



Scottish Government  
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# Scotland's Fiscal Outlook

The Scottish Government's  
Medium-Term Financial  
Strategy

January 2021

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## Foreword by the Cabinet Secretary for Finance



In the midst of this global pandemic and economic crisis, the outlook for the economies and public finances of countries and Governments around the world has been upended. We all face the same intractable challenge: to balance the competing demands of increased public spending, reduced tax income and the pressing need to support citizens and businesses. The challenges we faced pre-pandemic are also still with us: the need to tackle climate change, the desire to invest in our public services and the

efforts to build a wellbeing economy.

While we share this challenge with our friends and neighbours, Scotland does not have access to the same tools and flexibilities that would help us to minimise the impact of the crisis and spread the cost of the response.

Even before this crisis occurred, I had been clear that the current Fiscal Framework did not allow me adequately to manage the levels of fiscal risk in our Budget process. In the current context, these levels of risk and volatility have only been compounded. They illustrate, more than any of us could have predicted, the need for different parts of the UK to have access to fiscal levers in order to respond adequately to the needs of their local populations.

Despite the challenges brought by 2020, compounded by the implications of EU Exit, I believe in the people of Scotland's tenacity, commitment and ability to build a better society. I am certain that, together, we can meet these challenges. Now more than ever, we will need to be creative and enterprising, to lay out a vision of how we can emerge from this global crisis to rebuild, to innovate and to prosper. This crisis has shown us that we are resilient, united in our purpose and in our values.

I have made no secret of my belief that only in an independent Scotland can we truly and fully fulfil this ambition. Although it is not a focus of this document, only independence would give us the full fiscal levers we require in order to set a different trajectory to that of the UK Government.

Nonetheless, this document sets out how we will respond as a Government within our limited powers. It also outlines the further flexibilities and levers required in order to manage the risks and volatility with which the Scottish budget will need to contend in coming years.

By publishing this year's Medium-Term Financial Strategy (MTFS) alongside the Budget, I want to provide a clear direction at a time of significant uncertainty and set some context around the difficult decisions that need to be made as part of this Budget. After the Holyrood election, it will be for the incoming Government to work with the next Parliament to agree how best the MTFS can continue to support budget scrutiny, accountability and transparency, by setting out the evolving context for annual budgets.

The First Minister, by being open about the challenges brought by the Covid-19 pandemic, has set a clear tone for a maturing relationship between Scotland's government and its people. This document is an important part of our efforts to build on this commitment to fiscal transparency and parliamentary accountability.

A handwritten signature in black ink, appearing to read 'Kate Forbes', written in a cursive style.

**KATE FORBES MSP**

**Cabinet Secretary for Finance**

## Executive Summary

As the First Minister set out in this year's Programme for Government, COVID-19 has had a profound impact on our health, economy and society, indeed our whole way of life.

While we still face a global public health crisis, our focus will remain on managing its impacts, saving lives, and protecting our health service. But we know those impacts do not exist in isolation – the global health crisis has brought with it a global economic shock from which Scotland is not immune, which in turn has had a devastating effect on people, businesses and communities. While our mass vaccination programme presents a positive way forward, we must take a bold and ambitious approach to supporting the country through the crisis, and build the foundations for our recovery.

The transition period for EU Exit has now ended – leaving Scotland with a tumultuous and uncertain set of conditions that it did not ask for and does not want. The devastating cumulative impact of COVID-19 and the UK's exit from the EU will continue to be most acutely felt at the bottom of the income distribution. This will have ramifications for years to come, as well as risking the progress that we, as a government, have made in protecting Scotland's most vulnerable communities. Uncertainty and disruption will continue over the life of the next Scottish Parliament, which this strategic outlook covers.

This is the third MTFS published by the Scottish Government. For the first time, it is published alongside, rather than ahead of, the Scottish Budget, as part of a suite of publications including the Public Sector Pay Policy 2021-22, and the forthcoming publications of the Capital Spending Review (CSR) and the Infrastructure Investment Plan (IIP). The MTFS sets out the key financial challenges and opportunities that lie ahead. It provides the context for the Scottish Budget and also sets out the new and specific context that will govern the life of the next Scottish Parliament. This context will frame the decisions of the incoming Government's strategic approach to economic and fiscal policy.

Our Budget today has set out the steps we are taking to help households and businesses through the crisis. It demonstrates our commitment to build back fairer, stronger, and greener – providing a path to renewing our economy and society in the aftermath of the pandemic, mitigating against the worst impacts of the UK's exit from the EU. While we have reasons for optimism and are ambitious for how we rebuild the economy and a fairer society, we must also recognise the constraints we face to fully deliver on those ambitions. The forthcoming CSR and IIP will set out how approximately £33.5 billion of capital investment over the next five years can support 45,000 full-time equivalent jobs over those years.



While Scotland has gained additional tax and social security powers over recent years, UK Government decisions are still the single biggest factor in determining the size of Scotland's Budget. The powers of the Scottish Parliament cannot shield Scotland from the joint devastation of a global crisis and a harmful and reckless policy towards the EU, nor any decision by the UK Government to return to austerity.

This MTFS sets out the economic and funding risks and opportunities that we will need to consider in the coming years. It is not a budget and does not set out spending plans, but lays out the challenges we must manage in order to balance budgets over the coming years.

At the heart of this document are the fiscal principles and choices around balancing the need for proactive management of fiscal risk; but not at the expense of supporting vital public services. Scotland's fiscal sustainability must be maintained in a way that does not impact on those who can least afford it, whether that is ensuring a just transition to a green economy, or choosing to grow rather than to cut our way out of fiscal deficits. That is why this Government has done our utmost to maximise the effectiveness of public spending and protect budgets. We will continue to call upon the UK Government to avoid an austerity approach, which disproportionately affects the most vulnerable and poorest in society. We reiterate our demand of the UK Government to adopt a measured strategy for addressing public debt, which we called for in our *UK Fiscal Path - a new approach* paper published in June 2020 and updated in November 2020.

In setting future devolved budgets, the Scottish Government will take an approach based on efficiency and achieving value for money in the delivery of key outcomes. To do so in the face of continuing funding uncertainty, or without necessary powers to smooth spending trajectories meaningfully on a multi-annual basis, will require carefully balanced judgements in terms of acceptable levels of fiscal risk.

In order to achieve this balance, we will need to make maximum use of the levers we have as part of the Fiscal Framework,<sup>1</sup> and work hard to ensure that every spending line is delivering on the outcomes outlined in the National Performance Framework (NPF). This demands an enhanced effort across the public sector to scrutinise, challenge and evaluate the effectiveness of public spending, to ensure that we can maximise the impact within limited resources.

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<sup>1</sup> To learn more about the Fiscal Framework and how it operates, please consult Scottish Government (2017), *Fiscal Framework: factsheet*, URL: <https://www.gov.scot/publications/fiscal-framework-factsheet>

However, with the best will in the world, the Scottish Government does not possess sufficient fiscal levers and powers to allow us to make the progress we wish to see, whether protecting jobs in the medium term by providing businesses with the confidence that they need, or restructuring tax and economic drivers to promote longer-term sustainable growth. This is why this MTFs also sets out what further powers we will need to respond to these challenges in a way that lives up to our ambition.

With the Fiscal Framework Review approaching, the time is right to consider how we can enhance the Scottish Parliament's fiscal decision-making powers in order to be able to respond to future challenges. We will press the UK Government to widen our borrowing and reserve powers and include the devolution of additional tax powers within the scope of the Review.

The Introduction sets out the impact the current crisis has had on the outcomes of the NPF, showing that the pandemic is likely to widen inequalities over the medium term. In response, we must properly and sustainably fund public services.

Chapter 2 reports on the Scottish Fiscal Commission's (SFC) latest growth forecasts, which demonstrate that the economic backdrop remains highly uncertain. The whole global economy is going through a significant economic shock, likely to be followed by a lengthy period of economic recovery. For Scotland, this is compounded by the additional costs businesses face as a result of the UK's exit from the EU.

Chapter 3 sets out the funding outlook for the medium term, which continues to be fundamentally determined by UK spending decisions. It also seeks to illustrate the volatility and level of risk inherent in the Fiscal Framework, which determines Scotland's revenue, as well as risks and opportunities to Scotland's tax base.

In Chapter 4, we lay out our broad spending priorities, and provide three illustrative spending scenarios that could define the broad shape of the Budget over the next five years.

Chapter 5 brings together the funding and spending scenarios to illustrate the scale of the prioritisation decisions required in the future.

The medium-term outlook for both our budget and our spending priorities depends heavily on the success of the COVID-19 vaccination programme and the degree of long-term scarring inflicted by the COVID-19 pandemic, as well as the risks around the future trade relationship with the EU.

Chapter 5 also sets out what additional powers and flexibilities could, as part of the Fiscal Framework Review, enhance our ability to manage volatility, smooth spending trajectories and meet the challenges brought on by this new context.



The Conclusion summarises the MTFs and highlights the key elements that would enable the Scottish Government to manage fiscal risks more robustly. We need to make smart spending decisions. To do this effectively, we need the ability to set a bold and radical new approach on how to aid the recovery, providing opportunities to deliver a fairer and greener economy and driving sustainable public finances in a way that puts wellbeing at their core.

Finally, the Annexes provide more detailed information on the economic and financial modelling, as well as key data on the components of the Fiscal Framework.

## 1. Introduction

### 1.1 A turning point for Scotland

#### 1.1.1 The impact of COVID-19

The Scottish Government's core purpose is to create a more successful country with opportunities for all of Scotland's people to flourish, through increased wellbeing, and sustainable and inclusive economic growth.

The COVID-19 pandemic continues to have a profound impact on our health, economy and society, with damaging effects on the way of life and the wellbeing of people in Scotland. Considerable uncertainty remains over the long-term impacts of this pandemic as the response from Scotland, and countries around the world, continues to evolve.

*Scotland's Wellbeing: The Impact of COVID-19*, published in December 2020,<sup>2</sup> shows that the pandemic is likely to have significant and wide-ranging effects, right across the National Outcomes. The weight of evidence suggests that the pandemic may widen inequalities in income and wealth over the medium term, as well as making unequal outcomes more severe in a range of other areas. Health, Economy, Fair Work, and Business and Culture outcomes have been deeply negatively affected.

Our Budget, published today, sets out the steps that we have taken, and will continue to take, to support households and businesses through this difficult time. Our response requires an unwavering focus on tackling the continued public health crisis. But we recognise that, in turn, this brings significant economic and social harms, as well as a need to protect people's jobs and livelihoods in the immediate term alongside longer-term action to build back fairer and stronger. That is why we have made additional funding available to support businesses affected by the necessary restrictions to protect public health. We have also set out a comprehensive package of support for those facing financial insecurity or hardship.

Recognising the imperative to deal with the economic, as well as health and social crises that COVID-19 has brought, the Infrastructure Investment Plan will set out a multi-billion pipeline of investment over the coming five years, to boost market confidence and help public bodies with the certainty needed for sound financial planning.

However, alongside our ambitious plans for resilience, recovery and renewal in the face of the pandemic, this document sets out the precariousness and volatility of the ultimate funding position, and our

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<sup>2</sup> Scottish Government (2020), *Scotland's Wellbeing: The Impact of COVID-19*, URL: <https://nationalperformance.gov.scot/scotlands-wellbeing-impact-covid-19>

continued reliance on the UK Government. Since the start of the crisis, we have provided £8.6 billion of additional funding to support our society and economy, including over £3 billion additional investment for health and wider initiatives, alongside almost £3 billion supporting employees and businesses, much of it delivered through a four nations approach.

While additional funding received to date has been welcome, it falls short of what is properly required to tackle the scale of the challenge. This will make recovery from this crisis all the harder. If we are to meet the ongoing challenges of COVID-19 and the UK's exit from the EU, as well as support economic recovery, further funding and additional fiscal flexibilities are required.

### 1.1.2 Scotland cannot afford a return to austerity

Many key policy levers still remain out of our control, and our budget is still defined, in the main, by the spending decisions made by the UK Government. Following a decade of austerity, day-to-day spending on UK public services in 2019-20 was 6.6% lower in real terms than in 2009-10. Outside of health, real terms public service spending was 20% lower.<sup>3</sup>

In the UK Spending Review on 25 November 2020, the Chancellor began the process of reducing non-COVID related spend by up to £13 billion a year, compared to his plans as announced in the March 2020 UK Budget. These cuts to core spending mean that austerity will not be over for many public services.

This return to austerity must be avoided and has been repeatedly rejected by the Scottish electorate. We know that the spending cuts and tax rises implemented over the past decade, at a total value of 8.3% of GDP or £185 billion in 2019-20 GDP terms, have resulted in chronic underfunding of our public services, disproportionately affecting the most vulnerable and poorest in society. In turn, the Scottish Government has attempted to mitigate these impacts as far as possible.

There is also growing evidence that austerity has undermined economic growth, as periods of fiscal consolidation have reduced both output and productivity in the economy.<sup>4</sup> Both the International Monetary Fund (IMF)

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<sup>3</sup> Institute for Fiscal Studies (2020), *The IFS Green Budget*, URL: <https://www.ifs.org.uk/uploads/IFS%20GB2020%20Digital.pdf>

<sup>4</sup> Bardaka et al. (2020), 'Total factor productivity (TFP) and fiscal consolidation: How harmful is austerity?', *Economic Modelling*, 94, 908-922, URL: <https://doi.org/10.1016/j.econmod.2020.02.032> and Ostry et al. (2016), 'Neoliberalism: Oversold?', *Finance and Development*, 53(2), URL: <https://www.imf.org/external/pubs/ft/fandd/2016/06/ostry.htm>

and the OECD have highlighted that rising inequality is bad for growth.<sup>5</sup> The Scottish Government believes that growing the economy is vital to reducing the deficit and will prioritise economic growth and reducing inequality until the economy has fully recovered.

The economic rationale for infrastructure investment reinforces the important role that such funding plays in improving the productive capacity of the economy and delivering long-term economic benefits.<sup>6</sup> We know the austerity approach adopted by the UK after the 2008 financial crash is counter-productive for growth, and such an approach cannot be afforded again. In 2018, The First Minister introduced the National Infrastructure Mission, to help Scotland take a different path: one that returns our infrastructure investment to internationally competitive levels, supports communities and creates good jobs.

Research undertaken by The National Society for the Prevention of Cruelty to Children Scotland (NSPCC) Scotland and Barnardo's Scotland has highlighted the devastating impact of austerity measures on children and their families.<sup>7</sup> Some families are now struggling to obtain adequate food, secure housing and basic necessities. This has been exacerbated by UK Government welfare reforms over the last decade. The Scottish Government's commitment to tackling poverty must not be further impaired through the implementation of added austerity measures.

Cuts to public spending have also disproportionately affected women. This is due to a number of interrelated factors. Women are more likely to use public services, for example, they are the majority of welfare recipients. Women are also more likely to have a relatively lower income, as a consequence of a looser attachment to the labour market due to women disproportionately shouldering the burden of unpaid care.<sup>8</sup>

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<sup>5</sup> IMF (2014), *Redistribution, Inequality, and Growth*, URL: <https://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf> and OECD (2014), *Trends in Income Inequality and its Impact on Economic Growth*, URL: [https://www.oecd-ilibrary.org/social-issues-migration-health/trends-in-income-inequality-and-its-impact-on-economic-growth\\_5jxrjncwxv6j-en](https://www.oecd-ilibrary.org/social-issues-migration-health/trends-in-income-inequality-and-its-impact-on-economic-growth_5jxrjncwxv6j-en)

<sup>6</sup> Scottish Government (2018), *Infrastructure investment: evidence summary*, URL: <https://www.gov.scot/publications/exploring-economic-rationale-infrastructure-investment/>

<sup>7</sup> Barnardo's & NSPCC Scotland (2020), *Challenges from the Frontline – Revisited*, URL: <https://learning.nspcc.org.uk/media/2402/challenges-frontline-revisited-adversities-scotland.pdf>

<sup>8</sup> Women's Budget Group (2017), *Austerity is reducing social security for women* URL: <https://wbg.org.uk/wp-content/uploads/2017/11/soc-security-pre-budget-nov-2017-final.pdf> and Elson (2012), 'The reduction of the UK budget deficit: a human rights perspective', *International Review of Applied Economics*, 26(2), 177-190

Minority Ethnic (ME) households also face persistent structural inequalities in education, employment, health and housing, meaning that they have also been disproportionately affected by cuts to public spending.<sup>9</sup> For ME women, gender inequalities intersect with, and compound, racial inequalities, making them particularly vulnerable to cuts to benefits, tax credits and public services.

Fiscal commentators such as the Institute for Fiscal Studies (IFS),<sup>10</sup> the IMF<sup>11</sup> and the OECD<sup>12</sup> have been clear that now is not the time for new fiscal targets or a detailed fiscal consolidation strategy to reduce borrowing, pointing to uncertainty from the impacts of COVID-19 and current economic conditions. Indeed, the head of the IMF has said that the UK must stand ready to spend more to support businesses and households.<sup>13</sup> The OECD's Chief Economist has warned that governments should avoid short-term fiscal tightening and numeric targets for public deficits and debt and instead consider long-term sustainability goals.<sup>14</sup>

Internationally, countries are already committing to continuing fiscal support this year. The EU has suspended its fiscal rules for government budgets for 2021, and countries such as Germany and France have extended many of their financial support schemes to the end of the year. In the Financial Times' most recent annual survey of more than 90 leading economists, there was broad consensus that tightening fiscal policy too early would damage the recovery.<sup>15</sup>

Importantly, we know that the full effect of the COVID-19 pandemic will be felt over the five-year period covered in this document, with the Office for Budget Responsibility (OBR) suggesting it could take a full two years from now for output to return to pre-pandemic levels.<sup>16</sup> To ensure a fair and sustainable recovery, we must invest in our people, communities, and businesses – a defining priority of the 2021-22 Scottish Budget, but one

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<sup>9</sup> Reed and Portes (2014), *Cumulative Impact Assessment: A Research Report by Landman Economics and the National Institute of Economic and Social Research (NIESR) for the Equality and Human Rights Commission (EHRC)*, URL: <http://bit.ly/2nW8s6j>

<sup>10</sup> IFS (2020), *The IFS Green Budget*, *ibid.*

<sup>11</sup> IMF (2020), *Fiscal Monitor: Policies for the Recovery*, URL: <https://www.imf.org/en/Publications/FM/Issues/2020/09/30/october-2020-fiscal-monitor>

<sup>12</sup> OECD (2020), 'Coronavirus (COVID-19): Living With Uncertainty', *OECD Economic Outlook, Interim Report September 2020*, URL: <https://doi.org/10.1787/34ffc900-en>

<sup>13</sup> IMF Managing Director Kristalina Georgieva, speaking to Sky News 17 October

<sup>14</sup> Press Conference: OECD Economic Outlook 2020 (Interim report), URL: <https://tinyurl.com/y272yhcr>

<sup>15</sup> Financial Times (2020), 'UK economy set to be one of the last to recover from pandemic', URL: <https://www.ft.com/content/5c51299a-fd9f-4e14-9576-a42a6317c324>

<sup>16</sup> OBR (2020), *Economic and fiscal outlook – November 2020*, URL: <https://obr.uk/efo/economic-and-fiscal-outlook-november-2020/>

which requires the partnership and help of the UK Government within the current constitutional settlement.

When we emerge from the greatest economic shock of our lifetime, we must ensure that fiscal rules do not constrain the fiscal policy response, thereby weakening the economic recovery and doing more harm to the long-term fiscal position. Instead, we require a bold new approach from the UK Government as called for in our *UK Fiscal Path – a new approach*<sup>17</sup> paper published in June 2020 and its update in November 2020,<sup>18</sup> with fresh thinking on how to aid the recovery and deliver a fairer and greener economy that puts wellbeing at its core, while ensuring sustainable public finances over the longer term.

## 1.2 Delivering for the people of Scotland

The context for this year's MTFS is far from normal or stable. However, we cannot simply sit tight and wait for these storms to pass. COVID-19 has shown up some of the fault lines in our economic, financial and societal arrangements, including the disproportionate negative impacts on some sectors and in some communities. But it has also reinforced the need for long-term ambition – the need to support the transition to net zero, improve biodiversity, invest in our national infrastructure, make our public services fit for the future, harness the economic and social opportunities of new technology, make homelessness history and lift children out of poverty. Rather than return to business as usual, we need to create a more resilient, stronger, greener and fairer country, with better outcomes for all.

The impact of COVID-19 calls for a renewed focus on reducing inequalities and delivering improvement on national outcomes. This focus is needed in all our public service delivery and economic recovery activities, as well as in policies and programmes centred on health, wellbeing and social renewal.

### 1.2.1 Building back fairer and stronger from COVID-19

Even before the COVID-19 pandemic, we recognised that significant work lay ahead to meet our long-term ambitions – to eradicate child poverty, become a net zero society, and reform and renew our health service, economy, and communities. In the face of the pandemic, those ambitions become even more important and challenging. But these challenges also

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<sup>17</sup> Scottish Government (2020), *Coronavirus (COVID-19): UK fiscal path – a new approach*, URL: <https://www.gov.scot/publications/coronavirus-covid-19-uk-fiscal-path-new-approach/>

<sup>18</sup> Scottish Government (2020), *Coronavirus (COVID-19) - UK fiscal path: update - November 2020*, URL: <https://www.gov.scot/publications/covid-19-uk-fiscal-path-november-update/>



come with opportunities to rethink how we live and work as a society, how we access vital public services, and the type of economy we have.

The Government has set out its ambition to build back fairer and stronger from COVID-19. The 2020-21 Programme for Government (PfG)<sup>19</sup>, published in September 2020, committed to:

- a national mission to create new jobs, good jobs and green jobs - with a particular focus on our young people, supporting retraining and investing in our Green New Deal to tackle climate change
- promoting lifelong health and wellbeing - by tackling COVID-19, remobilising and reforming the NHS and social care and tackling health inequalities
- promoting equality and helping our young people fulfil their potential

The PfG includes, among other things, ambitious commitments to provide support and retraining to people facing redundancy and unemployment; a Scottish Youth Guarantee to ensure every young person has the opportunity of work, education or training; a comprehensive remobilisation of health and social care provision; and a strong emphasis on digital connectivity. The PfG has also reinforced the Scottish Government's commitment to achieving net zero by 2045, reducing child poverty to less than 10% of children living in relative poverty by 2030, and to building a wellbeing economy.

Our Climate Change Plan Update,<sup>20</sup> published in mid-December, sets out our pathway to meeting Scotland's emissions reduction targets over the period to 2032, but is also a strategic document on our green recovery from COVID-19. A green recovery is one that helps us toward net zero emissions in a way that is just, and that maximises the opportunities to deliver a thriving, sustainable economy, with a programme of £2 billion investment in green infrastructure over the next Parliament.

The forthcoming Capital Spending Review (CSR) and Infrastructure Investment Plan (IIP)<sup>21</sup> will address the significant medium-term challenges presented by the COVID-19 pandemic, given the profound impact the virus

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<sup>19</sup> Scottish Government (2020), *Protecting Scotland, Renewing Scotland: The Government's Programme for Scotland 2020-2021*, URL: <https://www.gov.scot/publications/protecting-scotland-renewing-scotland-governments-programme-scotland-2020-2021/>

<sup>20</sup> Scottish Government (2020), *Securing a green recovery on a path to net zero: climate change plan 2018-2032 - update*, URL: <https://www.gov.scot/publications/securing-green-recovery-path-net-zero-update-climate-change-plan-20182032/>

<sup>21</sup> Scottish Government (2021), *Capital Spending Review and Infrastructure Investment Plan 2021-22 to 2025-26* [forthcoming publications]

has had on our whole way of life, and the role infrastructure has to play in helping businesses and communities to adapt and recover.

Recognising the long-term nature of infrastructure provision, and the need to future proof investment, the CSR and IIP will address key long-term trends, including:

- Tackling and managing climate change;
- Accommodating technological developments;
- Adapting to demographic change.

Delivering our ambitions in a difficult economic and budgetary context, and within a set of fiscal and financial flexibilities than does not currently give us the powers we need, will undoubtedly be challenging.

The Scottish Budget remains intrinsically tied to decisions made by the UK Government. Leaving aside the Fiscal Framework, which creates a close interaction between UK and Scottish tax decisions, the Scottish Block Grant continues to be determined by decisions on spending made by the UK Government. The funding scenarios in Chapter 3 illustrate the funding limits within which the Scottish Government must operate over the coming years.

## 2. Scotland's economic outlook

This chapter provides an overview of the current economic outlook for Scotland from the Scottish Fiscal Commission (SFC), the Scottish Government's official independent economic and fiscal forecaster and the Office for Budget Responsibility (OBR), the official forecaster for the UK Government. The forecasts help highlight the potential medium-term risks and opportunities to the economy and underpin the forecasts of devolved tax revenue and social security expenditure.<sup>22</sup>

### 2.1 State of the economy

There have been unprecedented falls in economic activity in Scotland, the UK and other nations around the world as a result of COVID-19 and the restrictions imposed to manage and reduce its spread. In response to this, there has been an equally unprecedented level of support offered to households and businesses, with Scottish Government support for businesses and the self-employed reaching almost £3 billion.

The Scottish economy has begun a fragile recovery from the falls in spring 2020 and the roll-out of a large scale vaccination programme brings a welcome boost of optimism but the scale and speed of any recovery remains both fragile and uncertain.

To date, economic activity in Scotland is still around 5.7% lower than in February 2020, prior to the direct impacts of the COVID-19 pandemic. At the end of October, 195,200 employees in Scotland were still on full or part-time furlough. In effect, the Job Retention Scheme continues to support jobs and businesses but it may be masking the true impact of the crisis on the official unemployment rate which is still at a relative low of 4.2%.

However, there is evidence that the labour market is still in a precarious and relatively fragile state. HMRC's Real Time Indicator data suggests there are now around 75,000 fewer employees in Scotland relative to this time last year.<sup>23</sup> Data from the Office for National Statistics (ONS) shows that there are almost 935,000 fewer workforce jobs across the whole of the UK,

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<sup>22</sup> The figures in this chapter are the latest available as of Friday 22 January, which was the cut-off point for new data releases. All URLs were also last accessed on Friday 22 January 2021.

<sup>23</sup> ONS (2020), *Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted*, [Dataset] URL: <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworking/hours/datasets/realtimeinformationstatisticsreferencetableseasonallyadjusted>

relative to March 2020.<sup>24</sup> Furthermore, surveys on employers' intention to recruit remain subdued and the number of advertised vacancies across the UK are still around a third lower than at the start of 2020.

These figures emphasise the underlying challenges in the labour market caused by the pandemic as well as the importance of ongoing support to help mitigate the worst of the impacts and protect household incomes until the vaccination programmes can be fully rolled out. It is also why the Scottish Government has acted to support and protect businesses during the pandemic through business grants for those impacted by restrictions or packages of support for sectors that have been particularly affected during the crisis.

Given the scale and far-reaching impact of the pandemic, the latest forecasts from the SFC show a sombre outlook for the Scottish economy. GDP is now forecast to fall by 10.7% in 2020 as a whole and not recover to pre-pandemic levels until the start of 2024. After beginning to recover at the end of 2020, GDP is now forecast to fall again in 2021 Q1. The technical criteria for a Scotland-specific economic shock have also been met. As discussed in Box 1, the SFC note that this results from their forecasts being produced at a different time using different information than the latest OBR forecasts.

Over the longer term, the SFC expect a degree of longer-term scarring, with economic activity around 4% lower at the beginning of 2025 than their previous forecast published in February last year. Unemployment is expected to rise in 2020 and peak at 7.6% in 2021 Q2 (after the expected unwinding of the Coronavirus Job Retention Scheme) and will likely remain higher than pre-pandemic levels throughout the forecast horizon.

## 2.2 Economic risks and opportunities

The COVID-19 pandemic has either started, or accelerated, changes that are likely to result in permanent differences to the way that we live our lives, thus challenging us to rethink the way we shape our cities and communities.

It is already evident that this economic crisis has had different sectoral impacts. Retail, hospitality and leisure industries have been hit particularly hard by physical distancing measures, whilst industries that are able to use home working have been more sheltered. Areas of the country that rely on tourism have had a bruising year. Although some areas may have seen a cushioning effect from a rise in domestic "staycationing", research from the

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<sup>24</sup> ONS (2020), *JOBS05: Workforce jobs by region and industry*, [Dataset] URL: <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployetypes/datasets/workforcejobsbyregionandindustryjobs05>

IFS has highlighted that, particularly in rural and coastal areas with a disproportionate reliance on tourism related activities, the persistence of physical distancing and travel restrictions will continue to cause challenges. The same is true of some cities such as Glasgow which have large hospitality industries.<sup>25</sup> Likewise, the steep fall in the global oil price, and continuing lower levels of demand as a result of the economic downturn are likely to weigh heavily on the Oil and Gas industry and supporting supply chains based in Aberdeen and the North East.

While for many sectors the impact of these changes has been severe, the changes we have had to make to adapt to COVID-19 have also presented opportunities for some sectors of our economy. The need for physical distancing has increased the reward from investment in new technologies to allow us to remain in contact with colleagues, clients and friends and family. Scotland's existing strong and innovative technology sector means that we are well placed to maximise this new opportunity. This is why we commissioned Mark Logan, former Chief Operating Officer of Skyscanner, to undertake a review of the Scottish tech sector, creating a blueprint to raise it to world-class status. We are now working to take forward his ambitious recommendations, including the establishment of a national network of hubs for tech start-ups, offering world-class training programmes, intensive mentoring, and access to funding opportunities.

The pandemic has also accelerated changes in behaviour that may have permanent effects on the economy. It seems likely that home or flexible working will become more common, with more than 15% of companies already indicating that they will make more use of home working in the future.<sup>26</sup> These changes to working patterns will also lead to changes in the ways that people spend their money, and we may continue to spend more online or in local communities rather than in city centres. This provides us with an opportunity to build on the work we have already done to deliver 20-minute neighbourhoods, enabling people to live better, healthier lives and supporting our net zero ambitions. With more employers seeing the benefits of flexible working, this could have a transformative impact for our ambitions for fair work and equality at work. As part of this, we are committed to supporting local supply chain development and continuing to deliver on Community Wealth Building, ensuring that local people and

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<sup>25</sup> Davenport and Zaranko (2020), 'Levelling up: where and how?', *The IFS Green Budget*, URL: <https://www.ifs.org.uk/publications/15055?s=03>

<sup>26</sup> ONS (2021), *Business insights and impact on the UK economy*, [Dataset] URL: <https://www.ons.gov.uk/releases/businessinsightsandimpactontheukeconomy7january2021>

businesses have a genuine stake in producing, owning and enjoying the wealth they create.

Scotland has a highly skilled workforce, substantial natural resources and a long-standing reputation for innovation to help us adapt to any new circumstances in a post-COVID-19 world. We have notable strengths in sectors such as Food and Drink, Finance and Business Services as well as areas such as Life Sciences – a high wage, high productivity sector that generated over £300 million worth of business research and development for the Scottish economy alone in 2019.

We are pursuing a green recovery in the aftermath of COVID-19, capturing the opportunities of a transition to net zero and creating new jobs in the green energy sector. This is at the heart of the 2020-21 Programme for Government and our updated Climate Change Plan, both of which seek to capitalise on our strengths in natural capital, our skilled energy sector workforce and strong links with universities to set Scotland at the forefront of growing global markets such as renewable energy.

### 2.2.1 Scotland's relationship with Europe

The end of the transition period with the EU, and the new trading relationship that has replaced it, pose a significant challenge.

People living in Scotland can now no longer work, study or travel freely in the EU and it is likely that fewer people would now migrate to Scotland than if full membership had been retained. This makes our economy, culture and wider society poorer than it otherwise would have been.

New trading regulations are reducing the viability and competitiveness of Scottish exporters. This is particularly true for those sectors most exposed to the changes with the EU such as manufacturing, food and drink, agriculture, forestry and fisheries. These sectors face some of the sharpest increases in trade frictions, such as the introduction of customs controls, rules of origin and non-tariff barriers.

Already we have seen the impacts of additional trade requirements impacting on our exporters, particularly in the fishing industry. We are seeing delays in deliveries due to new non-tariff barriers and certification requirements, causing significant damage to businesses, particularly those trading in high-value, but perishable and short-shelf-life produce. This could, in turn, have a disproportionate impact on areas with a high degree of reliance on the fishing industry.

Some regions of Scotland may prove more resilient to leaving the EU Single Market than others, which in large part will be driven by existing differences in the sectoral composition of the regional economies. However, the new and diminished trading relationship with the EU will still have a detrimental impact across the wider economy. Whether this is through



lower levels of migration, increased barriers to trade, or detrimental impacts on future productivity and investment, there is substantial evidence that households and businesses across Scotland are likely to be worse off than if we had retained full membership in the EU. For example, Scottish Government modelling estimates that, even with a deal of the kind that the UK has negotiated, Scotland's GDP could be around 6% lower by 2030 than it would have been had we retained full EU membership.<sup>27</sup>

### 2.2.2 Vaccines, restrictions and recovery from the pandemic

A key determinant of the trajectory towards recovery is the speed at which restrictions are lifted across the country. This will depend on the success in suppressing the spread of COVID-19. Doubtless, the roll-out of the vaccination programme will also play an important part in this during 2021. In order to inform their forecast, the SFC have assumed that the vaccine will be rolled out to the majority of the adult population over the course of 2021, with vulnerable groups, including the over 50s, receiving their first dose by the end of May 2021. They are anticipating that such a timetable would allow for a gradual easing of restrictions, with stricter measures in place for Q1 2021 and some form of remaining restrictions in place until the final quarter of the year.

#### **BOX 1: THE "SCOTLAND-SPECIFIC ECONOMIC SHOCK"**

The Fiscal Framework has provisions for a 'Scotland-specific economic shock' to be triggered. When this happens, the Scottish Government has access to increased borrowing and reserve flexibility.

This provision is triggered when onshore Scottish GDP growth is below 1% in absolute terms on a rolling four-quarter basis, and 1 percentage point or more below UK GDP growth over the same period. This can be either on the basis of outturn data, or on the basis of forecasts.

The SFC's forecasts, published on 28 January, show that the technical requirements for this provision are triggered in 2021-22. The SFC has, however, made clear that the outlook for Scottish and UK GDP is broadly similar, and that these conditions are met due to respective forecasts being produced at different points in time, with the SFC forecast reflecting the impact of the latest restrictions in response to the spread of the new variant of COVID-19.

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<sup>27</sup> Scottish Government (2018), *Scotland's Place in Europe: People, Jobs and Investment*, URL: <https://www.gov.scot/publications/scotlands-place-europe-people-jobs-investment/>

The OBR forecasts, produced in November, had assumed that the UK would remain in restrictions broadly equivalent to Tier 3 in England until the spring, followed by an easing of restrictions. This would have seen the economy continue to grow throughout 2021. With the reintroduction of lockdowns across the UK, the outlook for the economy has changed significantly. The latest ONS data show that the UK economy contracted by 2.6% during November, after restrictions were reintroduced or strengthened across all four nations of the UK. The SFC now forecast that the Scottish economy will contract by 5.2% in the first quarter of 2021, before returning to growth in the second quarter, as the vaccine roll-out allows for a gradual easing of restrictions.

This divergence in the short-term outlook for the economy between the SFC and OBR forecasts, as a result of the differences in timing between them, triggers the Scotland-specific shock provision, rather than a significant difference in the performance of the Scottish economy. There is no evidence that Scotland's economic or tax performance has been materially different from that of the rest of the UK in 2020-21. Prior to the announcement of the recent lockdowns across the UK, the most recent data suggest that Scotland's economic performance has been broadly in line with that of the UK. Scotland's economy expanded by 16.0% in 2020 Q3, the same as the UK, following large falls in March and April.

The SFC has noted that it is entirely possible that the criteria for a Scotland-specific shock may no longer be met when the OBR publish updated forecasts in March, or when outturn data are published. More generally, the pandemic has led to unprecedentedly large swings in economic output, swings that have not been witnessed in modern history. This in turn leads to greater forecasting volatility and increases the likelihood that conditions such as those of the Scotland-specific shock will be met.

The triggering of this provision of the Fiscal Framework allows the Scottish Government to borrow £600m rather than £300m per year for forecast error on tax receipts and social security expenditure, and removes the limits on drawdown from the Scotland Reserve. This applies in the financial years 2021-22 until 2023-24. These flexibilities will not be withdrawn retrospectively should revised forecasts or outturn data indicate that the central criteria for a Scotland-specific economic shock are not met. The Scottish Government's approach to borrowing is set out in chapter 5.

### 2.3 Fiscal Implications of the economic outlook

Table 1 summarises the latest forecast for Scotland and the UK. It clearly shows the impact of the pandemic on economic activity, with Scottish GDP falling by 10.7% in 2020. As discussed in Box 1, Scotland has a weaker short-term GDP outlook than the UK as a whole, and therefore a different trajectory toward recovery, which the SFC have primarily attributed to the

different timings of the Scottish and UK forecasts. With restrictions now expected to persist for most of 2021, the economy recovers only slowly in this year, and it is not until 2022, when the SFC assumes that strict health control measures are no longer required, that the economy begins to rebound toward pre-pandemic levels. After 2023, Scottish and UK growth rates become more similar. However, as discussed above, it is not until 2024 that Scottish GDP returns to pre-pandemic levels, and GDP in 2025 remains 4% lower than was forecast in February last year.

**TABLE 1: HEADLINE ECONOMY FORECASTS**

	2020	2021	2022	2023	2024	2025
<b>GDP Growth (%)</b>						
OBR (UK)	-11.3	5.5	6.6	2.3	1.7	1.8
SFC (Scotland)	-10.7	1.8	7.5	1.6	1.6	1.7
<b>Employment Growth (%)</b>						
OBR (UK)	-0.4	-2.2	0.8	1.5	1.2	0.5
SFC (Scotland)	-2.4	-1.5	1.2	0.9	0.4	0.2
<b>Unemployment Rate (%)</b>						
OBR (UK)	4.4	6.8	6.5	5.4	4.5	4.4
SFC (Scotland)	6.0	7.1	5.9	5.0	4.7	4.5
<b>Nominal Average Earnings Growth (%)</b>						
OBR (UK)	1.2	2.1	2.0	2.4	3.0	3.5
SFC (Scotland)	2.5	2.6	2.4	2.7	3.0	3.3

Source: Scottish Fiscal Commission; Office for Budget Responsibility

Despite these divergences in the outlook for GDP, the extension of the Coronavirus Job Retention Scheme means that the labour market outlook for Scotland and the UK have remained more similar.

Table 2 below summarises the outlook for Scottish taxes and the associated BGAs. Although the labour market outlook is similar for Scotland and the UK, overall, the net tax position is forecast to improve from +£307 million in 2020-21 to +£611 million by 2025-26. This change is driven by improvements in the net Income Tax position, which is forecast to exceed the BGA by around £600 million a year from 2022-23. In part, the improvement in the Income Tax position reflects the recent positive outturn data for Income Tax, which came in above forecast in 2018-19. This feeds through into the change in expected Income Tax reconciliations, which have improved for future years.

**TABLE 2: LATEST FORECASTS OF TAX REVENUES AND BGAS**

£ million		2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
	Revenue	11,850	12,263	12,907	13,481	14,080	14,718
Income Tax	BGA	-11,677	-11,788	-12,294	-12,840	-13,475	-14,105
	Difference	173	475	613	641	605	613
	Revenue	517	586	629	664	701	740
LBTT <sup>1</sup>	BGA	-391	-515	-544	-601	-666	-723
	Difference	126	71	85	63	35	18
	Revenue	95	88	86	72	74	61
SLfT <sup>1</sup>	BGA	-87	-95	-91	-79	-74	-80
	Difference	8	-7	-5	-7	0	-19
	Revenue	12,462	12,937	13,623	14,217	14,855	15,519
TOTAL	BGA	-12,154	-12,398	-12,930	-13,520	-14,215	-14,908
	Difference	307	539	693	697	640	611
	Estimated Income Tax reconciliation <sup>2</sup>	-177	-319	74.3	126.8		

Note 1: The 2017-18 LBTT and SLfT revenue and BGA are outturn figures.

Note 2: Estimated Income Tax reconciliations are only available for years when a budget has already been produced. The 2020-21 reconciliation relates to 2017-18 Income Tax; the 2021-22 figure relates to 2018-19 Income Tax; the 2022-23 figure relates to 2019-20 Income Tax. See Annex C for details.

Figures may not sum due to rounding.

However, the increase in the net tax position is greater than can be explained by the better-than-expected outturn data and strong earnings and real time information (RTI) tax data in 2019-20. The SFC highlight that they do not expect Scottish tax revenues actually to perform significantly differently from UK tax revenues in 2021-22, and that the improved net

tax position largely arises because of the significant uncertainty around COVID-19 in both forecasts. In particular, the SFC and OBR have made different judgements on the outlook for earnings and employment, and place weight on different data sources for the labour market impacts of COVID-19.

Finally, the SFC are clear that they and the OBR have made their forecasts at a period of exceptional uncertainty, where the relationship between the economy and tax receipts is changing. Given that even minor differences in the forecast determinants can have a large impact on the net tax position, the SFC note that it is not unexpected that there is greater divergence between their and the OBR's forecasts.

While the triggering of the 'Scotland-specific shock' provision may provide some further flexibilities in the coming years, the volatile forecasting context may in turn increase the scale of likely future reconciliations. We discuss the resulting challenges for risk management and the need to smooth spending trajectories in more detail in Chapter 5. We have also developed a framework for analysing the impact of forecast error on the expected reconciliation, full details of which can be found in Annex A. These challenges highlight the volatilities within our fiscal settlement, which are explored further in the fiscal outlook scenarios in Chapter 3.

### 3. Scotland's fiscal outlook

This chapter sets out three illustrative scenarios for available funding in future Scottish Budgets and discusses the impact and size of various funding risks. These scenarios strip out the direct short-term impact of COVID-19, and focus on underlying medium-term risks for the Scottish public finances.

Under the Fiscal Framework, three key factors determine the available funding for the Scottish Budget:

- **UK Government spending decisions/fiscal stance.** Through the Barnett formula, the Scottish Government's Block Grant is determined by the UK Government's resource and capital expenditure in England on policy responsibilities devolved to the Scottish Parliament;
- **Relative growth in Scottish Government and UK Government tax revenues.** Under the Fiscal Framework, if Scottish revenues grow more quickly, the Scottish Budget is better off and vice versa. This means that Scotland's budget is influenced not only by tax policy and performance in Scotland but also by tax policy and performance in the rest of the UK.
- **Relative growth in Scottish and UK social security expenditure.** Under the Fiscal Framework, if Scottish expenditure grows more quickly, additional funding has to be found within the Scottish Budget. If UK expenditure grows more quickly, additional funds are available within the Scottish Budget for other uses. Again this means that Scotland's budget is influenced not only by policy changes within Scotland, but also what happens in the rest of the UK.

To manage short-term volatility, tax reconciliations and unforeseen shortfalls in social security funding, the Scottish Government also has limited powers to draw on the Scotland Reserve and to borrow.

#### BOX 2: THE LOSS OF FUNDING RECEIVED FROM EU PROGRAMMES

During 2014-20, Scotland is estimated to have received over £5 billion in funding from the EU through the European Multiannual Financial Framework (MFF). Under the Withdrawal Agreement, the UK will continue to participate in programmes funded under the current 2014-2020 MFF until their closure. This funding has supported a wide range of activities across Scotland, delivering infrastructure, sustaining rural communities, providing valuable support for the farming and fishing industries, and delivering research funding for universities.

The Scottish Government has been clear that funding must be replaced in full to ensure no detriment to Scotland's finances and to enable the benefits



that EU funding has provided to many sectors across Scotland to be maintained. This is in line with promises made during, and following, the EU referendum campaign, that Scotland would not be worse off as a result of the UK's exit from the EU.

On the replacement of pre-allocated programmes funding, fisheries and rural spending was included in the 2021-22 Spending Review settlements through non-Barnett allocations. The UK Spending Review provided £570 million to support farmers and land managers and £14 million to support fisheries in Scotland, which is insufficient to replace EU funding levels lost to Scotland.

It has now been confirmed by HMT that the replacement for the EU Structural Funds, the UK Shared Prosperity Fund, will be delivered from Whitehall, bypassing the Scottish Government. This is a clear incursion into devolved policy areas and overturns many years of established working practices. Unlike the UK, Scotland has already published clear plans for how we would use this funding and it is disappointing that the UK Government is preventing us from rolling these plans out.

On the replacement of competitive programmes funding, the UK Government sought to secure participation in a limited number of programmes including Horizon Europe and Erasmus Plus. Whilst the UK will have associated status for Horizon Europe, the UK Government have decided not to participate in Erasmus Plus and have provided little clarity on the replacement funding quantum or scope.

However, several key programmes were excluded, including European Territorial Cooperation, EU Health programme, Creative Europe, LIFE, the Connecting Europe Facility and Single Market Programme. Some of these programmes will not be replaced by the UK Government resulting in no extra funding being made available for a Scottish alternative.

The uncertain outlook on the replacement of EU programmes funding will continue well after the end of the Transition Period and are only exacerbated by provisions in the Internal Market Act and the decision to reduce the Spending Review to a single year. This means that there is extra funding risk over the five-year period set out in this document.

### 3.1 Central scenario

The scenarios focus on core spending, stripping out spend related to COVID-19. The central scenario is primarily determined by the expected Block Grant from the UK Government. The UK Government's latest Spending Review provided budgets for 2021-22 only, and did not provide the information needed for long-term planning. This settlement forms the basis of the central scenario, which beyond 2021-22 assumes that the Scottish Government Block Grant grows in line with spending plans set out by the

OBR. There remains significant uncertainty over future budget allocations. Although funding in response to COVID-19 has been guaranteed, there is no guarantee on core funding in future years. This was recently highlighted by the UK Government's decision in November to cut £10 billion from non-COVID-19 UK resource departmental spending in 2021-22 compared to plans set out in March 2020.

After the Block Grant, the second largest part of the budget is the net tax position. The Fiscal Framework is designed to protect the Scottish Budget from symmetrical UK-wide macroeconomic shocks, but differences in either economic performance or in tax policy will affect the budget. Even when overall economic performance is broadly similar, there is a risk that differences in the composition of the tax base may result in faster or slower growth in tax revenues in Scotland, for example when earnings growth is unequally distributed (see Annex B).

**TABLE 3: FUNDING COMPONENTS (NOMINAL) – CENTRAL SCENARIO**

£ million	2020-21	2025-26	Average annual growth
Total cash budget	39,972	47,826	3.7%
Resource budget limit <sup>1</sup>	30,928	37,603	4.0%
Net BGA and reconciliations	-22	612	-
New social security funding	3,203	3,988	4.5%
Capital budget limit	4,929	5,986	4.0%
Financial Transactions	611	0	-
Capital borrowing <sup>2</sup>	300	250	-3.6%

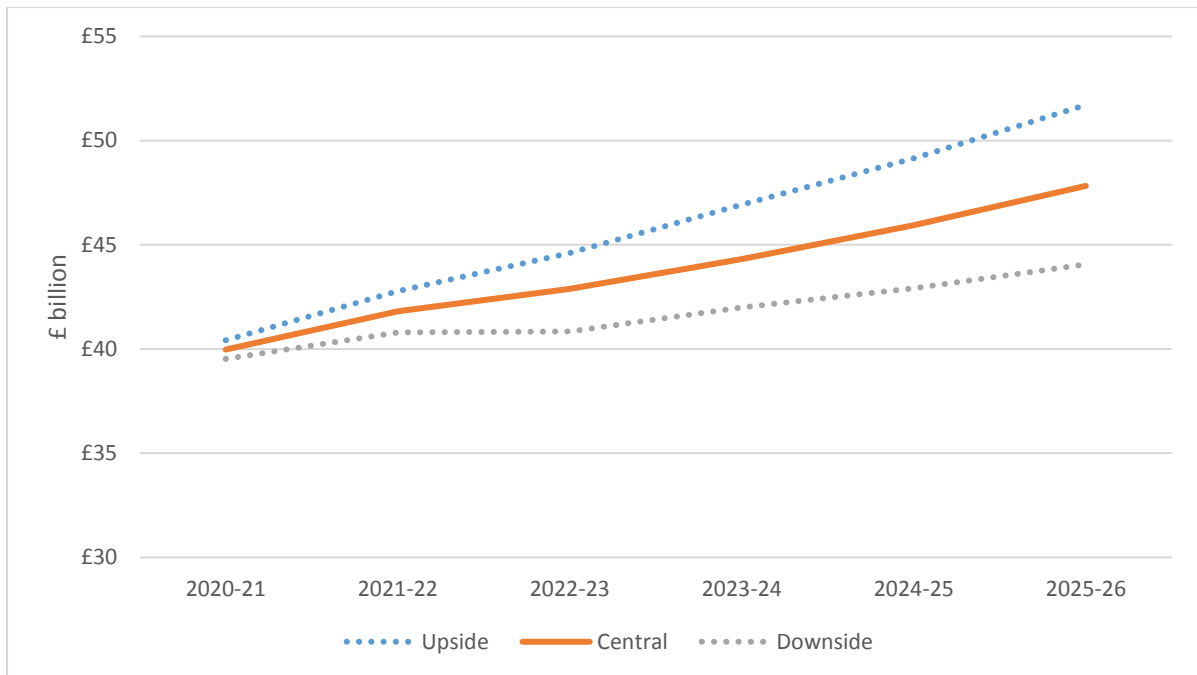
Note 1: Resource budget: Fiscal Resource Budget limit and the net BGA and reconciliations; updated for Supplementary Estimates; including additional adjustments for NDR, EU Replacement Funding, Scotland Act Implementation, and other smaller funding sources. Social security funding is not included and is shown separately.

Note 2: Chapter 5 sets out the Scottish Government's policy for capital borrowing.

As well as the central scenario, upper and lower scenarios are shown, which bring together uncertainty across all the different funding sources, shown in Figure 1 below. Overall, the Scottish Budget is forecast to grow by £7.9

billion between 2020-21 and 2025-26 in the central scenario excluding the short-term impacts of COVID-19. Broadly speaking, downside risks to the outlook slightly outweigh the upside risks, primarily reflecting risks around medium-term Income Tax reconciliations.

**FIGURE 1: FUNDING SCENARIOS**



The differences between these scenarios are caused by divergent assumptions on the UK fiscal stance and Scotland's relative tax performance and are discussed in more detail below.

### 3.2 UK fiscal stance

The Block Grant from the UK Government remains the single biggest determinant of funding for the Scottish Budget. The UK Government has rolled out fiscal stimulus measures worth at least £280 billion (14% of GDP) in 2020-21 as of November 2020<sup>28</sup> in order to mitigate the immediate impact of COVID-19 on the UK economy. As discussed in detail in Chapter 1, it is imperative that this fiscal support is not withdrawn prematurely, thereby undermining the economic recovery. Due to the sheer size and importance of the Block Grant, an early fiscal tightening by the UK Government poses the biggest risk to Scotland's funding outlook.

<sup>28</sup> OBR (2020), *November Economic and Fiscal Outlook*, *ibid*. There have been further fiscal measures announced since, including £4.6 billion in new lockdown grants to support businesses announced on 5 January 2021.

### 3.2.1 Lower scenario analysis

In the lower scenario, we assume that the UK Government adopts a tight fiscal stance in future years. Final UK spending in devolved portfolios would be lower than expected, either because of in-year underspends, due to a greater share of spending being directed toward reserved areas, or because of a reduction in overall spending. This would lead to lower Barnett consequentials, and a reduction in the Scottish Government budget. Growth in future years would then be slower than set out in the OBR's November Economic and Fiscal Outlook by 1% a year, leaving funding around 5% lower by 2025-26.

### 3.2.2 Upper scenario analysis

In the upper scenario, we assume that the UK Government adopts a looser fiscal stance in future years. Final spending on comparable areas would be higher than expected, either because a greater share of spending is directed toward comparable areas, or because of an increase in overall spending, perhaps motivated by interest rates remaining persistently low, or to provide additional stimulus to an economy that is underperforming expectations. This would lead to higher than expected Barnett consequentials, and overall spending would grow faster than that set out in the OBR's November Economic and Fiscal Outlook by 1% a year, leaving funding around 5% higher by 2025-26.

## 3.3 UK and Scottish relative fiscal performance

The devolution of tax powers means that the Scottish Government budget is increasingly determined by the performance of devolved taxes – most notably on non-saving, non-dividend (NSND) Income Tax and Land and Buildings Transaction Tax (LBTT).

If devolved Scottish tax revenue per head grows faster than in the rest of the UK, the Scottish budget will increase. This might happen if Scotland's economy grows more quickly than the rest of the UK's or if the Scottish Government introduces tax raising policy changes. However, even if economic performance is similar, structural differences in the tax base – such as the high concentration of high income earners working in Financial Services in London and the South East – may result in tax receipts growing at different rates, which can be both an opportunity and a risk.

That being said, the Scottish Government's budget does not necessarily worsen as a result of reduced taxation income during an economic downturn. This is because in a very narrow sense, the Fiscal Framework effectively cushions Scotland against economic shocks that affect the UK as a whole. This has been seen during the current pandemic, which has seen forecasts of Scottish devolved tax receipts for 2020-21 revised down by £661 million since February. Despite this, the net tax position for the

Scottish Government budget has improved slightly, as tax receipts across the UK have fallen by broadly the same proportion.

To date, there is no evidence that COVID-19 had a materially different impact on the Scottish and UK economies in 2020 – although the UK Government’s fiscal measures, and in particular the furlough schemes, might have masked any regional divergence.<sup>29</sup> However, due to the largely sectoral nature of the COVID-19 economic crisis, differences in the sectoral composition of the Scottish and UK economies pose downside, as well as upside risks, for Scotland’s relative tax performance in the medium term. Drawing on the, as yet limited, lessons from Scotland’s historic Income Tax performance in 2017-18 and 2018-19, Scotland’s greater exposure to movements in global commodity markets and the oil price could act as a drag on earnings and Income Tax growth in the medium term. These risks and opportunities, which are discussed in further detail in Annex B, have informed the upper and lower scenarios.

In the central scenario, Scottish and rest of UK tax receipts perform in line with the forecasts set out by the SFC and the OBR.<sup>30</sup> These are the forecasts that inform the Scottish Budget 2021-22. The lower and upper scenarios are discussed below. The scenarios also incorporate within them risk around future Income Tax reconciliation payments.

### 3.3.1 Lower scenario analysis

In the lower scenario, we assume for illustrative purposes that Scotland’s economy is hit by a number of headwinds, including a reduction in the tourism industry, a fall in international and intra-UK net immigration, and a sustained lower oil price. These factors would depress earnings and employment growth in Scotland relative to the rest of the UK<sup>31</sup> as well as growth in devolved tax receipts from 2021-22 onwards. The main impact would be on Income Tax, with receipts growing 1.4 percentage points less each year than in the central scenario, although other devolved taxes would also be weaker.

While the experience of 2019-20 clearly shows that it is possible for Scottish earnings and RTI Income Tax receipts to grow faster than in the rest of the UK, in particular once policy divergence is factored in, there is not yet any evidence of sustained faster tax growth in Scotland. This means

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<sup>29</sup> See also OBR (2020), Devolved Taxes and Spending Forecasts, p-6 URL: <https://tinyurl.com/y2qhddk9>

<sup>30</sup> The OBR’s forecasts of rUK receipts were updated at the Welsh Budget on December 21.

<sup>31</sup> Drawing on Scotland’s historic Income Tax performance, it is assumed that growth in employment is 0.7 percentage points lower than in the central forecast while earnings growth is 0.5 percentage points lower.

that it is possible for Scotland's relative tax performance to be weaker than set out in the central scenario, particularly since the SFC have been clear that they do not expect Scottish tax revenues to perform significantly differently to UK-wide tax revenues in 2021-22. This risk is reflected in a larger downside than upside scenario to the net tax position, i.e. the risks around Scotland's net tax position are thought to be asymmetric. This means that there is risk that the Scottish Budget will face negative reconciliations in the medium term.

In addition, a late UK Budget, as we have seen in both 2020 and 2021, would increase the tax policy risk. For example, should the UK Government introduce policy changes at its Budget on 3 March 2021, the Scottish Government would have limited time or means to respond to these changes. This could occur, for example, if the UK Government were to increase taxes to consolidate the public finances. This would increase the BGA and hence reduce the net position, unless the Scottish Government were to follow suit.

### 3.3.2 Upper scenario analysis

In the upper scenario, we assume that Scotland's devolved taxes grow faster than in the rest of the UK, for example because Scotland's economy is able to recover faster from the impact of the pandemic. These factors would support earnings and employment growth in Scotland, and stronger devolved tax receipts. The main impact is seen in Income Tax, which would grow 0.7 percentage points faster each year than in the central scenario, although other devolved taxes would also grow faster.<sup>32</sup>

In addition, UK Government policies which reduce taxes in the rest of the UK might be favourable to Scotland's net position if not implemented in Scotland as the BGA would decrease. Should Scotland adopt a similar tax cut, the impact on the net position depends on the exact design of the policy.

## 3.4 Summary of the scenarios

Table 4 provides a breakdown of projected Scottish Budget funding out to 2025-26 for the central scenario, as well as upper and lower scenarios.

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<sup>32</sup> Drawing on Scotland's historic Income Tax performance, it is assumed that growth in employment is 0.35 percentage points higher than in the central forecast while earnings growth is 0.25 percentage points higher.



TABLE 4: SUMMARY OUTLOOK FOR THE MTFS

£ million (nominal)	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Average annual growth
<b>Overall budget<sup>1</sup></b>							
Upper range	40,419	42,772	44,398	46,732	48,959	51,510	5.0%
Central scenario	39,972	41,803	42,888	44,309	45,943	47,826	3.7%
Lower range	39,524	40,787	40,833	41,996	42,910	44,059	2.2%
<b>Resource budget<sup>2</sup></b>							
Upper range	31,082	33,252	34,489	36,332	38,128	40,218	5.3%
Central scenario	30,928	32,663	33,467	34,825	36,099	37,603	4.0%
Lower range	30,773	32,020	32,294	33,095	33,758	34,643	2.4%
<b>New social security</b>							
Upper range	3,203	3,342	3,571	3,783	3,986	4,182	5.5%
Central scenario	3,203	3,310	3,503	3,676	3,837	3,988	4.5%
Lower range	3,203	3,278	3,437	3,572	3,693	3,800	3.5%
<b>Capital budget limit</b>							
Upper range	5,222	5,320	5,680	6,059	6,336	6,652	5.0%
Central scenario	4,929	4,973	5,260	5,558	5,757	5,986	4.0%
Lower range	4,637	4,631	4,852	5,079	5,210	5,365	3.0%
<b>Financial Transactions<sup>3</sup></b>							
Upper range	612	408	208	208	208	208	-19.4%

Central scenario	612	408	208	0	0	0	-
Lower range	612	408	0	0	0	0	-
<b>Capital borrowing</b>							
Upper range	300	450	450	350	300	250	-3.6%
Central scenario	300	450	450	250	250	250	-3.6%
Lower range	300	450	250	250	250	250	-3.6%

Note 1 Overall budget: Total Scottish Government funding excluding non-cash elements.

Note 2 Resource budget: Fiscal Resource Budget limit and the net BGA including forecast reconciliations, reserve drawdown, and resource borrowing. Social security funding is not included and is shown separately.

Note 3: Financial transactions include £200 million of draw down from the reserve in 2021-22

### 3.5 Key points on funding outlook and risks

The scenarios illustrate the key role of the UK's fiscal decisions on Scottish public finances. Future funding growth could be severely limited if the UK Government decides to consolidate the UK public finances and pursue a return to austerity.

COVID-19 and EU Exit have weakened the UK and Scottish economies. However, with regards to the net tax position, it is the relative performance of Scotland that determines Scotland's funding position. For each budget, the OBR and SFC forecast the UK's and Scotland's respective tax projected intake, which determine the budget envelope.

As demonstrated in Chapters 2 and 3, the Scottish Government budget can fluctuate within year and between years as a result of decisions taken by the UK Government. This means our spending plans, discussed in the following chapter, need to be considered in the context of uncertain and volatile budgets - made even more challenging by the tight fiscal controls applicable and limited fiscal levers available to the Scottish Government.

## 4. Broad spending outlook

This section of the MTFs sets out spending scenarios for 2021-22 and beyond in a context of increased volatility and growing demand for public services as a result of the pandemic and existing deeper structural trends. To a significant extent, our ability to set a robust budget that best delivers our ambitions to not just continue to manage the public health crisis, but to ensure we build back fairer and stronger, has been hampered by the UK Government's approach. The UK Spending Review in November 2020 did not provide the necessary detail to provide assurance to the Scottish Government regarding the direction or certainty of spending and resource-raising trajectories, including UK tax decisions, final BGAs and full allocation of identified COVID-19 funding. It also raises the prospect of quickly unwinding the current levels of COVID-19 related business and social support, which would in turn have damaging consequential effects.

### 4.1 Resource and capital spending context

#### 4.1.1 Resource spending: the 2021-22 resource budget baseline

Published alongside this MTFs is the Scottish Budget 2021-22. Despite the limitations caused by the delay to the UK Budget and the lack of information contained in the November 2020 UK Spending Review, we have progressed our budget planning on the basis of clear ambitions of recovery and renewal. The Budget document reinforces the commitments set out in the Programme for Government (PfG), and sets out how we will invest to build our economy back fairer and stronger.

The two biggest spending areas within the Scottish Budget 2021-22 are Health (£16.9 billion in 2021-22) and Local Government (£9.8 billion in 2021-22).

Public-sector pay in these areas accounts for a large part of this expenditure. Around half of employees in the devolved public sector in Scotland are employed by Local Authorities with a further third employed by NHS Scotland.

The next biggest spending area is Social Security (£4 billion in 2021-22). The remaining available budget (£44.8 billion in 2021-22) funds a wide range of other commitments across all Scottish Government portfolios. Taken together, Health, Local Government and Social Security represent almost three-quarters of the available budget in 2021-22.

Within a fixed budget envelope, increasing spend on one area means decreasing spend in another or raising the difference via tax revenues. The picture is further complicated for 2021-22 by the UK Spending Review's provision of non-recurring resource funding for COVID-19 on top of the

'core' baseline settlement, extending the approach from 2020-21, which makes budget planning across years all the harder.

#### 4.1.2 Capital spending: the Capital Spending Review

Investment in infrastructure is key to Scotland's economic recovery from COVID-19, and also in supporting public services, delivering our transition to net zero, and meeting the needs of people and communities across Scotland.

In the 2018 PFG, the First Minister announced a National Infrastructure Mission (NIM) to increase annual investment in infrastructure by 1% of 2017 Scottish GDP by 2025-26. This is the level required to match the ongoing investment of our key OECD competitors.

To support delivery of the NIM, Scottish Ministers established an independent Infrastructure Commission for Scotland. The Infrastructure Investment Plan (IIP) will adopt and build on the recommendations of the Commission in its Phase 1 report. It will set out our long-term vision and the pipeline of investment in public sector infrastructure over the period 2021-22 to 2025-26.

We will shortly be publishing our Capital Spending Review (CSR), which sets out capital spending plans over the same period, providing assurance on the affordability of the activity set out in the IIP and providing sight of those capital lines which do not deliver large infrastructure projects but are rather used to support jobs or research and development.

Importantly, expenditure in the CSR reflects our Climate Change Plan Update, published in December 2020, which details the policies and investments we are taking to support a green recovery and set Scotland on a pathway to a just transition to net zero. This includes introducing, boosting and accelerating more than 100 policies and proposals to cut greenhouse gas emissions across all sectors.

Infrastructure investment provides assets for the long term. Consequently, we plan for long-term trends that affect the nature of the infrastructure needed. The Infrastructure Investment Plan focuses on three core strategic themes for guiding investment decisions in Scotland:

- enabling the transition to net zero emissions and environmental sustainability
- driving inclusive economic growth
- building resilient and sustainable places

As part of the new approach to infrastructure investment outlined in the IIP, a new Scottish Government-wide prioritisation hierarchy will be introduced to support planning and decision-making. We will prioritise enhancing and maintaining our existing assets over new build in order to protect our

environment and ensure value for money. In future, a higher proportion of investment is likely to be directed towards the initial steps in the hierarchy than in previous years. As part of this strategy, we will be addressing backlogs by working towards doubling investment in maintenance and asset enhancement over the next five years.

Our capital plans are set in the context of the need to support our economy to recovery from the shocks caused by both the COVID-19 pandemic and the UK's exit from the EU, whilst driving forward a transition to net zero.

## 4.2 Our medium-term strategic spending priorities

The PfG published in September 2020 committed to:

- a national mission to create new jobs, good jobs and green jobs – with a particular focus on our young people, supporting retraining and investing in our Green New Deal to tackle climate change
- promoting lifelong health and wellbeing – by tackling COVID-19, remobilising and reforming the NHS and social care and tackling health inequalities
- promoting equality and helping our young people fulfil their potential

There is much we wish to achieve within these priorities. The Scottish Government must reach a balanced resource budget, so carefully considered decisions are required and spending will need to be prioritised effectively to maximise impact across multiple outcomes. The section below sets out our strategic spending priorities for the medium term in broad terms, alongside the risks and opportunities they might present. Given the longer-term focus of this document, we have chosen to draw out Climate Change as a separate priority to the ones listed in the PfG, as well as to better reflect our spending priorities for both resource and capital over the medium term.

### 4.2.1 New, good and green jobs

Central to our economic recovery is creating new jobs, good jobs and green jobs – with a particular focus on our young people, as well as supporting retraining and investing in our Green New Deal to tackle climate change.

The economic opportunity for both individual citizens and our communities is obvious – the real risk is not doing enough to maximise the potential of our people.

The Programme for Government highlighted a package of employability and skills support. The draft Scottish Budget has confirmed the continuing priority to support young people and all those affected by the pandemic.

The Scottish Government committed £100m of new investment for employability and skills support. The main focus of this financial support is

the delivery of the Young Person's Guarantee, with other investments being made in redundancy support through the Partnership Action for Continuing Employment (PACE) initiative, a National Transition Training Fund targeting help at those in sectors where there is the greatest risk of job losses. The Flexible Workforce Development Fund in 2020-21 will ensure that both levy payers and SMEs across Scotland can continue to invest in their existing workforce and respond to the impacts of the COVID-19 pandemic.

It is already evident that the pandemic is having a disproportionate economic effect on our young people, reducing job opportunities just as they are starting out in their careers. An additional £60m has been provided for the Young Person's Guarantee which will not only help relieve the current high levels of youth unemployment, it will also serve to support structural reforms in the medium to longer term by preventing the long-term scarring effects and detachment from the labour market usually associated with economic downturns. Evidence from the financial crisis of 2008 illustrated the significant cost of youth unemployment, and its associated scarring effects for public finances.<sup>33</sup>

The National Transition Training Fund will support access to retraining for those aged 25 or over whose jobs are at risk as a result of COVID-19 or who have been made redundant. In addition, Individual Training Accounts (ITA), offer up to £200 to people of all ages who are unemployed or earn less than £22,000 who wish to upskill. We also continue to provide support for individuals affected by redundancy through our PACE initiative. Through providing skills development and employability support, PACE aims to minimise the time individuals affected by redundancy are out of work. We are investing an additional £5 million to scale up and enhance our support for those made redundant.

Investing in our people is also likely to yield longer-term benefits for the public purse. In the short term, the immediate costs of these programmes are likely to be recouped to some extent through lower spending by the UK Government on unemployment related benefits and higher Scottish Income Tax receipts. While the immediate benefit to the Scottish Budget might be limited, investing in skills, infrastructure and innovation, including green technologies, will boost productivity and growth, and ultimately Income Tax receipts, in the longer term. Additionally, unemployment can be a driver of ill-health and other vulnerabilities which drive demand and cost pressures on the wider public purse. There are also wider non-fiscal benefits to people and society of alleviating worklessness for anyone out of work.

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<sup>33</sup> ACEVO Commission on Youth Unemployment (2012), *Youth unemployment: the crisis we cannot afford*, URL: <http://www.bris.ac.uk/media-library/sites/cmpo/documents/youthunemployment.pdf>



Employability plays an essential role in delivering the Scottish Government's aim of tackling poverty, supporting inclusive growth and wellbeing, promoting social justice and creating a fair and prosperous Scotland.

In addition to employability and skills support, a £100m Green Jobs fund will support new and increased opportunities for green job creation across Scotland. This is part of our wider commitment to invest in a net zero economy. The Scottish Government will take advantage of all available tools in pursuing this aim. This will include implementation of the Scottish Green Ports model, driving regional economic growth while creating exemplars of fair work practices and the highest standards of environmental protection. This will support growth and the creation of new, good and green jobs while meeting our ambition to deliver a net zero economy

#### 4.2.2 Promoting lifelong health and wellbeing

Delivery of high quality, timely health and social care services is pivotal to the health and well-being of the nation and requires both significant investment and ongoing reform. Published in 2018, the Scottish Government's Health and Social Care Medium-Term Financial Framework<sup>34</sup> considered drivers of demand growth and the approach to secure financially balanced and sustainable health and care services.

There are three key factors that drive demand growth in health and social care:

- price effects: the general price inflation within health and social services
- demographic change: this includes the effect of population growth on the demand for health and social care services as well as the impact of a population living longer
- non-demographic growth: this relates to demand-led growth, generated by increased public expectations and advances in new technology or service developments, for example, expenditure on new drugs

The Financial Framework showed that over the ten-year period from 2006-07 to 2016-17, NHS expenditure increased by 4.2% year-on-year, while social care expenditure rose by 3.8%.

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<sup>34</sup> Scottish Government (2018), *Health and Social Care: medium term financial framework*, URL: <https://www.gov.scot/publications/scottish-government-medium-term-health-social-care-financial-framework/>

While it is too early to fully assess the impact of COVID-19 on spending trajectories for 2020-21 and beyond, it is clear that the epidemic has caused significant additional costs and impacted on non-COVID-19-related healthcare in order to provide the necessary capacity in the system. Recovering from wider impacts of COVID-19 will take time and will also come with additional costs that create pressures on medium-term spending growth for the sector. Every additional percentage point of spending adds more than £150m in pressure to the health and care budget.

We are currently revisiting the performance and financial assumptions that underpin the Financial Framework. This will set out the anticipated next steps in the financial arrangements for our health and care services for future years, and will provide further detail on our delivery of the outcomes in the PfG and the Scottish Budget for 2021-22.

#### 4.2.3 Promoting equality and helping our young people fulfil their potential

Tackling poverty and inequality is a key priority for this government and underpins our wider ambitions for a fairer and more prosperous Scotland, including our commitment to tackle the poverty-related attainment gap.

As outlined within the most recent child poverty progress report, investment targeted to support households on low incomes reached almost £2 billion<sup>35</sup> in 2019-20. This includes £672 million of spend targeted to support the children living in those households. These estimates do not include the cost of universal services that we all benefit from – including free tuition and free prescriptions.

Social Security is a key responsibility for the Scottish Government. It is an investment in the people of Scotland and provides clear value for money for the public purse. With dignity, fairness and respect at the heart of Scottish social security, we are supporting low income families, young people entering employment, carers, and people facing a bereavement as well as delivering the ground-breaking new Scottish Child Payment for children under six. The latest spending forecast from the SFC projects that spending on the Scottish Child Payment will increase from around £9 million in 2020-21 and is estimated to be around £182 million in 2025-26. This flagship commitment has been described as a ‘game changer’ in the fight against child poverty by anti-poverty campaigners, but it is just one element of the Scottish Government’s anti-poverty strategy.

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<sup>35</sup> Scottish Government (2020), *Tackling child poverty: second year progress report (2019-2020)*, URL: <https://www.gov.scot/publications/tackling-child-poverty-delivery-plan-second-year-progress-report-2019-20/>

Our second Tackling Child Poverty Delivery Plan, to be published in March 2022, will outline the action we will take across 2022-26 to deliver further progress on our ambition to eradicate child poverty.

The demand for spending, both on children and low-income households more generally, will increase in future years in line with the strong recommendation of the Poverty and Inequality Commission stating that “the [child poverty] targets can be met, but ... substantial investment will be required to do so”. This will have to be managed as part of the future Resource Spending Review.

In 2021, Scotland is also introducing the first of the newly devolved disability benefits, the Child Disability Payment. This will be followed by the Adult Disability Payment in 2022. Once our programme of benefits delivery is fully delivered, Social Security Scotland will directly deliver 17 benefits, of which six are completely new forms of assistance. As demand-led payments, these commitments will put increasing pressure on resource budgets over the medium term and additional headroom will have to be identified. Despite this, we are determined to promote a rights-based approach to social security, and to ensure that all those entitled to help will be able to receive it.

#### 4.2.4 A just transition to a green economy

Scotland is taking world-leading action to tackle climate change. We have made several significant, multi-year, capital investment commitments to accelerate our just transition to net zero and deliver a resilient and green recovery from the COVID-19, investing an additional £2 billion over the next Parliament in transformational green infrastructure and investment. Our Climate Change Plan update details the policies and investments which will deliver this acceleration and the opportunities that our transition can capture.

The overall scale of cost is subject to very considerable uncertainty and will be determined to some extent by currently unknowable factors, such as the availability and cost of future technologies and the future actions and investments of UK government and other parts of the economy.

The Climate Change Committee (CCC) is relatively optimistic. In its recent report on the UK’s sixth Carbon Budget,<sup>36</sup> it argues that the net annualised cost for the UK to reach net zero over the period to 2050 will be less than 1% of GDP per year, as the initial upfront investment costs are steadily

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<sup>36</sup> Climate Change Committee (2020), The Sixth Carbon Budget – The UK’s path to Net Zero, URL: <https://www.theccc.org.uk/publication/sixth-carbon-budget/>

mitigated by fuel savings over the longer run. This figure is less than the CCC had previously forecast.

Reaching net zero, and all of the intervening annual emissions-reduction targets, provides substantial opportunities for transforming and enhancing the long-term resilience of the Scottish economy in every year from now until 2045. Targeted in the right way, this spending can also reduce inequality, promote innovation and enhance Scotland's competitiveness.

It is clear that the Scottish Government cannot fund the transition to net zero alone, but will set the conditions for attracting private investment. Businesses and households, along with other parts of the public sector and private investment mechanisms, will need to directly finance a large part of these costs, while ensuring that costs don't fall to households that can least afford it.

This may happen as a result of regulatory changes or, potentially, as a simple result of market-led choices as the costs of low-carbon technologies fall and the cost of carbon is increasingly internalised into prices, for example through the operation of the emissions trading scheme and other carbon pricing mechanisms.

Even where the costs are borne directly by business and households, the role of government remains of central importance, through setting the regulatory and legislative frameworks and the provision of specific and directed funding and investments at key moments and in critical markets in order to generate demand, to kick start new markets and to develop pace and momentum for change that can then be picked up by the private sector.

There is also an opportunity to drive whole system benefits, with Government action providing confidence, which can in turn leverage private investment, encouraging investors to diversify into green technology and innovation. In turn, these investments will create new products, markets and supply chains, all of which create and protect jobs.

The Scottish Government has committed to publishing its private Capital Investment Plan: Investing with Purpose, Scotland's Private Capital Investment Plan. The Plan seeks to align Scotland's strategy to attract internationally mobile private capital investment with the strengths in our economy; and link this explicitly to the recovery and economic transitions towards wellbeing and Net Zero. It responds to the independent Advisory Group on Economic Recovery (AGER) recommendation from Benny Higgins' report to support an investment-led recovery.<sup>37</sup>

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<sup>37</sup> AGER (2020), *Towards a Robust, Resilient Wellbeing Economy for Scotland: Report of the Advisory Group on Economic Recovery*, URL: <https://www.gov.scot/publications/towards-robust-resilient-wellbeing-economy-scotland-report-advisory-group-economic-recovery/>

Private capital is of course deployed in many sectors and assets of the economy, and the purpose of the plan is to set an agenda to optimise its deployment to generate wider spill-over benefits to communities, the environment and the economy. In that context, this plan seeks to support the investment priorities of the Climate Change Plan, the forthcoming Housing to 2040 strategy, and the unfunded needs and opportunities identified through the Infrastructure Investment Plan to mobilise capital to build a future facing economy and to deliver our ambitious targets for climate change.

In 2020, we launched our Green Investment Portfolio which showcases commercial green investment opportunities to investors. Scottish Development International are leading the delivery of this initiative, utilising Scotland's extensive network of global offices.

### 4.3 Medium-term resource expenditure outlook

To help understand the impact of a range of possible fiscal futures for resource expenditure, we have projected forward spend data for health, local government and social security, which together represent around three-quarters of the budget, along with the resource costs of repaying borrowing.

In this document we have not undertaken a scenario analysis for capital spending. In contrast to most resource spending, capital expenditure is mostly 'one-off' expenditure that does not represent an ongoing spending commitment (other than for maintenance). Therefore, capital spending decisions tend to be more flexible and entail fewer medium- to long-term fiscal risks, which are the focus here.

The nature of the devolved funding system means that the Scottish Government cannot set its spending independently of funding, which is largely determined by UK Government spending decisions. The three resource expenditure scenarios shown below are therefore broadly aligned with the resource funding scenarios, given that the Scottish Government has a very limited ability to diverge from its funding settlement through borrowing or mobilisation of the Scotland Reserve. It should be stressed that these scenarios are illustrative only, and not predictions or forecasts.

Health spending accounts for about half of the Scottish budget. This means that decisions on health spending significantly determine the availability of funding for other priorities. Additionally, the government is committed to applying a Barnett uplift (i.e. the addition to the Scottish Block Grant generated by increases in UK spending through the application of the Barnett formula) to the health resource budget for this Parliamentary term.

In the upper and central scenarios, health spending grows in line with the funding growth assumption (5.5% and 4% per annum, respectively),

reflecting the Government's commitment to pass through all health consequentials. However, in the low spending scenario annual health spending growth is only reduced to 3% to capture the unavoidable spending pressures caused by an ageing population.

Communities and local government spending grows by 5.5%, 4% and 2%, respectively, in the three scenarios. A large part of social care spending (which, like health, has shown trend growth of around 4% per annum) is covered by the local government budget. The assumption on the local government budget growth is the same as in the health scenario for the upper and central scenarios and spending is again 'protected' in the lower scenario, albeit at a lower rate of 2%.

Future social security spend is modelled by the Scottish Fiscal Commission (see table C2 in Annex C) and we are committed to fully funding demand-led Social Security benefits and the surrounding administration required to issue them - this spending therefore remains the same in all scenarios. There is of course a possibility that actual spend could differ from the forecast, which is covered in section 4.4.4.

The growth rate for the remainder of the budget is chosen so that overall spending is broadly in line with the funding scenarios - only for the lower scenario a lower bound of 1% growth is applied. Otherwise, this part of the budget would have to be reduced to accommodate the lower funding scenario, given the assumptions on health, local government and social security spending growth.

This means that:

- the upper scenario assumes 5.5% annual growth in health spending, local authority funding and 5.5% annual growth in the remainder of the budget (in line with growth in the upper funding scenario)
- the central scenario assumes 4% growth in health spending, local authority funding and 4% for the remainder of the budget (in line with funding growth)
- the lower scenario assumes 3% growth in health spending (above funding growth), 2% growth local authority funding and 1% growth for the remainder of the budget

Note that that any cost pressures, such as increases in paybills, inflationary uplifts or increase in demand-led provision, must be met from within these budgets. They also include a significant element of non-discretionary spend, including a range of statutory and contractual commitments across frontline services.

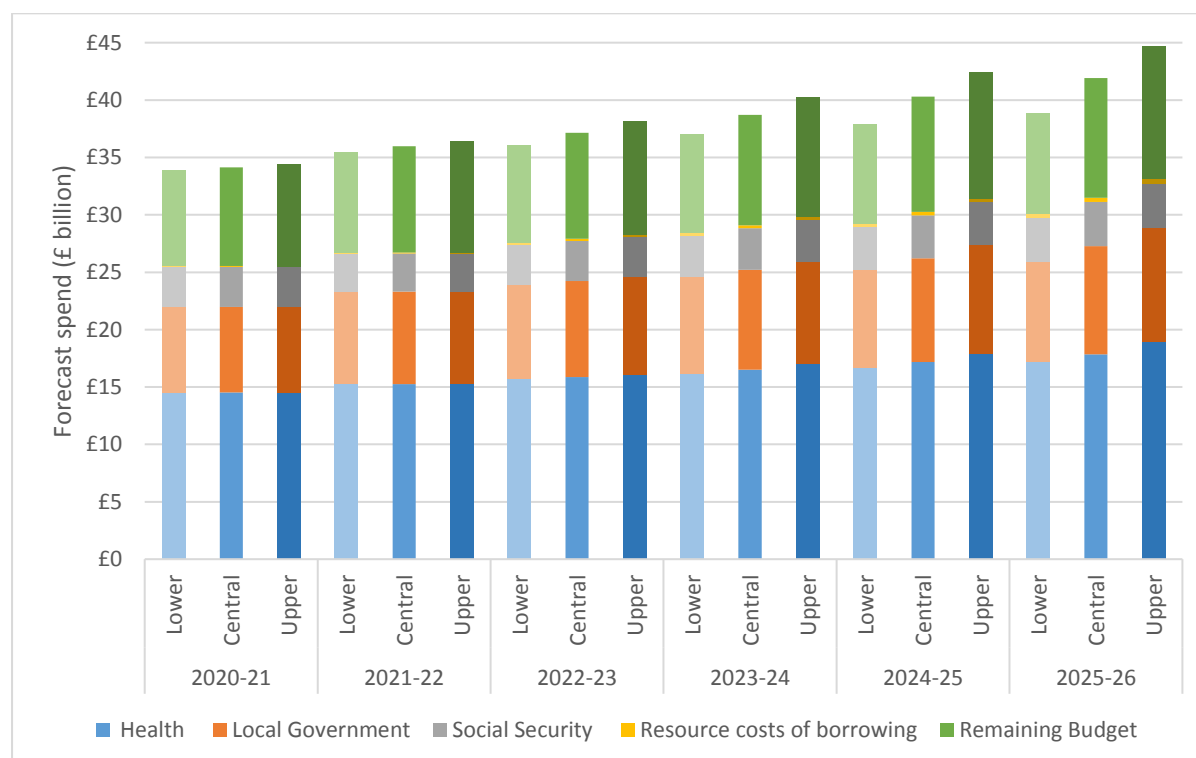


**TABLE 5: ILLUSTRATIVE RESOURCE SPENDING SCENARIOS (£ MILLION)**

	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Upper Range	34,431	36,472	38,129	40,243	42,402	44,660
Central Scenario	34,131	35,972	37,141	38,720	40,295	41,915
Lower Range	33,831	35,472	36,050	37,004	37,917	38,839

Table 5 shows upper, central and lower expenditure scenarios. For 2020-21 and 2021-22 the upper and lower scenarios show  $\pm$ £300m and  $\pm$ £500m short-term uncertainty, respectively, to reflect the extent of active budget management that is always required to accommodate changes in the fiscal situation. The triggering of the conditions of a ‘Scotland-specific economic shock’ results in greater flexibility around the use of the Scotland Reserve and resource borrowing for the 2021-22 budget. This, and one-off increases in 2021-22 are assumed to be unwound in future years.

Figure 2 illustrates the data; for each year there are three stacked bars for each of the three scenarios.

**FIGURE 2: RESOURCE SPENDING SCENARIOS**

For 2020-21 and 2021-22 the upper and lower ranges reflect a relatively small assumption on the uncertainty around:

- extra spending opportunities that may arise due to extra Barnett consequentials late in the year
- in-year underspending
- volatility in demand-led spending like social security or pensions

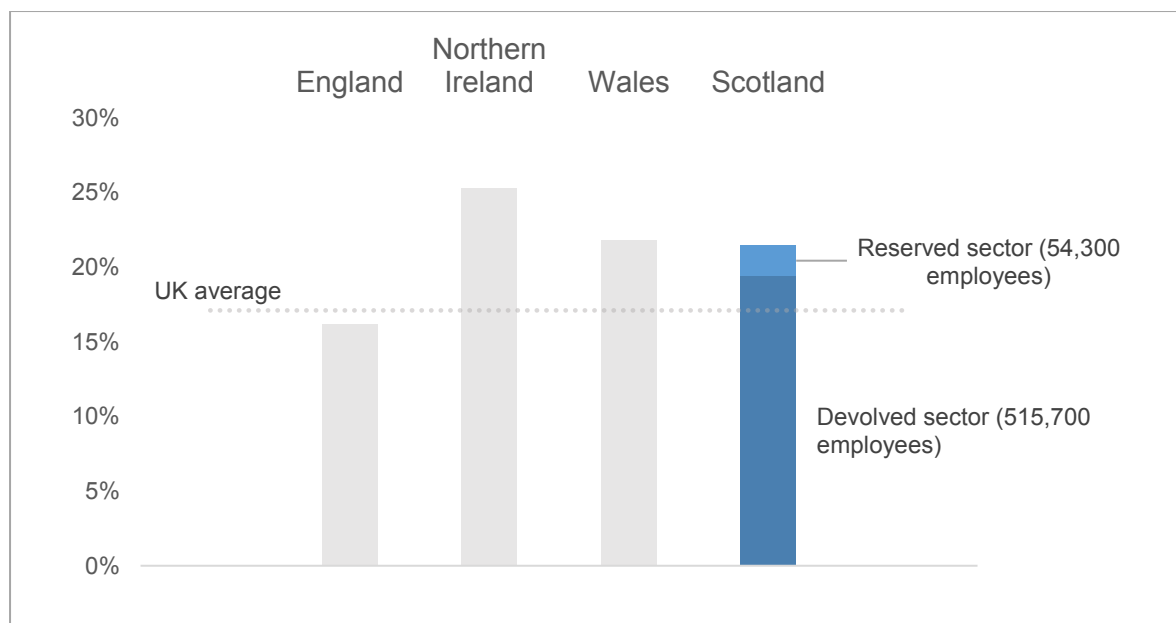
Ultimately, the Scottish Government is required to match spending and funding numbers and deliver a balanced budget by the end of the fiscal year.

#### 4.4 Resource spending risks and pressures

##### 4.4.1 Pay

Pay is a key driver of public expenditure and makes up around half of the Scottish resource budget. As of 2020 Q3, 515,700 individuals, representing around 19% of all Scottish workers, worked in the devolved public sector. The Scottish public sector is proportionally larger than the UK average of 17%, with the average in England being 15%.

**FIGURE 3: PROPORTION OF PEOPLE EMPLOYED BY THE PUBLIC SECTOR; UK NATIONS HEADCOUNT (2020 Q3)**



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

The relative larger size of the Scottish public sector carries with it a greater fiscal risk to the Budget, particularly in the context of the Barnett allocation, which is determined by population share and must be distributed over a comparatively larger workforce. A good example of this was the

changes to employer pension contributions in 2019, part-funded by Barnett consequential with a resulting £110m annual shortfall, in part due to Scotland having a larger workforce.

The Scottish Government pay and reward policies are distinctive, fair and progressive. Fulfilling our commitment on pay restoration, so that earnings for the lowest paid reflect a real terms increase in pay since 2010, demonstrates the value placed on the public sector while generating additional spending power to play a part in Scotland's wider economic recovery. The Scottish Government is also committed to exploring with Trade Unions and employers further opportunities for developing non-pay benefits, such as a shorter working week, as part of shaping the future of work. In the long term, this could be an opportunity to lessen the cost burden of pay awards to employers, act as a lever to improve productivity, optimise the role of automation and digitalisation of services, while creating high value job opportunities and contributing to the wellbeing economy.

In designing our pay policy, we must balance economic, fiscal and social factors. We will need to consider:

- changes to the cost of living (CPI Inflation 0.5% in September 2020)
- trends on private and public sector earnings (recent ONS data indicates a 7% pay premium for the public sector)<sup>38</sup>
- wider unemployment levels (expected to reach 7.6% during 2021, as the job retention scheme ends in April)

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

All of the devolved public sector workforces (including Health, Teachers, Police, Fire and Further Education (FE) Colleges) use the Scottish Government's Public Sector Pay Policy as a reference point and will negotiate new pay deals in 2021-22. The 2021-22 Public Sector Pay Policy is a single-year deal. Other public sector workforces typically follow the approach taken by the Public Sector Pay Policy in making their decisions on

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<sup>38</sup> The modelled average public sector earnings premium is the difference between average earnings of public sector and private sector employees after controlling for worker, job and firm characteristics; and there is greater diversity of workers in the private than public sector. Source: ONS (2020), *Public and private sector earnings: 2019*, [Dataset] URL: <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/articles/publicandprivatesectorearnings/2019>

whether single-year or multi-year deals are most appropriate and offer value for money.

Decisions on pay to support public servants as a result of their efforts in the pandemic will need to be balanced with the demand for funding available to support wider civil society and the economy. The 2021-22 Public Sector Pay Policy was announced alongside the Scottish Budget, continuing the progressive principles of recent years. Specifically, it outlined a 1% basic award supplemented by measures to address low-pay, namely a £750 cash underpin for salaries up to £25,000, the continuation of Scottish Ministers commitment to the real Living Wage of £9.50 per hour, alongside a cash cap of £800 to those earning £80,000 or above.

To illustrate the potential future costs, we have modelled three theoretical public sector pay award scenarios (see Table 6).

**TABLE 6: ILLUSTRATIVE CUMULATIVE PAYBILL COSTS (£ BILLION)**

	Baseline	2021-22	2022-23	2023-24	2024-25	2025-26
<b>Illustration of 1% pay award</b>						
<b>Total</b>	14.8	15.0	15.1	15.3	15.4	15.6
<b>Additional cost including Basic Award</b>		0.15	0.15	0.15	0.15	0.15
<b>Illustration of 2% pay award</b>						
<b>Total</b>	14.8	15.1	15.4	15.7	16.0	16.3
<b>Additional cost including Basic Award</b>		0.30	0.30	0.31	0.31	0.32
<b>Illustration of 3% pay award</b>						
<b>Total</b>	14.8	15.2	15.7	16.2	16.7	17.2
<b>Additional cost including Basic Award</b>		0.44	0.46	0.47	0.49	0.50

Note: This is the cost of the basic award including employer on-costs

#### 4.4.2 Public service pensions – a mandatory workforce cost

Within the UK, policy is largely reserved to Westminster in respect of public service pensions and wholly reserved in respect of state pensions, private sector pensions, and pensions taxation policy. Public service pensions are

both an important element of current and future Scottish Government obligations and a key part of public servants' terms and conditions.

Employer pension contributions are paid on employees' pensionable pay and total costs increase with workforce size. Pension costs are an element of the public sector paybill and are taken into account when assessing affordability of pay deals. Scottish Ministers remain committed to public service pensions which are affordable, sustainable and fair to Scotland's public servants and the communities they serve.

Employer pension contributions, along with the those paid by scheme members, are used to meet the cost of pensions in payment. Scheme cash shortfalls are met through UK Government funding mechanisms (Annually Managed Expenditure or AME) in the case of the NHS and Teachers' schemes, or through Scottish Government resource budget in the case of the Police and Firefighters' schemes.<sup>39</sup>

UK Government decisions on overarching policies, such as the discount rate used to value scheme liabilities as part of quadrennial scheme valuations, affect the Scottish public service pension schemes. For example, when the UK Government announced the 2018 discount rate decrease, which led to increased employer pension contribution rates from 1 April 2019, the annual cost across public sector employers in Scotland was in excess of £500 million. The Scottish Government received Barnett consequentials to cover some of this cost and has provided additional funding itself to help make up the shortfall for employers.

In the medium term, the upcoming round of public service pension scheme valuations – the 2020 scheme valuations – is the next pension event that could change pension costs for employers. The 2020 scheme valuations are likely to include the outcome of HM Treasury's review of the methodology for setting the discount rate (expected in 2021) as well as any changes to the rate itself. The employer pension contribution rates set in 2019-20 will remain in effect until new rates are set and implemented.

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<sup>39</sup> Pension schemes for the civil service and the judiciary are reserved schemes. While employer pension contributions are paid to these schemes in respect of Scottish employees/appointees, scheme cash flow is managed by the Cabinet Office and the Ministry of Justice, respectively, with shortfalls topped up by UK Government-funded AME. The Scottish Local Government Pension Scheme is a funded scheme, managed locally, with some public bodies as participating employers. Member and employer contributions are invested; resulting returns on investment are added to fund assets used to pay pensions.

#### 4.4.3 Ageing is a significant driver of public service expenditure

An ageing population puts increasing pressures on public expenditure, in particular pensions, health and social care. The predominant portion of a person's health care is required in old age and, in particular, the year and months before death. The Scottish population is ageing, with the population share of over 75-year olds increasing from 8.6% in 2020 to 13.2% in 2040. At the same time, as the proportion of working-age population decreases, this means that public services and welfare payments for all need to be funded on a smaller active economy. Equally, as medical research and advancement allow, people are living longer. While this is obviously worth celebrating, it is accompanied by higher and more complex care needs, with the incidence of comorbidity on the rise. While these changes are gradual and not necessarily significant over the period of this MTFs, policy interventions are required early in order to maintain the affordability of health care and the pension system over the long term. For health, this requires both more efficient service delivery as well sustained and concerted action to reduce demand through self-care, prevention and health improvement.

#### 4.4.4 Demand-led volatility risk

Expenditure on social security benefits is variable, being determined by the number of eligible people who apply for support, as well as how successful we are in rightly ensuring that those eligible benefit from this entitlement, all of whom must be paid at the rate set in the policy. We will have to meet this expenditure as it arises, even if it differs from the forecast used to set the Budget initially.

The SFC forecast that social security expenditure will have reached £3.5 billion in 2021-22, and that this will gradually rise to over £4.2 billion by 2025-26. The economic and social impacts of COVID-19 add to the risks for managing benefits expenditure.

Most of benefits expenditure is demand-led and budget allocations for these are based on SFC forecasts rather than spending limits. This introduces in-year volatility to the Scottish Budget. Given the potential for variability, the SFC reported a 2% variation for 2019-20<sup>40</sup>, which if replicated in 2021-22 would be over £70 million, expenditure that will have to be funded by the Scottish Government.

Over 90% of social security benefits expenditure is funded through BGAs, which are based on OBR forecasts of benefit expenditure in England and

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<sup>40</sup> SFC (2020), *Forecast Evaluation Report – September 2020*, URL: <https://www.fiscalcommission.scot/publications/forecast-evaluation-report-september-2020/>



Wales, at the time the Scottish Budget is set. Once outturn data are available, reconciliations are made to the Scottish Budget to ensure that the funding available ultimately corresponds to the BGAs based on the outturn data. If expenditure in England and Wales is ultimately higher than forecast, a positive BGA reconciliation (i.e. an addition) will be made to the Scottish Budget to reflect these changes, and vice versa.

Changes between actual and forecast Scottish expenditure, and the BGA reconciliations, are managed within the Scottish Government's budget management processes, in line with the principles and policies on the use of borrowing and reserve powers as set out in Chapter 5. Further information on the BGAs and reconciliations is set out in Annex C.

The Scottish Government will continue to manage any variance between actual and forecast expenditure or BGAs, in a competent, responsible and balanced way as part of the annual budget process, in line with the principles and policies set out in the MTFS.

#### **4.5 Approach to a Resource Spending Review**

In setting the annual budget each year, the Scottish Government has to make careful choices in the prioritisation of commitments and expenditure in order to reach a balanced budget position, taking into account the key demand pressures set out above.

The UK Government has indicated it will undertake a multi-year Spending Review later this year addressing spending from 2022-23. Building on the forthcoming Scottish multi-year Capital Spending Review, it will be the role of a Scottish Resource Spending Review and/or future Budgets - after the 2021 Scottish Parliament election - to balance the spending ambitions of the new Scottish Government within its fiscal constraints.

As in previous years we will explore a wide range of options, including:

- looking to deliver efficiency savings across portfolios including through the use of digital technology
- prioritising expenditure to ensure that there is a clear line of sight from spend to our core purpose and National Outcomes and the priority to build back fairer and stronger from COVID-19
- looking to build on the learning from the response to COVID-19
- identifying options to reduce demand in the longer term through early intervention
- considering options for public service reform to allow us to protect the delivery of public services at a time of continuing financial restraint
- options for generating additional revenues (beyond taxes)

Fiscal sustainability, value for money and an outcomes-focus will underpin the approach – keeping a clear line of sight from spending decisions to the Government’s Purpose and the National Outcomes in order to drive a fair and strong recovery from COVID-19 and to re-set progress towards meeting our statutory commitments on child poverty and climate change.

The final framework and timing for the spending review will be a decision for the new administration following the Scottish Parliament election in May 2021. A number of new spending commitments will likely follow from manifestos and difficult decisions will have to be made to create the financial “headroom” necessary to fund these commitments. Initial work is starting to consider how officials can provide support to the new administration to make progress on this work.

## 5. Managing fiscal risks – current powers and options for change

This section brings together the funding and spending scenarios set out in previous chapters and discusses the different sources of fiscal risk that need to be managed and our ability to manage them with available fiscal tools.

The chapter outlines the current fiscal levers available in terms of budget management tools, borrowing powers and devolved taxation powers. It also discusses the forthcoming review of the Fiscal Framework and the potential this brings for increased flexibility and localised ability to manage fiscal risks.

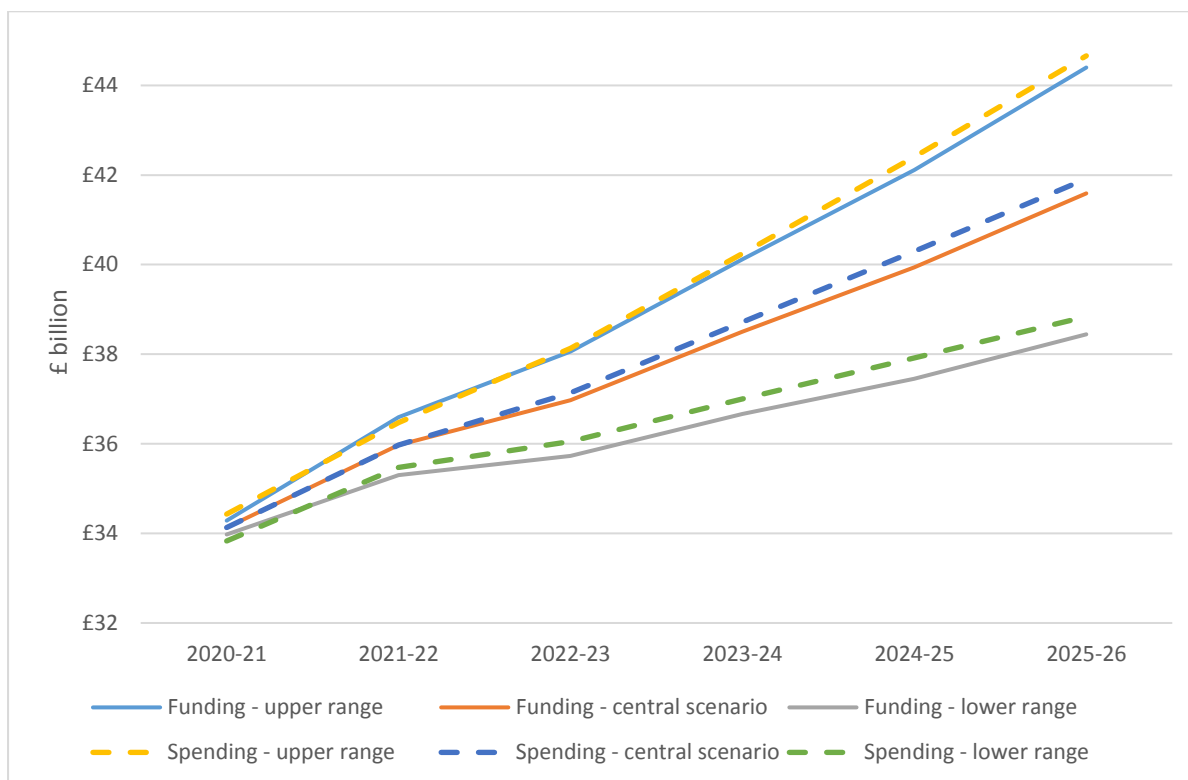
The current devolved funding arrangements have clear limitations in terms of managing risk, particularly in the face of economic shocks precipitated by COVID-19. It is the Scottish Government's view that the forthcoming Fiscal Framework Review should include greater fiscal flexibilities, alongside the devolution of further tax powers to Scotland, which would enhance Scotland's fiscal levers, enabling us to maintain and expand the tax base, raise devolved tax revenues and support the delivery of a prosperous and green recovery. This chapter provides an outline of a strategic set of tax powers that could be further devolved which adhere to the Scottish Government's principles of taxation and would better enable tax to serve the people and businesses in Scotland. Although the further flexibilities triggered by the 'Scotland-specific economic shock' provision of the Fiscal Framework are welcome, they are a temporary measure that fall short of the scale of flexibilities required to manage budgetary volatility.

The Scottish Government operates within a tight Fiscal Framework, with limited fiscal powers. Figure 4 below shows how the funding and spending scenarios compare, and illustrates the considerable fiscal uncertainty, even in the short term.

On the funding side, in-year consequential arisings from UK spending decisions, in-year reconciliations of devolved taxes as well as tax and social security BGAs create volatility that needs to be managed by the Scottish Government. The future budget trajectory is uncertain due to the delay to the UK Budget for 2021-22 and no lack of Spending Review settlement for subsequent years.

On the spending side, under- or overspending on budgets is a risk that requires constant management. Demand-led social security spending is a source of substantial uncertainty. These short-term volatility risks arise because the forecasts on which the budget is based can never fully reflect the contingencies occurring in real time. The Scottish Government's financial management needs to be extremely nimble to accommodate these contingencies, with limitations on the use of our Reserve and without having access to any sizeable borrowing facilities.

FIGURE 4: FUNDING AND ILLUSTRATIVE SPENDING SCENARIOS



The medium-term outlook for both our budget and our spending priorities, set out in the previous sections, depends heavily on the success of the COVID-19 vaccination programme and the degree of long-term economic scarring inflicted by the COVID-19 pandemic, as well as the on-going risks around the UK's trade relationship with the EU.

The illustrative central and upper spending scenarios are chosen to broadly mirror the funding scenarios, reflecting the current commitment to apply all health consequentials to the health budget and the given limits in the current Fiscal Framework on diverging in any significant degree from the funding envelope.

The lower illustrative spending scenario represents a significant reduction in spending growth in all portfolios, but still exceeds the lower funding scenario, where the Block Grant grows more slowly and the net tax position deteriorates. If the lower funding scenario became reality it would require a drastic re-prioritisation of budgets in order to achieve budget balance.

TABLE 7: SUMMARY OF KEY SHORT-TERM RISKS TO FISCAL SUSTAINABILITY

Risk	Mitigation
<p><b>In-year volatility caused by UK spending decisions</b></p>	<p>The devolved administrations in the UK are internationally in a unique position in having to manage such in-year volatility risks.</p> <p>The Scottish Government can use draw-downs and carry-forwards through the Scotland Reserve as well as reprioritising spending to manage this risk. However, it cannot use resource borrowing and the limits on the available powers are so restrictive that it is impossible to guarantee the ability to fully control for unpredicted UK budget decisions.</p>
<p><b>In-year volatility caused by forecast “error”</b></p>	<p>Forecasts are updated at various points in the year, which helps us understand the size of the volatility and put management measures in place. The Scottish Government can, subject to given limits, use resource borrowing and the Scotland Reserve to manage transitory volatility. Forecast reconciliations are sometimes in excess of the usual annual £300 million borrowing limit.</p>
<p><b>In-year revenue volatility caused by change in economic circumstances</b> (linked to forecast risk)</p>	<p>A large portion of devolved revenue is directly related to Scotland’s economic success. The economic contraction caused by COVID-19, for example, has led to reductions in Income Tax revenue.</p> <p>This risk is mitigated through the operation of the Fiscal Framework – as long as Scottish and UK revenues change in the same direction - so that changes in Scottish revenues and the corresponding BGAs cancel each other out, to a larger or smaller degree.</p>

TABLE 8: SUMMARY OF KEY MEDIUM- TO LONG-TERM RISKS TO FISCAL SUSTAINABILITY

Risk	Mitigation
<p><b>Reduction in Block Grant growth caused by UK spending decisions</b></p> <p>A key downside risk to the Scottish Budget over the medium-term – if the UK Government decides to consolidate public finances in the wake of COVID-19</p>	<p>The Scottish Government can make use of its limited reserve and borrowing powers to smooth the budget trajectory but that limits the ability to use those instruments for in-year volatility management.</p> <p>In the long term, affordability of spending is largely driven by UK Government decisions and spending, or taxes have to be adjusted to ensure that the Scottish fiscal position remains in balance.</p>
<p><b>Structural differences in UK and Scottish growth performance</b></p> <p>Scotland’s exposure to global commodity markets, in particular the oil price, is relatively greater and there are differences in the sectoral composition of the Scottish and UK economies</p>	<p>Our economic policies are the key long-term mitigation to ensure sustainable and robust economic growth and strong revenues. This means effective economic policies to enhance productivity and competitiveness in line with the principles of the Government Economic Strategy.<sup>41</sup></p> <p>At this point, we do not believe there is a fundamental difference in growth performance between Scotland and the UK, although the different sectoral composition poses a risk in the medium term (see Annex B). Such divergences should be sufficiently reflected in the budget forecasts, allowing for timely budget planning.</p>
<p><b>Structural differences in UK and Scottish tax base</b></p> <p>Differences in the composition of the tax base can pose a risk to the Budget, in particular if economic growth and earnings growth is unequally distributed (see Annex B for details)</p>	<p>This risk can be mitigated through changes to the Fiscal Framework.</p> <p>There is a risk that the current BGA mechanism puts Scotland at a permanent disadvantage and this issue should be reviewed as part of the Fiscal Framework Review.</p>

<sup>41</sup> Scottish Government (2015), *Scotland’s Economic Strategy*, URL: <https://www.gov.scot/publications/scotlands-economic-strategy/>

<p><b>Pay agreements are a key driver of public sector costs and spending</b></p>	<p>The Scottish Government's pay and reward policies aim to balance fairness and affordability, informed by dialogue with trade unions, alongside workforce planning that focuses on priorities</p>
<p><b>Demand pressures caused by an ageing population</b></p> <p>The fiscal pressures of an ageing population are most apparent in our health and social care system</p>	<p>We have committed to maintaining funding growth for health and social care at comparatively high levels. Nonetheless, we need to maximise the opportunities to mitigate the fiscal pressures.</p> <p>Driving down demand on the health system through public health improvement and prevention is a key element not only in improving people's health for better outcomes but also in managing the financial risks of health demand pressures.</p> <p>We continue to shift the balance of care towards mental health, and to primary, community and social care. We know that in many circumstances outcomes improves and fewer interventions are required when care is delivered in a community setting.</p>

### 5.1 Current levers for managing volatility and risk

The Fiscal Framework provides the Scottish Government with limited reserve and borrowing powers. In the usual operations of the Fiscal Framework, the Scotland Reserve is limited to £700 million, with an annual drawdown limit of £250 million for resource and £100 million for capital. This year, the 'Scotland-specific economic shock' provision means that there is no drawdown limit for the Reserve. The total limit for resource borrowing is £1.75 billion and the usual annual limit for its most likely use – forecast error under the Fiscal Framework – is £300 million per year. This year, due to the triggering of the 'Scotland-specific economic shock' provision of the Fiscal Framework, the annual borrowing limit is raised to £600 million. The total limit for capital borrowing is £3 billion with annual borrowing limited to £450 million.

It is worth stressing that the Reserve is the only mechanism for the Scottish Government to retain underspent funds for future years. The limitations on the use of the Reserve and the continual change in forecasts mean that it is neither feasible nor desirable for the Scottish Government to build up substantial balances in the Reserve. If the Scottish Government intentionally underspent its budget to carry forward funds to future years,



there is a significant risk that the limit would be breached and therefore these funds would be lost permanently. Within these limitations, the Scottish Government uses the following guidelines when managing the budget.

#### 5.1.1 Scotland Reserve policy

We will use the Scotland Reserve to prioritise any anticipated underspends for use in the subsequent financial year. This reflects the risk of funds being lost to the Scottish Government should excess underspends emerge in the provisional and final outturn process.

We want to ensure that the Reserve is built up using excess tax receipts or additional underspends emerging from the Provisional Outturn and Final Outturn Processes.

Our aim is to ensure that excess funds in the Reserve will be used as far as possible to smooth resource funding over time, to achieve a stable spending trajectory. However, this may be balanced against urgent and more immediate requirements such as funding COVID-19 emergent needs.

#### 5.1.2 Resource borrowing policy

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

Our resource borrowing powers will be used in a way that balances the principles of flexibility, stability and value for money.

The Scottish Government will assess all planned resource borrowing decisions to smooth the funding trajectory over five years. In order to promote budget stability and maintain flexibility in the Reserve, Scottish Government budgets will assume full borrowing against known and/or forecast Income Tax reconciliations. Any in-year volatility will be managed within the resulting overall budget envelope.

It is important to stress that this resource borrowing power can be used only for cash management and forecast error under the Fiscal Framework – it cannot be used to support additional Scottish Government borrowing in response, for example, to COVID-19.

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

Conversely, there are considerable risks related to forecast error, economic shocks and funding outlooks, depending on UK Government decisions. The resource borrowing powers do not address these sufficiently.

All of this means that the current Fiscal Framework does not meet the guiding principles set out by the Smith Commission in ensuring that the Scottish Government has the tools and powers to manage funding volatility, particularly on forecast error.

### 5.1.3 Capital borrowing policy

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

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

The 2019-20 Budget sets out the baseline for the NIM in 2019-20 of £5.2 billion, which will increase by £1.56 billion by the end of the next parliament in 2025-26. In order to achieve this increase in investment, capital borrowing will be required as part of a combination of funding sources that also include capital grant, financial transactions and alternative revenue-finance models, including private finance.

The National Loans Fund currently remains the preferred source of capital borrowing. Given the medium term impact on resource costs, this remains the optimum compromise between value for money, resource cost impact and maximising the use of the Fiscal Framework limits.

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

The Scottish Government will ensure that a minimum of £300m capital borrowing headroom will be available to be drawn down in the year following the period covered by the NIM (2026-27). This is a small adjustment to the borrowing policy first set out in the 2019 MTFS,<sup>42</sup> and is required to help us manage the impact of the higher degree of fluctuation we are now experiencing in UK funding. For example, the capital budget

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<sup>42</sup> Scottish Government (2019), *Scottish Government's Medium Term Financial Strategy: May 2019*, URL: <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/>

was reduced by around 5% between 2020-21 and 2021-22, including a fall of around two-thirds in Financial Transactions allocation.

Over the period of the NIM, our policy is to borrow between £250 million and £450 million annually to ensure that there is sufficient investment planned to support economic growth, and that investment increases overall year-on-year.

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

#### 5.1.4 Existing powers are too limited

It has been clear for some time that the scale of potential forecast error under the Fiscal Framework exceeds the level of flexibility provided by these powers.

The most obvious and initial problem is that the limits on Scottish Government borrowing and reserve flexibility have been fixed since the Fiscal Framework was agreed. Since the scale of the economy and tax revenues increase over time, the Scottish Government's practical ability to manage risk has therefore been effectively eroded each year.

However, even if the limits had been adjusted over time, they would still have been insufficient to adequately allow the Scottish Government to manage the volatility inherent in the forecasting process.

In order to assess the adequacy of the resource borrowing powers, we have developed a framework for analysing the impact of forecast error on the expected reconciliation, full details of which can be found in Annex A. Even using relatively conservative assumptions, there is up to a 1 in 6 chance that purely on Income Tax, and not including the other devolved taxes and social security benefits, the Scottish Government would face funding volatility as a result of forecasting error that the current powers could not deal with.

The SFC have also undertaken a similar analysis, set out in their recent forecasts. Although they have a slightly different approach, they also find that Income Tax reconciliations are likely to exceed Scottish Government borrowing powers on a somewhat regular basis, potentially as frequently as four times every ten years depending on the assumptions made.

The current Fiscal Framework therefore does not meet the guiding principles set out by the Smith Commission in ensuring that the Scottish Government has the tools and powers to manage the inherent funding volatility generated by the use of forecasts in our Budget process. The review of the Fiscal Framework is a key opportunity to remedy current shortcomings and enable the Scottish Government fully to manage the fiscal risks it faces.

## 5.2 The need for a robust, comprehensive and timely review of the Fiscal Framework

The Fiscal Framework Agreement states that a review of the Fiscal Framework should be undertaken by the Scottish and UK Governments after the Scottish Parliament elections in 2021, and that this will be informed by an independent report which will be presented to both governments by the end of 2021.

Given the significant changes in the political and constitutional landscape in the years since the agreement was made, and the recent and ongoing experience of COVID-19, the Scottish Government considers that the review, and the independent report which informs it, should take place as quickly as possible, and should be robust and comprehensive. However, as the arrangements for the review depend on joint agreement with the UK Government, we rely on their commitment to achieve this ambition.

The Scottish Government will continue to engage in good faith and set out a clear vision of what it wants the review to achieve. This will include arguing that the scope of the review, and the independent report which informs it, should be wide-ranging. It should consider not only how the Fiscal Framework has operated to date, but whether there is an appropriate balance between the risks to which the Scottish Budget is exposed, and the levers that the Scottish Government has to manage those risks, particularly in light of the COVID-19 pandemic.

It should ensure that the funding arrangements are fair, that budget volatility is minimised and that the Scottish Government has the powers and flexibility needed to manage the risks that we face and to support economic recovery in the years ahead.

Views from stakeholders other than the two Governments should be an integral part of the process, and the review should build on the issues identified in the joint working group report between the Scottish Government and the Scottish Parliament's Finance and Constitution and Social Security Committees.<sup>43</sup>

In particular, it is clear that the following topics should be considered as a minimum:

- **VAT, Income Tax and further tax powers** – extensive work has established a number of intrinsic difficulties with the VAT assignment

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<sup>43</sup> Scottish Parliament Finance and Constitution and Social Security Committees and Scottish Government (2020), *The scope and terms of reference for the independent report and review of the Fiscal Framework*, URL: [https://www.parliament.scot/S5\\_Finance/General%20Documents/Report\(2\).pdf](https://www.parliament.scot/S5_Finance/General%20Documents/Report(2).pdf)

methodology. As part of the Fiscal Framework review the two Governments should work together to determine whether the devolution of full VAT powers would present a better tool to protect and develop Scotland's fiscal self-sufficiency and resilience. This should take place as part of a wider review of the tax powers currently devolved, identifying further powers that would make the tax system work more efficiently in Scotland, and serve the people and businesses of Scotland more effectively. More detail is set out in sections 5.3.2 to 5.3.5.

- **BGA mechanism** – we need to ensure that this delivers a fair funding outcome for Scotland, and that there is an appropriate balance between risks and ability to manage them.
- **Volatility risk and budget management tools** – our budget management tools need to be sufficient to manage the volatility inherent in the Fiscal Framework.
- **Capital borrowing** – supporting economic growth through infrastructure and investment is important now more than ever. There is a clear case for increased capital borrowing powers and we should also re-examine the merits of a prudential borrowing regime as recommended by the Smith Commission.
- **Policy risks** – as set out earlier in this document, UK fiscal and policy decisions have profound effects on our own policy decisions, revenues and expenditure, and the economy in Scotland more widely, and within the existing framework these have presented a number of fiscal and policy constraints. The review must consider how to minimise any friction between both governments tax and social security regimes, including through better policy co-ordination, to ensure that the Scottish Government has maximum flexibility in its policy choices and ability to manage the impacts of UK policy choices through the Fiscal Framework and vice versa.

### 5.3 Devolved and reserved tax powers – responding to fiscal challenges

Under the current devolution settlement, the vast majority of tax powers remain reserved to the UK Parliament. The Scottish Parliament has limited levers to enable the Scottish Government to make the tax decisions necessary to protect and grow the Scottish economy, to facilitate the efficient operation of devolved policies and to effectively mitigate some of the fiscal risks set out in tables 7 and 8.

COVID-19 has emphasised the limitations of Scotland's devolved tax powers in responding to economic shocks. Scottish tax revenues are still highly dependent on decisions taken by the UK Government, and reserved tax policy can have significant impacts on devolved tax policy, for example the

partial devolution of Income Tax. More robust and extensive tax powers are essential for the Scottish Government to support an economic recovery which delivers a fairer, greener, and more prosperous Scotland, thereby addressing possible structural fiscal risks. Indeed, the case for additional fiscal powers has been supported by a number of stakeholders who responded to the Scottish Government's consultation on Supporting the COVID-19 Recovery.<sup>44</sup>

Where the Scottish Government does have the devolved tax powers to act, it has done so quickly and decisively:

- To assist homebuyers and support Scotland's housing market following the outbreak of COVID-19, the nil-rate band for residential LBTT was increased to £250,000 until the end of March 2021 and the time available in which to sell a previous main residence and claim a repayment of the Additional Dwelling Supplement was doubled for the most affected taxpayers
- To support businesses affected by COVID-19, additional reliefs were introduced to non-domestic rates as part of a comprehensive package of measures worth nearly £3 billion

It is evident, however, that the relationship between devolved and reserved powers creates the need for robust intergovernmental processes and governance structures to marshal the split and interplays of tax policy between the UK and Scottish Governments. We call on the UK Government to ensure that the impacts and consequences of UK tax changes, including on devolved revenues, are considered across the tax policy landscape in Scotland, with appropriate systems in place for collaborative policy development, consultation and advance notice. All of which is in the clear mutual interest of the UK and Scottish Governments, and would help to support the economic recovery from COVID-19.

### 5.3.1 Threats and opportunities in relation to the tax base and performance

COVID-19 will precipitate significant changes in the economy and the way we lead our lives in the short and long term. As we recover from the pandemic, and face other challenges in the future, such as the climate emergency, the opportunities for more effective tax policy in Scotland must be seized, alongside ensuring the risks to devolved tax revenues are managed.

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<sup>44</sup> Scottish Government (2021), *Budget 2021/22: Supporting the COVID-19 Recovery - Analysis of Consultation Responses*, URL: <https://www.gov.scot/publications/budget-2021-22-supporting-covid-19-recovery-analysis-consultation-responses/>



In the medium term there will be new economic opportunities through technological advances and a re-balancing of the economy towards growth sectors. The workforce of the future will be more mobile than ever before, as some workers are no longer physically bound to their place of work, and flexible work arrangements bring new people into the labour force, such as working mothers. Our social contract, which offers the widest range of public services available in the UK, will be more important than ever before in helping to attract people from across the world to live and work in Scotland, and thus widen the tax base.

The COVID-19 pandemic has emphasised the need to tackle the challenges that existed before the outbreak, and will persist in our recovery. Our future tax system will need to support: a green recovery; financially balanced and sustainable health and care services; and enhance innovation and investment in Scotland which helps businesses recover and embed Scotland's international attractiveness to live, work, study and invest in.

### **Non-Domestic Rates (NDR)**

The Non-Domestic Rates (Scotland) Act 2020 delivered a number of reforms recommended by the independent Barclay Review of Non-Domestic Rates<sup>45</sup> and was given Royal Assent on 11 March 2020, the same day that COVID-19 was declared a global pandemic by the World Health Organisation. As a tax on non-domestic property, Non Domestic Rates (NDR) has traditionally offered a stable source of revenues to the Scottish Government.

From the outset of the pandemic, the NDR system has been central to the Scottish Government's business support response, with over £1.9 billion of immediate support provided through a combination of COVID-specific reliefs and grants administered on the basis of property data held on the valuation roll. At the same time, as a tax based primarily on the occupancy of non-domestic properties, COVID-19 has struck right at the heart of the NDR tax base. Since the beginning of the pandemic, in the region of 40,000 to 50,000 Material Change of Circumstance (MCC) appeals have been lodged. These appeals are claiming there has been a change of circumstance that warrants a change in the rateable value of a given property. Any impact of these appeals on future revenues would likely manifest during coming years, but at this stage any risks to public finances are unquantifiable. The Scottish Government is working closely with the UK Government to understand the potential risks to both Scottish and UK-wide public finances, and the implications of these.

In order to provide some certainty both to ratepayers and to the public finances, the Scottish Government has taken the decision to delay the next

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<sup>45</sup> Barclay (2017), *Non-domestic tax rates review: Barclay report*, URL: <https://www.gov.scot/publications/report-barclay-review-non-domestic-rates/>



NDR revaluation by one year from 1 April 2022 to 1 April 2023, based on rental values one year earlier (1 April 2022). Prior to this decision, the default date for the next revaluation was 1 April 2020, and this would have delivered rateable values at the next revaluation that would have reflected pre-COVID conditions. The Scottish Government remains committed to three-yearly revaluations as recommended by the Barclay Review, but the decision to delay the revaluation will provide more opportunity for the commercial property market to stabilise following the pandemic and increase the likelihood that the revaluation process will deliver accurate rateable values in line with the Barclay Review's desire to promote stability and avoid economic shocks.

### **Income Tax**

As the devolution of tax powers is a relatively recent concept and Income Tax outturn data is only available with a significant lag, data on Scotland's historic Income Tax performance is limited and so far only covers 2017-18 and 2018-19. This means that our understanding is constantly evolving as more evidence becomes available. Looking ahead, Scotland's relative tax performance will depend on a number of factors, most importantly growth in income and employment.

If the Scottish economy is more severely impacted by, or takes longer to recover from, the effects of COVID-19 and Brexit, our relative Income Tax performance will suffer. In particular, Scotland's Income Tax performance is more exposed to any drop in the global oil price. This is exacerbated by differences in the way that the economy, and therefore the Income Tax base, is structured in Scotland compared to the rest of the UK. For example, the way that the BGA currently works means that the Scottish Budget is worse off if higher earners see relatively stronger earnings growth than other taxpayers, due to Scotland's relatively lower proportion of high income earners.

### **Land and Buildings Transaction Tax (LBTT)**

For LBTT, COVID-19 and overall levels of economic activity may impact on the nature of the demand for both residential and non-residential property. This could mean changes in the current housing market property type sales mix, in the demand for commercial property and the geographical distribution of LBTT revenues. For example, if future property price trends for houses and flats, or for rural and urban areas, diverge from current trends then the make-up of LBTT revenues across Scotland will also change. Alongside this, any changes in terms of the willingness of the financial sector to lend to individuals requiring mortgages would impact on LBTT. UK House Price Index data shows that in the 12 months to August 2020, 68% of residential property transactions in Scotland required a mortgage to support the purchase.

### Scottish Landfill Tax

Scottish Landfill Tax revenues will, as intended, reduce significantly in the run up to the ban on landfilling of biodegradable municipal waste on 31 December 2025 and beyond. In that context, key issues over the next five years will include the extent to which new incineration capacity comes on stream and its timing, the location of that capacity and overall levels of economic activity in Scotland.

Mitigating the risks to devolved tax revenues and their tax bases will be vital. We will work across the Scottish Government to ensure Scotland's devolved tax base is protected, and where possible broadened, to help pool risk more effectively and support public services. This will be influenced by measures beyond tax policy, such as efforts to tackle unemployment, supporting the creation of high-value Scottish jobs, and attracting those around the world to bring their skills and talent and make Scotland their home to live, work and study.

#### 5.3.2 Exploring further tax powers for Scotland

Tax policy is fundamental to any nation's ability to protect its economy and rebuild after a period of crisis. The time is right to consider the devolution of additional tax powers to Scotland: we are beginning the recovery from a major global economic and social shock and the UK has left the European Union. The Fiscal Framework Review provides a prime opportunity to consider further tax powers in a wider and more strategic context, and we will press the UK Government to agree to include such powers within the scope of the Review.

The Scottish Government considers that, ultimately, all tax powers should be transferred to Holyrood. Increased tax powers would enable the Scottish Parliament to tailor taxation to reflect the Scottish economic and social context. We recognise that additional tax powers would bring risks alongside opportunities: we are confident that accepting these risks will be worthwhile in return for additional levers to promote economic growth. Provided further tax powers are accompanied by adequately flexible fiscal levers and balancing borrowing powers, we believe that they would enhance our ability to manage and mitigate fiscal risks.

We will consider as a priority the powers needed to resolve the existing technical and policy problems in the current tax system, and to bring balance to the Scottish Budget. This includes the devolution of full Income Tax powers and VAT powers, alongside other taxes which form a coherent package with these powers, for example Capital Gains Tax.

**BOX 3: AIR DEPARTURE TAX AND AGGREGATES LEVY**

The Scotland Act 2016 provided for the devolution of UK Air Passenger Duty (APD) and the Aggregates Levy.

The Air Departure Tax (Scotland) Act 2017 made provision for Air Departure Tax (ADT), the replacement for APD in Scotland. Introduction of ADT in Scotland has however been deferred to allow the issues raised in relation to the Highlands and Islands exemption to be resolved. The UK Government will maintain the application of Air Passenger Duty in Scotland in the interim. The Scottish Government remains fully committed to introducing ADT and will work with stakeholders and with the UK Government to find a solution for aviation that remains consistent with our climate ambitions.

Following the resolution of outstanding state aid issues related to the UK Aggregates Levy and the conclusion of a UK Government review, the Scottish Government will take forward work to allow for the future introduction of a devolved levy in Scotland. We will work closely with stakeholders to consider policy options and develop the necessary evidence base to support this, building on the research published by the Scottish Government last year. However, it will be for the next Scottish Parliament to consider the legislation that would be required to provide for a levy in Scotland.

### 5.3.3 VAT assignment and VAT devolution

The Scotland Act (2016) provides for receipts from half of the VAT raised in Scotland to be assigned to the Scottish Budget (known as VAT assignment). VAT assignment had been expected to commence with effect from April 2021, with full fiscal impact in the Scottish Budget for the year 2021-22.

Due to the current economic climate, in particular the impact of COVID-19, the Scottish Government has agreed with HM Treasury to delay implementation of VAT assignment until the Fiscal Framework Review. To ensure robust and prudent fiscal management, it is our belief that we must avoid introducing a new element of unpredictable volatility to the Scottish Budget at this time.

We will seek to agree with the UK Government that the Fiscal Framework Review presents a valuable opportunity to revisit the Scottish fiscal settlement in its entirety. This would include consideration of whether other options, including the full devolution of VAT powers, would allow us to set tax policies and adopt the fiscal levers which are meaningful and appropriate to the Scottish context.

When VAT assignment was initially devised by the Smith Commission in 2015, the ambition was to increase Scottish revenues as a proportion of the Scottish Budget, but full devolution was not possible due to EU rules. Following the end of the EU Exit transition period, full devolution is now a practical possibility and we believe it to be considerably more advantageous than the assignment method considered in 2015, it would provide us with funding, based on actual expenditure in Scotland, rather than purely an accounting mechanism, based on survey data, to transfer funding.

The Scottish Government understands the vital importance of stability and certainty for businesses. Therefore, simplicity and predictability must be core to all Scottish tax policy making after the devolution of any such powers. Crucially, if the Scottish Parliament did have the ability to control VAT levers, this would present an opportunity to tailor our arrangements to better suit the needs and circumstances of Scottish businesses and consumers.

#### 5.3.4 Full devolution of powers over Income Tax

The Scottish Parliament currently has the power to set the rates and bands that apply to non-savings, non-dividend (NSND) Income Tax in Scotland (i.e. income from employment, self-employment, pensions, and property). The taxation of savings and dividend income remains reserved to the UK Government, as does the responsibility for defining the Income Tax base, which includes the tax reliefs and exemptions, including the tax-free Personal Allowance.

Since 2017-18, we have used our current powers over Income Tax to create a fairer and more progressive tax system in Scotland, protecting lower income earners whilst raising revenue to support investment in our public services and economy. In 2018-19, we introduced a new five-band structure for Income Tax. Outturn data published by HMRC in September 2020 shows that in 2018-19, Scottish Income Tax raised £119m more than the corresponding BGA, largely due to these tax policy reforms. We will publish a more detailed evaluation of our 2018-19 Income Tax reforms in the summer of 2021.

We have demonstrated that we have used our powers over Income Tax in a balanced and responsible way. Full devolution of powers over Income Tax would provide the Scottish Government with the full set of levers to respond to current and future economic challenges. It would allow the Scottish Government to design policies that better meet the needs of individuals and businesses in Scotland, that reflect our fairer and more progressive approach to taxation, and that tackle the aggressive forms of tax avoidance and evasion that still exist within the tax system.

We know that this would not come without challenges. The taxation of dividends is particularly volatile, and the continued uncertainties of having low interest rates pose a risk to revenues from savings taxation, certainly in the short term. Devolution, however, would provide an opportunity to improve the sustainability of these revenue streams.

### 5.3.5 Other reserved tax powers

We know that the devolution of certain reserved powers would create new challenges and interactions between the UK and Scottish tax systems. Therefore, as part of our preparation for the Fiscal Framework Review, we will consider other UK tax regimes that align closely, in policy or technical terms, with devolved policy powers and ambitions. This will entail a holistic review of the opportunities and challenges presented by each of the major existing reserved taxes.

For example, we know that both National Insurance Contributions and Capital Gains Tax have a close relationship with Income Tax and it is appropriate that we scrutinise how these could improve and protect the impact of Scottish Income Tax policy.

Capital Gains Tax is also a crucial lever in the taxation of wealth, and its design is skewed by the relatively higher values of assets in the South East of England. Devolution of this regime would allow us to tailor the policy as it applies to taxpayers in Scotland and ensure it operates as efficiently as possible.

## 6. Conclusion – an opportunity for renewal

As we emerge from the greatest economic shock of our lifetime, it is essential that fiscal rules do not unduly constrain the fiscal policy response, weakening the economic recovery and doing more harm to the long-term fiscal position. We need to make smart spending decisions; but we also require better adapted powers to deal with the challenges of the future. We are calling for a bold new approach from the UK Government. We will need to develop fresh thinking on how to aid the recovery, providing opportunities to deliver a fairer and greener economy and driving sustainable public finances in a way that puts wellbeing at their core.

The introduction to this document sets out the policy framework for our medium-term vision. The National Performance Framework (NPF) continues to embody our ambitions for Scotland and we will maintain our focus on outcomes that deliver an innovative, competitive and inclusive economy, enabling the transition to net zero emissions, building safe, healthy and resilient communities as well as tackling poverty and inequality. The purpose and values at the heart of the NPF give us a broad framework to advance national wellbeing, but the severity of impacts of COVID-19, coupled with the tight fiscal environment have highlighted that we will need to take great care to invest smartly to reset trajectories towards these outcomes.

Chapter 2 illustrates the impact on Scotland's economy of the joint shock created by COVID-19 and the UK Government's withdrawal from the European Union over the life of the next parliament. Chapter 3 shows how this uncertainty might affect the funding outlook for the Scottish Budget over the medium term, presenting a range of possible futures with upper and lower scenarios around the SFC's central funding scenarios. Chapter 4 lays out a broad spending outlook, including setting out illustrative scenarios modelled on current spending trajectories.

There is a balance between maximising the available budget to the Scottish Government in the short term and retaining capacity to manage in-year budget volatility to deliver on outcomes through existing powers and the reserve. However, Scotland's ability to shape its own response to the pandemic and economic recovery is limited by the fact that a large proportion of the Scottish Budget is still determined by the Block Grant received from the UK Government via the Barnett formula. In addition, the Scottish Government has virtually no borrowing powers to support additional spending on day-to-day public services to deliver on outcomes, as well as the limits on the use of the Scottish Reserve.

In Chapter 5, we have brought the funding and spending outlooks together to explain how we will use our existing powers and levers to manage fiscal risk in the medium term– and also to highlight where and how these fiscal powers and levers are clearly inadequate to allow us to smooth our



spending trajectories and manage the level of uncertainty faced by the Scottish Budget.

These concerns must be addressed in the upcoming review of the Fiscal Framework. The experience of the past year has perfectly illustrated the areas of strength and weakness within Scotland's fiscal settlement. We need a wide-ranging review of whether the Fiscal Framework still sufficiently enacts the principles agreed by the Smith Commission, as well as whether it provides the Scottish Government with the right balance between its levers, powers and responsibilities.

Ahead of the Fiscal Framework Review, however, we fully recognise our responsibilities for managing Scotland's funds within the remit of our existing powers. Levels of public spending in 2020-21 and 2021-22 have increased significantly, as a result of increased borrowing by the UK Government and the need to respond through reserved and devolved spending to the many immediate impacts of COVID-19. The Scottish Government will play its part in the action needed in future years to consolidate public finances; but this must be delivered in way that does not undermine economic recovery, erode public services or produce negative outcomes for our most vulnerable citizens and communities.

We will engage with the UK Government to press the case for an effective approach. We must also make smart devolved spending decisions to progress national outcomes within the available budget and in ways which will be sustainable over time. Our fiscal policy decisions must find the right balance to support and align with these ambitions. Medium-term planning will support the prioritisation of funding to target expenditure on activities that will have the greatest impact on the wellbeing of people in Scotland, while ensuring that plans are robust against fiscal risks. A focus on value for money, supported by evidence on the impact of available public spending and taxation choices, will be essential to a future Scottish Spending Review, underpinned by the National Performance Framework. Clear and transparent prioritisation will be needed, as our policy and financial interventions support the transition from short-term resilience and recovery in the face of the pandemic to longer-term growth and renewal, delivering long-term objectives including on the just transition to a net zero economy and tackling deep-seated inequalities in our society.

The Scottish Government remains committed to driving the reform of our public services, specifically with a focus on how we collectively use resources to deliver public value and with an increasing need to maximise the enabling power of further digitisation. Reform remains critical and the ethical imperative to deliver public value for our citizens has never been more morally significant. We will learn from the shifts in behaviour and service delivery brought about at pace by COVID-19, and the impact these shifts have had on outcomes.



Our approach to Public Service Reform is rooted in principles that the Christie Commission set out in 2011, of prevention, partnership, outcomes-based performance and empowering our people (communities, front-line staff and leaders). These principles recognise that public services can improve outcomes and work more efficiently when they work together to shape joined-up services around the distinctive needs of communities and citizens, including by building preventative approaches to strengthen positive outcomes and tackle persistent inequalities. We will explore how future spending reviews and budgetary processes can better enable cross-cutting action bringing together different sectors and government portfolios.

Much of the most powerful reform work occurs at local level, with public services, businesses, the third sector and communities coming together to shape service delivery and support around people's needs. This has been particularly evident in 2020, as the public, third, voluntary and communities sectors have come together to support people in need in the face of the COVID-19 pandemic. This commitment to work together to support people, with speed and conviction, with flexibility and agility, working round long-standing barriers, and focussed on a common purpose, embodies why the Scottish Government remains committed to reform.

As we approach the tenth anniversary of the publication of the Christie Commission's recommendations later this year, it is clear that the challenges it set out and sought to address remain as relevant as ever, including for ensuring our public services remain sustainable in the years ahead, despite increasing demands.

### List of Acronyms

ACEVO	Association of Chief Executives of Voluntary Organisations
ADT	Air Departure Tax
AGER	Advisory Group on Economic Recovery
AME	Annually Managed Expenditure
APD	(UK) Air Passenger Duty
BGA	Block Grant Adjustment
CCC	Committee on Climate Change
CERG	Climate Change Emergency Response Group
COVID	Coronavirus pandemic
COVID-19	Coronavirus Disease 2019
CPI	Consumer Price Index
CSR	Capital Spending Review
DLA	Disability Living Allowance
EHRC	Equality and Human Rights Commission
EU	European Union
FE	Further Education
FFFP	Fines, Forfeitures and Fixed Penalties
FT	Financial Transactions
GDP	Gross Domestic Product
HM	Her Majesty's
HMCTS	Her Majesty's Courts and Tribunals Service
HMRC	Her Majesty's Revenue and Customs
HMT/HM Treasury	Her Majesty's Treasury
IFS	Institute for Fiscal Studies
IIDS	Industrial Injuries Disablement Scheme
IIP	Infrastructure Investment Plan
IMF	International Monetary Fund
IPC	Indexed Per Capita
ITA	Individual Training Account

ITR	Income Tax Revenue
JSA	Jobseekers Allowance
LBTT	Land and Buildings Transaction Tax
LIFE	The LIFE (the Financial Instrument for the Environment) Regulation/ LIFE Programme
MCC	Material Change in Circumstances
ME	Minority Ethnic
MFF	European Multiannual Financial Framework
MSP	Member of the Scottish Parliament
MTFS	Medium-Term Financial Strategy
NDR	Non Domestic Rates
NHS	National Health Service
NIESR	National Institute for Economic and Social Research
NIM	National Investment Mission
NLF	National Loan Fund
NPF	National Performance Framework
NSND	Non-Savings, and Non-Dividend
NSPCC	National Society for the Prevention of Cruelty to Children
OBR	Office for Budgetary Responsibility
OECD	Organisation for Economic Cooperation and Development
ONS	Office for National Statistics
PACE	Partnership Action for Continuing Employment
PAYE	Pay As You Earn
PfG	Programme for Government
PIP	Personal Independence Payment
POC	Proceeds of Crime
RTI	Real-time information
rUK	Rest of the United Kingdom (e.g. England, Wales and Northern Ireland)
SDA	Severe Disablement Allowance
SFC	Scottish Funding Council
SG	Scottish Government

SGGEM	Scottish Government Global Econometric Model
SLfT	Scottish Landfill Tax
SME	Small to Medium Enterprise
SPI	Survey of Personal Incomes
TFP	Total Factor Productivity
UC	Universal Credit
UK	United Kingdom
URL	Universal Resource Locator
VAT	Value Added Tax
YOY	Year on Year

## Glossary

**Austerity:** a set of policies that aim to reduce government budget deficits, usually through spending cuts, tax increases, or a combination of both.

**Barclay Review:** the Barclay Review (chaired by Kenneth Barclay) was introduced to reform the business rates system in Scotland in order to better support business growth.

**Barnett Formula:** a formula used by the HM Treasury to calculate consequentials which form the Block Grant to devolved governments in Scotland, Wales and Northern Ireland. The Barnett formula seeks to give these governments a proportion (or consequential) of UK expenditure incurred in policy areas which are devolved.

**Budget:** a document prepared by the government to present its anticipated tax revenues and proposed spending/expenditure for the coming financial year.

**Block Grant:** the grant received by the Scottish Government made up consequentials of UK expenditure, calculated by the Barnett Formula.

**Block grant adjustment (BGA):** deductions from the Scottish Government's total Block Grant to reflect devolved tax receipts or social security expenditure.

**Capital borrowing:** money borrowed specifically for the purpose of Capital Expenditure.

**Capital Expenditure:** money spent on providing or improving non-current assets, which include land, buildings and equipment, which will be of use or benefit in providing services for more than one financial year.

**Consequentials or Barnett Consequentials:** a Barnett Consequential is the change to a devolved administration's assigned budget as a consequence of changes in spending by the UK Government.

**Deficit:** occurs when a government spends more money than it takes in.

**Demand-led:** refers to expenditure which can be predicted at the beginning of the year e.g. the payment of benefits which will depend on the number of eligible claimants. Usually managed through Annually Managed Expenditure (AME).

**Fiscal Consolidation:** is a policy aimed at reducing government deficits and debt accumulation in order to bring it to levels which are manageable or commensurate with expected revenues.

**Fiscal Framework:** the Fiscal Framework agreement was published alongside the Scotland Act 2016 setting out the new funding arrangements, fiscal rules and borrowing powers for the Scottish Government.

**Fiscal Framework Review:** the Fiscal Framework is due to be reviewed after the 2021 Scottish Parliament elections. The review will be informed by an independent report with recommendations presented to both Governments by the end of 2021.

**Funding Outlook:** projection of future funding built up by forecasting separate elements of funding and then aggregating these to produce a path for the total level of potential funding.

**Furlough (or Coronavirus Job Retention Scheme):** scheme through which the UK Government will pay up to 80% of people's wages for employees unable to work because their place of work has been forced to close, up to a maximum of £2,500 per month.

**Green New Deal:** harnessing the power of the Scottish National Investment Bank, a £3 billion Green Investment Portfolio and a Green Growth Accelerator - what the Climate Change Emergency Response Group (CERG) has termed a 'Green City Deal' - to attract green finance to Scotland.

**Income Distribution:** covers how a country's total GDP is distributed amongst its population.

**Macroeconomic Shock:** any event that has a large-scale impact on the economy, either positive or negative.

**National Outcomes:** are the Scottish Government's broad policy aims.

**Net zero:** achieving an overall balance between emissions produced and emissions taken out of the atmosphere.

**Non-tariff barriers:** any measure, other than a customs tariff, that acts as a barrier to trade.

**Outturn Data:** official published statistics about actual revenues and expenditure.

**Reconciliations:** adjustments to address historical budgets' forecast errors.

**Resource Borrowing:** money borrowed specifically for the purpose of Resource Expenditure.

**Resource Expenditure:** money that is spent on day-to-day resources and administration costs.

**Resource Spending Review:** a review to balance the spending ambitions of the new Scottish Government within its fiscal constraints.

**Scotland Reserve:** enables the Scottish Government to manage volatility associated with the fiscal powers.

**Smith Commission:** a commission of cross party talks to take forward commitments made by the three UK political parties (Conservative, Labour and Liberal Democrats) during the Scottish Independence referendum campaign.

**Tax Credits:** a means-tested government payment to help with day-to-day expenses for working people on low incomes.

**UK Spending Review:** allocation of funding to government departments.

**Volatility:** the tendency to change rapidly and unpredictably.



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# ANNEXES

The Scottish Government's Medium-Term Financial Strategy  
2021/22 to 2025/26

## ANNEX A - Assessing forecast error risk to the Scottish Budget

The Scottish Government has developed a framework for performing risk analysis on the likelihood, direction and magnitude of reconciliations payments for forecast errors over time. The framework developed in this analysis provides a tool that allows for insights into what the key drivers of forecast error risk are and to assess the capacity for the Scottish Government to be able to deal with it.

### Methodology

The framework to analyse reconciliation risk takes advantage of a technique called a *Monte Carlo Simulation*. This technique is often used to help understand and quantify the impact of risk and uncertainty across a variety of fields and professions such as in finance, project management and forecasting.

These simulations allow the user to perform risk analysis by building models of possible results by substituting a range of values – a probability distribution – for any factor that has inherent uncertainty in it. In the case of reconciliation risk analysis, the factor of concern is the inherent uncertainty around the forecast performance of the SFC and OBR.

Forecasting performance generally refers to information on an individual's or institution's forecast error – the difference between what was forecast and what then eventually happened.

It is worth iterating that economic forecasting is notoriously challenging. Even with excellent data and judgements, economies are inherently difficult to forecast. For example, a working paper from the International Monetary Fund (IMF) in 2018 noted that globally, economists had failed to predict 148 of the last 153 global recessions<sup>46</sup>. This was judged to be partly because the world is getting more inter-linked and complex, making accurate forecasts of individual economies increasingly difficult.

Unexpected events such as Global Financial Crises or Global Pandemics also exemplify the inherent difficulty faced by economic forecasters.

Given this, it is virtually certain that over time both the OBR and SFC are likely to have forecast errors. This is not a reflection or judgement on either institution, rather it is simply a standard reality for any forecaster.

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<sup>46</sup> An et al. (2018), 'How well do economists forecast recessions?', *International Finance*, 21(2), pp.100-121. URL: <https://www.imf.org/en/Publications/WP/Issues/2018/03/05/How-Well-Do-Economists-Forecast-Recessions-45672>

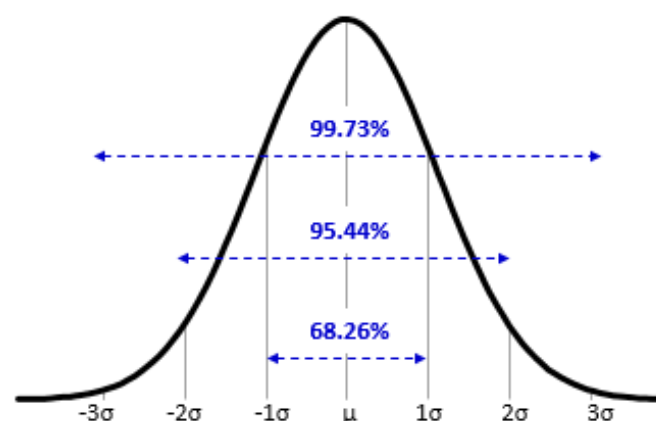
In the Scottish Fiscal Framework it is the forecast errors of the SFC and OBR that drive the subsequent reconciliation risk faced by the Scottish Government. It is important how both forecasters have performed and how related their performance is which can have significant effects on the level of reconciliation risk involved. Consequently, four characteristics of the OBR and SFC's forecast performance determine overall reconciliation risk. The first three are:

1. Each institution's average forecast error over time.
2. The variance of each institution's forecast errors over time.
3. The distribution of each institution's forecast errors over time.

These are standard statistical properties. For example the below is a representation of a Standard Normal Distribution, with mean  $\mu$  and Standard Deviation  $\sigma$  (the square of which is equal to the variance). These properties tell us things like what the average, or "most likely" outcome is over time (the mean  $\mu$ ), and the standard deviation and/or variance, provide a measure of how spread out from the mean observations tend to be over time.

The distribution can be thought of as the pattern of the forecast errors observed. For example, it might be expected that the forecast error is sometimes positive, and sometimes negative each with broadly the same respective probability which a normal distribution such as below can represent if the mean is equal to 0. Alternatively there may be reason to believe that it is more likely for forecast errors to be skewed in one direction, in which case other types of distributions can better capture this relationship.

#### CHART A1: DIAGRAM OF A STANDARD NORMAL DISTRIBUTION



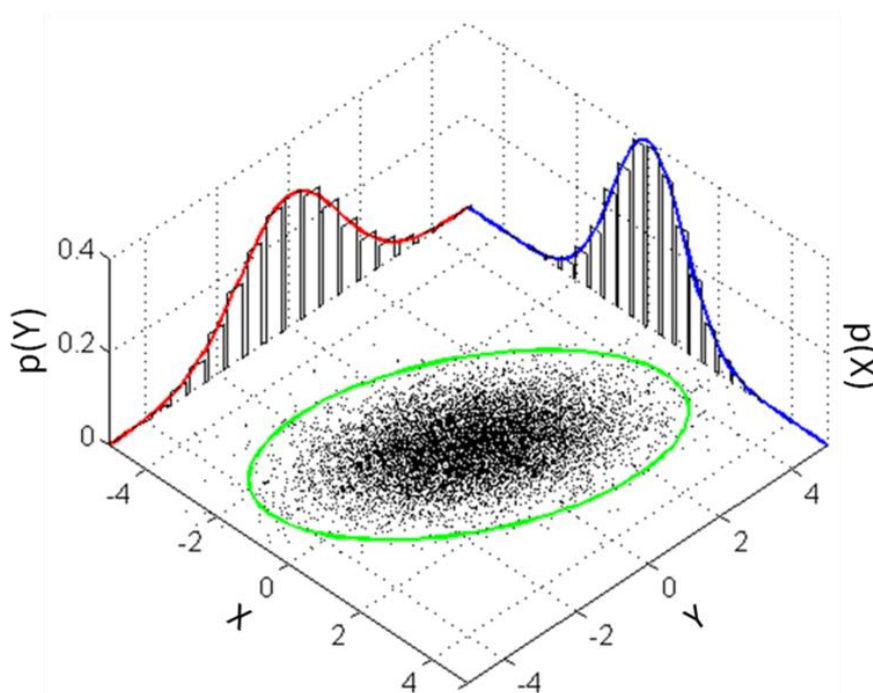
The fourth characteristic required is:

4. The correlation (or covariance<sup>47</sup>) between each institutions forecast errors over time

If the SFC and OBR's forecast errors have a degree of positive correlation, then on average, when the SFC or OBR have been too optimistic (or pessimistic) in their forecasts, it is likely that the other institution was similarly too optimistic (or pessimistic) at the same time. For example, Chart A2 below is a diagram showing a hypothetical joint distribution where there is a degree of positive correlation between two distributions (the elliptical skew to the green circle). Had there been zero correlation between the two distributions, the green line would be perfectly circular.

The reason the degree of correlation or covariance is needed is because reconciliations are a function of both institution's forecast performance over time. Whether or not the OBR and SFC's forecasts tend to be right or wrong in a similar direction and magnitude can actually have quite a large impact on the degree of reconciliation risk implied.

**CHART A2: DIAGRAM OF MANY SAMPLES FROM A MULTIVARIATE (JOINT) NORMAL DISTRIBUTION**



These four characteristics above (the average, variance, distribution and correlation of each institution's forecast error) can then be used to populate

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<sup>47</sup> Correlation and Covariance are statistical properties that are related to each other, but not (always) identical. During the simulations the covariance is used, but for ease, correlation is referred to in the note as this acts as a more universal reference point and is more widely understood.

the assumptions required to perform Monte Carlo Simulations in order to quantify the risk and uncertainty the Scottish Government could face from forecast error for a specific tax or social security.

Consequently, as long as it is possible to populate the hypothetical forecast errors for a given scenario, it is then also possible to calculate what the subsequent reconciliation risk would be.

Monte Carlo Simulations follow the above procedure by simulating the hypothetical forecast errors using probability distributions. These probability distributions represent the likelihood and uncertainty of the future OBR and SFC forecast errors and also allow the possibility to repeatedly “sample” or “draw” from these probability distributions. The reconciliation payment for each sample or draw is then calculated resulting in a probability distribution of reconciliation risk.

For example, taking a non-informative assumption that both the SFC and OBR’s forecast errors have a normal distribution, with an average forecast error of 0%, a variance of 1% and have zero correlation / covariance with one another.

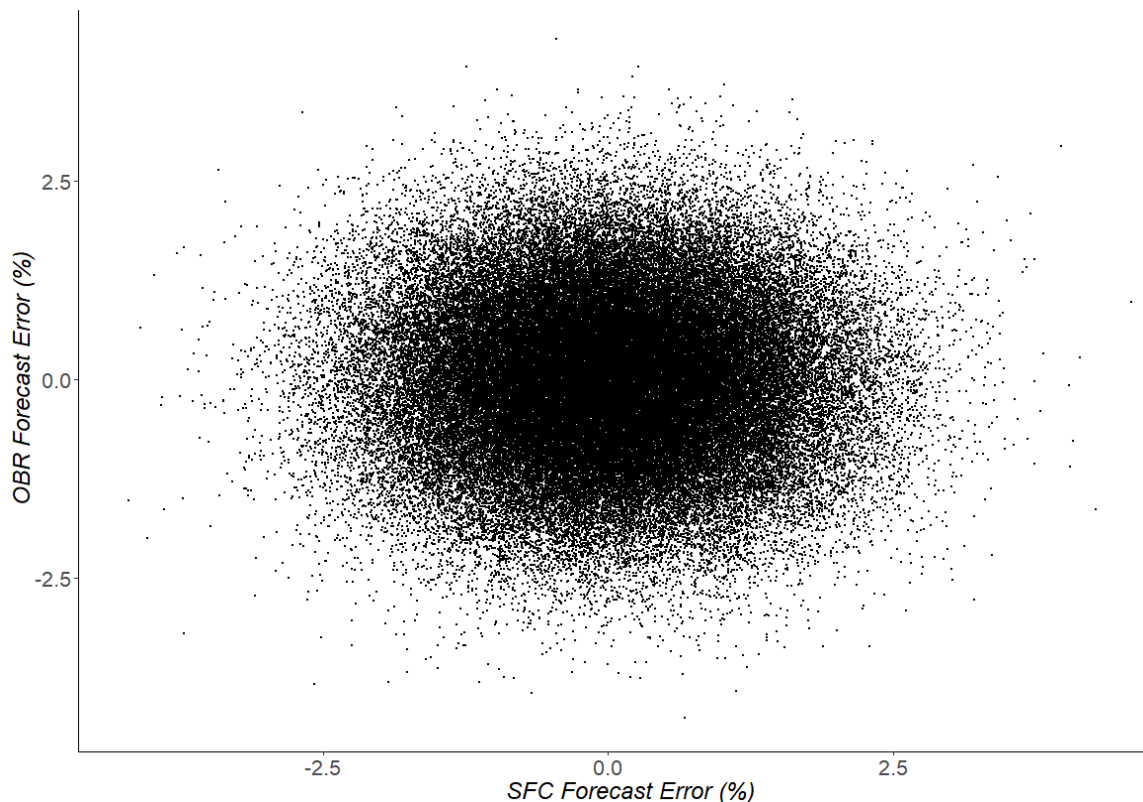
A Multivariate Normal Distribution can be drawn from, where  $\mathbf{X} = (X_1, X_2)$  is a 2 dimensional random vector with the following properties:

$$\mathbf{X} \sim N(\boldsymbol{\mu}, \boldsymbol{\Sigma})$$

With vector,  $\boldsymbol{\mu} = \begin{pmatrix} 0 \\ 0 \end{pmatrix}$  representing the assumed average forecast error of zero for the SFC and OBR, and the Covariance Matrix  $\boldsymbol{\Sigma} = \begin{pmatrix} 1 & 0 \\ 0 & 1 \end{pmatrix}$  representing a variance of 1 for each institution and covariance of 0 between each institution.

Using the above assumptions is it then possible to draw many samples (100,000 samples are used for each scenario in this paper) from this joint distribution such as below in Chart A3.

**CHART A3: 100,000 SAMPLES FROM A HYPOTHETICAL JOINT NORMAL DISTRIBUTION OF SFC AND OBR FORECAST ERROR**

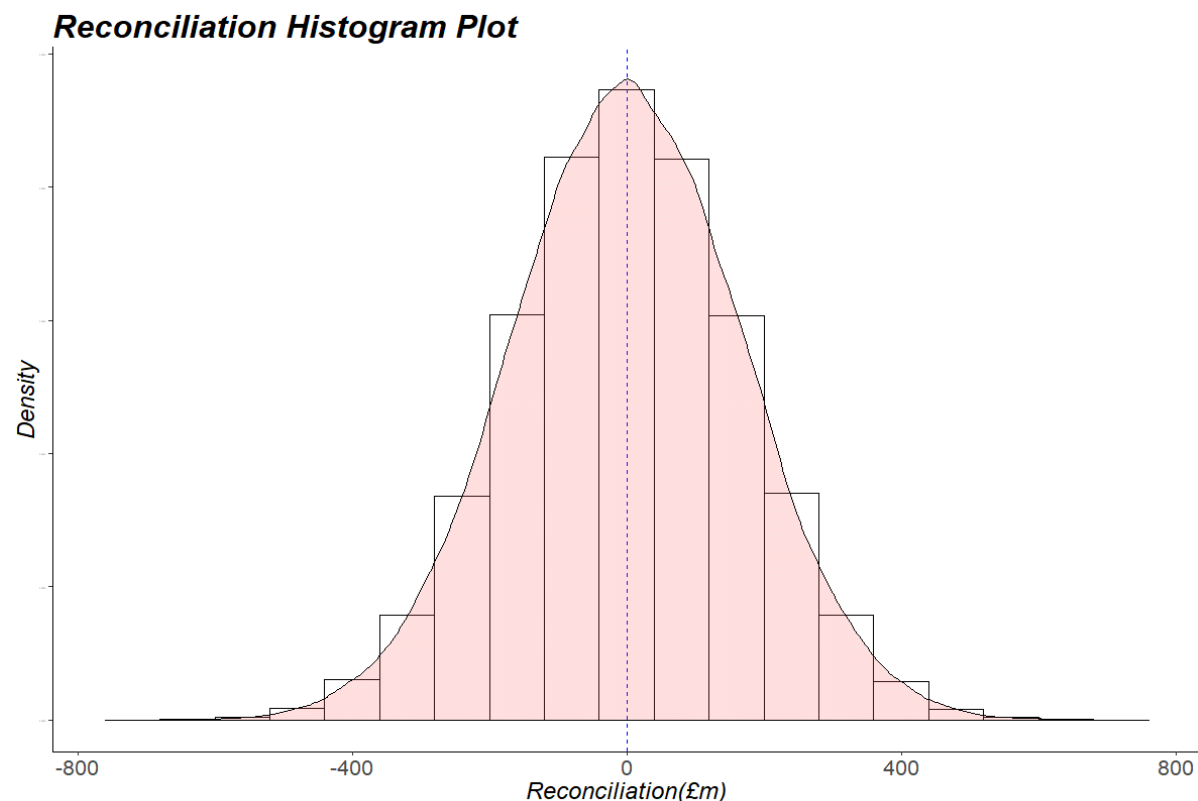


Each dot on Chart A3 represents a sample from this probability distribution, with each one representing a sample with an SFC forecast error, and a relative OBR forecast error.

Each one of these many thousands of samples can then be used to calculate a reconciliation value that would occur were these errors to occur in reality. Consequently, it is possible to create a probability distribution of reconciliation risk that allows us to quantify and assess what the average or likely reconciliation payment may be. The above example is visualised below in Chart A4, which is based on the 2018-19 Budget forecasts (from both the SFC and OBR) on devolved non-savings, non-dividends Income Tax.



## CHART A4: AN EXAMPLE OF A PROBABILITY DISTRIBUTION OF NSND INCOME TAX RECONCILIATION RISK BASED ON MONTE CARLO SIMULATIONS



This represents a simulated probability distribution of reconciliation risk based on the assumption that both the OBR and SFC's forecast errors have i) no correlation with each other, ii) both have an average forecast error of 0% iii) both have a forecast error variance of 1% and iv) their forecast errors have a joint-normal distribution.

Under this example scenario, because of the symmetry in each institutions forecasting performance, over time it would be expected that the positive and negative reconciliations even out, with a long-term average reconciliation payment of close to zero. However, year-on year there is likely to be volatility and, conditional on the forecast assumptions under this scenario, it would be expected that 80% of the time reconciliation payments would lie between negative £209 million and *positive* £211 million. Furthermore it is expected, that just over 3% of the time, reconciliations would exceed the -£300m borrowing limit currently available to the Scottish Government to deal with forecast error.

This demonstrates the strengths of Monte Carlo Simulations, with the ability to quantify the magnitude, direction and likelihood of an outcome from an inherently uncertain factor.

### **A central simulation on Income Tax Reconciliation Risk**

Using the above methodology, it is then possible to construct a central estimate of Reconciliation Risk as a results of devolved Non-Saving, Non-

Dividend Income Tax forecast error. It is not possible to know with complete certainty what the long-term forecasting performance of either the SFC or the OBR could be. However, it is possible to populate the required assumptions with any prior information available about what either institution's forecast performance may be.

One approach to this is to assume that the SFC's future forecasting performance is likely to be similar to that of the OBR's to date. The OBR rather helpfully maintain and publish a historical forecast database, which tracks all historical forecasts and the eventual outturn (if available)<sup>48</sup>. This includes revenue forecasts, of which there are historic forecasts of Income Tax revenue (ITR) receipts for the UK.

In the Scottish Fiscal Framework, it is the forecast of non-savings, non-dividend Income Tax Liabilities for the rUK and Scotland that is important and hence not directly comparable to the OBR's historic forecast performance of UK Income Tax Receipts. However, the two are likely to be strongly correlated, with similar factors driving the forecast performance of each series over time (earnings assumptions, employment assumptions, Income Tax policy, etc.). Therefore, although not directly comparable, there should still be very useful information in the historic performance that can be used to update the assumptions about the OBR's possible longer-term forecasting performance of rUK NSND Income Tax Liabilities based on how well they have forecast UK Income Tax Receipts.

Using the OBR's historic performance, and taking a "3-Year Forecast relative to the latest available Outturn Data available at the creation of each forecast, the assumption made is that both institutions could have an average forecast error of 5.2%; a forecast error variance of 6.8% and have a positively skewed distribution, which will be characterised by a multivariate Log-Normal Distribution. The choice of distribution reflects the fact that the vast majority of the OBR's forecast errors for Income Tax have been positive with a long right hand tail and hence may be better represented by a Log-Normal Distribution relative to a Normal Distribution. However, as a form of sensitivity analysis the results are tested using both a Multivariate Log-Normal and a Multivariate Normal Distribution and the choice of distribution does not radically alter the results. If anything the Log-Normal Distribution is actually more conservative and tends to marginally lower the risk profile.

Using the historic OBR forecasting performance, it is then possible to populate the assumptions for both the SFC and OBR's average, forecast error, the variance of the forecast error and the type of distribution.

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<sup>48</sup> Historical Official Forecast Database - which can be found at: <https://obr.uk/data/>

However, the one part of each institutions forecasting performance for which there is more uncertainty on, is the likely magnitude and direction of correlation between both institutions.

In general, the greater the degree of positive correlation between the two institutions' forecast errors, the lower the degree of forecast error risk. Conversely, the greater the degree of negative correlation the greater the degree of forecast error risk.

There are arguments that the forecasting performance of the OBR and SFC could likely have a degree of positive correlation over time. For example it may be expected that many unforeseen macroeconomic shocks (such as an unexpected change in monetary policy) are likely to affect both the Scottish and UK economies and hence influence OBR and SFC forecast errors in a similar direction.

However, given the uncertainty around the magnitude of this correlation however, a range is instead taken. In this case, the central scenario assumes a degree of positive correlation of between +20% to +80%.

Consequently, assuming that the SFC's Income Tax forecasting performance follows a similar pattern to that of the OBR's to date outlined above, and assuming a relatively wide range of positive correlation between the SFC and OBR's forecasting performance, then a central estimate is that there could be a 5% to 17% probability of negative Income Tax reconciliations exceeding -£300 million.

This central estimate is based on relatively conservative assumptions. As noted, any assumption on positive correlation reduces reconciliation risk and this central estimate only assumes that there is a degree of positive correlation and no chance of a negative correlation, which is potentially quite a strong assumption.

Likewise, the assumption that the SFC and OBR have perfectly symmetrical forecasting performances is also quite strong. Depending on the degree of asymmetry, this could further negatively exacerbate the reconciliation risk that may be expected as a result of forecast error.

Overall though, there is evidence that on devolved Income Tax alone, there is a relatively high probability that forecast error in a given year could be sufficiently large enough to overwhelm the current borrowing powers provided to the Scottish Government to deal with them.

This is based on quite conservative assumptions. It is possible that by making relatively small adjustments to the underlying assumptions that the estimated risk profile is significantly larger.

The risk profile will also inevitably become worse over time as the scale of the economy and tax revenues increase whilst the borrowing powers remain fixed in nominal terms.

## ANNEX B - Risks to Scottish Income Tax receipts

Income Tax devolution is still a relatively new concept and our understanding of Scotland's historic tax performance is constantly evolving as more evidence becomes available. Income Tax outturn data is only available with a significant lag as the deadline for completing self-assessment returns is 31 January following the tax year. As a result, evidence about Scotland's trends, relative to the rest of the UK, currently only spans two years, 2017-18 and 2018-19.

Under the Fiscal Framework, Scotland's budget position improves if tax receipts per head grow more quickly in Scotland than in the rUK (and vice versa). There are a number of factors which can affect Scotland's relative tax performance, including:

- Growth in earnings, pensions and property income: Growth in wages is one of the key drivers of Income Tax performance.
- Growth in the number of taxpayers: This in turn depends on growth in the (working age) population, the performance of the Scottish labour market as well as decisions around the UK-wide Personal Allowance which may lift some taxpayers out of paying tax altogether. The Fiscal Framework protects Scotland against its relatively slower population growth as it operates on a per head basis.
- Differences in the composition of the tax base, including the relative contribution of high Income taxpayers and their earnings growth.
- Policy changes and resulting changes to taxpayers' behaviours, including out-migration or a reduction in the number of hours worked.

Scotland's historic tax performance has been mixed to date. In 2017-18, Scottish receipts per head grew less quickly than in the rUK, resulting in a net loss to the Scottish Budget of -£97 million. Slower growth in incomes, as well as relatively slower growth in the number of taxpayers, explains the large majority of Scotland's budget shortfall in 2017-18<sup>49</sup>. There is some evidence that this was linked to the downturn in the oil and gas industry and wider North Sea supply chains, which resulted in a loss of high-paying jobs in the Aberdeen area. This was only partly offset by tax raising measures which are estimated to have generated an extra £108 million, compared to a scenario where Scotland had maintained the same rates and bands as the rUK.

Income Tax receipts per head did grow significantly faster in Scotland than in the rUK in 2018-19, resulting in a £119 million net gain to the Scottish

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<sup>49</sup> See also the Scottish Fiscal Commission's analysis available [here](#).

Budget. However, this was largely due to Scotland's Income Tax policy reform. The introduction of the five-band regime is estimated to have raised at least around £300 million, compared to a scenario where Scotland had maintained the same rates and bands as the rUK. We will never know for certain how much the policy changes raised as we are comparing the outturn data against a hypothetical scenario which we will never be able to observe. However, the Scottish Government, in collaboration with HMRC, is looking to publish a more detailed evaluation of the 2018-19 Income Tax reform in the summer of 2021, assessing the scale of the behavioural effects and the amount of revenue raised.

Economic and tax data on the performance of Scotland's underlying tax base in 2018-19 is only just emerging and the publication of the 2018-19 Survey of Personal Incomes in spring 2021 will shed further light on this issue. There is some evidence, however, that Scotland's performance may have improved compared to 2017-18, albeit only marginally: the gap in average earnings growth narrowed and GDP growth was broadly similar in both countries in that year. However, should the policy have raised more than £300 million, this would point to continuing weakness in Scotland's Income Tax base, relative to the rUK's. This could be due to Scotland's economic growth being less tax rich, lower employment growth and differences in the composition of the tax base. It is not until 2019-20 that we see a significant improvement in the underlying economic data, in particular on earnings growth, and PAYE liabilities from the real time information (RTI) system.

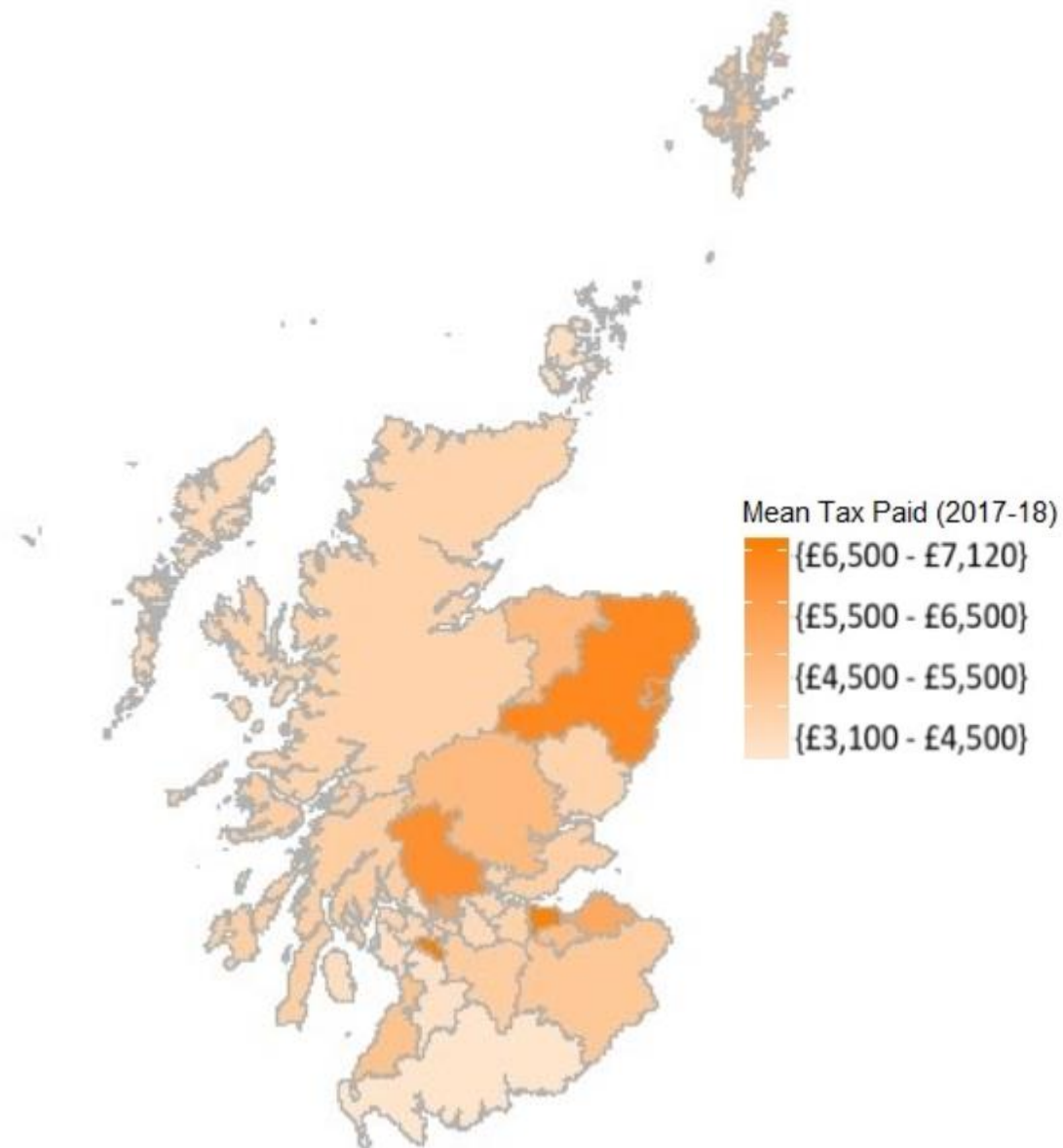
Under the Fiscal Framework, weaknesses in tax performance can also persist over time, unless a year of relatively weaker tax growth is followed by a strong performance in the following year. In other words, even if tax receipts per head had grown at the exact same rate in both countries in 2018-19, this would only have maintained the -£97 million shortfall which opened up in 2017-18. For this gap to close, Scotland would need a year of significantly faster receipts growth.

#### **Impact of sectoral differences: the importance of Scotland's oil sector**

As noted above, Scotland's greater exposure to movements in global commodity markets, and in particular the oil price, appears to have been a key driver of Scotland's relatively weaker Income Tax performance in 2017-18. The steep decline in the global oil price in 2015 and 2016 triggered a significant shock to the Scottish production sector but had a limited impact on the UK as a whole. This resulted in a loss of high paying jobs in the Aberdeen area and in the production sector and depressed earnings growth. As illustrated in Chart B1, there is also a regional dimension to this as Scotland is highly reliant on Income Tax receipts from taxpayers in the Aberdeen area and the two main cities, Edinburgh and Glasgow, which when taken together, including the respective central and

immediately surrounding local authorities, account for around 60% of total Income Tax receipts in Scotland (including savings and dividends).

**CHART B1: REGIONAL DISTRIBUTION OF INCOME TAX RECEIPTS, 2017-18**



*Source: HMRC National Statistic Tables based on the Survey of Personal Incomes (SPI) Statistics 2017-18*

As an illustration of the potential downside risks to Scotland's tax receipts, and drawing on the lessons from 2017-18, we have modelled the potential impact an oil shock could have on the Scottish Budget with the Scottish Government Global Econometric Model (SGGEM) of the Scottish and UK



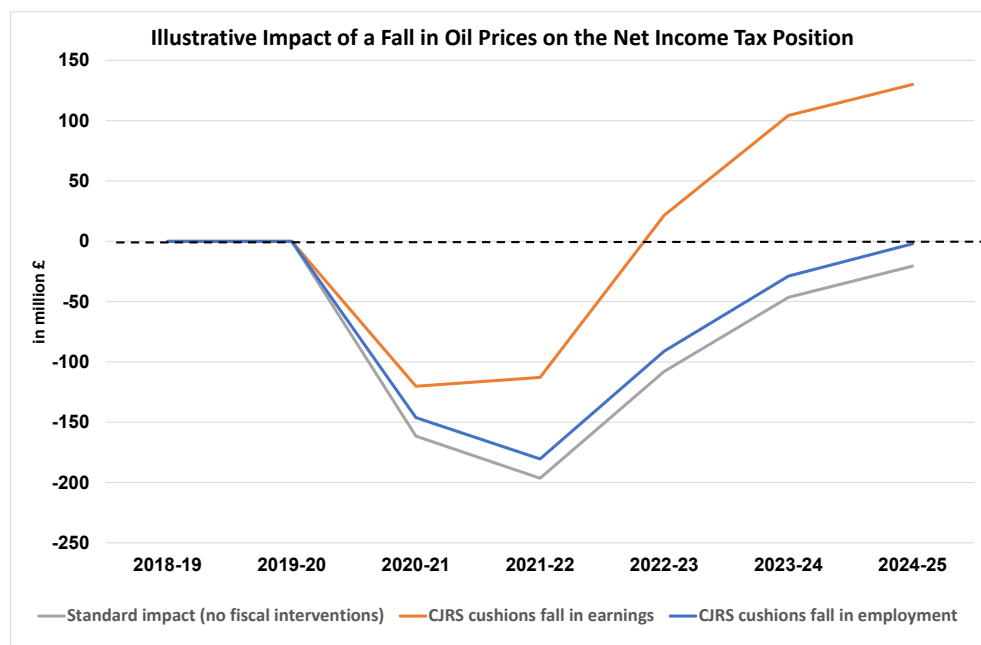
economies. The simulation applies an oil shock (oil price reduction) of a similar magnitude as witnessed during 2020 and the COVID-19 crisis.<sup>50</sup>

The key findings from SGGEM, is that even a relatively temporary oil shock can have quite persistent impacts. Although economic activity does recover quite quickly, the impact on earnings and employment growth can last a few years. Importantly, in the context of the Fiscal Framework, such an oil shock has asymmetric impacts on Scotland and the UK and consequently the net position of devolved tax revenues, most notably LBTT and Income Tax.

In the absence of any policy interventions, it is estimated that the fall in the oil price could reduce Scotland's Income Tax net position by between -£113 and -£196 million in 2021-22, depending on the cushioning effect of the furlough schemes.

The nominal fall in the Oil price was not as significant or as persistent as that witnessed during 2015-16 and consequently this does not necessarily mean that the impact on receipts will be as severe as shown here. Mainly this is because the oil price fell from a much lower level during 2020 and it is likely that oil producers might already have adjusted their production processes to this lower price environment. Secondly, the UK Government's furlough schemes might have cushioned the immediate impact.

#### CHART B2: ILLUSTRATIVE IMPACT ON INCOME TAX NET POSITION OF AN OIL SHOCK



<sup>50</sup> This is equivalent of around a temporary \$30 fall in the global oil price in 2020 Q1 and then recovering the vast majority of this fall in 2020 Q2, and fully recovering back to the baseline price by the end of 2022.

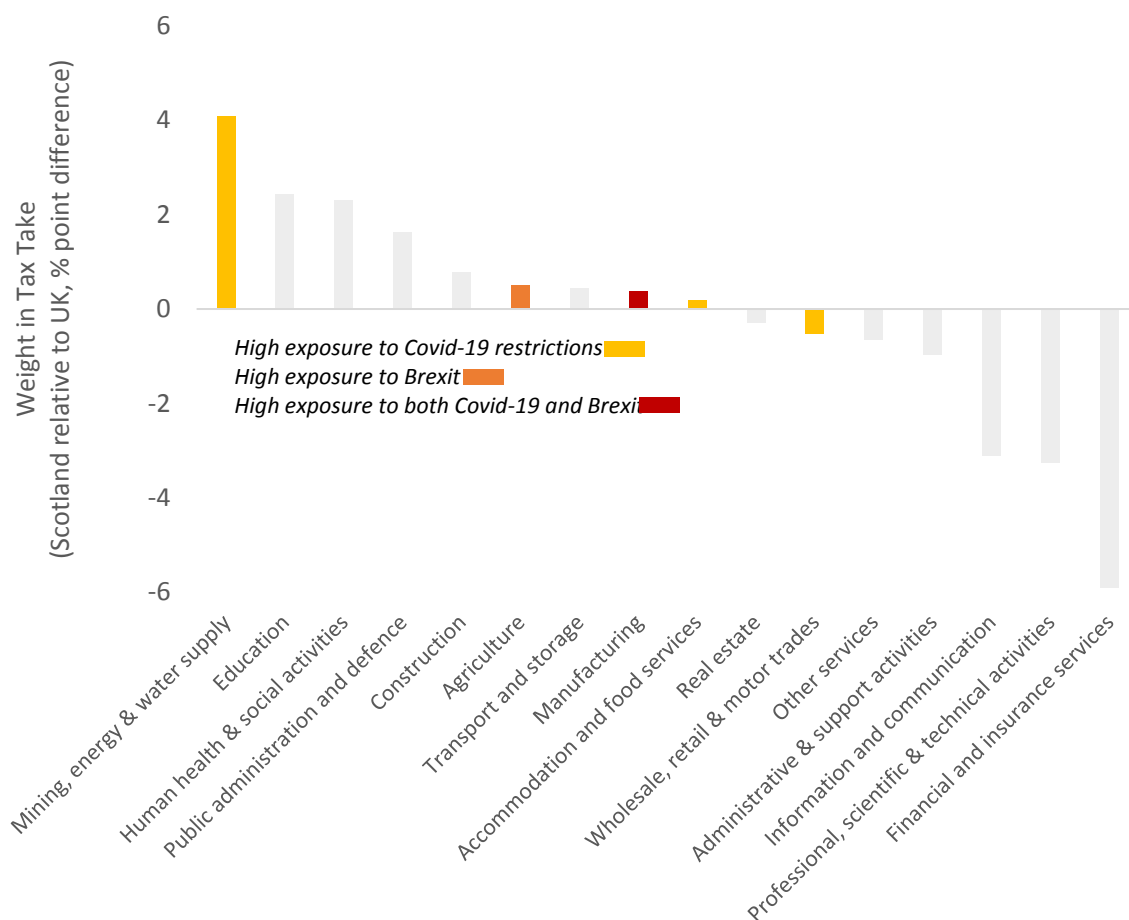


Looking ahead, there is a considerable risk that the Scottish Income Tax base might prove less resilient to COVID-19 and the UK's exit from the EU than the rest of the UK's, simply due to differences in the sectoral composition of the two economies.

In 2017-18, Scotland raised around 22.3% of its total Income Tax take from sectors disproportionately impacted by these shocks, compared to only 17.7% in the rUK. This is largely driven by the Mining & Quarrying sector which accounts for a much larger share of the overall tax take in Scotland than in the rUK. This might be partly offset by Scotland's relatively greater reliance on the public sector where earnings and employment have held up relatively well, compared to the private sector.

The UK Government's fiscal measures, including the furlough schemes, have so far masked underlying regional trends. However, as these schemes start to unwind from May 2021, differences are likely to emerge.

### CHART B3: ESTIMATED SHARE (%) OF TOTAL INCOME TAX RECEIPTS GENERATED BY SECTOR



Note: A positive figure indicates greater exposure in Scotland.

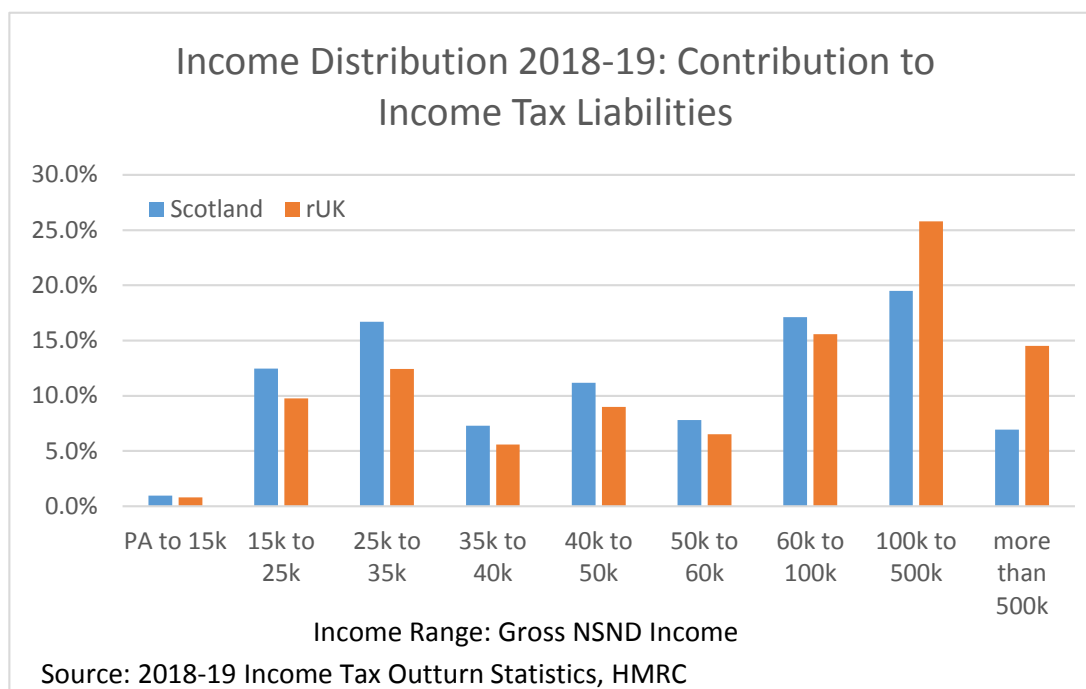
### Impact of differences in the income distribution

In addition to variations in economic growth, significant differences in the distribution of the Income Tax base in Scotland and the rest of the UK also pose a notable risk to the Scottish Budget, albeit to a lesser extent than differences in economic performance. Most importantly, there are relatively fewer high income taxpayers in Scotland than in the rest of the UK and their earnings are also typically lower.

Further analysis of the 2018-19 outturn data, which was published in September 2020, shows that Scotland had relatively more taxpayers in the £15,000 to £40,000 NSND income bracket than the rest of the UK.<sup>51</sup> However, significant differences start to emerge at the higher end of the income distribution. For example, the proportion of taxpayers earning £100,000 or more was considerably higher in the rest of the UK than in Scotland (2.6% vs. 1.7%) whilst incomes per head in that cohort were also 21% higher in the rUK.

As a result, Scotland raised a relatively smaller proportion of liabilities from individuals earning £100,000 or more in 2018-19 (26% vs. 40%).

#### CHART B4: DIFFERENCES IN THE INCOME DISTRIBUTION, 2018-19



<sup>51</sup> This is an extension of the analysis in the Scottish Income Tax Outturn Statistics using data from the Real Time Information (RTI) and Self-Assessment system. The published outturn statistics are available [here](#). This analysis, and the results, may therefore be different from the Survey of Personal Incomes (SPI) which is based on a representative sample of Scottish taxpayer records. SPI data for 2018-19 will not be published until later this year.

This means that UK-wide factors that disproportionately affect income at the basic rate, such as the increase in the UK-wide Personal Allowance, will have a relatively greater impact on Scottish liabilities. Under the Fiscal Framework, the reduction in Scottish receipts is partially offset by the reduction in the corresponding block grant adjustment (BGA). However, since the BGA does not account for differences in the income distribution between Scotland and rUK, the change in the BGA understates the reduction in revenues in Scotland when the Personal Allowance increases. This means that the Scottish Budget is made worse off by increases in the Personal Allowance.

For example, Scottish Government analysis suggests that the net position would have improved by around £52 million in 2017-18 and £88 million in 2018-19 if the Personal Allowance had been frozen at its 2016-17 level instead.

UK and Scottish Ministers agree that the impact of Personal Allowance increases on the Scottish Budget should be accounted for, in line with the spillover provision in the current Fiscal Framework Agreement. This states that when either government makes a policy decision that affects the tax receipts or expenditure of the other, the decision-making government should reimburse the other if there is an additional cost, or receive a transfer if there is a saving.

However, UK Ministers believe that only above inflation increases in the Personal Allowance should be accounted for. The Scottish Government believes that all increases in the Personal Allowance should be accounted for, as any increase impacts the Scottish budget. This issue remains unresolved. The Cabinet Secretary for Finance wrote to the Chief Secretary to the Treasury in December 2020 to set out her view on this issue, and to note that it may be necessary to engage the Fiscal Framework's dispute resolution procedures if agreement could not be reached. Further engagement will take place to resolve this issue as soon as possible.

The Scottish Government position should not be interpreted as implying that the Personal Allowance should not have been increased over time to mirror growth in earnings and maintain households' spending power. It simply suggests that the flaw in the operation of the Fiscal Framework should be remedied via a spillover claim. The Welsh Fiscal Framework automatically deals with this issue by using a BGA which accounts for the differences in the composition of the tax base. This would be preferable to having to deal with this via a separate spillover claim.

Conversely, UK-wide factors that have a disproportionate impact on the incomes of top earners will have a relatively larger effect on rUK receipts. There is evidence from a range of data sources that earnings growth is unequally distributed across the income distribution as earnings tend to grow more strongly at the bottom and top end of the income spectrum.

According to the SFC, individuals at the very top end of the income distribution in the UK (i.e. within the 99th percentile) have seen their incomes grow significantly faster since 2002, compared with Scottish individuals.<sup>52</sup> There can also be significant variation in income growth across deciles in individual years.

Since differences in the composition of the tax base were already evident when Income Tax was devolved and can only be changed very gradually, this issue must be considered as part of the Fiscal Framework review. One option that would address both of the issues set out above would be to mirror the approach in the Welsh Fiscal Framework which creates separate BGAs for each tax band rather than having a single BGA for Income Tax as a whole. Our analysis suggests that, had such a mechanism been in place since 2016-17 and applying the per capita indexation method, the shortfall in the Scottish Budget would have been £145 million lower cumulatively.

**TABLE B1: IMPACT OF DIFFERENT INDEXATION METHODS**

BGA (£ million)	2016/17	2017/18	2018/19
Current Fiscal Framework	10,719	11,013	11,437
By Band Indexation (per head)	10,719	10,962	11,343
Difference	0	-52	-94

<sup>52</sup> See also the Scottish Fiscal Commission's analysis available [here](#).

## ANNEX C - Fiscal Framework data

This Annex sets out the implications of the Fiscal Framework for the Scottish Budget. The Fiscal Framework Technical Note sets out more detail on how the Fiscal Framework operates including the evolution of the fiscal powers of the Scottish Parliament, the timelines for reconciliations and how they affect the Scottish Budget, the limits of the borrowing powers and Scotland Reserve, and the Fiscal Framework Review.<sup>53</sup>

At the time of the Scottish Budget on 28 January 2021, a UK Budget had not been published, but was instead scheduled for 3 March 2021. The block grant adjustments (BGAs) that inform the Scottish Budget would ordinarily be provided alongside the UK Budget.

The Fiscal Framework sets out that, where the Scottish Budget takes place before the UK Budget, the Scottish Budget will be based on provisional BGAs.<sup>54</sup> The provisional BGAs for the 2021-22 Scottish Budget (together with forecast BGAs for other years) are informed by OBR forecasts published alongside the UK Government's Spending Review on 25 November 2020.

The Framework also sets out that, where the UK Budget takes place less than three months before the start of the financial year, provisional BGAs will be applied to the Scottish Block Grant for that year. However, the UK and Scottish Governments have agreed that the Scottish Government can choose to use the BGAs provided alongside the UK Budget if it prefers to do so.

Reconciliations relating to 2021-22 will take place in the normal way against the set of BGAs which are ultimately used to determine the Scottish Budget for 2021-22.

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<sup>53</sup> [Fiscal Framework: factsheet - gov.scot \(www.gov.scot\)](https://www.gov.scot/publications/fiscal-framework/factsheet/pages/11.aspx)

<sup>54</sup> [Fiscal Framework: agreement between the Scottish and UK Governments - gov.scot \(www.gov.scot\)](https://www.gov.scot/publications/fiscal-framework/agreement-between-the-scottish-and-uk-governments/pages/11.aspx) Annex C, paragraph C.47

## Tax

Table C1 shows the latest forecasts for tax revenues from the SFC and BGA estimates from the OBR forecasts published alongside UK Government's Spending Review in November 2020.

**TABLE C1: FORECASTS OF TAX REVENUES AND BLOCK GRANT ADJUSTMENTS**

£ million		2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
	Revenue	11,838	11,850	12,263	12,907	13,481	14,080	14,718
Income Tax <sup>2</sup>	BGA <sup>1</sup>	-11,582	-11,677	-11,788	-12,294	-12,840	-13,475	-14,105
	Difference	+257	+173	+475	+613	+641	+605	+613
	Revenue	597	517	586	629	664	701	740
LBTT <sup>2</sup>	BGA <sup>1</sup>	-533	-391	-515	-544	-601	-666	-723
	Difference	+64	+126	+71	+85	+63	+35	+17
	Revenue	119	95	88	86	72	74	61
SLfT <sup>2</sup>	BGA <sup>1</sup>	-99	-87	-95	-91	-79	-74	-80
	Difference	+20	+8	-7	-5	-7	0	-19
	Revenue	12,555	12,462	12,937	13,623	14,217	14,855	15,519
TOTAL	BGA <sup>1</sup>	-12,213	-12,154	-12,398	-12,930	-13,520	-14,215	-14,908
	Difference	+341	+307	+539	+693	+697	+640	+611

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

Note 2: The 2018-19 Income Tax, LBTT and SLfT and 2019-20 LBTT and SLfT revenue and BGA are outturn figures.

Figures may not sum due to rounding.

The forecasts of tax revenues and BGAs for 2021-22 will inform the Scottish Budget. Updated BGA forecasts will be provided alongside the UK Budget on 3 March and the Scottish Government can choose to use these BGAs rather than the provisional BGAs from the Spending Review in November 2020 should it wish to do so.

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

### Social Security

Table C2 shows the SFC's latest expenditure forecasts for social security benefits and the BGA estimates from the OBR forecasts published alongside UK Government's Spending Review in November 2020.

**TABLE C2: FORECASTS OF SOCIAL SECURITY EXPENDITURE AND BLOCK GRANT ADJUSTMENTS (£ MILLION)<sup>4</sup>**

		2019- 20	2020- 21	2021- 22	2022- 23	2023- 24	2024- 25	2025- 26
ATTENDANCE ALLOWANCE	Expenditure	N/A	-534	-550	-568	-583	-599	-618
	BGA <sup>1</sup>	N/A	531	546	564	586	608	638
	Difference	N/A	-3	-3	-4	+3	+9	+19
PERSONAL INDEPENDENCE PAYMENT	Expenditure	N/A	-1,574	-1,669	-1,807	-1,916	-2,008	-2,105
	BGA <sup>1</sup>	N/A	1,555	1,682	1,856	2,009	2,158	2,309
	Difference	N/A	-19	+12	+49	+93	+150	+204
DISABILITY LIVING ALLOWANCE	Expenditure	N/A	-717	-696	-696	-692	-682	-673
	BGA <sup>1</sup>	N/A	719	685	665	642	610	557
	Difference	N/A	+2	-11	-31	-50	-72	-116
CARER'S ALLOWANCE <sup>2,3</sup>	Expenditure	-279	-299	-306	-322	-342	-359	-376
	BGA <sup>1</sup>	283	289	309	333	355	379	404
	Difference	+4	-9	+3	+11	+13	+20	+28
INDUSTRIAL INJURIES	Expenditure	N/A	-82	-80	-79	-78	-77	-76
	BGA <sup>1</sup>	N/A	84	81	79	77	76	74



<b>DISABLEMENT SCHEME</b>	Difference	N/A	+1	+1	0	0	-1	-2
	Expenditure	N/A	-8	-7	-6	-5	-5	-4
<b>SEVERE DISABLEMENT ALLOWANCE</b>	BGA <sup>1</sup>	N/A	8	7	7	7	6	6
	Difference	N/A	0	+1	+1	+1	+1	+2
	Expenditure	-279	-3,214	-3,308	-3,477	-3,617	-3,730	-3,853
<b>TOTAL SOCIAL SECURITY</b>	BGA <sup>1</sup>	283	3,185	3,310	3,503	3,676	3,837	3,988
	Difference	+4	-29	+1	+26	+59	+107	+135

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

Note 2: The 2018-19 and 2019-20 Carer's Allowance expenditure and BGA are outturn figures.

Note 3: Carer's Allowance Expenditure Forecast does not include Carer's Allowance Supplement expenditure.

Note 4: There are minor differences in the methodology used to calculate the SFC's spending forecasts and the BGA forecasts, which are based on expenditure outturn and OBR's November 2020 forecasts, so comparisons should be interpreted with caution. Figures may not sum due to rounding.

### Benefits Yet to Commence

Executive competence for the remaining benefits devolved under the Scotland Act 2016 (Cold Weather Payments and Winter Fuel Allowance) has yet to be transferred to the Scottish Government. Where relevant, BGAs will be agreed.

### Reconciliations and implications for the Scottish Budget

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

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

In relation to income tax, a reconciliation for both revenues and the BGA for the 2018-19 financial year will be applied to the 2021-22 Scottish Budget. Updated forecasts for the other past years - 2019-20 and 2020-21 - do not have any immediate impact on the Scottish Budget. Under the Fiscal Framework, a single reconciliation takes place three financial years after

each financial year and the updated forecasts in the interim have no direct impact.

In relation to LBTT and Scottish Landfill Tax, Carer's Allowance<sup>55</sup> and FFFP, reconciliations for the BGAs for 2019-20 financial year will be applied to the 2021-22 Scottish Budget.

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

### Income Tax

For Scottish income tax, outturn data is normally available around 16 months after the end of the financial year. Given this long lag of availability of outturn data, Income Tax revenue and BGAs are fixed for three years from the time the Budget is set. A single reconciliation is then applied to the Budget three financial years after the Budget is set, e.g the reconciliation for 2017-18 Income Tax was applied to the 2020-21 budget. Outturn data for Income Tax 2018-19 was delayed due to the impact of COVID-19 and was published in September 2020. Table C3 shows the confirmed 2018-19 Income Tax reconciliation applying to the 2021-22 Budget.

**TABLE C3: CONFIRMED INCOME TAX RECONCILIATION APPLYING TO 2021-22 BUDGET (£ MILLION)**

2018-19 INCOME TAX	Revenues	BGA	Net Position
Forecast as of Budget 2018-19	12,177	-11,749	+428
Outturn	11,556	-11,437	+119
Outturn against forecast	-621	+312*	-309

\* The BGA has been revised downward – this has a positive effect on net revenues.

Figures may not sum due to rounding.

The potential scale of the reconciliations applying to the 2022-23 and 2023-24 Budgets are shown in tables C4 and C5 using the latest forecasts.

<sup>55</sup> This was the only social security benefit in operation during 2019-20 that had a corresponding BGA.

**TABLE C4: FORECAST INCOME TAX RECONCILIATION APPLYING TO 2022-23 BUDGET (£ MILLION)**

2019-20 INCOME TAX	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2019-20	11,684	-11,501	+182	
Latest forecast	11,838	-11,582	+257	+74
Change	+155	-80		

Figures may not sum due to rounding.

**TABLE C5: FORECAST INCOME TAX RECONCILIATION APPLYING TO 2023-24 BUDGET (£ MILLION)**

2020-21 INCOME TAX	Revenues	BGA	Net Position	Forecast Reconciliation
Forecast as of Budget 2020-21	12,365	-12,319	+46	
Latest forecast	11,850	-11,677	+173	+127
Change	-516	+643		

Figures may not sum due to rounding.

Based on the latest forecasts, the reconciliation to the Scottish Budget 2022-23 for 2019-20 Income Tax is expected to be +£74m. An even larger positive reconciliation of +£127 million is expected to apply to the Scottish Budget 2023-24 to account for 2020-21 income tax.

However, these forecasts are not certain and the final position will not be known for sure until outturn receipts are available for 2019-20 in summer 2021, and for 2020-21 in summer 2022.

### Fully Devolved Taxes

Revenue Scotland manages and collects LBTT and SLfT and these revenue streams feed in to the Scottish Budget as they are collected. There is no reconciliation required for these revenues; the Scottish Government manages any variance between what was forecast and actual revenues as part of its in-year budget management process. The latest 2020-21 revenue

forecasts for LBTT and SLfT and the previous revenue forecasts are shown in Table C6.

**TABLE C6: 2020-21 REVENUE FORECAST (£ MILLION)**

	SFC Revenue Forecast – Budget 2020-21	641
LBTT	SFC Revenue Forecast – Budget 2021-22	517
	Change	-125
	SFC Revenue Forecast – Budget 2020-21	116
SLfT	SFC Revenue Forecast – Budget 2021-22	95
	Change	-21

Figures may not sum due to rounding.

The BGAs for these taxes are reconciled in two stages. An in-year reconciliation is made within the same financial year. This is usually on the basis of OBR forecasts produced alongside the UK Autumn Budget. This year, in the absence of the UK Autumn Budget, the OBR forecasts were instead published alongside the UK Spending Review in November 2020. On the basis of the provisional BGAs calculated alongside the UK Spending Review in November 2020, the in-year reconciliations for 2020-21 LBTT and SLfT are shown in table C7.

**TABLE C7: 2020-21 IN-YEAR BGA RECONCILIATIONS (£ MILLION)**

	Forecast BGA – Scottish Budget February 2020	-557
LBTT	Forecast BGA – UK Spending Review November 2020	-391
	In-year reconciliation to 2020-21 Budget	+166
	Forecast BGA – Scottish Budget February 2020	-87
SLfT	Forecast BGA – UK Spending Review November 2020	-87
	In-year reconciliation to 2020-21 Budget	0

Figures may not sum due to rounding.

The net effect on the Scottish Budget 2020-21 of the latest fully devolved revenue forecasts, as set out in table C6, when compared to the in-year BGA reconciliations, as set out in table C7 is +£21m, (comprising +£41m for LBTT and -£20m for SLfT).

Outturn data becomes available in the autumn following the end of each financial year. Using these outturn figures, a final reconciliation is applied to the Block Grant in the financial year two years after the Budget was set. Table C8 shows the final reconciliations for 2019-20 LBTT and SLfT BGAs applying to the 2021-22 Scottish Budget.

**TABLE C8: 2019-20 FINAL BGA RECONCILIATION (£ MILLION)**

	Forecast BGA – Scottish Budget February 2020 <sup>1</sup>	-527
LBTT	Outturn	-533
	Reconciliation to 2021-22 Budget <sup>2</sup>	-6
	Forecast BGA – Scottish Budget February 2020 <sup>1</sup>	-97
SLfT	Outturn	-99
	Reconciliation to 2021-22 Budget <sup>2</sup>	-2

Note 1: As a UK Budget had not been published at the time of the Scottish Budget in February, provisional BGAs were used to inform the Scottish Budget as directed under the Fiscal Framework. Updated BGAs were produced at the UK Budget in March. However, the provisional BGAs were used to inform the Scottish Budget.

Note 2: The final BGA reconciliation effectively calculates the difference between the in-year forecast of the BGA (used to calculate the in-year reconciliation) and the outturn data.

Figures may not sum due to rounding.

Table C9 table shows the confirmed net effect on the budget for 2019-20 LBTT & SLfT and compares outturn to forecasts.

**TABLE C9: 2019-20 OUTTURN COMPARED WITH FORECASTS (£ MILLION)**

	Revenues	BGA	Net Position	
	Forecast as of Budget 2019-20	643	-567	+76
LBTT	Outturn	597	-533	+64

	Outturn against forecast	-46	+34	-12
	Forecast as of Budget 2019-20	104	-91	+13
SLfT	Outturn	119	-99	+20
	Outturn against forecast	+15	-8	+8

Figures may not sum due to rounding.

### Social Security

The latest 2020-21 expenditure forecasts for Social Security and the previous expenditure forecasts are shown in Table C10.

**TABLE C10: 2020-21 EXPENDITURE FORECAST (£ MILLION)**

	SFC Expenditure Forecast - Budget 2020-21	-532
ATTENDANCE ALLOWANCE	SFC Expenditure Forecast - Budget 2021-22	-534
	Change	-2
	SFC Expenditure Forecast - Budget 2020-21	-
PERSONAL INDEPENDENCE PAYMENT	SFC Expenditure Forecast - Budget 2021-22	1583
	Change	-
	SFC Expenditure Forecast - Budget 2020-21	1574
	Change	+9
	SFC Expenditure Forecast - Budget 2020-21	-718
DISABILITY LIVING ALLOWANCE	SFC Expenditure Forecast - Budget 2021-22	-717
	Change	+1
	SFC Expenditure Forecast - Budget 2020-21	-292
CARER'S ALLOWANCE	SFC Expenditure Forecast - Budget 2021-22	-299
	Change	-7

<b>INDUSTRIAL INJURIES DISABLEMENT SCHEME</b>	SFC Expenditure Forecast – Budget 2020-21	-80
	SFC Expenditure Forecast – Budget 2021-22	-82
	Change	-2
<b>SEVERE DISABLEMENT ALLOWANCE</b>	SFC Expenditure Forecast – Budget 2020-21	-7
	SFC Expenditure Forecast – Budget 2021-22	-8
	Change	0
<b>TOTAL SOCIAL SECURITY</b>	SFC Expenditure Forecast – Budget 2020-21	-
	SFC Expenditure Forecast – Budget 2021-22	3213
	Change	-
<b>TOTAL SOCIAL SECURITY</b>	SFC Expenditure Forecast – Budget 2020-21	-
	SFC Expenditure Forecast – Budget 2021-22	3214
	Change	-1

Note: Figures may not sum due to rounding.

As with the fully devolved taxes, the BGAs for benefits are reconciled in two stages. An in-year reconciliation is made within the same financial year. This is usually on the basis of OBR forecasts produced alongside the UK Autumn Budget. This year, in the absence of the UK Autumn Budget, the OBR forecasts were instead published alongside the UK Spending Review in November 2020. On the basis of the provisional BGAs calculated alongside the UK Spending Review in November 2020, the in-year reconciliations to the 2020-21 Social Security BGAs are shown in Table C11.

**TABLE C11: 2020-21 IN-YEAR BGA RECONCILIATION (£ MILLION)**

<b>ATTENDANCE ALLOWANCE</b>	Forecast BGA – Scottish Budget February 2020	+535
	Forecast BGA – UK Spending Review November 2020	+531
	In-year reconciliation to 2020-21 Budget	-5
<b>PERSONAL INDEPENDENCE PAYMENT</b>	Forecast BGA – Scottish Budget February 2020	+1601
	Forecast BGA – UK Spending Review November 2020	+1555



	In-year reconciliation to 2020-21 Budget	-46
DISABILITY LIVING ALLOWANCE	Forecast BGA – Scottish Budget February 2020	+669
	Forecast BGA – UK Spending Review November 2020	+719
	In-year reconciliation to 2020-21 Budget	+50
CARER'S ALLOWANCE	Forecast BGA – Scottish Budget February 2020	+303
	Forecast BGA – UK Spending Review November 2020	+289
	In-year reconciliation to 2020-21 Budget	-14
INDUSTRIAL INJURIES DISABLEMENT SCHEME	Forecast BGA – Scottish Budget February 2020	+85
	Forecast BGA – UK Spending Review November 2020	+84
	In-year reconciliation to 2020-21 Budget	-1
SEVERE DISABLEMENT ALLOWANCE	Forecast BGA – Scottish Budget February 2020	+9
	Forecast BGA – UK Spending Review November 2020	+8
	In-year reconciliation to 2020-21 Budget	-1
TOTAL SOCIAL SECURITY	Forecast BGA – Scottish Budget February 2020	+3203
	Forecast BGA – UK Spending Review November 2020	+3185
	In-year reconciliation to 2020-21 Budget	-17

Figures may not sum due to rounding.

The net effect on the Scottish Budget 2020-21 of the latest devolved social security expenditure forecasts, as set out in table C10, when compared to the in-year BGA reconciliations, as set out in table C11 is -£18m.

Outturn data becomes available in the autumn following the end of each financial year. Using these outturn figures, a final reconciliation is applied to the Block Grant in the financial year two years after the Budget was set. Table C12 shows the reconciliation for the 2019-20 Carer's Allowance BGA

applying to the 2021-22 Scottish Budget, which is the only devolved social security benefit in operation in 2019-20 that required a BGA.

**TABLE C12: CARER'S ALLOWANCE 2019-20 FINAL BGA RECONCILIATION (£ MILLION)**

Forecast BGA - Scottish Budget February 2020 <sup>1</sup>	+286
Outturn	+283
Reconciliation to 2021-22 Budget <sup>2</sup>	-3

Note 1: As a UK Budget had not been published at the time of the Scottish Budget in February, provisional Block Grant Adjustments (BGAs) were used to inform the Scottish Budget as directed under the Fiscal Framework. Updated BGAs were produced at the UK Budget in March. However, the provisional BGAs were used to inform the Scottish Budget.

Note 2: The final BGA reconciliation effectively calculates the difference between the in-year forecast of the BGA (used to calculate the in-year reconciliation) and the outturn data.

Figures may not sum due to rounding.

Table C13 shows the confirmed net effect on the budget for 2019-20 Carer's Allowance and compares outturn to forecasts.

**TABLE C13: 2019-20 OUTTURN COMPARED WITH FORECASTS (£ MILLION)<sup>1</sup>**

	Revenues	BGA	Net Position
Forecast as of Budget 2019-20	-283	290	+6
Carer's Allowance Outturn	-279	283	+4
Outturn against forecast	+4	-7	-3

Note 1: There are minor differences in the methodology used to calculate the expenditure outturn and the BGA outturn, so comparisons should be interpreted with caution.

Figures may not sum due to rounding.

## Non-Tax revenue

### Fines, Forfeitures and Fixed Penalties

Revenue from Fines, Forfeitures and Fixed Penalties (FFFP) is paid into the Scottish Consolidated Fund after being collected by the Scottish Courts and Tribunals Service. No reconciliation takes place for revenue, as the Scottish

Government deals with any variation between forecast and receipts through in-year budget management. The SFC does not provide revenue forecasts for FFFP and instead the Scottish Government calculates its own estimates.

The latest Scottish Government 2020-21 revenue forecast for FFFP and the previous revenue forecasts are shown in Table C14.

**TABLE C14: 2020-21 REVENUE FORECAST (£ MILLION)**

	SG Revenue Forecast – Budget 2020-21	25
FFFP	SG Revenue Forecast – Budget 2021-22	13
	Change	-12

Note: Figures may not sum due to rounding.

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

Table C15 shows the final reconciliation for the 2019-20 FFFP BGA applying to the 2021-22 Scottish Budget.

**TABLE C15: 2019-20 FINAL BGA RECONCILIATION (£ MILLION)**

	Forecast BGA – Budget 2019-20	-27
FFFP	Outturn	-25
	Reconciliation to 2021-22 Budget	+2

Note: Figures may not sum due to rounding.

Table C16 shows the confirmed net effect on the budget for 2019-20 FFFP and compares outturn to forecasts.

**TABLE C16: 2019-20 OUTTURN COMPARED WITH FORECASTS (£ MILLION)**

	Revenues	BGA	Net Position

	Forecast as of Budget 2019-20	25	-27	-2
FFFP	Outturn	27	-25	+2
	Outturn against forecast	+2	+2	+4

Note: Figures may not sum due to rounding.

## Proceeds of Crime

Revenue seized under the Proceeds of Crime Act 2002 is also subject to a BGA. The basis on which this is carried out is currently the subject of dispute between the Scottish and UK Governments and the BGA remains at -£4m while the dispute remains unresolved.<sup>56</sup> The Scottish Government will seek to address this issue as part of the review of the Fiscal Framework.

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

Table C17 shows the confirmed net effect on the budget for 2019-20 PoC and compares outturn to forecasts.

**TABLE C17: 2019-20 OUTTURN COMPARED WITH FORECASTS (£ MILLION)**

		Revenues	BGA	Net Position
	Forecast as of Budget 2019-20	5	-4	+1
PoC	Outturn	4	-4	0
	Outturn against forecast	-1	0	-1

Note: Figures may not sum due to rounding.

## Reconciliations applying to 2021-22 Budget

Table C18 sets out the reconciliations which will be applied to the 2021-22 Budget.

<sup>56</sup> See [Fiscal Framework outturn report: 2019 - gov.scot \(www.gov.scot\)](https://www.gov.scot/resources/documents/2019/07/Fiscal_Framework_outturn_report_2019.pdf) for further background.

TABLE C18: RECONCILIATIONS APPLYING TO 2021-22 BUDGET (£ MILLION)

INCOME TAX 2018-19	-309
OF WHICH:	
FINAL REVENUE RECONCILIATION	-621
FINAL BGA RECONCILIATION	+312
LBTT 2019-20 FINAL BGA RECONCILIATION	-6
SLFT 2019-20 FINAL BGA RECONCILIATION	-2
FFFP 2019-20 FINAL BGA RECONCILIATION	+2
POC 2019-20 FINAL BGA RECONCILIATION	0
CARER'S ALLOWANCE 2019-20 FINAL BGA RECONCILIATION	-3
<b>TOTAL RECONCILIATION REQUIREMENT</b>	<b>-319</b>
NOTE: FIGURES MAY NOT SUM DUE TO ROUNDING.	

### Sources of Data

To view the various sources of data for Tax and Social Security that have been used to compile this Annex C, please see the data annex at [Fiscal Framework: factsheet - gov.scot \(www.gov.scot\)](https://www.gov.scot/data/annexes/annex-c-fiscal-framework-factsheet). Please note that data for Fines, Forfeitures and Fixed Penalties (FFFP) and Proceeds of Crime (POC) are as detailed in Table C19.

<b>TABLE C19: FFFP AND POC DATA SOURCES</b>	
<b>Data</b>	<b>Source</b>
FFFP Revenue Outturn and Forecasts	Scottish Government unpublished data
FFFP Budget 2019-20 Budget BGA	UK Autumn Budget 2018
FFFP Outturn BGA	HMCTS Trust Statement 2019-20
POC Revenue Outturn and Forecasts	Scottish Government unpublished data
POC 2019-20 Budget BGA	UK Autumn Budget 2018
POC Outturn BGA	N/A

## Capital Borrowing

The 2020-21 Scottish Budget announced plans to borrow the annual maximum of £450 million capital reflecting the climate emergency, however at time of publication no drawdowns have occurred.

The UK spending review of 2020 outlined a significant reduction to the medium-term Capital and Financial Transactions budgets, therefore in order to retain sufficient borrowing headroom to mitigate this in future years 2020-21 borrowing is likely to be less than previously advertised.

Final decisions for 2020-21 borrowing are yet to be finalised, however, £300m is used as an indicative figure in Table C20 as the current medium-term central scenario.

The 2021-22 Scottish Budget confirms the intention to borrow £450 million and this is assumed to be over a period of 25 years. Final decisions on all future borrowing will be taken over the course of the applicable financial years.

Chapter 5 sets out the Scottish Government's policy of borrowing between £250 million and £450 million over the remaining period of the National Infrastructure Mission, but this is not included in table C20 at this stage.

On the basis of existing and planned borrowing included in the table, the Scottish Government will have accumulated £2.22 billion in capital debt by the end of 2021-22, 74% of its overall limit. However as repayments of principle increase over time this ensures sufficient borrowing headroom will be available to support the National Infrastructure Mission in subsequent financial years.

**TABLE C20: CAPITAL BORROWING AND REPAYMENT SCHEDULE**

£ million	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
<b>Debt Stock at the start of the Year</b>	<b>1,036</b>	<b>1,258</b>	<b>1,617</b>	<b>1,844</b>	<b>2,212</b>	<b>2,113</b>	<b>2,004</b>
<b>Debt Stock as a percentage of Debt Cap</b>	<b>35%</b>	<b>42%</b>	<b>54%</b>	<b>61%</b>	<b>74%</b>	<b>70%</b>	<b>67%</b>
<b>Borrowing</b>	<b>250</b>	<b>405</b>	<b>300</b>	<b>450</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Repayment on 2015-16 borrowing</b>	<i>Capital</i>	9.4	9.4	9.4	9.4	9.4	9.4
	<i>Interest</i>	0.0	0.0	0.0	0.0	0.0	0.0
<b>Repayment on 2016-17 borrowing</b>	<i>Capital</i>	11.1	11.1	11.1	11.1	11.1	11.1
	<i>Interest</i>	0.0	0.0	0.0	0.0	0.0	0.0
<b>Repayment on 2017-18 borrowing</b>	<i>Capital</i>	7.1	14.3	14.6	14.9	15.2	15.8
	<i>Interest</i>	7.7	8.3	8.1	7.8	7.5	7.2



<b>Repayment on 2018-19 borrowing</b>	<i>Capital</i>	11.9	24.1	24.3	24.5	24.8	25.0
	<i>Interest</i>	2.1	2.2	2.0	1.7	1.5	1.3
<b>Repayment on 2019-20 borrowing</b>	<i>Capital</i>		3.8	7.7	7.7	7.8	7.8
	<i>Interest</i>	0.0	1.1	1.1	1.1	1.1	1.0
<b>Repayment on 2020-21 borrowing</b>	<i>Capital</i>			5.5	11.2	11.2	11.3
	<i>Interest</i>		0.0	1.7	1.8	1.8	1.7
<b>Repayment on 2021-22 borrowing</b>	<i>Capital</i>				10.0	20.1	20.4
	<i>Interest</i>				4.8	5.3	5.1
<b>Repayment on 2022-23 borrowing</b>	<i>Capital</i>						
	<i>Interest</i>						
<b>Total Repayments of Principal</b>		<b>28</b>	<b>47</b>	<b>63</b>	<b>73</b>	<b>89</b>	<b>100</b>
<b>Debt Stock at the end of the Year</b>		<b>1,258</b>	<b>1,617</b>	<b>1,844</b>	<b>2,212</b>	<b>2,113</b>	<b>2,004</b>
<b>Debt Stock as a percentage of Debt Cap</b>		<b>42%</b>	<b>54%</b>	<b>61%</b>	<b>74%</b>	<b>70%</b>	<b>67%</b>
<b>Repayment period for borrowing (years)</b>		10	20/ 25/ 25	25*	20*	0	0
<b>Interest rate</b>		0.97	0.60/ 0.56/ 0.76	0.63*	1.22*	0	0
<b>Is interest rate fixed or variable?</b>		Fixed	Fixed	Fixed	Fixed		

\*Figures related to 2020-21 and 2021-22 borrowing are indicative at this stage.

### Resource Borrowing

As set out in Chapter 5, the Scottish Government will make full use of resource borrowing in 2021-22. The table below shows the full budget impact of borrowing and reconciliations over the period.

**TABLE C21: MEDIUM-TERM IMPACT OF RECONCILIATIONS AND RESOURCE BORROWING (£ MILLION)**

	2020-21	2021-22	2022-23	2023-24	2024-25
<b>Known and Forecast Reconciliations</b>	- 207	-319	74	127	-
<b>Planned Resource Borrowing</b>	207	319	-	-	-
<b>Projected Resource Cost of Resource Borrowing</b>	-	-21	-75	-106	-106
<b>Net Impact</b>	-	-21	-1	21	-106
<b>YOY Net Impact</b>		-21	20	21	-127

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

- The projected resource cost of borrowing line comprises repayments of both principal and interest, both of which impact the resource budget.
- All drawdowns are based on NLF annuity structure loans, this is the only source of resource borrowing available to the Scottish Government under the Fiscal Framework.
- These loans are priced at 11 basis points above the equivalent UK par Gilt yield. Assumptions in Table C21 use the implied forward rates as of 15/01/21 plus a premium of 50 basis points.
- NLF annuity loans have principal deferred in the first (semi-annual repayment) period.
- A five-year tenor is assumed in all cases (the maximum allowable under the Fiscal Framework).

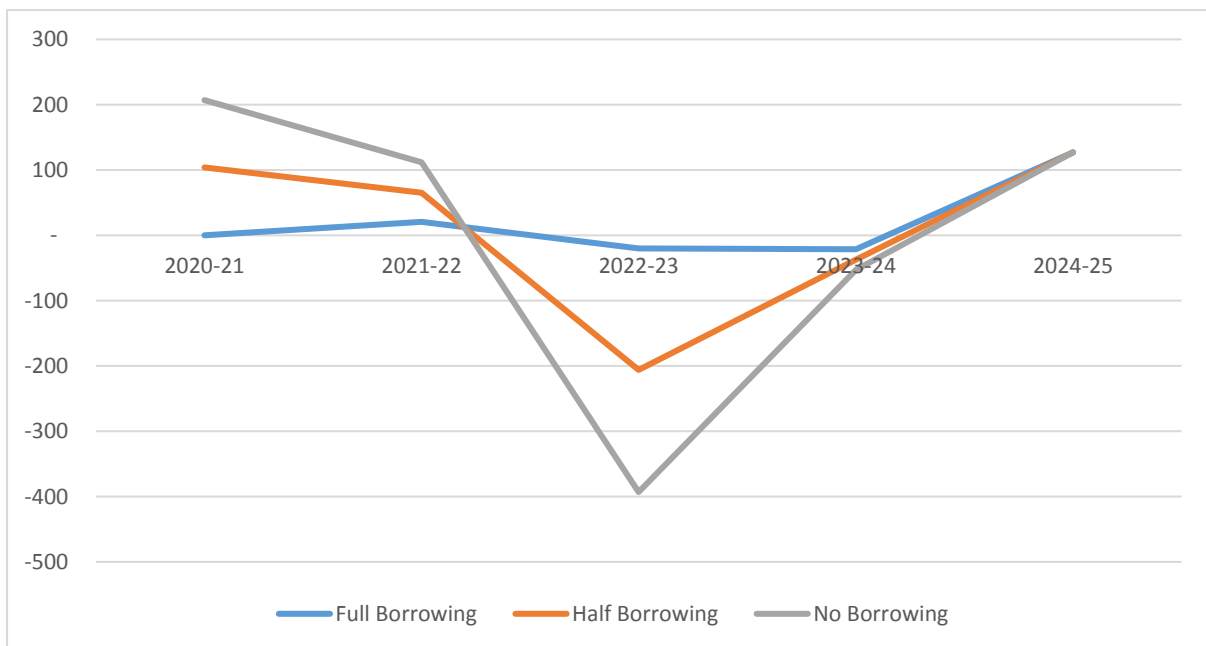
As stated in 5.1.2 The Scottish Government will assess all planned Resource Borrowing decisions to smoothen the funding trajectory over five years. The graphs below demonstrate what this trajectory would look like under three scenarios:

- Borrowing the full allowance – as per table above

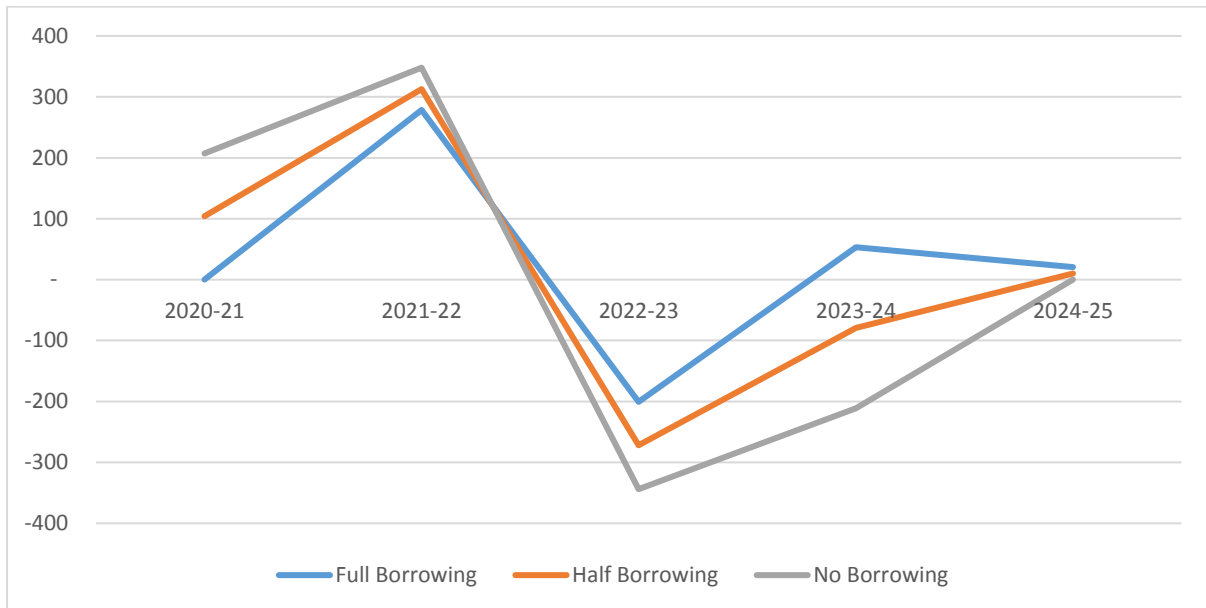
- Borrowing half the available allowance
- Borrowing nothing

In the case of 'no borrowing' the swings in the funding position are most pronounced for both budgets. The graphs below show the impact in the original and future budget years, taking into consideration actual or expected borrowing for reconciliations in each of the years as well as repayment of borrowing and interest in subsequent fiscal years.

#### CHART C1: INCREMENTAL EFFECT OF DIFFERENT BORROWING STRATEGIES ON THE SCOTTISH BUDGET AT 2021-22 SCOTTISH BUDGET



Note: Positive values connote reconciliation requirements and repayments which reduce the budget.

**CHART C2: INCREMENTAL EFFECT OF DIFFERENT BORROWING STRATEGIES ON THE SCOTTISH BUDGET AT 2020-21 SCOTTISH BUDGET**

These projections are subject to considerable volatility and have moved significantly in the course of one year. However, in each circumstance, planning to borrow in full against known and forecast adverse reconciliations *reduces volatility* over the medium term.

### Scotland Reserve

Table C22 shows the 2020-21 Reserve position following the 2021-22 Autumn Budget Revision and 2019-20 Final Outturn.

**TABLE C22: 2020-21 SCOTLAND RESERVE FORECAST AT 31 DECEMBER 2020**

<b>£ million</b>	
<b>2019-20 Opening Balance</b>	(605.0)
<b>2019-20 Movements</b>	172.4
<b>In-year Reserve Drawdown</b>	428.8
<b>Forecast Underspends</b>	(256.4)
<b>2019-20 Closing Balance</b>	(432.6)
<b>2020-21 Expenditure Commitments</b>	222.6
<b>Scottish Budget Commitments</b>	168.0
<b>Effects of Budget Revisions</b>	54.6
<b>2020-21 Forecast Residual Balance</b>	(210.0)
<b>Of Which</b>	
<b>Resource</b>	(68.9)
<b>Capital</b>	(141.1)

2020-21 drawdowns from the reserve have increased by £54.6 million to date. £24.6m was drawn down (£17.6m Resource and £7m capital) in the Summer Budget Revision in order to balance the funding position while an additional £30m of capital was drawn down in the Autumn Budget Revision

as an interim measure. It is highly likely that this additional Capital drawdown will be reversed through the 2020-21 Spring Budget Revision which should support drawdown assumptions in the 2021-22 Scottish Budget.

The Scotland Reserve (by nature) is a constantly moving position. Annual drawdowns are not finalised until the end of a financial year, equally additions to the reserve from any underspends or excess devolved tax receipts are not finalised until the final outturn is complete some six months after the end of the financial year.

Table C22 reflects the confirmed 2019-20 position following the 2019-20 final outturn process and interim 2020-21 drawdown plans. However anticipated underspends from 2020-21 which would result in additions to the reserve are not reflected here.



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