forecast BGA – UK Spring Statement 2022	79
	Forecast Reconciliation to 2023-24 Budget	**0**
Severe Disablement Allowance	Forecast BGA – UK Budget October 2021	7
	Forecast BGA – UK Spring Statement 2022	7
	Forecast Reconciliation to 2023-24 Budget	**0**
Total Social Security	Forecast BGA – UK Budget October 2021	3,313
	Forecast BGA – UK Spring Statement 2022	3,320
	Forecast Reconciliation to 2023-24 Budget	**+8**

Note 1: Carer's Allowance Expenditure Forecasts do not include Carer's Allowance Supplement (CAS) expenditure, whereas the Scottish Fiscal Commission includes CAS as part of Carer's Allowance Expenditure.
Note 2: Adult Disability Payment is the replacement benefit for Personal Independence Payment.
Note 3: Ultimately, the final BGA reconciliation will calculate the difference between the in-year forecast of the BGA (used to calculate the in-year reconciliation) and the outturn data (when available).
Figures may not sum due to rounding.

Table B.15 shows the forecast net effect on the budget for 2021-22 Social Security benefits by comparing the latest forecast expenditure and BGAs to the forecast expenditure and BGAs set at the time of the Scottish Budget 2021-22. The final net position will not be confirmed until final outturn is published later in the year.

Table B. 15: Latest forecast net position for 2021-22 social security expenditure (£ million)

		Expenditure	BGA	Net Position
Attendance Allowance	Forecast as of Budget 2021-22	-550	546	-3
	Latest Forecast – MTFS 2022	-521	515	-6
	Latest Forecast Net Position	**+29**	**-32**	**-3**
Adult Disability Payment	Forecast as of Budget 2021-22	-1,669	1,682	+12
	Latest Forecast – MTFS 2022	-1,754	1,726	-28
	Latest Forecast Net Position	**-85**	**+44**	**-40**
Disability Living Allowance	Forecast as of Budget 2021-22	-696	685	-11
	Latest Forecast – MTFS 2022	-701	701	-0

	Latest Forecast Net Position	**-6**	**+17**	**+11**
Carer's Allowance[1]	Forecast as of Budget 2021-22	-306	309	+3
	Latest Forecast – MTFS 2022	-300	293	-7
	Latest Forecast Net Position	**+6**	**-16**	**-9**
Industrial Injuries Disablement Scheme	Forecast as of Budget 2021-22	-80	81	+1
	Latest Forecast – MTFS 2022	-80	79	-1
	Latest Forecast Net Position	**+0**	**-2**	**-2**
Severe Disablement Allowance	Forecast as of Budget 2021-22	-7	7	+1
	Latest Forecast – MTFS 2022	-7	7	-0
	Latest Forecast Net Position	**+0**	**-1**	**-1**
Total Social Security	Forecast as of Budget 2021-22	-3,308	3,310	+1
	Latest Forecast – MTFS 2022	-3,363	3,320	-42
	Latest Forecast Net Position	**-55**	**+11**	**-44**

Figures may not sum due to rounding.
Note 1: Carer's Allowance Expenditure Forecasts do not include Carer's Allowance Supplement (CAS) expenditure, whereas the Scottish Fiscal Commission includes CAS as part of Carer's Allowance Expenditure.
Note 2: Adult Disability Payment is the replacement benefit for Personal Independence Payment.
Note 3: There are minor differences in the methodology used to calculate the SFC's spending forecasts and the BGA forecasts, which are based on expenditure outturn and OBR forecasts, so comparisons should be interpreted with caution

Non-Tax revenue

Fines, Forfeitures and Fixed Penalties

Revenue from Fines, Forfeitures and Fixed Penalties (FFFP) is paid into the Scottish Consolidated Fund after being collected by the Scottish Courts and Tribunals Service. No reconciliation takes place for revenue, as the Scottish Government deals with any variation between forecast and receipts through in-year budget management. The SFC does not provide revenue forecasts for FFFP and instead the Scottish Government calculates its own estimates.

The latest Scottish Government 2022-23 revenue forecast for FFFP and the previous revenue forecasts are shown in Table B.16.

Table B. 16: 2022-23 Revenue Forecast (£ million)

FFFP	SG Revenue Forecast – Budget 2022-23	25
	SG Revenue Forecast – MTFS 2022	25
	Change	**0**

Figures may not sum due to rounding.

Unlike the devolved taxes, there is only one reconciliation for the BGA. Outturn data are normally available three months after the end of the financial year, and the reconciliation is applied to the Block Grant for the financial year thereafter (i.e. two years after the Budget was set).

Table B.17 shows the forecast final reconciliation for the 2020-21 FFFP BGA applying to the 2022-23 Scottish Budget.

Table B. 17: 2021-22 forecast final BGA reconciliation (£ million)

FFFP	Forecast BGA – Budget 2021-22	-28
	Forecast BGA – UK Spring Statement 2022	-28
	Forecast Reconciliation to 2023-24 Budget	**0**

Figures may not sum due to rounding.

Table B.18 shows the forecast net effect on the budget for 2021-22 FFFP by comparing the latest forecast expenditure and BGAs to the forecast expenditure and BGAs set at the time of the Scottish Budget 2021-22. The final net position will not be confirmed until final outturn is published later in the year.

Table B. 18: Latest Forecast Net Position for 2021-22 FFFP (£ million)

		Revenues	BGA	Net Position
FFFP	Forecast as of Budget 2021-22	25	-28	-3
	Latest Forecast – MTFS 2022	21	-28	-7
	Latest Forecast Net Position	**-4**	**-0**	**-4**

Figures may not sum due to rounding.

Proceeds of Crime

Revenue seized under the Proceeds of Crime Act 2002 is also subject to a BGA. The basis on which this is carried out is currently the subject of dispute between the Scottish and UK Governments and the BGA remains at -£4m while the dispute remains unresolved.[37] The Scottish and UK Governments agreed to consider this issue as part of the review of the Fiscal Framework.

[37] See the Fiscal Framework outturn report 2019 for further background.

Outturn revenue for 2021-22 Proceeds of Crime will be published in winter 2022. The Scottish Government receives all revenues recovered under the Proceeds of Crime Act, however, outturn revenues are hypothecated for spend on community projects.[38] Due to this hypothecation of funds and the negative £4 million BGA, the net position for the Scottish Budget is negative £4 million while this BGA remains in force.

No reconciliation takes place while the BGA remains the subject of dispute between the Scottish and UK Governments.

Sources of Data

To view the various sources of data for Tax and Social Security that have been used to compile this Annex B, please see the data annex in the Fiscal Framework factsheet.[39]

Capital Borrowing

Chapter 4 sets out the Scottish Government's revised capital borrowing policy which is to assume £450 million of annual funding will be available through borrowing, the Scotland Reserve and Barnett consequentials. Of this £250 million will initially be assumed to be capital borrowing.

On the basis of existing and planned borrowing included in the table, the Scottish Government will have accumulated £1.976 billion in capital debt by the end of 2022-23, 71% of its overall limit. Based on the analysis in Table B.19, which assumes the £250 million borrowed annually is on a 15 year tenor, this policy can be sustained well beyond 2030-31 without exceeding the £3 billion limit imposed by the fiscal framework.

[38] Further information can be found at the Cashback for Communities website

[39] Scottish Government (2021), Fiscal framework: factsheet - gov.scot (www.gov.scot) – December 2021

Table B.19: Capital borrowing and repayment schedule (£ million)

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
Debt Stock at the start of the Year	606	1,036	1,258	1,617	1,744	1,814	1,976	2,128	2,266	2,389	2,498	2,591	2,669	2,744
New In Year Borrowing	450	250	405	200	150	250	250	250	250	250	250	250	250	250
Principal Repayments	-	7	26	52	60	67	71	72	73	74	75	75	63	51
Interest Repayments	-	8	11	13	14	16	15	14	13	13	12	11	10	9
Existing Resource Cost	-	15	37	64	74	83	86	86	86	86	86	86	73	60
Resource Cost of Projected Borrowing	-	-	-	-	-	0	14	35	57	79	101	124	146	169
Projected Total Resource Cost	0	15	37	64	74	83	100	122	144	166	188	210	219	229

Debt Stock at end of Year	1,036	1,258	1,617	1744	1,814	1,976	2,128	2,266	2,389	2,498	2,591	2,669	2,744	2,816
Percentage of Debt Cap	35%	42%	54%	58%	60%	66%	71%	76%	80%	83%	86%	89%	91%	94%
Notional Borrowing Repayments	9.4	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5	20.5
Headroom	1,964	1,742	1,383	1,256	1,186	1,024	872	734	611	502	409	331	256	184

*New In Year Borrowing from 2022-23 is projected borrowing based on the current Central Scenario.

Resource Borrowing

- As set out in Chapter 4, the Scottish Government will plan Resource Borrowing on the basis of minimising volatility to the Scottish Budget over the medium term. To achieve this outcome planning to borrow in full against forecast income tax reconciliations was the most effective approach as illustrated in previous MTFS documents and chart B2 below. However to achieve the same outcome borrowing closer to 50% of known and forecast reconciliations in 2023-24 is now the most effective approach h to minimise the volatility as a result of the £817m reconciliation in 2024-25. T. This situation arises because of the current circumstances Scotland specific shock rules expiring in the year before the largest forecast reconciliation in 2024-25.
- The scale of the forecast reconciliation in 2024-25 and the scale of change of that reconciliation.

Table B.20 below shows the full budget impact of borrowing and reconciliations over the period under the revised borrowing approach.

Table B.20: Medium-term impact of reconciliations and resource borrowing (£ million)

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Known and Forecast Reconciliations	- 207	-319	-15	-221	-817	-238
Planned Resource Borrowing	207	319	15	110	300	119
Projected Resource Cost of Resource Borrowing	-	- 21	-77	-110	-124	-169
Net Impact	-	-21	-76	-221	-641	-288
YOY Net Impact		-21	-55	145	-420	353

The incremental impact of resource borrowing, the costs of resource borrowing and known and forecast Income Tax reconciliations is as follows:

- The projected resource cost of borrowing line comprises repayments of both principal and interest, both of which impact the resource budget.
- All drawdowns are based on National Loans Fund (NLF) annuity structure loans, this is the only source of resource borrowing available to the Scottish Government under the Fiscal Framework.
- These loans are priced at 11 basis points above the equivalent UK par Gilt yield. Assumptions in Table B.20 use the implied forward rates as of 17 May 2022 plus a premium of 50 basis points.
- NLF annuity loans have principal deferred in the first (semi-annual repayment) period.

- A five-year tenor is assumed in all cases (the maximum allowable under the Fiscal Framework).

As stated in 4.2.2 The Scottish Government will assess all planned Resource Borrowing decisions to smoothen the funding trajectory over five years. Chart B.1 illustrates how the approach is assessed by comparing different borrowing strategies to assess which achieves the optimum outcome of minimising volatility. Three strategies being:

- Borrowing the full allowance
- Borrowing half the available allowance
- Borrowing nothing

The graphs below show the impact in the original and future budget years, taking into consideration actual or expected borrowing for reconciliations in each of the years as well as repayment of borrowing and interest in subsequent fiscal years.

In the case of 'no borrowing' the swings in the funding position are the most pronounced in 2023-24 and 2025-26. In the case of 'full borrowing' there's is now forecast to be a significant fluctuation in 2024-25. Borrowing half the allowance is forecast to reduce the volatility in the latter

The previous resource borrowing policy of borrowing 100% was the basis for the Scottish Budget 2022-23. Chart B. 2 illustrates the position at the time of the Budget, which was prior to confirmation of the forecast £817m tax reconciliation in 2024-25. As can be seen from the Chart the volatility at this point was significantly less than in the current circumstances which explained the approach at the time.

Chart B. 1: : Incremental effect of different borrowing strategies on the Scottish Budget at May 2022

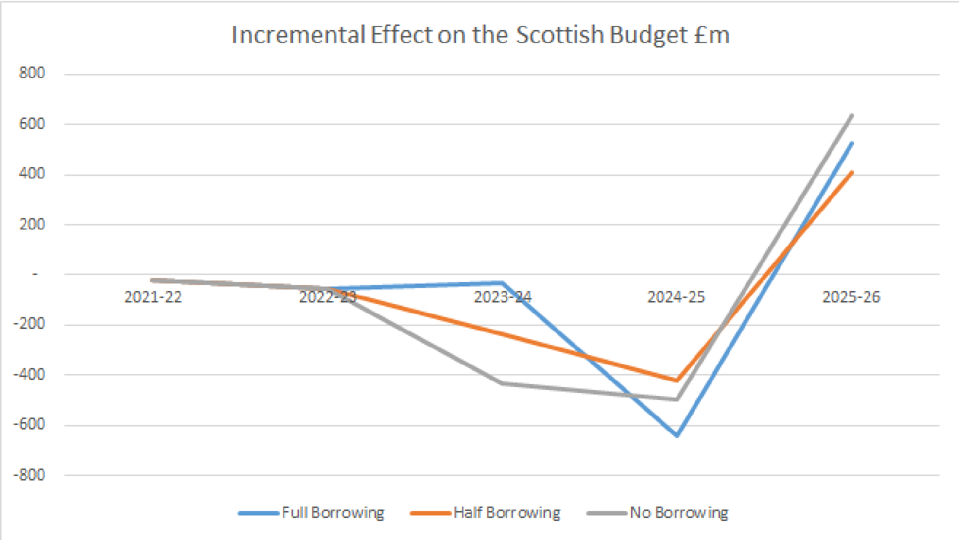
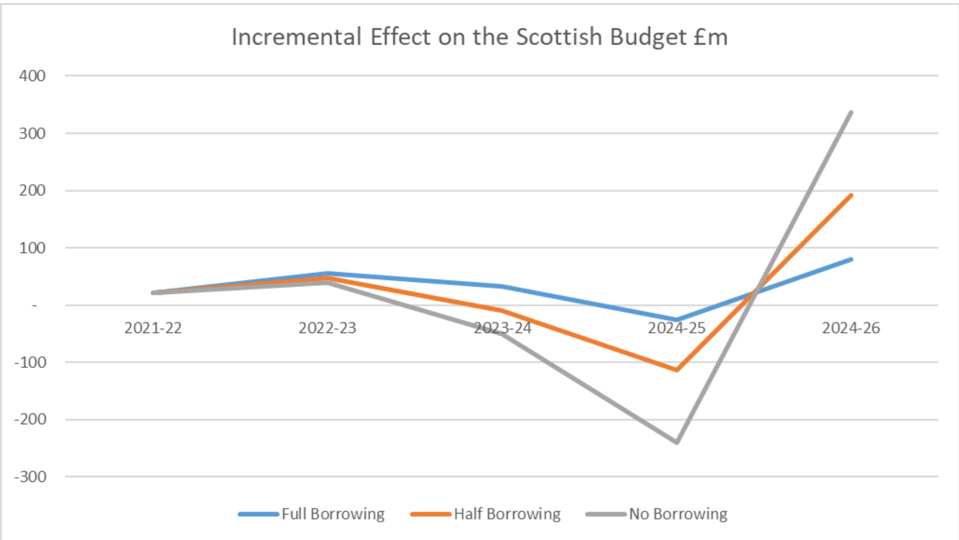


Chart B. 2: Incremental effect of different borrowing strategies on the Scottish Budget as at Dec 2021



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