Scotland’s Fiscal Outlook

The Scottish Government’s Medium-Term Financial Strategy

May 2023

Scottish Government
Riaghaltas na h-Alba

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Foreword by the Deputy First Minister and Cabinet Secretary for Finance

Good governance begins with sound public finances, and my number one priority is to ensure the Scottish finances remain on a sustainable trajectory so that we can deliver first class public services for our communities, improve equality by reducing poverty, and seize the opportunities of an economy that is fair, green and growing.

I am committed to balancing our budgets through maximising the value of public spending and putting robust policies in place to support and sustain effective public service delivery. Sound and responsible finances will provide the strong foundations from which we will deliver the three vital missions set out by the First Minister in our recently published policy prospectus 'A New Leadership – A Fresh Start'[1].

This Medium-Term Financial Strategy (MTFS) comes at a key moment as we recalibrate and refocus under the new leadership of the First Minister. It is my first fiscal statement as Finance Secretary, and I am setting out how this Government will maintain a sustainable financial position over the medium-term. In doing so, I am committed to being open and honest with the public about the financial position we face, and setting that out transparently in the MTFS.

The financial situation is, amongst the most challenging since devolution. Following on from a decade defined by UK austerity, over the past three years Scotland has faced a succession of economic shocks, with the Covid pandemic, the war in Ukraine, and the recent period of high inflation all driving significant pressures on the economy, society and the public finances. While these are challenges that all countries are facing, it is clear that decisions made by the UK Government, not least Brexit, have made things much worse with the UK one of the worst performing economies in the G7[2].

We are living through the biggest fall in living standards in decades, with the Scottish Fiscal Commission forecasting that average real disposable incomes are not set to recover to pre-pandemic levels until around 2026-27. The powers at our disposal to manage these pressures remain limited, with the Block Grant, still our largest source of funding, continuing to be tied to the decisions of the UK Government and subject to continued uncertainty. We face a real terms reduction in the resource Block Grant of 0.1% in 2024-25, and a small real terms increase of 1.1% from 2025-26 onwards. Whilst overall funding is projected to increase compared to what was set out in the

[1] Scottish Government (2023), Equality, opportunity, community: New leadership - A fresh start - gov.scot (www.gov.scot) – April 2023
[2] International Monetary Fund (2023), World Economic Outlook, April 2023: A Rocky Recovery (imf.org) – April 2023

last MTFS, this growth fails to compensate for the impact of the sustained rates of high inflation and the corrosive effect this has on the Government's spending power.

The pressures are even worse for capital, where we are facing a 7% real terms fall in our Barnett capital funding over the medium-term between 2023-24 and 2027-28. We also are due to face a large negative tax reconciliation (for the tax year 2021-22) in budget year 2024-25, one that outstrips the borrowing powers that we currently have to manage it.

We will continue to press the UK Government to provide sufficient funding to meet the scale of these challenges, and for more powers and necessary reforms to the Fiscal Framework through the forthcoming Review.

Despite these challenges and constraints, we will do all that we can to use the powers that we do have to their maximum, in order to deliver public services and improve the lives of the people of Scotland. The Scottish Government remains wholeheartedly committed to supporting the most vulnerable members of our society through our spending choices, and to ensuring we maintain a fair and progressive approach to tax policy. Even against the backdrop of a difficult fiscal outlook, we remain resolute in this approach to achieving the vital missions of this Government whilst remaining fiscally sustainable.

Today, I am setting out how this Government will address the challenges to the sustainability of the public finances. This strategy is anchored in three pillars:

- Strengthening how we manage public spending to **ensure public money is fully focused on delivering government objectives**, underpinned by necessary reform and prioritisation to maximise the impact of our available resources and capital investment.

- Increasing focus on economic policies and actions with the greatest potential to **grow and strengthen Scotland's well-being economy** and to grow the tax base to support the funding of our vital public services.

- Ensuring **a strategic approach to tax policy**, which considers the longer-term impacts of our tax choices on individuals and our competitiveness, and which has been developed through clear engagement with stakeholders.

Taken together, actions across all of these areas will ensure that this Government can deliver the vital public services that we all rely upon, and ultimately provide a more prosperous and fairer future for the people of Scotland.

Shona Robison MSP

Deputy First Minister and Cabinet Secretary for Finance

Executive summary

This is the sixth edition of the Medium-Term Financial Strategy (MTFS). It sets out the economic and fiscal outlooks from the financial year 2023-24 to 2027-28, underpinned by independent forecasts from the Scottish Fiscal Commission (SFC). Detailed tax and spend plans for each financial year are set out in subsequent annual budgets, subject to Parliamentary approval in the spring proceeding each financial year.

A. Economic outlook

The economic outlook has improved slightly since the Scottish Budget was published in December 2022 with the Scottish economy now forecast to avoid entering a technical recession in 2023. The Scottish labour market has continued to remain robust with high levels of employment and near-record low levels of unemployment.

However, economic conditions are set to remain challenging as inflationary pressures continue on households, businesses and public services. Relatively subdued growth is forecast over 2023 and households are set to see record falls in living standards that are not anticipated to recover to pre-pandemic levels until 2026-27. The outlook for inflation and the indirect impact that this has on tax revenue growth and spending pressures over the medium term remains highly uncertain.

B. Fiscal outlook

The financial situation facing the Scottish Government is expected to remain similarly challenging over the medium-term. Overall resource funding is expected to grow by 6.8% in real terms from £45.26 billion in 2023-24 to £50.971 billion by 2027-28. This is due to increases in the Block Grant and significant growth in the forecast net tax position. However, increases vary significantly between years. Pressures on funding are expected to be most severe in 2024-25 when resource funding is forecast to grow by only 1.2% in real terms. The medium-term funding outlook is also subject to considerable volatility, with the two main components of funding – the Block Grant and Income Tax net position – being uncertain.

The funding outlook cannot be considered in isolation. High inflation experienced in 2023-24 is expected to have a long lasting impact on public spending in Scotland, yet funding has not kept pace with this. We have used our devolved powers and chosen to support public sector workers through increased pay awards, invest in health and social care, and ensure those who need it most are supported via our social security system. We have made these decisions in response to an economic environment which is affecting people across the UK, but have not seen the UK Government similarly adapt its approach to public finances. As a result, public spending in Scotland is currently projected to grow at a faster rate than our central forecasts of funding. Our modelling indicates that our resource spending requirements could exceed our central funding projections by 2% (£1 billion) in 2024-25 rising to 4% (£1.9 billion) in 2027-28.

On capital, the funding outlook has worsened since the last MTFS. Total capital funding (excluding Financial Transactions) is expected to fall by around 7% in real terms between 2023-24 and 2027-28. Exacerbated by higher costs, this means that the trajectory of capital spending is more than funding available, with around a 16% gap in 2025-26.

C. A strategic approach to managing the public finances

Within this difficult context, and with limited powers at its disposal, the Scottish Government must ensure it delivers against the fiscal rule set by the UK Government, and is also required under Scottish legislation[3]– to balance the budget each year. Tough and decisive action must therefore be taken to ensure the sustainability of public finances and that future budgets can be balanced. Three pillars will underpin our strategic approach to managing the public finances.

Pillar 1: focusing spending decisions on achieving our three critical missions.

The Government will prioritise the programmes which have the greatest impact on delivery of the three missions set out in our policy prospectus. Within this, we will not back away from tough choices and targeting. We will underpin our spending decisions with the necessary reform to ensure that Scottish taxpayers get value for the taxes they pay. Recognising the current impact of inflationary pressures, particularly on pay deals for 2023-24, difficult choices may be required in this current financial year to ensure we reach a sustainable footing.

Adopting a multi-year outlook is key to achieving fiscal sustainability. We will publish refreshed multi-year spending envelopes for both resource and capital alongside the 2024-25 Budget, and extend the Capital Spending Review and Infrastructure Investment Plan period by one year, taking these to 2026-27. This will ensure spending is aligned to the three missions for this Parliament and that it takes account of the fiscal and economic reality at the time.

Recognising the changes since the publication of the Resource Spending Review (RSR), we will also deliver a refreshed set of actions against the four areas of reform prioritised in the RSR: Pay sustainability; Public Service Reform; Efficiency Levers and Raising Revenue and Innovation. These are set out in Annex B.

Pillar 2: supporting sustainable, inclusive economic growth and the generation of tax revenues

We recognise that economic growth is necessary to generate the tax revenues which support sustainable, high-quality public services, so – as we deliver our National Strategy for Economic Transformation – the Scottish Government will prioritise policies and actions with the greatest potential to grow Scotland's economy, expand and broaden the tax base to fund our vital public services, ensure we have good,

[3] Legislation.gov.uk (2000), Public Finance and Accountability (Scotland) Act 2000 (legislation.gov.uk) – January 2000

well paid jobs, and invest in making people's lives better. That is at the very heart of our approach to the wellbeing economy.

Ahead of Budget 2024-25, the Scottish Government will explore areas such as seizing opportunities in areas where Scotland has a competitive advantage, such as the Green economy, and supporting entrepreneurs, start-ups and scale-ups; helping businesses to raise productivity; and further boost labour market participation including through an enhanced childcare offer.

Pillar 3: maintaining and developing our strategic approach to tax

The primary role of any tax system is to raise revenue to fund public services. However, within this, there are choices for the government around who and what to tax, and by how much. We have policy responsibilities for tax rates and bands for Scottish Income Tax, Non-Domestic Rates income, Land and Buildings Transaction Tax and Scottish Landfill Tax and will seek to continue to apply these to best effect.

We will work with Scottish citizens, businesses, academics, trade unions, the third sector and other key stakeholders to ensure their voice is heard when we look at the type of tax system we have and want, to ensure it is fit for the challenges of the 21st century. We will establish an external tax stakeholder group this summer, chaired by the Deputy First Minister, ahead of setting out the Scottish Budget 2024-25. This group will build on the Government’s inclusive approach to tax policymaking and will consider how best to engage with the public and other stakeholders on the future direction of tax policy, including whether a “national conversation” on tax is required. The outcomes of this engagement will feed into the Budget 2024-25 and the development of the Government’s longer-term tax strategy. The Scottish Government will publish updates of these alongside the MTFS in 2024.

We will also publish a broader set of ready reckoners for all devolved taxes for 2023-24 alongside the MTFS 2023, to aid understanding of the impact of tax policy choices on the Budget.

Finally, the Scottish Government carefully considers any possible behavioural changes as part of our tax policy decisions. Building on the policy evaluation of the 2018-19 Income Tax reforms, the Scottish Government and HMRC are developing new, and robust, data sources and evidence to help better understand potential behavioural responses, including taxpayer movements across the UK over time.

1. A strategic approach to managing the Scottish public finances

Most independent nations operate under a set of fiscal rules set by the Government of the day. Under the current constitutional settlement, the Scottish Government has to deliver against one rule set by the UK Government, and is also required under Scottish legislation; to balance the annual budget. We have to do so with limited fiscal levers, in particular no ability to borrow for day-to-day spending and the majority of our funding determined by UK Government spending plans and the operation of the Barnett Formula to provide our consequential share each year. Despite this, the Scottish Government has a strong track record in delivering a balanced outturn against budget, while providing the people of Scotland with a broad range of public services.

Continuing to deliver this is becoming increasingly challenging. This MTFS illustrates the scale of likely future pressures on the public finances, on top of those already felt over recent years. Sustained high inflation has fundamentally reshaped the prices of what the public pound can buy in Scotland, yet the funding available to the Scottish Government has not grown to match these pressures. This has already led the Scottish Government to undertake reprioritisation action in the middle of a financial year, for example during the Emergency Budget Review in Autumn 2022, and we will continue to take action this year as needed. As we look ahead to future years, the UK Government continues to adopt a fiscal stance which results in low levels of real-terms growth in the Scottish Block Grant and inadequate levels of capital funding over the coming years, which do not keep pace with the anticipated pressures on public spending. Whilst the Scottish Government has successfully used its tax raising powers to increase its funding, these powers are limited, and do not permit the full range of revenue-raising options available to an independent country.

Whilst the forecasts of funding and spending set out in this MTFS are subject to uncertainty - including both the ongoing uncertainty about the pace at which inflation will return to target rates, and the fiscal policy to be applied by the next UK Government after the 2024 General Election – it is clear that action is needed.

The Scottish Government cannot rely on the UK Government to take action on the public finances to meet these spending challenges. We are committed to doing all we can within the powers at our disposal to ensure the public finances are on a sustainable path. This MTFS sets out the three pillars that will underpin the Scottish Government's strategic approach to managing the public finances over the medium term.

First, **we will focus spending decisions on achieving our three critical missions**. This will mean taking a relentless approach to ensuring that spending represents value for money to the taxpayer. The Scottish Government will ensure that public money is committed to delivering clearly defined outcomes. Within this, we will not back away from tough choices and targeting, and we will underpin our spending with the necessary reform to ensure that people in Scotland get value for the taxes they pay.

Second, **we will support sustainable, inclusive economic growth and the generation of tax revenues.** We recognise that economic growth is necessary to generate the tax revenues which support sustainable, high-quality public services. As we deliver our National Strategy for Economic Transformation, we will prioritise policies and actions with the greatest potential to grow and change Scotland's economy, taking advantage of economic opportunities on the path to a net zero economy, to expand and broaden the tax base to fund our vital public services, and make people's lives better.

Third, **we will maintain and develop our strategic approach to tax**. The primary role of any tax system is to raise revenue to fund public services and to allow us to invest in tackling poverty. However, within this, there are choices for the government around who and what to tax, and by how much. We will also openly work with Scottish citizens, businesses, academics , trade unions, the third sector and other key stakeholders to ensure their voice is heard when we look at the type of tax system we have and want, to ensure it is fit for the challenges of the 21st century.

Figure 1: Strategy for managing the public finances

To ensure the Scottish public finances are on a sustainable trajectory over the medium term, we will need to concentrate our actions on all three areas. In the short term, the Scottish Government will focus on the spending decisions ahead, as this is the most immediate lever through which we can affect fiscal sustainability. Tax policy choices and the strength of the Scottish economy will become increasingly important to the Scottish Government’s ability to invest in public services.

As we take forward actions to manage the public finances, we will continue to be open about the challenges and choices that will need to be made. Fiscal openness and transparency are important enablers of fiscal sustainability, helping to promote improved policies and strengthen accountability for fiscal management. The Scottish Government is committed to transparency, both in how it manages the public finances and in its wider work with civil society in Scotland's Open Government Partnership National Action Plans.

Box 1: The Role of the Scottish Fiscal Commission (SFC)

Since becoming a public body in April 2017, the SFC has played a key role in enhancing fiscal transparency in Scotland. The SFC has been successful in establishing constructive relationships with key stakeholders and has quickly developed a reputation for delivering independent and credible forecasts.

It provides the Scottish Government with the official independent economy, tax and social security forecasts that underpin the MTFS report and provides a commentary on the Scottish Government's funding position. Following recommendations from the OECD in its evaluation of the Commission and by the Parliament's Finance and Public Administration Committee, the SFC has continued to expand its work and build its capability, most recently moving into the area of reporting on fiscal sustainability. It published its first Fiscal Sustainability Report in March of this year, looking at the long term fiscal sustainability of the Scottish Budget.

Having key fiscal events in Scotland supported by an independent forecaster reduces any bias and ensures genuine transparency of Scottish public finances, in line with international best practice. It provides the Scottish Parliament and the general public with the means to scrutinise Scottish Government fiscal policy and sustainability. The Scottish Government places great importance on the role of the SFC and to the fiscal transparency it provides, using its forecasts at fiscal events since its inception in 2017.

The remainder of this chapter sets out further detail on each of the pillars of the Government's approach.

1.1 Public Spending: Focusing spending decisions on the Government's missions

Last month the First Minister set out the three Missions which will guide the Scottish Government's decision making over the next three years of this parliamentary term:

Equality: Tackling poverty and protecting people from harm

Opportunity: A fair, green and growing economy

Community: Prioritising our public services

It is critical that every pound the Scottish Government spends achieves maximum impact as we focus on these Missions, and that our programme of work is built on the strong foundations of sound public finances. The financial situation facing the Scottish Government continues to be among the most challenging since devolution with high inflation experienced globally in 2023-24 expected to have a long-lasting impact on public spending in Scotland. The Scottish Budget published for 2023-24 demonstrates how we have chosen to focus our resources on our public services, direct support to households and deliver fair pay settlements for public sector workers to mitigate the worst effects of the cost of living crisis, while growing our capital investment that supports the transition to net zero.

These choices will carry into future financial years and with ongoing impacts for public spending. We: have increased the Health and Social Care budget by more than £1 billion in 2023-24, far beyond our commitment to pass on frontline Barnett consequentials received from the UK Government; are continuing to invest around £1 billion a year in high quality early learning and childcare provision and will invest a further £15 million this year to expand our support for school age childcare; and have reallocated over £900 million to support enhanced pay deals for the public sector. Scotland did not receive additional in-year funding from the UK Government to support higher than anticipated inflationary pressures in 2022-23, meaning the recurring impact of pay deals had to be found within 2023-24 baseline budgets. These inflationary pressures continue to manifest in pay deals within the NHS for Agenda for Change and also for school teachers which have been agreed since the 2023-24 Budget was set. These therefore still require us to reprioritise and slow down or stop some programmes in 2023-24 to maintain fiscal sustainability.

We have also chosen to invest in social security over and above the funding we receive from the UK Government through the Block Grant Adjustment, reflecting this Government's choice to prioritise our resources for those in greatest need. Our expenditure on social security benefits is expected to grow from £4.2 billion, or 10% of the resource budget, in 2022-23 to 15% or £7.4 billion by 2027-28 on current trajectories. This investment will support low-income families with their living costs and older people to heat their homes in winter, and enable disabled people to live full and independent lives than might otherwise be possible.

Without any mitigating actions public spending is therefore currently projected to grow at a faster rate than our central forecast for funding, the majority of which is still determined by UK Government spending decisions. Our modelling indicates that resource spending may increase from £45.2 billion in 2023-24 to £52.8 billion in 2027-28, meaning that our spending requirements could exceed our central funding projections by £1.0 billion (2%) in 2024-25, rising to £1.9 billion (4%) in 2027-28.

The spending outlook is set out in full detail in chapter 4. Chapter 4 also explores the risks which may, if not managed, increase public spending further over the period. Most significantly, the central spending scenario is underpinned by the Office for Budget Responsibility (OBR) forecasts[4] which show inflation falling below 2% by the end of 2023-24 and continuing at a lower rate, but there is significant uncertainty in this forecast. Our experience of the financial years 2022-23 and 2023-24 has demonstrated the significant impact sustained high inflation can have on the Scottish Budget. The choices the Scottish Government makes to maximise value from public

[4] Office for Budget Responsibility (2023), Economic and fiscal outlook - March 2023 - Office for Budget Responsibility (obr.uk) – March 2023

spending and further embed good governance can control this spending trajectory and secure a sustainable future for Scottish public finances.

We know that we will need to target support and take tough decisions to both improve the underlying sustainability of our public finances in the face of these unprecedented shocks and pressures, and to ensure we can prioritise our resources towards realising our strategic missions.

That action will begin in the Scottish Budget 2024-25, due for presentation to the Scottish Parliament later this year, when we must address the immediate financial pressures in a year where the upper funding scenario is insufficient to meet our spending needs, and take decisions that will secure our fiscal stability over the medium term.

The Scottish Government's spending plans will unapologetically direct our resources to those in greatest need, and we will review opportunities for more effective targeting of existing provision and services. Universal provision can improve take up of benefits and services amongst those who most need support, and offer greater security and certainty for people, but these demand-led services come with limited opportunities to control costs once introduced. Facing both supply and demand pressures on public finances, we must consider whether targeting help may offer greater value for money and an improved offer to those most in need, while releasing resources to advance progress on our three missions.

We need to prioritise the programmes, such as early learning and childcare, which have the greatest impact on delivery of our three missions. In order to do this and to absorb the impacts of pay and other inflation into our baseline, the Scottish Government will need to take difficult decisions to stop spending money on programmes that make a less meaningful contribution to our missions.

Key to securing our fiscal sustainability is adopting a multi-year outlook, which gives greater transparency over the impact of annual budget decisions on future years' spending plans. It also gives our public bodies and other stakeholders greater confidence in the trajectory of public spending to support their own financial planning and enable them to invest efficiently and effectively in our shared priorities.

Later this year, the Scottish Government will publish refreshed multi-year spending envelopes for both resource and capital alongside the 2024-25 Budget. This will reset the portfolio spending envelopes previously published in the Resource and Capital Spending Reviews to reflect the new economic reality and ensure that spending is aligned to the three missions for this Parliament.

The Scottish Government will extend the Capital Spending Review (CSR)[5] and Infrastructure Investment Plan (IIP)[6] period by one year, taking these to 2026-27, as it will now take longer to deliver the intentions contained within those.

Given the challenging and volatile market conditions of the last two years, coupled with the UK Government's decisions that reduce our capital budget in real terms, the trajectory of public capital spending is more than the capital funding available, with around an estimated 16% gap in 2025-26.

To help to address the difference between the capital funding and spending outlook, we plan to publish a reset of the project pipeline, first set out in 2014 and last updated at the publication of the 2021 Infrastructure Investment Plan, alongside the 2024-25 Budget – providing transparency over which projects may now be delivered over a longer timescale. To do this we will undertake a prioritisation exercise to ensure we target the available capital spending to support employment and the economy through the Scottish Government's infrastructure plans, support the achievement of net zero emissions targets and underpin the provision of high-quality public infrastructure and services across Scotland.

Without further funding and increased fiscal flexibility through increased borrowing powers from the UK Government, tough decisions will need to be made as we prioritise infrastructure investment to meet the core missions set out in the policy prospectus. The Scottish Government will continue to press the UK Government to use the levers at its disposal to help mitigate the current market conditions and support infrastructure investment, but without further funding and associated fiscal flexibility through enhanced borrowing powers, tough decisions will need to be made to reprioritise the pipeline of projects set out in the Infrastructure Investment Plan.

1.1.1 Reform

Reform of public services and their delivery was central to the strategy the Scottish Government set out in the Resource Spending Review (RSR) (May 2022)[7] to improve outcomes and achieve sustainable public finances. Recognising that there have been significant global economic changes since May 2022, we have reviewed these commitments to prioritise actions which remain both relevant and likely to have a meaningful positive impact on financial sustainability. Annex B provides a progress update and summarises the outcome of the review, with actions spanning four key workstreams:

- **Public Bodies and Public Service Reform** as an overarching approach encompassing both larger-scale and longer-term reform alongside a range of

[5] Scottish Government (2021), Investing for jobs: Capital Spending Review 2021-2022 to 2025-2026 - gov.scot (www.gov.scot) – February 2021
[6] Scottish Government (2021), A National Mission with Local Impact: Infrastructure Investment Plan for Scotland 2021-22 to 2025-26 - gov.scot (www.gov.scot) – February 2021
[7] Scottish Government (2022), Investing in Scotland's Future: Resource Spending Review - gov.scot (www.gov.scot) – May 2022

'quick wins', which may be delivered through the measures and programmes detailed below.

- **Efficiency levers**, across digital, shared services, public sector estates, procurement and grant management, each of which are being progressed within Scottish Government, and by individual public bodies and partners.
- **Revenue raising** to maximise the funding available to invest in and support our public services.
- **Pay sustainability**, as explored in Chapter 4, is a significant component of our spending and the 2023-24 Pay Strategy reiterates that pay and workforce must more than ever be linked to both reform and to fiscal sustainability.

Learning from the Christie Commission[8] tells us that it takes leadership, change capacity and time for intended shifts in fiscal sustainability and improved outcomes to bear fruit, and alongside these cross-cutting workstreams, reform programmes will continue in the major areas of public spending.

1.1.2 Pay and workforce

Pay accounts for over £24 billion of resource expenditure across the devolved public sector in Scotland, and it is essential that our focus on fiscal sustainability and reform recognises the importance of our public sector workforce to the delivery of sustainable and effective public services. The Scottish Government will develop a pay and workforce strategy for 2024-25 which continues to reflect the principles of affordability, sustainability and fairness in the context of an expected fall in inflation.

1.1.3 Health and Social Care

Scotland continues to face significant population health challenges: stalling (and in some groups falling) healthy life expectancy,[9] and widening levels of inequality, exacerbated by COVID-19. Our system of public services, not just healthcare, is under unprecedented pressure and reform is essential if we are to manage this pressure within our budgetary constraints, and ensure that our spending choices target these health inequalities.

The Scottish Government recognises that factors that impact on people's health and wellbeing go beyond what the health and social care system itself can deliver and we are working across government on critical, cross-cutting issues that improve population health and the wider Scottish Government missions.

Under the leadership of the Cabinet Secretary for NHS Recovery, Health and Social Care, we continue to bring together our major reforms through the Care and Wellbeing Portfolio to improve population health and wellbeing, reduce health inequalities and improve the health and social care system sustainability. This

[8] Scottish Government (2011), Christie Commission on the future delivery of public services - gov.scot (www.gov.scot) – June 2011
[9] National Records of Scotland (2022), Healthy Life Expectancy in Scotland, 2019-2021 | National Records of Scotland (nrscotland.gov.uk) - December 2022

includes working with other programmes across the Scottish Government, such as those relating to child poverty, economic transformation, climate change and net zero to deliver these benefits. This approach seeks to create the conditions – social, economic and environment – which support, protect and generate good health.

1.1.4 Local Government

The RSR set out the critical role that local government plays in delivering services and improving outcomes for people in Scotland, while recognising the pressure on budgets experiencing growing demand. Ministers continue to work closely with Convention of Scottish Local Authorities (COSLA) Leaders to deliver a New Deal for Local Government[10] founded on a Partnership Agreement and a Fiscal Framework. The Partnership Agreement will confirm the intention for National and Local Government to work together to deliver shared priorities around tackling poverty; transforming our economy through a just transition to deliver net zero; and delivering sustainable person-centred public services.

The Local Government Fiscal Framework will seek to simplify and consolidate the Local Government Settlement to ensure reduced reliance on ring-fenced funding and establish clear routes to explore local revenue raising opportunities. In connection with the Partnership Agreement, the Local Government fiscal framework will provide for an improved shared understanding of the financial sustainability of public services and enable better alignment of resources to our shared priorities. The New Deal will be underpinned by a jointly agreed monitoring and accountability framework, drawing on proportionate reporting and data collection, to provide evidence and visibility over progress towards agreed outcomes.

1.2 The Economy: Supporting sustainable, inclusive economic growth and the generation of tax revenues

A strong Scottish economy is essential for stable Scottish public finances. As the Scottish Government set out in 'Equality, opportunity, community: New leadership – A fresh start'[11], we will grasp opportunities for economic growth and ensure we create an economy which is fair and green. The Scottish Government remains committed to the creation of a wellbeing economy, one which serves and prioritises the collective wellbeing of current and future generations. At the heart of this is economic growth for a purpose – to drive improved living standards, to reduce poverty, to promote wellbeing and to deliver sustainable high quality public services.

The Scottish Government is committed to taking action to ensure we deliver the growth and the tax revenues necessary to achieve fiscal sustainability and to deliver public services. This forms the second pillar of the Government's approach to managing the public finances.

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[10] Scottish Government (2023), A new deal for local government -gov.scot (www.gov.scot) – March 2023
[11] Scottish Government (2023), Equality, opportunity, community: New leadership - A fresh start - gov.scot (www.gov.scot) – April 2023

However, under the current constitutional settlement, the Scottish Government has limited powers with which to pursue this objective. Our borrowing powers are constrained, so our ability to support the economy in the short term by, for example, providing additional spending during the current cost of living crisis, is extremely limited. We also lack key levers to tackle Scotland's historically slower population growth relative to the rest of the UK, such as powers over migration policy which could be used to support growth. However, we have a greater ability to influence the long-term trajectory of the economy through other channels, for example through policies on education, infrastructure, or economic development. Given the importance of income tax revenues to the Scottish Budget, the Scottish Government will continue to ensure we fully consider the use of these levers to support the long-term and sustainable growth of the Scottish tax base.

The Scottish Government's National Strategy for Economic Transformation (NSET)[12] provides a ten-year framework for achieving a fairer, greener and growing economy. As we deliver NSET, the Scottish Government will prioritise policies and actions with the greatest potential to grow and transform Scotland's economy, expand and broaden the tax base to fund our vital public services, and make people's lives better. Given the importance of growing the tax base, creating more high quality and well-paid jobs as well as more opportunities for all in Scotland will be central to this mission.

This is not all new. We have already set up the Talent Attraction and Migration Service, are delivering A Trading Nation to grow Scottish exports, adopting a new approach to target inward investment that aligns with our values and strengths, providing access to superfast broadband for all through the Reaching 100% programme and are transforming employment support in Scotland through No One Left Behind.

Going forward, this renewed emphasis will require the Scottish Government to focus action on a number of areas, including:

- **Seizing new market opportunities in sectors in which Scotland can be world-beating, including the transition to net zero.** Historically, the strength of the oil and gas industry in the North East of Scotland has been an important part of our tax base. As well as being vital to our own national effort to decarbonise, developing and building the renewable technologies and sectors which will power the global transition to net zero offers Scotland an enormous economic opportunity to develop a new, sustainable tax base to help replace that which oil and gas historically provided. Focusing on how Government can align strategic support and investment around this opportunity will be important.
- **Continuing to support sectors and clusters of excellence in which Scotland already leads the world, such as space, digital and data, financial services and life sciences**. Sectors like these, driven by

[12] Scottish Government (2022), Scotland's National Strategy for Economic Transformation - gov.scot (www.gov.scot)- March 2022

investment and innovation, are powerhouses of the Scottish economy and key to the sustained growth of international exports. In a competitive global environment, government has a vital role to play in supporting them through, for example, infrastructure and a skills system which is responsive to industry needs.

- **Supporting entrepreneurs, start-ups and scale-ups**, so that Scotland is on track to become a leading European start-up nation, in which more businesses are created and grow to scale. New and growing companies are an essential driver of the innovation which is crucial to productivity growth, and deliberate government action can have a significant impact on attracting the mobile investment and talent which drives success.
- **Supporting businesses across the economy to raise productivity, so that they can raise wages and offer greater security of employment.** Adopting proven technology tools and management approaches could help boost productivity in the service sectors, like hospitality and retail, which are such an important part of Scotland's economy.
- **Focusing on labour market participation, helping more people to get into and stay in good, well-paid jobs which meet fair work principles, to underpin our other economic policy aims**. Two issues will be of particular importance. First, the Scottish Government needs to consider how we can **prevent experienced workers from leaving the labour market early**: healthcare services have an important role to play, as do businesses by offering more flexible working opportunities to help people balance work with other priorities and challenges in their lives. Second, we need to **help parents, in particular, to access more and better paid work**. Not only is this a vital part of tackling child poverty, but helping parents earn more can also reduce pressure on social security spending. Childcare provision in particular has a vital role to play here, particularly when integrated with other local services, and we already invest around £1 billion per year to provide high-quality funded early learning and childcare. One key objective of this funding is to support parents and carers to take up or sustain work, training or study opportunities. This year we are investing a further £15 million to develop a system of school age childcare and, by 2026, we will have built a system of school age childcare and developed a funded early learning and childcare offer for 1 and 2 year olds, focusing on those who need it most.

With focused action in these areas, the Scottish Government will help create the high-skill, high-wage jobs needed to underpin the tax revenues that are vital to sustainable public finances. And, because those jobs are created and sustained primarily by business, we will engage widely with business leaders to develop and agree a 'New Deal' with the private sector while using the devolved powers we have and Fair Work First to work with employers across the economy to deliver fair work. Within government, we will make the decisions needed to prioritise our actions and funding in a transparent, evidence-based way.

1.3 Taxation: maintaining and developing a strategic approach to tax

The third and final pillar of the Scottish Government's strategy focuses on developing the tax system. The primary role of any tax system is to raise revenue to fund and sustain public services, and to invest in measures to reduce poverty. However, within this, there are choices for the Government around who and what to tax, and by how much. We have policy responsibilities for tax rates and bands for Scottish Income Tax, Non-Domestic Rates income, Land and Buildings Transaction Tax and Scottish Landfill Tax and will seek to continue to apply these to best effect. As the second pillar of our approach sets out, tax performance and the economy are intrinsically linked, and delivering economic growth is key to realising the full benefits of the tax decisions the Government makes.

Tax presents a vital, and increasingly important, source of revenue, with tax devolution forecast to make a positive net contribution to the Scottish Budget. The most recent forecasts show that tax devolution will add an extra £574 million to the Scottish Budget in 2023-24, increasing to almost £1.7 billion by 2027-28[13], mainly as a result of Scottish Income Tax (which accounts for £325 million of the net position in 2023-24 and £1.6 billion in 2027-28). This is a significant improvement compared to last year's MTFS forecasts. Chapter 3 sets this out in fuller detail.

While these forecasts are encouraging, the Scottish Government is not complacent and sustained action will be needed to deliver a strong, growing economy that can support fiscal sustainability over the medium term, as set out under the second pillar of our strategy.

The policy decisions taken by the Scottish Government since Income Tax has been devolved have benefitted the Scottish Budget by up to an estimated £1 billion in 2023-24, when compared with matching Income Tax policy in the rest of the UK. Whilst this is offset by relatively weaker economic performance, with the overall impact on the Scottish Budget lower at £325 million in 2023-24 the policy decisions we have made have had a substantial impact on the revenues we raise. It is therefore vital that the Scottish Government uses its tax powers effectively, at the same time as managing the risks and impacts on taxpayers, the economy and competitiveness, if we are to achieve fiscal sustainability over the medium term.

However, the tax policy choices of the Scottish Government are limited by the current devolution settlement and the revenue for the Scottish Budget is heavily reliant on Scottish Income Tax, which is only partially devolved. The Scottish Government does not hold all the levers necessary to make the Scottish tax system work in the most effective way and has repeatedly called for the full devolution of Income Tax, National Insurance and VAT to better enable tax policy choices to collectively serve the interests of the people of Scotland. Whilst the Scottish Government will continue to press the UK Government to devolve further tax powers,

[13] This is the figure that was 'locked in' at Budget 2023-24 until outturn data becomes available. The latest forecasts suggest that the net position has improved to £411 million in 2023-24 but this has no impact on the Scottish Government's funding position.

we are committed to using the tax powers we do hold to continue to deliver a fair and progressive tax system, ensuring the sustainability of the public finances.

The Scottish Government's approach to tax is underpinned by a set of core principles, which were outlined in the Framework for Tax[14]. We will continue to build on these principles by:

- Continuing to look at the sustainability and the limitations of our tax base and the impact our tax policies have on economic and tax performance and fiscal sustainability;
- Building on our existing understanding of how different taxes interact with one another to help us better understand the burden of tax on individuals, households and businesses when making policy choices;
- Engaging more regularly and systematically with citizens and taxpayers to extend our understanding of attitudes towards the nature, purposes and extent of taxation and its role in Scotland's public services;
- Further considering how devolved taxes contribute to the Scottish Budget and how these interact with the Government's wider priorities on progressivity, competitiveness and contribution to fiscal sustainability.

With this in mind, the Scottish Government will establish an external tax stakeholder group this summer, chaired by the Deputy First Minister, ahead of setting out the Scottish Budget 2024-25. This group will build on the Government's inclusive approach to tax policymaking and will consider how best to engage with the public and other stakeholders on the future direction of tax policy, including whether a 'national conversation' on tax is required.

The outcomes of this engagement will feed into the Budget 2024-25 and the development of the Government's longer-term tax strategy. The Scottish Government will publish updates of these alongside the MTFS in 2024.

To support public understanding of the revenue impact of tax policy choices, the Scottish Government also publishes Income Tax 'Ready Reckoners' annually. These show the estimated revenue impacts of illustrative changes to Scottish tax policy and are used to assist researchers and policymakers, improve transparency and facilitate understanding. The Scottish Government has published a broader set of ready reckoners for all devolved taxes for 2023-24 alongside the MTFS 2023. These can be found at https://www.gov.scot/isbn/9781805259114.

Behavioural changes are a vital part of the Scottish Government's tax policy decisions. The Scottish Government's evaluation of the move to a more progressive Income Tax system in 2018-19 found no evidence of significant behaviour change, including cross-border migration. Building on this, the Scottish Government and HMRC are developing new, and robust, data sources and evidence to help better understand potential behavioural responses, including taxpayer movements across the UK over time.

[14] Scottish Government (2021), Framework for Tax 2021 - gov.scot (www.gov.scot) – December 2021

In addition to the tax system, the Scottish Government will also look to maximise other revenue raising opportunities and get best value of government assets with a view to putting our public finances on a sustainable trajectory.

1.3.1 Local taxation

The Scottish Government's strategic approach to taxation also applies to local taxes. Council Tax receipts will contribute around £2.9 billion in 2023-24 towards the funding of local public services. Council Tax rates are set by individual councils who are also responsible for its collection, administration and enforcement. All revenues are retained locally and not included within the Scottish budget. However, the Scottish Government and Parliament set the legislative framework and as part of this, we are committed to a fair, inclusive and fiscally sustainable form of local taxation.

The Scottish Government convened the Joint Working Group on Sources of Local Government Funding and Council Tax Reform to build consensus on an alternative to the present Council Tax. This group also forms part of the joint working to develop a fiscal framework for local government and is co-chaired by Scottish Ministers and COSLA. The Joint Working Group provides a space for joint dialogue on a range of issues relating to sources of local government funding and Council Tax. The group is also considering targeted changes to Council Tax (such as set out in the current consultation seeking views on the taxation of second homes and long-term empty properties) to reflect the current circumstances created by the cost of living crisis. Importantly, this group will also consider approaches to longer-term reform, including using deliberative engagement where appropriate to capture the views of citizens and taxpayers towards potential alternative approaches.

The Scottish Government also expects that an agreed fiscal framework for local government, once concluded, will set out an approach for considering any proposed new local taxes to ensure they are consistent with the ambitions to strengthen local democracy and fiscal accountability, whilst adhering to the strategic approach to taxation. Any new local taxes need to be created by an Act of Parliament, and we will introduce a Bill before summer 2023 to create a new discretionary power for local authorities to apply a visitor levy on overnight accommodation, thereby adding a further discretionary fiscal power for local authorities alongside the workplace parking levy created by the Transport (Scotland) Act 2019.

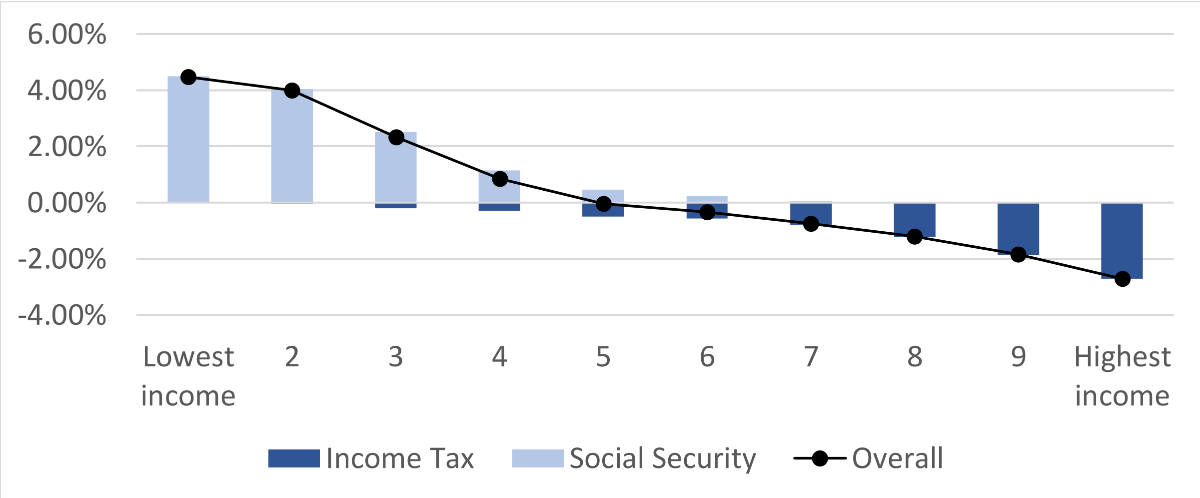
The principle of engaging with citizens and taxpayers also applies to our approach to Non-Domestic Rates, where the New Deal for Scottish Business discussions, announced by the First Minister, will provide an opportunity to explore, among other things, how non-domestic rates can support business growth and our communities.

1.4 A progressive approach to tax and social security

As the Scottish Government takes forward each of the elements of its strategy, it will retain the progressive approach it has taken to date. Although tough decisions will be required in order to manage the public finances, these will be underpinned by the desire to make Scotland a fairer country where everyone's life chances are improved.

Taken together, the evidence shows that the Scottish Government's tax and social security policies are reducing inequality and targeting support at those who need it most. Figure 2 shows the combined impact of income tax and social security policies on household incomes in Scotland, compared to the system in the rest of the UK. The Scottish Government's policies mean that households on the lowest incomes have seen their incomes increase by almost 4%, driven by the flagship Scottish Child Payment, a key part of delivering on our commitment to reduce child poverty. Further detail is set out in Annex E.

Figure 2: Impact of Scottish income tax and social security policies on household disposable income in 2023-24



Source: Scottish Government analysis using UKMOD. Change in equivalised income before housing costs

Looking ahead, the Scottish Government will continue to be transparent in the impact of our decisions, setting out how we are prioritising fair and progressive policies even as we make tough choices needed to deliver on our core missions.

1.5 Conclusion

Scotland, like many countries, has been through an acute series of economic shocks, which has led to real pressure on the Scottish public finances. These are challenges that no government can shy away from. This document sets out this government's strategy for addressing this challenge, whilst continuing to deliver on the three missions outlined by the First Minister.

Chapter 2 details the economic outlook which will define both Scotland's funding and pressures on public services in the years ahead, drawing on the independent forecasts from the SFC.

Chapter 3 sets out our strategy for funding public services, through the block grant, tax revenue, and other sources of income. It also sets out our approach to the use of

Scotland's borrowing and reserve powers, and our approach to the upcoming fiscal framework review.

Chapter 4 then sets out our approach to spending choices, and how we will maximise Scotland's resources to ensure that every pound spent in Scotland provides value to Scottish citizens.

2. Scotland's Economic Outlook

This chapter provides an update on the latest state of the Scottish economy[15]; a summary of the latest economic forecasts from the Scottish Fiscal Commission (SFC)[16] and the Office for Budget Responsibility (OBR)[17], and what these imply for the Scottish Budget.

2.1 Economic Context

Economic conditions in Scotland and the UK continue to remain challenging as inflationary pressures continue to create a cost of living crisis for households and businesses across the country and increase pressure on public services. However, there is evidence that the Scottish economy has proved to be more resilient than previously expected with the latest economic outturn data showing that, despite the scale of the global energy price shock, Scotland avoided entering a technical recession towards the end of 2022 as had been forecast.

Inflation in March 2023 remained above 10%[18], and is forecast to fall to around 3% by the end of 2023 - although uncertainty on this remains high. However, as highlighted by the International Monetary Fund[19] (IMF), falling energy prices in early 2023, stronger than expected economic data from Europe and the US, and the ending of strict COVID-19 quarantine policies in China, have all helped boost the outlook for the global economy this year – albeit an outlook that still remains subdued. The IMF singled out the UK as being particularly exposed to some of the recent global economic headwinds - and in April forecasted the UK to be one of the worst performing major economies in the world this year.

Despite this challenging outlook, the Scottish labour market has continued to remain robust with high levels of employment and near-record low levels of unemployment. The number of vacancies in the economy are still estimated to be significantly higher than pre-pandemic levels, although there is evidence that the number of people that are economically inactive due to long-term sickness has risen relative to before the pandemic.

In response to high inflation, average pay growth accelerated towards the end of 2022, with the labour market remaining tight. However, pay growth has failed to keep pace with inflation, causing reductions in the real purchasing power of households. Although inflation has begun to fall, prices are expected to be around 20% higher by the end of 2023 than they were at the start of 2020, meaning that household

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[15] The figures in this chapter are the latest available as of the 17th of May, which was the cut-off point for new economic data releases.

[16] Scottish Fiscal Commission (2023), SFC Fiscal and Economic Forecasts –Scotland's Economic and Fiscal Forecasts- May 2023

[17] Office for Budget Responsibility (2023), Economic and fiscal outlook - March 2023 - Office for Budget Responsibility (obr.uk) – March 2023

[18] Office for National Statistics (2023), Inflation and price indices - Office for National Statistics (ons.gov.uk) – April 2023

[19] International Monetary Fund (2023), World Economic Outlook, April 2023: A Rocky Recovery (imf.org) – April 2023

finances will continue to face significant pressures. This is also having a disproportionate effect on lower income households, who spend more on energy and food, with 16% of low income households reporting that they have had to eat less or skip meals in response to the cost of living crisis[20].

Uncertainty in the economy also remains high, particularly for the future outlook for rates of inflation in the UK and how monetary policy and interest rates evolve in tandem. The scale of any further future changes in UK monetary policy will continue to have significant implications for businesses and households in Scotland, whether via their return on savings and investments, changes in household mortgage payments, or how costly it is to service existing, or take on new levels of debt.

2.2 Latest Economic Forecasts for Scotland

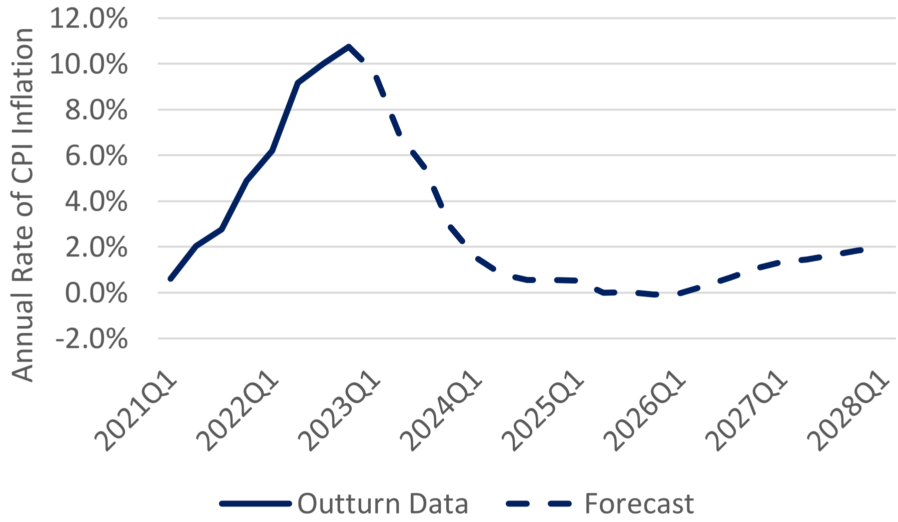
Our medium-term analysis is underpinned by the latest forecasts from the independent Scottish Fiscal Commission (SFC), which continue to show a fragile outlook for the economy.

While the SFC's overall economic outlook is not significantly different from their last forecast in December, they are now forecasting for the Scottish economy to avoid entering a technical recession this year (two consecutive quarters of negative economic growth). However, the overall size of the economy is forecast to remain relatively flat across 2023, and Scotland is still set to experience a record fall in living standards, with average real disposable incomes falling 4.1% from 2021-22 to 2023-24, in the face of high inflation, and are not set to recover to pre-pandemic levels until around 2026-27.

The SFC continue to mirror the inflation outlook of the OBR, shown in Figure 3, which sees the annual growth rate of the Consumer Price Index (CPI) falling sharply to 2.9% by the end of 2023 – although it will still average 6.1% across the year as a whole. Much of this outlook is driven by base effects, where inflation falls because prices rose to high levels last year. However, the SFC note the level of variation in price increases across different goods and services, with for example, food price inflation continuing to increase and currently sitting at around 20%.

[20] Resolution Foundation (2023), Hoping and coping • Resolution Foundation – April 2023

Figure 3: Outlook for Inflation (CPI, year-on-year growth)



Source: Scottish Fiscal Commission; Office for Budget Responsibility

Consequently, the SFC note that the outlook for inflation remains one of the key sources of uncertainty in their forecast, particularly around the future path of "core inflation" which excludes energy and food prices but has remained elevated. The Bank of England noted in their latest Monetary Policy Report that in the UK, Eurozone and the US there is evidence of headline inflation falling, but core inflation has remained elevated and stronger than projected[21].

The SFC continue to forecast that the Scottish labour market will remain tight over the medium-term. They forecast that unemployment will remain near historic lows, increasing slightly to their assumed long-term trend rate of unemployment of 4.1%, but remaining lower than the 4.7% peak unemployment rate in their previous forecast.

The SFC is also forecasting slightly stronger employment and earnings growth at the beginning of the forecast. The upward revision to earnings growth in 2023-24 is driven by the relative tightness of the labour market putting further upward pressure on nominal pay growth and by inflation. The upward revision to employment growth in 2023-24 reflects recent labour market outturn data and an upward adjustment to Scotland's adult economic activity rate.

2.3 Fiscal Implications for the Economic Outlook

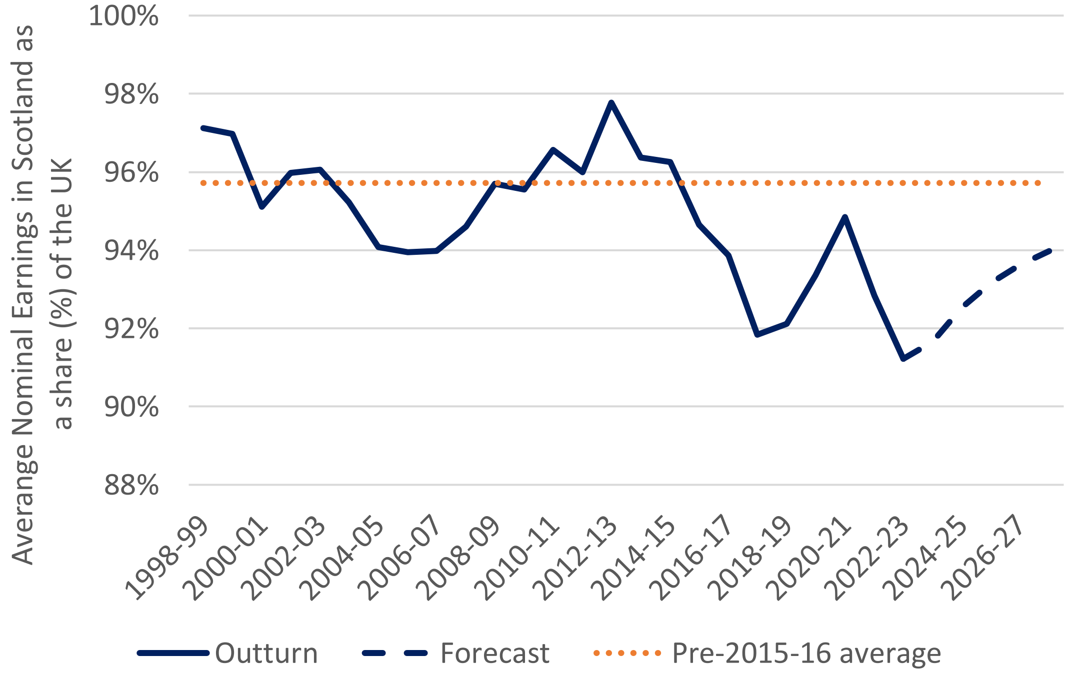
As set out in last year's Medium Term Financial Strategy[22], tax receipts can be sensitive to the performance of particular sectors. In particular, relatively poorer earnings performance in the North East of Scotland, and strong earnings in financial

[21] Bank of England (2023), Monetary Policy Report - May 2023 | Bank of England – May 2023
[22] Scottish Government (2022), Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy - gov.scot (www.gov.scot), May 2022

services in London and the South East, has contributed towards average earnings in Scotland having grown more poorly relative to the rest of the UK.

Earnings are a key determinant of fiscal performance. Figure 4 below shows the SFC's historic estimate of Scotland's earnings as a share of the UK average and how that improves steadily when comparing their latest forecasts and those of the OBR. Due to the operation of the Fiscal Framework, this relatively faster earnings growth will generally improve the Scottish funding outlook. This is discussed further in Chapter 3.

Figure 4: Outlook for relative nominal average earnings between Scotland and the UK



Source: Scottish Fiscal Commission analysis, May 2023[23].

The SFC have also made a small upward revision to their house price forecast in response to slightly lower interest rate rise expectations relative to December 2022 and consequently have revised up their forecast of Land & Buildings Transaction Tax (LBTT) revenues.

2.4 Economic Outlook Summary

The SFC's economic outlook has improved slightly since the Scottish Budget was published in December 2022 with the Scottish economy now forecast to avoid entering a technical recession in 2023.

However, the medium-term is still forecast to remain challenging, with relatively subdued growth in 2023 and households to see record falls in living standards which

[23] Scottish Fiscal Commission (2023), SFC Fiscal and Economic Forecasts –Scotland's Economic and Fiscal Forecasts- May 2023

aren't set to recover to pre-pandemic levels until 2026-27. The outlook for inflation and the indirect impact that then has on tax revenue growth and spending pressures over the medium-term remains highly uncertain and this is complicated further by the intricacies of the Fiscal Framework.

Chapter 3 sets out these complexities and uncertainties and what this means for the medium-term funding outlook for the Scottish Budget in more detail.

3. Scotland's Funding Outlook

3.1 How Scotland's funding outlook is determined

This chapter outlines the Scottish Government's 'central' funding outlook over the five years from 2023-24 to 2027-28. It sets out the assumptions and decisions that underpin this, and how the outlook has changed compared to last year's MTFS.

The Scottish Government's funding outlook is affected by decisions by both the UK and Scottish Governments, as well as Scotland's economic performance relative to the rest of the UK. The projections therefore combine independent forecasts of tax and spending provided by the SFC and OBR, with information published by His Majesty's Treasury (HMT), and the Scottish Government's own assessments of future risks inherent in the current funding framework, drawing on a range of sources as well as historic trends.

There is a significant level of uncertainty within the funding outlook. Alternative scenarios, setting out a more optimistic and pessimistic outlook, are presented at the end of this chapter.

The Scottish Government is committed to being open and transparent about its multi-year funding outlook and the risks and uncertainties that might lead to the actual position being higher or lower than this, to support Parliament and other stakeholders to fully scrutinise the sustainability of the Scottish Government's spending plans. In this MTFS, we have therefore put a greater emphasis on discussing upside and downside funding risks than in previous editions.

This chapter sets out:

- The central outlook for overall resource funding, which informs the Scottish Government's spending plans[24], and the assumptions underpinning this;
- The central outlook for each component of the Scottish Government's resource funding position;
- The overall central outlook for overall capital funding;
- The Scottish Government's capital borrowing policy;
- Funding risks including upside and downside scenarios; and
- How the Scottish Government manages these risks, within the limitations of powers available.

3.2 Summary of Scotland's funding outlook

The Scottish Government's funding outlook is comprised of five high level categories, each of which is discussed in detail in this chapter:

- **The Block Grant** – this is the single largest source of funding for the Scottish Government. The Barnett Formula determines the Block Grant and annual

[24] We have not included a funding forecast for AME as this is annual discretionary funding covered by HMT.

growth is dependent on the UK Government's overall fiscal plans and its spending priorities.

- **Devolved taxes** – the Scottish Government receives the revenue from these taxes, the largest of which is Scottish Income Tax. The Scottish Budget is then reduced based on how quickly revenues of the corresponding tax have grown in the rest of the UK (rUK) on a per head basis.
- **Non-domestic rates (NDR)** – this revenue is raised by Local Authorities on non-domestic properties. All revenue raised is ultimately returned to Local Government via the Local Government Settlement.
- **Social Security Block Grant Adjustments** – this is funding provided by the UK Government for devolved social security payments, based on the growth in expenditure on the corresponding payment in rUK on a per head basis.
- **Other income and expenses** – other revenue and costs including resource borrowing and associated costs as well as revenues from the Scottish Crown Estate.

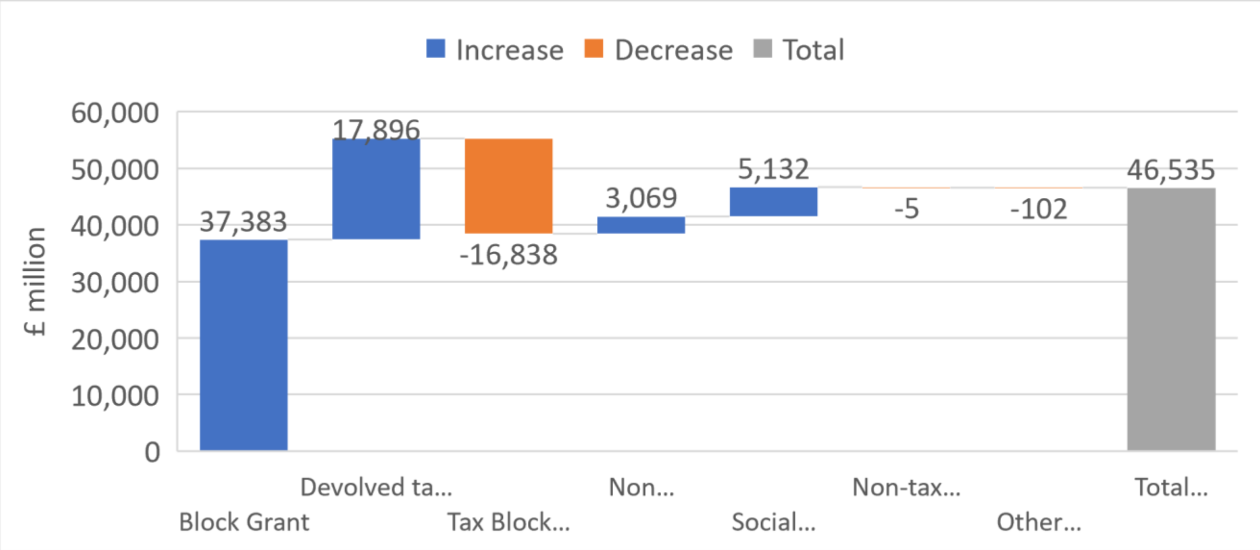
Overall, we expect the cash funding available to the Scottish Government to grow steadily from £45,260 million in 2023-24 to £50,971 million by 2027-28, (Table 1), an overall cash increase of 12.6% and a real terms increase of 6.8%. This is due to increases in the Block Grant and significant growth in the net tax position over this period. However, these increases will vary significantly between years. Pressures on funding will be most severe in 2024-25 when overall resource funding (including NDR) is forecast to grow by only 1.2% in real terms. Figure 5 illustrates the composition of the funding outlook for 2024-25.

Table 1: Central outlook for Scotland's resource funding sources (cash terms)

Figures in £million, current prices		*Forecast*			
Resource Funding	**2023-24***	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Block Grant	36,832	37,383	38,153	39,038	40,135
Net tax position	574	1,058	1,240	1,344	1,661
Of which:					
Devolved tax revenue	16,674	17,896	18,658	19,513	20,654
Tax Block Grant Adjustment	-16,100	-16,838	-17,418	-18,168	-18,993
Non-domestic rates (NDR) distributable amount	3,047	3,069	3,158	3,437	3,328
Social Security Block Grant Adjustment	4,434	5,132	5,435	5,697	6,003
Non-tax income & block grant adjustments	-5	-5	-5	-5	-5
Other income/expenses	378	-102	-63	-96	-151
Total resource funding, inc NDR income**	**45,260**	**46,535**	**47,917**	**49,415**	**50,971**

*Based on funding position as set at Budget 2023-24 so net position figures differ from latest SFC forecasts. **Totals may not sum due to rounding.

Figure 5: Composition of the central outlook of resource funding for 2024-25

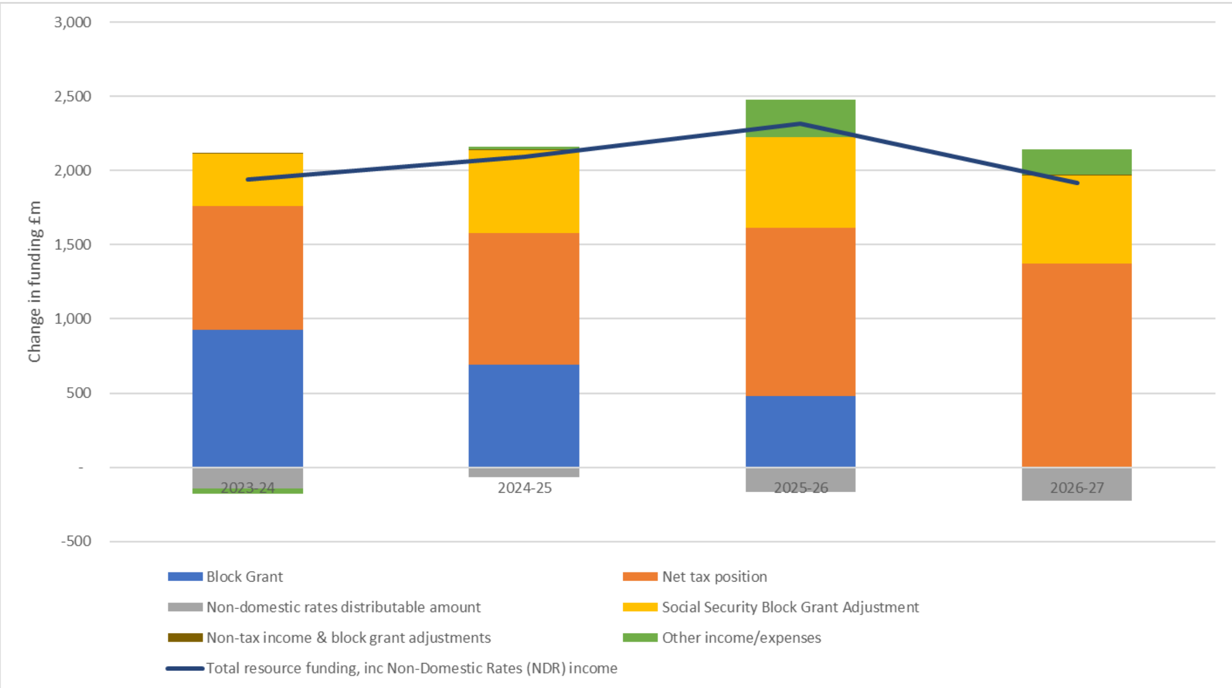


Source: Scottish Government

Annex F provides a full breakdown of the resource funding envelope.

Changes since May 2022: The economic and fiscal landscape has changed significantly since last year's MTFS, with implications for the funding outlook. As illustrated in Figure 6 the total resource funding outlook (including NDR) has improved significantly in cash terms, by an average of £2.1 billion per annum over the period 2023-24 to 2026-27.

Figure 6: Change in resource funding components since the May 2022 MTFS



Source: Scottish Government, SFC, OBR

The main driver for this is the significant improvement in the forecast net tax position, which has increased by an average of £1.1 billion per annum over the period 2023-24 and 2026-27, compared to last year's MTFS. This is due to a number of factors, including better than expected Income Tax outturn data for 2020-21, strong in-year performance for 2022-23, and policy changes in 2023-24 – but most importantly significant shifts in the underlying forecasts of relative economic performance compared to the rUK. As noted by the SFC, significant revisions to the outlook for the net tax position are quite common. In this instance, the improvements in the medium term are driven by divergence between the two forecasters' judgements about future earnings growth: the OBR forecasts growth in nominal earnings to average 2.0% between 2024-25 and 2027-28 which is lower than the SFC's forecast of 2.6% over this period and below historic trends. Risks to the net tax position are discussed further in section 3.10.

Improvements in the net tax position also feed through to a significant improvement in 'other income' in 2025-26 as latest forecasts suggest positive, rather than negative, reconciliations for 2022-23 and hence no requirement for potential resource borrowing in that year.

Increases to the Block Grant announced at the UK Government Autumn Statement[25], published in November 2022, and at the Spring Budget[26], published in March 2023, also contribute to the improved outlook. The improvement, compared to last May, is most significant in the early years of the outlook with no change in the outlook for 2026-27. Increases to the social security Block Grant Adjustments contributed around a further £530 million on average per year, although these are fully offset by higher forecasts of spending on social security benefits in Scotland over the same period.

3.3 Components of Scotland's funding outlook

This section sets out the assumptions underpinning the elements of the central resource funding outlook (Table 2). The approach to these funding assumptions has not changed substantially from that taken in the May 2022 MTFS[27].

Overall, the Scottish Government views the assumptions underpinning the central funding outlook as reasonable. This judgement is echoed by the SFC, which is tasked with reviewing the robustness of the Government's central funding scenario and underpinning assumptions as part of their remit. The Scottish Government also considers these assumptions to be prudent, with a relatively balanced likelihood of both more and less funding when looking at all elements in the round.

[25] UK Government (2022), Autumn Statement 2022 HTML - GOV.UK (www.gov.uk) – November 2022
[26] UK Government (2023), Spring Budget 2023 - GOV.UK (www.gov.uk), March 2023
[27] Scottish Government (2022), Scotland's Fiscal Outlook: The Scottish Government's Medium-Term Financial Strategy - gov.scot (www.gov.scot) – May 2022

Table 2: Central resource funding assumptions

Funding Component	Source of central funding assumption
Block Grant	2023-24 and 2024-25 figures in line with the latest Barnett and ringfenced funding settlements provided by HM Treasury (HMT) at Main Estimates. 2025-26 to 2027-28 Barnett projections in line with the March 2023 OBR projections for Public Sector Current Expenditure (PSCE) growth in RDEL (Resource Department Expenditure Limits). Ringfenced funding, such as the Rail Resource Grant and replacements for EU funding, held at 2024-25 levels in cash terms.
Net tax position:	
Devolved tax revenue	May 2023 SFC Forecasts
Block Grant Adjustment	March 2023 OBR Forecasts
Social Security Block Grant Adjustments	March 2023 OBR Forecasts
Non-Domestic Rates (NDR)	May 2023 SFC Forecasts, adjusted to reflect outturn adjustments in the NDR pool and taking into account the policy to bring the pool back into balance in 2024-25
Other Income and Expenses	Reconciliations implied by SFC and OBR forecasts; other projections based on assumptions and decisions made by the Scottish Government

Source: Scottish Government

3.4 Block Grant

The Block Grant is the core source of the Scottish Government's funding and is made up of two elements: the baseline Block Grant plus any changes to the core funding, also known as consequentials, which are determined by the Barnett formula. In essence, the formula provides the Scottish Budget with a population share of the change in 'comparable' UK Government departmental spending in England.

Therefore, the Block Grant is not only determined by how much the UK Government expects to spend in total, but also how it prioritises resource departmental spending (RDEL) and capital departmental spending (CDEL) across devolved and reserved spending areas within a given funding envelope. For example, considering recent policy decisions at Spring Budget 2023[28], higher UK Government spending on

[28] UK Government (2023), [Spring Budget 2023 - GOV.UK (www.gov.uk)](), March 2023

devolved policy areas, such as childcare, results in more funding being available to the Scottish Government while increased spending in reserved areas, such as Defence, will not generate any Barnett consequentials.

The UK Government has also used Part 6 of the UK Internal Market Act 2020 to fund activity in devolved policy areas. This includes funding streams under its Levelling Up agenda, including the Community Renewal Fund, the Community Ownership Fund, the Levelling Up Fund and the UK Shared Prosperity Fund. This funding should have been provided directly to the Scottish Government to allocate in line with national priorities. The Scottish Parliament did not consent to the Internal Market Act and the remains opposed to it. It enables the UK Government to bypass devolved decision making and override democratic processes for allocating funding in wholly devolved policy areas in Scotland, which risks incoherence, stakeholder confusion and inefficiency in public spending.

As set out in Table 3, the approach to the central forecast is broadly consistent with the methodology in last year's MTFS. However, unlike last year, the Scottish Government no longer assumes additional consequentials in the remaining years of the Spending Review (SR) period given that the end of the period is approaching and there is less certainty over any assumed consequentials materialising.

As a result, the Barnett resource Block Grant is expected to grow by 3.3% in real terms between 2023-24 and 2027-28 although annual rates vary significantly across years. In 2024-25, the block grant is expected to fall marginally by 0.1% but it is projected to grow by 1.1% in real terms from 2025-26 onwards.

Table 3: Central Outlook for Resource Block Grant funding

Figures in £million, current prices		***Forecast***			
Resource Funding	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**
RDEL Block Grant as at UKSR 21	34,942	35,577	N/A	N/A	N/A
Additional consequentials from subsequent UK fiscal events	1,176	1,091			
Assumed Block Grant beyond SR period			37,438	38,323	39,420
Non-Barnett ringfenced funding and Rail Resource Grant	715	715	715	715	715
Total RDEL Block Grant	36,832	37,383	38,153	39,038	40,135

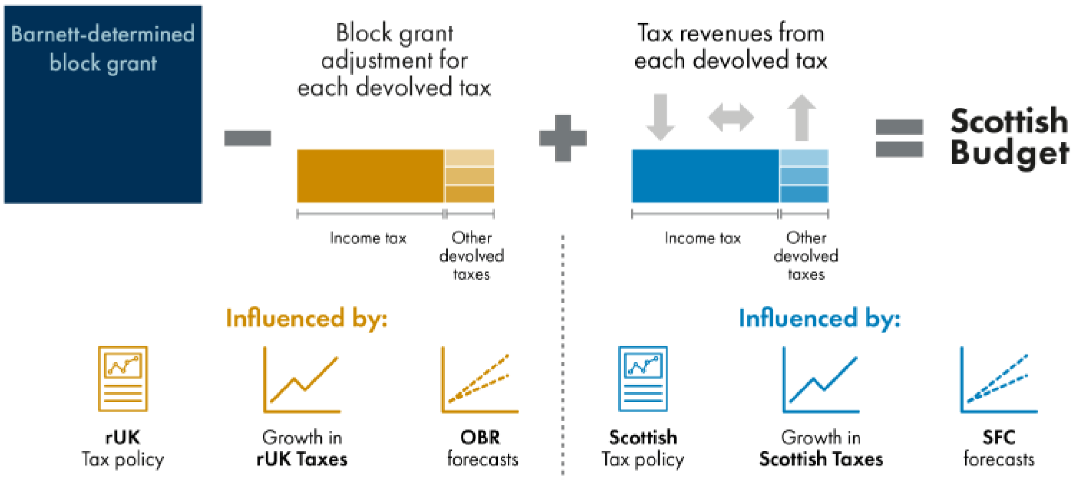
Source: Scottish Government, OBR

3.5 Net impact of devolved tax revenue & Block Grant Adjustments

The Scottish Government receives the revenue from fully and partially devolved taxes – namely Scottish Income Tax (SIT), Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT)[29]. As illustrated in Figure 7, as the Scottish Government now raises devolved tax revenue, a corresponding BGA is made to account for the tax revenue that is foregone by the UK Government.

[29] UKG equivalents are Income Tax, Stamp Duty Land Tax and Landfill Tax

Figure 7: The operation of the Fiscal Framework



Source: Scottish Parliament Information Centre

The difference between the amount of revenue the Scottish Government receives from these taxes and the corresponding BGA determines the net impact of devolved tax on the Scottish Budget, otherwise referred to as the 'net tax position'; this is the spending power available to the Budget.

Under the current Fiscal Framework[30], the overall impact of tax devolution on the Scottish Budget depends on the performance of tax receipts per person in Scotland relative to the rest of the UK. If tax receipts per person in Scotland grow faster than in the rUK, there will be additional funding for the Scottish Budget, and vice versa. The performance of the Scottish economy, alongside Scottish and rUK tax policy decisions, influence the scale of tax revenues, and whether the Scottish Budget is larger or smaller than it would have been without the devolved powers.

The net tax impact in the central funding outlook, as presented in Table 4, is based on the latest SFC and OBR forecasts. However, for 2023-24 the position for Income Tax is set at the level incorporated into the 2023-24 Budget (£325 million).

[30] Scottish Government (2022), Fiscal framework: factsheet - gov.scot (www.gov.scot) – July 2022

Table 4: Impact of devolved taxes on the Scottish Budget (Source: SFC, OBR)

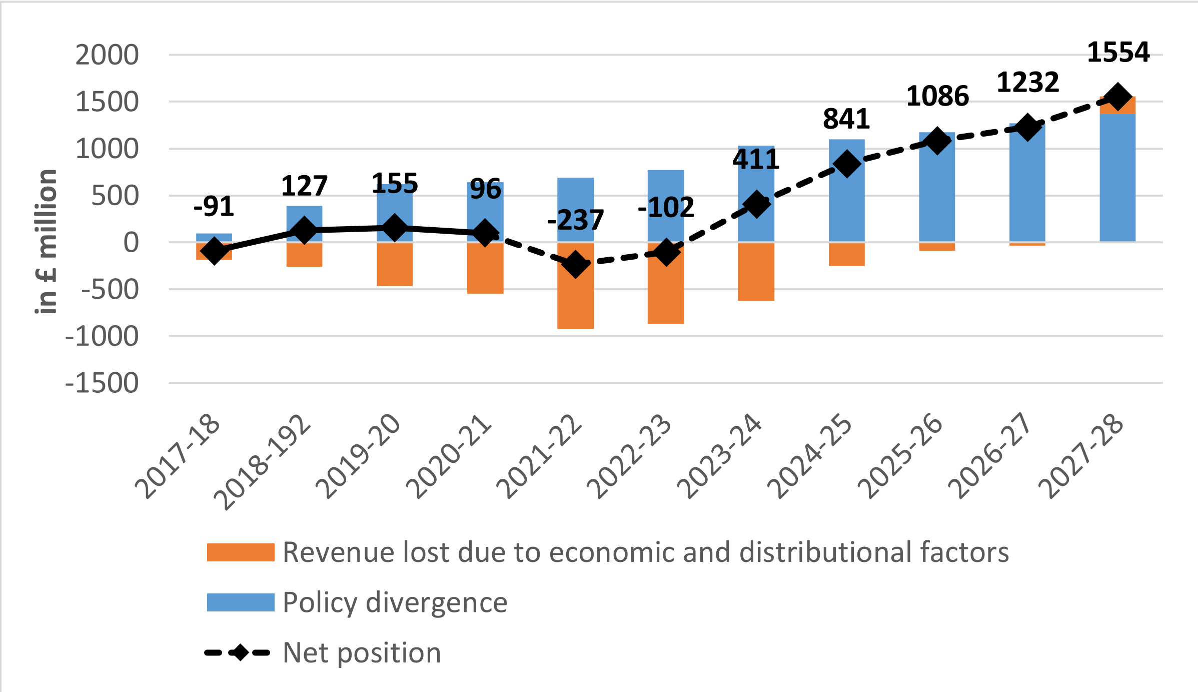
Figures in £million, current prices		*Forecast*			
Resource Funding	**2023-24***	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Income Tax					
Revenue*	15,810	17,080	17,808	18,591	19,646
Block Grant* Adjustment	-15,485	-16,239	-16,722	-17,359	-18,092
Net Income Tax* position	325	841	1,086	1,232	1,554
Land and Buildings Transaction Tax					
Revenue	772	733	792	905	992
Block Grant Adjustment	-519	-508	-612	-723	-809
Net LBTT position	254	225	179	183	183
Scottish Landfill Tax					
Revenue	92	83	58	16	16
Block Grant Adjustment	-96	-91	-84	-87	-92
Net SLfT position	-5	-8	-26	-71	-76
Total net tax impact	574	1,058	1,240	1,344	1,661

*Figures shown for 2023-24 are based on the SFC and OBR forecasts as at the Scottish Budget 2023-24 Budget, published in December 2022. The latest SFC and OBR forecasts for 2023 will affect the Scottish funding position through reconciliations. **Some figures may not sum due to rounding.

As illustrated in Table 4, tax devolution is forecast to make a positive net contribution to the Scottish Budget and therefore presents a vital additional source of revenue.

Income Tax: As noted above, fiscal devolution means that the Scottish Budget is now more closely linked to Scotland’s relative economic and tax performance. However, the relationship between the economy and tax is complex, and reflects a range of factors, including macro-economic performance, regional and sectoral issues, demographics, the composition of the tax base as well as differences in government economic and tax policy. Figure 8 illustrates the contributions of these different components to the Income Tax net position, based on outturn data and latest forecasts.

Figure 8: Illustrative contributions to Scotland's net Income Tax position (£million)



Source: Scottish Government, SFC, OBR

The Scottish Government estimates that the Scottish Budget will benefit by up to around £1 billion in 2023-24, when compared with matching Income Tax policy in the rUK (blue bars).[31] This is in line with SFC estimates from the December budget. However, relatively weaker economic performance on employment and earnings growth, alongside differences in the income distribution, partly offset this (orange bars). Therefore, the SFC now forecasts Scottish Income Tax to be only £411 million greater than the corresponding BGA in 2023-24 (black line). While this is above the £325 million estimate from forecasts accompanying the Budget (see Table 4), there is no impact on Scottish Government spending power in 2023-24 as figures for Income Tax are "locked in" until outturn becomes available. and the final reconciliations are calculated.

Scotland's labour market outcomes have broadly matched, if not exceeded, the UK performance in recent years, with high employment and low unemployment. The relatively weaker performance of Scottish Income Tax primarily reflects weaker earnings growth, particularly amongst higher rate taxpayers, and distributional factors. As discussed in the 2021 and 2022 MTFS publications, this weaker relative performance since Income Tax was devolved is associated with lower receipts in the North East of Scotland, caused by the downturn in the oil and gas industry, at the same time as strong growth in rUK receipts in London and the South East, driven by growth in the financial services sector. However, even if the Scottish and UK economies were growing at similar rates, it would not necessarily be the case that the respective tax bases would grow similarly as well, for example if particular

[31] This estimate does not account for behavioural responses which might reduce the yield from the policy.

sectors that contain a disproportionate number of high-income taxpayers were going through cyclical or structural change.

The Scottish Government continues to monitor the key drivers of Scotland's tax performance as more evidence and data become available. Although tax performance remains a key risk to the resource funding position, recent evidence across a range of indicators suggests that the relatively weaker economic performance has lessened. Provisional in-year Pay As you Earn (PAYE) tax data for the first 11 months of 2022-23 suggest that growth in Scottish PAYE income tax receipts has outperformed the rest of the UK. Indicative analysis for the first six months of the financial year also suggests that these improvements in relative tax performance are broad based across all sectors. However, a full assessment of Real Time Information RTI tax performance in 2022-23 will only be available when data for the full financial year, including the bonus season, will be published alongside HMRC Scottish Income Tax Outturn 2021-22 in summer 2023. We will consider opportunities to update Parliament at this point.

These improvements are also reflected in the latest set of forecasts by the SFC and the OBR which suggest that Scotland's net position will continue to improve further in the medium term. While positive, the Scottish Government is not complacent and is therefore taking further action to help boost the long-term and sustainable growth of the Scottish tax base and ensure this improvement is realised.

Fully devolved taxes: For LBTT, the expected medium-term net position over the next five years remains positive and similar to what it was at the time of the Scottish Budget. Across the period, a slight weakening of this positive net position is anticipated from 2025-26 onwards. This is in part due to the temporary increase in the UK's Stamp Duty Land Tax (SDLT) residential nil rate band coming to an end on 31 March 2025 and the impact of this on SDLT revenues.

The medium-term LBTT forecast in total has not changed significantly since the Scottish Budget 2023-24. However the residential LBTT forecast is a little more optimistic, based on house prices rising more than expected at that time, while there is a more negative view of non-residential LBTT, largely based on 2022-23 outturn data.

The net position for LBTT is close to where it was six months ago, reflecting the fact that the Scottish and rUK residential property markets have historically tended to track each other in terms of general direction as they are subject to the same base rate and mortgage rate changes.

For SLfT, the net position is expected to be negative in each year of the funding outlook. The negative net position for SLfT accelerates sharply from 2026-27 when the ban on landfilling biodegradable municipal waste (BMW) in Scotland will come into operation. Before the ban comes into effect (31 December 2025), the volume of waste going to landfill is expected to decline as waste is diverted to other means of disposal, such as energy from waste.

3.6 Block Grant Adjustments for devolved Social Security benefits

For the social security BGAs, the central funding outlook is based on the OBR's March 2023 forecasts for benefit expenditure in England and Wales. 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 changes to the eligibility for certain benefits, changes to the generosity of certain payments or decisions on how payments are uprated over time.

The social security BGAs that inform the funding envelope are set out in Table 5.

Table 5: Impact of social security Block Grant Adjustments on the Scottish Budget

Figures in £million, current prices		***Forecast***			
	2023-24	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Attendance Allowance	646	714	728	733	744
Personal Independence Payment	2,500	2,840	3,095	3,347	3,609
Disability Living Allowance	826	900	915	906	920
Carer's Allowance	367	404	421	441	465
Industrial Injuries Disablement Scheme	84	84	80	77	74
Severe Disablement Allowance	6	6	5	4	3
Cold Weather Payments	5	5	5	5	5
Pension Age Winter Heating Payment[32]	N/A	179	184	185	183
Total social security BGA	4,434	5,132	5,435	5,697	6,003

32 *The Pension Age Winter Heating Payment is still to be devolved and will replace the Winter Fuel Payment in Scotland. This benefit will commence from winter 2024. The forecasts from 2024-25 to 2027-28 are a Scottish Government estimate, so as not to create an artificial gap between forecasted expenditure and funding.

Source: Scottish Government, OBR

The forecast BGA is set to increase annually, from £4,434 million in 2023-24 to £6,003 million in 2027-28. The latest forecast for the 2023-24 social security BGA is £73 million higher than the BGA used in the Scottish Budget 2023-24 and £352 million higher than in the 2022 MTFS.

The upward revision since May 2022 reflects wider post-pandemic trends of ill-health in the UK population which translates into higher-than-expected recent caseloads, which the OBR assume will persist throughout the forecast period. Their judgement about caseloads reflects new claims for disability-related benefits rising further above pre-pandemic levels. The rise in new claims for benefits such as Personal Independence Payment (PIP) has also been compounded by an increase in the success rate of those claims.

Moreover, the UK Government's decision – mirrored in Scotland – to uprate benefits in 2023-24 in line with much higher inflation (10.1%) than anticipated in May last year has also increased social security spending in England and Wales, and hence the BGAs the Scottish Government receives.

Annex E sets out details of the assessment of the distributional impact of the Scottish Government’s Income Tax and social security policy choices.

3.7 Non-Domestic Rates (NDR)

NDR are administered and collected by councils. NDR revenue raised is pooled centrally and may be in deficit or surplus at any point in time, but all revenues are ultimately distributed back to Local Authorities over time. The Scottish Government guarantees the sum of General Revenue Grant funding and NDR income, thereby bearing any volatility risk with NDR revenue between forecast and outturn. NDR policy decisions including the poundage and reliefs are made annually by Scottish Government at the Budget.

The central estimate of the NDR Distributable Amount – the amount guaranteed to Local Authorities each year – draws directly from the SFC’s forecasts of NDR revenues (the Contributable Amount) adjusted to reflect the closing balance of the NDR pool from the previous financial year, estimated prior year adjustments and taking into account Scottish Government policy on clearing the NDR pool deficit in 2024-25. From 2025-26 onwards, it is therefore assumed that the Distributable Amount will equal the forecast Contributable Amount.

The SFC forecasts reflect the revaluation which took effect on 1 April 2023, as well as policies announced at the Scottish Budget 2023-24, such as reforms to the Small Business Bonus Scheme. To better reflect market circumstances this revaluation was based on one year ‘tone’ date for the first time, and transitional reliefs were introduced to protect those seeing the highest increases in rateable value. The next revaluation is scheduled for 2026. Reforms to the appeals system were also introduced on 1 April 2023 and are intended to encourage swifter resolution at an early stage. One effect of this would be to provide greater revenue certainty.

Table 6: Impact of Non-Domestic Rates on the Scottish Budget

All figures in £million, current prices	2023-24	2024-25	2025-26	2026-27	2027-28
Non-Domestic Rates – Distributable amount	3,047	3,069	3,158	3,437	3,328

Source: Scottish Government, SFC

3.8 Other income

This category aggregates all the smaller components of the resource funding envelope not covered above and accounts for less than 1% of the total. Each of these line items was assessed independently using existing policies (where applicable) but given the inherent volatility of these items, the interdependencies across them, and also the scope for discretion, a collective view was also taken in determining final funding assumptions. Table 7 sets this out in detail.

The material elements are:

- **Reconciliations** - These relate to OBR and SFC forecast error in past years. They occur after tax outturn data becomes available and, for Income Tax, affect the financial year three years after the tax year to which they relate (i.e. the reconciliation that affects the 2024-25 Scottish Budget relates to the 2021-22 tax year). Estimates of future reconciliations are directly derived from latest SFC and March OBR forecasts for the period 2023-24 to 2026-27. No assumption is made for 2027-28 as this is beyond the reconciliations forecast period. A significant reconciliation is expected for the 2024-25 Budget in relation to Income Tax which exceeds the Scottish Government's current borrowing powers.
- **Resource Borrowing -** This provides funding to offset the impact of adverse Income Tax reconciliations in future years. Borrowing amounts are maintained at levels assumed for the 2023-24 Scottish Budget (£41 million and £300 million for 2023-24 and 204-25 respectively) and have changed from the assumptions made in the 2022 MTFS due to significant shifts in the estimated reconciliations.
- **Borrowing costs** - These are derived directly from capital and resource borrowing assumptions.
- **Scotland Reserve.** The Scotland Reserve provides the Scottish Government limited ability to manage spending across financial years. No Scotland Reserve assumption is included for future years. The Scottish Government's approach to the Scotland Reserve is discussed in section 3.11.
- **ScotWind Revenue -** In 2022-23, the Crown Estate Scotland concluded the first round of offshore wind leasing which generated in excess of £756 million

of income. Consistent with last year's MTFS, deployment of ScotWind income is maintained at £310 million in 2023-24 and £350 million in 2024-25. Decisions on profiling of other offshore leasing Crown Estate Revenues, including Innovation and Targeted Oil and Gas (INTOG) revenues, will be taken when they can be reliably quantified.

- **Migrant Surcharge -** This is income derived from charges on migrants for using NHS Services and is redistributed to devolved governments on a Barnett basis. The funding assumed is £160 million per annum, broadly in line with recent outturn data.

Table 7: 'Other income' assumptions used in the resource central funding estimate (£million)

		Forecast			
	2023-24	**2024-25**	**2025-26**	**2026-27**	**2027-28**
Reconciliations	46	-687	88	86	-
Resource Borrowing	41	300	-	-	-
Resource Borrowing Costs	-114	-124	-166	-174	-120
Capital Borrowing Costs	-103	-127	-150	-173	-197
ScotWind	310	350	-	-	-
Scotland Reserve	-	-	-	-	-
Migrant Surcharge	160	160	160	160	160
King's and Lord Treasurer's Remembrancer (KLTR)	5	5	5	5	5
Other*	33	21	-	-	-
Total other income	378	-102	-63	-96	-151

*Other includes corrections to historic UK funding settlements and machinery of government transfers due to be received

Source: Scottish Government

3.9 Scotland's Capital Funding Outlook

This section sets out the central capital funding outlook (Table 8) and the assumptions underpinning this, which are largely unchanged from last year. This is structured around four categories:

1. **The Capital Block Grant –** this is the single largest source of funding for the Scottish Government's capital budget, which is driven by the UK Government's spending priorities and overall fiscal plans and determined through the Barnett Formula.
2. **Capital Borrowing –** Under the Fiscal Framework, the Scottish Government can borrow additional capital up to a maximum of £450 million per annum and £3 billion in total.
3. **Ringfenced funding and City Deals –** Funding received through the Block Grant but outside of Barnett arrangements include network rail ringfenced funding and City Deals.
4. **Financial Transactions** - Financial Transactions (FTs) are a type of funding allocated to the Scottish Government by HMT. They can only be used to make loans to or equity investments in private sector entities. The funds must ultimately be repaid by the Scottish Government to the UK Government.

Table 8: Central capital funding assumptions

Funding Component	Source of central funding assumption
Block Grant	The 2023-24 and 2024-25 figures are the latest Barnett funding provided by HMT at Main Estimates. The 2025-26 to 2027-28 projections are based on the March 2023 OBR projections for Public Sector Gross Investment (PSGI) growth.
Capital Borrowing	Current Scottish Government capital Borrowing policy which assumes £450 million additional funding will be available through borrowing and other funding in each year.
Ringfenced funding and City Deals	The 2023-24 and 2024-25 figures for Ringfenced funding are the latest provided by HMT at Main Estimates. City Deals are maintained at £100 million per annum for the duration of the period.
Financial Transactions	No Financial Transactions funding is included for years beyond 2024-25. This is in line with our understanding of HMT's latest plans.

Source: Scottish Government, OBR

As illustrated in Table 9, total capital funding excluding FTs is expected to fall by around 1.6% in cash terms between 2023-24 and 2027-28. This reflects the UK Government's plans to hold capital spending broadly flat in cash terms beyond 2024-25. This means that capital funding is projected to fall in real terms by 6.7%. This real terms fall is felt most acutely in 2024-25, where funding is projected to fall by 3.7%

Table 9: Central Outlook for Scotland's Capital Funding

All figures in £million, current prices	2023-24	2024-25	2025-26	2026-27	2027-28
Total CDEL Block Grant	4,820	4,691	4,700	4,720	4,727
Ringfenced funding and City Deals	734	732	732	732	732
Capital Borrowing and other funding per policy	450	450	450	450	450
Total Capital Funding excl FTs	6,004	5,873	5,882	5,902	5,909
Financial Transactions	410	176			
Total Capital Funding incl FTs	6,414	6,049	5,882	5,902	5,909

Source: Scottish Government, OBR

The overall capital funding outlook has worsened since the last MTFS, with the 2022 UK Government Autumn Statement indicating that the capital block grant will remain broadly flat in cash terms for three years from 2025-26. The other driver of the weaker position relates to FTs. In May 2022, Government included in the central funding scenario an additional £400 million in FTs split over 2023-24 and 2024-25 as a result of previous years' adjustments due to be made by HMT. As of May 2023, the UK Government has agreed to provide £187.6 million but no agreement has been reached over the remaining £212.6 million FTs. This outstanding amount is therefore not included in the central outlook.

Annex F provides a full breakdown of the capital funding envelope.

3.9.1 Capital Borrowing

Under the Fiscal Framework, the Scottish Government can borrow additional capital up to £3 billion cumulatively with an annual limit of £450 million. In taking annual borrowing decisions, the Scottish Government also takes into consideration the affordability of ongoing debt repayments.

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.

In 2022 the Scottish Government amended its Capital Borrowing policy to assume £450 million of additional annual funding would be available through a combination of borrowing, the Scotland Reserve and other capital funding. Within this £450 million total, £250 million will initially be assumed to be funded through borrowing.

The Scottish Government can borrow £250 million annually at a 15-year tenor, almost indefinitely, even within the existing cumulative limit of £3 billion imposed by the Fiscal Framework. Where capital borrowing is required to be greater than £250 million the tenor will be amended to balance the resource cost impact and longer-term fiscal sustainability.

As the medium-term Barnett outlook for capital is constrained in real terms, there is an increasing likelihood that to achieve the full additional £450 million per annum, actual borrowing would need to be greater than the £250 million assumed. Decisions on the nature and scale of capital borrowing will be made at the end of each financial year, based on the resource and capital funding outlook at the point where drawdown decisions are finalised.

3.10 Funding risks

All sources of funding are subject to uncertainty due to policy risks, economic risks, and forecast error. These risks are often difficult to quantify, for example, because either the scale of the risk, or the probability of it occurring, is unknown. The identification and management of risks – both on the upside and downside – are essential for prudent stewardship of the public finances and smoothing funding variability over time. Annex D provides a summary of the risks to the funding and spending positions set out in this document.

This section presents illustrative upside and downside scenarios for the funding envelope, based on analysis of historic funding variability and forecast error for the two principal sources of variation, the Block Grant and the Income Tax net position, alongside judgements about the key challenges lying ahead.

3.10.1 Risks to the UK Government Block Grant

Changes to UK Government spending plans remain the most significant source of funding risk for both resource and capital funding. The level of uncertainty is heightened by the UK General Election due to be held before the end of 2024, with a potential change in the overall UK fiscal stance as well as the shape of Government spending.

As noted by the Institute for Fiscal Studies (IFS)[33], the current ‘pencilled in’ spending plans beyond the UK Spending Review period are extremely tight, “perhaps implausibly so, given the pressures on public services”. Under those plans, overall day-to-day departmental spending is expected to grow by around 1% in real terms, well below the 1.8% average seen over the past 40 years and below the 2.8% average for this UK Parliament. Once likely increases on the NHS as well as

[33] Institute for Fiscal Studies (2023), [The fiscal backdrop to Spring Budget 2023 | Institute for Fiscal Studies (ifs.org.uk)]() – February 2023

commitments on childcare and defence are taken into account, this could imply real terms cuts for some departments.

Scottish Government analysis of historic trends shows that initial allocations for both resource and capital funding (in periods outside spending reviews) were ultimately increased. Based on this historic analysis, the high scenario illustrates an annual growth in resource funding 2.7% points higher each year than in the central forecast, while annual growth in capital funding is 3.1% points higher. By contrast, the low scenario assumes that annual growth is 1% point lower than in the central scenario.

3.10.2 Risks to the net tax position

The Fiscal Framework cushions the Scottish Budget against any UK-wide symmetric economic shocks. In short, if economic factors, such as inflation, or policy decisions, were to affect tax receipts in Scotland and the rest of the UK equally, the net tax position would be largely unchanged. As noted in Box 2, there is no clear evidence yet as to whether inflation – via its impact on nominal wage growth - will affect the UK and Scotland in the same way.

Box 2: Inflation and the Income Tax Net Position

Higher inflation and a relatively tight labour market, with near record low unemployment, have been contributing to upward pressure on nominal earnings growth. Growth in nominal wages across the UK was at 7.0% in the private sector and 5.6% in the public sector in January to March 2023.

Faster pay growth would boost Scottish Income Tax receipts. However, this only tells part of the story, as it is Scotland's relative performance in earnings growth compared to the rest of the UK that matters for the Scottish Budget. In other words, if higher inflation leads to higher nominal earnings growth in both Scotland and the rUK, Scottish tax receipts increase but so does the off-setting BGA. The net position will only be affected by inflation if earnings growth is different between Scotland and rUK. This is because the Fiscal Framework cushions the Scottish Budget against any UK-wide and symmetric economic shocks. However, it does not account for any sectoral, distributional and forecast risks.

Factors that might lead to a different impact on tax receipts in Scotland relative to the rest of the UK include differences in the structure of the two economies or the structure of the tax base. Data on this is still emerging but three possible drivers of differential impact are set out below:

- Differences in the relative size of the public sector. Should private sector wage growth continue to outpace public sector pay growth, this might present a downside risk to Scotland's tax performance. In 2019-20, the latest year for which detailed sectoral Income Tax data is available, around 21% of Scottish tax receipts came from Public Administration, Education and Human Health & Social Work, compared to 15% in the rUK. Hence, slow public sector wage growth has a larger impact on Scottish receipts.

- Differences in the income distribution mean that fiscal drag – whereby taxpayers are pulled into higher bands as earnings grow and thresholds remains frozen – could be more pronounced in Scotland.

- Differences in earnings growth in particular sectors may also have an impact, with recent data suggesting stronger earnings growth in Scotland than rUK in the Finance and Insurance sectors.

In summary, it is too early to draw firm conclusions as to whether inflation is impacting Scotland's relative income tax performance but the Scottish Government will continue to monitor this.

Income tax performance remains a major risk to the funding position, and there can be significant shifts in the net position from year to year, although there are encouraging signs from recent data that historic trends might have lessened. Similar to December 2022, the SFC forecasts show a period of relatively faster earnings growth in Scotland, compared to the rUK, which can have a material impact on the net position. To put this into context, as noted by the SFC, a 0.1% relative increase in Scottish average nominal earnings growth would lead to a £25 million increase in the net position. By comparison, a 0.1% relative increase in Scottish employment growth rates would lead to a £13 million increase in the net position.

Income Tax policy decisions by either the Scottish or UK Governments can also have a significant effect on Income Tax receipts. For example, the SFC forecasts are currently based on the assumption that the Higher Rate Threshold in Scotland will remain frozen over the forecast period. However, policy decisions about the rates and bands are made annually at the Scottish Budget. Should the Scottish Government decide to uprate the threshold in line with inflation, for example, this would reduce Scottish Income Tax receipts below what is set out in the 'central' funding forecast. Possible developments in UK Income Tax policy may also influence the funding outlook. With a UK General Election expected in 2024, media speculation has suggested the possibility of 1p cut to the Basic Rate of Income Tax in the rest of the UK. This may result in an improvement to the Scottish Government's position, possibly in the range of around £400 million per annum should the policy not be mirrored in Scotland.

As highlighted by the SFC, recent improvements in the Income Tax net position are partly driven by differences in the independent forecasters' judgements, in particular in relation to earnings growth. The SFC highlight that were earnings growth to be more similar in Scotland and the UK, the Income Tax net position would be materially lower than is currently projected.

Across the range of risk drivers, some are quantifiable in terms of scale but likelihood remains subject to judgement for them all. The scenarios presented in Box 3 draw on an analysis of historic forecast errors for the Income Tax net position.

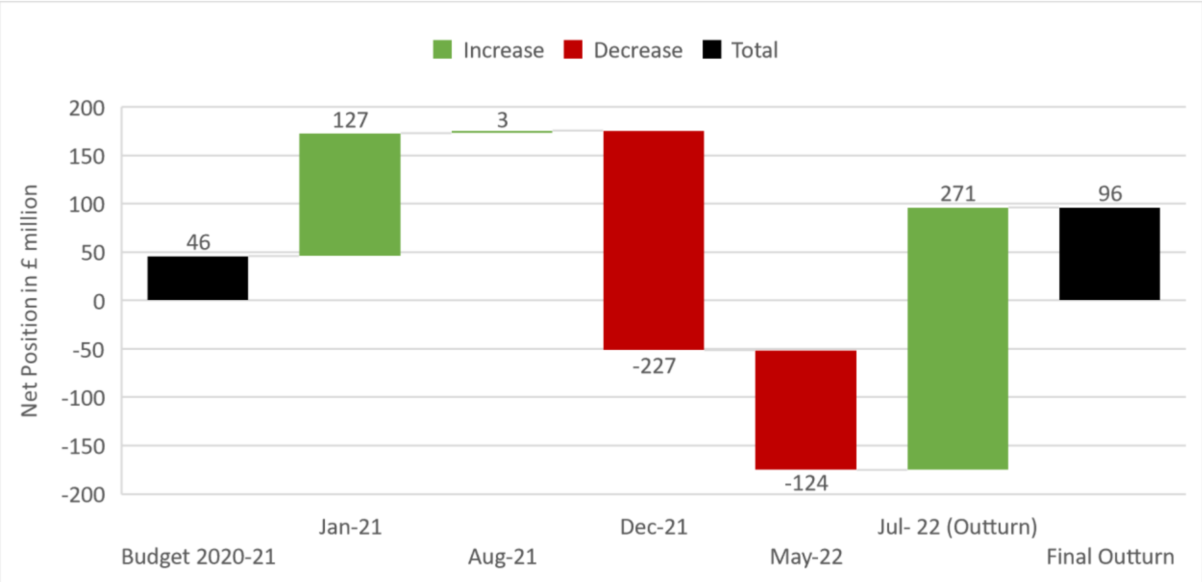
Box 3: Forecasts of the net position and funding volatility

In addition to economic and policy risks, the net tax position remains subject to significant forecast variation. Forecast error is an inherent part of forecasting. In the case of the Scottish Budget, the risk of forecast error is heightened by the Fiscal Framework drawing on two different forecast institutions, the SFC and the OBR, both forecasting a different part of the funding position.

Having official independent forecasts is vital as it reduces bias and improves overall fiscal transparency. However, the differences in timing, judgement and methodology between the OBR and SFC continue to present a risk for the Scottish Government's funding outlook, contributing to continuing volatility. This is illustrated in Figure 9 which compares different rounds of forecasts over time.

The original, budget-setting, forecasts produced in February 2020 of the £46 million net position were 'locked in' until outturn data was available in summer 2022. Despite economic upheaval – original forecasts were produced prior to the full extent of Covid 19 pandemic - the final net position was only £50 million higher than originally forecast. Forecasts between the original budget-setting forecasts and final outturn projected different outcomes – some higher and some lower than the final outturn.

Figure 9: Volatility of the Income Tax net position



Source: Scottish Government, SFC, OBR

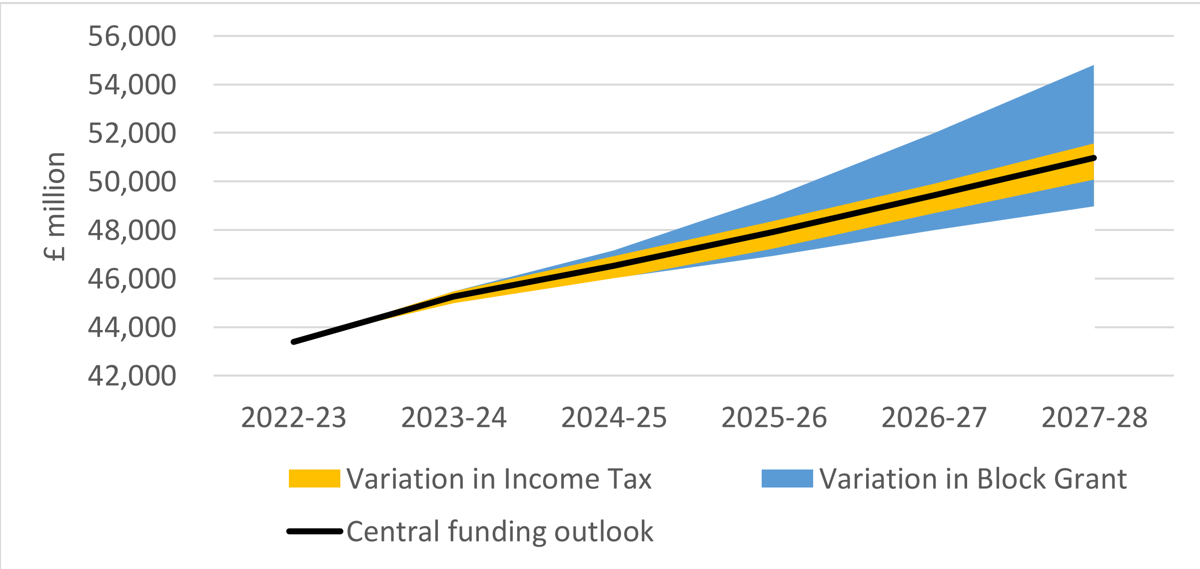
However, it also shows that there is significant volatility in the forecasts produced in between the budget setting forecasts and final outturn. This will in part reflect that the net position is the difference between the forecasts of two large numbers (income tax and the BGA), and so small changes in either forecast can result in large changes in the net position. Unlike for forecasts of Scottish and rUK receipts, these forecasts of the net position do not appear to become more accurate over time. Indeed, in this example, the forecast error of the net position was largest just two months prior to the outturn data becoming available.

This volatility in forecasts does introduce a challenge to forward planning and efforts to smooth the funding outlook over time. This is because forecasts for the anticipated reconciliation to be applied in future budgets – in the case of the 2020-21 outturn to be applied in Budget 2023-24 - inform decisions on future resource borrowing and spending. In addition, should outturn figures be significantly different from the latest available forecast, the impact on the funding outlook can be twofold: not only will anticipated reconciliations change but such updates can also impact the outlook for the future net position should the forecasters judge any unexpected improvements or deteriorations in tax revenues to have a permanent effect.

With only four years of Income Tax outturn data available at present (2017-18 to 2020-21), our understanding of these challenges is still evolving. However, our analysis of historic forecast errors over this relatively short time period indicates that the average amount of variability, the so-called standard deviation, was around £100 million across the four years. We have used this as the basis to generate a 95% confidence interval by adding/subtracting two standard deviations to the central net tax position, with further adjustments to account for greater downside risks and growth in the net tax position over time.

Figure 10 and Table 10 set out an illustrative upside and downside scenario for the funding outlook based on the risks to the Block Grant (blue range) and to volatility in the forecast of the net tax position (orange range). The uncertainty in the Block Grant is the most significant factor.

Figure 10: Illustrative upside and downside scenarios for the resource funding outlook



Source: Scottish Government

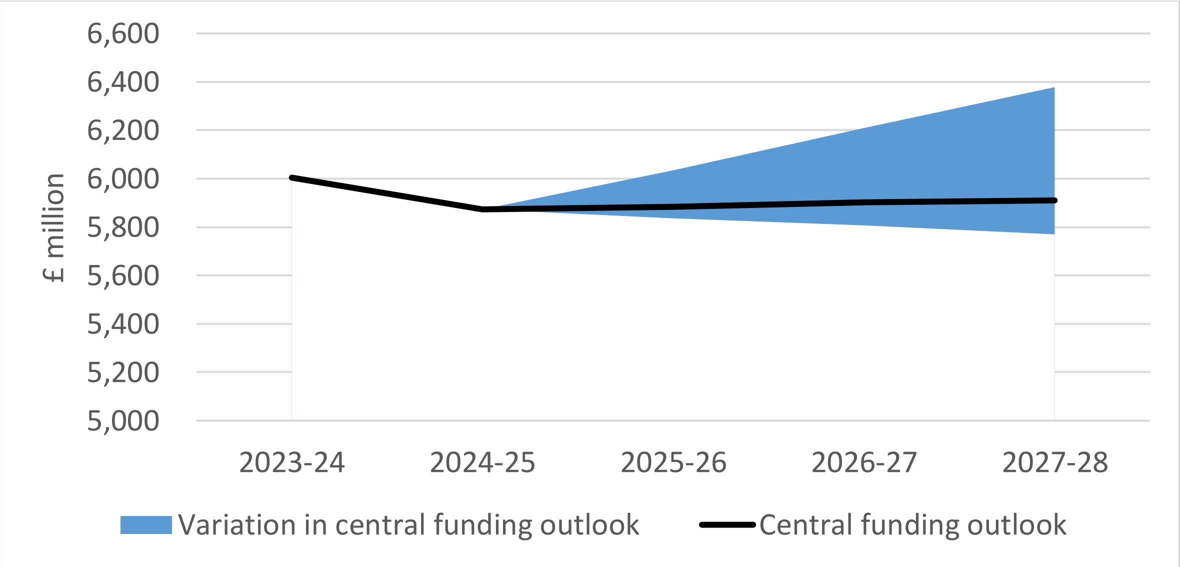
Table 10: Illustrative upside and downside scenarios for the resource funding outlook (£million)

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Central funding outlook	43,387	45,260	46,535	47,917	49,415	50,971
Upside scenario	43,387	45,466	47,166	49,363	51,973	54,805
% variation	0.0%	*0.5%*	*1.4%*	*3.0%*	*5.2%*	*7.5%*
Downside scenario	43,387	44,951	45,965	46,882	47,945	48,933
% variation	0.0%	*-0.7%*	*-1.2%*	*-2.2%*	*-3.0%*	*-4.0%*

Source: Scottish Government

The Scottish Government has taken a similar approach to illustrative modelling of capital funding, with the upside and downside scenarios based on variation to the block grant – see Figure 11 and Table 11.

Figure 11: Illustrative upside and downside scenarios for the capital funding outlook (£m)



Source: Scottish Government

Table 11: Illustrative upside and downside scenarios for the capital funding outlook (£m)

	2023-24	2024-25	2025-26	2026-27	2027-28
Central funding outlook	6,004	5,873	5,882	5,902	5,909
Upside scenario	6,004	5,873	6,033	6,209	6,378
% variation	*0.0%*	*0.0%*	*2.6%*	*5.2%*	*7.9%*
Downside scenario	6,004	5,873	5,835	5,808	5,769
% variation	*0.0%*	*0.0%*	*-0.8%*	*-1.6%*	*-2.4%*

Source: Scottish Government

3.11 Funding Risk Management

3.11.1 Tools available within the Fiscal Framework

The Fiscal Framework provides the Scottish Government with limited fiscal tools to manage volatility and risk.

The Scotland Reserve enables the Scottish Government to defer funding or carry forward underspends, within set 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.

The Scottish Government can use Resource Borrowing in very specific circumstances - for cash management and to address tax and social security forecast error reconciliations.

The total cumulative limit for resource borrowing is £1.75 billion. The normal annual limit for all resource borrowing is £600 million but for forecast error the annual limit is £300 million and for cash management the annual limit is £500 million. Resource borrowing can only be sourced from the National Loans fund (NLF) and the term of any loans must be between 3 and 5 years.

The triggering of the 'Scotland-specific economic shock' provision in 2021-22, means that some of these restrictions are relaxed until 2023-24. This includes the drawdown limits for the Scotland Reserve and an increase to the annual limit for resource borrowing for forecast error from £300 million to £600 million.

3.11.2 Limitations of powers compared with scale of the risks

The limited range of these powers means they do not fully address the fiscal risks they are intended to mitigate, or the volatility the Scottish Budget is exposed to. We have published analysis in previous Scottish Government MTFS documents illustrating that the £300 million annual borrowing limit for forecast error is insufficient to cover the degree of forecast error risk the Scottish Budget is exposed to each year. Based on the 2018-19 Budget forecasts, there was between a 5% and 17% probability of negative Income Tax reconciliations exceeding -£300 million. Updating this analysis to include all devolved taxes and social security benefits and rebasing this to the 2023-24 Scottish Budget it is estimated that there is now between a 14% and 27% probability of total negative reconciliations breaching the £300 million annual borrowing powers for forecast error.

This risk will continue to grow as borrowing powers are fixed in nominal terms, meaning their value is eroded each year in real terms.

This lack of borrowing provision is most clearly demonstrated by the forecast position in 2024-25, where reconciliations are currently forecast to be £687 million. As 2024-25 is also first year where the Scotland Specific Economic shock rules cease to apply, this creates an unmitigated exposure of £387 million.

The Scotland Reserve theoretically provides an opportunity to address anticipated forecast exposures or reconciliation shortfalls which exceed borrowing capacity, but the current limits mean that in practice this is not feasible.

The Scotland Reserve does not represent “additional” funds, it is simply the rolling forward of funds not spent in previous financial years, whether as a result of planned deferral of funding or unanticipated late adjustments at the end of a financial year. In order to use the Reserve to address an anticipated future reconciliation, the Scottish Government would need to plan to underspend its budget in one financial year at a point where the full extent of the in-year funding position is not clear.

Such underspending would generate additional risks for the Scottish Government. As only £250 million of resource funding can (normally) be drawn down in one financial year, the Scottish Government would have almost no margin for error to avoid funds being locked in the reserve (and unable to access them), or have funding surrendered to HMT if the £700 million total reserve cap was breached.

Lifting of the drawdown limits and an increase in the reserve cap to a more sustainable level would go some way to improving the Scottish Government’s practical ability to manage volatility in its funding position.

The planned review of the Fiscal Framework (see Box 4) is an important opportunity to address the limitations of borrowing and reserve powers, among others.

Box 4: Fiscal Framework Review

The Fiscal Framework is due for review in 2023, following agreement between both the Scottish Government and the UK Government to jointly commission an independent report on the Block Grant Adjustment arrangements.

The review is anticipated to be a negotiation between both governments, resulting in an updated framework agreement. The final version of the independent report has been submitted to both governments for consideration, but the timing and arrangements for its publication are still under discussion with the UK Government. Discussions are ongoing between governments about the timing and process for the subsequent review.

The Scottish Government is clear that the review must minimise the volatility currently inherent in the operation of the framework. It must also ensure that Scotland has the necessary powers to manage the risks within our devolved responsibilities, and to support economic recovery.

The revised Fiscal Framework should provide the Scottish Government with budget levers commensurate to the forecast errors it has to manage - including, for example, the £687 million negative reconciliation that is forecast to occur in 2024-25.

Heading into the review the Scottish Government will aim to:

- Ensure the BGA methodology continues to protect the Scottish Budget from potential slower population growth in Scotland than in rUK.
- Secure greater budgetary flexibility and appropriate budget management tools.
- Continue to protect the Scottish Budget from economic shocks that affect the Scottish and UK economies equally.
- Ensure that the Scottish Government has the appropriate suite of policy levers and is not unduly exposed to risks outside of its control.

In the longer term, the Scottish Government believes that independence is the best route to ensuring the economy and public finances can be managed effectively and in a way that meets the needs of Scotland. Independence would also give the Scottish Government the power to design immigration policy tailored to Scotland's needs, and return the right to free movement in the EU, both of which are critical to the economy.

3.11.3 Policy Approach to the management of funding risks

Whilst the combined risks across the funding outlook are significantly greater than the tools available to manage them, it is nonetheless important to consider the full spectrum of risks in any decisions on the use of discretionary funding tools such as drawdowns from the Scotland Reserve and borrowing. The Scottish Government has considered the interaction of these risks and mitigations available and this has led to a slight revision to Reserve and Resource borrowing policy for this MTFS.

Previous approach

Previous iterations of the Scottish Government's MTFS have outlined the following Scotland Reserve and Resource Borrowing policies:

- The Scottish Government prioritised use of the Scotland Reserve to carry forward any forecast underspends for use in the subsequent financial year. This was intended to ensure that there was 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 mitigate the risk of funds being lost to the Scottish Government.
- The Scottish Government assessed all planned resource borrowing decisions to smooth the funding trajectory over five years. This was by considering the net effect of the forecast reconciliations, resource borrowing and repayments of resource borrowing.

The principles behind these policies are intended to balance risks; ensuring budgets are balanced, funding is not lost, and that borrowing is maintained at sustainable levels.

Experience to date has shown that the reconciliations are themselves so volatile that it is difficult to measure the efficacy of any borrowing decisions by these specific metrics. It is also the case that by restricting measurement to reconciliations and costs, the wider impact of resource funding volatility in year, and across years, is not fully considered. Borrowing and Scotland Reserve decisions need to be taken together, given the relationship between them. Finally, the Scottish Government does have some discretion in other sources of income which are fully devolved and unrestricted by an HM Treasury budget limit or Fiscal Framework limit defined in statute. An example includes the receipts from the Kings Lord Treasurer Remembrancer (KLTR). These items allow some minimal additional flexibility in some financial years.

Consequently, the Scottish Government's approach is being adjusted to one which applies to all discretionary funding tools in order to maximise the impact of the collective fiscal tools available.

<u>Current approach</u>

The Scottish Government will use its limited discretionary funding tools, such as the Scotland Reserve and Borrowing, to achieve the following in objectives in order of priority:

1. Ensure a balanced budget by the end of each financial year,
2. Mitigate volatility in the medium term resource funding outlook.

By necessity decisions on borrowing and the Reserve will be finalised at the end of each financial year and use the best estimates at the time of in-year and future year funding positions.

Projections of discretionary funding for future years, where required for establishing the Central Funding Outlook, will be considered on a case-by-case basis, balancing these two key objectives. Projections remain subject to change with drawdown decisions taken in March of any financial year.

4. Scotland's Spending Outlook

4.1 Resource Spending Outlook

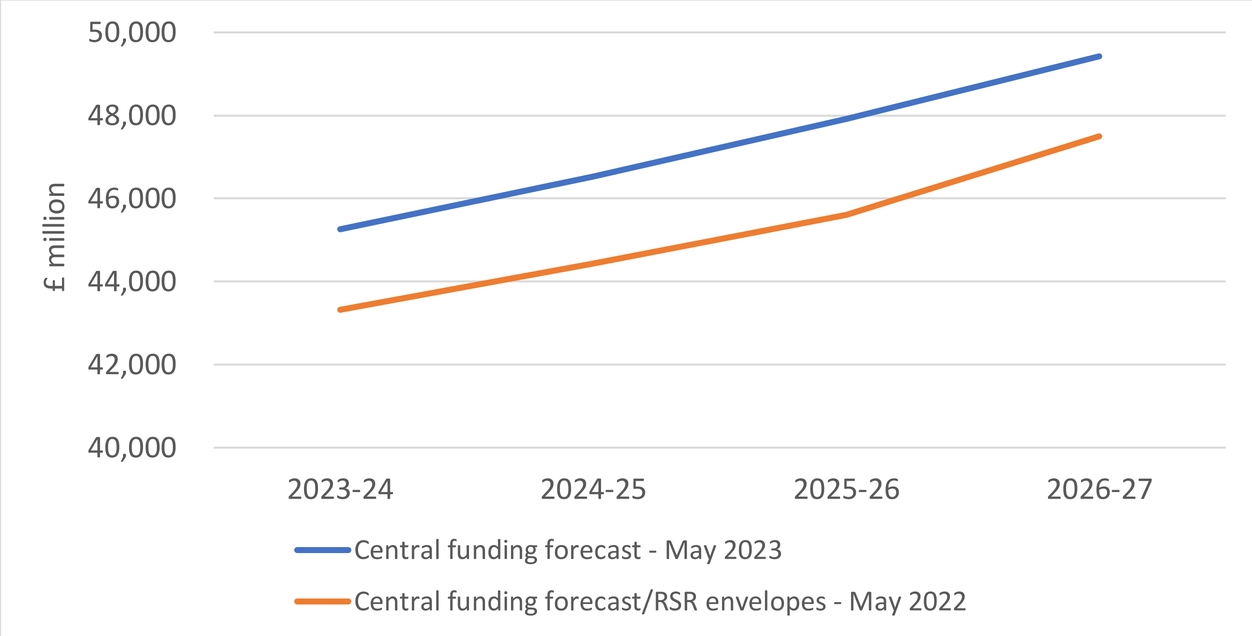
The 2022 MTFS was published alongside the Resource Spending Review (RSR), which set out the Scottish Government's resource spending plans until 2026-27 and provided a strategic framework for the Scottish Government, its public bodies and other delivery partners to plan effectively for the future. The MTFS recognised the challenging and volatile economic and fiscal context for the RSR, which was published in a week when inflation reached a then 40-year high of 9%.

By the end of 2022, inflation had peaked at 11.1%, the highest UK rate since 1981. This has had a severe impact on business and households, and the OBR were forecasting at the time that average real household disposable income (which is often used as a measure of living standards) would fall by 7.1% in real terms from 2021-22 to 2023-24. In the Emergency Budget Review (EBR) in November 2022 and in setting the 2023-24 Budget, the Scottish Government chose to use its fiscal powers to mitigate the pressures being felt by people in Scotland and support our public services. Social Security benefits were uprated by 10.1% - the Consumer Price Index (CPI) rate in September 2022, when benefits rates are reviewed - to reflect the increased cost of living, an additional £1 billion was allocated to the health and social care budget, and over £900 million was reallocated to enhance public sector pay awards.

In all, the Budget set in December for 2023-24 was £1.7 billion higher than envisaged at the time of the RSR in May 2022, supported by changes in income tax and LBTT which asked those who are best able to contribute more to pay more.

These decisions have a recurring impact on the Scottish Budget and have changed both spending and funding baselines. Figure and Table 12 illustrates the increase in the central funding outlook compared to the funding outlook at the time of the RSR. Scottish Government spending plans as reflected in the RSR were set within the central funding outlook. The funding outlook is explored in Chapter 3.

Figure 12: Central funding trajectory vs RSR envelopes



Source: Scottish Government

Table 12: Central funding outlook vs RSR envelopes (£m)

	2023-24	2024-25	2025-26	2026-27
Central funding outlook/RSR envelopes - May 2022	43,321	44,439	45,600	47,498
Central funding outlook - May 2023	45,260	46,535	47,917	49,415

Source: Scottish Government, SFC, OBR

This chapter will explore the drivers of growth in public spending in Scotland from the starting point of the 2023-24 Budget. This approach assumes, for the purpose of illustrating the drivers of public spending and pressures on the Scottish Budget, that the Scottish Government's current policies and services continue. Chapter 1 sets out the Scottish Government's strategy to manage the fiscal challenge and the policy choices we have ahead of us.

Underpinning the spending outlook is the OBR forecast of inflation. Growth in public spending is usually measured against the GDP deflators published quarterly by the OBR, and we have assumed that, in general, public spending is constant in real terms – i.e. grows in line with the GDP deflators. The OBR forecasts that inflation under this measure will fall rapidly from 5.7% in 2022-23 to 2.5% in 2023-24, and will stabilise at under 2% during the forecast period of this MTFS (Table 13). This means that, while the effects of high inflation seen in the past year will have a lasting effect on the level of public spending, that rate of growth is unlikely to be sustained. Section 4.3 explores spending risks, including the impact on the Scottish Budget if inflation does not reduce as forecast by the OBR.

Table 13: GDP Deflators[34]

	2024-25	2025-26	2026-27	2027-28
Year-on-year growth	1.6%	1.0%	1.2%	1.7%

Source: OBR

There are elements of the Scottish Budget where GDP deflators may not fully capture the inflationary pressures experienced by the Scottish public sector, and we expect greater pressure on public spending. These are explored below.

4.1.1 Pay

Pay accounts for over £24 billion of resource expenditure across the devolved public sector in Scotland (including Local Government).

The RSR spending plans assumed that pay awards would average 2% a year across the public sector, which was based on the Scottish Government's 2022-23 Pay Policy - published in December 2021 – which established pay parameters equivalent to a 1.6% pay award for those bodies covered by the Pay Policy. However, circumstances swiftly changed and pay awards (excluding pay progression) averaged around 6.4% in 2022-23 as Ministers sought to set fair pay deals to support public sector workers through the cost of living crisis and avoid costly disruption to public services from industrial action. These deals included the 7% equivalent average pay award for NHS Agenda for Change, and Local Government staff.

The Scottish Government's 2023-24 Public Sector Pay Strategy published on 22 March 2023[35] sets the framework to deliver fair, affordable pay awards, and a sustainable workforce to drive innovative and efficient public services. Each public body covered by the Pay Strategy must ensure their pay proposals are affordable and sustainable within their financial settlement for 2023-24, drawing as appropriate on business efficiencies and workforce changes as part of ongoing public service re-design and wider reform.

The key features of the 2023-24 Public Sector Pay Strategy are:

- the implementation of the real Living Wage rate of £10.90 per hour, including internships and Modern Apprentices;
- a suggested cash underpin of £1,500 for public sector workers who earn £25,000 or less;
- pay uplift for Chief Executives is capped at the same cash amount as the lowest paid;
- setting a pay award floor of 2%; and

[34] UK Government (2023), GDP deflators at market prices, and money GDP March 2023 (Quarterly National Accounts) - GOV.UK (www.gov.uk) – April 2023
[35] Scottish Government (2023), Public sector pay strategy 2023 to 2024 - gov.scot (www.gov.scot) March 2023

- recommending a central metric of 3.5% and setting both an award ceiling and pay envelope maximum of 5%.

The high rate of inflation has driven the growth in public sector pay. The Office for National Statistics (ONS) and OBR forecast that inflation will drop below the Bank of England's 2% inflation target from 2024-25. As a result, pay growth is assumed to return to more normal levels between 2024-25 and 2027-28, at a level which is consistent with assumptions made in the RSR. To illustrate future pay bill costs across the devolved public sector, three theoretical public sector pay award scenarios are modelled below (see Table 14).

Table 14: Illustrative pay award scenarios (£ million)

	Baseline				
	(2023-24)	2024-25	2025-26	2026-27	2027-28
Illustration of 2% pay award in 2023-24, and 1% pay award from 2024-25 onwards					
Total	24,306	24,549	24,795	25,042	25,293
Additional cost		243	245	248	250
Illustration of 3.5% pay award in 2023-24, and 2% pay award from 2024-25 onwards					
Total	24,477	24,966	25,465	25,975	26,494
Additional cost including Basic Award		490	499	509	519
Illustration of 5% pay award in 2023-24, and 3% pay award from 2024-25 onwards					
Total	24,617	25,355	26,116	26,899	27,706
Additional cost including Basic Award		738	761	783	807

Notes: These projections include the cost of the Local Government workforce. 2023-24 costs reflect agreed pay settlements for Health, Fire and Teachers which are above 3.5%. This table assumes workforce numbers remain at 2023-24 levels throughout the period. Figures may not sum due to rounding.

Source: Scottish Government

4.1.2 Workforce

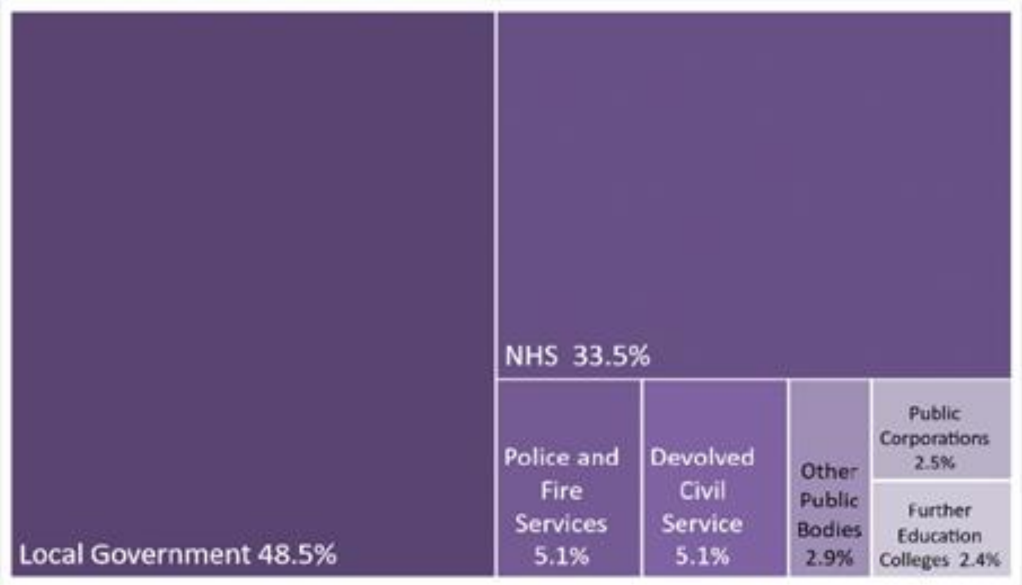
The devolved public sector full-time equivalent workforce (FTE) is around 460,400 FTE, and has historically grown by around 2% per annum over the last 5 years.

Employment (headcount) in the public sector in Scotland was 594,500 as of December 2022, representing over a fifth (21.9%) of all employment in Scotland[36]. The proportion of people in employment in the public sector across the UK as a whole was 17.7%

Of the total number of people employed in the public sector in Scotland, just over 90% are working in the devolved public sector.

The breakdown of the devolved public sector (headcount) is illustrated in Figure 13. Over 80% of people in the devolved public sector are employed in either Local Government or the NHS.

Figure 13: Percentage breakdown of Scottish Devolved Public Sector, Q4 2022 (FTE)



Note: Totals may not equal the sum of the individual parts due to rounding
Source: Scottish Government

For many public bodies, the pay bill is the most significant element of their budget and the Pay Strategy requires all public bodies to satisfy themselves of the affordability and sustainability of the pay awards within existing budget allocations. The RSR launched a programme of work to pursue a twin-track approach to reform, which asks public bodies to identify opportunities for both further efficiencies and joined-up service delivery that directs collective resources towards shared priorities. This requires and supports public bodies to consider the size and shape of the workforce, alongside opportunities around, for example, digital reform, revenue generation, estates rationalisation and improved procurement.

As a result of this ongoing reform and the rapid growth in the pay bill in 2023-24, we have assumed that public bodies will have both the need, and the tools to manage

[36] Scottish Government (2023), [Footnotes - Public sector pay strategy 2023 to 2024 - gov.scot (www.gov.scot)]() – March 2023

growth in their workforces at a lower rate than we have seen in recent years. As such, we have illustrated an overall 1.1% per annum workforce growth assumption from 2023-24 to 2027-28 in the central scenario, with the lower scenario at 0.3%, and an upper scenario at 2.2% per annum, which takes account of variable growth rates across the public sector (see Table 15). We have assumed higher than average rates of growth for the Health workforce in each scenario. The actual rate of growth will be determined by a number of factors including affordability, service demand and labour supply.

Where a reduction in workforce is required for a public body to remain sustainable, we would expect this to be through natural turnover wherever possible and we restated our commitment to no compulsory redundancies in this year's Public Sector Pay Strategy[37]. Individual public bodies must ensure their policies, practices and systems comply with their equalities and Fairer Scotland obligations.

Table 15: Illustrative cumulative pay award and workforce costs (£ million)

	Baseline (2023-24)	2024-25	2025-26	2026-27	2027-28
Low Scenario - 2% pay award in 2023-24, and 1% pay award from 2024-25 onwards, 0.3% workforce growth					
Total	24,306	24,627	24,953	25,284	25,619
Difference from Central Scenario	-171	-613	-1,075	–1,556	-2,058
Central scenario - 3.5% pay award in 2023-24, and 2% pay award from 2024-25 onwards, 1.1% workforce growth					
Total	24,477	25,240	26,028	26,840	27,677
High Scenario - 5% pay award in 2023-24, and 3% pay award from 2024-25 onwards, 2.2% workforce growth					
Total	24,617	25,738	26,912	28,140	29,426
Difference from Central Scenario	140	498	884	1,300	1,749

Notes: These projections include the cost of the Local Government workforce. 2023-24 costs reflect agreed pay settlements for Health, Fire and Teachers which are above 3.5%.

Source: Scottish Government

4.1.3 Health and social care

While key cost drivers such as demographics and inflation affect all areas of public spending, the impact is particularly pronounced for health and social care. For example, recent pressures relating to pay, drugs and medicine costs have exceeded

[37] Scottish Government (2023), Public sector pay strategy 2023 to 2024 - gov.scot (www.gov.scot) – March 2023

previously modelled growth, and in contrast to other areas technological and scientific advances lead to increased rather than decreased costs as both expectations and demand grow. This is especially relevant in the context of an ageing population, as explored in section 4.3.3, which is likely to create growing physical and mental healthcare needs and a greater demand on social care services. Overall, the annual disease burden is forecast to increase by 21% for the Scottish population over the next two decades[38]. These changes in disease burden are based only on projected demographic change and assume stable prevalence of disease but provide helpful insights to demonstrate the scale of increased pressures and efforts needed to mitigate the underlying causes of ill health and support people to live longer lives in good health.

Considering these cost pressures, our previous modelling assumptions of 3.5% in the 2018 Medium Term Financial Framework for Health and Social Care, and the SFC's recent Fiscal Sustainability Report, which projected that health spending would grow more quickly than other public services, we have applied a higher growth rate of 4% per annum to Health and Social Care expenditure.

4.1.4 Social security

The Scottish Government is committed to building a modern social security system with dignity, fairness and respect at its heart. Social security is key to helping us substantially reduce levels of child poverty in Scotland and provides vital financial support to households, including those struggling because of the cost of living crisis.

To maintain the real terms value of Scottish Benefits, the Scottish Government uprated all Scottish benefits by 10.1% from 1 April 2023, including those without a statutory requirement to uprate. Benefits are uprated by the CPI rate in the previous September, so reflect a higher rate of inflation than the GDP deflators applied to our modelling of other public spending. To further support low-income families with children, the Scottish Child Payment was increased from £20 per week per eligible child to £25 when it was rolled out to eligible children under 16 in November 2022.

High rates of inflation have not otherwise had a major effect on demand for devolved social security benefits in Scotland. The main reason for this is that disability benefits account for the majority of devolved social security expenditure (80% in 2023-24), and eligibility for these benefits is less sensitive to macroeconomic changes than for income replacement benefits, such as Universal Credit, which are mainly delivered by the Department for Work and Pensions (DWP) in Scotland. Demand for disability benefits fluctuates more directly with changes in the 'health of the nation'. In its December 2022 forecast, for example, the SFC highlighted a significant increase in demand for disability benefits across the UK, including Personal Independence Payments, commenting that reasons for this likely increase could include factors such as increased NHS waiting times following the Covid-19 pandemic, the increasing number of people who are economically inactive because of long-term

[38] Public Health Scotland (2022), Scottish Burden of Disease Forecasting Briefing (scotpho.org.uk) – November 2022

sickness, and financial pressures on individuals in the cost of living crisis. The same factors are likely to apply to the demand for Scottish disability benefits.

These developments, together with certain revisions to modelling assumptions, are taken into account by the SFC in preparing revised social security expenditure forecasts. As shown in Table 16, in the latest forecast, expenditure will increase by around £0.5 billion a year from 2024-25 above the forecast which informed spending plans in the RSR in May 2022. However, a substantial proportion of the funding for this additional expenditure, for example, statutory uprating requirements and health related increases in expenditure on disability benefits is provided by the UK Government through Block Grant Adjustments (BGAs). In each year of the RSR, the total increase in forecast expenditure compared to the May 2022 forecast is funded entirely through increases in BGA funding forecasts, as shown in Table 17, reflecting that the increases in expenditure are largely due to wider economic and UK policy changes.

Table 16: SFC forecasts of social security expenditure

£million	2023-24	2024-25	2025-26	2026-27
Resource Spending Review - May 2022	5,072	5,725	6,108	6,490
Latest forecasts - May 2023	5,290	6,192	6,638	7,000
Growth	**+218**	**+467**	**+530**	**+510**

Source: Scottish Government, SFC

Table 17: Forecasts of social security BGAs

£million	2023-24	2024-25	2025-26	2026-27
Resource Spending Review - May 2022 *	4,082	4,574	4,825	5,103
Latest forecasts - May 2023 **	4,434	5,132	5,435	5,697
Growth	**+352**	**+558**	**+610**	**+594**

* Based on the OBR's March 2022 forecast
** Based on the OBR's March 2023 forecast

Forecast social security expenditure also covers new Scottish benefits for which there are no UK equivalents, such as Scottish Child Payment, and the replacement of existing DWP benefits in Scotland. The SFC currently forecast the total additional investment from Scottish benefits compared to BGA funding as rising from £756 million in 2023-24 to £1,274 million in 2027-28. This difference will need to be funded from elsewhere within the Scottish Budget, through tax and spending changes. It will help those with the greatest need, supporting low-income families with their living costs and older people to heat their homes in winter, and enable disabled people to live full and independent lives.

New social security benefits, which are only available in Scotland, account for £620 million of this forecast additional expenditure in 2027-28. This includes forecast expenditure of £436 million on Scottish Child Payment. This is a significant investment which the Scottish Government has made in the people of Scotland. It is key to helping us substantially reduce levels of child poverty in Scotland and drive progress toward the 2030 targets.

Deliberate policy choices made to benefits as they are devolved, coupled with improvements in delivery of replacement benefits driven by a social security system founded on the principles of dignity, fairness, and respect are forecast by the SFC to account for the remaining £654 million forecast additional expenditure in 2027-28. Much of this results from improvements made to Adult Disability Payment (ADP), which replaces Personal Independence Payment in Scotland. Changes include reforms to improve the experience of people applying for the benefit, introduction of longer awards in appropriate circumstances, and changes to terminal illness rules.

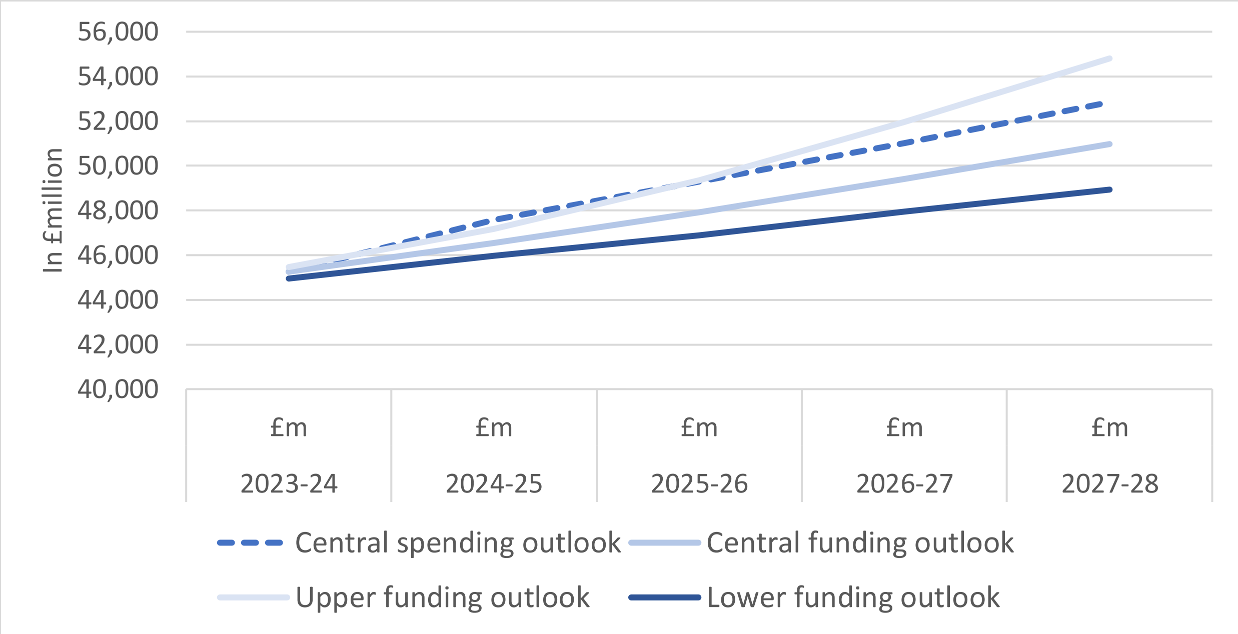
ADP has been in place nationally for less than a year and it is not yet possible to draw any firm conclusions on how the operation of the new system in practice will change how much is spent nationally in Scotland on ADP specifically or disability benefits more generally. The SFC recognises that elements of the disability payment forecasts contain more judgements than other parts of the forecast and are therefore more uncertain, with uncertainty growing towards the latter part of the forecast period. This introduces a significant amount of uncertainty into the Scottish Government's spending projections and into the management of the public finances over the medium-term.

4.1.5 Resource spending outlook: summary

Applying historic rates of growth to the 2023-24 baseline suggests a central resource spending scenario which increases from £45.2 billion in 2023-24 to £52.8 billion in 2027-28. Forecast growth averages 3.6% per annum in the final years of our medium-term horizon, which is higher than forecast inflation of 1% - 1.7% from year to year and, more significantly for the public finance outlook, higher than forecast funding growth which averages 3.1% under the central funding scenario for 2025-26 to 2027-28.

This small divergence in the central funding and spending scenarios compounds the particular challenge we face in 2024-25 when, from a balanced outturn in 2023-24, forecast spending increases by 5.1% due in part to the £0.9 billion forecast increase in social security expenditure from year-to-year due to the continuing effect of high inflation and the launch of three new benefits. In the same year, we face significant funding constraints due to an expected negative tax reconciliation and limited growth in the block grant in the final year of the UK Spending Review. This means our central spending outlook for 2024-25 is £1.0 billion (2%) higher than the central funding scenario and £409 million higher than the high funding scenario.

Figure 14: Resource Spending Outlook summary



Source: Scottish Government

Table 18: Resource Spending Outlook summary (£ million)

	2023-24	2024-25	2025-26	2026-27	2027-28
Central spending outlook	45,260	47,575	49,304	51,013	52,846
Central funding outlook	45,260	46,535	47,917	49,415	50,971
Surplus/(Shortfall)	*0*	*-1,040*	*-1,387*	*-1,598*	*-1,875*
Upside funding scenario	45,466	47,166	49,363	51,973	54,805
Surplus/(Shortfall)	*206*	*-409*	*59*	*960*	*1,959*
Downside funding scenario	44,951	45,965	46,882	47,945	48,933
Surplus/(Shortfall)	*-309*	*-1,610*	*-2,422*	*-3,068*	*-3,913*

Source: Scottish Government, SFC, OBR

The Scottish Government is required to balance its budget each financial year, so must absorb these pressures. The Emergency Budget Review (EBR)[39] in November 2022 is an example of the quick response required by the Scottish Government when fiscal risk materialises in-year. With no ability to increase borrowing or change income tax rates in the middle of a financial year, Ministers delivered in-year savings through the EBR to meet the additional costs arising from high inflation and the war in Ukraine – neither of which could have been foreseen when the Budget was set in December 2021.

[39] Scottish Government (2022), Emergency Budget Review: 2022 to 2023 - gov.scot (www.gov.scot) – November 2022

In the later years of this forecast period the central spending outlook lies between the central and the upper funding scenarios. This suggests that if funding is at the upper end of forecasts and spending is held at the central outlook, there may be flexibility within the annual budget to increase investment in public services. However, it is vital that we manage Scottish public finances on a sustainable trajectory and - while seeking to strengthen revenues by growing our economy and therefore our tax base – we must recognise and prepare for the fiscal challenge we face. Chapter 1 set out the Scottish Government's approach to managing the upward pressures on public spending within the fiscal outlook

4.2 Capital Spending Outlook

The Policy Prospectus 'Equality, opportunity, community: New leadership – A fresh start'[40], sets out the importance of achieving and maintaining a balanced budget, while prioritising capital investment to reach net zero and maintain high quality public infrastructure and services across Scotland. These align with the priorities the Scottish Government used to frame the 2021 Infrastructure Investment Plan (IIP)[41] which outlines several projects to reduce Scotland's carbon emissions, increase our resilience to climate change and improve our local infrastructure.

As discussed in the May 2022 Targeted Review of the Capital Spending Review (CSR),[42] there are several pressures facing the Scottish capital programme. These include reopening the economy in the aftermath of COVID-19; new commitments to further address the global climate crisis; shortages in the supply of construction materials which had been exacerbated by the crisis in Ukraine; and labour shortages driven by the UK's exit from the European Union. These challenges continue to impact the capital budget, with construction supply chain issues coinciding with the sustained high inflation levels, which peaked in the construction sector at around 25% last summer.

Since publication of last year's MTFS there have been significant changes to the economic climate with sustained high inflation increasing interest rates and making borrowing more expensive. The increased cost of borrowing, exacerbated by supply chain issues and material inflation has resulted in revenue financed investments being more expensive than expected, and therefore impacting value for money assessments.

The combination of these factors and the real-terms fall in capital funding will have an impact on our ability to achieve the target set out in the National Infrastructure Mission (NIM). The NIM was introduced with the aim of raising Scottish infrastructure investment to £6.86 billion in 2025-26 to protect and create jobs in the short term and

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[40] Scottish Government (2023), Equality, opportunity, community: New leadership - A fresh start - gov.scot (www.gov.scot) – April 2023

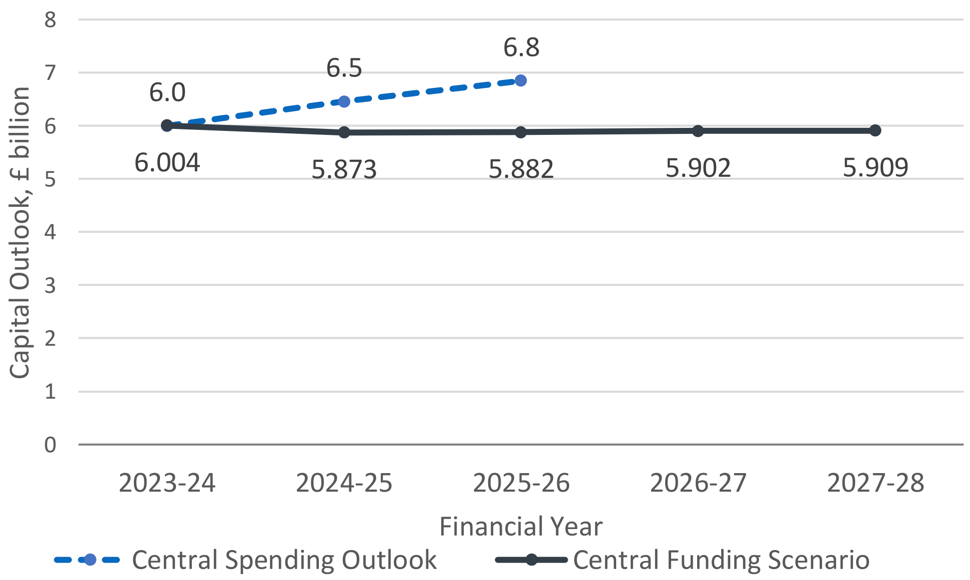
[41] Scottish Government (2021), A National Mission with Local Impact: Infrastructure Investment Plan for Scotland 2021-22 to 2025-26 - gov.scot (www.gov.scot) – February 2021

[42] Scottish Government (2022), Context - The Outcome of the Targeted Review of the Capital Spending Review – Updated Spending Allocations for 2023-24 to 2025-26 - gov.scot (www.gov.scot) – May 2022

support inclusive economic growth and productivity in the long term. However, the current trajectory of funding from the UK Government and the higher cost of revenue financed investments mean that it is likely to take longer than expected to achieve the target.

Figure 15 shows that the projected capital funding (excluding Financial Transactions (FTs)) for 2023-24 to 2027-28 remains at around £5.9 billion per year, while the spending outlook for the remainder of the CSR period (up to 2025-26) steadily increases, resulting in a projected difference between funding and expected need in the region of £900 million for 2025-26. This corresponds to a 16% funding gap in 2025-26 and is driven by the prudent overcommitments identified in the Targeted Review of the Capital Spending Review and the current estimate of the inflationary pressures.

Figure 15: Funding outlook (excluding FTs) compared with spending outlook from 2023-24 onwards



Source: Scottish Government, OBR

The challenges outlined above mean that we cannot deliver all of the Scottish Government's capital commitments within the funding available and to the original planned timescales without access to additional capital funding.

As set out in Chapter 1, the Scottish Government will publish refreshed multi-year spending envelopes for capital alongside the 2024-25 Budget, and extend the CSR and IIP period by one year to 2026-27. This will reset the spending envelopes published in CSR to reflect the new economic reality and our three critical missions for this parliament.

The Scottish Government will continue to press the UK Government to use the levers at its disposal to help mitigate the current market conditions and support infrastructure investment, but without further funding and associated fiscal flexibility through enhanced borrowing powers, tough decisions will need to be made to reprioritise the pipeline of projects set out in the IIP.

As we undertake this review and prioritisation exercise in advance of the 2024-25 Budget, we will prioritise capital spending which supports employment and the economy through the Scottish Government's infrastructure plans, and which has greatest impact on realising our three missions. This will move us towards achieving net zero and underpins the provision of high-quality public infrastructure and services across Scotland, within the budget available.

4.3 Spending Risks

4.3.1 Inflation

The modelling of the spending outlook in section 4.1.5 is underpinned by the latest forecasts from the OBR which show inflation falling below 2% by the end of 2023-24, and continuing at that lower rate. However, as considered in section 2.2, there is considerable uncertainty in the inflation forecast.

Experience of the financial years 2022-23 and 2023-24 has illustrated the significant impact sustained high inflation may have on the spending outlook. Across the public sector, and particularly on infrastructure programmes, we – like businesses and organisations across Scotland - have seen high inflation erode our buying power during the cost crisis. As a result, the amount we pay for the largest elements of our budget – employees and social security benefits – has increased.

Any additional expenditure arising as a result of sustained inflation must be managed within the limits of the Scottish Government's existing fiscal powers, and further stretch the fiscal challenge outlined in Chapter 1 and above.

4.3.2 Demand-led expenditure

Demand-led expenditure appears across the public sector and will always carry a degree of forecast risk. Budgets reflect expected levels of demand for, for example, concessionary travel, but expenditure will vary according to the number of people who are eligible for, and choose or need to use the service, and will be affected by behavioural and economic factors. This has become a more significant feature of the Scottish Budget with the devolution of Social Security, which is now the third largest area of public spending in Scotland, after Health and Local Government. Under the Fiscal Framework, these programmes must all be managed within the resource budget and the Scottish Government has limited levers to manage demand-led volatility. Increases in demand-led expenditure therefore reduce the funding the Scottish Budget has available for other programmes.

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 the SFC's forecasts rather than spending limits, and the Scottish Government must meet social security expenditure as it arises, even if it differs from the SFC forecast used to set the initial medium-term spending plans or the Budget.

The risk relating to social security spending is exacerbated by the uncertainty in the related BGAs, as it relates to social security policy in the rest of the UK. Changes in either UK Government policy relating to devolved benefits, or the OBR's forecasts of benefit demand in the rest of the UK, can affect the funding available to the Scottish Government in either direction, and the impact of social security spending on the wider spending priorities. The value of the BGA is currently around 80% of social security spending, and to this point has been a source of stability as trends in UK and Scottish social security expenditure have mirrored one another. However, as Ministers choose to exercise their devolved social security powers and establish a distinctive Scottish system, expenditure on social security is set to grow in value as a proportion of the Scottish Budget, and the potential impact of any variation in the forecasts is also increasing.

Any changes between actual and forecast 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 3. Further information on the BGAs and reconciliations is set out in Annex C.

Existing borrowing and reserve powers can help manage in-year forecasting risk for social security and tax, however these powers have strict annual and overall limits and there is considerable risk that the quantum of any adverse movements may exceed the applicable annual limits for any one year.

4.3.3 Demographic Change

Scotland's population is expected to undergo significant change over the medium and longer-term. Some of this change creates risks to aspects of funding and spending that the Scottish Government will need to manage going forward.

Like most western countries the Scottish population is ageing. The recent SFC report on Fiscal Sustainability[43], published in March 2023, analyses the projected impact of demographic change on the economy and public finances over the next 50 years.

These trends are already evident in the medium-term horizon considered in this MTFS. The number of over-65s in Scotland is projected to grow by 9.7% over the next five years according to the latest population projections. At the same time, the number of younger people is expected to decline over this time, with the under-18 population projected to decrease by 5.6%. Over this period the working age population is expected to fall slightly by around 0.7%.

While population projections are inherently uncertain, the general direction of these demographic shifts is clear, both over the medium and longer-term.

As the SFC report sets out, these demographic shifts may significantly impact upon the scale and shape of Scotland's public expenditure. An ageing population is likely to put further pressures on public expenditure, in particular on health, social care and

[43] Scottish Fiscal Commission (2023), Fiscal Sustainability Report – March 2023 | Scottish Fiscal Commission – March 2023

social security. The SFC project that health spending will account for half of all devolved spending by 2072-73, increasing from 35% in 2027-28. These spending pressures are further increased by increasing numbers of people with multimorbidity and more complex care needs, and the projected increase in the overall burden of disease in Scotland.

In comparison, the reduction in the number of younger people means that some of these expenditure pressures may be offset by reduced demand in other areas, such as education, and younger age health and social care services (although, as with any age cohort, this must be balanced against the level of need for these services). We will need to think strategically about how medium- and long-term structural shifts in expenditure can be managed alongside public service reform to reflect the future shape and needs of the changing population.

List of Acronyms

AfC Agenda for Change

BGA Block Grant Adjustment

BMW Biodegradable Municipal Waste

CDEL Capital Departmental Spending

COSLA Convention of Scottish Local Authorities

CSR Capital Spending Review

FFFP Fines, Forfeitures and Fixed Penalties

FT Financial Transactions

FTE Full Time Equivalent

GDP Gross Domestic Product

HM His Majesty's

HMRC His Majesty's Revenue and Customs

HMT His Majesty's Treasury

IFS Institute for Fiscal Studies

IMF International Monetary Fund

INTOG Innovation and Targeted Oil & Gas

LBTT Land and Buildings Transaction Tax

MTFS Medium-Term Financial Strategy

MSP Member of the Scottish Parliament

NDR Non-Domestic Rates

NHS National Health Service

NIM National Infrastructure Mission

NLF National Loans fund

NSET National Strategy for Economic Transformation

NZET Net Zero, Energy and Transport

OBR Office for Budget Responsibility

ONS Office for National Statistics

PIP Personal Independence Payment

PSCE Public Sector Current Expenditure

PSGI Public Sector Gross Investment

RDEL Resource Department Spending

RSR Resource Spending Review

rUK Rest of the UK

SDLT Stamp Duty Land Tax

SFC Scottish Fiscal Commission

SIT Scottish Income Tax

SLfT Scottish Landfill Tax

UKG UK Government

VAT Value Added Tax

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.

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 2023. The review will be informed 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).

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.

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.

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.

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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Annex A: Central Resource Spending Outlook

Table A. 1: Central Resource Spending Outlook

	2023-24	2024-25	2025-26	2026-27	2027-28
Social Security	5,290	6,192	6,638	7,000	7,389
Health and Social Care	18,176	18,903	19,660	20,446	21,264
Local Government	10,958	11,403	11,720	12,054	12,417
Other	10,836	11,076	11,286	11,513	11,777
Total	45,260	47,575	49,304	51,013	52,846
Central funding outlook	45,260	46,535	47,917	49,415	50,971
Modelled shortfall	0	-1,040	-1,387	-1,598	-1,875
		-2%	-3%	-3%	-4%

Note on Local Government funding

The figures set out in this table reflect the funding made available to local government by Scottish Government through the combination of General Revenue Grant, including Specific Revenue Grants, and forecasts of income raised locally by Non-Domestic Rates. This only reflects c. 50% of actual expenditure by local government which is otherwise funded by service fees and charges and council tax.

Local government is subject to similar spending pressures as the rest of the public sector. Our underlying assumption therefore is that the same inflationary and pay and workforce assumptions should apply to local government as to the rest of the public sector excluding the NHS, and that we recognise that the same demographic pressures experienced by health and social care, apply to social care services delivered by local government. We have applied pay, price and social care inflation on a pro rata basis to the split of pay, social care and ‘other’ expenditure across local government as reported in the 2021-22 Scottish Local Government finance statistics.

The resource funding made available to local government in 2023-24 includes an additional £343 million over and above the allocation published in the 2023-24 Scottish Budget document, and a further £120.6 million (that was previously allocated as capital) from 2024-25. These reflect funding previously agreed with COSLA to support local government pay deals.

Annex B: RSR Update

Context

This Medium-Term Financial Strategy (MTFS) demonstrates that the fiscal environment has become even more challenging than when the Resource Spending Review (RSR) was published (May 2022).

Considering this, and the wider changed landscape, a review of the commitments set out in the RSR has been undertaken to prioritise actions which remain both relevant and likely to have a meaningful positive impact on fiscal sustainability. Following this review, some commitments have been reset, and others deprioritised. A summary is provided for each of the workstreams below.

The fiscal context and drivers for reform and efficiencies are clear, and while effective public service reform is a cornerstone of fiscal sustainability, there is no predetermined savings target for the overall programme. This allows each proposal to be considered on its own merit, with proportionate appraisal and evaluation of the financial case to ensure it contributes to the overarching fiscal sustainability objective.

While it is recognised that many of the activities under the core workstreams and in the major reform programmes will take time to implement and to deliver benefits, it is critical that progress is effectively quantified and tracked. This will include providing regular updates to the Scottish Parliament Finance and Public Administration Committee on the workstreams set out.

Public Service Reform/Public Bodies

The RSR stated that "this review begins a journey of reform to meet the most pressing issues facing Scotland over the medium-term", in reference to both larger-scale reform and smaller, quicker immediate action to drive efficiencies, both of which are necessary to support fiscal sustainability. Reform is an ongoing programme of change to better meet people's needs and reduce demand over time. This will improve outcomes, and support fiscally sustainable public services. The Scottish Government committed to this programme in the recently published Policy Prospectus.

Specific work is underway with Public Bodies being asked to pursue a twin-track approach, working with their sponsors in government to:

- Demonstrate the actions required to increase efficiency and joined up service delivery to meet budgetary allocations in the short term,
- Identify both short and longer-term opportunities for fundamental organisational and service delivery change which directs collective resources towards shared priorities. This includes ongoing collaboration on delivering place based, person-centred public services which improve

outcomes and reduce future demand. In the face of ongoing and significant budgetary challenges, this is vital for long-term fiscal sustainability.
- Articulate what barriers must be addressed to enable bodies to deliver efficiency and reform, in both the short and longer-term.

The fiscal context and drivers for reform are clear. Effective public service and public body reform is a cornerstone of future fiscal sustainability. This work will inform the 2024-25 Scottish Budget, informing spending decisions including what will be necessary to support the longer-term reform of our public services. The RSR continued the expectation that public bodies would deliver recurring annual efficiencies of at least 3%. Since the publication of the RSR, the fiscal realities facing public bodies have changed significantly. Rather than maintaining this universal target, it is recognised that public bodies are best placed to assess both the opportunities and action that must be taken to ensure fiscal sustainability, with budgetary allocations providing the parameters for this.

Importantly, this Government's ambitions for public service reform include, but also go beyond, the five areas of focus around efficiencies (as set out below) and the public bodies landscape that were set out in the RSR. Public bodies and their sponsors in government will be considering all options for delivering efficiency in these five areas and in addition revenue raising, managing pay sustainability and service model transformation.

The aim, as set out in the 2023-24 Scottish Budget, is to achieve fiscally sustainable person-centred public services, which over time both improve outcomes and reduce inequalities of outcome across communities in Scotland.

Efficiency Levers

<u>Digital</u>

The RSR recognised the importance of digital reform, and this continues to progress through a programme to deliver digital connectivity and inclusion across Scotland, contributing to sustainable economic growth and the development of a strong digital economy.

Central to achieving this is the Digital Programme, which intends to deliver a new approach that looks beyond individual services and programmes, and considers the overall functioning and capability of the system. This work will create conscious system design and management to enable the delivery of modern digital public services that are easy to access, predictable and effective.

The programme of work is underway through a workstream which will iteratively deliver a common methodology for digital transformation, focused on the design, data, architecture, capability, commercial, and programme and project management components of the change process.

Another key aspect of the programme which is currently being scoped is to establish Scottish Government level control of digital investments through a prioritisation process, based on business need and contribution to digital public services. This would deliver a portfolio of programmes and projects which is right-sized to available funds and capability. Progress continues to be made in individual public bodies, such as Disclosure Scotland where Robotic Process Automation is being progressed to reduce the manual administrative burden and innovate using more cost effective AI techniques. The Independent Living Fund Scotland is an early adopter of the Scottish Government's Digital Payments Programme, which is intended to roll out to additional partners over the coming year.

Shared Services

The RSR committed the Scottish Government to working with public bodies to consider where a more collaborative approach to service delivery could drive efficiencies as well as capitalising on the experience of partnership working throughout the COVID-19 pandemic. This work is ongoing, as it is recognised that the most significant scope for 'quick wins' lies through such collaborative working, realising opportunities for more efficient joint operations and joined-up service delivery that directs collective resources towards shared priorities. That work takes place in the context of wider considerations about public body reform supported by the Scottish Government.

The response to the work with public bodies set out in section 2 has been positive about the opportunities for bodies to work together on common ambitions. For example, Scottish Enterprise, Highlands and Islands Enterprise and South of Scotland Enterprise have been working together to identify options for greater inter-agency collaboration, more collaborative and shared approaches to common functions, collaborative procurement, shared delivery and shared services. The Scottish Delivery Bodies Group is also taking forward a shared service feasibility review, considering where savings, improved performance and improved service delivery can be achieved, through shared approaches.

The Scottish Government remains committed to the prioritisation of the in-flight programme that will transform its own delivery of shared services including HR, Finance and some payment functions. Reliance on outdated systems to produce data on people and finances is neither efficient nor effective, hence the actions to make this a strategic priority for 2023 and beyond. That will produce benefits for both the Scottish Government and over 30 bodies that take those services. The HR function is due to be implemented during 2023-24 with the Finance function coming on-stream towards the start of 2024-25. Changes to working practices are part of that complex programme of transformation, aligned to workstreams that will use cloud-based services, increasing the resilience, and ease of updating HR and Finance functions. A significant programme to support this large change programme is ongoing with that support to external customers being a priority.

Public Sector Estates

The RSR reaffirmed the Scottish Government commitment to minimise cost and maximise best value in relation to the public sector estate. A Single Scottish Estate programme of work is underway that supports this commitment to enable a more efficient approach to public sector property management to deliver value for money, save public funds, reduce the public sector property footprint and support progress towards net zero estate targets. The work will build on existing good practice and further collaborative estate management to deliver the right size and quality of estate in the right places across all publicly funded bodies in Scotland.

This estates programme of work will support publicly funded bodies to work across organisational boundaries to co-locate, share on-site services wherever possible, make best use of technology and changes in working practices to optimise the estate footprint and release surplus space. For example, Registers of Scotland hybrid working has reduced their required footprint enabling them to sub-let space to other public sector organisations and provide an estate management service for all tenants.

The Scottish Government is also progressing co-location opportunities, working with organisations across the Scottish Ministers' estate. This includes Scottish Children's Reporter Administration, Police Investigations & Review Commissioner for Scotland and Scottish Courts Service sharing one building in Hamilton, using their combined strength to achieve a cost effective lease and working well together in the building. The Scottish Government's Glasgow office project is also progressing, involving the consolidation of the office estate of Scottish Government and four of its public bodies that would see the Glasgow estate reduce from five separate buildings to a new single, net zero carbon building, making significant savings on space and costs.

A place based approach, working with stakeholders, will continue to identify opportunities for short, medium and longer-term improvements. Governance to oversee this work will shortly be introduced and stakeholders updated on this work.

The Scottish Government will continue to deliver expert advice and lead pathfinder solutions as the programme builds on existing work to innovate, transform and improve Scottish Ministers' estate.

Procurement

The RSR recognised the need for a Procurement Strategy for Scotland, and this was published in April 2023. It sets out that the focus of procurement is not only on efficiencies and savings. It is on maximising the impact of spend on sustainable outcomes. Compliance with the sustainable procurement duty is the mechanism through which public procurement contributes to and tracks its contribution to Scottish Government's overarching purpose with each contracting authority required to set out in its procurement strategy how it intends to comply with the duty, and report annually on progress.

Further improvements are being delivered through the Scottish Government led 'Plan for the Future' programme, governed by the cross-sector Public Procurement Group. This covers a number of national and Scottish Government programmes and workstreams to drive and underpin improvement, including:

- Future e-Procurement Strategy to maximise efficiency, effectiveness and reporting capability across Scotland
- Maximising the Impact of Procurement Programme, aimed at using the full flexibility of the rules to deliver on Scottish Government priorities and underpin continuous improvement
- Milestones and progress reports tracked through Scottish Government PMO, reporting regularly to the governance board, steering group and key stakeholders.

Grant Management

The RSR identified a cross-cutting opportunity to improve the management of grants, with work ongoing to review value for money within grants. It is critical that all expenditure is managed in a transparent and effective way, and grants are no exception to this.

In the initial stages of the review, the opportunity themes identified are:

- Improved Data and Management Information
- Aggregation of similar funds
- Collaborative relationship management

A long term program of improvement aligned to Scottish Government-wide improvement activity is being undertaken to support better impactful outcomes for the expenditure within grants issued by Scottish Government.

Where grants are issued by public bodies, individual bodies are also enhancing their approach to grant management, for example partnership activity is underway between Creative Scotland, Event Scotland and City of Edinburgh Council to explore the alignment of funding, contracting and monitoring processes with Edinburgh's Festivals.

Revenue Raising

The RSR recognised that fiscal balance can be achieved by focusing on both spending and revenue raising opportunities. The unprecedented challenges facing public finances require the consideration and use of all levers at the disposal of Scottish Government and public bodies in order to secure stable and proportionate funding to invest in and maintain public services.

The commitment for Scottish Government to work with public bodies who can charge for services to explore ways to recover more of their costs, and to identify options that should be prioritised, is being progressed as part of the wider programme of Public Service Reform.

Initial discussions were held between Scottish Government and public bodies during 2022-23 to identify opportunities and understand barriers to progress. The programme of work was then formally commenced through a further meeting in May 2023.

Guidance and a robust decision-making process have been developed to support public bodies in considering, developing and implementing new revenue raising ideas, and to ensure full appraisal of any impacts on individuals and businesses is carried out. The outputs from this programme of work are intended to support the funding position for the 2024-25 Scottish Budget and subsequent budget allocations.

Pay Sustainability

The RSR included commitments to hold the total public-sector pay bill (excluding Local Government) at around 2022-23 levels, whilst returning the overall size of the public sector broadly to pre-COVID-19 levels. We have since evolved our approach.

We published a Pay Strategy in March 2023 emphasising the link between pay, workforce, reform and fiscal sustainability. This built on the 2023-24 Budget which set out that it is for individual public bodies – in dialogue with their respective Trade Unions - to determine the target operating model for their workforces and to ensure workforce plans and projections are affordable in 2023-24 and over the medium term, and reflect the continued commitment to no compulsory redundancies. Strategic partners – Trade Unions and employers across the devolved public sector in Scotland – are central to the delivery of fair, affordable, and sustainable bodies, including their workforces.

This change recognised the relative size of public bodies within the devolved public sector – in particular, around one third of employment (headcount) in the devolved public sector is in the NHS. The NHS workforce has grown, by almost 13,500 FTE (over 9%) between December 2019 and December 2022, and is likely to require further growth to respond to the changing demographic and health and care needs of the people of Scotland.

Pay and workforce must more than ever be explicitly linked to both fiscal sustainability and reform to secure the delivery of sustainable and effective public services over the medium term, while supporting wellbeing and the principles of Fair Work.

Major reform programmes

Specific larger scale reform programmes underway are an integral part of a wider 10-year Public Service Reform programme. This includes, for example:

- The **Education Reform Programme** to deliver a revised Target Operating Model for the New Education Agency, New Inspectorate and the New Qualifications Body. It is expected that these will be considered over the coming months, reflecting specific dependencies on the outcomes of the Independent Review of Qualifications and Assessment and the Review of the Skills Delivery landscape. Thematic projects are being established and defined with an aim to deliver the common areas of work required, including Digital, Roles and Responsibilities, HR, Operational Services, Organisation Design and Culture, Finance, and Comms & Engagement.
- Tackling child poverty through the second delivery plan (to 2026), **Best Start, Bright Futures**, which sets out ambitious action to provide immediate support to families, and to deliver progress in the medium and longer-term to break the cycle of poverty in a sustainable way for children, parents, households and communities. Given the importance of delivering equality for all in Scotland this programme makes an important contribution to the policy prospectus. As part of this, pathfinders are developing and learning is already emerging, highlighting the potential for transformational change in public services and outcomes for parents. Modelling (from March 2022) suggests that child poverty levels would be around 10 percentage points higher in 2023-24 in the absence of Scottish Government policies, however the modelling also forecasts a gap to close from 2026 to meet the statutory 2030 target – the next annual progress report will be published before the end of June, providing a detailed update. It is critical that work continues to focus on interventions that will make the biggest impact on the targets in the short, medium and long term, including through the use of place based person-centred tests of change.
- The Scottish Government is committed to keeping **The Promise** by 2030. In March 2022 the Promise Implementation Plan was published setting out the actions and commitments that will be taken across portfolios. These include the introduction of the Children's Care and Justice Bill (presently progressing through Parliament): supporting prevention through investment of £500 million in whole family wellbeing; and work underway to review the Children's hearing system, due to report in Spring 2023. In addition, change in support of children and young people who are care experienced is being progressed through education, justice and health reform.
- The **National Strategy for Economic Transformation** (NSET), published in March 2022, is a 10-year strategy to transform the Scottish economy and maximise the opportunities to achieve our vision of a wellbeing economy.

Delivery plans for each of the strategy's six programmes of action were published in October 2022 and progress is being made on each of the programmes, including the launch of the Techscaler Network (November 2022) and the opening of six of the seven techscaler hub locations. Annual reports will be published outlining the progress in delivering the strategy, with the first of these due in early summer this year.

- Scottish Government is committed to delivering a **National Care Service** to secure a system that is genuinely accountable to people, embeds Human Rights at the heart of support and improves quality, fairness and consistency of provision that meets the needs of Scotland's people. The National Care Service (Scotland) Bill is progressing with a revised timetable to allow further engagement to reach consensus on the way forward. At the same time significant investment and improvement activity is underway to ensure people and staff see the benefit of change now.
- The Scottish Government remains committed to delivering a **New Deal for Local Government** in partnership with COSLA, as set out in the Policy Prospectus. This will include a fiscal framework, enable better collaboration to jointly deliver shared priorities, to tackle the collective challenges faced, and to improve outcomes for people. The New Deal will provide the framework for working in partnership with Local Government on a wide range of policies and programmes, including public service reform. Constructive engagement between Scottish Government and COSLA is ongoing with a focus on the co-design of the new deal.
- The **Justice Vision**, published in February 2022, sets out the Government's Transformative Vision for the justice sector for this parliamentary term and beyond. This included a year one delivery plan, focussing on the collaborative work being taken forward across the justice sector in 2022-23. This work continues, with transformational change programmes set up for each of the priority areas, better serving justice for women and children, hearing victims' voices, and shifting the balance between use of custody and justice in the community. Two key bills are currently being progressed through Parliament, The Victims and Witnesses and Justice Reform Bill, and the Bail and Release from Custody Bill. A full progress report will be published in the summer, including a measurement framework.

Annex C: Fiscal Framework

This Annex sets out the implications of the Fiscal Framework for the Scottish Budget. More detail on how the Fiscal Framework operates is set out in the Fiscal Framework Technical Note. This includes 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.[44]

This Annex outlines the latest BGAs which were published alongside the UK Spring Statement 2023. The SFC's latest revenue and expenditure forecasts have been published alongside this Medium-Term Financial Strategy.

Tax

Table C. 1 shows the latest forecasts for tax revenues from the SFC and the latest BGA estimates following the UK Spring Statement 2023.

Table C. 1: Forecasts of Tax Revenues and Block Grant Adjustments

		2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
	Revenue	**13,387**	**14,764**	**16,210**	**17,080**	**17,808**	**18,591**	**19,646**	**20,799**
Income Tax[2]	**BGA[1]**	**-13,624**	**-14,866**	**-15,799**	**-16,239**	**-16,722**	**-17,359**	**-18,092**	**N/A**
	Difference	**-237**	**-102**	**411**	**841**	**1,086**	**1,232**	**1,554**	**N/A**
	Revenue	**807**	**840**	**772**	**733**	**792**	**905**	**992**	**1,053**
LBTT[2]	**BGA[1]**	**-642**	**-722**	**-519**	**-508**	**-612**	**-723**	**-809**	**N/A**
	Difference	**165**	**118**	**254**	**225**	**179**	**183**	**183**	**N/A**
	Revenue	**125**	**112**	**92**	**83**	**58**	**16**	**16**	**16**
SLfT[2]	**BGA[1]**	**-102**	**-101**	**-96**	**-91**	**-84**	**-87**	**-92**	**N/A**
	Difference	**23**	**12**	**-5**	**-8**	**-26**	**-71**	**-76**	**N/A**
	Revenue	**14,320**	**15,716**	**17,074**	**17,896**	**18,658**	**19,513**	**20,654**	**21,869**
Total	**BGA[1]**	-14,368	-15,688	-16,415	-16,838	-17,418	-18,168	-18,993	N/A
	Difference	-49	28	660	1,058	1,240	1,344	1,661	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 2021-22 LBTT and SLfT revenue and Block Grant Adjustment are outturn figures.
Figures may not sum due to rounding.

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.

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

Social Security

Table C. 2 shows the SFC's latest expenditure forecasts for social security benefits and the latest BGA estimates following the UK Spring Statement 2023.

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

		2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Attendance Allowance	**Expenditure**	**-588**	**-643**	**-715**	**-762**	**-790**	**-816**	**-842**
	BGA[1]	**549**	**646**	**714**	**728**	**733**	**744**	**N/A**
	Difference	**-9**	**3**	**-1**	**-34**	**-57**	**-72**	**N/A**
Personal Independence Payment	**Expenditure**	**-2,032**	**-2,713**	**-3,227**	**-3,559**	**-3,852**	**-4,178**	**-4,554**
	BGA[1]	**2,022**	**2,500**	**2,840**	**3,095**	**3,347**	**3,609**	**N/A**
	Difference	**-10**	**-213**	**-387**	**-463**	**-505**	**-569**	**N/A**
Disability Living Allowance	**Expenditure**	**-738**	**-803**	**-836**	**-831**	**-824**	**-827**	**-835**
	BGA[1]	**736**	**826**	**900**	**915**	**906**	**920**	**N/A**
	Difference	**-2**	**23**	**64**	**85**	**82**	**94**	**N/A**
Carer's Allowance [2]	**Expenditure**	**-315**	**-373**	**-429**	**-483**	**-518**	**-544**	**-572**
	BGA[1]	**314**	**367**	**404**	**421**	**441**	**465**	**N/A**
	Difference	**-1**	**-6**	**-25**	**-62**	**-77**	**-79**	**N/A**
Industrial Injuries Disablement Scheme	**Expenditure**	**-78**	**-84**	**-86**	**-84**	**-83**	**-81**	**-79**
	BGA[1]	**79**	**84**	**84**	**80**	**77**	**74**	**N/A**
	Difference	**2**	**-1**	**-2**	**-3**	**-6**	**-7**	**N/A**
Severe Disablement Allowance	**Expenditure**	**-6**	**-6**	**-5**	**-5**	**-4**	**-3**	**-3**
	BGA[1]	**6**	**6**	**6**	**5**	**4**	**3**	**N/A**
	Difference	**0**	**0**	**0**	**0**	**0**	**0**	**N/A**
Cold Weather Payments	**Expenditure**	**-20**	**-22**	**-23**	**-23**	**-23**	**-22**	**-22**
	BGA[1]	**21**	**5**	**5**	**5**	**5**	**5**	**N/A**
	Difference	**1**	**-17**	**-17**	**-17**	**-17**	**-17**	**N/A**
TOTAL SS	**Expenditure**	**-3,746**	**-4,644**	**-5,321**	**-5,746**	**-6,093**	**-6,472**	**-6,898**
	BGA[1]	**3,728**	**4,434**	**4,953**	**5,250**	**5,512**	**5,820**	**N/A**
	Difference	**-19**	**-210**	**-368**	**-495**	**-580**	**-652**	**N/A**

Benefits Yet to Commence

The Carer Support Payment will be the next social security payment to be introduced, replacing Carer's Allowance in Scotland. Social Security Scotland will begin a pilot by the end of this year, followed by national launch in spring 2024.

Pension Age Winter Heating Payment is still to be devolved and will replace the Winter Fuel Payment in Scotland. This new benefit will commence from winter 2024.

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 2021-22 financial year will be calculated when outturn data are available in summer 2023 and applied to the Scottish Budget 2024-25. The updated forecasts for 2021-22, 2022-23 and 2023-24 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 2022-23 financial year will be calculated when outturn is available later this year and applied to the Scottish Budget 2024-25.

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 is 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 2020-21 Income Tax was applied to the 2023-24 budget. Outturn data for 2021-22 Income Tax is due to be published in Summer 2022, which will allow the Scottish and UK Governments to calculate and agree the final 2021-22 Income Tax reconciliation, which will be applied to the Scottish Budget 2024-25.

Table C. 3 shows that the latest forecast 2021-22 Income Tax reconciliation is negative £712 million. The final position will not be known until outturn receipts are available in summer 2023.

Table C. 3: 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**	
Outturn	**13,387**	**-13,624**	**-237**	**-712**
Outturn against forecast	**+1,124**	**-1,836**		

Figures may not sum due to rounding.

The potential scale of the reconciliations applying to the 2025-26 and 2026-27 Budgets are shown in tables C. 4 and C. 5 using the latest forecasts.

Table C. 4: 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	**13,670**	**-13,860**	**-190**	
Latest forecast	**14,879**	**-14,866**	**+12**	**+203**
Change	**+1,208**	**-1,005**		

Figures may not sum due to rounding.

Table C. 5: Forecast Income Tax Reconciliation Applying To 2026-27 Budget (£ Million)

2023-24 Income Tax	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2023-24	**15,810**	**-15,485**	**+324**	
Latest forecast	**16,210**	**-15,799**	**+411**	**+86**
Change	**+400**	**-314**		

Figures may not sum due to rounding.

Based on the latest forecasts, the reconciliation to the Scottish Budget 2025-26 for 2022-23 Income Tax is forecast to positive £88 million. A reconciliation of positive £86 million is expected to apply to the Scottish Budget 2026-27 to account for 2023-24 Income Tax.

However, these forecasts are not certain and the final position will not be known for sure until outturn receipts are available for 2022-23 in summer 2024, and for 2023-24 in summer 2025.

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 2023-24 revenue forecasts for LBTT and SLfT and the previous revenue forecasts are shown in Table C. 6.

Table C. 6: 2023-24 Revenue Forecast (£ Million)

LBTT	**SFC Revenue Forecast – Budget 2023-24**	**773**
	SFC Revenue Forecast – MTFS 2023	**772**
	Change	**-1**
SLfT	**SFC Revenue Forecast – Budget 2023-24**	**79**
	SFC Revenue Forecast – MTFS 2023	**92**
	Change	**12**

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 2023-24 LBTT and SLfT are shown in table C. 7.

Table C. 7: 2023-24 Indicative In-Year BGA Reconciliations (£ Million)

LBTT	**Forecast BGA – Scottish Budget December 2022**	**-517**
	Forecast BGA – UK Spring Statement 2023	**-519**
	Indicative In-year reconciliation to 2023-24 Budget	**-2**
SLfT	**Forecast BGA – Scottish Budget December 2022**	**-99**
	Forecast BGA – UK Spring Statement 2023	**-96**
	Indicative In-year reconciliation to 2023-24 Budget	**+2**

Figures may not sum due to rounding.

As set out in Table C. 8, the forecast net effect on the Scottish Budget 2023-24 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 C. 8: Change In Net Position For 2023-24 Scottish Budget (£ Million)

Fully Devolved Tax	Forecast In-Year BGA Reconciliation	Change in SFC revenue forecast from Scottish Budget 2023-24	Forecast Net Position
LBTT	**-2**	**-1**	**-3**
SLfT	**2**	**12**	**+14**
TOTAL	**0**	**11**	**+12**

Figures may not sum due to rounding. These figures are indicative, with the official in-year BGA reconciliation not available until Autumn 2023.

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 C. 9 shows the forecast final reconciliations for 2022-23 LBTT and SLfT BGAs applying to the 2024-25 Scottish Budget.

Table C. 9: 2021-22 Forecast Final BGA Reconciliation (£ Million)

LBTT	**Forecast BGA – Scottish Budget December 2022**	**-717**
	Forecast BGA – UK Spring Statement 2023	**-722**
	Forecast Reconciliation to 2024-25 Budget	**-5**
SLfT	**Forecast BGA – Scottish Budget December 2022**	**-103**
	Forecast BGA – UK Spring Statement 2023	**-101**
	Forecast Reconciliation to 2024-24 Budget	**+2**

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 C. 10 shows the forecast net effect on the budget for 2022-23 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 2022-23. The final net position will not be confirmed until final outturn is published later in the year.

Table C. 10: Latest Forecast Net Position For 2022-23 LBTT And SLfT (£ million)

		Revenues	BGA	Net Position
LBTT	Forecast as of Budget 2022-23	749	-664	+86
	Latest Forecast – MTFS 2023	840	-722	+118
	Latest change in Forecast Net Position	90	-58	+33
SLfT	Forecast as of Budget 2022-23	101	-82	-18
	Latest Forecast – MTFS 2023	112	-101	12
	Latest change in Forecast Net Position	12	-18	-7

Figures may not sum due to rounding.

Social Security

The latest 2023-24 expenditure forecasts for Social Security and the previous expenditure forecasts are shown in Table C. 11.

Table C. 11: 2023-24 Expenditure Forecast (£ Million)

Attendance allowance	SFC Expenditure Forecast – Budget 2023-24	-614
	SFC Expenditure Forecast – MTFS 2023	-643
	Change	-29
Personal independence payment	SFC Expenditure Forecast – Budget 2023-24	-2,690
	SFC Expenditure Forecast – MTFS 2023	-2,713
	Change	-24
Disability living allowance	SFC Expenditure Forecast – Budget 2023-24	-765
	SFC Expenditure Forecast – MTFS 2023	-803
	Change	-38

Carer's allowance	**SFC Expenditure Forecast – Budget 2023-24**	**-372**
	SFC Expenditure Forecast – MTFS 2023	**-373**
	Change	**-1**
Industrial injuries disablement scheme	**SFC Expenditure Forecast – Budget 2023-24**	**-84**
	SFC Expenditure Forecast – MTFS 2023	**-84**
	Change	**0**
Severe disablement allowance	**SFC Expenditure Forecast – Budget 2023-24**	**-6**
	SFC Expenditure Forecast – MTFS 2023	**-6**
	Change	**0**
Cold Weather Payments	**SFC Expenditure Forecast – Budget 2023-24**	**-24**
	SFC Expenditure Forecast – MTFS 2023	**-22**
	Change	**2**
Total social security	**SFC Expenditure Forecast – Budget 2023-24**	**-4,554**
	SFC Expenditure Forecast – MTFS 2023	**-4,644**
	Change	**-90**

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 2023-24 Social Security BGAs are shown in Table C. 12.

Table C. 12: 2023-24 Indicative In-Year BGA Reconciliation (£ Million)

Attendance allowance	**Forecast BGA – Scottish Budget December 2022**	**621**
	Forecast BGA – UK Spring Statement 2023	**646**
	Forecast In-year reconciliation to 2023-24 Budget	**+25**
Personal independence payment	**Forecast BGA – Scottish Budget December 2022**	**2,481**
	Forecast BGA – UK Spring Statement 2023	**2,500**

	Forecast In-year reconciliation to 2023-24 Budget	+19
Disability living allowance	Forecast BGA – Scottish Budget December 2022	802
	Forecast BGA – UK Spring Statement 2023	826
	Forecast In-year reconciliation to 2023-24 Budget	+24
Carer's allowance	Forecast BGA – Scottish Budget December 2022	365
	Forecast BGA – UK Spring Statement 2023	367
	Forecast In-year reconciliation to 2023-24 Budget	+2
Industrial injuries disablement scheme	Forecast BGA – Scottish Budget December 2022	82
	Forecast BGA – UK Spring Statement 2023	84
	Forecast In-year reconciliation to 2023-24 Budget	+1
Severe disablement allowance	Forecast BGA – Scottish Budget December 2022	6
	Forecast BGA – UK Spring Statement 2023	6
	Forecast In-year reconciliation to 2023-24 Budget	+0
Cold Weather Payment	Forecast BGA – Scottish Budget December 2022	3
	Forecast BGA – UK Spring Statement 2023	5
	Forecast In-year reconciliation to 2023-24 Budget	+3
Total social security	Forecast BGA – Scottish Budget December 2022	4,360
	Forecast BGA – UK Spring Statement 2023	4,434
	Forecast In-year reconciliation to 2023-24 Budget	+73

Figures may not sum due to rounding.

Table C. 13 sets out the net effect on the Scottish Budget 2023-24 of the latest expenditure forecasts for Social Security benefits with a BGA when compared to the total forecast in-year BGA reconciliations, is negative £16m.

Table C. 13: Change In Net Position For 2023-24 Scottish Budget (£ Million)

	Indicative In-Year BGA Reconciliation	Change in SFC expenditure forecast from 2023-24 Scottish Budget	Change in forecast net Position
Total social security benefits with a BGA[1]	73	90	-16

1) Carer's Allowance, Attendance Allowance, Child Disability Payment, Disability Living Allowance, Adult Disability Payment, Industrial Injuries Disablement Allowance, Severe Disablement 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 C. 14 shows the forecast final reconciliation for the 2022-23 Social Security BGAs applying to the 2024-25 Scottish Budget.

Table C. 14: Forecast Social Security 2022-23 Final BGA Reconciliation (£ Million)

Attendance allowance	**Forecast BGA – Scottish Budget December 2022**	**545**
	Forecast BGA – UK Spring Statement 2023	**549**
	Forecast Reconciliation to 2023-24 Budget[1]	**+4**
Personal independence payment	**Forecast BGA – Scottish Budget December 2022**	**2,024**
	Forecast BGA – UK Spring Statement 2023	**2,022**
	Forecast Reconciliation to 2023-24 Budget	**-1**
Disability living allowance	**Forecast BGA – Scottish Budget December 2022**	**732**
	Forecast BGA – UK Spring Statement 2023	**736**
	Forecast Reconciliation to 2023-24 Budget	**+3**
Carer's allowance	**Forecast BGA – Scottish Budget December 2022**	**315**
	Forecast BGA – UK Spring Statement 2023	**314**
	Forecast Reconciliation to 2023-24 Budget	**-0**

Industrial injuries disablement scheme	**Forecast BGA – Scottish Budget December 2022**	**78**
	Forecast BGA – UK Spring Statement 2023	**79**
	Forecast Reconciliation to 2023-24 Budget	**1**
Severe disablement allowance	**Forecast BGA – Scottish Budget December 2022**	**6**
	Forecast BGA – UK Spring Statement 2023	**6**
	Forecast Reconciliation to 2023-24 Budget	**0**
Cold Weather Payments	**Forecast BGA – Scottish Budget December 2022**	**3**
	Forecast BGA – UK Spring Statement 2023	**21**
	Forecast Reconciliation to 2023-24 Budget	**+18**
Total social security	**Forecast BGA – Scottish Budget December 2022**	**3,703**
	Forecast BGA – UK Spring Statement 2023	**3,728**
	Forecast Reconciliation to 2023-24 Budget	**+25**

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 C. 15 shows the forecast net effect on the budget for 2022-23 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 2022-23. The final net position will not be confirmed until final outturn is published later in the year.

Table C. 15: Latest Forecast Net Position For 2022-23 Social Security Expenditure (£ Million)

		Expenditure	**BGA**	**Net Position**
Attendance allowance	**Forecast as of Budget 2022-23**	-545	545	0
	Latest Forecast – MTFS 2023	-558	549	-9
	Latest change in Forecast Net Position	**-14**	**5**	**-9**
Personal independence payment	**Forecast as of Budget 2022-23**	-1,948	1,933	-15
	Latest Forecast – MTFS 2023	-2,032	2022	-10
	Latest change in Forecast Net Position	**-84**	**89**	**5**
	Forecast as of Budget 2022-23	-710	687	-23

Disability living allowance	**Latest Forecast – MTFS 2023**	-738	736	-2
	Latest change in Forecast Net Position	**-28**	**48**	**20**
Carer's allowance	**Forecast as of Budget 2022-23**	-315	323	8
	Latest Forecast – MTFS 2023	-315	314	-1
	Latest change in Forecast Net Position	**0**	**-9**	**-9**
Industrial injuries disablement scheme	**Forecast as of Budget 2022-23**	-81	79	-1
	Latest Forecast – MTFS 2023	-78	79	2
	Latest change in Forecast Net Position	**3**	**0**	**3**
Severe disablement allowance	**Forecast as of Budget 2022-23**	-6	6	0
	Latest Forecast – MTFS 2023	-6	6	0
	Latest change in Forecast Net Position	**0**	**0**	**0**
Cold Weather Payments	**Forecast as of Budget 2022-23**	-21	14	-7
	Latest Forecast – MTFS 2023	-20	21	1
	Latest change in Forecast Net Position	**1**	**7**	**8**
Total social security	**Forecast as of Budget 2022-23**	-3,626	3,587	-38
	Latest Forecast – MTFS 2023	-3,746	3,728	-19
	Latest change in Forecast Net Position	**-121**	**140**	**19**

Figures may not sum due to rounding.
Note 1: 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 2023-24 revenue forecast for FFFP and the previous revenue forecasts are shown in Table C. 16.

Table C. 16: 2023-24 Revenue Forecast (£ Million)

FFFP	**SG Revenue Forecast – Budget 2023-24**	25
	SG Revenue Forecast – MTFS 2023	25
	Change	**0**

Figures may not sum due to rounding.

Unlike the devolved taxes, there is only one round of 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 C. 17 shows the indicative BGA reconciliation for 2022-23 which is to apply in 2024-25 once outturn data is available.

Table C. 17: 2022-23 Indicative BGA Reconciliation (£ Million)

FFFP	**Forecast BGA – Budget 2022-23**	**-28**
	Forecast BGA – UK Spring Statement 2023	**-25**
	Forecast Reconciliation to 2024-25 Budget	**+3**

Figures may not sum due to rounding.

Table C. 18 shows the forecast net effect on the budget for 2022-23 FFFP by comparing the latest forecast expenditure and BGAs to the forecast expenditure and BGAs set at the time of the Scottish Budget 2022-23. The final net position will not be confirmed until final outturn is published later in the year.

Table C. 18: Latest Forecast Net Position For 2022-23 FFFP (£ Million)

		Revenues	**BGA**	**Net Position**
FFFP	**Forecast as of Budget 2022-23**	25	-28	-3
	Latest Forecast – MTFS 2023	25	-25	0
	Latest Forecast Net Position	**0**	**0**	**-3**

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.[45] The Scottish and UK Governments agreed to consider this issue as part of the review of the Fiscal Framework.

Outturn revenue for 2022-23 Proceeds of Crime will be published in winter 2023. The Scottish Government receives all revenues recovered under the Proceeds of Crime Act, however, outturn revenues are hypothecated for spend on community projects.[46] 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, please see the data annex in the Fiscal Framework factsheet.

Capital Borrowing

Table C. 19: Capital Borrowing and Repayment Schedule (£ Million)

£million	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**	**2023-24**
Debt stock at start of Year	607	1,036	1,258	1,617	1,744	1,814	2,026
New In Year Borrowing	450	250	405	200	150	300	250
Principal Repayments	-	7	26	52	60	67	79
Interest Repayments	-	8	11	13	14	16	24
Total Resource Cost	-	**15**	**37**	**64**	**74**	**83**	**103**
Resource Cost of Projected Borrowing	-	-	-	-	-	-	-

[45] Scottish Government (2019), 6. Proceeds of Crime - Fiscal framework outturn report: 2019 - gov.scot (www.gov.scot) – September 2019
[46] Further information can be found at the Cashback for Communities website

Projected Total Resource Cost	**0**	**15**	**37**	**64**	**74**	**83**	**103**
Notional Borrowing Repayments	9.4	20.5	20.5	20.5	20.5	20.5	20.5
Debt Stock at end of Year	1,036	1,258	1,617	1,744	1,814	2,026	2,177
Percentage of Debt Cap	35%	42%	54%	58%	60%	68%	73%
Headroom	1,964	1,742	1,383	1,256	1,186	974	823

£million	**2024-25**	**2025-26**	**2026-27**	**2027-28**	**2028-29**	**2029-2030**	**2031-32**
Debt stock at start of Year	2,177	2,312	2,434	2,541	2,634	2,711	2,786
New In Year Borrowing	250	250	250	250	250	250	250
Principal Repayments	88	89	91	92	94	82	70
Interest Repayments	24	23	22	20	19	17	16
Total Resource Cost	**112**	**112**	**112**	**112**	**112**	**99**	**86**
Resource Cost of Projected Borrowing	15	38	61	84	108	132	156
Projected Total Resource Cost	**127**	**150**	**173**	**197**	**220**	**231**	**242**
Notional Borrowing Repayments	20.5	20.5	20.5	20.5	20.5	20.5	20.5
Debt Stock at end of Year	2,312	2,434	2,541	2,634	2,711	2,786	2,858
Percentage of Debt Cap	77%	81%	85%	88%	90%	93%	95%
Headroom	688	566	459	366	289	214	142

Projected Borrowing based on Scottish Government Capital Borrowing Policy with interest calculated on forward rates as of 11/05/2023. A 50 basis point premium is applied to all interest rate assumptions

Resource Borrowing

The table below details the Resource Borrowing repayments and debt stock on the basis of existing plans and assumptions.

As chapter 3.11 details the volatility in reconciliations is significant and therefore so is the scope for borrowing plans to shift accordingly. This table should therefore be treated as indicative.

Table C. 20: Resource Borrowing and Repayment Schedule (£ Million)

	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Debt Stock at start of Year	207	505	480	414	596	446	286
New In Year Borrowing	319	47	41	300	0	0	0
Principal Repayments	21	72	108	117	150	160	110
Interest Repayments	0	4	6	6	16	14	10
Total Resource Cost	**21**	**77**	**114**	**124**	**166**	**174**	**120**
Debt Stock at end of Year	505	480	414	596	446	286	176
Percentage of Debt Cap	29%	27%	24%	34%	25%	16%	10%
Headroom	1,245	1,270	1,336	1,154	1,304	1,464	1,574

Grey highlight denotes estimated/volatile figures
Projections are based on forward rates as of 11/05/2023. A 50 basis point premium is applied to all interest rate assumptions

Annex D: Summary of Fiscal Risks

Risk	What this risk might mean for the Scottish Government
RISKS TO THE FUNDING POSITION	
Changes to UK Government spending plans.	The Block Grant is the core source of the Scottish Government's funding. It is not only determined by how much the UK Government expects to spend in total but also how it priorities resource departmental spending (RDEL) and capital departmental spending (CDEL) across devolved and reserved spending areas within a given funding envelope. Changes to UK Government spending plans remain the most significant source of funding risk for both resource and capital funding. Based on an analysis of historic trends, a high scenario illustrates an annual growth in resource funding 2.7% higher each year than in the central forecast, and 3.1% higher for capital funding. In a low scenario, annual growth could be 1% lower than in the central scenario.
The overall impact of tax devolution on the Scottish Budget depends on the performance of tax receipts per person in Scotland relative to the rest of the UK. The performance of the Scottish economy, alongside Scottish and rUK tax policy decisions influence the scale of the tax revenues.	Income tax performance remains a major risk to the funding position. As highlighted by the SFC, recent improvements in the Income Tax net position are partly driven by differences in the independent forecasters' judgements, in particular in relation to earnings growth. The SFC highlight that were earnings growth to be more similar in Scotland and the UK, the Income Tax net position would be materially lower than is currently projected.
Forecast variations and income tax reconciliations.	Having official independent forecasts is vital as it reduces bias and improves overall fiscal transparency. However, forecast error is an inherent part of forecasting. The way the fiscal framework was designed heightens the impact of forecast error, as it uses forecasts from two independent organisations and the differences in timing, judgement and methodology between the OBR and SFC continue to present a risk for the Scottish Government's funding outlook and

	contribute to continuing volatility in the fiscal outlook. Volatility in forecasts introduces a challenge to forward planning and efforts to smooth the funding outlook over time. This is because forecasts for the anticipated reconciliation to be applied in future budgets inform decisions on future resource borrowing and spending.
RISKS TO SPENDING POSITION	
Volatility in demand-led budgets, in particular the demand-led nature of social security.	Demand-led expenditure appears across the public sector and will always carry a degree of forecast risk. Budgets reflect expected levels of demand but expenditure will vary according to the number of people who are eligible for, and choose or need to use the service and will be effected by behavioural and economic factors. This has become a more significant feature of the Scottish Budget with the devolution of Social Security, which is now the third largest area of public spending in Scotland, after Health and Local Government. These programmes must all be managed within the resource budget and the Scottish Government has limited levers to manage demand-led volatility. Increases in demand-led expenditure therefore reduce funding the Scottish Budget has available for other programmes. Expenditure on social security spending 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 the SFC's forecasts rather than spending limits, and the Scottish Government must meet social security expenditure as it arises, even if it differs from the SFC forecast used to set the initial medium-term spending plans or the Budget.
Demographic change.	Scotland's population is expected to undergo significant change over the medium- and longer-term. Some of this change creates risks to

	aspects of funding and spending that the Scottish Government will need to manage going forward. Like many western countries, the Scottish population is ageing. An ageing population is likely to put further pressures on public expenditure, in particular on health, social care, and social security. In comparison, the reduction in the number of younger people means that some of these expenditure pressures may be offset by reduced demand in other areas, such as education.
RISKS TO BOTH FUNDING AND SPENDING	
Continued inflationary pressures and the cost of living crisis.	Inflationary pressures continue to create a cost of living crisis for households and businesses across the country and increase pressure on public services. Scotland is set to experience a record fall in living standards, with average real disposable incomes falling from 4.1% from 2021-22 to 2023-24, in the face of high inflation, and are not set to recover to pre-pandemic levels until around 2026-27. Experience of the financial years 2022-23 and 2023-24 has illustrated the significant impact sustained high inflation may have on the spending outlook. Across the public sector, and particularly on infrastructure programmes, we – like businesses and organisations across Scotland – have seen high inflation erode our buying power during the cost crisis. As a result, the costs we pay for the largest elements of our budget – employees and social security benefits – have increased. Any additional expenditure arising as a result of sustained inflation must be managed within the limits of the Scottish Government’s existing fiscal powers.

Annex E: Distributional Analysis Methodology

This Annex sets out details of the assessment of the distributional impact of the Scottish Government's Income Tax and social security policy choices since the devolution of these powers following the Scotland Act 2016.

The analysis considers the impact of Income Tax and social security policy changes on households across the income distribution. The analysis takes into account the number of people in the household, its composition, and interactions with the wider (UK and Scottish) tax and benefit system. In doing so, it extends previous analysis as part of the 2023-24 Budget in December, which looked only at Income Tax policy. This analysis showed that Income Tax policy in Scotland continues to be progressive, with higher income households proportionately contributing the most. Extending the analysis to include decisions on social security provides a broader understanding of the distributional impacts of overall Scottish Government policy. However, it is important to note that changes to social security policies are not funded directly by Income Tax policies.

There are a number of challenges in understanding the impact of policy on households. Distributional models do not automatically capture any behavioural responses that may also affect incomes, and small sample sizes mean that it is often not possible to capture the impact of policies on particular protected characteristics, such as race.

Methodology

The analysis has been produced in UKMOD, an open-access microsimulation model developed by the Institute for Social and Economic Research (ISER) at the University of Essex. The model applies tax and benefit rules to a set of individual and household-level data, allowing the user to simulate and compare alternative scenarios.

The input data in UKMOD is derived from DWP's Family Resources Survey (FRS). The analysis in this report uses three years of FRS data, namely 2016-17, 2017-18, and 2018-19[47]. To pool the data, the grossing weights used to scale the FRS sample to the whole population are divided by the number of data years, in this case three. The income components and other monetary variables from each year of data to 2023-24 are taken from a range of sources, including historical data and forecasts by the Office for Budget Responsibility (OBR), but no adjustments are made for demographic change.

Tax parameters

The analysis compares tax liabilities across the different income deciles under the 2023-24 policy proposal, as set out in the Scottish Budget, compared to the rates

[47] The 2020-21 FRS data collection was severely disrupted. This meant that it was not possible to obtain a representative sample for the year. Recently published FRS data for 2021-22 will be incorporated in the next version of the model.

and bands in England and Northern Ireland. These tax parameters are summarised in Table E.1.

Table E.1: Summary of Tax Parameters

Scottish policy 2023-24		Counterfactual scenario	
Band	**Rate**	**Band**	**Rate**
£12,571 - £14,732	19%	£12,571 - £50,270	20%
£14,733 - £25,688	20%		
£25,689 - £43,662	21%		
£43,663 - £125,140	42%	£50,271 - £125,140	40%
Above £125,140	47%	Above £125,140	45%

Social security parameters

The modelled social security benefits include the following[48]:

- Scottish Child Payment: a £25 weekly payment to eligible families;[49]
- Discretionary Housing Payment: a payment to support people with housing costs[50]. The Scottish Government is using DHPs to mitigate the bedroom tax and benefit cap.
- Carers Allowance Supplement: two lump sum £271.50 payments to recipients of Carers Allowance;[51]
- Best Start Grant and Best Start Foods: a range of payments made to eligible families.[52]

Benefits such as Free School Meals or the School Clothing Grant are not included in the analysis.

Results

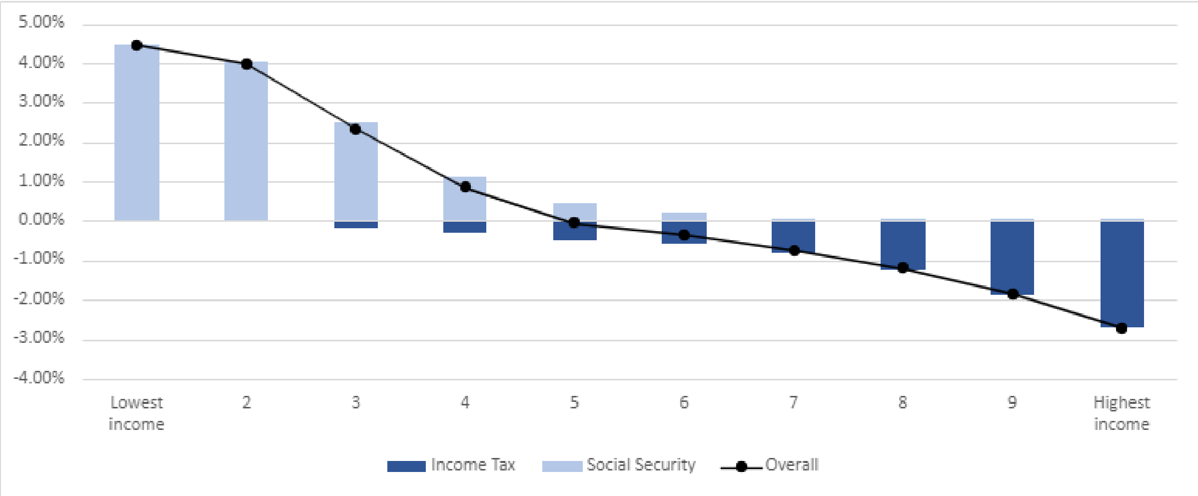
Figure E.1 below shows the combined impact of our Income Tax and social security policies on household incomes in Scotland, compared to the system in the rest of the UK, and shows clearly that the Scottish Government's tax and social security policies are reducing inequality and targeting support at those who need it most. Scottish Government policies mean that household incomes increase by around 4% for households in the lowest and second lowest deciles and around 3% in the third.

The majority of this increase is due to Scottish Child Payment which gives £25 per week per child to families on low incomes and is a key part of delivering on our

[48] The relevant comparator for Social Security is England and Wales.
[49] Scottish Government (2023), Scottish Child Payment - mygov.scot – May 2023
[50] Scottish Government (2023), Discretionary Housing Payment - mygov.scot – May 2023
[51] Scottish Government (2023), Carer's Allowance Supplement - mygov.scot – May 2023
[52] Scottish Government (2023), Best Start Grant and Best Start Foods - mygov.scot – May 2023

commitment to reduce child poverty with smaller contributions from other benefits such as Discretionary Housing Payment and Best Start Grant.

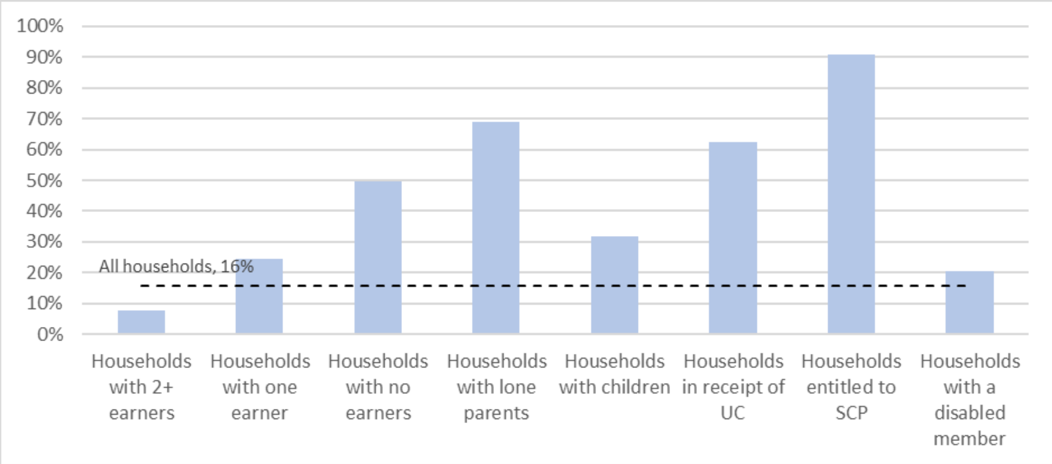
Figure E.1: Cumulative impact of Scottish tax and benefits policy decision since 2016-17



Source: Scottish Government analysis using UKMOD. Change in equivalised household disposable income before housing cost

An alternative way of looking at the analysis is by household type. Figure E.2 below shows the proportion of people who receive more than a 1% increase in income as a result of Scottish Income Tax and social security policies. Since the increase to people's incomes mainly comes from Scottish Child Payment (SCP), a higher than average proportion of people in households with lone parents (70%), households with children (over 30%) and households entitled to SCP (over 90%) are affected. Whereas a less than average proportion of people in households with more than two earners (almost 10%) are affected. This is because households with more than two earners are less likely to be entitled to means tested benefits and more likely to pay more Income Tax.

Figure E.2: **Proportion of people in households with a more than 1% increase in income**



Source: Scottish Government analysis using UKMOD. Change in equivalised household disposable income before housing costs

Note: The scenarios do not assume full UC roll-out. ‘Households in receipt of UC’ does not include those currently in receipt of the legacy benefits. ‘Households entitled to SCP’ is based on household characteristics reflecting entitlement rather than receipt of SCP.

Looking ahead, we will continue to monitor the impact of tax and social security policies on households, and we will aim to incorporate other Scottish Government policies such as Free School Meals and the School Clothing Grant in our distributional analysis.

Annex F: Scottish Government Discretionary Funding Envelope

Table F. 1: Fiscal Resource Funding Envelope (£ Million)

Fiscal Resource Funding (£million)	2023-24 Budget	2023-24 Forecast	2024-25 Forecast	2025-26 Forecast	2026-27 Forecast	2027-28 Forecast
Core Barnett Settlement	36,023	36,118	36,668	37,438	38,323	39,420
Ringfenced Funding	715	715	715	715	715	715
Total UK Settlement (A)	**36,737**	**36,832**	**37,383**	**38,153**	**39,038**	**40,135**
Social Security Block Grant Adjustment (B)	**4,360**	**4,434**	**5,132**	**5,435**	**5,697**	**6,003**
Block Grant Adjustment for Taxes and Non-Tax Income	(16,131)	(16,130)	(16,868)	(17,449)	(18,198)	(19,023)
Scottish Income Tax	15,810	15,810	17,080	17,808	18,591	19,646
Land and Buildings Transaction Tax	773	772	733	792	905	992
Scottish Landfill Tax	79	92	83	58	16	16
Non-Tax Income	25	25	25	25	25	25
Net Budget Adjustment for Taxes and Non-Tax Income (C)	**557**	**569**	**1,053**	**1,235**	**1,339**	**1,656**
Reconciliations	46	46	(687)	88	86	0
Resource Borrowing	41	41	300	0	0	0
Resource Borrowing Costs	(120)	(114)	(124)	(166)	(174)	(120)
Capital Borrowing Costs	(112)	(103)	(127)	(150)	(173)	(197)
Scotwind	310	310	350	0	0	0
Scotland Reserve	0	0	0	0	0	0
Migrant Surcharge	120	160	160	160	160	160

KLTR	5	5	5	5	5	5
Other	0	20	21	0	0	0
Machinery of Government	0	13	0	0	0	0
Other Income and Funding Adjustments (D)	**289**	**378**	**(102)**	**(63)**	**(86)**	**(151)**
Total Scottish Government Fiscal Resource Funding (A+B+C+D)	**41,944**	**42,213**	**43,466**	**44,759**	**45,978**	**47,643**
Non Domestic Rates - Distributable Amount	**3,047**	**3,047**	**3,069**	**3,158**	**3,437**	**3,328**
Total Scottish and Local Government Fiscal Resource Funding	**44,991**	**45,260**	**46,535**	**47,917**	**49,415**	**50,971**

Capital Funding (£m)	**2023-24 Budget**	**2023-24 Forecast**	**2024-25 Forecast**	**2025-26 Forecast**	**2026-27 Forecast**	**2027-28 Forecast**
Core Barnett Settlement	4,757	4,820	4,691	4,700	4,720	4,727
Ringfenced Funding	632	632	632	632	632	632
Borrowing (per Capital Borrowing Policy)	450	450	450	450	450	450
Scotland Reserve	0	0	0	0	0	0
City Deals	100	100	100	100	100	100
Machinery of Government	0	2	0	0	0	0
Total Capital Funding	**5,939**	**6,002**	**5,873**	**5,882**	**5,902**	**5,909**

Financial Transactions Funding (£m)	2023-24 Budget	2023-24 Forecast	2024-25 Forecast	2025-26 Forecast	2026-27 Forecast	2027-28 Forecast
Core Barnett Settlement	186	172	176	0	0	0
Scotland Reserve	50	50	0	0	0	0
Corrections to historic settlement be reflected	188	188	0	0	0	0
Total Financial Transactions Funding	**424**	**410**	**176**	**0**	**0**	**0**

Scottish Government
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