IFS

Institute for Fiscal Studies

IFS Report R238

Bee Boileau
David Phillips

The overall funding outlook

Economic and Social Research Council

2. The overall funding outlook

Bee Boileau and David Phillips

The Scottish Government's overall budget depends both on funding from the UK government, which is determined largely via the Barnett formula, and on its own devolved revenues, borrowing and reserves, which are governed by the Fiscal Framework. This chapter of the report looks at the funding outlook in the short term (2022–23 and 2023–24), medium term (2024–25 to 2027–28) and beyond, drawing on Scottish Government and Scottish Fiscal Commission (SFC) figures.

Key findings

1. The funding available to the Scottish Government in 2023–24 for day-to-day non-benefits spending is around £1.5 billion higher than forecast in May 2022 at the time of the Resource Spending Review. Of this, just over £0.8 billion reflects higher funding from the UK government via the Barnett formula, and another £0.8 billion reflects a forecast improvement in net revenues from devolved taxes, only a small part of which is due to new tax raising measures. This cash-terms increase is partially, but not fully, offset by higher forecast inflation.

2. The Scottish Budget for 2023–24 shows day-to-day non-benefits spending increasing by 1.6% in real terms, on average, compared to what was originally budgeted to be spent this year, which is more generous than the 1% fall expected at the time of the Resource Spending Review. However, these comparisons exclude in-year top-ups to the funding available to the Scottish Government this year, which SFC forecasts suggest amount to around £1.1 billion. Taking account of this additional funding would suggest the amount available for non-benefits spending will actually fall by 1.6% next year compared to this, or 0.8% after adjusting for major one-off costs such as council tax rebates. The Scottish Government formally allocated some of this additional funding in the Autumn Budget Revision in November 2022, but the SFC's forecasts suggest there may be another £400–600 million available for allocation in the Spring Budget revision in February 2023.

3. Medium-term funding projections by the Scottish Government suggest an improved outlook for the next four years compared to what was expected at the time of the Resource Spending Review in May 2022. However, the outlook remains difficult, with funding for day-to-day non-benefit spending set to be almost 2% lower in 2027–28 than in 2022–23. This is despite forecasts for a significant increase in net revenues from Scotland's devolved income tax revenues over the next few years: if this did not materialise, the reduction could be closer to 5% over the same period. This reflects several factors including planned spending restraint by the UK government, significant forecast growth in Scotland's devolved benefit spending as a result of policy reforms (reducing the amount available for public services), and the plan to draw down reserves fully this year (boosting funding this year, and thereby depressing growth in spending going forwards).

4. These cuts to overall funding would imply difficult trade-offs for the Scottish Government as it allocates funding between different services. For example, if health spending were increased by 2.9% a year in real terms each year between 2023–24 and 2027–28 (the increase planned for 2023–24 and roughly in line with estimates of what might be needed in the long term) and spending on the net zero, energy and transport portfolio were increased by 4% a year (slightly less than planned, on average, in the Resource Spending Review), the amount available for all other service areas would fall by around 6% between 2023–24 and 2024–25, and by 13% by 2027–28. Without the forecast improvement in the net income tax position, the implied falls would be almost 10% and 19%, respectively, for those two years.

5. The Scottish Government's medium-term projections were purposefully cautious, and based on the indicative spending totals set out by the UK government in the Autumn Statement, a reasonable central projection for 2027–28 would be for funding to be around 1% higher in that year than projected by the Scottish Government. This would be a useful sum of money but would not significantly ameliorate the difficult trade-offs the Scottish Government would face. The indicative spending totals pencilled in by the UK government would imply difficult trade-offs between public services in England too, and it would not be surprising if they were revised up in future UK Budgets or Spending Reviews. This would provide additional funding for the Scottish Government, but uncertainty about UK government spending decisions beyond 2024–25 and constraints on Scottish Government borrowing mean it is not unreasonable to make long-term plans on a cautious basis.

6. The long-term funding outlook beyond 2027–28 will also be largely determined by UK government spending decisions and the performance of Scotland's devolved tax

revenues relative to equivalent revenues in the rest of the UK (rUK).[1] The Barnett formula determines how much the Scottish Government's budget increases when UK government spending in England increases. It provides Scotland with a population-share of the change in spending planned for England, which means the same cash per-person increase in Scotland as in England before considering the impact of differential population growth. Because spending is currently higher per-person in Scotland than England, the same cash per-person increase represents a smaller *percentage* increase in Scotland. When cash spending per person grows in England, this reduces the percentage by which spending in Scotland exceeds that in England, making it more difficult for the Scottish Government to maintain higher levels of service provision than in England, such as free personal care and free university education, and to meet rising spending pressures.

7. The speed of this 'Barnett squeeze' depends on the rate of growth in spending in England (both real-terms growth and to offset inflation), and the rate of population growth in Scotland relative to England. Using long-term projections for inflation and GDP growth from the Office for Budget Responsibility – assuming public spending is held constant as a share of GDP – and taking into account population projections from the Office for National Statistics, we project Scottish Government funding would increase by an average of 1.2% per year in real terms over the 30 years between 2027–28 and 2057–58. This compares to an average of 1.4% per year in England over the same period, with bigger gaps in earlier years and smaller gaps in later years. Under this scenario, spending per person in Scotland would fall from 124% of English levels in 2027–28, to 121.4% in 2032–33, and to 115% in 2057–58.

8. Faster real-terms spending growth in England to meet the rising costs of health and social care (which are expected to grow faster than GDP) would result in bigger absolute increases in funding for the Scottish Government, making it easier for it to meet these costs itself. However, it would increase the Barnett squeeze on funding levels relative to England – although funding per person in Scotland would remain higher than in England. Boosting Scottish population growth would reduce both the relative and absolute levels of funding per person received via the Barnett formula, potentially making it more difficult to meet these rising costs. This is because the Barnett formula only partially accounts for population growth when allocating funding.

[1] Strictly speaking, the comparator has switched to England and Northern Ireland, following the devolution of tax powers to Wales in 2018–19 (Stamp Duty Land Tax and landfill tax) and 2020–21 (income tax). We use the term rUK throughout for ease of reference.

2.1 The short term: 2022–23 and 2023–24

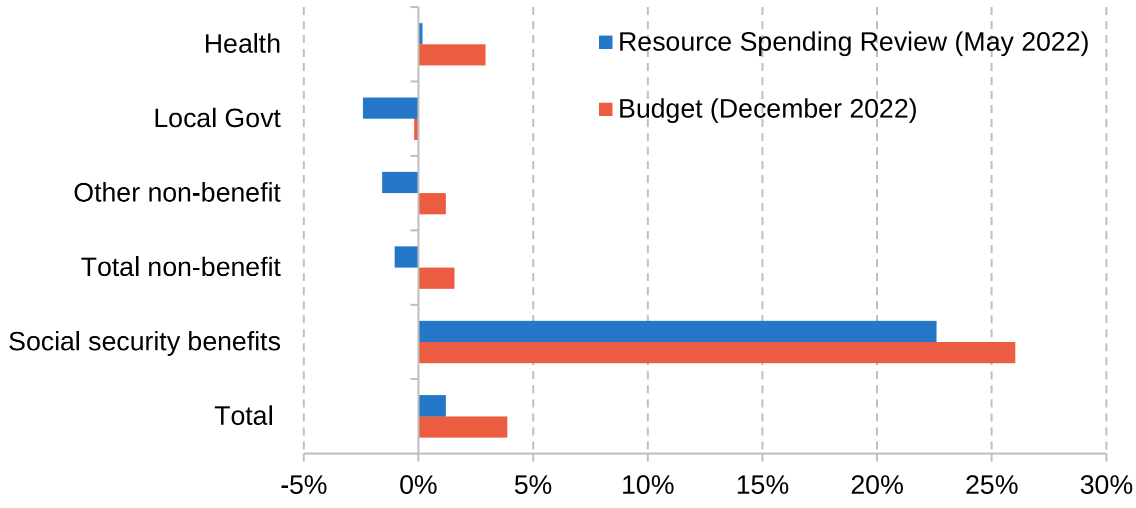
The Scottish Government set out its initial plans for spending in 2023–24 (and the following three years) in its Resource Spending Review in May 2022. The blue bars in Figure 2.1 show that these plans implied real-terms cuts to most services compared to what was initially budgeted to be spent in the current financial year, 2022–23. Overall, Scottish Government figures suggested that excluding spending on social security benefits (which was due to increase by 22.6%), spending was set to fall by 1.0% in real terms. Figures from the Scottish Fiscal Commission (2022a), published alongside the Resource Spending Review, showed a bigger year-on-year real-terms cut of 2.8% to non-benefits spending, because these figures take into account the in-year top-ups to spending in 2022–23 whereas the Scottish Government's practice of comparing to initial budgets does not (a higher baseline increases the size of subsequent cut).

The 2023–24 Budget published in December 2022 shows a significantly different picture. Spending plans for 2023–24 have been topped up by around £1.5 billion compared to those set out in May. Updated figures from the Scottish Government, shown by the red bars, therefore show most service areas seeing real-terms increases in funding, with total non-benefits spending set to increase by 1.6% in real terms compared to what was originally budgeted for spending this year, despite an increase in forecast inflation. We discuss plans for local government (including schools) in more detail in Chapter 4.

It is important to note that all of these real-terms figures are based on the GDP deflator measure of inflation, which measures the change in price of goods and services produced in the UK. As a result, these figures exclude increases in the costs of imported energy and food. This means that they are likely to understate the true rate of cost growth facing public services, and in turn, to understate the real-terms planned spending cuts as of the Resource Spending Review and to overstate the planned real-terms increases in spending as of the Budget. However, it is still highly likely to be the case that the outlook has improved somewhat since the Resource Spending Review in May.

Several factors explain the improved funding outlook for next year, as shown in Figure 2.2. First, in the Autumn Statement, the UK government announced additional spending on public services – in particular, the NHS, schools and local government – and business rates reliefs in England, which has generated just under £1.1 billion in additional funding for the Scottish Government via the Barnett formula. The Resource Spending Review had already assumed £250 million would be forthcoming, so the net effect is an additional £0.8 billion for the Scottish Budget.

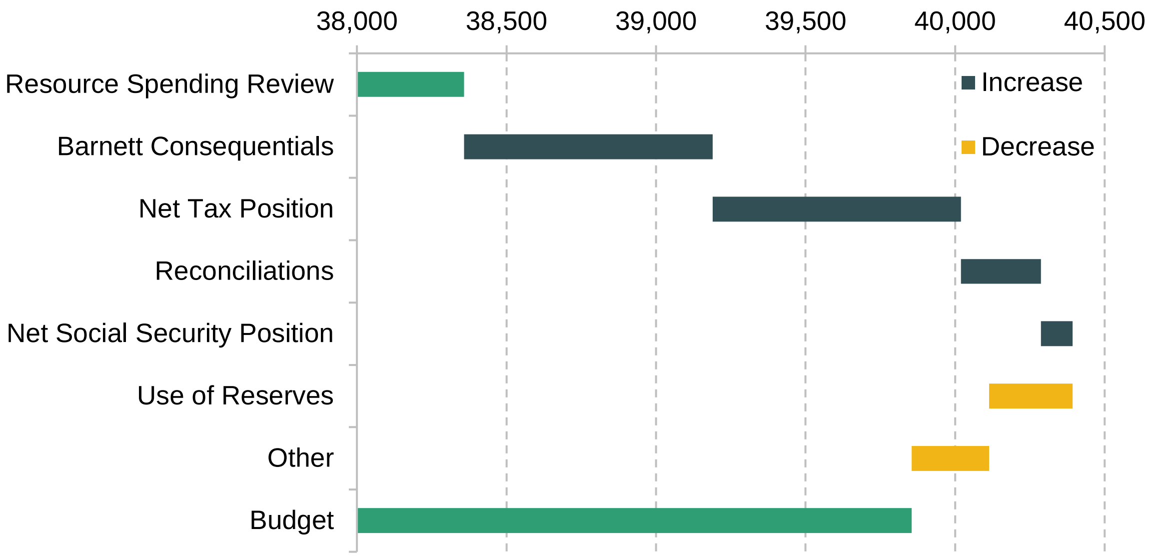
Figure 2.1. Planned real-terms changes in spending, 2022–23 to 2023–24



Note: Other non-benefit spending includes all other Scottish Government portfolios, as well as funding for the Scottish Parliament and Audit Scotland. The vast majority of total non-benefit spending relates to spending on public services but this also includes some spending on cash transfers to households such as Discretionary Housing Payments. Figures adjusted for inflation using Office for Budget Responsibility GDP deflator forecasts (March 2022 forecasts for the Resource Spending Review and November 2022 forecasts for the Budget).

Source: Authors' calculations using Scottish Government (2022a, b).

Figure 2.2. Contributions to change in funding for 2023–24 for non-benefit spending between the Resource Spending Review and the Budget, £ million



Source: Authors' calculations using Scottish Fiscal Commission (2022b).

Increases in the amount forecast to be raised from devolved taxes, relative to the amount subtracted from the Scottish Government's block grant funding to account for tax devolution (the block grant adjustments or BGAs), also generate about £0.8 billion compared with previous forecasts. This amount mostly relates to income tax (where the forecast net position has improved by almost £0.7 billion), only a small part of which (£130 million) is as a result of income tax policy changes. Instead, most of the improvement in the net tax position relates to a forecast improvement in the growth of the underlying tax base relative to rUK. We discuss this further in Chapter 3.

There are also several smaller changes, which largely offset each other. First, final outturn income tax revenues in 2020–21 were better than previously forecast, generating a positive reconciliation payment for the Scottish Budget in that year. Second, compared with previous forecasts, there has been an improvement in the net position on devolved benefit spending next year (although the forecasts still imply that spending will exceed funding by almost £0.8 billion, reducing the amount available for non-benefit spending). However, the planned drawdown of all reserves this year means that there will be no funding available to draw down next year, as previously planned. Also, a number of other forecast changes will reduce funding.

The implications of in-year increases in funding in 2022–23

The year-on-year changes in spending published by the Scottish Government in its 2023–24 Budget overstate the true year-on-year changes in spending power though. This is because by using the original 2022–23 Budget as the baseline for comparison, the figures ignore in-year top-ups to spending this year.[2]

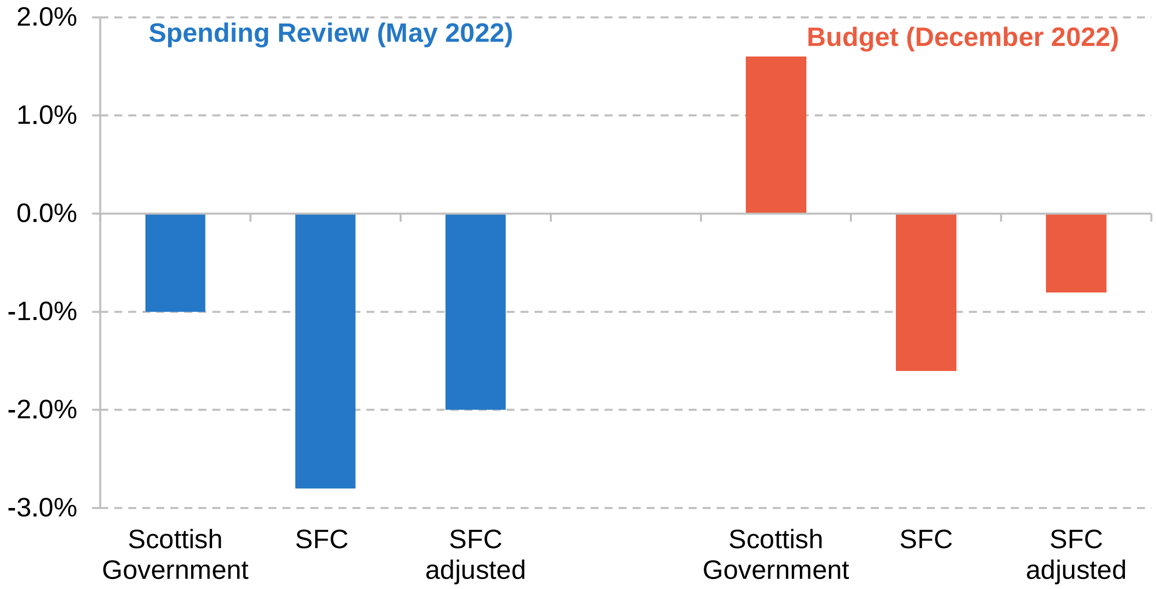
The SFC's forecasts imply that the total amount available for non-benefit spending in 2022–23 will be approximately £1.2 billion higher than initially budgeted for. Just under £0.1 billion of this relates to transfers of responsibility from the UK government to the Scottish Government ('Machinery of Government' changes), meaning just over £1.1 billion of genuine additional funding. Of this, the largest components are extra UK government funding via the Barnett formula (£450 million), largely as a result of measures to help address the cost-of-living crisis, and additional drawdown of reserves (£605 million as opposed to £120 million), following bigger than expected payments into reserves in 2021–22. Borrowing is also set to be somewhat higher (£100 million as opposed to £20 million) than originally planned.

[2] The Scottish Government argues that Budget-to-Budget comparisons are most meaningful because in-year top-ups to the base year may reflect one-off spending items (such as this year's council tax rebates), and top-ups may be made to the subsequent year, which cannot be taken into account. In addition, in-year top-ups are uncertain until confirmed by the UK government's Supplementary Estimates process. However, to the extent that in-year top-ups are being used to pay for recurrent costs (such as higher local government pay settlements), ignoring them will overstate current expectations of the increase in funding available to pay for recurrent costs.

Part of this funding was allocated in the Autumn Budget Revision – largely to pay for cost-of-living support, such as council tax rebates (£280 million) and higher funding for councils to pay for pay rises (£140 million). However, comparing this revised Budget to the latest SFC forecasts suggests that around £0.4–0.6 billion has yet to be formally allocated to specific service lines, equivalent to just over 1%–1.5% of the Scottish Government's funding for non-benefit resource spending. It is likely that part – and perhaps even all – of this has been earmarked internally by the Scottish Government, and the allocation of these remaining funds could be announced in the Spring Budget Revision in February.

If all this extra funding is allocated in the current year – and the Scottish Government has said it plans to draw down its Reserves in full – rather than increasing in real terms, then non-benefit spending will fall by 1.6% in real terms next year. This is illustrated in the second red column of Figure 2.3. Stripping out confirmed spending on council tax rebates and 'bridging payments' for families with children (which is not officially part of Scotland's social security benefit spending but is more akin to this than spending on public services), the amount available to spend is set to fall by 0.8%, as shown in the third red column of Figure 2.3.

Figure 2.3. Comparison of Scottish Government and SFC figures for real-terms changes in funding for non-benefit spending, 2022–23 to 2023–24



Note: The 'Scottish Government' columns show Budget-derived figures, using Budget-to-Budget comparisons. The 'SFC' columns show figures derived from the SFC's Economic and Fiscal Forecasts, comparing the latest funding position for 2022–23 with the Budget for 2023–24. The 'SFC adjusted' columns subtract spending on council tax rebates and bridging payments for low-income families from the SFC's 2022–23 baseline, reducing the size of the subsequent cut.

Source: Authors' calculations using Scottish Government (2022a, b).and Scottish Fiscal Commission (2022a, b).

Therefore, while the Budget documentation accurately reflects the amount available to spend next year, it overstates the true *increase* in available resources relative to this year. Nevertheless, the additional funding available in 2023–24, as a result of additional UK government funding and a forecast improvement in the net tax position, means that, despite higher inflation, the picture next year looks a little less difficult than it did when the Resource Spending Review was published in May 2022. And if the Scottish Government does not utilise all of the additional funding available this year, it will be able to carry it forward as Reserves, allowing it to top up spending in 2023–24 or subsequent years.

2.2 Medium term: 2024–25 to 2027–28

The funding available in subsequent years has also increased relative to what was set out in the Resource Spending Review. In 2024–25, this reflects both additional UK government funding via the Barnett formula and a forecast improvement in the net tax position by the SFC. From 2025–26 onwards, the net tax position is forecast to continue to improve, but this is partially offset by pencilled-in plans by the UK government to hold down the rate of growth in departmental spending to 1% in real terms: if kept to, over time this would act to reduce the funding provided via the Barnett formula compared with previous expectations.

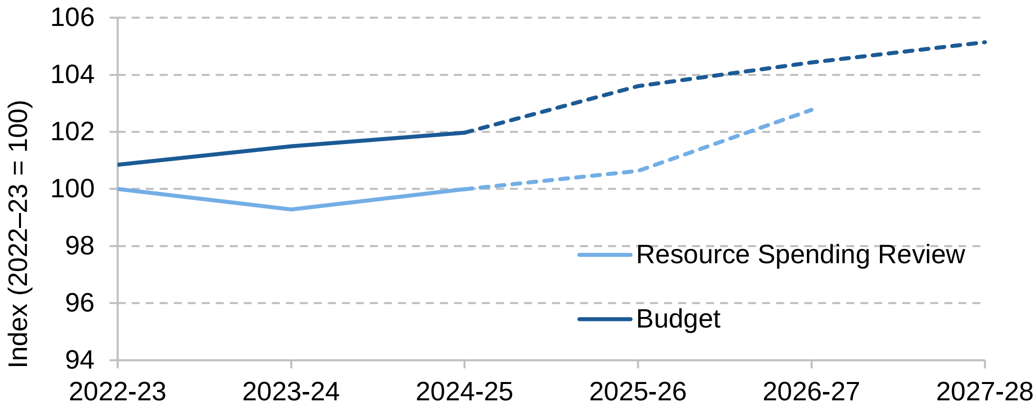
Figure 2.4 shows real-terms projections for Scottish Government funding for 2022–23 to 2027–28, based on figures reported by the SFC as of the Resource Spending Review (the dashed lines) in May 2022 and the Budget in December 2022, again using the GDP deflator to adjust for inflation.[3] Panel A shows total resource funding, including for social security benefits. Panel B shows funding for non-benefit spending. Panel C shows funding for non-benefit spending, stripping out the forecast change in the net tax position from 2023–24 onwards, except that part which relates to new revenue-raising policy measures. Figures are normalised to 100 in 2022–23 as of the Resource Spending Review in May 2022, to make it easier to see how the overall projections have changed since then, and how the projected funding available changes over time.

It is worth noting that the Scottish Government has been deliberately ‘cautious’ when making these projections, assuming a slower rate of growth in its block grant funding than it would receive if funding for comparable services in England (which determines how much the Scottish Government receives via the Barnett formula) were to increase by 1% a year in real terms, in line with the overall average. If it did, then funding would be around 1% higher than assumed by the Scottish Government by 2027–28; this is a useful amount, but does not significantly change

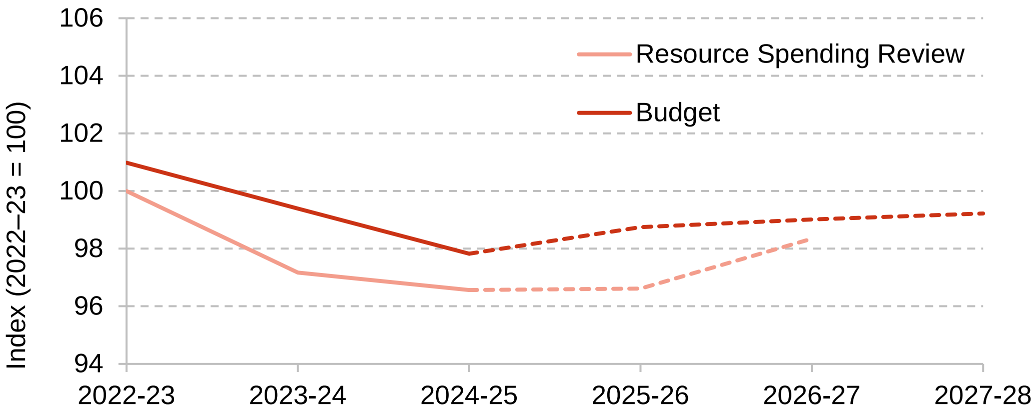
[3] Note that forecast falls in energy and food prices mean that it is less likely that this measure of inflation will underestimate inflation facing public services in the medium term than in the short term (indeed, it may overestimate costs).

Figure 2.4. Real-terms resource funding (2022–23 = 100), 2022–23 to 2027–28

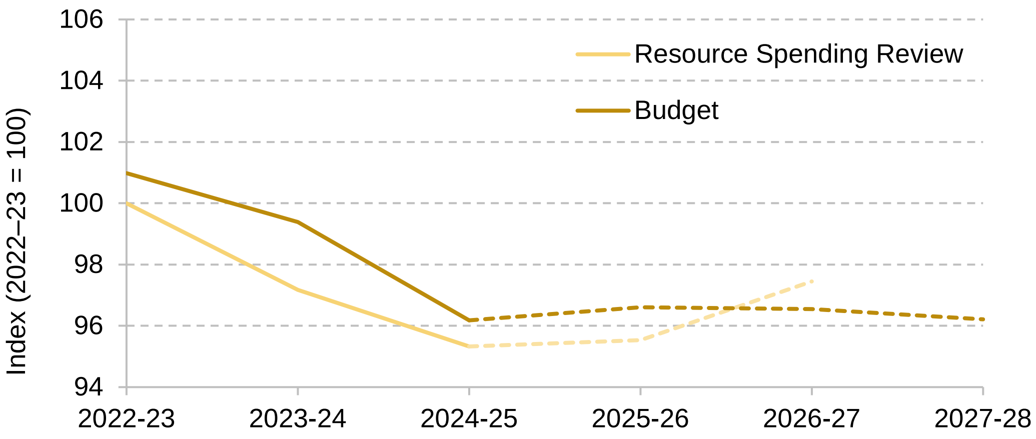
Panel A. Total



Panel B. Excludes benefit spending



Panel C. Illustrative scenario for spending excluding benefit spending and the forecast boost to funding from a strengthening net tax position



Source: Authors' calculations using Scottish Fiscal Commission (2022a, b).

the picture presented by their more ‘cautious’ assumptions. In addition, the spending totals pencilled in by the UK government would require it to make difficult choices when allocating spending between services in England. The Office for Budget Responsibility (2022a) shows that if spending on health services increased by 3.1% a year in real terms between 2024–25 and 2027–28, alongside commitments on defence and aid spending, then this would imply cuts averaging almost 1% to other public service spending. Therefore, it would not be a surprise if these totals were to be revised up in future UK Budgets or Spending Reviews. This would provide additional funding for the Scottish Government, but uncertainty about UK government spending decisions beyond 2024–25. So, constraints on Scottish Government borrowing mean it is not unreasonable to make long-term plans on a cautious basis.

Bearing this in mind, and using the Scottish Government’s projections, panel A of Figure 2.4 shows that the total available for total resource spending has increased for every year compared to those figures published alongside the Resource Spending Review in May 2022 (the dark blue line is above the light blue line in every year). There is around 1% more available to spend in the current financial year, around 2% more over the next two years, and almost 3% more in 2025–26, with the gap then shrinking in 2026–27. The panel also shows that the amount of funding is set to increase each year in real terms, according to the projections published by the SFC, amounting to a 5% real-terms increase overall by 2027–28. While this is an increase, it is relatively small, reflecting in large part the tight spending plans pencilled in by the UK government in the November 2022 Autumn Statement.

Panel B shows a somewhat different pattern for non-benefit spending. As for total spending, the amount available to spend is projected to be higher in real terms in each year than in the Resource Spending Review in May 2022 (the dark red line is above the light red line in every year). However, the increase relative to these previous projections is generally a little smaller than for total spending, reflecting the fact that future benefit spending is expected to be higher as a result of higher inflation and higher disability benefit caseloads, absorbing some of the increase in planned spending between May and December.

More significantly, panel B shows that the funding available for non-benefit spending is set to fall in 2023–24 and 2024–25 relative to the current financial year and then increase only modestly. As a result, it would still be around 2% lower than in 2022–23. The fall and subsequent very slow growth reflect several factors. First, as shown in Section 2.1, additional reserve drawdown and extra funding from the UK government in the current financial year mean that rather than increase, as suggested in Scottish Government Budget documentation, the amount available for non-benefit spending is set to fall in 2023–24. Second, forecasts suggest that the Scottish Government will have to repay over £800 million to the UK government in 2024–25 to offset what now appear to be optimistic forecasts of Scotland’s net tax revenue position when the 2021–22 Budget was set. Third, the aforementioned tight spending plans for

2025–26 onwards pencilled in by the UK government will affect how much the Scottish Government receives via the Barnett formula. Fourth, benefit spending is forecast to grow substantially (see Table 2.1), partly reflecting new benefits and reforms to disability benefits being rolled out by the Scottish Government, which will reduce the amount available for public service spending and other spending. We show below that the resulting funding squeeze implies difficult trade-offs when allocating funding between service areas.

Panel C shows projections of the amount that would be available for non-benefit spending, stripping out changes in funding resulting from changes in the net tax position for income tax (with the exception of changes driven by newly announced tax policies).[4] Because the net income tax position (and the overall net tax position shown in Table 2.1) is now forecast to improve significantly over the next few years (an issue discussed in more detail in Chapter 3), stripping these changes out would significantly reduce the amount of funding available to the Scottish Government. For example, funding for non-benefit spending would fall by around 5% in real terms between 2022–23 and 2024–25, and then be little changed over the following three years. If the forecast improvement in the net income tax position does not materialise, the bigger funding squeeze implied would therefore make the already difficult trade-offs between service areas even more challenging.

Table 2.1 shows just how much forecasts for the overall net tax position have changed since those published in May 2022 and used as part of the Resource Spending Review. At that time, net revenues from Scotland's devolved taxes were forecast to be around −£300 million for the current financial year (2022–23), and −£30 million in 2026–27. The latest forecasts show net revenues of £24 million for this year, and almost £1.2 billion in 2026–27, rising to £1.4 billion the year after. This amounts to around 3% of the projected amount available for non-benefit spending by the Scottish Government in that year. The table also shows that the latest forecasts imply that net spending on benefits – on top of the funding provided by the UK government through associated BGAs – will be largely or fully covered by net revenues from Scotland's devolved taxes. This was not the case at the time of the Resource Spending Review in May 2022, when tax revenues and benefit spending forecasts implied that around £1.3 billion of general funding from the UK government would have to be used to help fund devolved Scottish benefits.

4 In particular, increases in revenues associated with increases in income tax rates and freezes or reductions in income tax thresholds announced as part of the 2023–24 Budget are not stripped out of future forecasts. All other changes in the net income tax position are stripped out. In doing so, we account for the fact that the forecasts published alongside the Budget in December will be used to determine the net amount of income tax revenue available for spending in 2023–24. If these forecasts are proved wrong, a reconciliation payment would be required in 2026–27 after outturns data are available, and the Scottish Government could borrow to pay for this payment in full or in part. Full underlying calculations are available from the authors on request.

Table 2.1. Net social security and net tax position (cash terms), 2022–23 to 2027–28, £s million

	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28
Resource Spending Review (May 2022)						
Tax revenues	15,304	16,058	16,897	17,716	18,433	
Tax BGAs	15,610	16,324	16,730	17,612	18,464	
Net tax position	*−306*	*−265*	*167*	*103*	*−31*	
Benefit spending	4,063	4,963	5,615	5,998	6,380	
Benefit BGAs	3,602	4,082	4,574	4,825	5,103	
Net benefit position	*−462*	*−881*	*−1,042*	*−1,173*	*−1,277*	
Budget (December 2022)						
Tax revenues	15,525	16,663	17,433	18,222	19,173	20,448
Tax BGAs	15,501	16,101	16,535	17,146	18,006	19,028
Net tax position	*24*	*562*	*898*	*1,076*	*1,167*	*1,419*
Benefit spending	4,077	5,136	6,051	6,442	6,791	7,155
Benefit BGAs	3,703	4,360	5,006	5,231	5,467	5,739
Net benefit position	*−374*	*−776*	*−1,046*	*−1,212*	*−1,325*	*−1,416*

Source: Authors' calculations using Scottish Fiscal Commission (2022a, b).

Scenarios for different public services

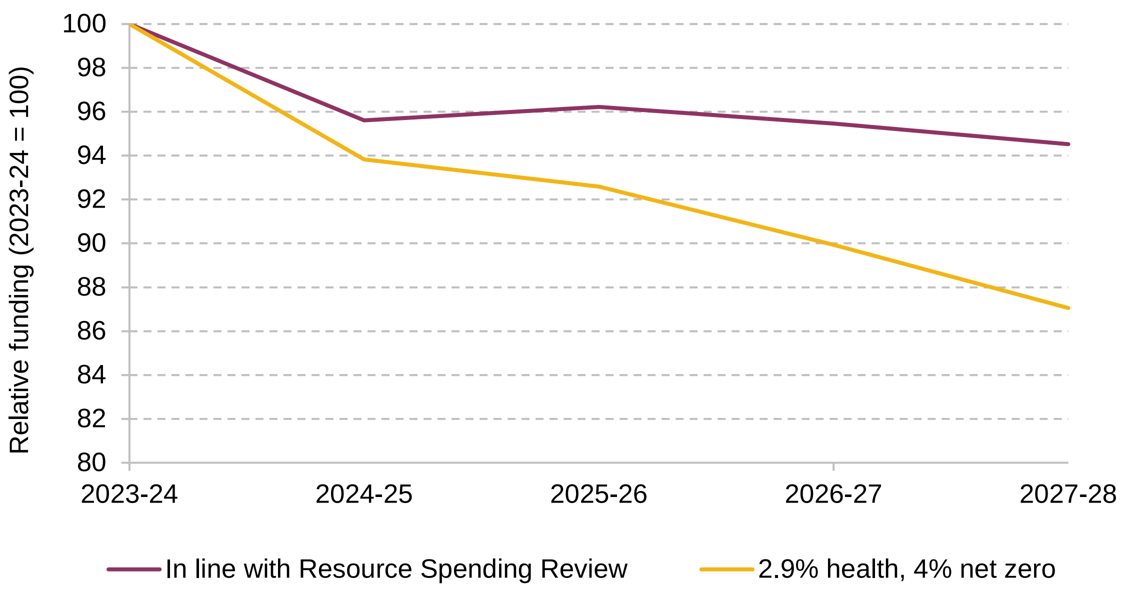
As already mentioned, the projections of the amount of funding available for non-benefit spending over the next four years imply difficult trade-offs in the amount provided to different public services. Figure 2.5 illustrates this by showing the implications for other service areas of different scenarios for the 'health and social care', and the 'net zero, energy and transport' portfolios, which were prioritised for additional funding in the Resource Spending Review. Figures are normalised so that the amount available is equal to 100 in 2023–24, making the real-terms changes that would be required in future budgets easy to observe.

The purple line in Figure 2.5 shows the total funding for other portfolios (such as local government, education and justice) if the health and social care and net zero, energy and transport portfolios were allocated the same real-terms increases planned in the May 2022 Resource Spending Review, which averaged 0.8% and 5.7% per year, respectively. As shown, the (relative) prioritisation of these budgets would mean that other portfolios are squeezed even further, falling in real terms by 5.5% between 2023–24 and 2027–28. In order to restore the funding levels of these portfolios to their 2023–24 levels in real terms in 2027–28, more than

£1.1 billion would be required in that year, equivalent to raising Scottish income tax by around 2p on the pound in that year.

The yellow line shows the funding that would be available for other portfolios if health and social care funding were instead increased by 2.9% in real terms per year, the same as is planned between 2022–23 and 2023–24 in the Budget; this is arguably a more realistic depiction of what will be needed to meet rising costs and demands. In addition, the net zero, energy and transport portfolio is assumed to receive an additional 4% in real terms each year, again the same as planned between 2022–23 and 2023–24. As shown, this would make the outlook for other services substantially more challenging, with available funding falling almost 13% in real terms between 2023–24 and 2027–28, or an average of 3.4% each year. To restore these funding levels to their 2023–24 levels would require £2.7 billion, or approximately the equivalent of an additional 4–5p on the pound on income tax rates.

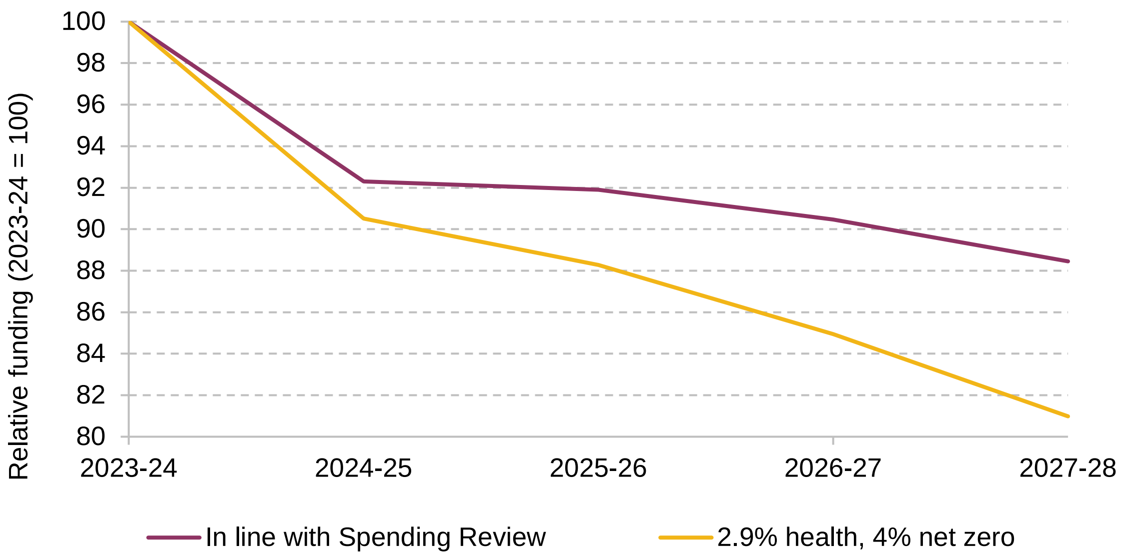
Figure 2.5. The impact of differing degrees of prioritisation of the 'health and social care' and 'net zero, energy and transport' portfolios for other non-benefit spending



Source: Authors' calculations using Scottish Government (2022a) and Scottish Fiscal Commission (2022b).

Figure 2.6 shows the outlook for other portfolios under the same assumptions if the forecast improvement in Scotland's net income tax position is not borne out. In both cases, other portfolios would be considerably squeezed. In order for health and social care to grow at 0.8% in real terms each year between 2023–24 and 2027–28, and net zero, energy and transport at 5.7%, funding for other portfolios would have to be cut by around 3% a year in real terms, with a particularly large cut of 8% in 2024–25. If these two portfolios were increased at the same rate as between 2022–23 and 2023–24, shown by the yellow line, funding for other portfolios would need to fall by an average of 5% a year, and almost 10% in 2024–25. This would be unlikely to materialise (in that either health, net zero or benefits would be increased less quickly and/or taxes increased), but further illustrates the importance of the forecast improvement in Scotland's net income tax position to its future funding outlook.

Figure 2.6. The impact of differing degrees of prioritisation of the 'health and social care' and 'net zero, energy and transport' portfolios for other non-benefit spending, excluding funding from the forecast improvement in net tax position



Source: Authors' calculations using Scottish Government (2022a) and Scottish Fiscal Commission (2022b).

2.3 Longer term: the Barnett squeeze

We now consider the longer-term outlook for the Scottish Government's funding, which the SFC will be considering in its first Fiscal Sustainability Report in March 2023.

As in the short and medium term, the amount available to spend in the longer term will depend on funding from the UK government, largely via the Barnett formula, and devolved tax revenues. Focusing on the first of these, the design of the Barnett formula is likely to squeeze the amount of funding the Scottish Government receives per person related to England, which, all else equal, will increasingly make it harder for the Scottish Government to continue to provide more generous public services and social security benefits than south of the border. In particular, the Barnett formula provides the Scottish Government with a population share of the change in spending on comparable services in England. And because spending per person in Scotland is currently higher than in England – on average, 26% higher between 2022–23 and 2024–25, according to HM Treasury (2021) estimates – and therefore it currently receives a share of spending that is much higher than its population share, these population-based increments translate into smaller percentage changes in funding than in England. When spending is being increased, this tends to lead to the initial gap in spending narrowing over time – a process of convergence termed the Barnett squeeze.

The speed and extent of this process depends on two main factors.

- The rate of increase in spending on comparable services in England. The higher this rate, the greater is the increase in funding for the Scottish Government. However, with bigger cash-terms increases in spending, the gap between the percentage increase in England and Scotland is larger, increasing the rate and extent of convergence in spending levels between those two parts of the UK.
- The difference between Scotland's and England's rates of population growth. When Scotland's population grows less than that of England, the increases in spending in Scotland have to be spread among fewer additional people than in England. This slows the rate and extent of convergence in spending levels per person.

Historically, the large increases in spending during the 2000s were associated with a significant convergence in spending between Scotland and England. This was due to the relatively generous spending increases in England – and despite slower growth in the population in Scotland than England. In contrast, Phillips (2022) has shown that the austerity of the 2010s, combined with a flaw in the way the Barnett formula treated cuts to local government funding in England, saw divergence in funding, as spending in Scotland was cut by less in percentage terms than in England.

Future trends are uncertain, but with spending highly likely to grow in cash terms in the longer term, convergence is set to resume. Figure 2.7 illustrates the potential implications using different scenarios for spending and relative population growth. Panel A shows how differences in the rate of real-terms spending growth in England would affect the Scottish Government's funding in absolute terms and relative to England. Panel B shows how differences in the rate of inflation would affect the Scottish Government's absolute and relative funding levels. Panel C shows how differences in the rate of population growth would affect the Scottish Government's absolute and relative funding levels.

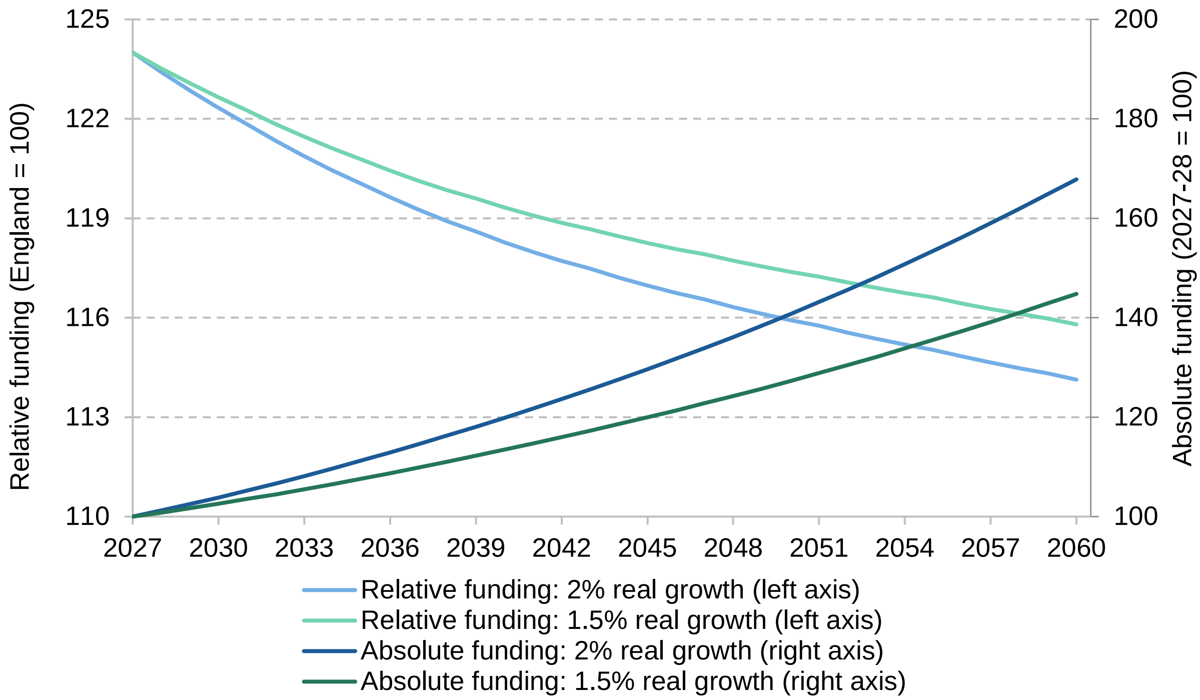
Looking first at panel A, the dark blue and dark green lines show clearly that bigger real-terms increases in spending in England will lead to bigger real-terms increases in Scotland. For instance, based on current central population projections and 2% inflation per year, 1.5% per year real-terms increases in spending in England would mean that Scottish funding per person would increase by 16% in real terms between 2027–28 and 2042–43, and by 39% by 2057–58.

In contrast, 2% per year increases in spending would mean 24% and 59% increases in total by the same years. However, faster real-terms increases in spending in England would lead Scottish funding per person *as a share of English funding per person* to fall more quickly. It would fall from around 124% in 2027–28 to around 116.3% by 2057–58 if English spending increased by 1.5% a year, but to 114.6% if English spending increased by 2% a year. Faster spending growth in England, while making it easier for the Scottish Government to maintain and potentially improve the range and quality of services provides, would make it more challenging to continue to offer a higher level of service provision than England.

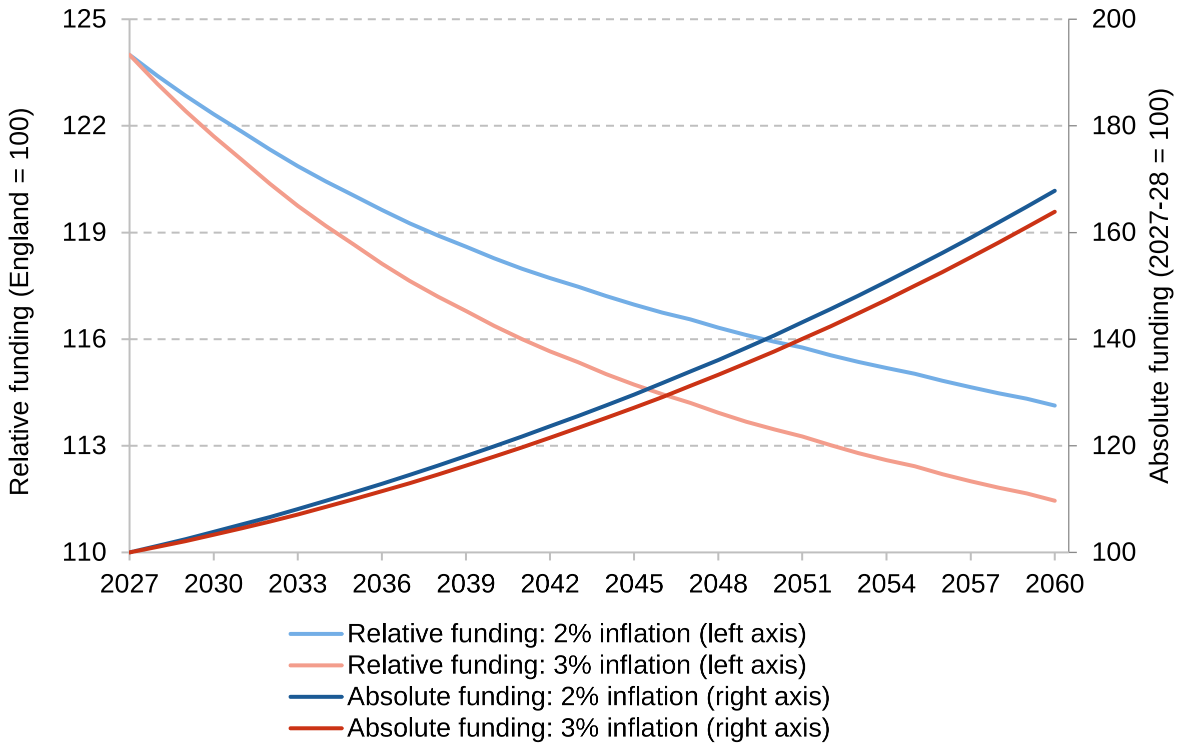
Panel B shows that holding real-terms growth in spending in England fixed at 2%, higher inflation would reduce both the absolute and relative funding of the Scottish Government over time. For example, with 2% real spending increases in England and 2% inflation, Scottish Government funding per person would increase by 59% in real terms by 2057–58, as already highlighted. But with 2% real spending increases in England and 3% inflation, Scottish Government funding per person would increase by 55% by 2057–58. Relative funding would fall to 114.6% of England's levels with 2% inflation by the same date, but 112% with 3% inflation. Both the slower absolute growth and bigger relative squeeze reflect the fact that higher inflation would increase the total cash-terms increase in funding to which the Barnett formula is applied, allowing more of a squeeze to occur.

Figure 2.7. Scenarios showing the potential impact of the Barnett squeeze on the Scottish Government's funding, 2027–28 to 2060–61

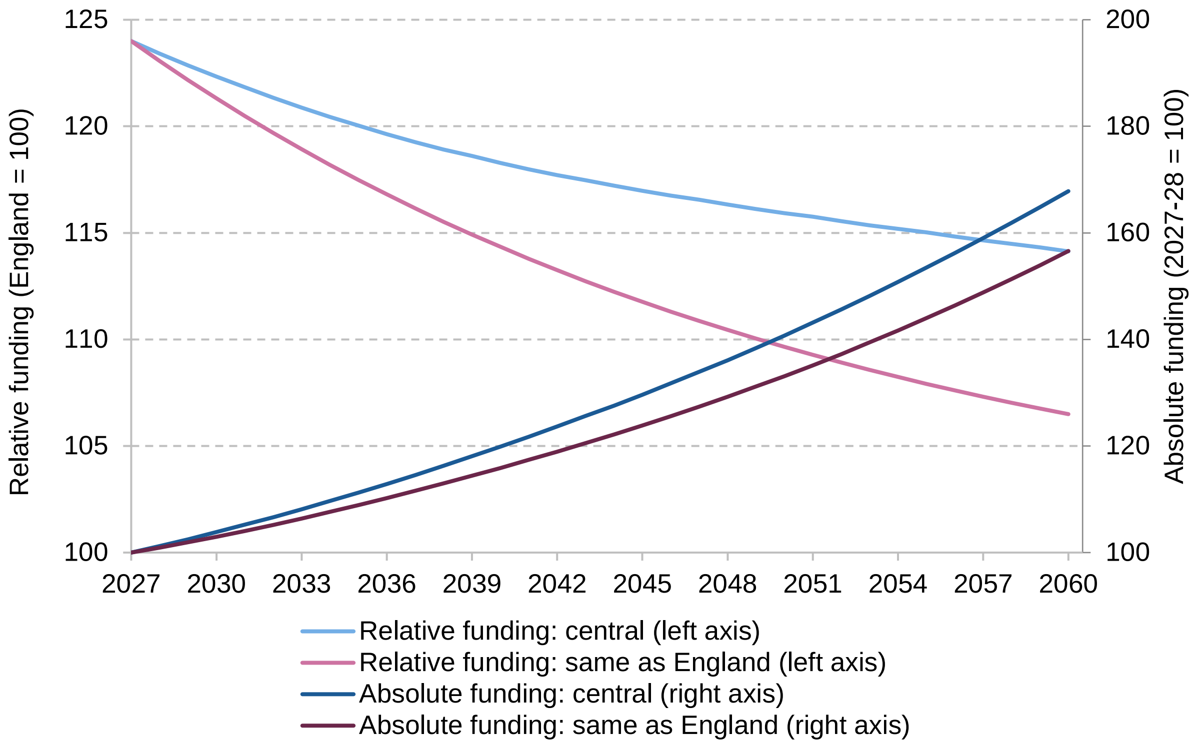
Panel A. Varying real rate of growth



Panel B. Varying inflation



Panel C. Varying population growth



Source: Authors' calculations using HM Treasury (2021) and Office for National Statistics (2022).

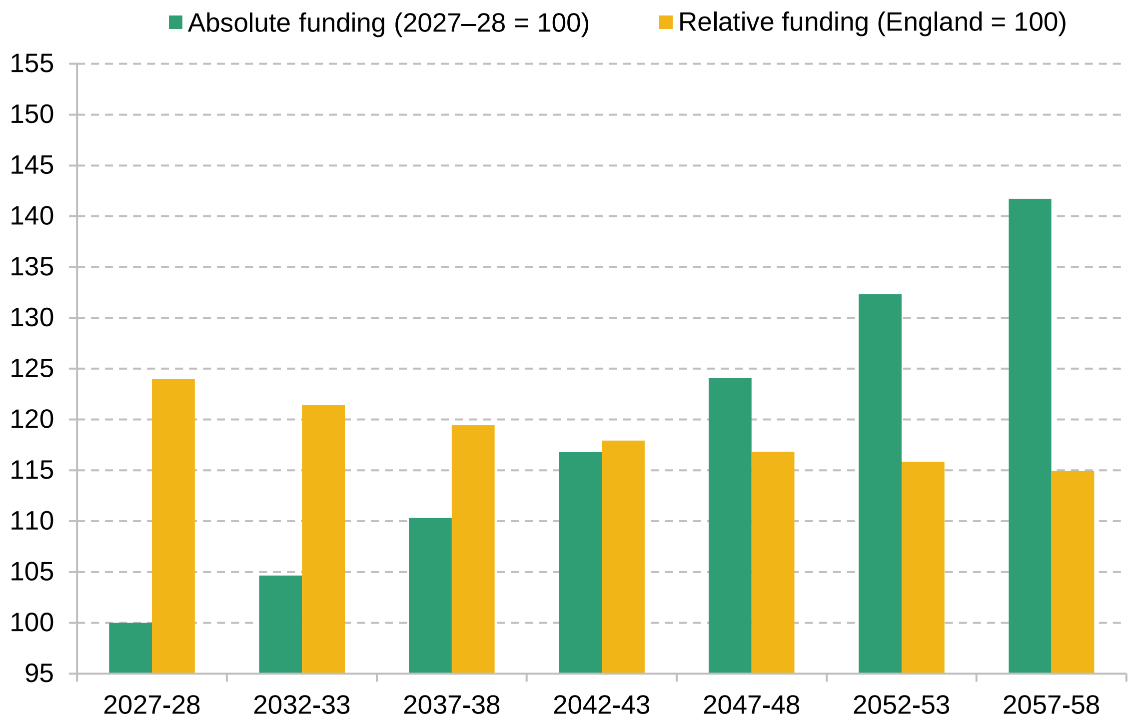
Finally, panel C shows that holding real-terms growth in spending and inflation fixed at 2%, faster population growth in Scotland reduces both absolute and relative funding per person and therefore increases the rate of convergence in spending per person. For example, if the Scottish population were to grow as fast as the English population is projected to, funding per person would increase by 49% (not 59%) by 2057–58, and relative funding fall to 107.3% (not 114.6%) of English levels. This reflects Scottish Government funding having to be spread across more people in this scenario (Phillips (2022) discusses this issue further).

While future trends in real-terms spending, inflation and population growth are uncertain, we do have projections for each of these from the OBR and Office for National Statistics (ONS). In Figure 2.8 we assume that real-terms spending in England on items subject to the Barnett Formula increases in line with OBR long-term assumptions for GDP per person and ONS central projections for population growth, inflation increases in line with OBR long-term assumptions for inflation, and population increases in line with ONS central projections for population. This would hold spending on items subject to the Barnett Formula constant as a share of GDP; as discussed by the Office for Budget Responsibility (2022b), this would likely be insufficient to meet the rising cost of healthcare and social care spending. However, meeting those pressures would likely require substantial increases in taxation, whereas increases in line with GDP would not, which is why we choose this for our main projection.

These assumptions imply real-terms spending growth in England of 1.6% per year, inflation of 2.3% a year, and population growth averaging approximately 0.2% and −0.2% per year, on average, in England and Scotland in the 30 years from 2027–28. Given these assumptions, the Figure shows that real-terms funding per person in Scotland would grow by an average of 1.2% per year per person compared to 1.4% per year per person in England. As a result, relative funding per person would fall from 124% of English levels in 2027–28 to 121.4% in 2032–33, 117.9% in 2042–43 and 115% in 2057–58.

Therefore, under a scenario where spending on public services in England is increased in line with GDP growth, rather than increasing in line with (higher) projected demand and cost growth, the Scottish Government would face a notable additional pressure because the Barnett formula would deliver even smaller percentage increases to its funding. Counteracting this additional squeeze (let alone the full increases in costs and demands facing Scottish Government spending) would require some combination of significant increases in taxes and cuts to certain services, unless there was stronger growth in the Scottish economy and devolved tax bases than in rUK. The SFC is expected to look further at this issue – including the potential increases in costs and demands facing the Scottish Government – in its forthcoming Fiscal Sustainability Report.

Figure 2.8. Main projection for Scottish Government's absolute and relative funding per person, 2027–28 to 2057–58



Source: Authors' calculations using Office for Budget Responsibility (2022b) and Office for National Statistics (2022).

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