University of Strathclyde Glasgow

Scotland's Budget Report 2023

Fraser of Allander Institute

Executive summary

When Deputy First Minister (DFM) and Finance Secretary Shona Robison rises next week to present her first Scottish Budget, she will do so against one of the most challenging fiscal backdrops in the history of Scottish devolution.

The Scottish economy has not performed as badly as many had anticipated, with no recession this year, but growth has been essentially non-existent for the past two years. And with the Bank of England set to keep interest rates higher for longer than previously anticipated, the Scottish Fiscal Commission's (SFC) forecasts are likely to follow the pattern presented by the Office for Budget Responsibility for the whole of the UK – slower growth and higher inflation than at their previous update.

Between the Medium-Term Financial Strategy (MTFS) in May and the Autumn Budget Revision, spending pressures – mostly on pay – had increased by £930m. Since then, there have been £520m-worth of spending cuts announced; there is £380m in additional Barnett funding; and £260m in additional borrowing and use of the Scotland Reserve. This leaves the prospective position of the Scottish Government in 2023-24 at £232m, which might mean not all of the cuts announced by the DFM on the eve of the Autumn Statement are necessary.

But the situation for 2024-25 is much more difficult. Part of it was already in the MTFS, with resource spending plans already outstripping funding by £1bn and capital plans £450m larger than projected funding. As the Scottish Government must balance funding sources with expenditures, this was clearly always unsustainable.

More positive Income Tax net revenues in outturn and forecast are likely to add around £970m to funding available next year, and there are £310m of Barnett consequentials to add – plus an additional £180m additional funding to compensate for the devolution of winter fuel payments. In total, funding is £1,455m higher than expected in May.

But spending pressures are also higher, with higher-than-budgeted-for pay awards creating ongoing difficulties. Assuming the higher scenario for pay this year and next from the MTFS – themselves probably too low for what actually happened – would add about £500m to spending. Adding in winter fuel payments expenditure brings spending plans to £646m above the MTFS – meaning a £780m improvement to the net funding position.

This is before any of the additional spending commitments made by the Scottish Government, which have been numerous in recent months. First Minister Humza Yousaf said in October it would be 'fully funded' – which of course depends on what councils would have done in the absence of the freeze. If we assume they would have mirrored last year's increases, we estimate compensation would run to £330m. The First Minister (FM) also announced so an additional £100m for NHS waiting list reduction.

And at least £325m of the DFM's 'savings' announced in Parliament on 21 November were actually reprofiling of spending into future years, when plans already exceeded projected funds using May's forecasts.

On the basis of announced policy and commitments, we estimate that the net funding gap is £1,465m for 2024-25: £799m on resource and £665m on capital.

In the report, we also look at the outlook for spending and tax. We analyse how public sector employment has been evolving in Scotland relative to other areas of the UK; what capital borrowing plans using Scottish Government bonds might mean for capital spending; and how social security spending has been evolving.

On the tax side, we have updated our analysis of how much proposed Income Tax policies would raise under our understanding of the SFC's methodology; what reforms to smooth out marginal tax rates might look like; what the consequences of the council tax freeze are for the revenues and for households; the cost of matching reliefs on non-domestic rates; and the practical difficulties in introducing new taxes to combat short-term funding gaps.

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1. Introduction

1.1 The backdrop to the Budget

Shona Robison, the Deputy First Minister (DFM) and Cabinet Secretary for Finance, is in an unenviable position. While the Scottish and UK economies have avoided the recession that many had predicted for this year (including us), economic growth has been very low, and looks to remain subdued for the foreseeable future.

On the other hand, inflation has remained stubbornly high in the UK. The latest reading of the consumer prices index (CPI) showed growth of 4.6% in the 12 months to October 2023. This is well below the peak in quarter 4 of 2022, but it remains over double the Bank of England's (BoE) target. The Office for Budget Responsibility (OBR) now expects inflation to remain higher for longer than it did in March, and markets expect this will lead to the Bank of England keeping interest rates at about 4% in the medium-term.

This tighter monetary policy looks set to keep economic activity growing at a sluggish pace as the BoE tries to rein in the inflationary pressures. And it is against this backdrop that the Chancellor of the Exchequer, Jeremy Hunt, delivered his Autumn Statement around three weeks ago.

There was a modest improvement to the 'headroom' with which the Chancellor met his self-imposed fiscal rules, primarily as a consequence of the decision to freeze Income Tax and National Insurance Contributions (NICs) thresholds for the whole of the forecast period. This is what is known as 'fiscal drag' – a process through which more people are brought into higher rates of tax as their earnings grow faster than the thresholds, therefore increasing tax revenues.

Faced with this improvement, Jeremy Hunt chose to cut NICs for employees and the self-employed, and to make full expensing of investment in plant and machinery permanent. This meant little in the way of additional funds for the Scottish Government through either Barnett consequentials or changes to the Block Grant Adjustments (BGAs).

And without further funding from Westminster, the backdrop of the Scottish Budget looks extremely challenging. Scottish Income Tax revenues have been boosted by the increases in rates in recent years, but relative growth in receipts has been faster in the rest of the UK – with the consequence of little additional benefit to funds available.

And with spending commitments already outstripping funds available for 2023-24, the DFM announced an array of around £680m in 'savings' for the current financial year during a sparsely attended statement in the Chamber – perhaps because it took place on the eve of the Autumn Statement. This was a combination of genuine cancellations of projects and programmes (around £200m), additional funding from the UK Government (around £160m) and deferrals into future years (around £320m).

But with the Scottish Government constrained in how much it can borrow, and a large gap between funding and spending commitments in the medium-term – as announced by the DFM herself multiple times – it seems implausible that all these delayed projects and programmes will indeed take place. In fact, given the forecast for growing shortfalls in funding every year until 2028-29, deferrals into future years might help meet in-year constraints, but actively exacerbate the problem in future years.

This is before any policy decisions taken by the Scottish Government that might make the funding outlook more challenging. First Minister (FM) Humza Yousaf announced a freeze in council tax rates for next year and promised to 'fully fund' it by compensating local authorities. It is rather unclear how much this will mean in practice – but even a minimal amount of additional funding contributes to the worsening of the financial outlook. The same is true for other 'additional' spending announced, such as the £100m a year to tackle waiting lists.

This report sets out the challenges facing the DFM when she rises to deliver the Budget next week. In the rest of chapter 1, we set out the economic outlook on the basis of which the Scottish Fiscal Commission (SFC) is producing its forecasts. In chapter 2, we estimate the net funding position of the Scottish Government and any risks attached to that. Chapter 3 provides a more detailed look at spending, both in departmental priorities and in social security, and explores the extent to which trends in spending on a number of areas match the expected demographic pressures from population change. Chapter 4 is a detailed look at tax levers, exploring costings for additional revenue from Scottish Income Tax changes, the options for reforming Scottish Income Tax thresholds to improve progressivity and labour market outcomes, and topics on local taxation.

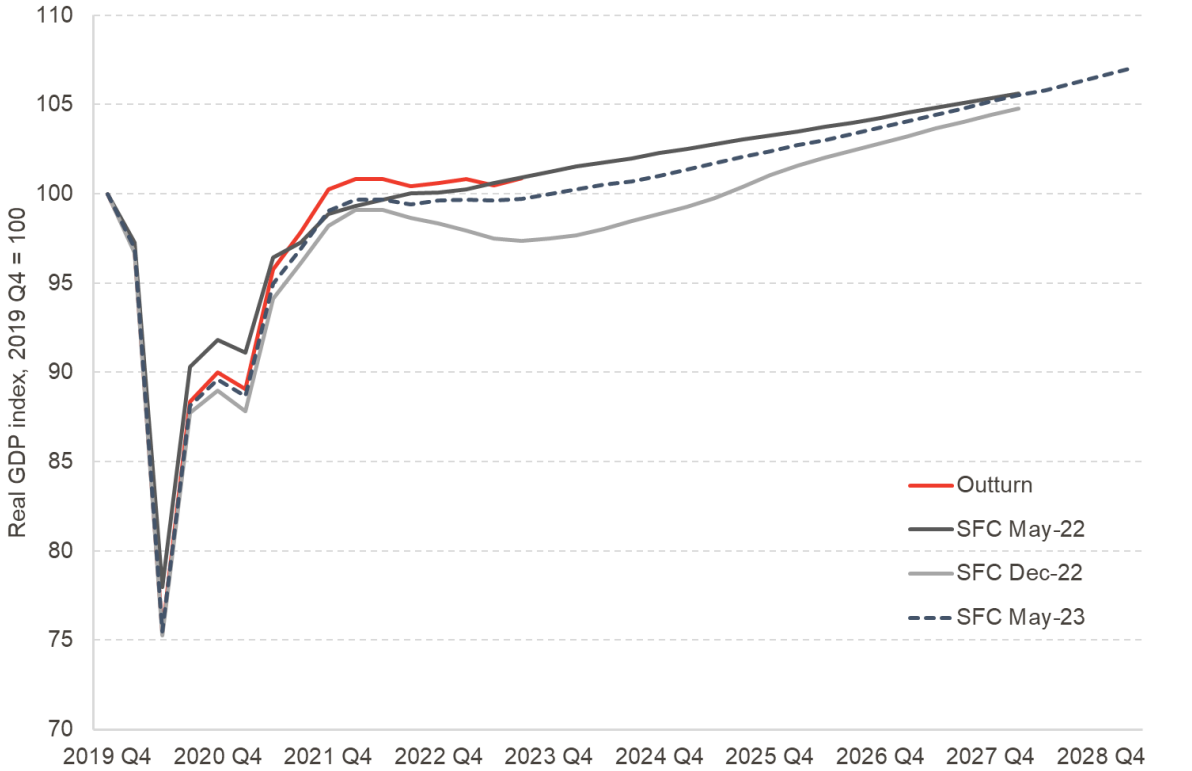
1.2 Economic outlook

This section focusses on the main economic developments in Scotland and the rest of the UK (rUK) in recent quarters, and how these are likely to be reflected in the SFC's forecasts next week.

Scotland's economy has bucked recession this year, but the SFC is unlikely to be very optimistic going forward

As with GDP for the UK as a whole, the level of Scottish GDP has been revised up throughout 2021 and 2022 in line with the Office for National Statistics' (ONS) Blue Book 2023 revisions. This means that the economy recovered more quickly than anticipated from the pandemic, which is welcome news. It is now estimated that the Scottish economy is 0.9% larger than it was prior to the outbreak of the pandemic.

Chart 1.1: Scotland's real GDP: outturn and successive SFC forecasts



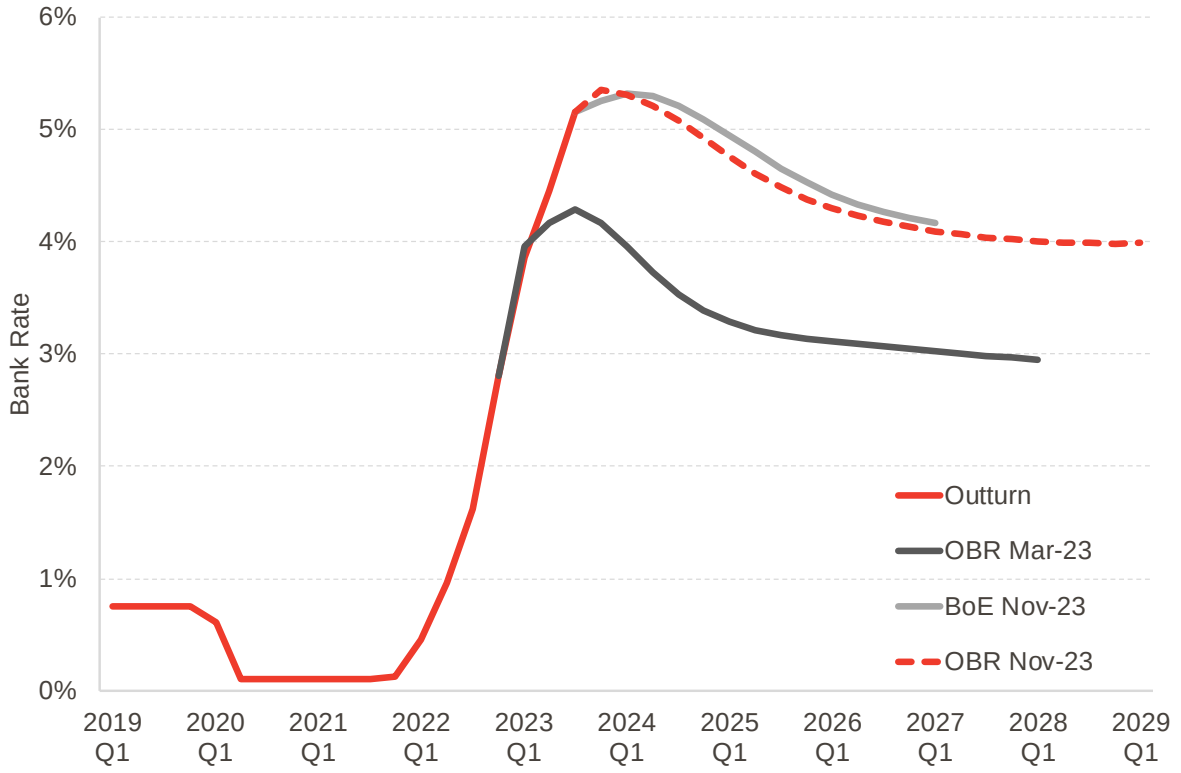
Source: Scottish Government, SFC, FAI calculations

However, despite the higher level of GDP, growth has not been particularly great – particularly in quarter 2 of 2022 when the Scottish economy contracted by 0.3%, before bouncing back with 0.4% growth in quarter 3. Scotland's better performance than the UK as a whole in quarter 3 can in large part be explained by being unaffected by large-scale strikes in the health sector.

But market participants now expect the Bank Rate to both peak and stabilise at a higher level than a few months ago. Partly, this is a reflection of the fact that the BoE has increased

interest rates further than expected – but the persistence of the higher level is also reflective of more persistent inflation, which will take longer to remove from the system.

Chart 1.2: Bank Rate and market expectations used in different forecasts



Source: OBR, BoE

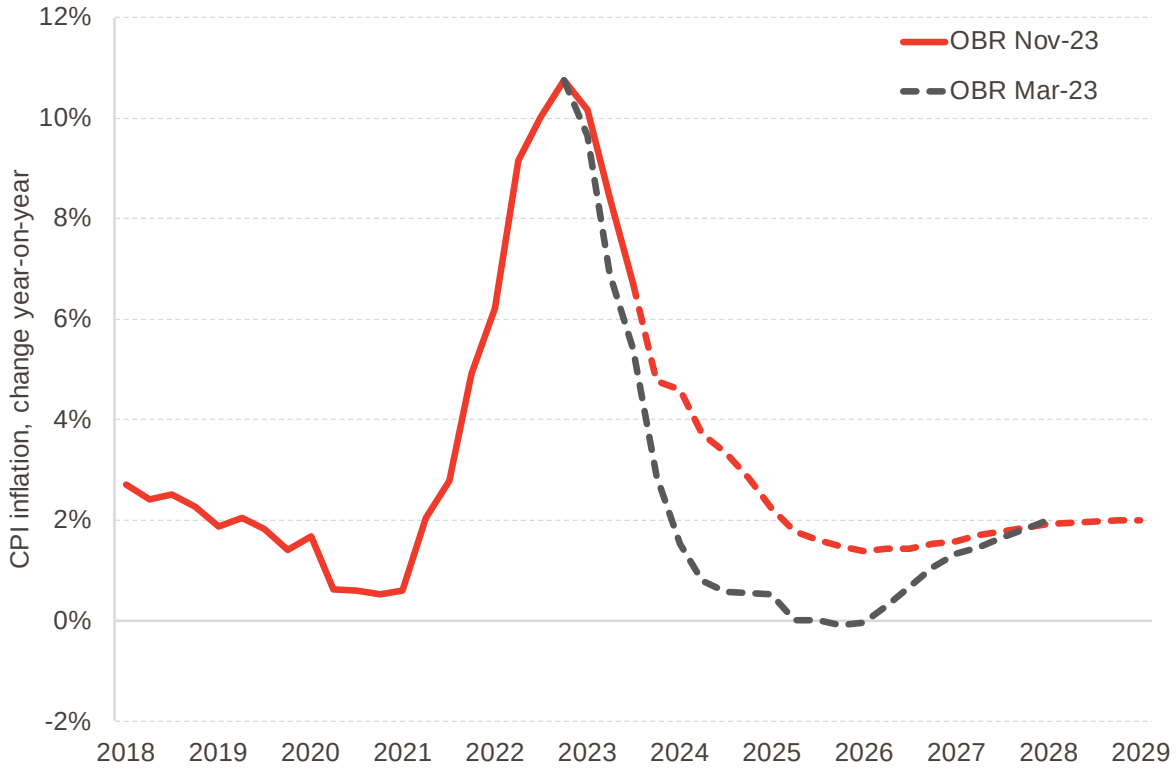
The higher level of interest rates is likely to cool demand substantially and is one of the main reasons the OBR downgraded its real GDP growth forecasts at the UK level. It is also part of the reason why we downgraded prospects for the Scottish economy in our 2023 Q3 Economic Commentary.

Of course, it will be the SFC's forecasts on the 19 December which will be used for the official assessment of the Scottish Government's finances, but it seems unlikely they will diverge significantly – especially as much of the better performance of Scotland in quarter 3 relative to the UK as a whole is explained by one-off factors such as strike action in England rather than underlying strength.

Inflation has revealed itself to be more permanent than anticipated, and has spread economy-wide

CPI inflation peaked in the UK at 10.7% in quarter 4 of 2022, and has been falling since then – though near as fast as in other countries, and at a slower pace than the OBR had previously anticipated. Whereas in March it expected CPI inflation to fall below target by early 2024, the OBR now sees it remaining above 2% until mid-2025.

Chart 1.3: CPI inflation at successive OBR forecasts



Source: OBR. Dashed lines are forecasts

Prices have continued to rise faster than targeted by the Bank of England, putting further pressure on the Monetary Policy Committee to hold interest rates at a higher level for longer. And it also means pain for consumers, who have seen prices rising at a much faster rate than they have been accustomed to.

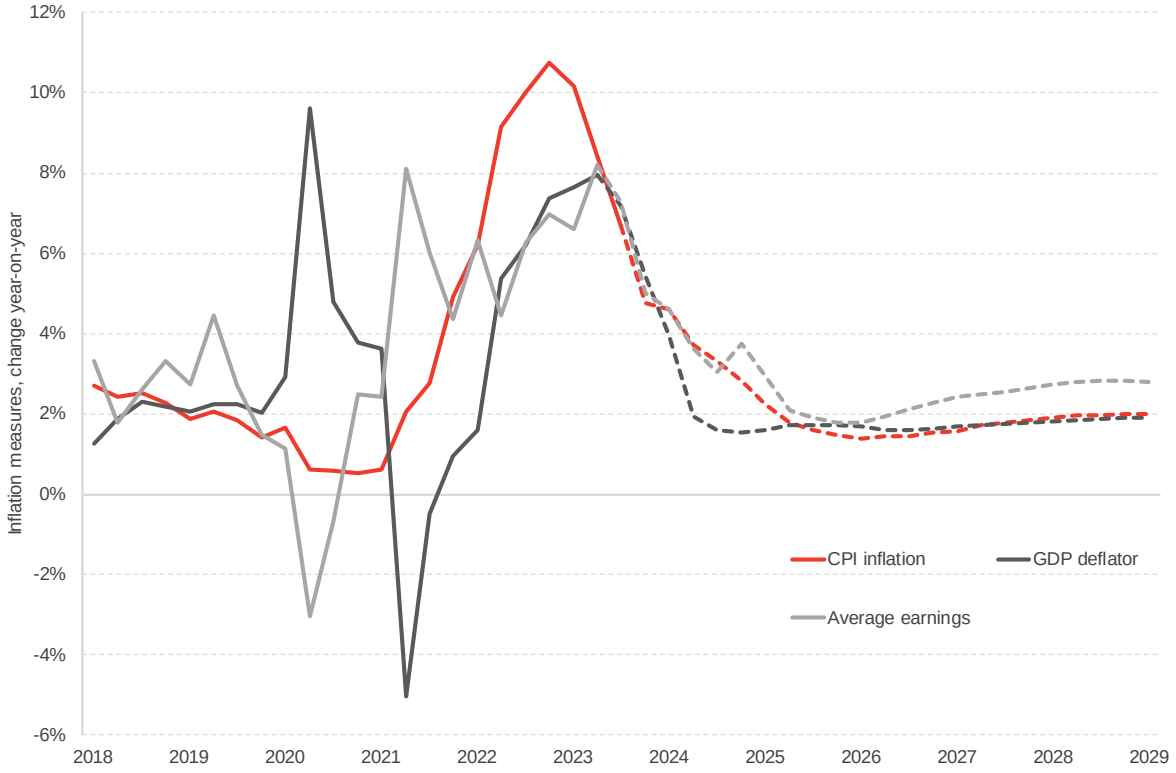
It is worth remembering that falling inflation is not the same as falling prices, just that they are rising less quickly. While that is welcome, it still means that there has been a permanent increase in the *level* of consumer prices – which are now 15% higher than they would have been in the absence of the pandemic recovery's supply constraints and the Russian invasion of Ukraine. This will not change – rather, with inflation remaining above target, this permanent effect will yet grow a further 18 months.

Why has inflation become so embedded? Energy prices are much lower than they were at the beginning of the year, which is good news, but this has been outweighed by strong pay growth, which remains above 7% year-on-year.

The generalised effect of inflation on the economy is illustrated by movements in the GDP deflator, which is a broader measure of inflation – taking into account the increase in prices used in domestic production and excluding import prices. As chart 1.4 shows, CPI inflation started increasing steeply towards the end of 2021 as overseas shocks fed through to consumer prices immediately. Growth in the GDP deflator lagged behind increased in CPI

inflation (tracking the sustained increase in average earnings instead), highlighting the widespread and domestically generated nature of the inflation in the UK economy.[1]

Chart 1.4: Inflation and average earnings, outturn and OBR November 2023 forecasts



Source: OBR. Dashed lines are forecasts

Living standards may not be forecast to fall as far as previously thought, but the OBR is still forecasting the two worst consecutive years on record

Living standards are usually measured using real household disposable income (RHDI) per person – a comprehensive measure which accounts for inflation, income flows to households, changes in taxes and benefits, and population growth.

The OBR is forecasting UK RHDI per person to fall for three years in a row – from 2022-23 to 2024-25 – in what would be the first time it has happened since record began in 1955. This would be a total fall of 3.4%, and reflects two main factors.

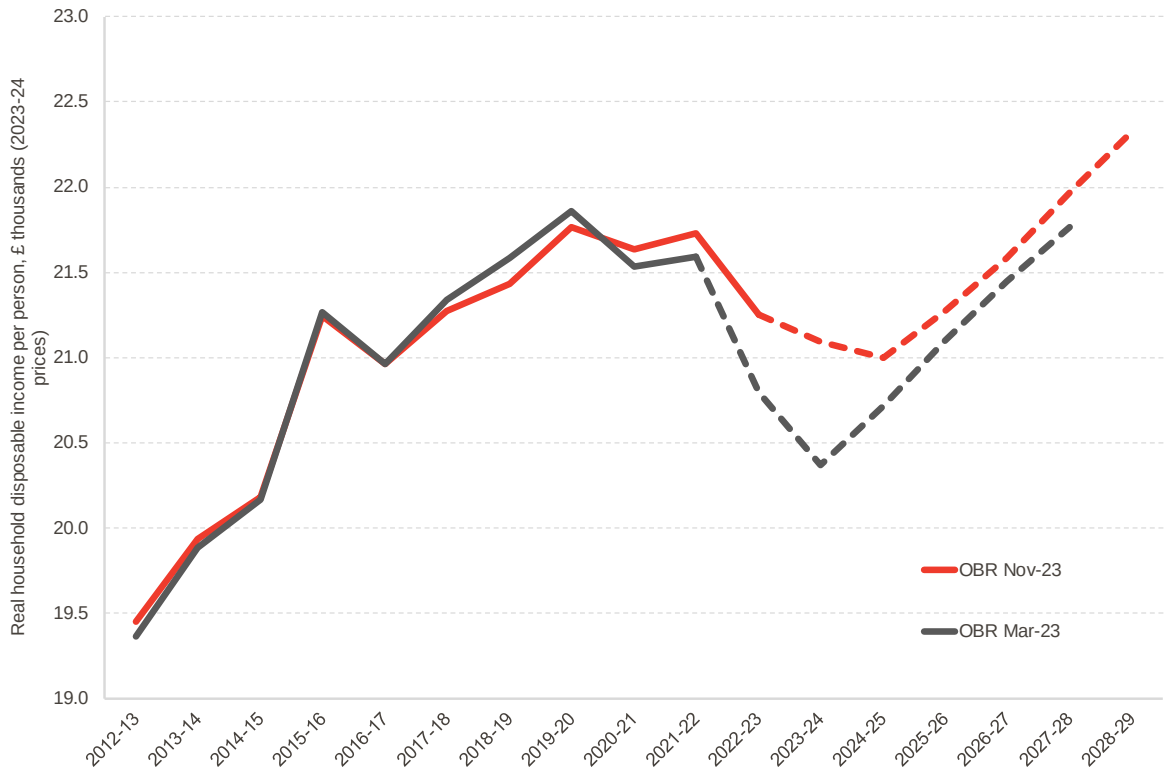
The first is the sheer level of the inflationary shock, which has caused a large increase in the price level which has not been met in full by increases in both labour and non-labour income.

But the other main source of this fall is caused by policy, and it is one that is share across both Scotland and the rest of the UK. The freeze in thresholds for taxes on labour income – enacted separately by the Scottish Government for Scottish Income Tax and by the UK

[1] Average earnings growth was higher than normal in 2021 due to the widespread use of the furlough scheme in 2020, which replaced 80% of normal earnings (and slightly less in some months). Average year-on-year growth in earnings between quarter 2 of 2019 and quarter 2 of 2021 was 2.4%, broadly in line with growth pre-pandemic.

Government for Income Tax in the rest of the UK and NICs – has the effect of reducing disposable income significantly throughout the OBR's forecast. This is true even with the cuts in the NICs rates, which only partly offsets the fiscal drag of the threshold freeze.

Chart 1.5: UK real household disposable income per person



Source: OBR. Dashed lines are forecasts

The economic outlook is challenging – there might be no recession, but growth is hardly happening

The story of the Scottish economy in the last 24 months has been one of essentially flat-lining. There have not been two quarters of consecutive contraction, and so a technical recession (which many had predicted, including us) has been avoided. But the economy is still the same size as in the first quarter of 2022, which qualifies as poor performance by any standard.

Of course, the Scottish and wider UK economies have been buffeted by a number of shocks and have in fact been more resilient than the general consensus at the time. But the after-effects of these shocks and the Bank of England's expected path for interest rates in its fight to bring down inflation weigh down growth prospects.

In many ways, fiscal authorities are in a bind. Any fiscal stimulus is likely to lead to aggregate demand rising further above the supply potential of the economy, and would probably lead the Bank to take a more aggressive approach to offset it.

The supply potential of the economy is hard to change in the short-run – the Treasury has tried to incentivise more people into the workforce, but even the OBR's relatively optimistic assumptions about their effectiveness do not shift the dial in any meaningful way.

With monetary policy determined at UK level and little in the way of manoeuvre on its own fiscal stance, the DFM's decisions will need to deliver a budget that takes all these constraints into account, and some large parts of her funding are already determined – especially as it pertains to the Block Grant. But the monetary dominance in the current UK situation is a reminder that fiscal policy's ability to influence macroeconomic outcomes can be a mirage.

2. The net funding position

2.1 The 2023-24 funding position and its consequences for 2024-25

When Deputy First Minister Shona Robison presented the Medium-Term Financial Strategy (MTFS) in May, she highlighted the challenges in the coming years. Based on funding projections and spending commitments, there was a funding gap of around £1bn for 2024-25. With additional borrowing flexibilities in the Fiscal Framework Agreement (see box 1) and a less unfavourable Income Tax reconciliation, our best guess was that on the MTFS basis, that gap was down to around £600m – still a substantial sum, and that does not even include potentially expensive additional measures such as the council tax freeze announced in October.

Nevertheless, the central projection at the time of the MTFS for the net funding position was for a balanced budget in 2023-24 – a position that the Scottish Government has to achieve in each year. But in-year spending pressures, in large part as a result of inflation and pay deals, had increased by the time of the Autumn Budget Revision (ABR), to an implied £928m.[2]

At the ABR, the DFM announced £164m of spending cuts in-year, in addition to increased funding of £376m. Of those £376m, £120m represented additional funding from the UK Government through Barnett consequentials from UK Government spending changes over the Summer, and £256m were other sources of income – mostly through additional use the Scotland Reserve. This left the funding gap at £387m for this year.

[2] This has been calculated by taking the MTFS balance of £0 and the DFM's statement of the remaining £387m of a funding gap after the increases in income and reductions in spending in the ABR.

Chart 2.1: Cumulative changes in the net funding position after successive announcements

Source: Scottish Government, FAI calculations

On the eve of the Autumn Statement, the DFM presented plans in the Debating Chamber and informed the Finance and Public Administration Committee of her plans to further reduce spending by £360m, which when combined with some £35m in additional funding already in place as a result of Main Estimates, meant a combined easing of pressures of around £395m on top of the ABR.

This means total reductions in spending are around £525m in 2023-24, with Education and Skills (£165m), Transport, Net Zero and Just Transition (£145m) and NHS Recovery, Health and Social Care (£70m) the most severely affected portfolios. Though this was presented as £680m of in-year 'savings', it is worth noting that £155m of those are additional UK Government income through Barnett consequentials.

However, the documentation alongside these £525m reductions in spending is not clear at all in terms of how much are genuine savings to be baselined into future years and how much are one-off reductions, and it requires some detective work and inference to arrive at estimates of true savings.

A few of the items are exceptional revenues (for example, out-of-court settlements that cannot be expected to be repeated). Others still are presented as 'reprofiling' of spending into future years. And we have no idea what impact items like the £10m savings on employability spending will do – the note in the DFM's letter makes it sound like it should have no impact at all, which at first glance does not seem believable, and the explanation given does not help clear up the confusion either.

As far as we can tell, baseline reductions probably amount to as much as £200m of the total £525m, or just below two-fifths – and that is assuming that cut to the Scottish Funding Council by £100m (the single largest saving announced) is permanent.

But that still means £325m in deferred spending – which in practical terms translates as increasing spending in future years. But is that really credible when the Scottish Government was already facing such a large funding gap for next year?

There are two main considerations for these planned cuts, in particular the £360m itemised in the letter to the Committee but not included in the ABR. The first is that the Autumn Statement did allocate an additional £223m to Scotland in the current financial year as a result of consequentials from the NHS pay deal in England. This would mean that the required spending cuts to balance the budget in the Spring Budget Revision would be in the region of £125m, not the additional £360m claimed in the letter.

The second point is that these cuts may be presented as deferrals by the DFM, but they will more than likely need to be permanent unless substantial additional revenue is found. With a large funding gap already in the baseline for next year, the Scottish Government would either have to increase tax revenues or limit its spending further.

Of course, it is perfectly possible for the Government to choose to continue to fund some or even of all these deferred programmes into future years. But if it were to do so, and in the absence of higher revenues, other areas would have to be squeezed instead – making for a difficult set of trade-offs for the DFM.

Box 1: The revised Fiscal Framework Agreement

In July 2023, the UK and Scottish governments published the long-awaited update to the Fiscal Framework, following the review that has been going on for the last couple of years. For more background, see our blog from late 2021.

For those new to it, the Fiscal Framework sets out the rules for how the devolution of tax and social security powers following the Scotland Act 2016 is supposed to work in terms of finances. It sets out the mechanisms by which the Scottish block grant is adjusted to reflect the fact that large amounts of tax and social security powers are now the responsibility of the Scottish Parliament.

It also sets out fiscal flexibilities that the Scottish Government can choose to use in managing these new powers, as new tax and social security powers also come with risks that require to be managed.

The mechanism for adjusting the Block Grant will remain permanently as the Index Per Capita (IPC) method.

This is one of the most complex areas of the fiscal framework but definitely one of the most significant.

For tax, it sets out the mechanism for working out how much the UK Government has "given up" by devolving a tax to Scotland, given that it is a significant loss in revenue. As, following devolution, there are different policies pursued in rest of UK and Scotland, this is not straightforward. Essentially though, the mechanism agreed in 2016 was to grow the tax at the point of devolution at the rate that it grows in the rest of the UK per person. This is known as the Index Per Capita (IPC) method.

So, the idea is that, all else being equal, if taxes per head grow quicker in Scotland, the Scottish Budget will be better off – conversely, if taxes per head grow more slowly, the Scottish Budget will be worse off.

In 2016, when the fiscal framework was first agreed, the IPC method was the Scottish Government's preference, whereas the UK Government preferred the "Comparable Method" (which would generally be worse than the IPC method for the Scottish Budget). So they agreed to use IPC for the first 5 years and review it as part of this process.

They have now agreed that the IPC method will remain on a permanent basis.

Interestingly, this means that on a permanent basis, the mechanisms for adjusting the block grants for Wales and Scotland will be different, given Wales's Fiscal Framework uses the Comparable Method, albeit with additional provisions to keep a funding floor in place.

Borrowing powers for managing forecast error have been increased significantly.

Resource borrowing powers to manage forecast error associated with tax and social security powers have been increased from £300m to £600m. These flexibilities are required because when budgets are determined, the tax, social security and block grant adjustment estimates are set on the basis of forecasts from both the Scottish Fiscal Commission and the Office for Budget Responsibility. When the outturn data is available, if there is a discrepancy (which is very likely) then the Scottish Budget has to reconcile these differences.

All limits, such as resource and capital borrowing powers, will be uprated in line with inflation.

When the Fiscal Framework was first agreed, the limits on borrowing for both resource and capital, and the limits for what could be put into the Scotland reserve, were set in cash terms and have been fixed ever since.

This agreement sets out that the ones that remain will be uprated by inflation, and that the limits on the additions and drawdowns on the Scotland Reserve will also be abolished. Essentially, the limits will remain constant in 2023-24 prices, using the latest set of deflators published by the OBR. The deflator used will be the GDP deflator. This measures inflation across the whole economy, not just that experienced by consumers (as is the case for CPI). It is the measure of inflation that is generally used to put Government spending into real terms.

The table below sets out how the limits will be uprated using the deflators published alongside the Autumn Statement in November: of course, the limits for years after 2024-25 will be updated when future forecasts of deflators are available.

Table A.1: Uprated Fiscal Framework Limits

£m	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Resource Borrowing Limit	600	610	621	631	642	654
Capital Borrowing Limit	450	458	465	473	481	490
Scotland Reserve Cap	700	712	724	736	749	763
Resource Borrowing Cap	1,750	1,779	1,810	1,839	1,872	1,907
Capital Borrowing Cap	3,000	3,050	3,103	3,153	3,209	3,269

Source: HMT, OBR, FAI calculations

As is expanded on below, however, these new agreements on uprating do not make up for the fact that these limits have been significantly eroded in real terms since the original fiscal framework was agreed in 2016.

Some decisions were deferred yet again.

One thing that is a little disappointing is that there was no final decision on VAT Assignment. See our blog from 2019 to get the background on this.

VAT Assignment was included as part of the Smith Commission powers. The idea was that half of VAT raised in Scotland would be assigned to the Scottish Budget, which would mean, if the Scottish Economy was performing better than the UK as a whole, the budget would be better off, and conversely, if VAT was growing less quickly in Scotland, the budget would be worse off.

However, after almost 10 years, it has become clear that there is no way to estimate VAT in Scotland that is precise enough for this to have budgetary implications. It is a large amount of money (more than £5bn) so even small fluctuations in how it is estimated can mean changes of hundreds of ms of pounds.

In the recent review, the Governments have agreed to just keep discussing it. We think it is time that everyone admitted it is just not a sensible idea.

2.2 The 2024-25 net funding position

The challenging position faced by the Scottish Government was highlighted by the DFM when she presented the MTFS. Despite the then-balanced position for 2023-24 – which has since turned into a significant shortfall – resource spending commitments for 2024-25 were already £1bn in excess of the projected funding, with capital commitments exceeding funding by £450m.

This is clearly unsustainable without action, as the Scottish Government must balance the two sides of the ledger in every year. This funding already included some borrowing, in the form of £300m for the projected reconciliation and between £450m for capital investment,[3] the limits under the previous iteration of the Fiscal Framework Agreement.

With less of a negative reconciliation[4] on Income Tax relating to 2021-22 – which has now determined to be £390m rather than the £715m estimated by the SFC in May – and with more room to borrow to cover it, the Scottish Government can now finance all the reconciliation through borrowing, rather than having to either find revenue or cut spending to make up the difference over and above the borrowing limits.

There is more good news on taxes in Income Tax – this time on the forecasting side. While the ultimate forecasts that will determine the Scottish Government's spending power next year are the SFC's, indications from the OBR forecast published in November are that strong non-savings, non-dividends Income Tax receipts, combined with the higher tax rates in Scotland, should boost the net position for revenues. We estimate this to add £580m to revenues in the Scottish Budget after accounting for growth in the BGAs.

Scotland has also received some Barnett consequentials from the Autumn Statement, to the tune of £310m in 2024-25, as part of two measures applying to England: the 75% relief for retail, hospitality and leisure and the freezing of the small business multiplier. As this is a Barnett consequential of a devolved policy area, the Scottish Government is under no obligation to use these funds for the same purpose or to replicate the measures. It could do so – but it might cost around £360m for the retail, hospitality and leisure relief alone.

Finally, the Scottish Government will have responsibility for the winter fuel payment – to be called Pension Age Winter Heating Payment – with adjusted BGAs from next year, adding £178m to funding.

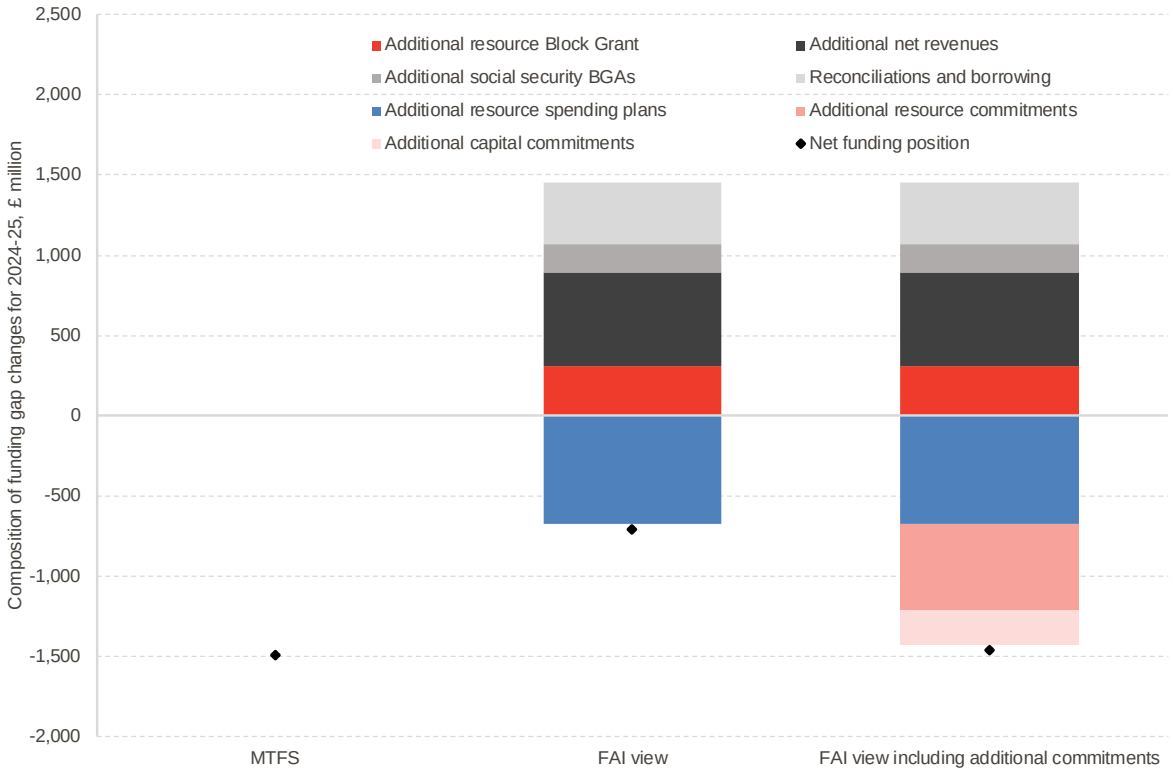
[3] The Scottish Government's and SFC's projections included £250 of planned borrowing for capital investment and £200m of funding from other sources pencilled in, but which could be borrowed if necessary.

[4] The Scottish Budget's net additional revenue from Income Tax is the difference between revenues collected and the Block Grant Adjustment, which is calculated on the basis of receipts for non-savings, non-dividends Income Tax in England and Northern Ireland. When the SFC and OBR forecast each of these for 2021-22, the net additional revenue was expected to be £475m. This was then revised to -£237m in May, which would have meant a -£715m reconciliation. But higher receipts in Scotland in that year in outturn have meant that the net additional revenue is now £85m, which means the reconciliation is instead £390m.

In total, we expect funding to be £1,445m higher in 2024-25 than was projected in the MTFS

But if funding is increased, so are spending commitments, and this offsets almost half of the improvement to the net funding position relative to the MTFS.

Chart 2.2: Decomposition of funding gap for 2024-25 at the MTFS, in our assessment and if spending commitments were fulfilled



Source: Scottish Government, SFC, FAI calculations

We assume that the increase in the BGAs for the Winter Heating Payment are spent in delivering the replacement benefit.

And with pay awards running higher in 2023-24 than originally projected back at the MTFS, we have taken the high-cost scenario for pay that the Scottish Government presented back in May. This means an additional cost of £498m relative to the MTFS projection.

Taken together, this adds £676m to spending – leaving the Scottish Government's net funding position £780m better off than at the MTFS, but still £711m short of the required balance

This would require cuts to both resource and capital spending. The resource funding position would be -£260m, with the capital funding position an unchanged -£450m from the MTFS.

And this is before any of the policy commitments from the Scottish Government are accounted for, and which could put the funding gap as high as £1,465m

The Scottish Government has committed to 'fully funding' the council tax freeze announced by the FM in October. We still have no clarity on this, and so we will need to wait for details

during the Budget. But if we assume that local authorities would have behaved the same way as last year, compensating them would cost around £329m.

On the same day, the FM also announced £100m to reduce NHS waiting lists – which adds to spending pressures by that very amount.

And the DFM's announcements of 'reprofiling' spending from this year into the future would add a further £325m, according to our (probably slightly too generous) estimate of how much of the £525m of savings announced translated into genuine spending reductions. Most of the changes were presented as shifting spending into the future – storing up problems for a time when shortfalls are already being projected.

Our overall assessment is that resource funding is £260m short of current spending plans, and £799m short of spending commitments; and that capital funding is £450m short of current plans, and £665m short of spending commitments

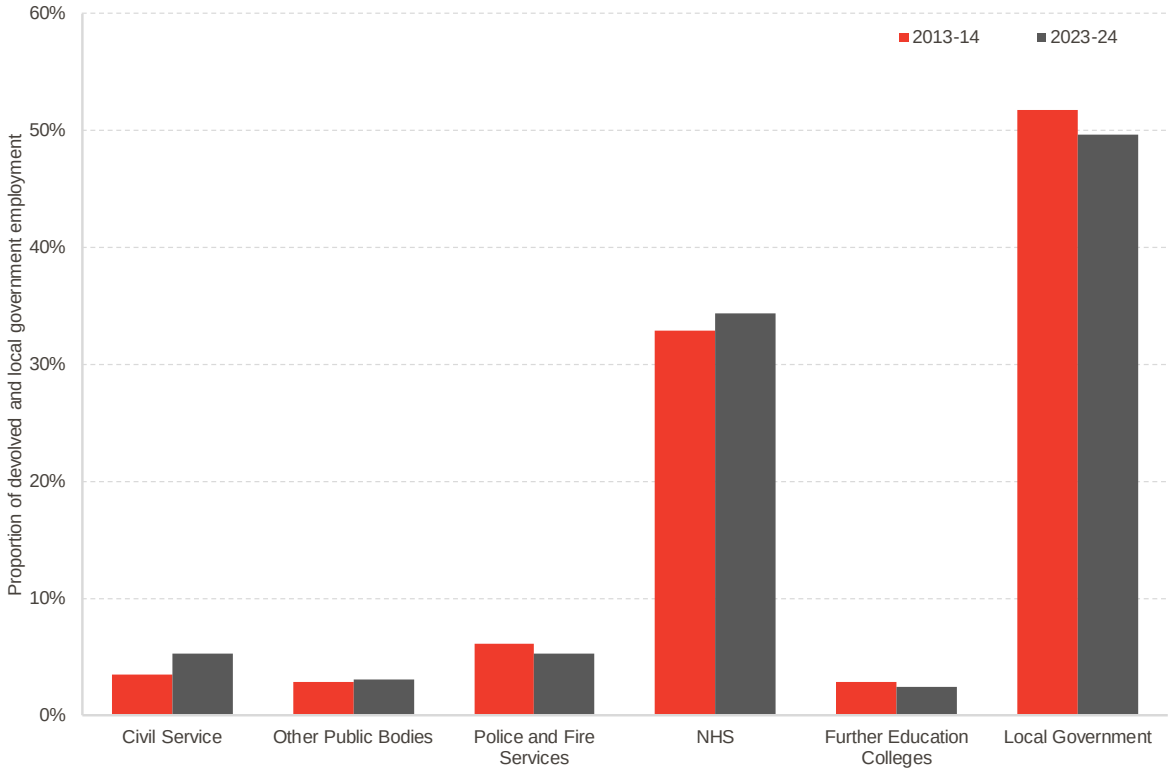
3. The spending outlook

3.1 The interaction between Scotland's public sector employment and budget pressures

In recent years, the rising demand placed on public services and the tight labour market has been a key consideration for both the UK Government and the devolved administrations. The Scottish Government's challenge is to plan its workforce in order to deliver its objectives while adhering to its funding circumstances, as highlighted by an Audit Scotland report in October.

Around 1 in 5 people in work in Scotland work in the devolved or local government sector, a proportion which has risen by less than 1 percentage point in the past ten years. But the overall numbers mask a change in composition, with particular growth in the civil service and the NHS.

Chart 3.1: Distribution of devolved and local government employment



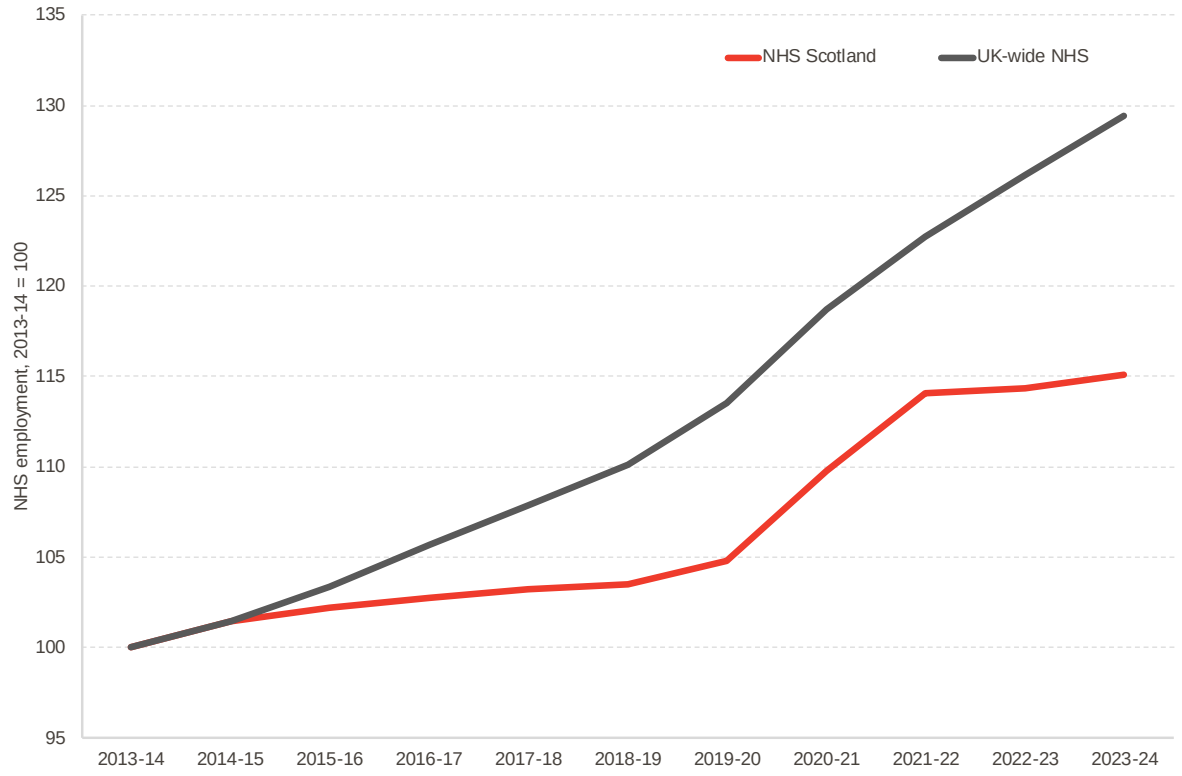
Source: Scottish Government, FAI calculations. 2023-24 are half-year numbers

The growth in civil service employment is unsurprising, and reflects growing devolved competencies. Since 2013-14, the Scottish Government has created both a revenue and a social security administration, which will be responsible for large shares of the increase – as will a number of other competencies devolved under the Scotland Acts 2012 and 2016.

The growth in NHS employment, however, reflects increased funding to reflect the growing need of the population. NHS Scotland employment has grown at 1.4% a year for the past ten years, making it one of the fastest growing sectors of the devolved and local government sectors.

But this apparently high growth turns out to be much lower than that for the combined four health systems of the UK. UK-wide NHS employment has grown at 2.6% a year for the last decade. The cumulative effect is that today's NHS Scotland workforce is 15.1% higher than it was ten years ago; a number which is 29.5% for the UK as a whole. Even the high growth in Scotland during the pandemic was only enough to match the UK trend.

Chart 3.2: Growth in NHS employment since 2013-14



Source: Scottish Government, ONS, FAI calculations. 2023-24 are half-year numbers.

Flatlining headcount is related to the Scottish Government's pay policy and its interaction with its mostly fixed budget. Scotland has prioritised higher pay awards, which have resulted in fewer days lost to strike action – in fact, this was one of the reasons for better economic performance than the UK as a whole during quarter 3 of 2023.

But higher pay within an unchanged envelope means employing fewer people than otherwise be the case. Given that the Barnett formula means higher spending per person than in England, we might have expected Scotland to be near or even above the UK-wide figures if it had the same pay policy.

This is a particular difficulty for the Scottish Government going forward for two reasons. The first is that higher pay awards add to ongoing costs, as they increase spending both in-year

and in future years. They will therefore require additional funding in future if they are to be maintained – or more restrained awards in future.

The second issue relates to the interaction with the long-term sustainability of Scotland's public finances. The SFC highlighted that higher health spending going forward is highly likely in its *Fiscal Sustainability Report*, both as a result of population ageing and other cost pressures. This no doubt adds to these cost pressures and makes it harder still to provide the required level of health care for a population whose needs are increasing.

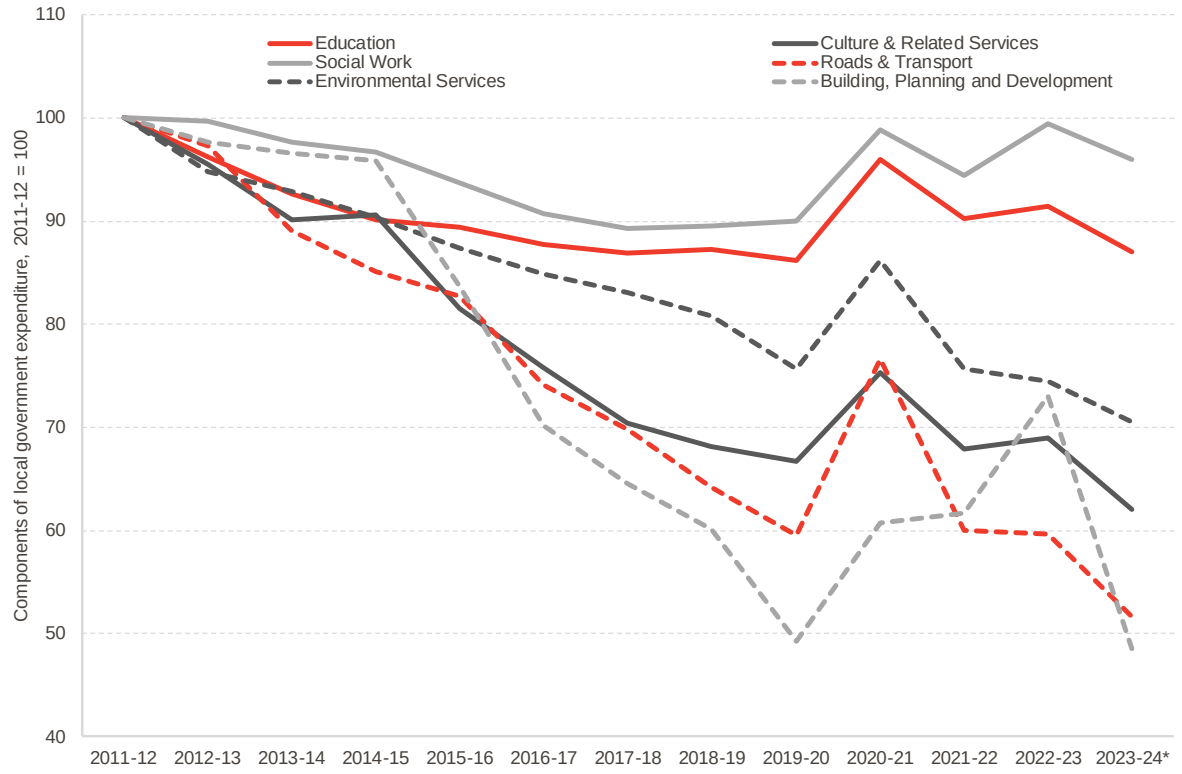
3.2 Local government funding and spending trends

The tight settlements which constrain the Scottish Government have a large direct effect on local government as well.

This is because local authorities heavily rely on transfers from the Scottish Government to deliver services. Of the £13.8bn in general funding to local government, £9bn (65.4%) comes straight from General Revenue Grant.

Local authorities have a number of statutory responsibilities, which include delivering education and social care – the two areas where real-terms spending has fallen the least when compared with the start of the 2010s.

Chart 3.2: Real terms changes in local government outturn expenditure by service area



Source: Scottish Government, FAI calculations. 2023-24 are budgets

By contrast, spending on other areas, particularly those unprotected or non-statutory, have fallen significantly over the past decade. With pressure on some services, particularly social care, forecast to rise as the population ages, and with Scottish Government settlements tight, this is a challenging backdrop. And the challenge would not be made any easier were local authorities to have to contend with not being able to increase council tax in the coming year if they were not to be fully compensated for it.

3.3 Capital borrowing and bond issuance

The Scottish Government's borrowing limits have finally been updated to account for inflation

As part of the Fiscal Framework Agreement, the Scottish Government is allowed to borrow for capital spending. Until this year, the limit for Scottish Government debt had been set in cash terms at £3bn, with no provision for uprating, and with a maximum drawdown of £450m in any year – again, set in cash terms.

Clearly this is problematic – by 2023-24, the cap was 20% lower in real terms than at the outset of the Fiscal Framework's implementation. So the provision to uprate it by the GDP deflator (as described in box 1) is welcome.

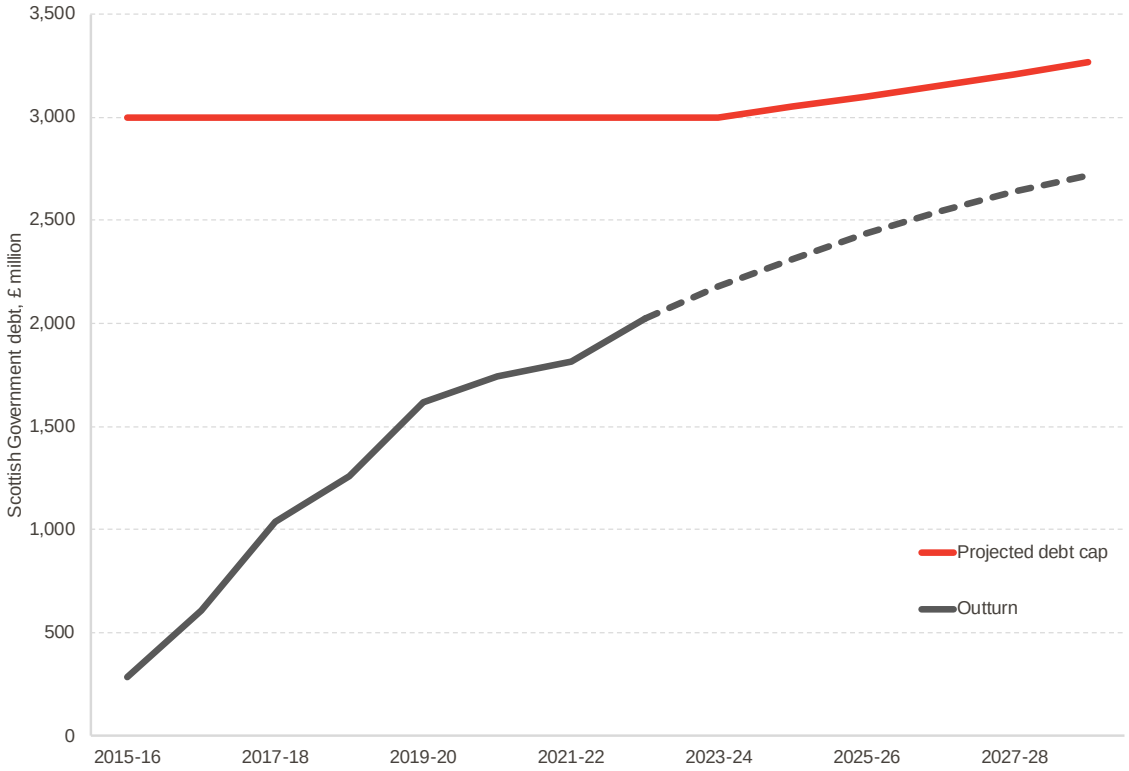
But the uprating from 2023-24 onwards permanently freezes the cap at £3bn and the drawdown limit at £450m in 2023-24 prices, and so bakes in the 20% in real terms that has occurred since 2016-17. Restoring it to the levels when the framework was first introduced would require the 2023-24 limit to be set at £3.77bn and indexed in line with inflation from then on.

The Scottish Government has made extensive use of these borrowing powers

Since the Fiscal Framework Agreement first came into place, the Scottish Government has used its facility with the National Loans Fund (NLF) quite a lot. This in some sense is unsurprising – it allows the Scottish Government to top up capital budgets while borrowing at a low rate, as the NLF rate closely tracks that of UK government gilts.

In all years but one, the Scottish Government has borrowed over £200m, with two instances above £400m. Under current plans as set out in the Medium-Term Financial Strategy (MTFS), £250m would be borrowed every year, reaching 83% of the cap (£2.7bn) by 2028-29.

Chart 3.3: Scottish Government debt, outturn and forecast



Source: SFC, OBR, FAI calculations. Note: Dashed lines are forecasts

How does the announcement of Scottish Government-issued bonds fit in with this?

Earlier in the year, First Minister Humza Yousaf announced plans to issue the first-ever government bonds for Scotland to finance infrastructure. In theory, the power to issue government bonds was devolved as part of the Scotland Act 2012, with the power given full effect in April 2015.

The first point to raise is that this does not change the limits to borrowing in the Fiscal Framework Agreement. Rather it is an alternative to borrowing from the NLF. The NLF uses borrowing from the UK Treasury to then lend to public bodies, and charges a minimal spread on top of the rates paid on gilts. This would be a plan to sell bonds directly to investors.

Doing so is not an easy or quick process. One of the key steps is likely to be establishing a credit rating from major rating agencies. This would provide potential investors with a professional evaluation of Scotland's creditworthiness. This process is likely to be fairly involved, consisting of a detailed assessment of Scotland's economic, fiscal and political environment.

Two questions that have since been asked are:

- What will this rating (and therefore the likely interest rate that would have to be paid) be compared to UK government bonds; and

- To what extent does this tell us about the likely cost of borrowing for an independent Scotland?

The answer to the first question is that there is likely to be a premium to be paid by Scotland compared to UK Government bonds (that is, it will be more expensive), as a new entrant to the bond market. However, given that ultimately the borrowing is underwritten by the UK Government, it may be that the premium is fairly small. But it will of course depend partly on the rating and then investors' reaction to that.

The answer to the second is much more unknown. Given that bonds issued under the current arrangements will be underwritten by the UK Government, it is likely that this tells us little about the interest rate that may need to be paid by an independent Scotland.

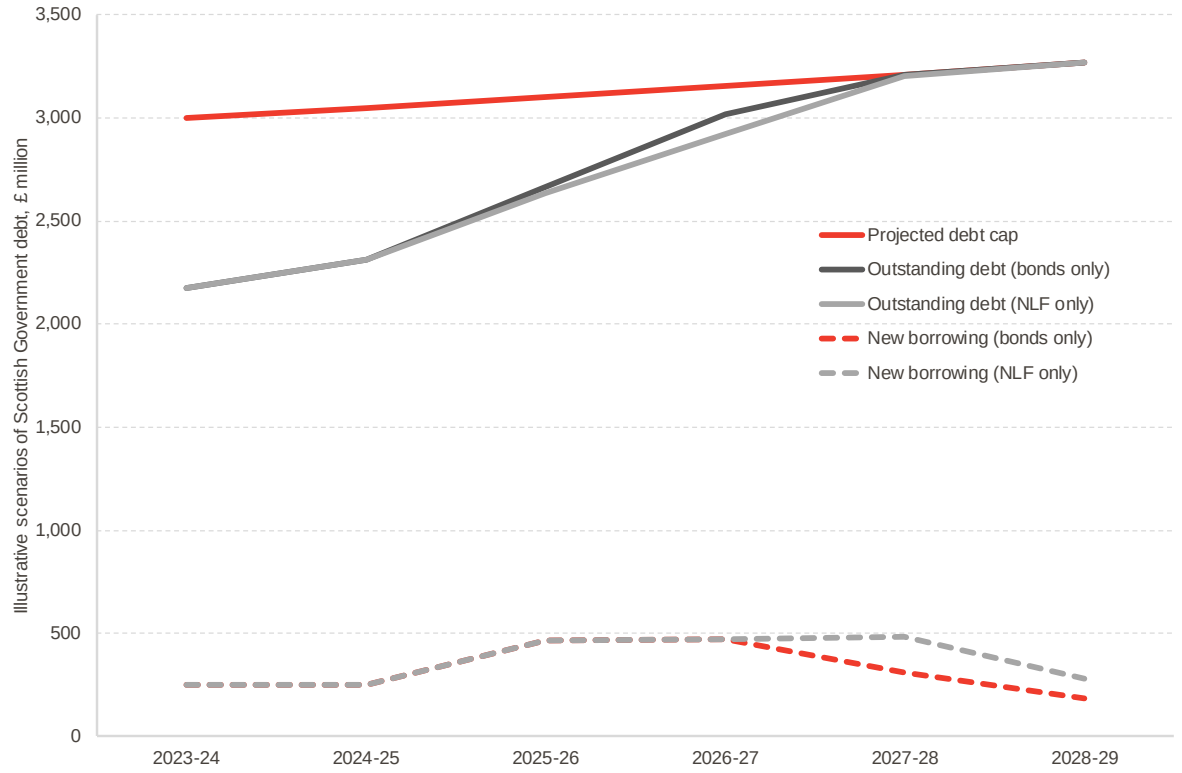
The FM set out why they may wish to do this in his speech – focussing on the enhanced profile it could give Scotland internationally, and the additional investment it could attract from international investors. It may be that the process of establishing and issuing the bonds is seen as strengthening the Scottish state in advance of a future independent Scotland. But in a constrained fiscal environment, it will be fair to ask whether borrowing in a more expensive way makes sense.

Some of the design of any borrowing would be more flexible when issuing a bond than when borrowing from the NLF. The NLF requires the Scottish Government to repay both interest and principal during the term of the loan, whereas many bonds are conventionally issued with coupon payments (bond jargon for interest payments) only, with the full repayment of principal due at maturity.

That could bring a one-off cashflow advantage, although it means that less debt is being repaid until bonds start to mature. In the long-run, there should be no difference between the two.

But because the Scottish Government has a hard cap on borrowing it must adhere to, borrowing on an interest-only basis would actually accelerate the accumulation of debt. Take the scenario in chart 3.4, which is done on a purely illustrative basis. It assumes that the Scottish Government issues bonds from 2025-26 onwards (in line with the FM's announcement) and that it takes up its full allowed drawdown. In this stylised scenario, issuing bonds with delayed repayment would lead the debt cap to be hit a year earlier and *less* money being available for investment throughout the forecast period – and that is saying nothing of the cost of servicing that debt.

Chart 3.4: Illustrative scenarios for borrowing using bonds and the NLF



Source: SFC, OBR, FAI calculations. Note: Dashed lines are forecasts

3.4 Social security

Social security has become a priority for the Scottish Government following the devolution of certain social security benefits and powers through the Scotland Act 2016.

This allowed the Scottish Government to introduce new benefits, change the process for devolved benefits, and 'top-up' UK benefits – powers which the Scottish Government have made substantial use of.

In this section, we discuss trends, risks, and forecasts in social security spending.

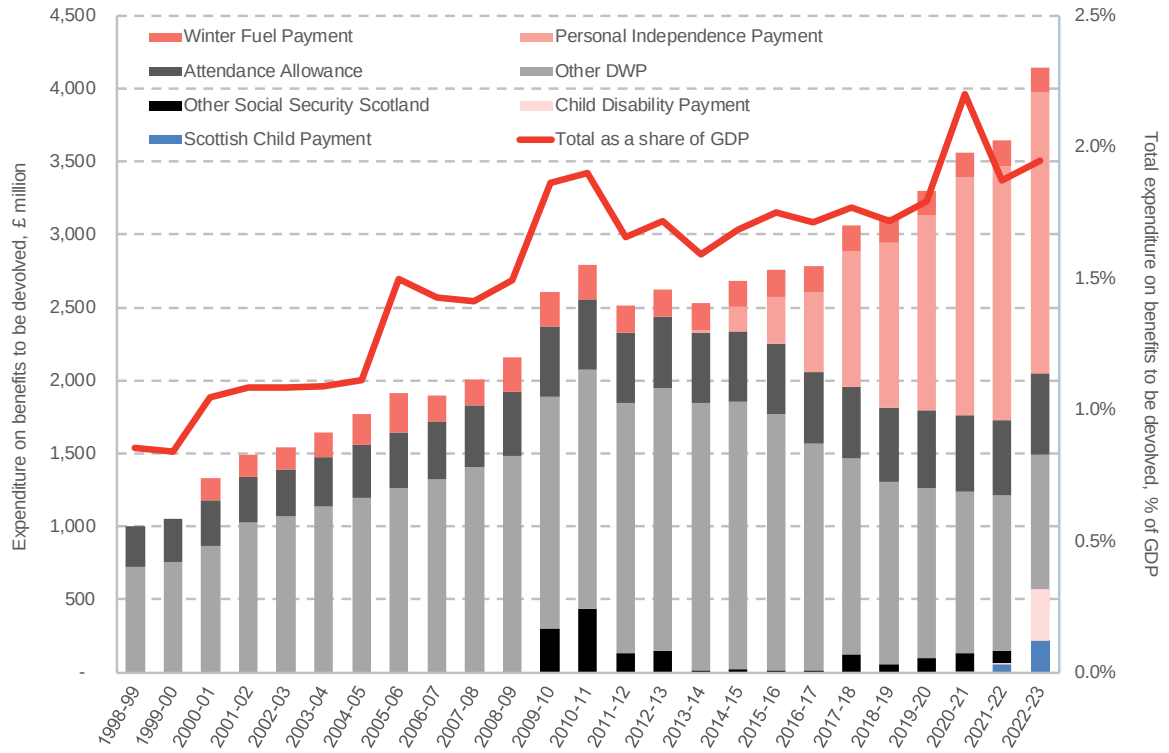
If you want to understand the basics of how social security works in Scotland, check out our overview here.

Scotland is spending a rapidly increasing amount on social security

Devolved social security makes up around 10% of the Scottish Budget in 2023-24, up from 7.5% in 2017-18.

In cash terms, the amount paid out in devolved social security benefits has increased by over £1 billion in the past five years, from £3 billion in 2017-18 to over £4.1 billion in 2022-23 – growing at an annual average of 6.9%.

Chart 3.5: Devolved Social Security Expenditure (as of Scotland Act 2016)



Source: Scottish Government

So, what's driving this increase in spending?

A big chunk of the increase in cash terms comes from uprating for inflation and population growth. For example, in the 2023-24 financial year benefits received a 10.1% increase (in line with the September 2022 CPI rate). This added £433m to spending in 2023-24. The Scottish Government will announce on 19 December what policy in this area will be for 2024-25, but in the absence of any statements indicating a new policy, it would be reasonable to assume the same uprating policy will be in place this year – which would also match what the UK Government announced in the Autumn Statement. This will mean uprating benefits by 6.7%.

The remaining part of the increases can be explained by the introduction and expansion of devolved social security programs administered by Social Security Scotland. Some benefits are still in the process of being transferred from the Department of Work and Pensions (DWP) to Social Security Scotland, such as Winter Fuel Payments which have just been fully operationally devolved from next year onwards.

Most (over 80%) of the increase in social security spending over the past year is focused on two benefits:

- Adult Disability Payment (ADP) and Personal Independence Payment, increasing by £642m; and
- Scottish Child Payment, increasing by £216m.

The Scottish Child Payment is a new social security program, launched in February 2021, and is expected to increase from £56m in 2021-22 to £442m in 2023-24 - £80m higher than initially forecasted in December 2021. This is because eligibility was extended to include all children under 16 in low-income families and the increase in the weekly payment rate from £20 to £25.

Some modelling suggests it could lift around 50,000 children out of poverty in 2023-24. It's the flagship policy for meeting statutory targets to reduce relative child poverty to 10% by 2030, so it is clear why the Scottish Government are spending a large chunk of the budget on it.

The ADP is Scotland's replacement for the main disability benefit for people of working age, namely the Personal Independence Payment (PIP). Launched in August 2022, the shift from the DWP to Social Security Scotland is ongoing and expected to take two years.

The SFC anticipates higher spending on ADP due to the "friendlier" application process, which is likely to lead to more claimants. It is forecasted that the caseload will increase from around 420,000 in 2023-24 to 660,000 in 2028-29.

However, these estimations are quite uncertain, as we are not yet sure how many people will successfully take up this benefit.

Another reason for the increased caseload is because there is growing demand for disability payments across the UK.

While the reasons for this aren't yet fully clear, the SFC and the Institute for Fiscal Studies point to increasing NHS waiting times, economic inactivity due to ill health, and people being more likely to seek support in response to the rising cost of living. All of this drives higher caseloads and puts additional pressure on spending.

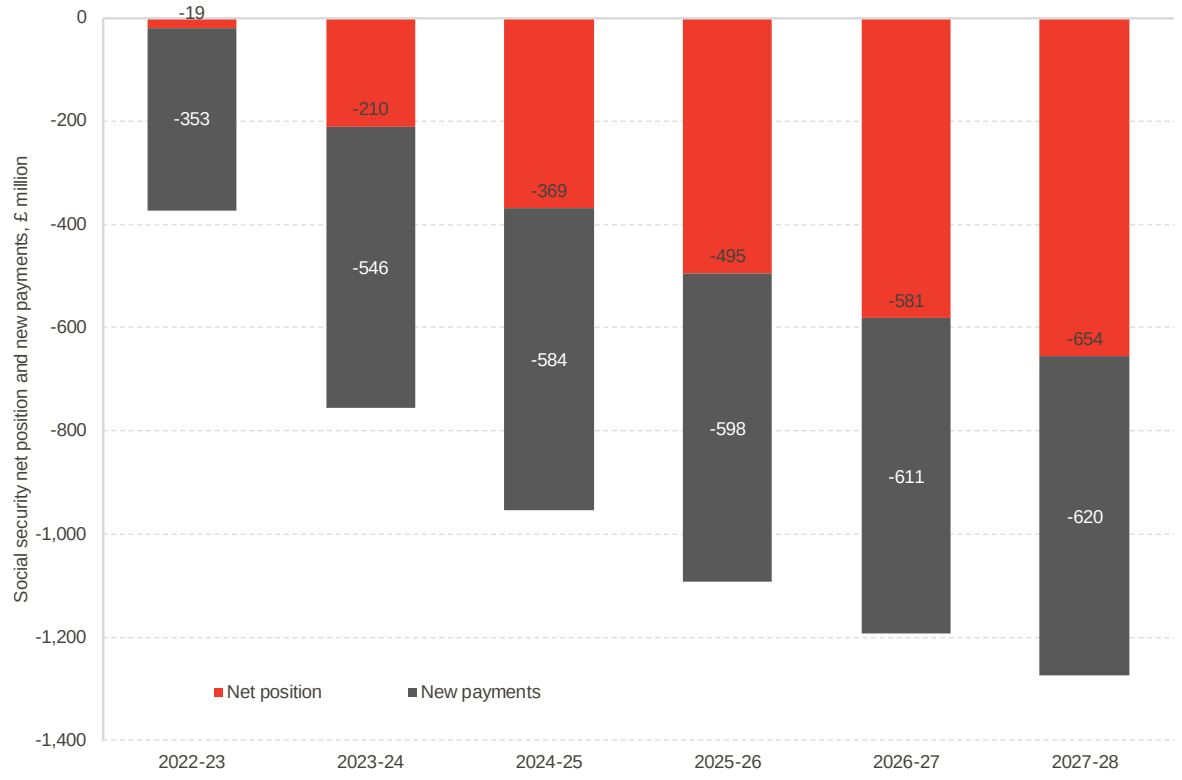
This trend is expected to add £60 m to spending in 2023-24, reaching £223 m in 2027-28. But, since this trend is happening nationwide, it could also mean increased funding provided by the UK Government.

The main risk that the Scottish Government faces is the difficulty in managing a demand led program through a mostly fixed budget

The UK government adjusts the Barnett formula allocation to fund social security provision in Scotland at UK rates, but the Scottish Government has widened the scope of existing payments and introduced additional payments, such as the Scottish Child Payment.

This means that gap between what is spent on devolved social security compared to the funding provided by the UK Government continues to grow: a negative net position.

Chart 3.6: Social security net position and new payments (as of May 2023)



Source: SFC

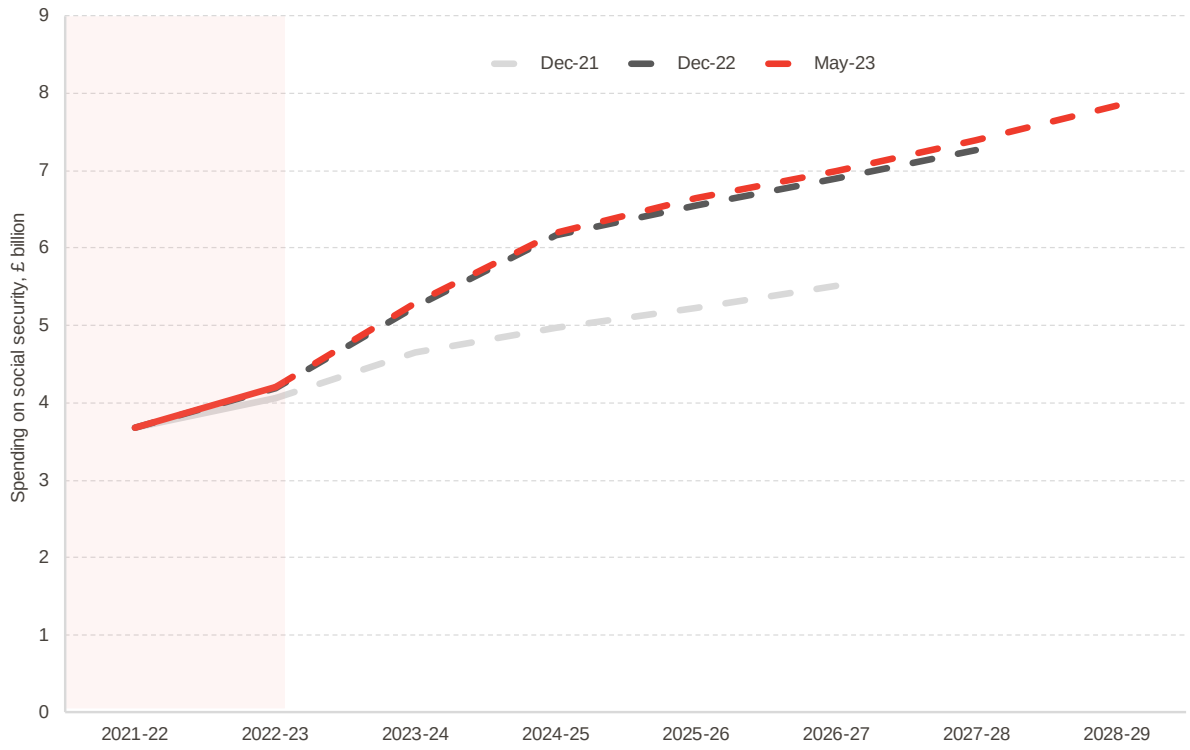
In other words, social security spending is due to increase significantly over time for two main reasons; firstly, the 'friendlier' system leading to higher take-up, and secondly, the introduction of new benefits (such as Scottish Child Payment) that the UKG Block Grant doesn't account for, so therefore have to be funded from elsewhere in the budget.

This means a growing wedge between the money transferred from UKG through the Block Grant for spend on devolved benefits in England and Wales, and the amount actually spent in Scotland – resulting in a negative social security net position.

The SFC forecasts that social security spending will reach £7.8bn in 2028-29 – making up 13% of the forecasted budget. In real terms, the SFC expects more than £6.5bn to be spent on social security in 2027-28 in real terms, compared to £4bn in 2023-24.

These increases are largely driven by a larger number of recipients and an increase in benefit rates caused by forecasted inflation, as well as a larger number of devolved benefits – as outlined above.

Chart 3.7: Successive social security spending forecasts



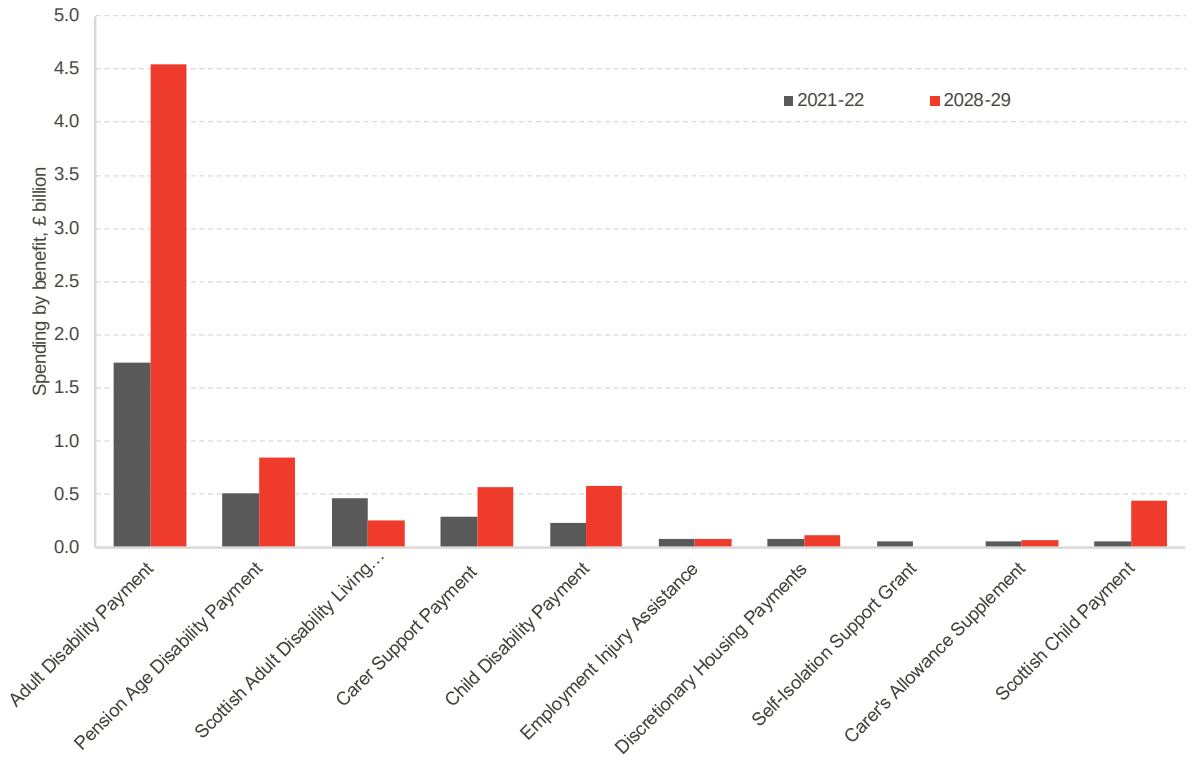
Source: SFC. 2021-22 reflects outturn data, 2022-23 to 2026-27 reflects forecast data

Chart 3.8 shows the breakdown of social security spending for 2021-2022 compared to 2027-28. Notably, Adult Disability Payment stands out as the program with the most significant spending increase. This partly reflects people being transferred across from the DWP to Social Security Scotland for this benefit over the next two years.

Yet, the SFC has pointed out the high level of uncertainty associated with this estimate. This uncertainty arises because Adult Disability Payment operates on a demand-driven basis, and we're not sure about the exactly how many people will qualify or take-up this benefit.

This uncertainty highlights a challenge for the Scottish Government: managing a program driven by demand within the constraints of a fixed budget for social security spending.

Chart 3.8: Social security spending by benefit, 2021-2022 vs 2028-29[5]



Source: SFC. 2028-29 figures are forecasts.

In 2022-23, the total amount needed to fund social security commitments above and beyond the amount of social security funding in the block grant was £374m; next year, it will be £776m, and in 2027-28 SFC estimates it will reach £1.4bn.

These amounts must be funded by the Scottish Government out of revenues beyond the block grant.

The Scottish Government has repeatedly asserted their commitment to a 'human rights based' approach to social security – and some evidence so far suggests that this approach is benefiting poorer households.

However, the less-than-upbeat forecasts pose some increasingly important questions about what measures will be required to fund the planned social security spending. In the context of tight budgets, the scope for any further change may certainly be limited

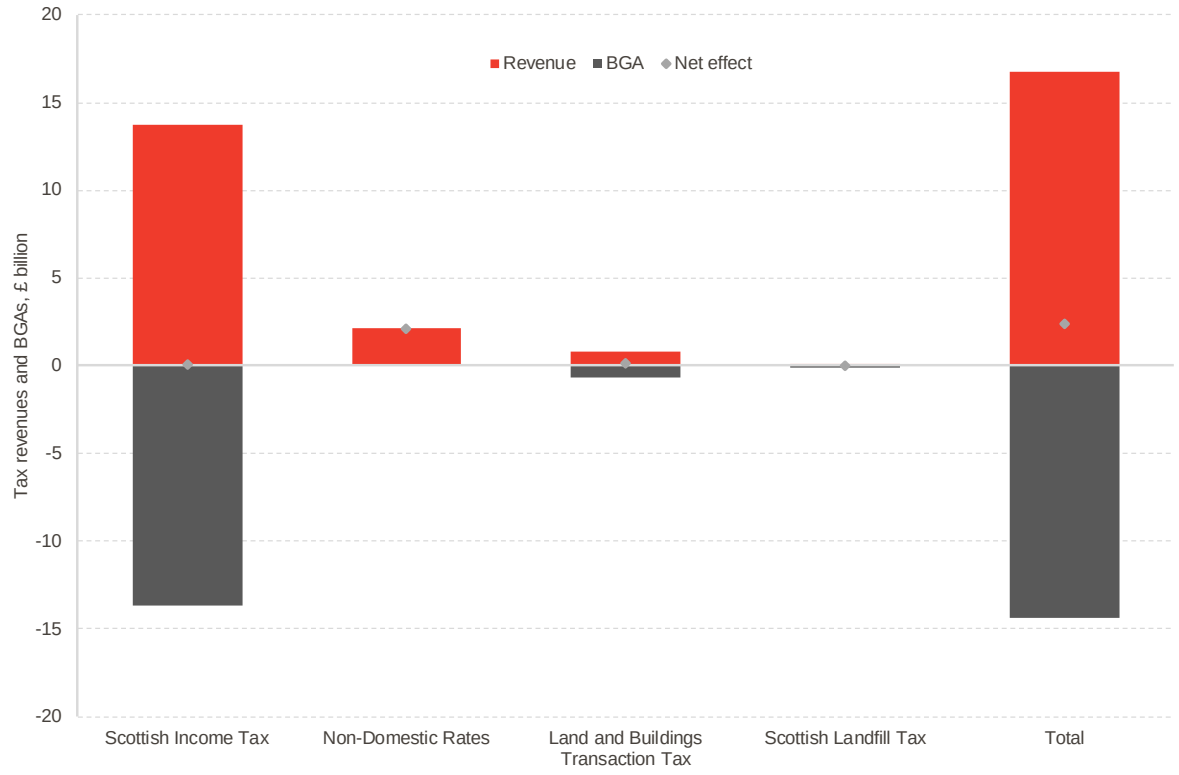
[5] Not shown in the chart (and under £40 m expenditure) - Scottish Welfare Fund, Employability Services, Best Start Foods, Best Start Grant, Funeral Support Payment, Severe Disablement Allowance and Child Winter Heating Assistance

4. The tax outlook

4.1 Trends in revenues

Scottish Government tax revenues were £16.8bn in 2021-22, the latest year for which there is full outturn data. Of the four tax streams in control of the Scottish Government, Scottish Income Tax on non-savings, non-dividend income is by far the largest, accounting for over 80% of revenues, with non-domestic rates (NDR, 13%) a distant second.

Chart 4.1: Scottish Government tax revenues, 2021-22



Source: Scottish Government, FAI calculations

However, Scottish Income Tax, Land and Buildings Transaction and Scottish Landfill Tax are all part of Fiscal Framework Funding, which means that they are subject to BGAs to compensate for the fact that the UK Government no longer collects these taxes.[6] This means that the net effect of these taxes on the Scottish Budget is much smaller than the revenues they raise.

This means the additional spending power of the Scottish Government from tax collection was only £2.4 billion in 2021-22 – although this was forecast by the SFC to increase to as

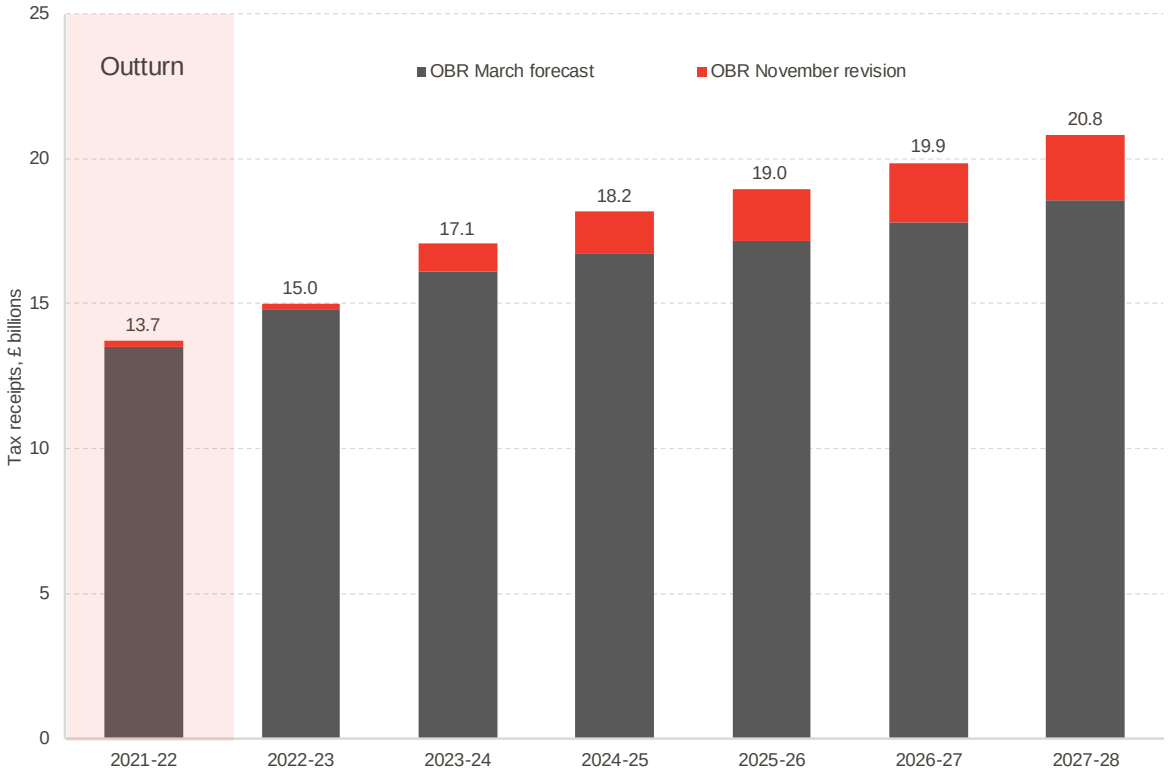
[6] See box 1 for a more detailed discussion of the Fiscal Framework.

much as £5 billion by 2026-27, largely as a result of increases in tax rates on income and the recovery in NDR revenues.

Looking to the future, it is possible to use forecasts from the SFC and the OBR to explore what Scotland's future tax position might look like.

In the OBR's November 2023 forecasts, they revised up their forecast of Scottish Income Tax receipts in each year between 2022-23 and 2027-28. They now estimate that Income Tax receipts in Scotland will grow by 6.9% on average between 2022-23 and 2028-29, with high growth rates of 9.3% and 13.8% in the first two years of the forecast and lower rates of growth in the forecasts latter years. Compared with the SFC's May 2023 forecast, the OBR's November forecast projects comparatively higher levels of Income Tax receipts in Scotland in each year between 2022-23 and 2027-28.

Chart 4.2: OBR Scottish Income Tax forecasts, 2021-22 to 2027-28



Source: OBR

4.2 An update on how much proposed Income Tax changes would raise

In September, we published a short briefing on how much revenue some proposals for a new Income Tax band would raise. We did so on the basis of our understanding of the Scottish Fiscal Commission's current methodology on how taxpayers may respond to changes in their tax rates – published in their May 2021 paper.

Of course, there is uncertainty regarding how much the actual behavioural response will be to any policy measures, and especially on Income Tax, as parameters such as taxable income elasticities, or TIEs – essentially the extent to which people affected by the change in their tax bill will respond – is extremely difficult to estimate.

But the SFC is using the best evidence available – and as it says in the aforementioned paper, there is strong evidence of behavioural responses, even if the exact figure of how much is uncertain.

And crucially, the SFC's approach provides the official forecast, which combines with other funding elements of the Scottish Government to set the spending envelope. So it is important to consider how much might be raised under this methodology.

Of course, it is worth making it clear that this is our own work and not an official forecast:

1. It is our interpretation and implementation of the SFC's approach. We have taken great care to replicate previous costings to the best of our ability, but the analysis remains our responsibility;
2. It is the SFC's historical approach, and they could change it if they wish and if there were compelling evidence for doing so; and
3. It uses modelling calibrated to the SFC's May forecast, and changes to economic forecasts by the SFC in the production of their upcoming forecasts would lead to small changes in estimates.

We have refined our methodology, especially around the Personal Allowance taper

Since then, we have made some further refinements to our modelling, the most significant of which was to our method for calculating the behavioural response to a taxpayer's change in tax rates they face. We still quantify two main effects:

- The 'intensive margin' effect, which quantifies how much declared income changes by at the marginal rate that people face, on the assumption that they continue to have the same income streams. This is called the marginal effective tax rate (METR) effect in the literature, and is generally the largest behavioural effect.
- And the 'extensive margin' effect, that is, to what extent people chose whether or not to participate altogether in an activity given their new average liabilities. For example, people may choose to not work anymore, or may no longer find it worthwhile to rent

out a property. This is called the average effective tax rate (AETR) effect in the literature, and tends to be significantly smaller than the METR effect.

As part of the METR effect, we have incorporated a further interaction for people whose Personal Allowance (PA) is tapered away. For those earning between £100,000 and £125,140 a year, £1 of their PA is withdrawn for every £2 of additional income, meaning they face an effective marginal Income Tax rate of 63%.

Our refined methodology means that between two-fifths and a half of the potential yield of the measures is likely lost through behaviour

Including this interaction the calculation of taxpayers' behavioural response increases the size of the METR effect. The difference between the two options is similar to before – as the SFC assumes larger behavioural responses higher up the income distribution, more of the overall yield is lost to behaviour when the threshold for the proposed band is higher.

As the table below shows, we estimate that a 44p rate on incomes between £75,000 and £125,000 would raise around £41m, and a 45p rate on incomes between £58,285 and £125,140 would raise around £136m.

Table 4.1: FAI estimates of revenues from Income Tax proposals for 2024-25 and size of behavioural effects

£ million	Static costing	METR effect	AETR effect	Post-behavioural costing	Yield lost to behaviour
Option A: 44p rate between £75,000 and £125,140	84	-36	-7	41	52%
Option B: 45p rate between £58,285 and £125,140	222	-72	-14	136	39%

Source: FAI calculations. May not sum to totals due to rounding to the nearest £1m.

Modelling the Income Tax changes proposed by the STUC this month

We have also used our Income Tax model to consider how the package of Income Tax measures proposed by the STUC earlier in the month might be costed using our understanding of the SFC's current methodology.

Our estimate for the additional revenue raised by the package under this methodology is £645m, over two-thirds of which comes from dropping the higher rate threshold to £40,000.

We get similar results published by the STUC analysis for the two rate increases. However, we get lower estimates of revenue for the changes in thresholds when applying assumptions similar to the ones we expect the SFC to use. This could mean that behavioural responses around threshold changes may not be fully accounted for.

Table 4.2: FAI estimates of revenues from the STUC-proposed Income Tax package for 2024-25 and size of behavioural effects

£ million	Static costing	METR effect	AETR effect	Post-behavioural costing	Yield lost to behaviour
Reduce higher rate threshold to £40,000	504	-40	-5	459	9%
Increase higher rate (£40,000 to £125,140) by 1p	157	-35	-7	115	27%
Increase top rate (above £125,140) by 1p	24	-21	0	2	90%
Introduce 45p band between £75,000 and £125,140	84	-38	-7	39	54%
Widen 45p to incomes from £58,000 to £125,140	65	-13	-23	30	54%
Total revenue raised by the package				**645**	

Source: FAI calculations. May not sum to totals due to rounding to the nearest £1m.

It is worth noting that some of these measures have interactions with one another, and therefore they may raise different amounts if done separately. For example, our estimate of revenue for the increase in the higher rate from 42p to 43p is £115m if the higher rate threshold were £40,000, but only £94m under the current threshold of £43,662.

4.3 How could the Scottish Government create a more progressive Income Tax system with better work incentives?

The Scotland Act 2016 enabled the Scottish Government to set its own tax policy on non-savings, non-dividend income – i.e., on earnings from employment.

Income Tax is considered partly devolved in Scotland. Although the Scottish Government has the power to set tax rates and thresholds that apply to earnings in Scotland, it does not have the power to change allowances - such as the personal allowance - or adjust tax policy surrounding earnings from interest and dividends.

Since 2017-18, Income Tax policy in Scotland has diverged from that of the rest of the UK (rUK). Today, there are two new bands that exist in Scotland (the 'starter' and 'intermediate tax' band), as well as changes to the basic and higher rate of tax.

Table 4.3: Scottish Income Tax rates and bands, 2023/24

Tax rate	Band	Rate
Personal Allowance	Up to £12,570	0%
Starter Rate	£12,571 - £14,732	19%
Scottish Basic Rate	£14,733 - £25,688	20%
Intermediate Rate	£25,689 - £43,662	21%
Higher Rate	£43,663 - £125,140	42%
Top Rate	Over £125,140	47%

Source: Scottish Government

Table 4.4: rUK tax rates and bands, 2023/24

Tax rate	Band	Rate
Personal Allowance	Up to £12,570	0%
Basic rate	£12,571 to £50,270	20%
Higher rate	£50,271 to £125,140	40%
Additional rate	Over £125,140	45%

Source: UK Government

The devolution of Income Tax policy has enabled the Scottish parliament to raise additional funds for the Scottish budget. The Scottish Fiscal Commission (SFC) estimated that Scotland's devolved Income Tax policies raised an additional £750 m in tax revenue between 2017-18 and 2021-22, when compared with Income Tax policy in the rUK. However, owing to Scotland's comparatively weaker economic performance and a different income distribution compared, the overall increase in the Scottish budget from Income Tax devolution was £85 m in 2021-22.

When comparing Scotland with the rUK, those earning up to £27,800 tend to pay a little less than they would in the rUK, and those with earnings above this level tend to pay significantly more.

In addition to Income Tax, earners below State Pension age must also pay National Insurance Contributions (NICs) on their income. National insurance is not devolved and therefore the same rates and thresholds apply in Scotland as they do in the rUK.

Following changes to NICs that the Chancellor announced in November, the following rates and thresholds of NICs apply in Scotland and rUK from January 2024 onwards for employees[7].

Table 4.5: Class 1 Employee NIC rates and thresholds from 6 January 2024

NIC thresholds	Bands	Rate
Lower Earnings Limit	Up to £12,570	0%
Primary Threshold	£12,571 - £50,270	10%
Upper Earnings Limit	Above £50,271	2%

Source: UK Government

What does this mean for marginal tax rates?

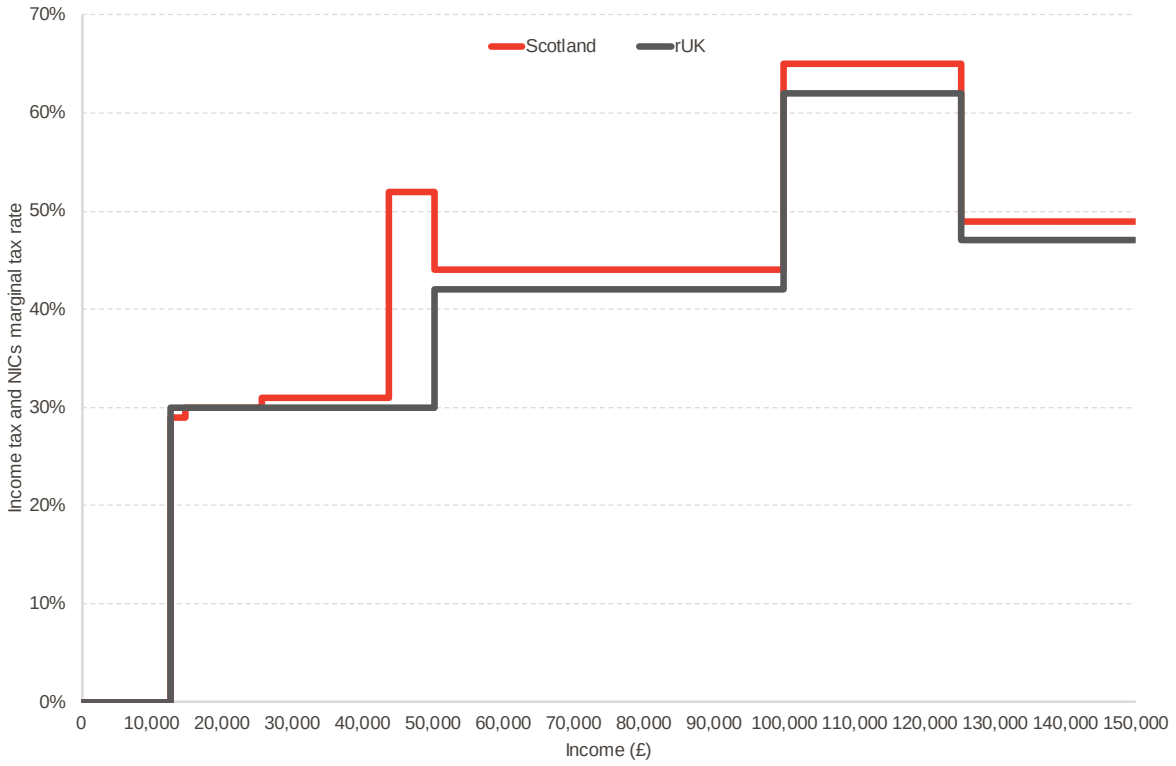
Marginal tax rates are a term used to describe the rate of tax an earner pays on each additional unit of income they earn. They are calculated as the total rate of Income Tax plus NICs for each unit of income earned, considered alongside personal allowances and any taper rates that may apply.

Generally, marginal tax rates are designed in a progressive way, where the marginal tax rate increases in steps as a worker earns more. In the rUK, this tends to be the case, except for earnings between £100,001 and £125,000, where the marginal tax rate increases to 62%, before falling to 42% for all earnings beyond £125,000. This increase in the marginal tax rate for earnings between £100,001 and £125,000 is due to the taper rate, where for each £2 earned above £100,000, there is a £1 reduction in the £12,500 tax free personal allowance.

Like employees in rUK, earners in Scotland experience a sharp increase in their marginal tax rate for earnings between £100,001 and £125,000, rising to 65%. However, earners in Scotland also face a significant increase in their marginal tax rate to 52% for earnings between £43,663 - £50,270, which earners in the rUK do not.

[7] Different rates apply to self-employed persons – in this blog we have focused on employees as they make up the largest proportion of the workforce.

Chart 4.3: Marginal tax rate for employees from 6 January 2024



Source: FAI Calculations

What is driving this increase in the marginal tax rate in Scotland?

This sharp increase in the marginal tax rate is driven by deviations in Scottish Income Tax policy from the rUK. In the rUK, rates of NICs fall from 10% to 2% at the same level of earnings (£50,270) that Income Tax increases from 20% to 40%. However, because earners in Scotland move up to the higher rate band at a lower threshold of £43,662, they start paying a higher rate of tax of 42% without any immediate reduction in their NICs rate.

Some argue that this sharp rise in the marginal tax rate may disincentives earnings at the margin. By this, we mean that if a worker is earning £43,662 each year, they may be disincentivised to earn more because they would have to pay 52p for each additional pound they earn (up to £50,270).

Although this distortion in the Scottish marginal tax rate may impact workers incentive, it does bring in an additional £600 m of tax revenue each year[8].

In the following section, we explore two potential reforms to Scottish Income Tax policy that could smooth out this distortion in marginal tax rates, whilst importantly, ensuring there is no

[8] In 2024-25, changing the upper threshold of Scottish intermediate rate from £43,662 to £50,270 would reduce Income Tax revenue collected in Scotland by £602 m.

significant reduction in the revenues from Income Tax that the Scottish Government currently collects.

There are two reforms to Scottish Income Tax policy that this analysis focuses on

To be clear, we do not advocate for any particular reform. Instead, we model the impact on Scottish Income Tax revenue from two reforms that are available to the Scottish Government.

This modelling uses a 5-year forecasting window, where if a change to Income Tax resulted in less than a £15m change to tax receipts on average each year, then it is considered broadly revenue-neutral. In addition, this report also assumes Income Tax thresholds in Scotland and the personal allowance are mostly frozen between 2024-25 and 2028-29, using the SFC's assumptions on indexation as set out in their May 2023 forecast.

All reforms are assumed to be implemented from 2024-25 onwards unless otherwise specified.

Reforms have been costed using our model which is based on the SFC's published methodology, and which we first used when looking at the revenue-raising potential of proposed measures for an additional rate between the higher and top rates.

Potential reform 1

The first reform could be to make the following changes to Scottish Income Tax rates and thresholds:

- Increase the intermediate rate upper threshold to £50,270;
- Increase the basic rate by 1%;
- Increase the intermediate rate by 2%; and
- Increase the higher rate by 1%.

This would result in the following thresholds and rates of Income Tax across Scotland.

Table 4.6: Tax rates and thresholds for reform 1

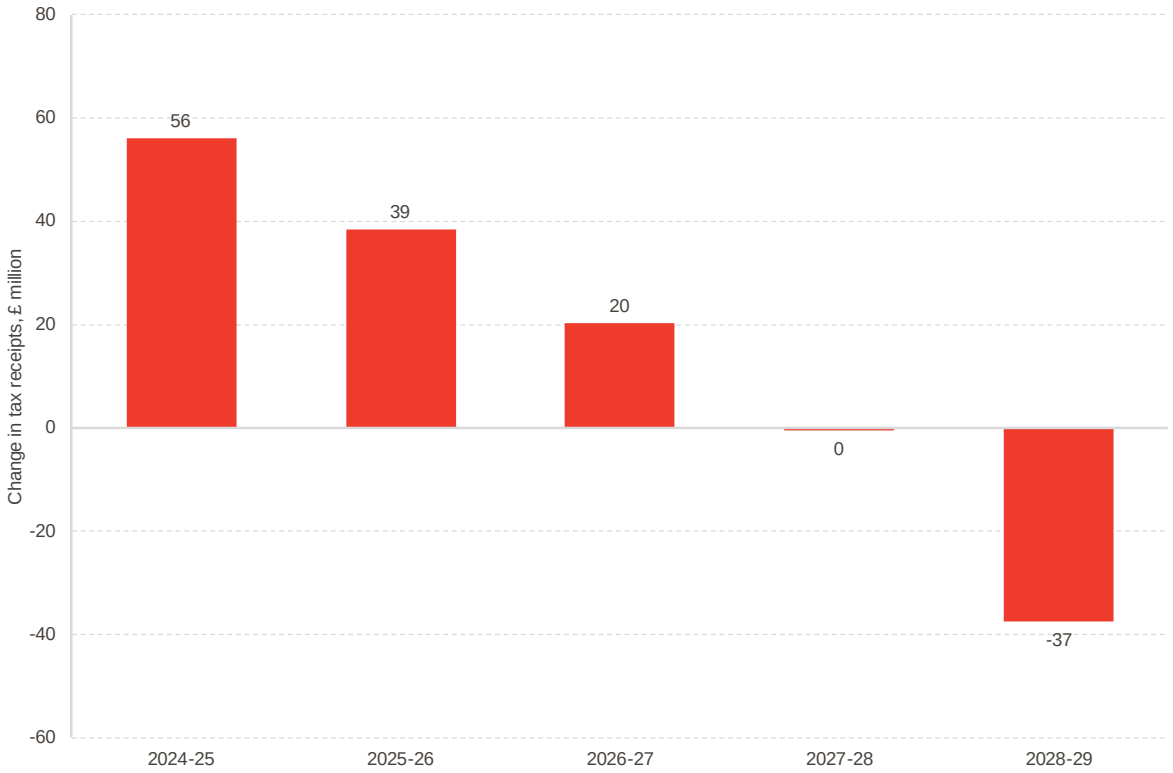
Tax tresholds	2024-25	2025-26	2026-27	2027-28	2028-29
Up to £12,570	0%	0%	0%	0%	0%
£12,571 - £14,732	19%	19%	19%	19%	19%
£14,733 - £25,688	21%	21%	21%	21%	21%
£25,689 - £50,270	23%	23%	23%	23%	23%
£50,270 - £125,140	43%	43%	43%	43%	43%
Over £125,140	47%	47%	47%	47%	47%

Source: FAI Calculations

This reform would smooth out the distortion in marginal tax rates for earnings between £43,663 - £50,270 and bring in, on average, an additional £15 m of tax revenue for the Scottish government each year and £77 m over the 5-year forecasting window.

In 2024/25 and 2025/26, this reform would raise an additional £56 m and £38 m, respectively. However, the value of tax receipts collected from this policy would gradually decrease, going negatively from 2027/28 onwards.

Chart 4.4: Change to Scottish Income Tax receipts from reform 1, £m ms



Source: FAI Calculations

Potential reform 2

The second reform includes raising the intermediate rate threshold from 2024-25 onwards, and incrementally increasing the basic rate, intermediate rate and higher rate. Specifically, this reform refers to -

- Increasing the intermediate rate upper threshold to £50,270;
- Increasing the basic rate to 21% between 2024-25 and 2026-27 and to 22% from 2027-28 onwards;
- Increasing the intermediate rate to 22% between 2024-25 and 2026-27 and to 23% from 2027-28; and,
- Increasing the higher rate to 43% between 2024/25 and 2027-28 and to 44% in 2028-29.

This would result in the following thresholds and rates of Income Tax across Scotland:

Table 4.7: Tax rates and thresholds for reform 2

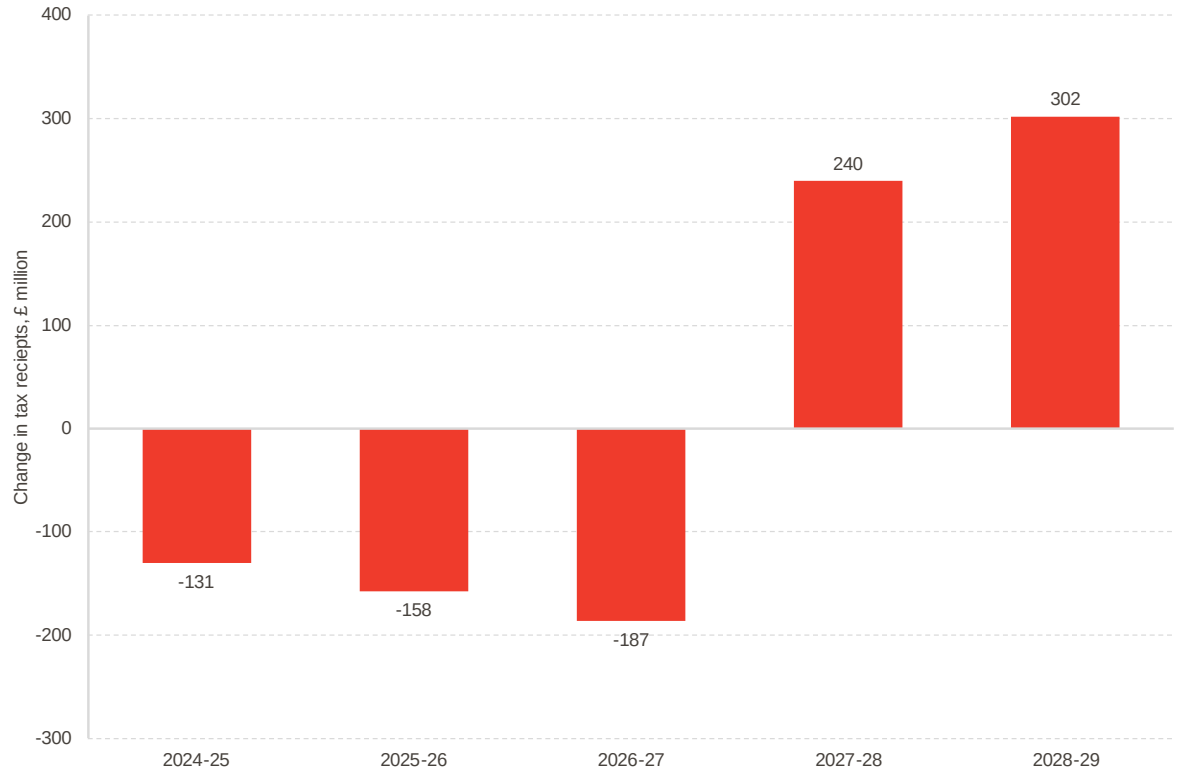
Tax tresholds	2024-25	2025-26	2026-27	2027-28	2028-29
Up to £12,570	0%	0%	0%	0%	0%
£12,571 - £14,732	19%	19%	19%	19%	19%
£14,733 - £25,688	21%	21%	21%	22%	22%
£25,689 - £50,270	22%	22%	22%	23%	23%
£50,270 - £125,140	43%	43%	43%	43%	44%
Over £125,140	47%	47%	47%	47%	47%

Source: FAI Calculations

Like the first reform we modelled, this reform would also smooth out the marginal tax rate for earnings between £43,663 - £50,270 and increase the Income Tax revenue collected in Scotland. Notably, this reform would increase the average revenue from Income Tax collected each year by £13 m and increase the total revenue of Income Tax collected by £67 m over the 5-year forecasting window.

However, it is important to note that this reform would cost an average of £159 m between 2024-25 and 2026-27, before raising an additional £240 m and £302 m in 2027-28 and 2028-29, respectively.

Chart 4.5: Change to Scottish Income Tax receipts from reform 2, £m ms



Source: FAI Calculations

What next for Income Tax in Scotland?

On the 19 December, the Scottish Government will announce its proposed spending and tax plans for the year ahead. Although this is expected to be a particularly challenging budget for the new Finance Secretary and Deputy First Minister Shona Robinson, it could present an opportunity for the Scottish Government to think about its Income Tax policy more broadly.

In this chapter, we have explored the distortion in Scotland's marginal tax rate, and touched upon how it could be reducing labour market incentives for employees around the £43,662 - £50,270 income range. Through this analysis, we hope to highlight the potential reforms within the Scottish Government's gift to smooth out Scotland's marginal tax rate, whilst importantly, ensuring they are revenue-neutral, and therefore do not significantly affect the Scottish Government's spending power over the medium-term.

4.4 The council tax freeze – how much will it cost and who will benefit?

Council tax rates are usually set each year by each local authority as laid out in the Local Government Finance Act 1992 through the setting of an anchor band D rate. The Scottish Government (SG) has control over what are called the 'multipliers' – essentially what the ratio between each of the bands and the band D rate.

Table 4.8: Council tax multipliers currently in place

	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H
Multiplier	0.67	0.78	0.89	1.00	1.31	1.63	1.96	2.45

Source: Scottish Government, FAI calculations

Given that the multipliers set the level of each band relative to band D, the decision on the percentage increase in each year for band D indirectly imposes the same percentage increase on all other bands.

Council tax rate policy might be local government's responsibility, but the SG has in the past negotiated coordinated policy with COSLA (the Convention of Scottish Local Authorities), which represents all 32 local authorities in Scotland. This included a freeze in rates between 2008-09 and 2016-17 and in 2021-22, as well as an agreement to cap increases at 3% in 2017-18 and 2018-19. In all these cases, this included compensation from the SG to local authorities for revenue forgone.

Abidance with the SG's desired path for council tax rates is formally voluntary for local authorities, although divergence is unlikely to be without consequences. Grants from SG form the bulk of local government funding (65% in 2021-22), and local authorities are therefore not in a strong negotiating position to go against the government or to reject certain additional funding in exchange for uncertain tax collection down the line.

The SG consulted over the Summer on increasing the multipliers for properties in bands E to H, by 7.5%, 12.5%, 17.5% and 22.5%. These are the highest-banded properties, although that does not mean they are necessarily the current highest-value properties, as council tax in Scotland is still based on 1991 property valuations.[9] The table below shows what the proposed multipliers have been had the proposal been introduced.

Table 4.9: Council tax multipliers proposed in the Summer consultation

	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H
Multiplier	0.67	0.78	0.89	1.00	1.41	1.83	2.30	3.00

Source: Scottish Government, FAI calculations

[9] The same is true in England. Wales did a revaluation in 2003 and is in the process of consulting on a second revaluation which would take place in 2025. Council tax was never introduced in Northern Ireland, which still operated domestic rates – a proportion of calculated values based on 2005 property values.

Methodology and establishing the counterfactual

To estimate how much the policy will cost, we need to establish what the tax base will be next year, as well as how much revenue will be generated based on the new proposals (the freeze and no change in multipliers) compared to a counterfactual - what would have happened had the FM not announced the freeze.

One possible counterfactual would be that the anchor band D rate in 2024-25 would be the same as in 2023-24 in the first place, in which case the only cost would be the cancellation of the multiplier increase. While that is theoretically possible, it seems highly unlikely it would have been the case. Councils' budgets have been stretched for a number of years, and with inflation running high, keeping rates at the same cash level would reduce their funding in real terms. Additionally, whenever not compensated by the SG to do so, local authorities have chosen to increase council tax rates. So on the basis of financial constraints and revealed past behaviour, this can be discounted as a realistic counterfactual.

Last year, councils put their band D rate up by between 3.9% and 10%, with an average of 5.4%.[10] We use this as our benchmark counterfactual for 2024-25, while also showing what the cost of the policy would be when assessed against a 3% and an 8% increase, respectively, which are roughly equidistant from the actual increase in 2023-24.

Estimating the tax base and revenue from the counterfactual scenarios

We obtain the number of chargeable dwellings by band for each of the 32 local authorities in September 2023 (the latest available data) from the SG's council tax datasets. Clearly the number of dwellings is not static over time, and so we compare the growth in the number of dwellings in each band in each local authority between September 2023 and September 2022, applying those growth rates to forecast the number of dwellings liable for council tax in 2024-25. This means an overall growth of 0.8% in the number of properties, with growth skewed towards higher bands.

Table 4.10: Forecast for the number of dwellings in Scotland in each band

Dwellings (thousands)	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H	Total
2023-24	497	579	420	360	358	215	138	14	2,582
2024-25 (projected)	496	581	424	365	362	218	140	14	2,601
Growth	-0.2%	0.3%	0.9%	1.4%	1.1%	1.7%	1.7%	1.2%	0.8%

Source: Scottish Government, FAI calculations

Multiplying this by the council tax rates in each local authority gives us the maximum total liability for council tax for each authority, and for Scotland when aggregated. However, not all properties will pay council tax. Between council tax reduction for those on low incomes and with other qualifying criteria, single person discounts, exempt dwellings and other discounts, SG statistics show only 75% of the maximum yield from council tax was billed by local

[10] This is calculated as the average of the percentage increases across all councils. The increase in average council tax of a band D property is 5.2% if calculated based on total band D equivalents, as reported in the council tax datasets, which accounts for composition, but they are different measure of the same change.

authorities in 2021-22.[11] Although it is band A properties that have the lowest billable proportion, reductions happen across the bands – reflecting the fact that valuations are on an obsolete basis.

Table 4.11: Proportion of council tax billed in each band in 2021-22

	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H	Total
Potential council tax (£m)	474	609	498	474	617	447	343	46	3,507
Billed council tax (£m)	231	387	352	377	528	401	316	41	2,632
Billed proportion (%)	49%	63%	71%	80%	86%	90%	92%	90%	75%

Source: Scottish Government, FAI calculations

As 2021-22 is the latest data available for these proportions, we apply them to the potential revenue from each local authority in each band, giving us a forecast for the tax base in 2024-25 in each of the counterfactual scenarios. Table 4.12 also presents the forecast for revenues both including and excluding the proposed multiplier increase.

Table 4.12: Council tax revenues under different counterfactual scenarios

Net revenues (£m)	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H	Total
2023-24	228	405	375	406	570	443	355	45	2,826
2024-25 (excluding multiplier increases) assuming:									
3% increase	234	418	390	424	594	464	372	47	2,943
5.4% increase	239	427	398	433	606	474	379	48	3,004
8% increase	245	439	409	445	622	487	390	49	3,085
2024-25 (including multiplier increases) assuming:									
3% increase	234	418	390	424	638	522	437	57	3,121
5.4% increase	239	427	398	433	651	533	446	58	3,186
8% increase	245	439	409	445	669	547	458	60	3,272

Source: FAI calculations

Costing the freeze in council tax rates

The process of estimating the revenue raised with frozen rates for 2024-25 is fairly similar – we take the projected number of chargeable dwelling for 2024-25, multiply them by the rates for each band (which would be the same as in 2023-24) and then apply the billed proportions from table 4.11. The cost of the measure is then the revenue under this scenario against each of the counterfactual assumptions we have made.

[11] We have not made an adjustment for collection rates, as liability still exists, although it would be possible to make assumptions about that going forward. To do so, the starting point would be that the average rate from latest statistics on collection (97.2%) is maintained going forward, making only a small difference to the overall results.

Table 4.13: Cost of the council tax freeze under different counterfactual scenarios

Net revenues (£m)	Band A	Band B	Band C	Band D	Band E	Band F	Band G	Band H	Total
2024-25 with freeze	227	406	379	412	576	451	361	45	2,857
Difference in revenue from freeze against baseline (excluding multiplier increases) assuming:									
3% increase	-7	-12	-11	-12	-17	-14	-11	-1	-86
5.4% increase	-12	-21	-20	-21	-30	-23	-19	-2	-148
8% increase	-18	-32	-30	-33	-46	-36	-29	-4	-229
Difference in revenue from freezing against baseline (including multiplier increases) assuming:									
3% increase	-7	-12	-11	-12	-62	-72	-76	-12	-264
5.4% increase	-12	-21	-20	-21	-75	-82	-85	-13	-329
8% increase	-18	-32	-30	-33	-93	-97	-97	-15	-415
Memo: difference in revenue from cancelling multiplier increases against baseline assuming:									
3% increase	*0*	*0*	*0*	*0*	*-45*	*-58*	*-65*	*-10*	*-178*
5.4% increase	*0*	*0*	*0*	*0*	*-45*	*-59*	*-66*	*-11*	*-182*
8% increase	*0*	*0*	*0*	*0*	*-47*	*-61*	*-68*	*-11*	*-187*

Source: FAI calculations

As shown above, the cost of the policy is heavily dependent on the assumptions made regarding what action councils would have taken in the absence of the FM's policy announcement. This matters all the more because of the SG's promise to "fully fund" the freeze. We still have no clarity on what that will mean – but clearly planning on these three different bases (as a matter of example) would be very different.

If councils were planning increases that mirrored last year's, fully funding the freeze and cancellation of the multipliers would cost £329m - £148m for the former and £182m for the latter. A 3% increase would cost £264m, whereas an 8% increase – higher than last year but not much above inflation, and therefore not bringing significant spending power increases – would cost £415m.

We await more detail from the negotiations to see where the compensatory figures will settle, but we have also assessed how the freeze will affect people at different places in the income distribution.

Who will benefit the most from the proposed policy?

On top of estimating the cost of the policy, it is important for the debate to understand what the distributional impact is likely to be and who benefits the most. Understanding the impact on households requires a different set of data and a process of analysis called microsimulation.

The main data source is the Family Resources Survey (FRS) which is a comprehensive dataset produced by the Department for Work and Pensions (with additional funding from the Scottish Government) that collates info on household incomes. It is the main dataset by governments across the UK to analyse the impact of tax and benefit decisions on households.

Most of this data collected for the FRS is available publicly through the UK Data Service. This means that people outside of government (including us) can use the data to do our own analysis of the impact of tax and benefit decisions on households.

There is one omission in the publicly available dataset which is worthy of note for council tax analysis. The FRS data can be split into different countries and regions of the UK, but in the

public data it is not disaggregated to local authority. This is for disclosure reasons: in small local authorities, it might be possible to work out who someone is by the information included in the survey.

This is problematic for council tax analysis because different rates apply in different local authorities. The FRS does tell us which council tax band people are in, but the best we can do is use the Scottish average band D rate and multipliers to calculate the amount of council tax people pay.

This usually isn't a big problem. For some households we'll be estimating that a council tax bill that is too high, and for others it will be too low, but these will offset each other to some degree, leaving the overall totals the model produces in the right ballpark.

Microsimulation model

The FRS gives us information on total household income, and using the average band D rate and multipliers we can estimate of how much people pay in council tax. It also provides us with information on the characteristics of households in the survey sample meaning that we can estimate which households would be eligible for discounts, exemptions and reductions (i.e. Council Tax Reduction). All this is done by a microsimulation model that simulates the impact of a range of policies and economic factors (for example inflation) for each household in the FRS sample (which is a micro-level dataset, hence the term microsimulation).

At the Fraser of Allander Institute, we purchase the services of the IPPR Tax Benefit Model, but other organisations (and governments) use different models. However, they all operate along the same principles, but may incorporate different assumptions.

The key word here is **eligible –** just because someone can claim single person discount or Council Tax Reduction, it does not mean they will. This may be because they do not know they are eligible, or that they do not think it is worth the effort, for example. In some cases, we can use administrative data to provide a guide to take-up, but in the case of Council Tax Reduction, no take-up statistics are available. Nor is there any independent body who has been tasked to come up with a best estimate that others could use- the Scottish Fiscal Commission do not forecast local taxes so do not have to look at council tax and CTR like they do with other devolved taxes and benefits.

The difference in the take-up assumption is one of the key reasons why modelled estimates of impact may look different, depending on who is producing the estimates. Other reasons that results may look different include definitions of income (for example whether they include an offset for housing costs) and the assumptions made around uprating of variables in future years (we are producing results for the financial year 2024/25 which obviously hasn't happened yet, so incomes could look very different). In addition, from time to time, errors are found in models or updates are made to improve the way the models work and as noted in the data section, governments may have access to more reliable source data.

Given all these uncertainties, is it worth doing any kind of estimation? Well, in our opinion, yes. Because regardless of these uncertainties, there are underlying trends which hold which are valuable to illustrate. Some work has been done by ourselves to check how the modelled outputs we produce differ from others, such as the Scottish Government (see here for example). Whilst there will always be differences, these usually aren't big enough to warrant any panic - i.e. the overall trends are the same even if the actual numbers are a little different.

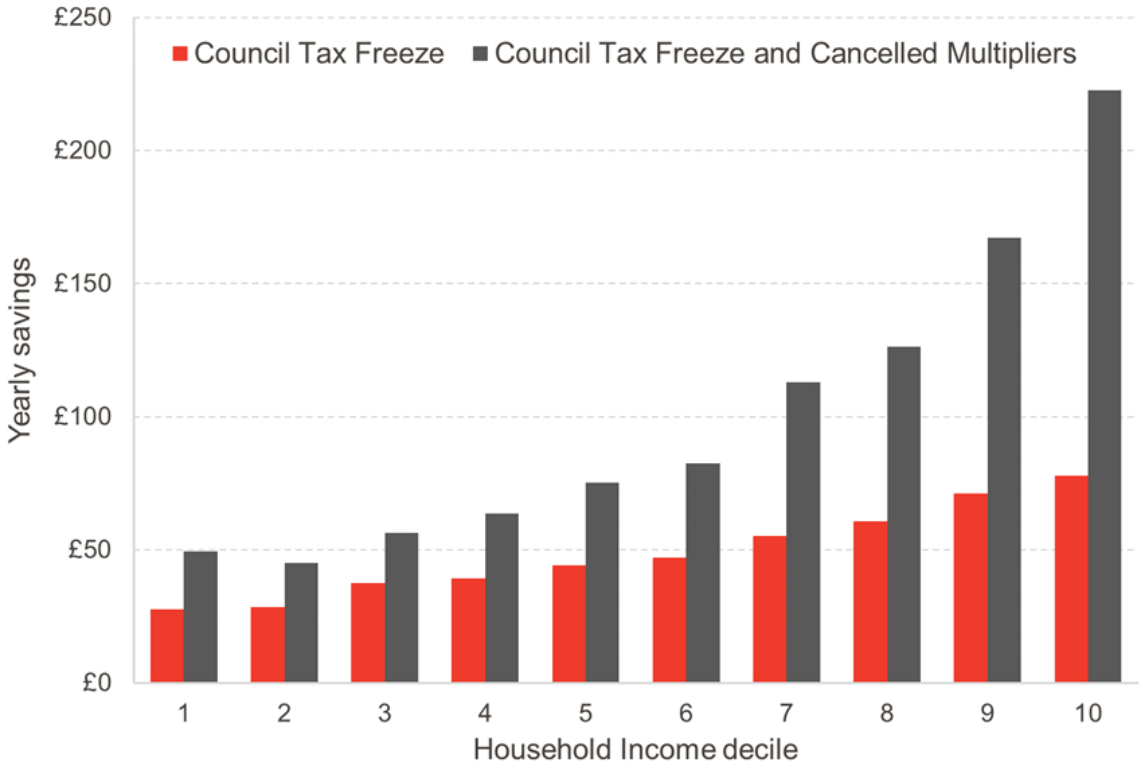
There are two key issues which analysis of the impact on households looks at, which provide slightly different insights. The first is the absolute (cash) impact and the second is the relative (cash relative to income) impact. These impacts are usually shown by income decile which are constructed by dividing the population into ten equal sized groups and plotting their income from low (income decile 1) to high (income decile 10).

To model the freeze, we base our central estimates on a 5% counterfactual increase in council tax rates with 3% and 8% modelled as the lower and upper reasonable bounds.

Modelled estimates – absolute gains

Chart 4.6 shows that those who benefit the most in cash terms from the freeze and the decision not to go ahead with the change in the multipliers are those in the higher income deciles.

Chart 4.6: Impact of council tax freeze and decision not to go ahead on multiplier changes by income decile relative to 5% increase (absolute impact)



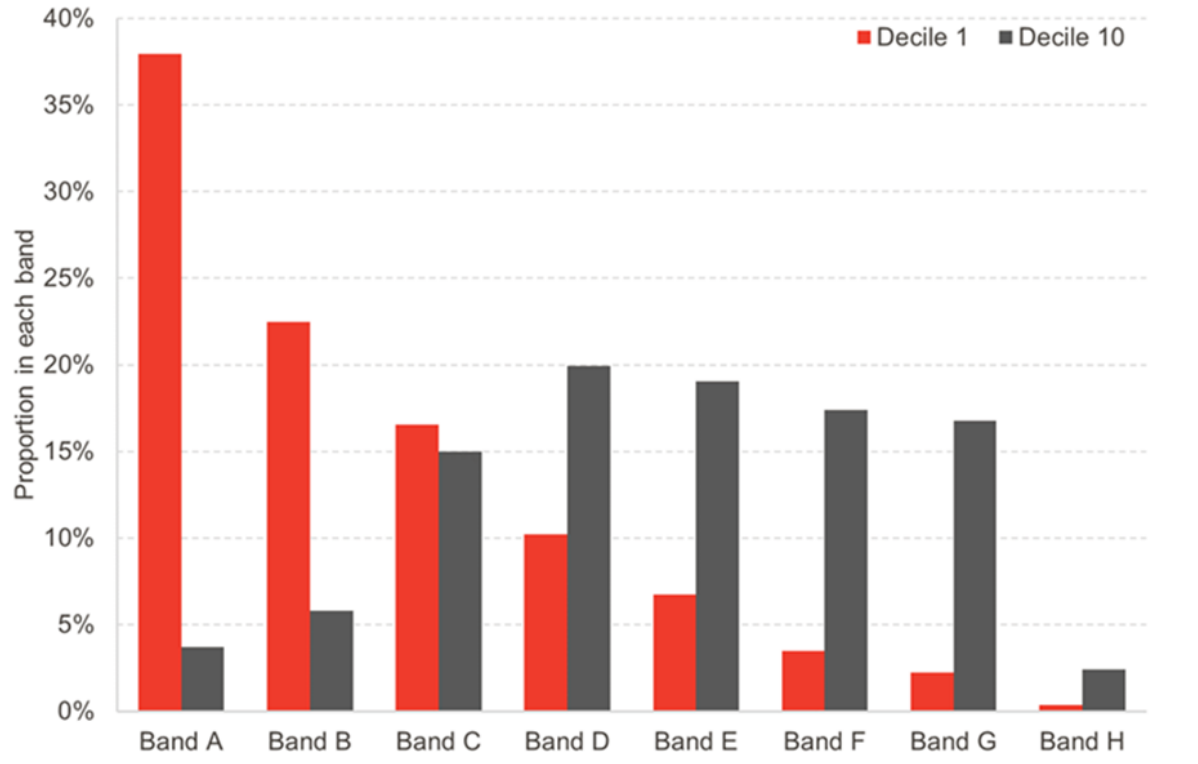
Source: IPPR model, FAI calculations

Freezing rates alone saves those in the wealthiest income decile around £78 per year - £50 more than those in the lowest income decile who save £28. The proposed plans to increase the multipliers for bands E-H would generally (although for from precisely) impact households in the wealthiest income deciles the most. As expected, the cancellation of the policy can be seen to have a larger impact, relative to the freeze alone, on the highest income deciles. The combined savings from freezing rates and cancelling multipliers for those in the 10th decile are around £223 per year compared to £78 in the 1st decile.

These figures are inclusive of modelled estimates of discounts, reductions, and Council Tax Reduction. The fact that there are households in the lowest income deciles who are impacted by this is either due to them not being eligible for CTR or due to take up being less than 100%. Even if take up of Council Tax Reduction was 100%, the trend shown in Chart 4.6 of the absolute gains being larger for those at the top of the income distribution would still hold.

Another issue to point out is that although, on average, those in higher income deciles pay more, there are households in income decile 10 (the highest) that are in homes in Band A, and even households in income decile 1 (the lowest) who are in Band H homes (see Chart 4.7). Whilst no doubt this issue will have been exacerbated by the lack of a revaluation since the early 1990s (with many households in the wrong band if Council Tax was based on current relative property values) it unlikely that incomes would ever be perfectly correlated with the value of the property. The most obvious example is for pensioners, who may live off a relatively small pension, but have no mortgage so they are able to live in a relatively expensive home.

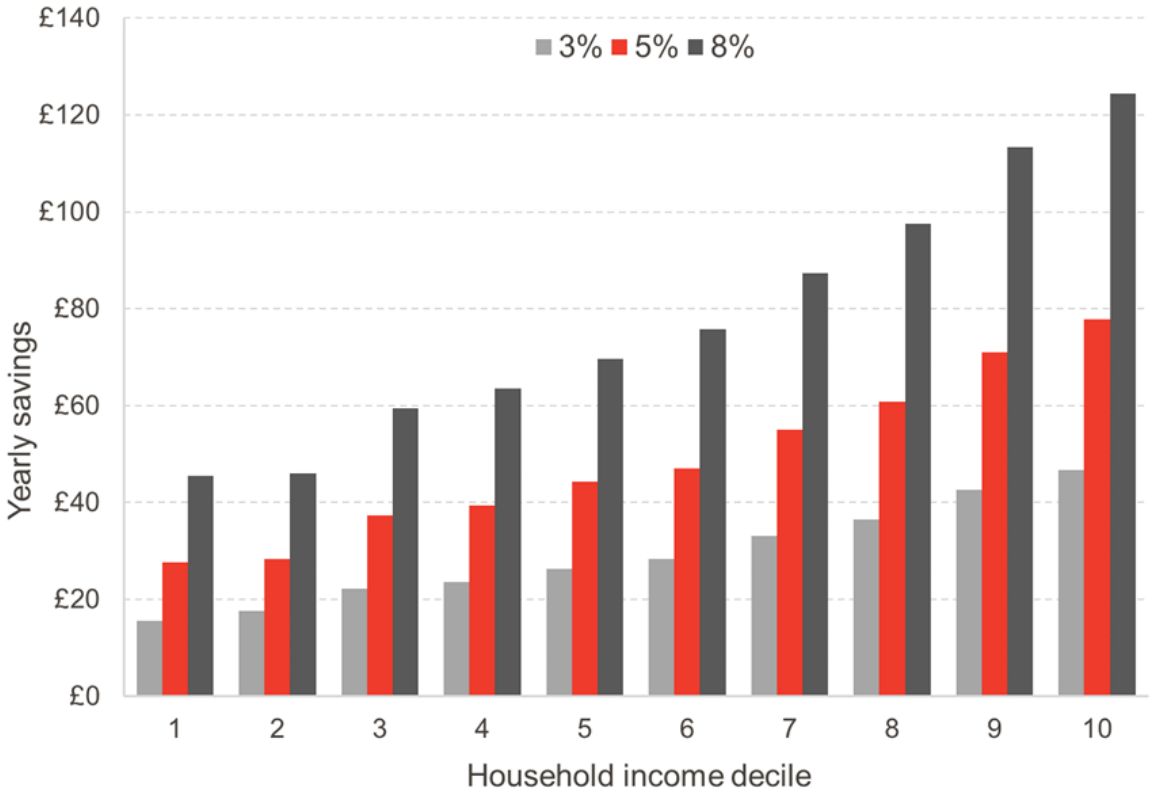
Chart 4.7: Council tax band by income deciles



Source: IPPR model, FAI calculations

While the average increase in council tax rates across councils was 5.4% last year – some local authorities increased rates by as much as 10%. For cash strapped councils who were budgeting on a larger increase than the previous year's average, considering a counterfactual rise closer to 8% may be more realistic.

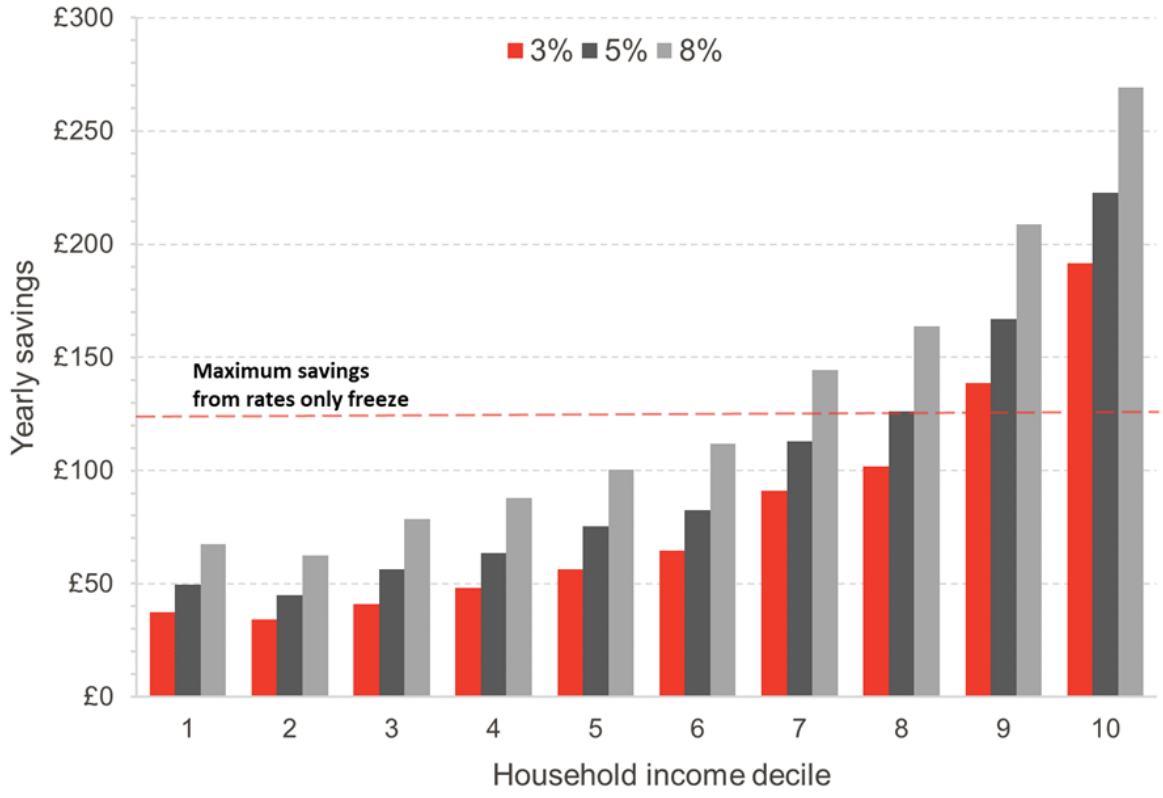
Chart 4.8: Impact of council tax freeze (only) by income decile relative rates rising by 3%, 5%, and 8% (absolute impact)



Source: IPPR model, FAI calculations

Chart 4.8 shows that for some households in councils where rates may have risen as much as 8%, yearly savings of the freeze alone could be as high as £124 for those in the highest income decile and £46 for those in the lowest.

Chart 4.9: Impact of council tax freeze and cancelled multipliers by income decile relative rates rising by 3%, 5%, and 8% (absolute impact)



Source: IPPR model, FAI calculations

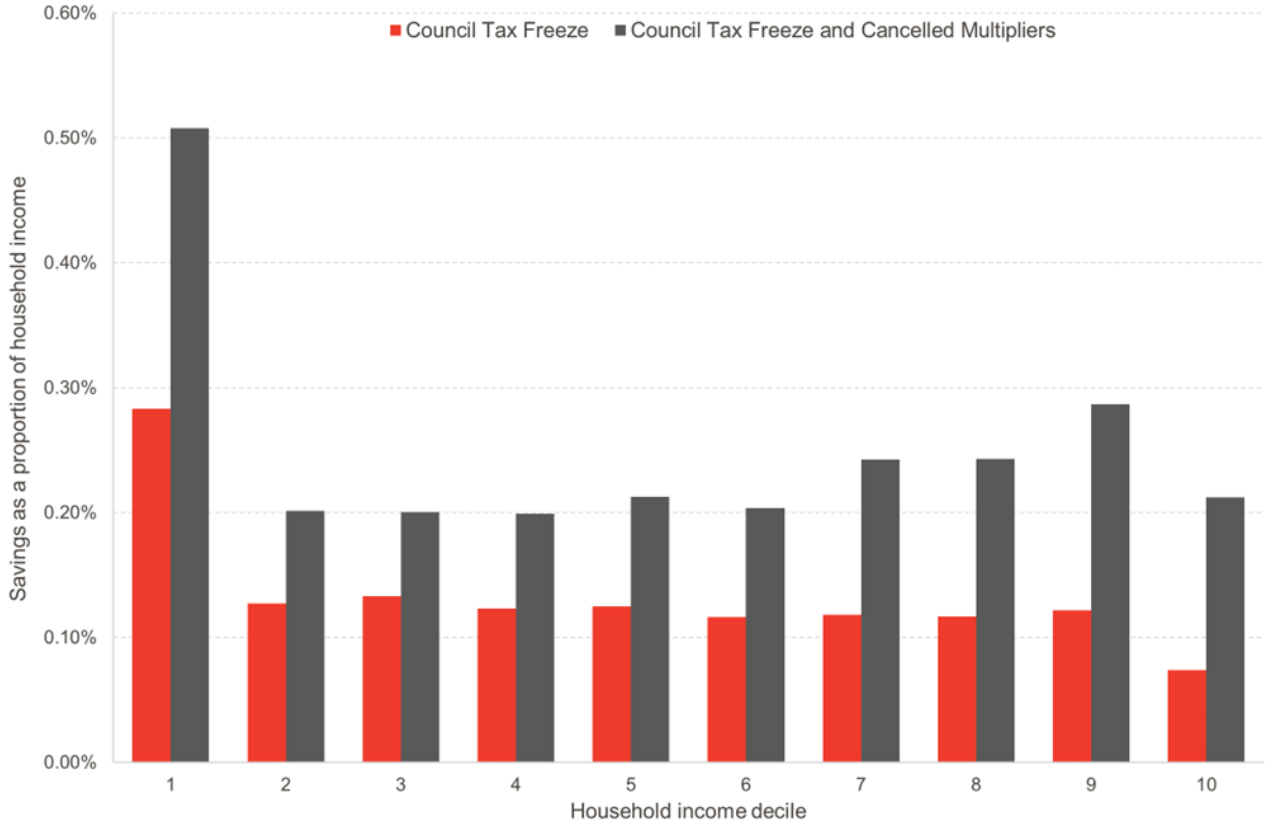
As mentioned before, cancelling the change in multipliers alongside freezing council tax rates produces a more unequal split in the absolute gains between the highest and lowest income deciles than the freeze alone. Chart 4.9 shows that relative to a counterfactual increase in rates of 8%, income deciles 7 and above all save more per year than the highest decile would under a rates-only freeze at 8% (dashed red line). The maximum yearly savings from both the cancellation of the multipliers and the freeze is just under £270 for the highest income decile and £67 for the lowest decile.

Modelled estimates – relative gains

A common response to the findings from Chart 4.6 (that absolute cash savings benefit higher income households) is that the opposite is true when you look at what this means relative to someone's income; the argument being that £25 to someone on a low income will make a bigger difference than £75 paid to a higher income household.

Chart 4.10 shows that as a proportion of income, the freeze benefits those in the lowest income decile the most, and those in the top income decile the least when shown as a proportion of income. For the deciles in between, it's a bit more mixed. When the cancelling of the freeze is added to the picture, income deciles 2, 3, 4, and 6 seem to benefit the least.

Chart 4.10: Impact of council tax freeze and cancelled multipliers by income decile relative to a 5% increase in rates (relative impact)



Source: IPPR model, FAI calculations

The same argument is used to criticise the current form of council tax – on average higher income households pay more as a proportion of income council tax hits poorer households more.

These two arguments can't be used interchangeably. It is difficult to defend the council tax freeze on these grounds (i.e. poorer households benefit more in relative terms) at the same time as doing nothing about the underlying unfairness of council tax itself. At the same time, those who criticise council tax due to its underlying unfairness in terms of bills as a proportion of income can't use the same argument to criticise the freeze.

There are, however, plenty of other reasons to criticise council tax (see here for previous complaining). It is a tax that is not designed well and has been left to deteriorate further through lack of revaluation. The only valid option is to reform.

4.5 Non-domestic rates

Non-domestic rates (also known as business rates) are a form of property tax for non-domestic properties, for example commercial and industrial premises. This is a devolved tax, so the non-domestic rates (NDR) differ between Scotland and the rest of the UK – in fact, there are different regimes for each of the four nations. The amount of tax that a non-domestic property is liable for is determined by three elements:

- The ***rateable value*** of the property – this is an estimate of the market rental value of a property;
- The ***poundage*** – this is a tax rate set nationally by the Scottish Government that is applied to the rateable value of the property;
- Any ***reliefs*** the property is eligible for – these are tax reliefs for properties of certain characteristics that are deducted from the tax bill.

The NDR liability is then calculated as follows:

$$\boldsymbol{NDR = \left(Rateable\ Value \times \frac{Poundage}{100}\right) - Reliefs \pm Adjustements}$$

The final tax bill is also adjusted for overpayments or underpayments from previous years.

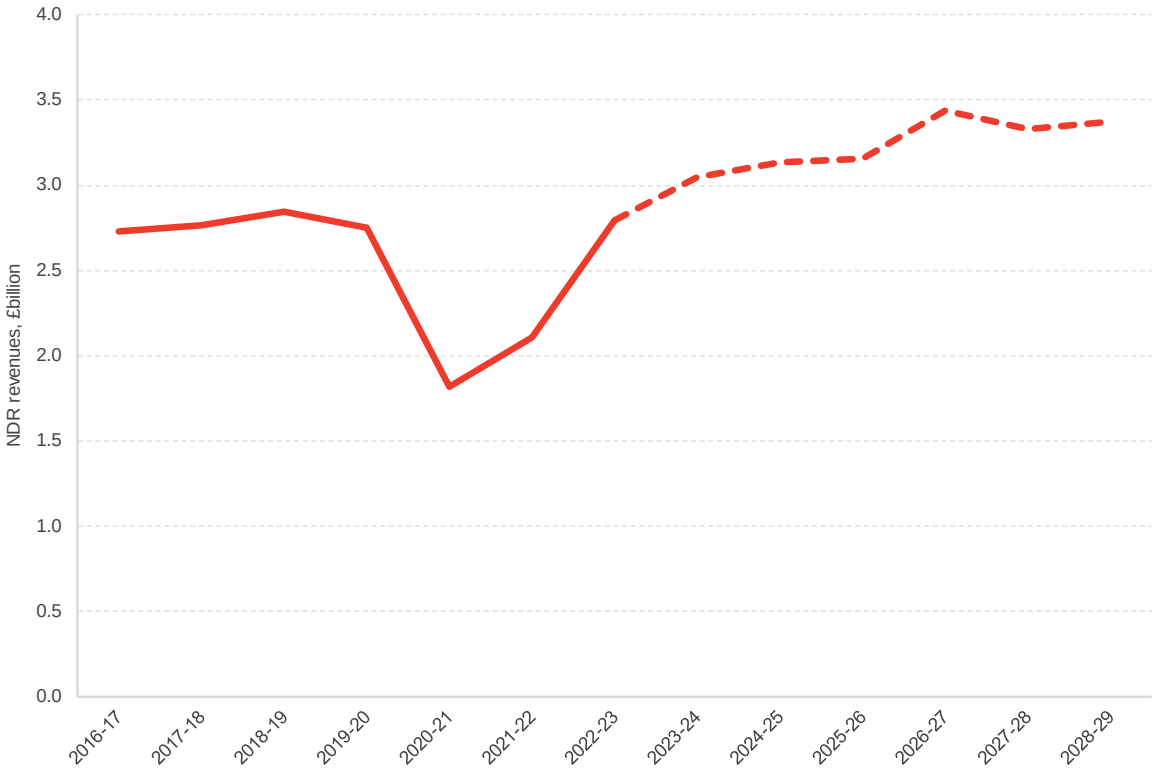
NDR operates differently from other taxes in that it operates a ring-fenced account, and so revenue collected is ultimately paid back to local authorities. This is because all revenues get collected into a central NDR pool, which subsequently gets allocated and distributed back to local authorities as part of the local government finance settlement.

At each Budget, the Scottish Government sets the poundage for the coming year and announces any changes to reliefs. Recent adjustments and changes to these three elements will be discussed in the following sections.

NDR revenues

In 2022-23 revenue from NDR totalled £2.8bn. Chart 4.11 shows that NDR revenue in cash terms has returned to pre-pandemic levels. Revenue dropped during the pandemic in part due to an increase in reliefs, most notably the reliefs for retail, hospitality, leisure and airport properties – which were heavily affected by public health restrictions – and the introduction of the Intermediate Property Rate in 2020-21.

Chart 4.11: NDR tax revenue and forecasts, 2016-17 – 2028-29, £bn

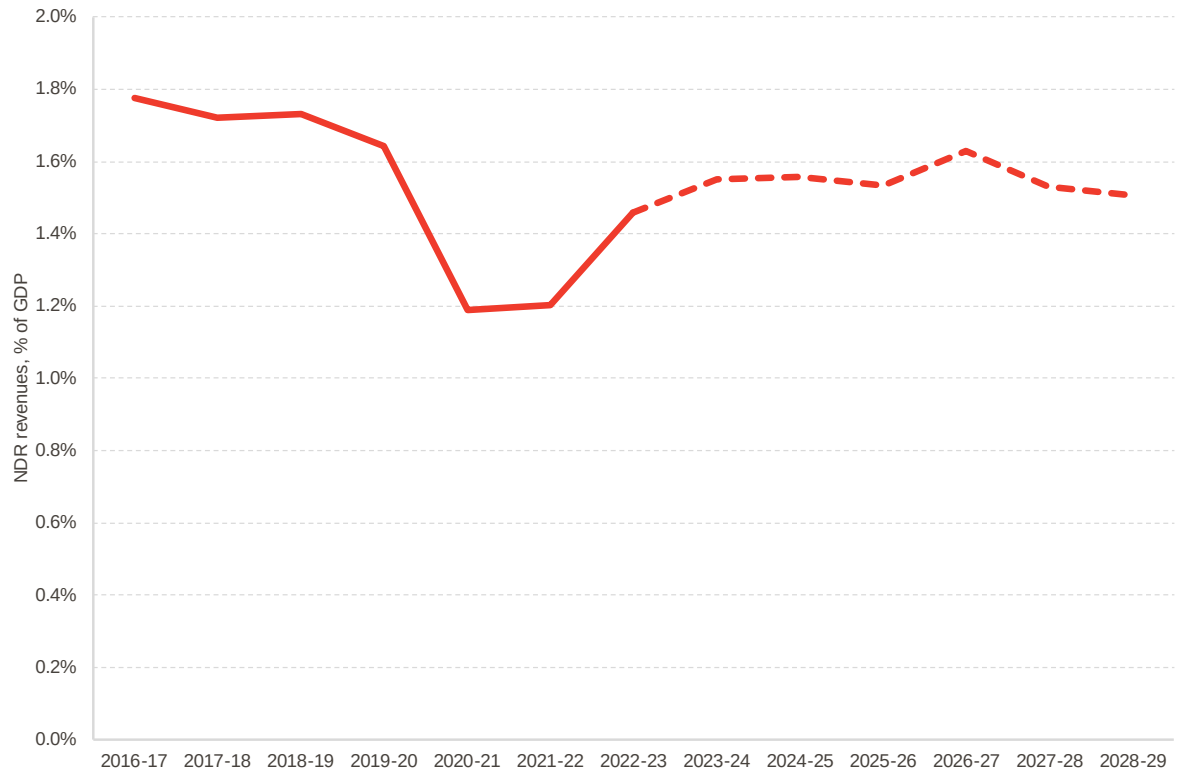


Source: Scottish Government and SFC. Dashed lines are forecasts.

Chart 4.11 also shows the forecasts for future tax revenues produced by the Scottish Fiscal Commission in May 2023, based on the poundage and reliefs announcements in last year's Budget and the updated valuation roll from the revaluation of rateable values in April 2023. NDR revenue is forecast to grow over the next 5 years to £3.4bn in 2028-29.

While NDR revenue in cash terms has returned to pre-pandemic levels, revenue as a proportion of GDP has not returned to its previous levels (Chart 4.12). In 2022-23 NDR revenue accounted for 1.46% of GDP, down from 1.73% in 2018-19 and its high of 1.78% in 2016-17. The SFC expects some recovery over the forecast period, but the introduction of the intermediate rate in particular means that revenues as a share of GDP are forecast to remain below the levels in the mid-2010s.

Chart 4.12: NDR tax revenue as proportion of GDP, 2016-17 – 2028-29



Source: Scottish Government. Dashed lines are forecasts.

Revaluations happen – and much more frequently than for council tax

A property's rateable value is an estimate of the market rental value the property could achieve. These valuations were revalued in April 2023, based on property valuations as of 1st April 2022 (the tone date), with 2017 being the previous revaluation. While the poundage and reliefs are set at a national level, valuations are conducted at a local council level. The Scottish Government have committed to moving to a three year revaluation cycle. Therefore, these recent revaluations will remain in place until 2026, with new valuations based on the tone date of 1st April 2025 released in April 2026.

The April 2023 revaluation increased the total rateable value on the valuation roll by £390m, a 5.36% increase. When accounting for revaluation transitional relief and poundage rates and thresholds, gross income following revaluation is expected to have increased by 3.37% (£339m).

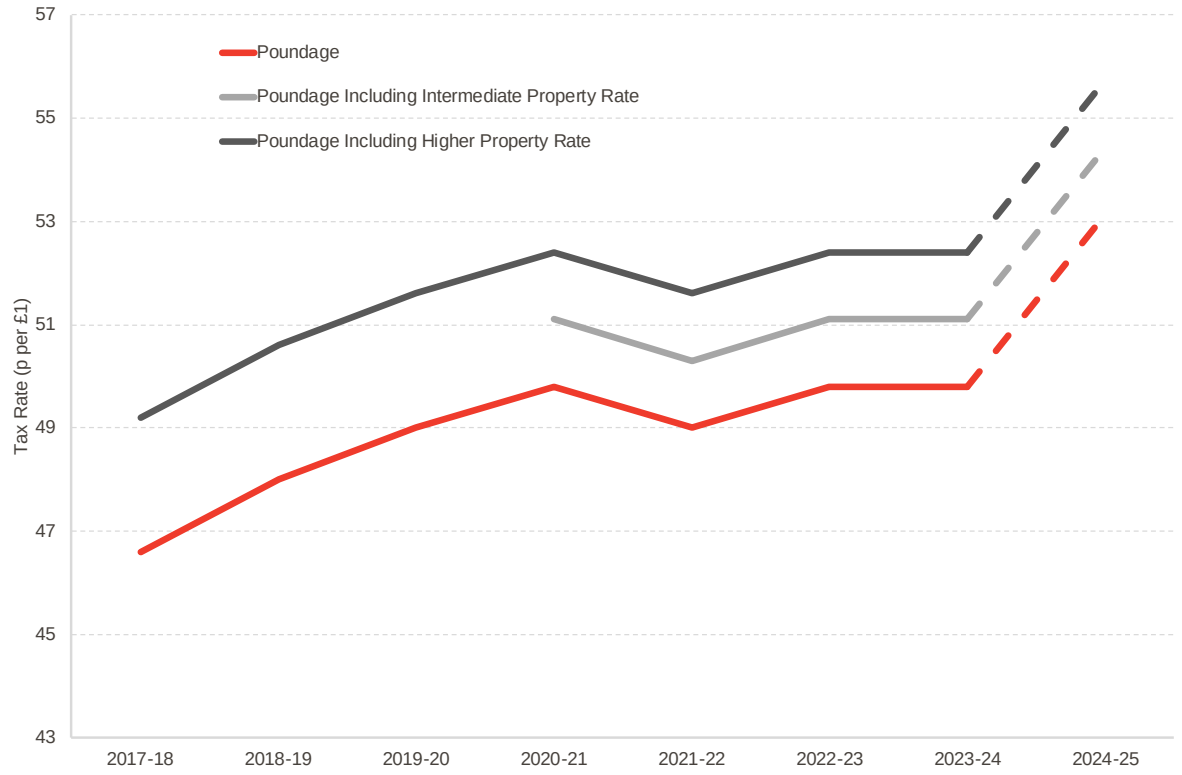
Evolution of the poundage

The poundage is a tax rate applied to the rateable value of the property. It is set nationally by the Scottish Government and in last year's budget was set at 49.8p for every £1 of rateable value for 2023-24. Properties with a high rateable value are liable for additional supplements, so face higher tax rates. Properties with a rateable value between £51,000 and £100,000 pay the Intermediate Property Rate – an additional supplement of 1.3p per £1

(51.1p per £1). Properties with a rateable value above £100,000 pay the Higher Property Rate – an additional supplement of 2.6p per £1 (52.4p per £1).

The poundage and additional supplement rates remain frozen from the previous budget (2022-2023). However, the threshold at which properties were liable to pay the Higher Property Rate was risen from £95,000 to £100,000. Chart 4.13 shows the trend in poundage and additional supplement rates since 2017-18, including the introduction of the intermediate rate in 2020-21. The poundage rate has increased from 46.6p per £1 in 2017-18 to 49.8p in 2022-23, where it has remained frozen.

Chart 4.13: Trends in the Poundage and Additional Supplement Rates 2017-18 – 2024-25



Source: *Scottish Government* and FAI calculations. *Note: Dashed lines are forecasts.*

Assuming the poundage is unfrozen in the 2024-25 budget and is increased in line with inflation (September 2023 CPI rate), we estimate poundage will increase by 3.3p to 53.1p. Provided the size of the additional supplements remain the same, the intermediate and higher property rates will increase to 54.4p and 55.7p, respectively. We estimate this increase in poundage will increase forecasted NDR revenue in 2024-25 by £0.2bn to £3.25bn.

There are Barnett consequentials from the UK Government's RHL relief in the Autumn Statement, but they might not be enough to replicate the measures

In the recent UK Autumn Statement, the Chancellor announced a one-year extension of their retail, hospitality and leisure (RHL) relief introduced in the 2022 Autumn statement. This RHL

relief provides a 75% discount to businesses occupying eligible retail, hospitality and leisure properties in England, with a cap of £110,000 per business.

As this area of policy is devolved in Scotland, there is a Barnett consequential for this. The OBR estimates this to be around £230m.

Using the valuation roll for 2023, we have modelled how much this might cost to replicate, and we think it might be as much as £360m, even after accounting for businesses with no liability due to the small business bonus – though this may be a slight overestimate if some businesses are eligible for other reliefs. The higher cost of the relief is largely due to there being less concentration in the RHL industries in Scotland, which means relatively fewer businesses affected by the cap. We think less than 1% of RHL businesses would get no relief at all if the same cap applied.

4.6 What other taxes have been proposed, and can the Scottish Government actually enact them?

There are a number of proposed taxes that the Scottish Government are currently considering introducing. However, there is no legislation for a lot of these suggested taxes so it is unlikely they will be in place for the 2024-25 budget.

Wealth taxes

A number of organisations have suggested implementing a wealth tax. There are a number of compelling arguments for the desirability of a wealth tax, both in terms of growth in inequality and intergenerational fairness, as inherited and accumulated wealth perpetuate and entrench those inequalities.

But taxing wealth is a complicated matter. The UK Wealth Tax Commission considered the issues surrounding introducing one at UK level, and came down on the side of a one-off levy rather than a recurring tax, which would necessitate frequent asset revaluations and high administrative costs.

The further down the layers of administration one goes, the larger the challenges become.

The Scottish Government can theoretically legislate to introduce new taxes, although it feels unlikely that the Treasury would be on board with the creation of a tax that clearly sits within the reserved powers sphere.

And the challenges around information access and the movement of assets across the UK, itself an integrated market with no restrictions on capital, would mean that the Scottish Government would not be able to implement a comprehensive wealth tax.

There have been suggestions to legislate to invest local authorities with power to levy a tax on wealth at a local level. The power to create such a tax does exist, but it is hard to see how this could operate in the intended way within local authorities' boundaries. Physical property is possible to tax that way because it is not moveable (see council tax, for example), but the same is not true for financial wealth.

On the practical side, it is completely unrealistic to rely on revenue from such a tax for the foreseeable future if eve . The definition of wealth to be operationalised would have to go through consultation, discussion with experts and drafting of legislation, as well as discussions regarding access to data and mechanism of assessment. And that is before we get to the setting up of a system ready to assess and collect it. As a reference point, when the now-defunct Health and Social Care Levy was first announced, it took HMRC 18 months to set up the system to collect a new tax despite the fact that it was essentially the same as National Insurance Contributions.

There is no prospect of any of these stages being completed in time for the 2024-25 budget. The Scottish Government would face far fewer barriers in making sweeping reforms to council tax to make it much more linked to the current value of properties, and yet it has consistently failed to do so. As mentioned before, physical property is the easiest to tax at a

local level. A move towards ownership rather than occupancy being the criterion for liability when combined with reform to rates and valuations would go some way towards making it more akin to a wealth tax.

We welcome the fact that the STUC's report proposing it is realistic about the fact that proposing it in early 2024 would mean implementation in the late 2020s. But even accounting for the fact that getting something set up would take years, the complexities and difficulties of creating a wealth tax at sub-national level would mean it would be not be able o deliver the effects intended.

Local Visitor Levy

The Local Visitor levy proposes to allow local councils to charge a tax on overnight accommodation to act as a tourism tax. The funds raised would be invested in local facilities and services used by visitors to the area. If approved councils can choose to apply the levies to all or parts of their area, following consultations with local communities, businesses and tourist organisations.

The Visitor Levy (Scotland) Bill was introduced into the Scottish Parliament in May 2023 and is currently at Stage 1 of the process where committees are examining the Bill, gathering views through consultations and producing reports before MSPs debate the Bill and decide on the general principles of the Bill. One Stage 1 is complete, Stage 2 (where MSPs can propose changes or 'amendments' to a Bill that must be debated and agreed up) and Stage 3 (a further round of amendments that must be debated and agreed) must be completed for the Bill to be passed and become law.

Implementation of a Local Visitor Levy might be a helpful solution for very localised issues, especially in the case of communities heavily affected by short-term tourism leading to congestion of local infrastructure. However, it is unlikely to raise significant revenues at a national level.

Cruise Ships Levy

At their recent party conference, the Scottish Greens announced a new levy on cruise ships visiting Scotland. The proposal was light on detail, but would be aimed at tackling the dual problems cruise ships provide in harmful emissions and the effects of large numbers of tourists on port communities.

Much like the proposed Local Visitor Levy, this might provide some much-needed relief for small communities, but is unlikely to be significant in terms of revenues at national level. But unlike the Local Visitor Levy, the fact that it is not yet being considered at Stage 1 in Parliament means that it will not be in place for the foreseeable future.

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