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Scotland's Fiscal Outlook

The Scottish Government's
Five Year Financial Strategy

May 2018

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Foreword by the Cabinet Secretary for Finance and the Constitution



The context and content of the Scottish Budget has changed significantly since the Scottish Parliament began scrutinising our budget almost 20 years ago.

Since then we have seen the devolution of a range of additional powers to the Scottish Parliament, including the ability to raise our own tax revenues, and we have seen the introduction of a new Fiscal Framework that sets out the way in which Scottish public finances will be managed.

This changing landscape and increasing complexity of our public finances requires adjustments both to the way in which the Scottish Parliament undertakes its scrutiny of the budget and the way in which the Scottish Government manages Scotland's public finances.

This document forms a key part of the revised Parliamentary budget process that has arisen out of the Budget Process Review Group and the development of a year-round approach to budget scrutiny.

It ensures that both Parliament and Government have foresight of the financial challenges and opportunities that lie ahead and will help ensure that we are able to adapt to these circumstances to fund the public services which our people and economy rely upon.

The Scottish Government will continue to manage Scotland's finances in a competent, responsible and balanced way – as has been the case in every year since 2007. This will include the continuation of our approach to taxation being founded on our four key principles of *Certainty*, *Convenience*, *Efficiency* and *Proportionality*, ensuring that we are able to provide stability for our taxpayers and public services during the turbulent and uncertain economic climate in the coming years.

Growing and supporting the Scottish economy is key to our efforts to ensure financial stability and to maximise the resources available for our public services. Transforming Scotland's economy is at the heart of everything this Government does, including the way in which we plan, utilise and allocate our available financial resources.

The Scottish Government is ambitious for Scotland and we will target our resources to support the delivery of the social contract. Over the remainder of this Parliament we will deliver on our key commitments, built on the principle of equality for all, from birth through early years and education, to employment and retirement. We will ensure that people are able to access essential public services, when they need them, which are free at the point of delivery. This will include our commitments to:

- increase resource spending on the NHS by £2 billion over the course of this Parliament;
- protect the Police resource budget in real terms for the entirety of the Parliament;
- a transformative expansion of Early Learning and Childcare (ELC) provision – increasing funded entitlement to 1,140 hours per year;
- allocate £750 million through the Attainment Scotland Fund, over the term of the Parliament to tackle the attainment gap;
- protect free tuition and commit to provide an annual minimum income for the least well-off full-time students in Higher Education; and
- shape and fund a distinctly Scottish social security system based on dignity and respect.

In order to support that ambition, this Medium Term Financial Strategy explains the Fiscal Framework and funding arrangements that the Scottish Government now operates within, outlines our approach to financial management and fiscal rules, sets out a range of possible funding scenarios for the Scottish Budget over the next five years based on Scottish Government modelling using the Scottish Fiscal Commission economic and fiscal forecasts as the central scenario. The Strategy also details our key policy priorities and approach to supporting Scotland's economy.

The economic and financial outlook is uncertain, and delivering our first Medium Term Financial Strategy over multiple years, as a devolved government working within a UK framework, is not straightforward.

Our public finances continue to face the impact of the financial constraints imposed on us by the UK Government's austerity approach and the financial pressures created through the £2.6 billion real terms reduction in our discretionary block grant (between 2010-11 and 2019-20), but the Scottish Government is determined to deliver a strong economy, protect the delivery of public services and reduce inequality – all of which will continue to be supported through our longer term approach to financial planning.

The Scottish Government does not have all the flexibility and levers available to the UK Government to manage and plan its finances. We do not at this stage have any confirmed resource budgets beyond 2019-20, and the forecasts that underpin the Strategy will change between now and the point that we set firm budgets in the future. Funding levels in this document are indicative and our approach to setting firm budgets for future years will require refinement and adjustment based on the most up to date information at the time.

This document also makes a case for the UK Government to make different choices on their approach to economic and fiscal policy, in view of the impact of their current approach to Scotland's public finances. In particular, this includes taking a different course on austerity, the UK Government's intention to leave the EU Single Market and Customs Union and their damaging approach to immigration. The UK Government's proposed approach on immigration alone could see real Gross Domestic Product in Scotland 9.3 per cent lower by 2040, undermining tax revenues and public services. Different choices on any or all of these policies would deliver a better deal for Scotland. We will continue to make the case for the UK Government to change its course where its policies are damaging our economy and public services.

It is clear that the economic and financial outlook over the medium term will be challenging, but it is the job of the Scottish Government to manage those challenges and to prioritise our use of the Scottish Budget to effectively deliver on our commitments, grow the economy and support our vital public services.

This is the first step in the new budget process and it is one that will evolve over time, to continue to support the Scottish Government's responsible approach to financial management.



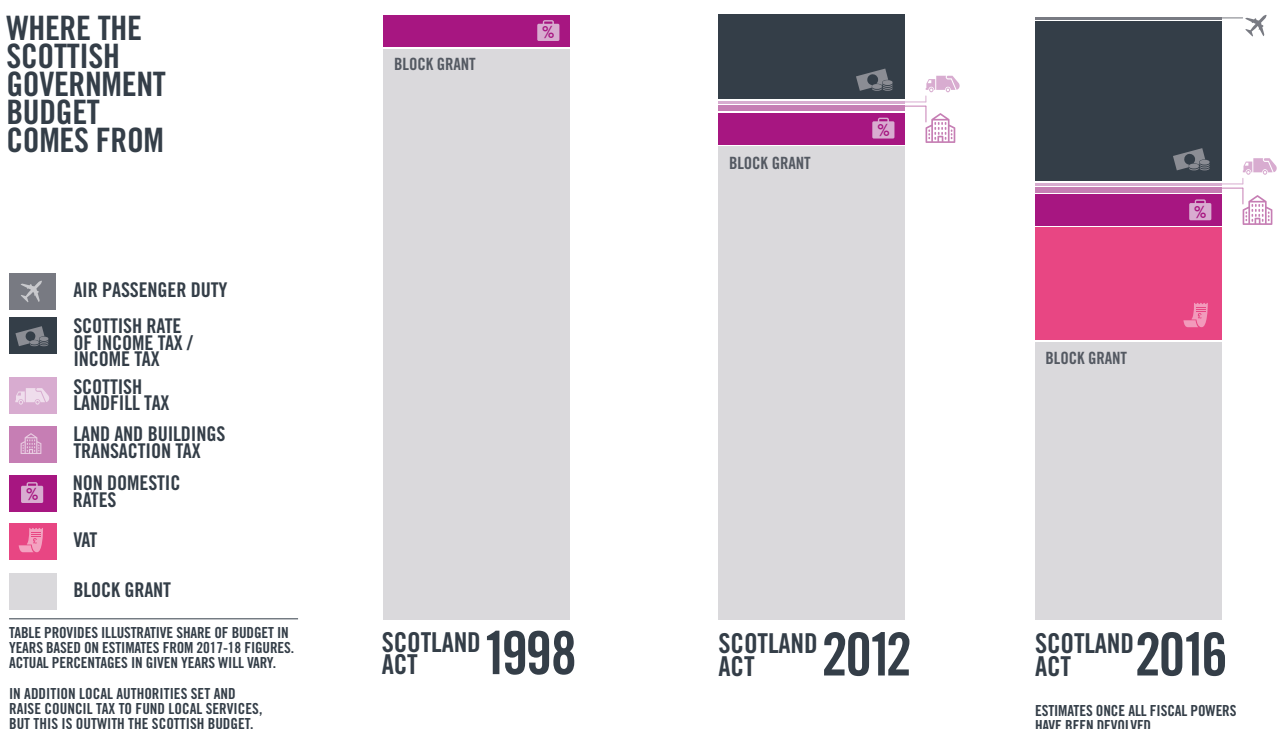
Derek Mackay MSP

Cabinet Secretary for Finance and the Constitution

1 Introduction

- 1.1. The purpose of this document is to set out a medium-term view of Scotland’s public finances and the Scottish Government’s broad approach to using the new financial powers that were provided through the Scotland Acts 2012 and 2016.
- 1.2. This is the first time that this document has been produced and it is expected to develop further in future years as more information becomes available and experience of working within the Fiscal Framework grows.
- 1.3. The Scottish Government has implemented a number of new fiscal powers in recent years and is implementing the remaining new powers against the background of the UK’s exit from the EU, the potential economic impact of which will be a factor both in the tax revenues likely to be raised in Scotland and in future spending decisions. Despite the introduction of these new powers, the fiscal outlook remains largely dependent on spending decisions made by the UK Government.
- 1.4. The period since the introduction of Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) in April 2015 has been one of unprecedented change in Scotland’s fiscal landscape. Revenues raised in Scotland up to financial year 2014-15 made up under 10 per cent of the overall funding for devolved expenditure; by 2020-21, with the assignment of Value Added Tax (VAT), they will make up approximately 50 per cent of that funding. In addition, the implementation of the new social security powers under the Scotland Act 2016 is the largest and most complex programme of change being delivered since devolution and is likely to provide a transfer to the Scottish Budget of more than £3.5 billion for these new responsibilities.
- 1.5. Figure 1.1 illustrates how these changes affect the components of funding for the Scottish Government. Once all Scotland Act 2016 fiscal powers are devolved, it is expected that approximately 50 per cent of the Scottish Government’s budget will come from devolved or assigned taxes.

FIGURE 1.1 – SOURCES OF SCOTTISH GOVERNMENT FUNDING



1.6. Delivering improved public services within this rapidly changing financial landscape is made more challenging by the impact of UK Government austerity. Over the decade between 2010-11 and 2019-20, Scotland's discretionary resource budget allocation – the funding for day-to-day government expenditure – has reduced by more than 9 per cent or £2.6 billion in real terms.

1.7. As set out in Chapter 6, Scottish Government analysis suggests that these real terms reductions in the budget allocations from the UK Government are likely to continue over the next five years. The central projection for HM Treasury resource budget allocations, on a like for like basis, indicates that a further real terms reduction of around 1 per cent (approximately £250 million) in resource budgets between 2018-19 and 2022-23 is likely.

1.8. While the economic and fiscal outlook has rarely been so uncertain, that only enhances the case to look further ahead, so that we are best able to adapt to fund the public services which our people and economy rely upon. In line with our Fairer Scotland vision, we will aim to do this in a way that understands the impact of our revenue generation and budget allocation decisions on the diversity of our population.

1.9. Developing a longer term financial outlook is a sensible planning mechanism for a mature government to follow. We have taken an overview of the factors above in setting out our Medium Term Financial Strategy.

1.10. In 2016, the Scottish Parliament established the Budget Process Review Group to undertake a review of the Parliament's budget process. The production of this document addresses some of the key recommendations from this group (and from Audit Scotland) and contributes to the new annual budget cycle which those recommendations introduce. It is also a contribution to our commitment to be an Open Government pioneer, and to stimulate engagement in our democratic processes throughout Scotland.

1.11. Delivering a new Medium Term Financial Strategy over multiple years as a devolved government working within a UK framework is not straightforward. The Scottish Government does not have all the flexibility and levers available to the UK Government to manage and plan its finances. For example, while the Scottish Government has the power to set the rates and bands of income tax in Scotland – but not reliefs or exemptions, including the Personal Allowance – it has no power over setting the level of VAT and no control over all other reserved taxes (including Capital Gains Tax, Corporation Tax, National Insurance Contributions and Inheritance Tax), and its borrowing powers are severely limited. We have made a Programme for Government commitment to explore how responsibility for a broader range of taxes might enable the Scottish Parliament to take more balanced budget decisions, grow the economy and tackle poverty more effectively. We will provide an update on this work in autumn 2018.

1.12. The Scottish Government intends to publish a Medium Term Financial Strategy every year and expects that this new financial planning document will develop and evolve over time to include additional information. This document does not provide a detailed five year budget, nor will it provide detail at the individual portfolio level, as currently it is not possible to provide that level of budget certainty.

1.13. If you have comments on the content or the presentation of this document, we would be delighted to have them. Please contact the Finance Co-ordination Mailbox (finance.co-ordination@gov.scot).

2 The Scottish Budget and Fiscal Framework

How the Scottish Budget financial settlement has evolved

2.1. When a devolved government was first introduced in Scotland in 1999, it inherited funding arrangements driven by the long-standing Barnett formula. Under the Barnett formula, the Scottish Government's block grant each financial year is equal to the block grant baseline plus a population share of changes in UK Government spending on areas that are devolved to the Scottish Parliament. This mechanism continues to apply today to changes in UK Government spending on areas that are devolved to the Scottish Parliament. The detail of how the Barnett formula works is set out in the UK Government's Statement of Funding Policy¹.

2.2. The Scottish Government's budget is now determined through a combination of block grant funding from HM Treasury, adjusted to reflect forecasts of receipts generated through taxes devolved to Scotland (through the Scotland Acts 2012 and 2016) and the planned use of available devolved borrowing powers. The Scottish Government will retain all devolved and assigned Scottish tax revenues.

2.3. This means that the block grant is reduced to take account of the tax revenues raised in Scotland and no longer raised in the rest of the UK. This is done through a Block Grant Adjustment (BGA) mechanism which is set out in the Fiscal Framework.

2.4. It should be remembered that macroeconomic and monetary policy, and the overall public expenditure control framework, are reserved matters. This means that the UK Government's decisions on the envelope for public expenditure and its allocation between UK Departments are still a major determining factor in the overall funding available for Scottish devolved public spending.

2.5. Once overall public expenditure budgets have been determined in accordance with the Statement of Funding Policy and the Fiscal Framework, the Scottish Government has freedom to make its own tax decisions and spending decisions on devolved programmes, within the overall budgetary control totals set by HM Treasury and in compliance with the Consolidated Budgeting Guidance issued by HM Treasury.

2.6. The Scotland Acts 2012² and 2016³ and the associated Fiscal Framework⁴ change the sources of funding that support Scottish Government expenditure. Currently the revenue raising powers include:

- **Income Tax** – HM Revenue and Customs (HMRC) is responsible for the collection and management of income tax in Scotland and the rest of the UK. The Scotland Act 2016 gave the Scottish Parliament the power to set all income tax rates and bands (but not the power to determine any reliefs or exemptions, including the Personal Allowance) that apply to Scottish taxpayers' non-savings and non-dividend (NSND) income. On 20 February 2018 the Scottish Parliament set new income tax rates and bands for the new tax year 2018-19.⁵

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/479717/statement_of_funding_2015_print.pdf

2 <http://www.legislation.gov.uk/ukpga/2012/11/contents/enacted>

3 <http://www.legislation.gov.uk/ukpga/2016/11/contents/enacted>

4 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/503481/fiscal_framework_agreement_25_feb_16_2.pdf

5 <http://www.gov.scot/Resource/0053/00531596.pdf>

- **Land and Buildings Transaction Tax** – This replaced the UK Stamp Duty Land Tax in Scotland from 1 April 2015. The new Land and Buildings Transaction Tax (LBTT) is applied to residential and commercial land and buildings transactions in Scotland (including commercial purchases and commercial leases) where a chargeable interest is acquired. Revenue Scotland administers the collection of this tax.
- **Scottish Landfill Tax** – The Scottish Landfill Tax (SLfT) replaced the UK Landfill Tax in Scotland from 1 April 2015. Revenue Scotland administers the collection of this tax with support from the Scottish Environment Protection Agency.

2.7. Further tax raising powers still to be adopted by the Scottish Government include:

- **Air Departure Tax** – Following the Scotland Act 2016, the Scottish Parliament passed the Air Departure Tax (Scotland) Act 2017 which provides for Air Departure Tax (ADT). This will replace UK Air Passenger Duty (APD) in Scotland once the new tax is introduced. The Programme for Government 2017-18 reaffirmed the Scottish Government's commitment to reducing the overall burden of ADT by 50 per cent, and to abolishing the tax altogether when resources allow.

The introduction of this new devolved tax has been deferred until the issues related to State aid and the Highlands and Islands exemption have been sufficiently resolved to avoid compromising the devolved powers. The Scottish Government and UK Government are working closely to find a solution.

- **Aggregates Levy** – This is a tax on the commercial exploitation of rock, sand and gravel. The Scotland Act 2016 gave the Scottish Parliament the power to legislate for a tax to replace the Aggregates Levy in Scotland. The UK tax has on-going domestic and EU legal issues around State aid which need to be resolved before the power can be commenced. The ability to set Aggregates Levy policy will provide opportunities to better integrate environment, planning and other policies within Scotland.
- **Value Added Tax (VAT)** – In Scotland, VAT is estimated to raise around £10 billion a year for the UK Government. The Scotland Act 2016 allows for receipts from the first 10p of the standard rate of VAT and the first 2.5p of the reduced rate of VAT in Scotland to be assigned to the Scottish Government. All VAT policy, including the power to set VAT rates, will remain reserved to the UK Government.

Scottish assigned VAT is expected to be the second largest tax revenue, after income tax, for the Scottish Government. A transitional year for VAT assignment powers is expected to operate in 2019-20, and the Scottish Government's budget will face the fiscal impact of these measures from 2020-21.

2.8. The financial settlement continues to evolve to take account of changes being introduced. For example the social security forecasts which are set out in the Supplementary Financial Memorandum to the Social Security (Scotland) Bill show that by 2022-23, the Scottish Government will potentially receive a funding transfer of more than £3.5 billion from the UK Government to fund the delivery of the new social security benefits. Funding for existing benefits will be transferred through the Fiscal Framework. This level of funding assumes no changes to eligibility criteria and uprating policy by the UK Government. Future increases in social security demand and new policy choices will require to be funded from the Scottish Budget in the future.

How is the Scottish Government resource budget now calculated?

2.9. The Fiscal Framework sets the rules by which these new tax powers are implemented and managed. The key element of this is how the block grant is adjusted to account for the fact that the Scottish Budget is now funded to a greater extent through Scottish tax revenues.

2.10. An initial baseline adjustment is made for each tax. This is to compensate the UK Government for the tax revenue which is now being retained by the Scottish Government. This deduction is equal to the UK Government's receipts from the relevant tax generated in Scotland in the year immediately prior to devolution.

2.11. In subsequent years, the Block Grant Adjustments (BGAs) for each tax are updated to take account of changing UK Government tax revenue over time. The block grant is therefore adjusted in line with the change in corresponding UK Government tax revenues per head.

2.12. This means that if devolved Scottish tax revenues per head grow at the same rate as in the rest of the UK, the Scottish Budget will be no better or worse off than before devolution. This is because the amount being taken out through the Block Grant Adjustment is the same as the amount coming in through devolved tax revenues.

2.13. If per capita tax revenues grow faster in Scotland than the rest of the UK then the Scottish Budget is better off than would have been the case under pre-devolution funding arrangements, and vice versa. The reasons for this could reflect differences in economic performance in Scotland and the UK as well as different choices about tax policy.

2.14. The Scottish Budget is, therefore, now calculated as follows:



2.15. It is worth noting that Block Grant Adjustments are initially based on forecasts. Once outturn data is available, any difference between the forecast Block Grant Adjustment and the outturn Block Grant Adjustments will be applied to the Scottish Government block grant following the publication of outturn data. The exception is VAT, which relies on estimates of Scottish specific data, from survey data, as Scottish VAT cannot be identified separately without an unreasonable administrative burden on businesses.

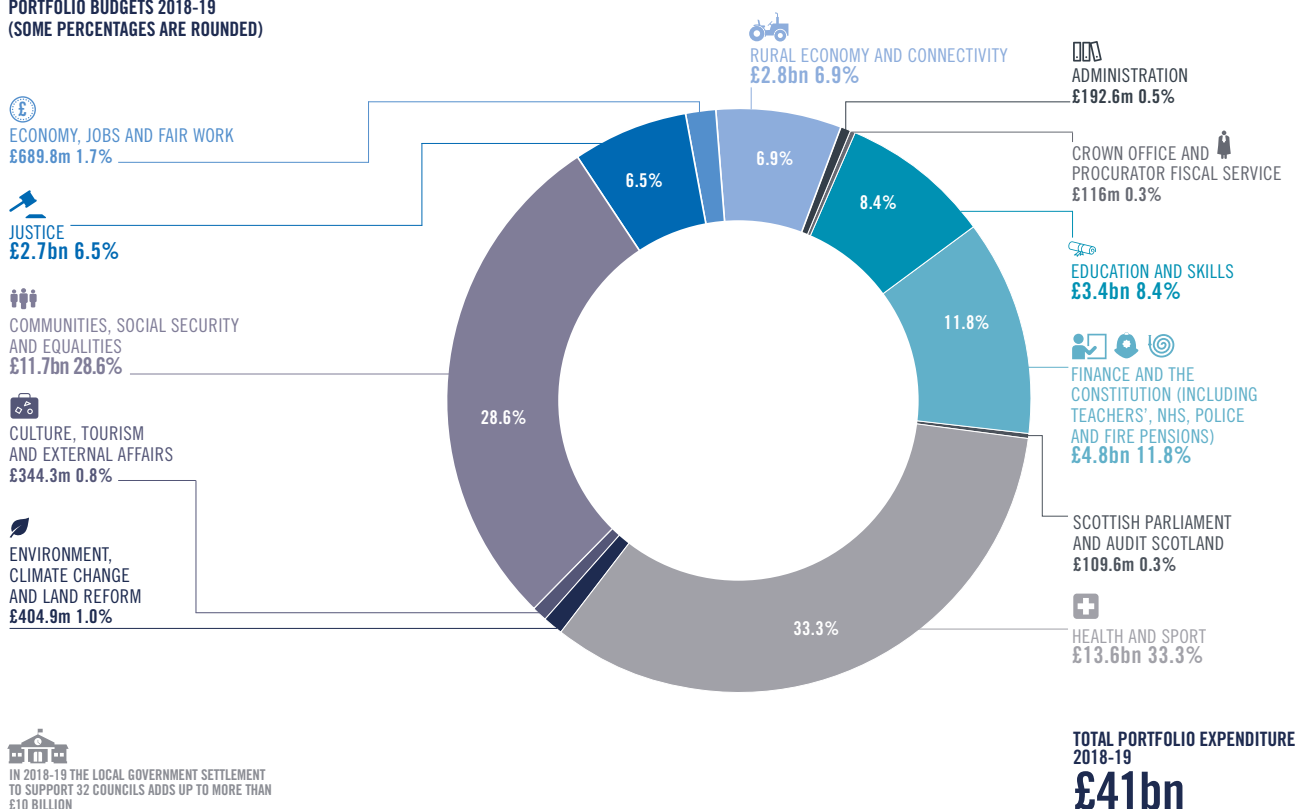
2.16. It is recognised that these changes are new and need time to determine how they will work and best be implemented. It is therefore planned that an independent review of the current Fiscal Framework will be undertaken and that this review should be informed by an independent report with recommendations presented to both Governments by the end of 2021.

Key components of the Scottish Budget

2.17. The funding available to support the Scottish Budget consists of a number of elements: resource funding, capital funding, Financial Transactions from the UK Government through the residual block grant, and other sources of income including devolved taxes and non-domestic rates. Chart 2.1 illustrates the way in which the overall Scottish Budget (resource, capital and Financial Transactions) was allocated across Portfolios in 2018-19 – with the percentage share and budget amounts for the larger Portfolios.

CHART 2.1 – TOTAL PORTFOLIO BUDGETS FOR 2018-19

PORTFOLIO BUDGETS 2018-19
(SOME PERCENTAGES ARE ROUNDED)



Resource budget

2.18. The resource budget funds spending on operating costs for public services. The resource budget has two elements: cash and non-cash. The cash element covers day-to-day spending, including staff pay, heating and lighting for schools, hospitals and other public buildings, support for front line public services and social security payments. This element of the budget is funded by a combination of the newly devolved taxes and the block grant.

2.19. The non-cash element of the resource budget is used to meet depreciation and particular accounting charges and is ring-fenced so it cannot be used for any other purpose. The budget projections in this document do not include any analysis of non-cash.

2.20. A small number of programmes, while they fall within the devolved responsibilities of the Scottish Government, are funded annually by the UK Government on the basis of demand (known as UK funded Annually Managed Expenditure (AME)). These budgets are ring-fenced for specific purposes – principally NHS and Teachers’ pension payments and student loans. While the amounts for these areas are significant – NHS and Teachers pension costs alone are in excess of £2.5 billion per year – the UK funding mechanism means that these areas have no impact on the wider budget management of the Scottish Government. These areas are funded on the basis of the estimates of what we need and HM Treasury fiscal rules prohibit the use of funding provided for these areas to support other expenditure. Consequently, although these amounts are included in the total budget managed by the Scottish Government, they are not considered further in this publication.

2.21. Public sector pensions are clearly a significant future call on the public finances and an area of significant financial risks given the demographic changes expected in the medium and longer term. However, the mixture of reserved and devolved funding arrangements for the vast majority of central government pension liabilities in Scotland shares the risk between the Scottish and UK Governments. We are keeping pension liabilities in devolved areas under careful review.

Capital budget

2.22. Capital spending is money that is spent on maintenance of and investment in new assets that support and will create growth in the future. The Scottish Government capital budget plays an important role in funding major infrastructure projects in Scotland. When contracts are agreed for these, they become legal commitments which run over a number of financial years and impact on future budgets. The capital budget is funded from a combination of the block grant received from the UK Government, capital receipts (for example sale of land and buildings) and any capital borrowing undertaken by the Scottish Government.

2.23. The Scottish Government’s Infrastructure Investment Programme includes both economic and social infrastructure and is defined as:

“The physical and technical facilities, and fundamental systems necessary for the economy to function and to enable, sustain or enhance societal living conditions. These include the networks, connections and storage relating to enabling infrastructure of transport, energy, water, telecoms and internet, to permit the ready movement of people, goods and services. They include the built environment of housing; public infrastructure such as education, health, justice and cultural facilities; safety enhancement such as waste management or flood prevention; and public services such as emergency services and resilience.”

2.24. The capital budget also funds expenditure on maintenance which enhances the economic life of existing assets and can also be used for financial assets such as investments and loans. Capital grants can also be used to enable other organisations, such as local authorities and registered social landlords, to fund their own capital programmes.

Financial Transactions

2.25. Financial Transactions (FTs) are a subset of capital funding from HM Treasury which were introduced in financial year 2012-13 and which can only be used to make loans to, or equity investments in, entities or individuals outside the public sector. FTs need to be repaid to the Scottish Government for onward repayment to HM Treasury. Agreement has been reached with HM Treasury that only 80 per cent of the total needs to be repaid, with the remainder available for recycling into other FT funded schemes. The most recent repayment schedule for FTs is illustrated in **Annex A**.

2.26. No interest is payable to HM Treasury by the Scottish Government for the repayment of FTs. Interest rates charged on FT schemes can vary and be at commercial or below market rates, depending on the purpose of the loan and compliance with State aid rules. The repayment period should be appropriate to the nature of the loan/investment and could be shorter or longer in duration.

Other sources of funding

Non-domestic rates

2.27. Non-domestic rates (NDR), also known as business rates, are a tax on non-domestic properties to help pay for local council services. They are charged on most non-domestic and commercial properties, including shops, offices, pubs and hotels.

2.28. This tax is collected and retained by local authorities, on behalf of the Scottish Government. The Scottish Government guarantees each local authority's needs-based formula share of the annual central government funding. This formula share is derived from a combination of the retained NDR income together with a general revenue grant paid by the Scottish Government.

2.29. The operation of the Non-Domestic Rate Account is set out in Schedule 12 of the Local Government Finance Act of 1992. The legislation requires that Ministers set a distributable amount of NDR income for any year in the annual Local Government Finance Order, which is issued in advance of the start of the financial year to which it relates.

2.30. The distributable amount is set with reference to the forecast NDR income to be collected for the year and the accumulated balance on the NDR account. From 2018-19 the Scottish Fiscal Commission (SFC) is responsible for preparing the forecast for NDR income to be collected. The forecast of the likely NDR income for the year is developed based on a number of factors (including the impact of a revaluation, an assessment of likely successful appeals losses, the level at which the poundage is set and the package of reliefs that Ministers wish to put in place). The distributable amount is based on that forecast, the accumulated balance in the NDR account and the overall financial outlook for the Scottish Budget.

2.31. The estimate of NDR income is unlikely to equal the amount actually collected for that year by local authorities, as a range of factors will influence the final receipts (e.g. economic growth may be higher/lower than forecast or successful appeals may be more/less than forecast). A statement of the NDR account is published annually in accordance with legislative requirements.

2.32. The Scottish Government is committed to keeping the NDR Account in balance over time. The impact of variations in forecast, against actual receipts, when compared with the distributable amount, can be expected to give rise to individual surpluses or deficits at times.

2.33. Details of the amounts of NDR income estimated to be collected and distributed, together with the calculation of the amount to be distributed, are published in the annual Scottish Budget.

Fees and charges

2.34. Charging for public services is a feature of the public sector landscape across the world, and is particularly important in the delivery of services provided by local authorities and public bodies.

2.35. Where it is well targeted and designed, charging can be an integral part of a progressive approach to the delivery of public services, reducing the burdens on taxpayers and encouraging the type of behaviours that we would want to see as a progressive society, particularly in relation to environmental behaviours. For example, the Scottish Government is setting up an expert panel to advise on the use of fees and charges to manage materials which are difficult to collect and recycle and which cause significant environmental impacts.

2.36. The Scottish Government, in consultation with local government partners and public bodies will continue to consider the role of fees and charges in a progressive approach to delivery of public services.

The Scottish Budget process

2.37. There are a number of important steps in the budget setting process. The resources managed by the Scottish Government must be authorised by a Budget Act agreed by the Scottish Parliament. The Scottish Fiscal Commission also has a crucial role to play here in accurately forecasting future income in Scotland from devolved taxes and expenditure on devolved social security.

2.38. The principles and procedures for the annual budgeting process, the format of the budget documents and procedures for in-year reallocation of budgetary provision are the subject of a Written Agreement between the Scottish Government and the Scottish Parliament Finance and Constitution Committee – which was agreed by the Scottish Parliament on 8 May 2018.

2.39. Under the full Scotland Act 2016 powers, the Scottish Parliament will ultimately be responsible for agreeing around £21 billion in devolved and assigned tax revenue and over £3.5 billion in devolved social security spending. To enable the Scottish Government to manage the additional risks and volatility associated with the devolution of these powers, the Fiscal Framework set out a limited set of fiscal tools available to it. These are explained further in Chapter 3.

2.40. In recent years the Scottish Government has delivered a series of annual budgets, an approach which will continue for the 2019-20 budget process, the last year of the current UK Spending Review period. There is an expectation that the next UK Spending Review (in 2019) will offer sufficient multi-year budget information to provide the Scottish Government with the opportunity to develop a multi-year approach to the development of its budgets.

Other factors which affect the Scottish Budget

2.41. In addition to spending decisions by the UK Government at the UK Autumn Budget that will impact on the Scottish Budget via Barnett consequentials, there are other factors which will have consequences for the Scottish Government's budget. These include:

- **Reconciliations of forecasts to outturn** – Block Grant Adjustments are initially based on forecasts by the UK Government Office for Budget Responsibility of corresponding UK tax receipts and expenditure in the rest of the UK. Once outturn data is available, any difference from the forecast figure will be applied to the Scottish block grant in the subsequent Scottish Budget. For the fully devolved taxes, outturn data is available around six months after the financial year and for income tax, outturn data is available around 15 months after the financial year.

For income tax, there is a further reconciliation applied to the block grant to account for any difference between the Scottish Fiscal Commission income tax forecast used at the budget for the relevant financial year and final HMRC outturn for Scottish income tax. In effect, it is therefore the net difference between this reconciliation and the income tax BGA reconciliation outlined above that will have an impact on the Scottish Budget.

- **Land and Buildings Transaction Tax and Scottish Landfill Tax** – The Scottish Government receives these receipts during the financial year from Revenue Scotland as they are collected. There is therefore no need for a reconciliation. However, any variance from forecast amounts is managed within the year as part of the overall budget management strategy.
- **Tax policy changes by the UK Government at the Autumn Budget** – Policy changes made by the UK Government to taxes that are devolved to Scotland will feed through to the Scottish Budget via adjustments to the block grant.

The role of the Scottish Fiscal Commission

2.42. The Scottish Fiscal Commission was established on a statutory basis from 1 April 2017 under the Scottish Fiscal Commission Act 2016. The Commission is structurally and operationally independent of the Scottish Government. Commissioners are accountable to and give evidence to the Scottish Parliament as required.

2.43. The Commission produces, twice yearly, independent forecasts of:

- Revenue from fully devolved taxes;
- Non-savings, non-dividend income tax receipts;
- Onshore Gross Domestic Product (GDP) in Scotland; and
- Expenditure on devolved social security benefits.

2.44. The Commission is also responsible for setting out its assessment of the reasonableness of the Scottish Government's projections of borrowing requirements.

2.45. Under the Fiscal Framework arrangements, the independent forecasts by the Commission have a crucial role in helping the Scottish Government plan its expenditure. For example, these forecasts are vitally important in developing the annual budget and this new Medium Term Financial Strategy by forecasting what the future likely income will be for the Scottish Government over the next five years as well as expenditure on social security.

3 Financial Management and Fiscal Rules

3.1. The Fiscal Framework is an agreement between the Scottish and UK Governments that determines how the Scottish Government is funded. This agreement will be reviewed in 2021, following the first five years of its operation.

3.2. The funding model agreed in the Fiscal Framework provides a transparent mechanism to adjust the Scottish Government block grant to reflect the introduction of newly devolved revenues and the transfer of additional responsibilities, such as social security, to the Scottish Government. The Fiscal Framework gives the Scottish Government access to resource and capital borrowing powers to ensure budgetary stability and manage the volatility associated with greater revenue-raising powers. Within the Framework the Scottish Government is also permitted to operate a (limited) Scotland Reserve.

3.3. This Chapter describes the range of fiscal rules and financial management mechanisms available in more detail and explains how the Scottish Government is using them.

Capital borrowing

3.4. The Scottish Government's capital borrowing powers were originally granted in the Scotland Act 2012 and the limits were increased in the Scotland Act 2016. In addition to the capital block grant, the Scottish Government can increase capital expenditure through borrowing up to £450 million per year up to a maximum total of £3 billion under the provisions of the Scotland Act 2016. These capital borrowing limits came into effect for the Scottish Government on 1 April 2017.

3.5. The Scottish Government may borrow from the UK Government through the National Loans Fund, by way of a commercial loan (directly from a bank or other lender) or by issuing bonds. Where borrowing is through the UK Government, repayment arrangements are set out in a Memorandum of Understanding between the Scottish Government and UK Government.

3.6. Capital borrowing powers have been used in each year to date to support the capital investment programme and promote economic growth in Scotland. The Scottish Government agreed a notional borrowing arrangement with HM Treasury in 2015-16 and 2016-17 as part of managing the budgetary impact of Office for National Statistics classification decisions on a number of Non-Profit Distributing (NPD) projects, including the Aberdeen Western Peripheral Route. As a result, the amounts recorded against borrowing limits for those years are notionally repaid over 30 years (linked to the life of the underlying NPD contracts). This notional borrowing arrangement counts towards the overall capital borrowing cap, but does not have a cash impact on the Scottish Budget.

3.7. The Fiscal Framework requires the Scottish Government to notify HM Treasury each month of its planned capital borrowing, its outstanding debt and its debt repayment profile. The Scottish Government is able to borrow within the agreed limits as it deems appropriate.

3.8. The Scottish Government has to date borrowed exclusively from the UK Government. The 2018-19 Scottish Budget plans to make full use of the £450 million capital borrowing powers available to maximise infrastructure investment and economic impact. Final decisions on the specific borrowing arrangements for 2018-19 will be taken over the course of the year, reflecting an on-going assessment of programme requirements and value for money assessment of the options available.

3.9. This document models the impact of one further full year of capital borrowing in 2019-20, but final decisions on future borrowing levels will be taken as part of the 2019-20 budget and subsequent budget processes. These decisions will be taken annually in light of the economic outlook at the time, weighing the cost of borrowing and the opportunity cost of using up more of the overall £3 billion borrowing limit against the potential benefits of economic stimulus.

3.10. Table 3.1 (below) sets out the capital borrowing and repayments, based upon capital borrowing undertaken to date, plus planned borrowing of a further £450 million in 2019-20.

TABLE 3.1 – CAPITAL BORROWING AND REPAYMENTS

£m	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Borrowing	283	333	450	450	450	-	-	-
Repayment on 2015-16 borrowing	-	9	9	9	9	9	9	9
Repayment on 2016-17 borrowing	-	-	11	11	11	11	11	11
Repayment on 2017-18 borrowing	-	-	-	7	14	15	15	15
Repayment on 2018-19 borrowing	-	-	-	-	7	14	15	15
Repayment on 2019-20 borrowing	-	-	-	-	-	7	14	15
Total Annual Repayments*	-	9	21	27	41	56	64	65
Repayment period for borrowing (years)	30	30	25	25	25	-	-	-

Note 1: *This reflects the repayment of the principal loan and in addition there will be interest costs to meet (at around 2% for borrowing to date).

Note 2: Figures may not sum due to rounding.

3.11. The affordability and sustainability of all Scottish Government long-term revenue commitments, including repayment of debt stock, are assessed through the budget process and are kept within a maximum of 5 per cent of the total annual budget available.

3.12. The Scottish Fiscal Commission has a duty to assess the reasonableness of Scottish Government projections of borrowing in its economic forecasts. To date the Commission has assessed the borrowing projections as reasonable.

3.13. Local authorities also have the power to borrow under the Local Government (Scotland) Act 1975 which defines the purposes for which local authorities may borrow, meaning that they can only borrow for capital expenditure. Capital borrowing by local authorities sits outside the Scottish Budget.

3.14. The amount of borrowing that a local authority can undertake is regulated by the Prudential Code under which authorities determine the maximum amount that they can afford to borrow based on a series of indicators such as affordability, prudence and sustainability.

Overall affordability of capital investment

3.15. The Scottish Government is committed to ensuring that revenue-funded methods of investment are maintained at a sustainable level and do not constrain choices in future years.

3.16. The Scottish Government uses a self-imposed limit to ensure that revenue-funded investment – including repayment of capital borrowing under the new powers – will not exceed 5 per cent of the total annual budget available.

3.17. Under current plans and arrangements, committed Scottish Government projects are estimated to peak in 2019-20 at 3.88 per cent. When planned projects, which are not yet contractually committed, and planned borrowing in 2018-19 and 2019-20 are included, this increases to 4.23 per cent in 2020-21. These investments are consistently monitored and the Scottish Budget documents include an analysis of the performance against this 5 per cent limit. Table 3.2 illustrates revenue commitments as a percentage of the annual total budget available for the years 2018-19 to 2022-23.

TABLE 3.2 – REVENUE COMMITMENTS AS A PERCENTAGE OF THE ANNUAL TOTAL BUDGET

	2018-19	2019-20	2020-21	2021-22	2022-23
Committed projects	3.63%	3.88%	3.79%	3.71%	3.59%
Committed projects plus planned projects and planned borrowing	3.74%	4.11%	4.23%	4.17%	4.04%

3.18. Table 3.3 splits out the commitments and planned commitments into the different categories of revenue-funded investment.

TABLE 3.3 – BREAKDOWN OF COMMITTED PROJECTS PLUS PLANNED PROJECTS AND PLANNED BORROWING INTO CATEGORIES (%)

	2018-19	2019-20	2020-21	2021-22	2022-23
PPP/PFI	1.94%	1.93%	1.85%	1.81%	1.72%
NPD/Hub	0.63%	0.67%	0.80%	0.81%	0.80%
Network Rail Borrowing – RAB	1.06%	1.30%	1.30%	1.28%	1.25%
Capital Borrowing	0.11%	0.21%	0.28%	0.27%	0.27%
Total	3.74%	4.11%	4.23%	4.17%	4.04%

3.19. Committed projects are those where a contract has been signed. The assets will therefore be under construction, or the project is operational. Committed projects also include the Scottish Government's share of the revenue costs of PFI projects (which are completed and in operation) and the five pre-pipeline NPD projects. Unitary charges usually include on-going maintenance commitments over the project life, as well as costs associated with project construction and financing. Costs associated with planned projects and investments are those where a contract is not yet signed.

3.20. It should be noted that, following the reclassification of Network Rail from a private to a public sector organisation, the funding regime will change from 2019-20 and rail projects will become entirely grant-funded. This will change the way the 5 per cent limit takes account of rail projects which are currently revenue-financed.

3.21. In the interests of maintaining comparability, current modelling of commitments contains estimates of the Network Rail investment as if it had been Regulatory Asset Base (RAB) funded. The Scottish Government is therefore currently reviewing this approach to reflect the new and more complex fiscal environment.

Resource borrowing

3.22. The Scotland Act 2012 gave the Scottish Government access to a resource borrowing facility of up to £200 million per year within a statutory overall limit for resource borrowing of £500 million. This could be used to meet any in-year excess in expenditure over income.

3.23. The Scotland Act 2016 extended this facility to enable the Scottish Government to borrow from the National Loans Fund in certain situations where there are specific cash management challenges. The Scottish Government now has the power to borrow up to £600 million each year within a statutory overall limit for resource borrowing of £1.75 billion, for the following reasons:

- in-year cash management, with an annual limit of £500 million;
- forecast error on devolved and assigned taxes, and on devolved social security expenditure, arising from forecasts of Scottish receipts/expenditure and corresponding UK forecasts for the Block Grant Adjustments, with an annual limit of £300 million; and
- observed or forecast shortfall in devolved or assigned tax receipts or devolved social security expenditure incurred where there is, or is forecast to be, a Scotland-specific economic shock, with an annual limit of £600 million.

3.24. It is important to note that if an economic shock occurs it is not possible for the Scottish Government to apply resource borrowing to provide an economic stimulus – only to meet a shortfall in tax receipts or demand-led social security spending.

3.25. These enhanced borrowing powers came into force from 2017-18 onwards. All resource borrowing must be from the National Loans Fund and the repayment period must be between three and five years, to be determined by the Scottish Government at the time of borrowing. The Scottish Government is required to provide regular monthly forecasts to HM Treasury of the amount of resource borrowing it expects to make, outstanding debt and repayment profiles and can borrow within the agreed limits as deemed appropriate.

3.26. The resource borrowing power is deliberately restricted to very specific circumstances and does not detract from the fundamental requirement for a balanced Scottish Budget each financial year. If circumstances arise where the conditions to allow resource borrowing become available, the Scottish Government will make a decision on whether and how to use it based on the overall situation at the time.

3.27. A decision will depend on assessing the impact of resource borrowing, including the repayments over future financial years, against the impact of taking other steps, such as reducing expenditure in-year or using money available in the Scotland Reserve.

Scotland Reserve

3.28. The Scotland Act 2016 replaced a previous power under the Scotland Act 2012 to operate a limited cash reserve. This can be used to build up funds when devolved revenues are higher than forecast and to drawdown funds when devolved revenues are lower than forecast. The Scotland Reserve replaced the previous Budget Exchange provisions set out in the Consolidated Budgeting Guidance.

3.29. The Scotland Reserve allows the Scottish Government to smooth all types of spending and is intended to assist the management of tax volatility and to determine the timing of expenditure. The Scotland Reserve applied from 2017-18 onwards and is split between resource and capital.

3.30. The Reserve is capped in aggregate at £700 million, or only 2.2 per cent of the total Scottish Budget in 2018-19, which falls to 1.8 per cent in 2022-23, based on the central projection in this document. Annual drawdowns from the Reserve are limited to £250 million for resource and £100 million for capital.

3.31. The Scotland Reserve is now the mechanism by which any underspend in the Scottish Budget can be carried forward to be used in a subsequent financial year. In recent years, with very tight financial management, underspend has been low, less than 1 per cent of the total discretionary budget, but even so, managing money across financial years is likely to use up a substantial proportion of the £250 million resource and £100 million capital limits. This very severely restricts the Scottish Government's ability to build up a reserve and draw down from it.

3.32. The balance in the Scotland Reserve at the start of 2017-18 was £74 million. The closing balance on the Reserve for 2017-18 will be reported as part of the provisional outturn statement to the Scottish Parliament in June 2018. Spending plans for 2018-19 anticipate around £230 million of expenditure that will be funded from carry forward from 2017-18, which will be managed through the Scotland Reserve.

3.33. The Scottish Government intends to build up the balance in the Scotland Reserve over time as resources allow, in order to have a financial cushion available, while ensuring that there remains sufficient capacity in the Reserve to prudently manage any underspend across financial years.

Effective financial management and reporting

3.34. The Public Finance and Accountability (Scotland) Act 2000 provides for the use of resources by the Scottish Government (and other directly funded bodies) and sets out accountability arrangements for management of those resources. The Scottish Public Finance Manual⁶ (SPFM) is issued by the Scottish Government to provide guidance to itself and other relevant bodies on the proper handling and reporting of public funds. It sets out the relevant statutory, Parliamentary and administrative requirements, emphasises the need for economy, efficiency and effectiveness, and promotes good practice and high standards of propriety.

Economic intervention and investment

3.35. The Scottish Government's consideration of any investment or significant financial decision follows the principles and procedures of the SPFM to ensure the regularity, propriety and value for money of the use of resources.

3.36. This includes:

- preparing and refining a business case to ensure that proposals are in line with strategic objectives, the evaluation of options, detailed analysis of costs and benefits and all relevant commercial and financial considerations, including the affordability and balance of risks of the proposal;
- carrying out due diligence to substantiate the assessment where relevant;
- acting within EU State aid rules; and
- where appropriate, consultation with and scrutiny from the Scottish Parliament.

3.37. Before entering into any form of agreement giving rise to a contingent liability, for example a guarantee or indemnity, the SPFM requires a careful appraisal of the risks, with steps to be taken to restrict the total contingent liability to a minimum. All such arrangements are monitored as part of regular financial management activity.

Developing financial reporting – tailored for Scotland consolidated public accounts

3.38. While the Scottish Government already publishes a range of financial and economic information, it is continuing to develop its approaches. Working with financial year 2016-17 as a shadow year, the Scottish Government has collected the necessary information to support further reporting outputs. This brings together the financial information of all sectors of the devolved public sector in Scotland, including public bodies and local government, and has established a process for the 2017-18 financial year.

3.39. The Scottish Government is currently considering options for the presentation of this information, with the focus being to minimise the burden on Scottish public bodies and ensure that what is produced is useful and adds value. As part of this process, the Scottish Government will be engaging with Audit Scotland.

6 <http://www.gov.scot/Topics/Government/Finance/spfm/Intro>

4 Role of the UK Government

4.1. While the Scottish Parliament now has expanded powers, the UK Government retains a central role in determining both the size of the Scottish Budget and the overall economic climate. This is because key economic levers remain reserved to Westminster – monetary policy, macroeconomic policy and the majority of tax powers. Control over migration policy, which has a major impact on the economy, is also reserved.

4.2. Responsibility for tax policy and the economy are shared between the Scottish and UK Governments. This document outlines the Scottish Government's approach to sustainably managing Scotland's finances. Where decisions taken by the UK Government have an impact on Scotland's economy and public finances, we will continue to engage constructively with the UK Government to reduce any detriment to Scotland.

Current UK Government fiscal policy

4.3. Through the Fiscal Framework, the UK Government sets the overall funding envelope that is available to Scotland. While new powers allow the Scottish Parliament to use its taxation powers to increase or decrease the budget available, the starting point for the Scottish Budget is still determined by the size of the block grant.

4.4. This has been particularly challenging over the last decade with the UK Government's approach to austerity. This has meant that in real terms over the ten years to 2019-20 the Scottish Government's discretionary budget allocation will have been cut by over 9 per cent (£2.6 billion).

4.5. Managing difficult financial circumstances is the job of Government, which is why during the development of the 2018-19 Budget the decision was taken by the Scottish Government to introduce a five band income tax policy to generate additional revenues and reverse the real terms cut to the budget imposed by the UK Government.

4.6. The Scottish Government is committed to investing in our public services and our infrastructure and has continually urged the UK Government to change its course on austerity to provide the resources that our public services need.

4.7. A particular concern is how the UK Government's austerity policies disproportionately affect the most disadvantaged individuals. For example, the Resolution Foundation⁷ estimates that the UK Government's policies will leave the poorest third of households an average of £745 a year worse off by 2022-23.

4.8. Social security changes that came into effect in April 2018 are being imposed on some of the most vulnerable sectors of society. The Resolution Foundation has estimated that 2018-19 is set to be the second biggest single year of social security cuts, with £2.5 billion of cuts expected.

7 <https://www.resolutionfoundation.org/app/uploads/2018/03/Spring-Statement-response.pdf>

4.9. The Scottish Government is fully committed to supporting and protecting these vulnerable populations and has made available £62 million in 2018-19 to local authorities to:

- fully mitigate the bedroom tax for more than 70,000 households;
- help mitigate other UK Government policies such as the Benefit Cap and Local Housing Allowance rates; and
- support those on low incomes.

4.10. Despite the UK fiscal deficit having now returned to pre-crisis levels, the UK Government is planning for further tax rises and spending cuts until the middle of the next decade. This objective is underpinned by the UK Government's fiscal rules to:

- reduce the structural deficit to below 2 per cent of GDP by 2020-21;
- have net debt as a percentage of GDP falling in 2020-21; and
- return the public finances to balance at the "earliest possible date in the next Parliament", currently assumed to be 2025-26.

4.11. To achieve these targets, the UK Government plans to continue with its programme of tax rises and spending cuts over the coming years. It is estimated that the UK Government's current plans aim to reduce the structural deficit by 6 per cent of GDP, or around £120 billion in today's terms.

4.12. The latest forecasts from the Office for Budget Responsibility show that the scale of the tax rises and spending cuts planned by the UK Government mean that it is on course to not just meet its first two fiscal targets in 2020-21⁸ but to go beyond them. The UK Government can therefore meet these fiscal objectives while reversing some of the spending cuts that are currently planned. As a broad illustration:

- this could provide approximately £60 billion of additional investment over the five year period to 2022-23, compared to current UK Budget plans, as set out at the Spring Statement. This in turn would make an additional £5 billion of investment available for Scotland over this period, compared to current UK Budget plans;
- alternatively, the UK Government could also adopt a more gradual deficit reduction which strikes a better balance between ensuring the sustainability of the UK public finances and investing in the public services which are vital to supporting households and long-term economic growth. As outlined in **Annex C**, such an approach could potentially provide an additional £7 billion in investment for Scottish public services relative to current plans.

8 See OBR March 2018 Economic and Fiscal Outlook: http://cdn.obr.uk/EFO-MarCh_2018.pdf page 185.

4.13. The UK Government therefore has flexibility to meet its fiscal objectives without implementing in full the spending cuts that are currently planned for the coming years. Were the UK Government to use some of this fiscal headroom, this could result in billions of investment in our vital public services in Scotland.

4.14. While the central budget forecasts in this document have to be based on the UK Government fiscal rules and therefore upon a continuation of UK Government austerity, it is clear that austerity is a choice made by the UK Government rather than an economic necessity.

Immigration

4.15. In considering the financial outlook for this new document, it is important to reflect on the key fact that population growth has been the most significant driver of GDP growth in both Scotland and the UK in recent years.

4.16. The strategic importance of population growth to Scotland's economy has been recognised since 2007 in the National Performance Framework. The Purpose Target to match average European (EU15) population growth over the period 2007 to 2017 has been met – statistics published in April 2018 confirm that Scotland's population grew slightly faster than the EU15 average over the last 10 years, closing the previous gap between Scotland and the EU15 in relation to population growth.

4.17. International migration has been the largest contributor to Scotland's population growth over the past 10 years, and to a greater extent than in any other part of the UK. The most recent population projections from National Records of Scotland indicate that all of Scotland's population growth over the next 25 years is expected to come from migration (from both overseas and the rest of the UK). Therefore migration is essential for Scotland and is particularly important given the prospect of more projected deaths than births in Scotland every year from now on.

4.18. The age profile of the population will also change. The proportion of the population of state pension age will increase by 25 per cent over the next 25 years. People aged 75 and over are projected to be the fastest growing age group in Scotland, increasing by 79 per cent over the same period.

4.19. At the same time as we expect to see these large increases in the proportion of the population of pensionable age, the working age population will grow only slightly, by around 1 per cent over the next 25 years.

4.20. All of this creates challenging future population demographics for Scotland.

4.21. The Scottish Fiscal Commission, in its first Economic and Fiscal Forecasts published in December 2017⁹, observes that “the size of the population aged 16 to 64, which makes up most of the working age population, is very important for the economy and public finances. These individuals are more likely to be working and will be generating the highest tax receipts, for example, in income tax.”

4.22. In variant population projections, where migration is reduced, the proportion of working age people in the population begins to decline. For example, in the scenario where projected migration from the EU is cut by half, the proportion of the population of working age falls by 0.8 per cent over the next 25 years.

4.23. Migration is crucial to help grow our working age population, but the impact of the UK's exit from the EU, the prospect of future restrictions on migration from the EU, and the 'hostile environment' policy of the UK Government all exacerbate the challenge and inhibit Scotland's population growth.

4.24. That has a direct impact on our economic prospects. The long-term impact on the economy of lower migration, as a result of the UK's exit from the EU, was set out in our recent paper "*Scotland's population needs and migration policy: Discussion paper on evidence, policy and powers for the Scottish Parliament*".¹⁰ The 'Brexit' effect of reduced migration could reduce Scotland's GDP by 4.5 per cent per year by 2040 – equivalent to a fall of almost £5 billion a year. That is a more significant reduction than the rest of the UK will face, where real GDP could be 3.7 per cent lower by 2040 as a result of an EU exit-driven reduction in migration. The proportionately larger impact on Scotland is equivalent to £1.2 billion per year by 2040.

4.25. If the UK Government achieves its arbitrary net migration target, to reduce net migration to the 'tens of thousands', the economic impact would be even more extreme. Using a low migration variant of the population projections, where net migration to the UK is assumed to be +85,000 per year in the long-term, real GDP in Scotland could be 9.3 per cent lower by 2040, or £10.2 billion of lost GDP.

4.26. This provides a compelling economic case for why Scotland needs a tailored approach to migration, particularly in the context of an evolving devolution settlement where the Scottish Parliament now has significant new powers in relation to taxation. The downside risks of immigration policies decided by the UK Government, and not supported by any party in the Scottish Parliament, have significant consequences for Scottish areas of devolved responsibility.

UK exit from the EU

4.27. The prospect of the UK leaving the European Union has created huge and significant uncertainties for the Scottish Government, the public sector, businesses and families.

4.28. While the outcome of the negotiations on the UK's departure from the EU is not yet known, both the Scottish Fiscal Commission and the Office for Budget Responsibility expect it to have a negative impact on the economy. This is due to the uncertainty created by the negotiations, and the anticipated outcome of the final settlement, which is expected to reduce growth in trade and limit immigration.

4.29. The actual impact on the Scottish Budget will depend on future UK Government spending decisions and the relative impact on Scottish and UK tax receipts. Changes in UK Government spending will directly affect the Scottish Budget through the Barnett formula.

4.30. The uncertainty over a UK exit from the EU – with no clearly agreed path in terms of our on-going access to key EU markets – is hampering economic growth and investment. The UK Government pursuit of a hard exit will undermine Scotland's economic prospects by creating significant impediments to trade in good and, in particular, services. Our paper "Scotland's Place in Europe: People, Jobs and Investment" showed that the pursuit of a hard exit will damage the Scottish economy and risk jobs and investment. A hard exit threatens to cost our economy £12.7 billion (£2,300 per person) a year by 2030, compared to remaining in the EU.

4.31. An EU exit which results in the UK being outside the European Single Market and Customs Union will have the most damaging consequences for Scotland. The EU is the largest single market for Scotland's international exports, with exports worth £12.7 billion in 2016 supporting directly and indirectly hundreds of thousands of jobs across Scotland.

4.32. Outside the Single Market we would also miss out on new measures in services and digital, for example, estimated to be worth an additional 2.4 per cent of EU GDP. The equivalent for Scottish GDP would be £3.6 billion, or £668 per person.

4.33. It is therefore clear that membership of the Single Market and Customs Union is the only way to allow the continued level of EU market integration that is so critical to the future of the economy.

4.34. Membership of the European Union also allows direct access to EU funding programmes, worth over £5 billion in the current 2014-20 EU budget round. Outside of the European Union, access to these funding streams is not guaranteed, creating significant uncertainty for those who are reliant on them.

Funding disputes

4.35. In recent years, the Scottish Government has also been pursuing a number of funding discussions with the UK Government in relation to issues such as the backdating of Police and Fire VAT; the funding deal that the UK Government reached with the Democratic Unionist Party (and the consequences of that for the rest of the UK); future levels of Network Rail funding; and funding to support the preparation for the UK Government's decision to leave the European Union – which taken together represent over £3 billion of potential funding.

4.36. Clearly all of these topics have a bearing on the overall level of funding available to the Scottish Government and a positive resolution to these would provide additional funding to support public services in Scotland.

5 Investing in Our Economy

5.1. Support for the economy is key to our efforts to ensure financial stability and maximise the resources available for our public services. Our ambition is to build a modern, dynamic, open economy which benefits everyone in Scotland. The 2017 Programme for Government puts transforming Scotland's economy at the heart of everything this Government does, including the way in which we plan, utilise and allocate our available financial resources.

5.2. In line with this, we have an ambitious programme of infrastructure investment for 2018-19 of more than £4 billion and £20 billion over the life of this Parliament. Our investment strategy is set out in our Infrastructure Investment Plan, with sustainable economic growth through increasing competitiveness and supporting employment opportunities for all included in our guiding principles for investment. We recognise that both economic and social infrastructure help the productive capacity of the economy in both the short term through employment effects, and also in the longer term by improving productivity. We are therefore using all of the levers at our disposal to maximise investment to support economic growth and ensuring that spending is targeted as effectively as possible.

5.3. Capital expenditure in the Scottish Budget in 2018-19 is estimated to support around 22,000 Full Time Equivalent (FTE) jobs directly. In total, when supply chain and re-spending of wages are taken into account, the entire Scottish capital budget for 2018-19 is estimated to support around 40,000 FTE jobs and contribute £2.3 billion to Scottish GDP.

5.4. When the indirect effects arising from this are considered, this expenditure is estimated to support a further 11,000 FTE jobs through supplier industries in the wider Scottish economy. This means that an additional 6,000 FTE jobs are supported through the 'induced' effects, as a result of the re-spending of wages.

Supporting business growth through business rates

5.5. The non-domestic rates system has a key role to play in delivering sustainable economic growth through the direct impact on the operating costs of businesses and on the totality of resources available to fund public services. The Barclay Review of non-domestic rates was established to deliver a rates system designed to better support business growth, long-term investment and reflect changing market places. The subsequent recommendations include measures to support growth, to improve administration of the system and to increase fairness.

5.6. While responding to the Barclay Review, the Scottish Budget delivered the most attractive package of non-domestic rates in the UK. The Budget delivered the number one ask of Scottish businesses by capping the business rates uplift at the consumer price index (CPI) rather than the retail price index (RPI). It supported the most competitive reliefs package in the UK, worth a record £720 million, up from £660 million in 2017-18, and maintained the Small Business Bonus Scheme with the maximum savings achievable through the scheme increasing to £7,200.

5.7. Having been introduced in April 2018, the Business Growth Accelerator will encourage new business investment by temporarily suspending rates liabilities and the Day Nurseries relief will reduce the overheads to nursery providers who have such an important role to play in ensuring our children have the best start in life. These recommendations were delivered as quickly as possible following the Programme for Government and are unique across the UK.

5.8. Scotland's Economic Strategy¹¹ sets out an overarching framework for how we aim to achieve a more productive, more cohesive and fairer Scotland. Our Economic Strategy has made clear that the questions of tackling inequality and securing economic growth are not mutually exclusive. That is why inclusive growth is central to our Economic Strategy – it aims to increase productivity and reduce inequality through fostering innovation, increasing investment and promoting internationalisation.

5.9. Scotland's economy continues to show resilience but it faces challenges of demographic change, technological advances and preparing our workforce for the jobs of the future. The UK's exit from the EU continues to provide serious economic headwinds and our economy continues to show the impacts of years of austerity. But we know we can and must do more to secure growth for everyone in Scotland, no matter their background or where they live.

Fair Work and pay

5.10. In creating the conditions for a more productive, more cohesive and fairer Scotland, the Scottish Government is doing everything it can to promote fair working practices.

5.11. The past 30 years have seen a marked narrowing of the priorities of many private sector companies. An increasing emphasis on short-term profit and shareholder return has promoted a business model which rewards the minimisation of labour costs. This situation has led to the imbalance in shared benefit of enterprise, and some unwelcome developments such as greater job insecurity, poor contracting through the inappropriate use of zero-hours contracts, underemployment and poverty pay – all of which reinforce cycles of inequality.

5.12. Despite the challenge of employment law being reserved to the UK Government, the Scottish Government is determined to take action to improve these working practices and promote, champion and to support a Fair Work approach.

5.13. Fair Work sits at the intersection between economic and social policy and is central to the Scottish Government's twin goals of boosting competitiveness and tackling inequality. Increasing the quality of jobs has wider social benefits beyond productivity and tax.

5.14. Fair Work has demonstrable benefits to:

- health;
- skills development;
- reducing inequalities; and
- can support greater innovation in our businesses.

5.15. As a Government we are at the forefront of the promotion of Fair Work through measures including the promotion of the Living Wage, the creation of the Fair Work Convention, our approach to procurement, and the delivery of the Business Pledge.

11 [Scotland's Economic Strategy 2015](#)

5.16. As a key part of driving forward Fair Work and promoting fair working practices, the Scottish Government is actively championing the real Living Wage to help ensure that people's basic pay meets the cost of living. We have achieved our target of reaching 1,000 accredited employers by autumn 2017, are the first Government of the home nations to be Living Wage accredited and are actively promoting the payment of the 'real' Living Wage to those working on government contracts. All these actions help ensure that, at 81.6 per cent, Scotland has the highest rate of workers in the UK earning the real Living Wage.

Growing our economy

5.17. Beyond creating the conditions for Fair Work, we want Scotland to be the best place to do business in the UK and Europe. To do that we need to ease the cost of doing business, provide high quality transport and digital infrastructure, attract talent, create opportunity for exports, trade and investment, drive ambition and make sure that ambitious businesses can get the help they need to overcome their barriers to growth.

5.18. That is why the Programme for Government articulated the Scottish Government's vision for Scotland to be an inventor and producer of the goods, industries and skills of the future, not just a consumer. Scotland has a competitive advantage in the emerging technologies and innovations that will both drive future growth and deliver our low carbon future. We have also established strengths in key sectors like renewable energy, creative industries, life sciences, tourism, food and drink and advanced manufacturing – we intend to build on these strengths. We are now delivering that vision and will build on this theme in future years.

5.19. Critical to this vision is the Scottish Government's commitment to build and invest in Scotland's infrastructure. The recent Scottish Budget delivered major investments that underpin our focus on innovation, infrastructure and investment, internationalisation and inclusive growth. These include:

- Developing our cities and regions, reducing costs and making Scotland an attractive place to do business:
 - committing over £1 billion over the next 10-20 years to support City Region Deals for Glasgow, Aberdeen, Inverness, Edinburgh and South-East Scotland, with planned action to secure new deals for Stirling, Clackmannanshire and the Tay Cities;
 - £96 million to deliver the most attractive business rates package in the UK with the increase to the rates poundage capped at CPI inflation; and
 - a 64 per cent increase of £270 million in the Economy, Jobs and Fair Work budget, forming part of a total investment of £2.4 billion in our enterprise and skills bodies.
- Supporting innovation and commercialisation of research through:
 - a 70 per cent increase in investment in business Research and Development; and
 - £18 million as part of a £65 million package of investment for the National Manufacturing Institute to make Scotland a global leader in advanced manufacturing.

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- Providing world class infrastructure and building low carbon innovation through:
 - supporting every home and business across Scotland to have access to superfast broadband by 2021 through the procurement of the R100 programme;
 - investing £1.2 billion in our transport infrastructure, including key road projects and further electrification of the rail network;
 - the Low Carbon Infrastructure Transition Programme, which is co-funded by the European Regional Development Fund (ERDF) and is expected to fund large scale projects which support the ambitions of Scotland's Energy Strategy, which was published in December 2017. This, coupled with a new £60 million fund to support innovative energy projects, will keep Scotland at the forefront of low carbon innovation; and
 - investing almost £40 million to provide electric vehicle charging infrastructure, with concentrated action to support and encourage the take-up of electric vehicles in cities and towns to contribute essential action towards our target to phase out the need for new petrol and diesel cars and vans by 2032.
 - Improving the financial investment landscape in Scotland by creating a programme of additional economic investment of almost £0.5 billion over the next three years, by:
 - setting aside resources of £340 million to provide initial capitalisation for the Scottish National Investment Bank; and
 - creating a new £150 million Building Scotland Fund announced by the Scottish Government in December 2017.

5.20. Providing the right environment to encourage and support investment in Scotland is a fundamental building block for growing the Scottish economy. That is why the creation of the new Scottish National Investment Bank is so important. As an innovative, commercial enterprise which will provide a new supply of capital to boost investment in the Scottish economy, this is expected to encourage the leverage of additional private investment and will drive forward new investment in Scotland.

5.21. The publicly owned Scottish National Investment Bank will become a cornerstone of the economy that we want to create in Scotland. It has the potential to be transformative and will operate under a core set of principles and missions. It will support sustainable growth and bring benefits to individuals and communities across the country, in the process making Scotland a fairer and more prosperous country.

5.22. This represents a significant new development in helping to build the economy of Scotland, and the Scottish Government is committed to investing £2 billion over ten years to support this venture to capitalise the Bank, to provide a significant boost to the supply of capital stimulating the Scottish economy.

5.23. Beyond providing the environment to encourage and support major infrastructure investment, we are taking strides to reform our business environment in order to underpin long-term economic growth. We will do this primarily through building on the successes and transforming the impact of our enterprise and skills agencies. The Scottish Government has established a new Strategic Board to maximise the impact of the collective investment made in enterprise and skills development and to create the conditions for delivering inclusive growth.

5.24. We need to take action at all levels to build and grow the economy, which is why the Scottish Government has committed to creating a new enterprise agency in the South of Scotland, with an interim Economic Partnership in place, backed with an investment of £10 million.

5.25. In light of the UK's exit from the EU and an uncertain European landscape, it is especially important to build collaborations and networks to encourage future European and worldwide investment. To that end, the Scottish Government is boosting Scotland's trade, export and international profile through establishing a Board of Trade to support the delivery of our Trade and Investment Strategy; is establishing new hubs in Berlin and Paris to help ambitious Scottish companies take advantage of business opportunities across Europe; and is strengthening our existing presence in Brussels and Canada.

Economic performance

5.26. As our economic approach builds momentum, we are seeing Scotland lead the way on many economic indicators:

- Scotland has secured more Foreign Direct Investment projects than any other part of the UK outside London;
- Scotland has seen the fastest productivity growth in the UK since 2007;
- Scotland's international goods exports (including oil and gas) increased by 19 per cent to £28.8 billion between 2016 and 2017 - the fastest growth of any of the UK nations;
- Scotland has outperformed the UK in terms of R&D spending growth - over the latest year and since 2007;
- Scotland has the highest proportion of employees paid at least the Living Wage of all UK nations - at 81.6 per cent; and
- Scotland outperforms the UK on female and youth employment, unemployment and inactivity rates.

5.27. Scotland's economic performance has been resilient in 2017 despite challenging economic conditions that continue to be dominated by heightened uncertainty as the UK moves closer to leaving the EU. With four consecutive quarters of growth in 2017, Scotland's economy grew 0.8 per cent overall in 2017, rising from 0.2 per cent growth in 2016. While the pace of growth remains below its long run trend rate, the strengthening over the year was driven by continued growth in the services sector alongside a return to growth in the production sector. The construction sector contracted in 2017 as it continues to adjust back to its long-run trend following exceptionally fast growth in 2015.

5.28. Scotland's labour market is strong - over the past year unemployment and inactivity have fallen, while employment has risen. The latest data for January to March 2018 show that unemployment fell to 4.3 per cent, while the number of people in employment rose to 2.63 million. This is up by 10,000 over the past year and 66,000 more than the pre-recession peak in 2008.

Economic outlook for the next five years

5.29. Over the next couple of years, a number of independent forecasters present a slightly stronger outlook for economic growth. However, the pace of growth is expected to remain below its historic trend. Independent forecasts for the Scottish economy suggest that GDP will grow by between 0.7 per cent and 1.4 per cent in 2018 and that growth will increase in 2019.¹² The improved outlook relative to 2017 reflects a stronger world economy and more optimism for oil and gas and related production activities.

5.30. There are signals from some business surveys that, while business optimism has improved over the past year, business investment intentions are fragile and Scottish consumer sentiment remains weak. This period of heightened uncertainty as a result of the UK's exit from the EU is identified as a key factor affecting the economic outlook by all independent forecasters.

5.31. The Scottish Fiscal Commission produces official forecasts of the Scottish economy over a five year time horizon and its latest forecasts are published alongside this document.

5.32. The Scottish Fiscal Commission's economic forecasts in turn feed into its fiscal forecasts. Forecasts of employment and wage growth are key drivers of the economic and income tax forecasts. Other factors such as demography, migration, productivity and trade in the coming years are also key to determining the forecasts.

5.33. Table 5.1 sets out the latest headline economic forecasts by the Scottish Fiscal Commission (SFC).

TABLE 5.1 – HEADLINE ECONOMIC FORECASTS (CALENDAR YEAR BASIS)

	2017 (outturn)	2018	2019	2020	2021	2022	2023
GDP (per cent growth)	0.8%	0.7%	0.8%	0.9%	0.9%	0.9%	0.9%
Employment (millions)	2.64	2.65	2.65	2.65	2.66	2.66	2.66
Earnings (per cent growth)	1.1%	1.6%	1.9%	2.2%	2.6%	2.9%	3.2%

12 Fraser of Allander Economic Commentary
https://www.sbs.strath.ac.uk/economics/fraser/20180328/FEC_Vol_42_No_1.pdf
 EY Scottish ITEM Club 2018 Forecast
[http://www.ey.com/Publication/vwLUAssetsPI/ey-scottish-item-club-2018-forecast/\\$FILE/ey-scottish-item-club-2018-forecast.pdf](http://www.ey.com/Publication/vwLUAssetsPI/ey-scottish-item-club-2018-forecast/$FILE/ey-scottish-item-club-2018-forecast.pdf)
 PWC UK Economic Outlook
<https://www.pwc.co.uk/economic-services/ukeo/pwc-ukeo-march18-full-report.pdf>
 Scottish Fiscal Commission
<http://www.fiscalcommission.scot/publications>

5.34. The SFC's latest forecasts continue to suggest that economic growth will be lower in Scotland than the UK as a whole over the next five years. This reflects their judgement that productivity growth will be weaker in Scotland over the period, as well as an expectation that the working age population will grow more slowly in Scotland.

5.35. The SFC's report highlights that:

- the UK's exit from the EU will impact negatively on Scotland's economy and reduce migration, productivity and trade in the coming years;
- in comparison with Office for Budget Responsibility (OBR) forecasts: while there is a gap in total GDP growth between the SFC and OBR forecasts, it is much narrower for GDP per head; and
- by 2022 GDP per capita is forecast to grow by 1.0 per cent a year in the UK (OBR) and 0.7 per cent in Scotland (SFC).

Longer-term economic outlook

5.36. Over the long term, Scotland's economy faces significant challenges from demographic change and the UK's exit from the EU but there are also opportunities associated with transition to the low carbon economy, digitalisation and technological advances and preparing our workforce for the jobs of the future.

5.37. The world economy is changing at a dramatic pace. The successful economies of the future will be resource efficient and low carbon, and they will harness the power of technology. The opportunities for those that adapt and lead these changes are substantial. The Programme for Government 2017 sets out actions to make Scotland a country that will lead change and reap the economic rewards it will bring.

5.38. The Scottish Government recognises the importance of emerging technologies in Scotland, such as automation, and its role in shaping our future prosperity. Scotland has a highly skilled workforce and we will continue to support and develop it in line with modern advances in technology. We can capitalise on changes in global forces, focusing on safeguarding and developing future jobs by preparing a workforce that can adapt and respond effectively to these changes. We share a common objective with the Scottish Trades Union Congress (STUC) – to ensure automation and digitalisation have positive outcomes for all of Scotland's people. Taking this action now to harness the potential of technological change is vital to building a modern, successful and dynamic economy.

5.39. The Scottish Government will continue to place the transformation of Scotland's economy at the heart of everything we do, and through our Economic Strategy we will achieve a more productive, cohesive and fairer Scotland. Building and growing our economy will in turn provide increased tax revenues for Scotland, which will be used to support and enhance the range of public services that we provide.

6 Funding Outlook

6.1. As explained in Chapter 2, the way in which the Scottish Government is funded is changing significantly and as a result the Scottish Government's overall budget is increasingly influenced by the performance of the Scottish economy.

6.2. In 2015-16, almost all of the Scottish Budget came from the UK Government via a block grant. In 2016-17, this had fallen to around 80 per cent and in 2017-18 to 60 per cent. It is expected to fall further following the assignment of VAT in 2020-21.

Range of factors and uncertainties affecting the funding outlook

6.3. As the Scottish Government moves away from being funded primarily through the block grant to a combination of devolved taxes and the block grant, the number of variables which will affect its longer term funding outlook will increase. UK Government spending decisions will continue to affect the Scottish Budget but, as well as these, Scottish Government policy and the relative performance of the Scottish economy will play increasingly important roles.

6.4. One of the most important parts of the new Fiscal Framework is the Block Grant Adjustment for the devolved taxes. This means that the Scottish Budget is not dependent on the total amount of tax raised through devolved taxes, but rather on whether Scotland is raising relatively more or less tax than the rest of the UK.

6.5. Broadly speaking, therefore, under the Fiscal Framework there are three key determinants that can impact upon the Scottish Budget either positively or negatively. All of these relate in some way to UK Government policy, and so are not entirely within the control of the Scottish Government:

- **Changes in UK Government spending** – the block grant from the UK Government remains the single largest source of funding for the Scottish Budget. Changes in the grant are determined by changes in the spending of UK Government Departments through the Barnett formula, and so remain entirely outside the control of the Scottish Government;
- **UK Government fiscal policy** – changes in UK Government tax policy can result in UK Government tax receipts growing at different rates from devolved tax receipts. For example, increases in property taxes in England may result in property tax income increasing faster in the rest of the UK than in Scotland, which would reduce the size of the Scottish Budget. As this occurs as a result of UK Government policy, it is outside the Scottish Government's control; and
- **Scottish tax revenue relative to the rest of the UK** – through the Block Grant Adjustment process, the Scottish Budget is determined by the relative amount of tax raised in Scotland compared to the rest of the UK. If the Scottish Government can successfully grow tax revenue per head for devolved taxes faster than in the rest of the UK, through better economic performance, its budget will increase. If the Scottish Government makes tax policy decisions which increase or decrease tax revenue, these will also increase or decrease the Scottish Budget.

6.6. Further uncertainty in the funding outlook is introduced through the forecast process itself and through divergence in economic performance. Risks around Scottish Government income differing from forecast can be twofold:

- Scottish devolved tax is different from forecast; or
- the rest of UK tax is different from forecast.

6.7. If Scottish and UK taxes are both different from forecast by the same amount, the Scottish Government income should be unaffected. However, it should be recognised that there is an additional risk in forecasting Scottish taxes, as there is a greater lag in data becoming available for Scotland, with the latest Scottish Fiscal Commission (SFC) forecasts of income tax currently based on 2015-16 data.

6.8. Tax forecasts are often linked to economic forecasts. Economic variables such as employment and incomes will be important in determining decisions such as whether households decide to purchase a house, or whether businesses choose to invest. For example, the income tax forecast can be affected by a range of potential factors including:

- relative employment growth;
- relative wage growth;
- changes in income distribution in Scotland and the rest of the UK; and
- impact of policy changes.

6.9. To this extent, the tax forecasts are often viewed as being closely linked to the economy forecast, with the overall business cycle effects on employment and wage growth likely to be key drivers in the short term, although other factors such as the distribution of incomes and policy choices also play a role. Towards the end of the five year period, longer term underlying trends such as productivity, demographics, and labour market participation may also begin to affect the forecast.

6.10. It should be noted that, while tax receipts can vary, the impact on the Scottish Budget is driven by the scale of any changes relative to any changes in the rest of the UK on a per capita basis.

6.11. While the Scottish and UK economies have historically tended to follow similar paths, they do on occasion diverge. Recent data suggests that they are in a period of divergence at the moment across several areas, with GDP growth, earnings growth and employment growth currently weaker in Scotland. For example, in 2017 the Scottish economy grew by 0.8 per cent, compared to 1.8 per cent for the UK, and although employment grew in Scotland by 0.3 per cent over the year, this was slower than the 1 per cent for the UK. However, the most recent GDP figures showed UK growth of only 0.1 per cent for the first quarter of 2018, which suggests that previous growth forecasts for the UK may have been optimistic.

6.12. It is difficult to assess if and for how long this divergence will continue and to what extent it will impact on the Scottish Budget. As set out in Chapter 5, growing the economy and tax base are key priorities for the Scottish Government. These are reinforced by Scotland's Economic Strategy which presents the strategic plan for existing and future Scottish Government policy, offering a cohesive platform for building economic policy. The Scottish Government is taking a wide range of actions to build and support the Scottish economy through building high quality infrastructure, creating opportunities, driving ambition and supporting entrepreneurial talent and innovation.

6.13. The economic picture is complex. Income tax per head in Scotland has historically been lower than in the UK as a whole, representing a difference of income distributions, with relatively fewer additional rate taxpayers in Scotland.

6.14. This difference can in part be explained by the downturn in the oil and gas industry over this period. Recent evidence suggests that this sector is returning to growth. The divergence may be partly offset by the introduction of a lower higher-rate income tax threshold in Scotland in 2017-18 which would increase Scottish receipts.

Latest forecasts

6.15. The forecasts used to inform the economic modelling change over time and the Scottish Fiscal Commission has produced an updated set of forecasts alongside the publication of this document.

6.16. Table 6.1 (below) shows the SFC forecasts that were produced for the 2018-19 Scottish Budget and updated in February 2018 to reflect changes in income tax policy and compares these to the Block Grant Adjustment figures that were provided by the UK Government as part of the UK Autumn Budget 2017.

TABLE 6.1 – FEBRUARY 2018 FORECASTS FOR REVENUE AND BLOCK GRANT ADJUSTMENT (AS AT BUDGET ACT 2018)

£m		2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Income Tax	Revenue forecast	11,214	11,584	12,177	12,647	13,152	13,733	14,372
	BGA forecast	11,214	11,523	11,749	12,056	12,477	12,936	13,403
	Difference	0	61	428	591	675	797	969
LBTT	Revenue forecast	483*	557	588	628	668	707	748
	BGA forecast	534*	591	600	622	650	682	689
	Difference	-51	-34	-12	6	18	25	59
SLfT	Revenue forecast	148*	137	106	88	90	82	82
	BGA forecast	131*	104	94	86	79	75	71
	Difference	17	33	12	2	11	7	11
TOTAL	Revenue forecast	631	12,278	12,871	13,363	13,910	14,522	15,202
	BGA forecast	665	12,218	12,443	12,764	13,206	13,693	14,163
	Difference	-34	60	428	599	704	829	1,039

Note 1: At the UK Spring Statement 2018, no BGA information from HM Treasury was available beyond 2021-22. The 2022-23 BGA data has been calculated by the Scottish Government.

Note 2: *The 2016-17 LBTT and SLfT revenues and Block Grant Adjustment figures are outturn figures.

Note 3: Figures may not sum due to rounding.

6.17. Since then, the UK Government has provided updated Block Grant Adjustment figures at the UK Spring Statement 2018 and the SFC has now published their updated revenue forecasts to accompany the publication of this document. Table 6.2 details the latest revenue forecasts provided by the SFC in May 2018 and the latest Block Grant Adjustment estimates from the 2018 UK Spring Statement.

TABLE 6.2 – MAY 2018 FORECASTS FOR REVENUE AND BLOCK GRANT ADJUSTMENT

£m		2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Income Tax	Revenue forecast	11,267	11,467	11,969	12,345	12,805	13,335	13,936
	BGA forecast	11,267	11,626	11,930	12,215	12,612	13,015	13,531
	Net Difference	0	-159	39	130	193	320	405
LBTT	Revenue forecast	484	550	614	656	697	738	781
	BGA forecast	534	586	588	606	630	656	689
	Net Difference	-50	-36	26	50	67	82	92
SLfT	Revenue forecast	148	142	114	93	95	87	87
	BGA forecast	131	104	106	91	81	77	71
	Net Difference	17	38	8	2	14	10	16
TOTAL	Revenue forecast	11,899	12,159	12,697	13,094	13,597	14,160	14,804
	BGA forecast	11,932	12,316	12,623	12,912	13,323	13,749	14,291
	Net Difference	-32	-157	74	182	274	411	513

Note: Figures may not sum due to rounding.

6.18. These revised estimates for income tax revenues and Block Grant Adjustments for 2017-18 and 2018-19 do not have any immediate impact on the Scottish Budget. Under the Fiscal Framework, Block Grant Adjustments (BGA) for income tax are fixed for a financial year based on the forecast at the previous fiscal event: for the 2018-19 budget the net revenues for that year were fixed based on the BGA and tax forecast in autumn 2017.

6.19. Final revenues and Block Grant Adjustments for income tax are recalculated when outturn data is available and a budget adjustment agreed at that point. In the case of income tax, this reconciliation will only take place with a considerable lag. For example, outturn data for Scottish income tax revenues in 2017-18 will not be available until July 2019, with the impact of any reconciliation being applied in the 2020-21 Scottish Budget.

6.20. The updated forecasts for future years provide an indication of the level of revenues that the SFC anticipates, but these figures will not be used to set the 2019-20 budget in December 2018, as that will make use of the next set of forecasts that the SFC produces.

Approach to modelling the funding outlook

6.21. Other countries have developed medium term financial reporting and have generally used some form of scenario or sensitivity analysis to forecast available funding, based on levels of risk and forecast errors measured on a combination of economic and fiscal variables.

6.22. Modelling Scottish Government funding scenarios is more challenging as the Fiscal Framework is still very new and there is limited information to consider on the performance of forecasts relative to outturn data. In addition, under the current UK Government Spending Review, the UK Government has not yet set budgets for UK Departments and Devolved Administrations beyond 2019-20 (2020-21 for capital), but has indicated an intention to set out an updated plan for the overall UK public spending envelope at the Autumn Budget in 2018 and to undertake a Spending Review in spring 2019.

6.23. The Scottish Government has undertaken economic modelling to develop a scenario analysis based on forecasting potential levels of funding available over the next five years and aggregating these to produce a path for total potential funding. This sets out a central scenario and then quantifies the uncertainty around the central scenario to produce upper and lower ranges.

6.24. The central funding scenario includes the following elements:

- resource budget limit (excluding new social security funding);
- social security funding;
- capital budget limit;
- Financial Transactions;
- Block Grant Adjustment;
- income from devolved and assigned taxes; and
- capital borrowing.

6.25. The economic modelling looks directly at the evidence on historical variations in the individual factors determining the Scottish Budget, such as Barnett consequentials or differences in per person income tax growth rates in Scotland and the rest of the UK. These historical variations are used to build up a probability of such differences continuing, and their impact on the Scottish Budget. The estimated uncertainty is then used to present fan charts around the central forecast. Further detail is presented in **Annex B**.

6.26. This modelling approach assumes that the current Fiscal Framework methodology (indexed deduction per capita) is used across the entire five year period.

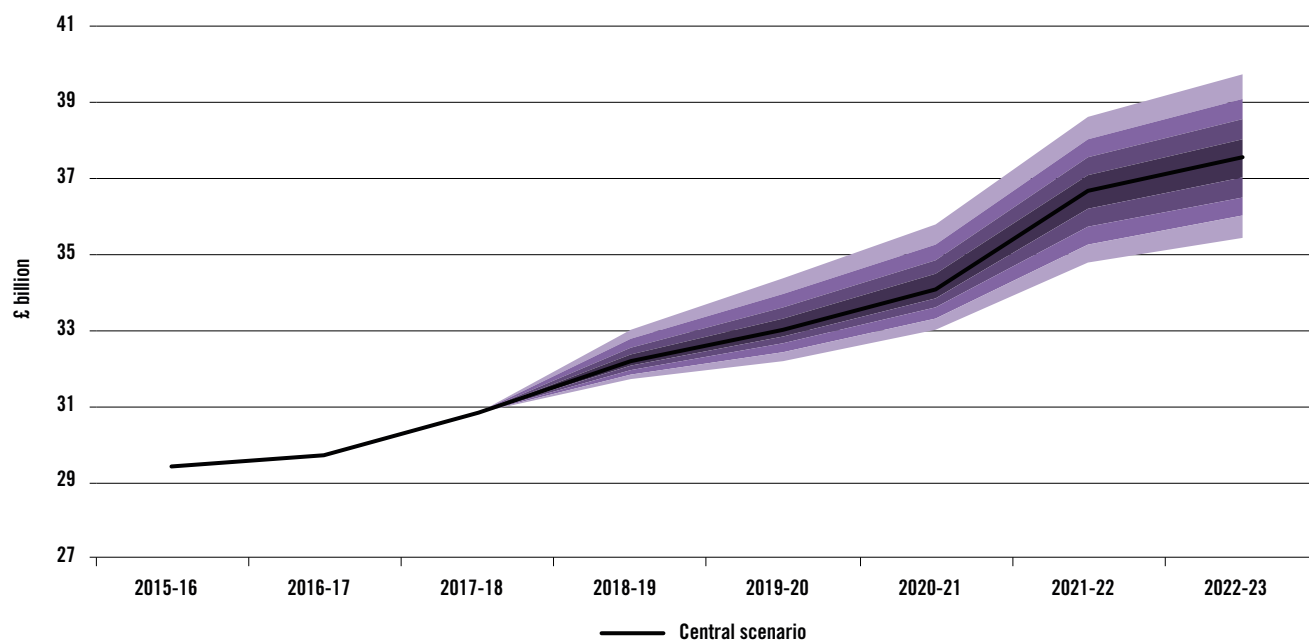
6.27. It should be noted that there are a number of risks to the Scottish Budget which have not yet been captured within this modelling and scenario development, such as the assignment of VAT which will impact on the Scottish Budget from 2020-21. It is expected that further information will be built into modelling in future years as information and understanding increases, including future UK Government funding once a new Spending Review is undertaken.

Paths for the Medium Term Financial Strategy

6.28. Chart 6.1 illustrates the forecast path for the potential overall Scottish Budget. By 2022-23, the budget is forecast to reach £37.6 billion, within a likely range of between £35.5 billion and £39.7 billion. While this represents the most likely upper and lower range, there is a chance that the final budget will lie outside this range.

6.29. This 2022-23 figure includes £3.6 billion associated with the devolution of social security powers. As this additional funding is accompanied by new social security responsibilities for the Scottish Government, this increased funding will not be available for use in other areas. This social security directed funding will increase from 2019-20 onwards, with a particularly large increase in 2021-22 when the powers for some of the major benefits are expected to be devolved to Scotland.

CHART 6.1 – OUTLOOK FOR THE OVERALL SCOTTISH BUDGET



6.30. The model uses the following assumptions for estimating the net impact of the newly devolved revenues on the Scottish Budget (i.e. the difference between Scottish revenue and the corresponding Block Grant Adjustment (BGA)). For the years up to and including 2018-19, we use the agreed Scottish Budget positions for each Budget Act. For income tax, these forecasts will not be revised until forecasts are reconciled to outturn data in 2020-21 and 2021-22 respectively.

6.31. For 2019-20 onwards, we use the May 2018 Scottish Fiscal Commission forecast for each devolved tax. The BGA forecast data used is based on the UK Government 2018 Spring Statement forecasts. The figures covering 2019-20 until 2022-23 are included in Table 6.2 and these figures will all be updated prior to the next Scottish Budget.

6.32. Table 6.3 illustrates this devolved tax and BGA data for 2016-17 to 2022-23 that has been used in the central scenario.

TABLE 6.3 – REVENUE AND BLOCK GRANT ADJUSTMENT IN THE CENTRAL SCENARIO (£M)

£m		2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Income Tax	Revenue	4,900	11,857	12,177	12,345	12,805	13,335	13,936
	BGA	4,900	11,750	11,749	12,215	12,612	13,015	13,531
	Net Difference	0	107	428	130	193	320	405
LBTT	Revenue	538	507	588	656	697	738	781
	BGA	500	545	600	606	630	656	689
	Net Difference	38	-38	-12	50	67	82	92
SLfT	Revenue	133	149	106	93	95	87	87
	BGA	100	119	94	91	81	77	71
	Net Difference	33	30	12	2	14	10	16
TOTAL	Revenue	5,571	12,485	12,871	13,094	13,597	14,160	14,804
	BGA	5,500	12,414	12,443	12,912	13,323	13,749	14,291
	Net Difference	71	71	428	182	274	411	513

Note 1: Tax revenues for 2016-17 to 2018-19 are as agreed in respective Scottish Budget Acts and from 2019-20 onwards are the May 2018 SFC forecasts.

Note 2: BGA forecasts for 2016-17 to 2018-19 are specified by HM Treasury (HMT) at the time of agreeing the respective Scottish Budget Acts. From 2019-20 onwards these are the latest forecasts provided by HMT at the Spring Statement 2018.

Note 3: 2016-17 income tax revenue forecast: in this year the Scottish Rate of Income Tax applied. Full Scottish income tax powers took effect from 2017-18. This explains the substantial increase in forecast revenues between 2016-17 and 2017-18.

Note 4: Figures may not sum due to rounding.

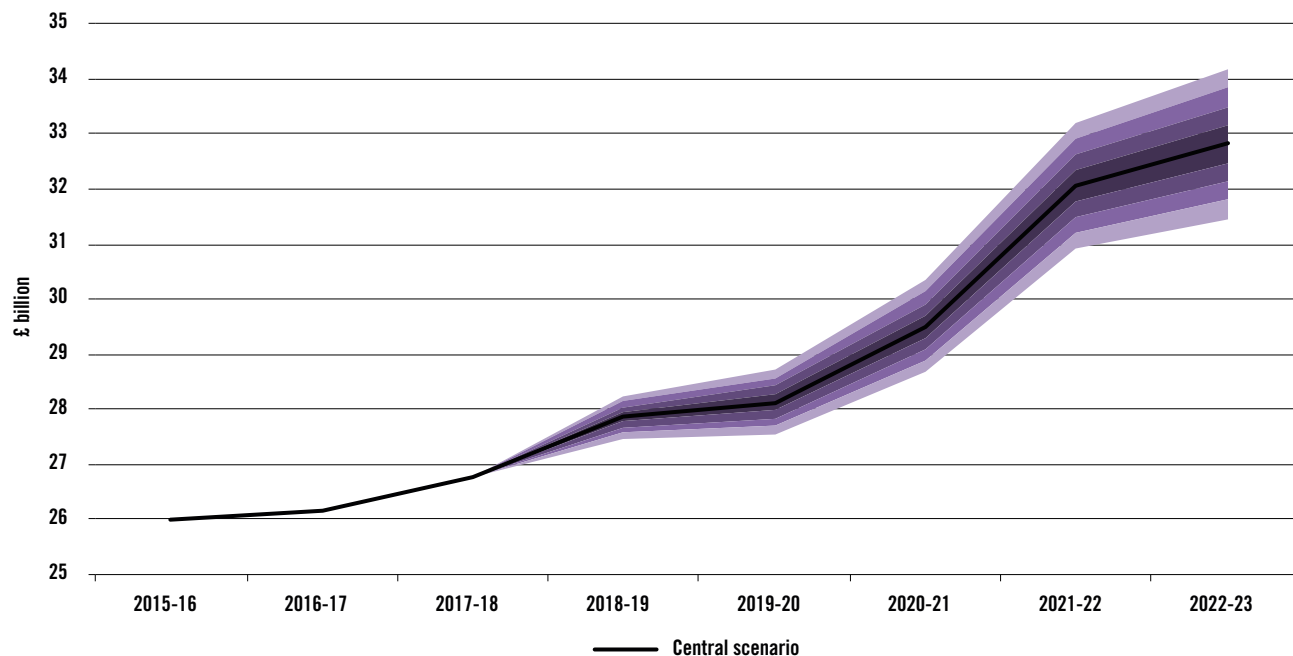
6.33. While indicative estimates of Scotland's net budget position, such as those shown in Tables 6.1, 6.2 and 6.3, may provide an indication of the direction of travel and potential scale of the final reconciliation, significant uncertainties remain, as experience shows that forecasts are subject to considerable change between fiscal events.

6.34. In addition, forecasts of Scottish receipts are produced by the Scottish Fiscal Commission while the Block Grant Adjustment is determined by forecasts of growth in receipts from the rest of the UK as provided by the OBR. This introduces an additional element of uncertainty, as there are many factors that may contribute to differences in these forecasts, some of which are unrelated to different views about the outlook for the Scottish and UK economies. For example, the OBR and SFC produce these forecasts at different times using different methodologies, assumptions and input data.

6.35. Once outturn data is published a reconciliation and a budget adjustment are agreed for the financial year thereafter. The Scottish Government will subsequently manage any negative or positive variance from the initially agreed budget position. The Scottish Government will closely monitor any risks arising from the net BGAs.

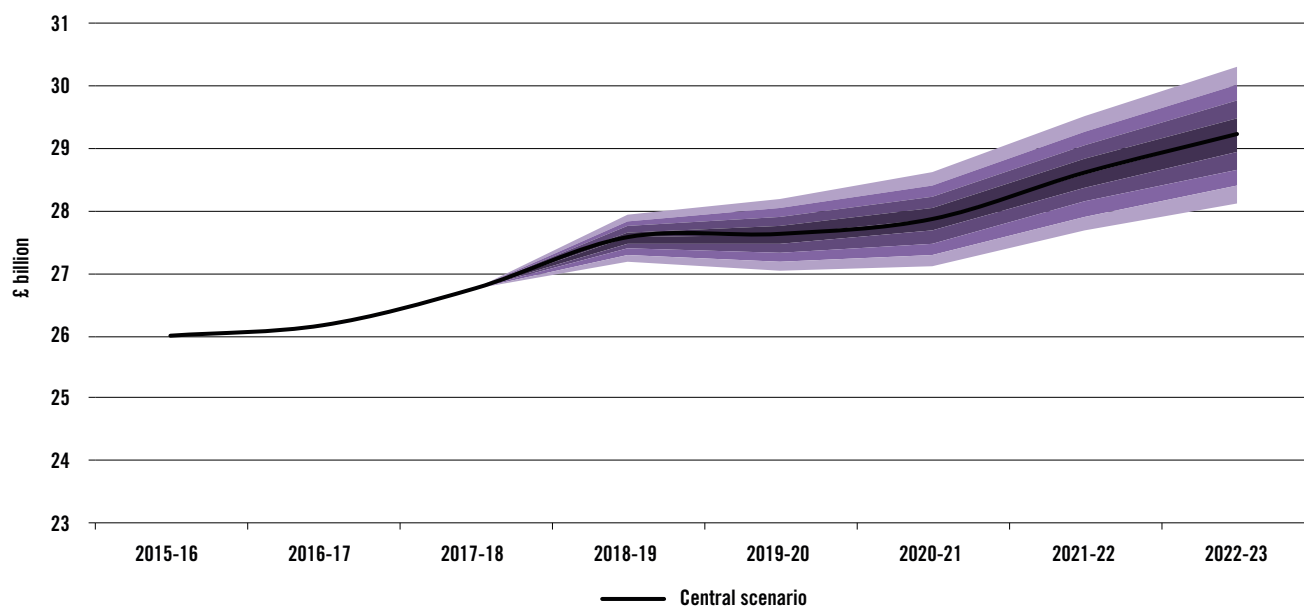
6.36. Chart 6.2 illustrates the potential path for the total resource budget. The increase in the resource budget in 2021-22 associated with additional social security powers is visible in the projection.

CHART 6.2 – OUTLOOK FOR RESOURCE BUDGET (INCLUDING SOCIAL SECURITY)



6.37. The potential path for the resource budget excluding funding for the new social security powers has also been considered and Chart 6.3 illustrates that. The profile for growth in 2021-22 is noticeably flatter than for overall resource spend. The risks are proportionately similar to the overall resource budget, with a range of ±£1,095 million.

CHART 6.3 – OUTLOOK FOR RESOURCE BUDGET (EXCLUDING SOCIAL SECURITY)



6.38. Chart 6.4 illustrates the potential path for the capital budget excluding Financial Transactions. This is symmetric around the central forecast, at $\pm£240$ million by 2022-23. This variation in the earlier years is smaller as we already have allocated capital budgets out to 2020-21, which could still vary due to spending decisions by the UK Government. The variation in later years reflects the uncertainty over funding levels ahead of the next UK Spending Review in 2019.

6.39. The capital budget also assumes that full capital borrowing ($£450$ million) will be undertaken in 2019-20, but that no commitment on capital borrowing has been included at this stage for any years beyond 2019-20.

CHART 6.4 – OUTLOOK CAPITAL BUDGET (EXCLUDING FINANCIAL TRANSACTIONS)

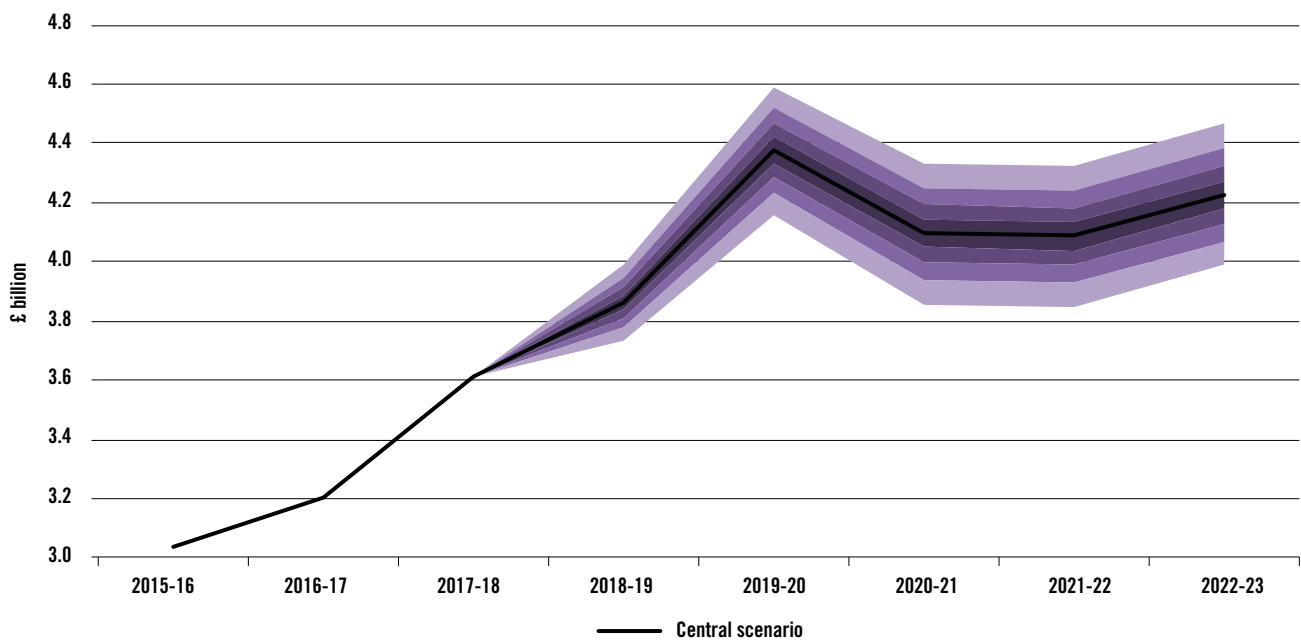


TABLE 6.4 – SUMMARY OUTLOOK FOR THE MEDIUM TERM FINANCIAL STRATEGY, WITH UPPER AND LOWER RANGES (£M)

	2018-19	2019-20	2020-21	2021-22	2022-23
OVERALL BUDGET¹					
Upper range	33,035	34,373	35,770	38,621	39,736
Central scenario	32,212	33,024	34,110	36,661	37,555
Lower range	31,704	32,201	33,026	34,774	35,447
Resource budget²					
Upper range	28,238	28,736	30,355	33,214	34,189
Central scenario	27,860	28,129	29,510	32,070	32,824
Lower range	27,481	27,522	28,664	30,926	31,458
<i>Of which, new social security</i>					
Upper range	298	528	1,738	3,689	3,872
Central scenario	290	507	1,649	3,466	3,602
Lower range	282	486	1,560	3,243	3,332
Capital budget³					
Upper range	3,993	4,592	4,333	4,324	4,464
Central scenario	3,863	4,376	4,095	4,086	4,226
Lower range	3,733	4,160	3,857	3,848	3,989
Financial Transactions					
Upper range	804	1,044	1,083	1,083	1,083
Central scenario	489	519	505	505	505
Lower range	489	519	505	0	0

Notes:

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

2 Resource budget: Fiscal Resource Budget limit and the net Block Grant Adjustment; updated for the Scottish Rate Resolution; including additional adjustments for NDR, Scotland Act Implementation, Migrant Surcharge, Queen's and Lord Treasurer's Remembrancer (QLTR), Rail Resource Grant; and social security funding.

3 Capital budget: Capital Budget limit plus Capital Borrowing.

TABLE 6.5 – SUMMARY OUTLOOK FOR THE MEDIUM TERM FINANCIAL STRATEGY, WITH UPPER AND LOWER RANGES (£M) – EXPRESSED IN REAL TERMS (AT 2018-19 PRICES*)

	2018-19	2019-20	2020-21	2021-22	2022-23
OVERALL BUDGET					
Upper range	33,035	33,841	34,642	36,764	37,142
Central scenario	32,212	32,514	33,033	34,898	35,104
Lower range	31,704	31,703	31,984	33,102	33,133
Resource budget					
Upper range	28,238	28,292	29,397	31,617	31,957
Central scenario	27,860	27,694	28,578	30,528	30,681
Lower range	27,481	27,097	27,760	29,439	29,405
<i>Of which, new social security</i>					
Upper range	298	520	1,683	3,512	3,619
Central scenario	290	499	1,597	3,299	3,367
Lower range	282	478	1,511	3,087	3,114
Resource budget (<i>exc Social Security</i>)					
Upper range	27,940	27,780	27,722	28,112	28,360
Central scenario	27,570	27,203	26,990	27,235	27,336
Lower range	27,199	26,626	26,257	26,358	26,312
Capital budget					
Upper range	3,993	4,521	4,196	4,116	4,173
Central scenario	3,863	4,308	3,966	3,889	3,950
Lower range	3,733	4,096	3,735	3,663	3,729
Financial Transactions					
Upper range	804	1,028	1,049	1,031	1,012
Central scenario	489	511	489	481	472
Lower range	489	511	489	0	0

*Using HM Treasury GDP Deflators as at 3 April 2018

What does this modelling indicate?

6.40. The central scenario analysis suggests that, by 2022-23, the Scottish Budget (excluding non-cash and Annually Managed Expenditure) could be around £37.6 billion.

6.41. The scenario modelling indicates that the potential range for this could be between £35.5 billion and £39.7 billion, reflecting potential growth in the Scottish Budget between 2017-18 and 2022-23 of between £4.2 billion and £8.4 billion (in cash terms).

6.42. The range of this variability amounts to around ± 6 per cent of the overall budget. This reflects the uncertainty around the block grant and Scottish devolved tax income and the impact of economic uncertainty around the UK's exit from the EU, but also highlights how differences can cumulate over a relatively short period.

6.43. As Chapter 5 sets out, the Scottish Government is committed to the delivery of our Economic Strategy and on improving overall Scottish economic performance and ensuring revenues are towards the upper end of the forecasts. We are seeing positive results as our economic approach builds momentum and now see a number of positive economic indicators in Scotland including on foreign direct investment, productivity growth, international goods exports and R&D spending growth. This includes:

- the number of VAT/PAYE registered businesses increasing to 176,400 in 2017 – the highest figure since the time series began (in 2000);
- Scotland securing 122 Foreign Direct Investment (FDI) projects in 2016, more than any part of the UK outside London for the fifth year in a row; and
- all three of Scotland's largest cities (Glasgow, Edinburgh and Aberdeen) being in the UK's top 10 for numbers of FDI projects secured.

6.44. The analysis also suggests that the single largest source of variance in the Scottish Budget is likely to be the Block Grant Adjustment. Uncertainty around the Block Grant Adjustment is estimated at around \pm £930 million by 2022-23, while uncertainty around Barnett consequentials, social security and Financial Transactions taken together is around \pm £1,200 million.

6.45. As new data on income tax becomes available and as new Scottish Fiscal Commission forecasts are issued, these figures will be subject to change.

6.46. As mentioned earlier, there are also a number of variables in the Scottish Budget that are not yet captured, such as the assignment of VAT, which will impact on the Scottish Budget from 2020-21.

6.47. **Annex B** describes some of the background information and assumptions used to produce this modelling approach.

7 Policy Priorities

The distinct Scottish Government policy approach

7.1. A decade ago, in 2007, the introduction of the Scottish Government National Performance Framework (NPF)¹³ and the outcomes-based approach to Government was ground breaking and presented the foundation for a transformative shift in how future policy would be developed and delivered by the Scottish Government.

7.2. Our “Scottish Approach” is focused on outcomes – on driving improvement; on building on the strengths and assets of individuals and communities; and on services which are shaped and co-produced by both service providers and the people and communities who receive and engage with those services.

7.3. The principles of this performance framework have stood the test of time and they are as relevant now as they were ten years ago. Since its introduction the NPF was refreshed in 2011 and 2016. With the introduction of the Community Empowerment (Scotland) Act 2015 (which came into force 15 April 2016), the outcomes-based approach has been given a statutory footing and the Scottish Government has taken this opportunity to undertake a wholesale review of the framework to ensure that it is as strong and relevant as it can be.

7.4. The scope of this review includes building wider consensus around the framework; improving alignment with the UN Sustainable Development Goals and other frameworks, such as Scotland’s National Action Plan for Human Rights and Scotland’s Economic Strategy; and simplifying the language and look of the framework to make it more accessible. Subject to Parliamentary consideration, the new National Performance Framework will be formally launched in summer 2018.

7.5. Building on the outcomes approach, Scotland’s Economic Strategy sets out an overarching framework for how we aim to achieve a more productive, cohesive and fairer Scotland. It is the strategic plan for existing and future Scottish Government policy and represents the blue print for building a stronger and more diverse future Scottish economy.

Managing challenges and uncertainty

7.6. Despite the economic turbulence created by the UK Government through the uncertainty around the UK’s exit from the EU and its continued approach to austerity, the Scottish Government’s clear vision of building the economy, protecting public services and developing a fairer and more inclusive society continues to lead Scotland through these uncertain times.

7.7. In common with other developed countries, Scotland has an ageing population, reflecting welcome medical and economic advances, and Scotland will benefit hugely from the skills and life experiences of its older citizens. However, changes in the Scottish population will create pressure on public sector budgets in the future.

7.8. This is reflected in the latest Programme for Government, where the First Minister highlights that, “as our population ages, we must meet the needs of our older citizens while ensuring fairness across the generations”.

13 [The Scottish Government National Performance Framework](#)

7.9. An ageing population is not new. It has been with us for the last 15 years but is set to accelerate from 2021 onwards and is happening at a faster rate than in the rest of the UK. There are two dimensions to this:

- first, we will see a big increase in the number of people aged 75 plus, as baby boomers age. Over the next 20 years, more than 70 per cent of all population growth will be in the 75 plus age group. The Fraser of Allander Institute's assessment of long-term fiscal challenges noted that as our population ages and as the prevalence of chronic health conditions increases, Scotland's public finances are likely to come under significant pressure over the medium to long term from rising health costs; and
- second, our working population is ageing too, with fewer younger workers and more workers in the 50 plus age bracket. Over recent years the number of people aged 50 plus who are still working has increased in Scotland, but remains lower than in some countries in Europe. With less certainty over migration levels after the UK's exit from the EU, it will be even more important that people aged 50 plus remain in work to retirement age. As well as maintaining the size of our working population and associated income tax revenues, it is important that Scotland draws on the skills and experience of older workers and provides the opportunity for work as an important part of a fulfilling life.

7.10. A further challenge is to ensure that Scotland can maximise the benefits of its currently diverse population. A more inclusive economy where all members of Scottish society, irrespective of gender, race, disability, age or socio-economic background, are able to access appropriate, quality jobs, generate business opportunities or undertake skills progression would optimise economic and social impact.

7.11. While there is some uncertainty about how elements of demographic change will play out, the fundamentals are set, and are well understood. The challenge of an ageing population will continue at least for the next 25 years and over the longer term all future Scottish Governments will need to respond to the pressures this creates.

7.12. In contrast, the impact of technological change is less clear, yet is likely to be significant in scale. Commentators have described artificial intelligence, automation and other technological changes as one of the 'biggest economic issues of our age' and forecasts suggest that one in five jobs in Britain's cities could be displaced by 2030.

7.13. 80 per cent of the workforce in 2030 is already in the workforce now. One of the biggest strategic challenges associated with technological change is its impact on jobs – some jobs are at risk of being overtaken by automation entirely, many others will change significantly. Overlaying Scotland's demographics – in particular our ageing workforce – amplifies this challenge.

7.14. Again this will play out well beyond the five year time horizon of the Medium Term Financial Strategy, but its potential impact on economic performance, employment levels and tax revenue, constitutes a key consideration for current and future Governments and drives our investment in the economy.

Paying for public services and our policy goals

7.15. The First Minister set out a clear vision for Scotland through the 2017 Programme for Government, focused on building an inclusive, fair, prosperous and empowered Scotland. The Scottish Government will continue to implement that vision in 2018-19 and beyond and this year's budget provided the resources necessary to support that work in 2018-19.

7.16. The Programme for Government sets out the key elements of the social contract between the Scottish Government and the people of Scotland including health care, a strong and fair justice system, excellent public sector education (including free tuition fees) and support for the vulnerable – an approach which begins to lay foundations to address the demographic challenges outlined above.

7.17. Despite the challenging economic and financial context, the Scottish Government has sought to protect public services, but recognised that a fresh debate was required to talk about how we continue to maintain appropriate investment in our public services, while recognising the pressure that household incomes are under.

7.18. Ahead of the 2018-19 Budget the Scottish Government published an income tax discussion paper. Following that, we have introduced a revised, fairer income tax system for Scotland which uses the powers available to us as a lever to counter on-going UK Government austerity and support sustainability in our public services.

7.19. The Scottish Government's approach to taxation is founded on the four key Adam Smith principles of certainty, convenience, efficiency and proportionality to the ability to pay:

- **certainty** – this is important for households and businesses alike to ensure that financial decisions can be taken from an informed position on the path of future tax policy. That is why, for example, the Scottish Government provided certainty to landfill operators by committing that Scottish Landfill Tax will be no lower than prevailing UK rates;
- **convenience** – the vast majority of income taxpayers pay their income tax through Pay As You Earn (PAYE), with little or no administrative impact on taxpayers. Decisions made in setting Scottish income tax rates and bands were made with this in mind. That is why the Scottish Government also legislated for a digital first approach to the fully devolved taxes, delivering convenience and efficiency through the use of a modern electronic payment system, while still allowing for paper returns where required;
- **efficiency** – this is central to the Scottish Government's approach on the fully devolved taxes. That is why the Scottish Government enabled the Land and Buildings Transaction Tax to be collected by Registers of Scotland, on behalf of Revenue Scotland, drawing on their existing knowledge and expertise of property taxes and the familiarity of taxpayers and agents with the processes involved; and
- **proportionality** – proportionality to the ability to pay is vital. Everyone benefits from public services and all those who can contribute are expected to do so, and those with the broadest shoulders should make the greatest contribution. Scotland led the way in the UK by establishing a progressive approach to the setting of rates and bands for Land and Buildings Transaction Tax, with the amount paid more closely related to the value of the property or transaction and therefore to the ability of individuals to pay.

7.20. As well as these principles, the Scottish Government's approach to tax is based on collaborative tax policy development, characterised by regular and engaged consultation with taxpayers, industry representatives and professional bodies and a firm approach to tax avoidance.

7.21. We want to encourage a culture of responsible taxpaying where people and companies pay their tax as Parliament intended.

7.22. The 2018-19 Budget provided a more progressive approach to taxation in Scotland, that offers both significant protection to the lowest earning tax payers and asks those best able to afford it to contribute more towards sustaining public services.

7.23. This approach introduced new income tax Starter and Intermediate rates which, alongside the increase in the Personal Allowance, see no one earning less than £33,000 per year paying more than they did in 2017-18 – meaning that more than half of all taxpayers will pay less than if they lived elsewhere in the UK.

7.24. Those changes are combined with a 1 per cent increase in the Higher Rate Threshold and asking Higher and Top rate taxpayers to pay 1 per cent more. In combination, these policies were sufficient to reverse the real terms cuts to Scottish Budgets in 2018-19, imposed by the UK Government, and are projected to contribute over £400 million a year in net additional revenues by 2022-23.

7.25. The public response to the taxation changes confirms a wider public acceptance of this balanced approach to funding public services. In developing that approach we set out four policy tests that we believe any income tax policy change must meet if it is to successfully support our economy and the delivery of, and investment in, our public services. The four tests are:

- **revenue** – income tax policy should maintain and promote the level of public services which people in Scotland expect;
- **protecting lower earners** – the lowest earning taxpayers should not see their taxes increase;
- **progressivity** – any tax changes should make the tax system more progressive and reduce inequality; and
- **economic growth** – the changes we make, along with our decisions on spending, should support our economy.

7.26. The Scottish Government's chosen income tax policy met those tests in the following ways:

- **revenue** – the policy is expected to raise over £210 million in 2018-19 in net additional revenues for public services in Scotland. Rate-setting decisions have been taken to ensure a balance where any behavioural impacts are forecast to be minimised;
- **protecting lower earners** – overall, when combined with the planned increase in the Personal Allowance, for an unchanged income, 70 per cent of Scottish taxpayers (those earning up to £33,000) will not pay any more tax in 2018-19 than they did in 2017-18;

- **progressivity** – the policy improves the progressivity of the tax system by increasing the number of bands, lowering the rate on income up to £13,850, and asking the highest earning 30 per cent of taxpayers to contribute more for an unchanged income than they did last year. Under our proposal the Gini co-efficient¹⁴ in Scotland is estimated to fall; and
- **economic growth** – the proposal will increase income tax revenues by around 1.4 per cent and the Budget sets out a range of expenditure decisions that will support inclusive growth. As outlined in the income tax discussion paper, any economic impacts from a tax rise on this scale are likely to be relatively small. Moreover, because lower earners (who spend a higher proportion of their income) are protected, the risk of an immediate impact on consumer spending will be reduced. Increasing the Top Rate by 1p, rather than the 5p proposed under some of the alternative approaches assessed in the discussion paper, also reduces the risk that high earners would change their behaviour in ways that impact on the economy.

7.27. The additional revenues generated from our income tax policy are part of what allows us to sustain our social contract with the people of Scotland and deliver on the key policy commitments set out below, which we will deliver over the medium term.

Public Service Reform – maximising the use of our resources

7.28. In addition to building the tax base in Scotland and maximising available funding, the Scottish Government is committed to reforming how public services use resources to address demographic and resource pressures to improve outcomes, especially for those whose wellbeing and life chances are poorest.

7.29. This commitment is rooted in the Christie Commission's four key principles of prevention, performance, partnership and people. This recognises 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, including building preventative approaches to strengthen positive outcomes and tackle persistent inequalities.

7.30. This commitment to reform underpins many of our key spending commitments, including supporting the transformation in health and social care; investment in preventative activity to give all our young people the best start in life; closing the attainment gap; and extending healthy life expectancy.

7.31. This approach requires our public services to shape their work around the needs of people – working together and with the third sector, private sector and communities to pursue accelerated progress on reform activity at local and regional levels through:

- strong, shared leadership to provide vision and drive;
- digital transformation;
- freeing up frontline staff to draw on their skills, insight and understanding of people's needs to reform local services;

¹⁴ The Gini co-efficient is a measure of how equally income is distributed across the population. It takes a value between 0 and 100 where 0 represents perfect equality. In 2015-16, the Gini co-efficient for Scotland was 34. World Bank figures show a range from around 60 (South Africa) to around 25 (Norway).

-
- involving and empowering communities to take action to improve their wellbeing; and
 - embracing the power of data and digital technologies to improve outcomes.

7.32. Examples of this work and how we are creating the conditions for reform include:

- **education reform** – with local government we have established six new Regional Improvement Collaborative areas. These bring together local and national expertise to support our schools to respond to local needs, work collaboratively and drive improvement, including in closing the attainment gap;
- **children’s services** – we are supporting local public services to redesign children’s services in ways that enable prevention and early intervention and reduce the need for high-intensity, high-cost services; and
- **public health** – our joint work with COSLA to take forward public health reform recognises that we must empower communities to make decisions to create the conditions for health in their areas. This work will take advantage of the Local Governance Review, which is creating space for new ideas to empower local communities and support inclusive growth at local and regional levels.

Outline of key policy priorities

7.33. The Scottish Government’s core purpose, to focus on creating a more successful country with opportunities for all of Scotland to flourish through increased wellbeing, and sustainable and inclusive economic growth, drives the delivery of our policies and public services.

7.34. This is built on the principle of equality for all, from birth through early years and education, to employment and retirement, with access to essential public services, at the right time, which are free at the point of delivery. We target our resources to support the delivery of this ‘social contract’.

7.35. We have a clear vision of the main commitments that will achieve this, which have been set out in the Programme for Government each year, with delivery over the current Parliamentary term and beyond.

7.36. The budget for these commitments in 2018-19 has been agreed by the Scottish Parliament and decisions on the level of future investment required in these policy areas will be taken as part of future budget setting processes. In detailing these commitments and explaining the challenges ahead, it is important to understand that this document is not seeking to set or determine future budgets for individual commitments or portfolios.

7.37. It is also important to note that this document does not cover all of the spending commitments that the Scottish Government will meet over the next four years, but instead highlights a range of key commitments with an indication of the potential investment that will be required to deliver them.

Resource budget

7.38. The key resource budget commitments that support the Scottish Government's social contract and require significant investment are:

- Health;
- Police;
- Early Learning and Childcare;
- Attainment;
- Higher Education; and
- Social Security.

Health

7.39. The NHS, which celebrates its 70th anniversary in 2018, is our most treasured public service. The Scottish Government is committed both to reform of and investment in the health service, including a pledge to increase resource spending on the NHS by £2 billion over the course of this Parliament.

7.40. The Scottish Government will also be publishing a Medium Term Health and Social Care Financial Framework in June 2018. The Health Framework has been developed in consultation with NHS Boards, COSLA, local government and Integration Authorities. That document considers the whole health and social care landscape (recognising that it is a framework and that further detail on financial plans and how transformation will be achieved will require to be set out elsewhere). That Framework has been structured into five main sections that:

- set out an overview of current expenditure – considering historical expenditure trends and examine how these resources have been used to deliver additional activity and an associated estimate of productivity;
- provide an estimate of the resources required to meet Scotland's health and social care needs in the future - Scotland like all other countries in the world is facing increases in demand for care due to demographic growth and increased expectations from people using services;
- map out policy initiatives and how these will influence the future shape of expenditure;
- set out the transformation activities that will be required to ensure the health and social care system is financially sustainable in the long term; and
- consider transformation funding - how reform and system change will be financed.

7.41. In the early years of the Parliament the health budget has received significant additions on an annual basis, including additional resource investment of over £400 million in the health service in 2018-19. This continued investment will ensure that prevention and early intervention improve healthy life expectancy while we transform the way we deliver health and social care to adapt to Scotland's changing health and care needs. As part of the overall financial settlement for Health, reflecting our commitment to the social contract, the Scottish Government will continue to support the provision of free prescriptions, free personal care for the elderly and free eye examinations.

7.42. That investment needs to continue over the remainder of this Parliament and decisions on the precise allocations for each year will be taken as part of the annual budget setting process.

7.43. In order to illustrate the impact of the £2 billion commitment (and to meet the commitment to pass on all health resource consequentials), Table 7.1 models an increase in the health budget of around £400 million in 2019-20, a further £300 million in 2020-21 and around an additional £600 million in 2021-22. The precise profile of funding will be considered as part of the annual budget process in the usual way.

7.44. The commitment for increased health funding runs to 2021-22 and no commitments on funding levels for the period beyond 2021-22 currently exist. For the purposes of this Medium Term Financial Strategy we have modelled an inflationary uplift in the health budget for 2022-23.

TABLE 7.1 – POTENTIAL HEALTH FUNDING UPLIFT PROFILE

£bn	2018-19	2019-20	2020-21	2021-22	2022-23
Potential Health Funding Uplift	-	+0.38	+0.29	+0.59	+0.24
Potential Health Budget Total	12.87	13.25	13.54	14.13	14.37

Police

7.45. The Scottish Government is dedicated to protecting local communities through effective policing and, with recorded crime at a 42 year low, Scotland is as safe as it has been for over a generation.

7.46. Building on the success of police reform, we will continue to support the Scottish Police Authority (SPA) and Police Scotland to deliver the priorities in the Policing 2026 Strategy which was laid before Parliament in June 2017. The Strategy sets out how Police Scotland will strengthen its service to communities and respond to changing demands.

7.47. In order to support that work the Scottish Government will continue to protect the resource budget of the SPA in real terms for the entirety of the Parliament – delivering an additional £100 million of investment by 2021. This equates to approximately £20 million extra in each financial year.

7.48. In addition, from April 2018 we have ensured that policing will fully benefit from being able to reclaim the VAT previously paid to the UK Government. This commitment means that the effective spending power on policing will increase by around £25 million compared with previous years. This does not require additional budget to be allocated to Police Scotland, it simply allows them to use their existing budget provision for other purposes as they no longer need to meet the VAT liability.

Early Learning and Childcare

7.49. Our focus on the early years will embed an approach rooted in prevention and early intervention, and will support those children and families who will benefit most. That is why, as part of providing the best start for every child, we are committed to a transformative expansion of Early Learning and Childcare (ELC) provision.

7.50. We have already increased publicly funded, high quality Early Learning and Childcare by almost 50 per cent to 600 hours per year since 2007 and extended entitlement to around a quarter of two year olds, and the 2018-19 budget continues to fund that in full through local authorities. We are now working closely with local authorities to deliver our ambitious goal of increasing funded ELC entitlement to 1,140 hours per year – the same number of hours a child spends in primary school.

7.51. This will require substantial additional investment in both extra staff and premises – the 2018-19 budget delivers over £240 million of investment (resource and capital) for ELC expansion.

7.52. In line with the commitment in the 2017 Programme for Government to provide multi-year funding allocations for the ELC expansion programme, agreement has now been reached with COSLA on both the overall quantum of funding to support the expansion and the profile of that funding between now and 2021-22.

7.53. This will require further (recurring) uplifts in resource funding to local authorities of £210 million in 2019-20, £201 million in 2020-21 and £59 million in 2021-22. The multi-year funding deal agreed with local authorities currently extends until 2021-22. For the purposes of this modelling we have simply rolled forward the 2021-22 figures into 2022-23 (decisions on funding beyond 2021-22 will be agreed in future budget processes).

7.54. Table 7.2 sets out the resource funding package that has been agreed with local authorities to support the ELC expansion.

TABLE 7.2 – ELC EXPANSION RESOURCE FUNDING AGREED WITH LOCAL AUTHORITIES

£m	2018-19	2019-20	2020-21	2021-22	2022-23
Resource funding	96	307	508	567	567
Annual additional funding	-	+210	+201	+59	-

7.55. In addition to the local authority funding outlined above there are also other small elements of ELC funding within the Scottish Government Education and Skills Portfolio budget.

Attainment

7.56. All children and young people, whatever their background or circumstances, deserve the same chance to reach their full potential. That is why improving outcomes for children, young people and their families is at the heart of the Scottish Government's agenda and spending plans.

7.57. Our top priorities are to raise attainment and close the attainment gap; promote health and wellbeing; and improve skills and employability. Ensuring the best start in life for every child, irrespective of their gender, ethnicity, disability or socio-economic background, contributes to each of these four high-level priorities. Everyone will benefit in future if we invest in our young people now.

7.58. In order to support this work, the Scottish Government has committed to allocate £750 million through the Attainment Scotland Fund, over the term of the Parliament, to tackle the attainment gap.

7.59. We are already two years into this commitment, with Pupil Equity Funding already beginning to transform schools by enabling head teachers to secure the additional staffing or resources they need to support pupils affected by poverty and boost attainment levels. As minority ethnic children and children living in a household with a disabled parent or child are more likely to be in poverty, this fund also tackles wider inequalities. In 2018-19, we have allocated £180 million towards raising attainment and closing the attainment gap.

7.60. In order to fulfil this commitment, we will need to allocate around £180 million in each of the remaining years of the Parliament in order to meet the £750 million overall commitment. The precise profile of this funding has not yet been finalised, but for the purposes of the Medium Term Financial Strategy, we have assumed that this will be approximately £180 million in 2019-20 and 2020-21.

Higher Education

7.61. Scotland has an internationally successful Higher Education sector, including some of the world's oldest and most prestigious universities as well as world leading modern and specialist institutions.

7.62. The Scottish Government has made clear that we want every child, no matter their background, to have an equal chance of entering and succeeding in Higher Education – a commitment that was made in the 2014 Programme for Government. By 2030, the Scottish Government wants 20 per cent of students entering university to be from Scotland's 20 per cent most deprived backgrounds and we want a better gender balance across subjects studied.

7.63. We believe education should be based on the ability to learn, not to pay, and we are providing record levels of support for students in higher and further education as part of our commitment to the social contract. We are protecting free tuition and are also committed to providing an annual minimum income for the least well-off full-time students in higher education. We are also working closely with universities and colleges to reach a better gender balance across courses with more girls entering Science, Technology, Engineering and Mathematics (STEM) and more boys entering social science, teaching and care courses.

7.64. We continue to prioritise funding for this and have invested over £1 billion in Higher Education in the budget settlement for the Education and Skills portfolio in 2018-19. We will fund over 125,000 free places in 2018-19. For the purposes of this document, we have assumed that a similar level of funding will be required in each of the following financial years out to 2022-23 to continue to support the delivery of this policy. Decisions on the actual amounts of funding in each year will be taken in the annual budget process. Funding is delivered through the Scottish Funding Council.

Social Security

7.65. The Social Security (Scotland) Bill was approved by the Scottish Parliament on 25 April 2018. The Bill sets up a framework for a new, Scottish social security system, drawing on the responses received to our wide public consultation and engagement programme. It transposes 11 devolved social security benefits onto a Scottish legislative platform, allowing the Scottish Government to shape a distinctly Scottish social security system based on dignity and respect. At all stages we have committed to include the views of people with lived experience of applying for and receiving devolved benefits.

7.66. The range of benefits that are being transferred from the UK Government to the Scottish Government are:

- Personal Independence Payments;
- Carer's Allowance;
- Attendance Allowance;
- Disability Living Allowance;
- Winter Fuel Payments;
- Cold Weather Payments;
- Severe Disablement Allowance;
- Industrial Injuries Disability Benefits;
- Funeral Expenses Payments (to be replaced by Funeral Expense Assistance);
- Sure Start Maternity Grant (to be replaced by Best Start Grant); and
- Discretionary Housing Payments.

7.67. The annual block grant to the Scottish Government will be adjusted to reflect the transfer of responsibility for social security from 2018-19, with additional adjustments made in future years as these social security benefits transfer to Scotland. This transfer process will be undertaken in a phased way with the majority of the social security expenditure (and associated funding) expected to come online from 2021-22 and the years that follow. Initial baseline additions to the block grant will be calculated based on UK Government spending on the area in Scotland in the year prior to devolution (as forecast by the Office for Budget Responsibility) – additions or deductions to the baseline will then be processed based on UK Government spending.

7.68. The Scottish Fiscal Commission will be responsible for the production of independent forecasts to inform the Scottish Government's annual budget.

7.69. The Scottish Government has made a number of clear commitments around the way in which it will manage the social security system in Scotland. This includes announcing that the delivery of the first of the newly devolved benefits – an increased Carer’s Allowance – will take place from summer 2018 (and be backdated to April 2018) preparing for the effective delivery of the new Best Start Grant and the new Funeral Expense Assistance by summer 2019, and the introduction of a Young Carer Grant by autumn 2019.

7.70. The anticipated costs associated with these new and enhanced benefits will be met from the Scottish Budget and the anticipated additional costs for the four benefits referred to here are set out in Table 7.3.

TABLE 7.3 – ANTICIPATED ADDITIONAL COSTS OF DEVOLVED BENEFITS

£m	2018-19	2019-20	2020-21	2021-22	2022-23
Carers Allowance Supplement	35.0	37.0	40.0	42.0	44.0
Best Start Grant	-	15.3	15.4	15.4	15.6
Funeral Expense Assistance	-	3.4	3.5	3.5	3.5
Young Carer Grant	-	0.5	0.5	0.5	0.5
TOTAL	35.0	56.2	59.4	61.4	63.6

7.71. The estimated implementation costs for the new social security system (as set out in the Financial Memorandum to the Social Security (Scotland) Bill) are £308 million over the period to 2020-21. These costs continue to be refined and updated as the iterative transfer of the powers progresses and as a result an agreed profile of spend has not been fixed at this time – but the Minister for Social Security confirmed at the Stage 3 debate on the Bill in April 2018 that she does not expect that figure to increase.

7.72. The Fiscal Framework provides a baseline £66 million for social security administration costs and a one-off amount of £200 million for implementation for all the newly-devolved powers (these amounts are factored into the funding projections contained in Chapter 6 of this document). These amounts represent the financial settlement delivered by the Fiscal Framework, but do not represent the full costs of implementation or administration of the new social security powers. Any additional sums required would need to be funded from the existing Scottish Budget envelope. Any required funds will be allocated as part of the normal Scottish Budget process.

7.73. In addition to the benefits highlighted above, as part of our commitment to tackling child poverty, the Scottish Government has pledged to introduce an Income Supplement for low income families. Further work is being undertaken to develop the policy of the income supplement and assess what the most cost-effective delivery route would be. Decisions on a delivery model will be based on analysis which demonstrates the most effective use of resources in lifting the maximum number of children out of poverty. Funding for the income supplement will be considered through the normal budget process at the appropriate time and no costs have been included as part of the Medium Term Financial Strategy.

7.74. The Scottish Government also remains committed to continue to fully mitigate the deductions to housing support for working age households in the social rented sector who are deemed to be under-occupying their home by the Department for Work and Pensions (DWP), commonly known as the bedroom tax. This is currently achieved through Discretionary Housing Payments. We are committed to using our new powers to abolish the bedroom tax at source through Universal Credit (UC) as soon as practicable and officials had been working with DWP towards achieving this by spring 2019. DWP have recently advised that the changes to the UC system to allow the bedroom tax to be abolished in Scotland would be delayed until May 2020 at the earliest. We expect to spend over £125 million in 2018-19 on social security reform mitigation measures including fully mitigating the bedroom tax to help protect those on low incomes and continuing to mitigate the bedroom tax in full is expected to cost around £55 million each year of the Medium Term Financial Strategy period.

What this means for spending elsewhere

7.75. In addition to these key areas of investment, there are of course a range of wider commitments across all Scottish Government portfolios that will need to be managed from within our available budget. This will include commitments on homelessness, child poverty, concessionary travel, free personal care, supporting the Scottish economy, establishment of the Scottish National Investment Bank, delivering on our climate change ambitions and continuing to deliver the range of public services that we have responsibility for. All of these will require a share of the overall resource budget funding that is available.

Local government funding

7.76. As partners in the delivery of public services, the Scottish Government invests a significant proportion of its budget in supporting local government to provide the essential and high quality services the people of Scotland expect and deserve.

7.77. This funding is split into revenue and capital funding and in 2018-19 the Scottish Government will provide local government with £9,814 million¹⁵ of resource funding and £876 million capital funding. This represents a real terms increase in the level of resource and capital funding available to local government in 2018-19.

7.78. Revenue funding from the Scottish Government to local authorities is made up of three different components:

- general revenue grant – this makes up the majority of the funding support from the Scottish Government for local authority for revenue expenditure;
- non-domestic rates income (NDR) – this tax is collected and retained by local authorities on behalf of the Scottish Government. The Scottish Government guarantees each local authority's needs-based formula share which consists of a combination of the retained NDR income together with the General Revenue Grant paid by the Scottish Government; and
- specific revenue grants – these are provided by the Scottish Government and are tied to spending to support the delivery of specific policy objectives.

¹⁵ This includes £34 million agreed at Stage 1 of the 2018-19 Budget Bill which was paid in 2017-18.

Public sector pay

7.79. The Scottish Government recognises the importance of supporting workers across the public sector and in 2017 agreed to remove the 1 per cent public sector pay cap from 2018. The cap had been in force since 2013 as a result of austerity measures. To help the public sector further, the Scottish Government allowed public bodies to bring forward their pay award date, meaning early access to pay awards for many public sector workers.

7.80. The Scottish Government is acutely aware of the impact that inflation and social security cuts have on working households and the removal of this 1 per cent pay increase cap will bring a much needed boost to family finances. Given the prevalence of women employed in the public sector, it should also particularly boost women's income. At the same time the need remains to balance this with what public sector employers can reasonably afford in the context of a Scottish Budget squeezed by a continued UK Government austerity policy.

7.81. Decisions on future pay policy will be taken as part of the annual Scottish Budget process, with the next budget expected in December 2018. To illustrate the potential costs of a progressive approach to pay for public sector workers, we have modelled three theoretical public sector pay award scenarios (see Table 7.4).

7.82. A central scenario assumes a continuation of the 2018-19 pay policy (based on 3 per cent up to £36,500, 2 per cent up to £80,000 and £1,600 above £80,000) in each of the years covered by the modelling. An upper scenario of 4 per cent and a lower scenario of 2 per cent are also modelled. Table 7.4 indicates what the aggregate cost could be for each year for each scenario. The costings of the policy are based on the Scottish Government, the 43 public bodies covered by the pay policy, the NHS, teachers, police, fire and further education (they do not include other local government pay costs).

TABLE 7.4 – MODELLED PUBLIC SECTOR PAY SCENARIOS

Forecast Paybill based on Scenarios	Cost (inc on-costs) – £m			
	2019-20	2020-21	2021-22	2022-23
2% per year	248	253	258	264
3%/2% per year	313	321	330	338
4% per year	497	517	537	559

7.83. The importance of carefully controlling pay increases in the public sector remains. The Scottish Government recognises that maintaining employment and fair rates of pay in the public sector is crucial in ensuring Scotland's economy remains strong and that investment in Scotland's public services remains a priority.

7.84. That is why the Scottish Government has continued its commitment to the real Living Wage and why it has maintained its position on no compulsory redundancy. It is also the Scottish Government's view that it is for employers to take their own decisions about pay progression based on business need, maintaining headcount and affordability.

7.85. The Scottish Government acknowledges the contribution of public sector workers in achieving our ambition and delivering on our priorities. That is why the 2018-19 pay policy sets an important direction of travel, subject to available resources, and will continue in future years to strike the balance between affordability and offering a fair deal for staff.

EU funding

7.86. European funding in Scotland is very important to a wide range of sectors and its loss following the UK's exit from the EU could create pressures on Scotland's public finances. The current EU funding round (2014 - 2020) is expected to benefit Scotland by over £5 billion, with the funding programmes supporting jobs, delivering infrastructure, sustaining rural communities, providing valuable support for the farming and fishing industries and delivering research funding for universities.

7.87. Details of successor arrangements to replace these EU funding programmes have yet to be proposed by the UK Government and this continues to create significant uncertainty for those who rely heavily on this investment. In addition to the direct funding that Scotland's people, public services and businesses receive from the EU, there will be wider cost implications of the UK's exit from the EU. These cannot be fully quantified at present as they are dependent on the outcome of negotiations with the EU and on policy decisions yet to be taken, and this creates an uncertain future for Scotland.

7.88. This document does not therefore speculate on the future financial arrangements for post-exit EU funding as these have yet to be set out by and agreed with the UK Government. However, we have been absolutely clear that Scotland must not be any worse off in respect of the funding allocations that replace those currently provided from the EU.

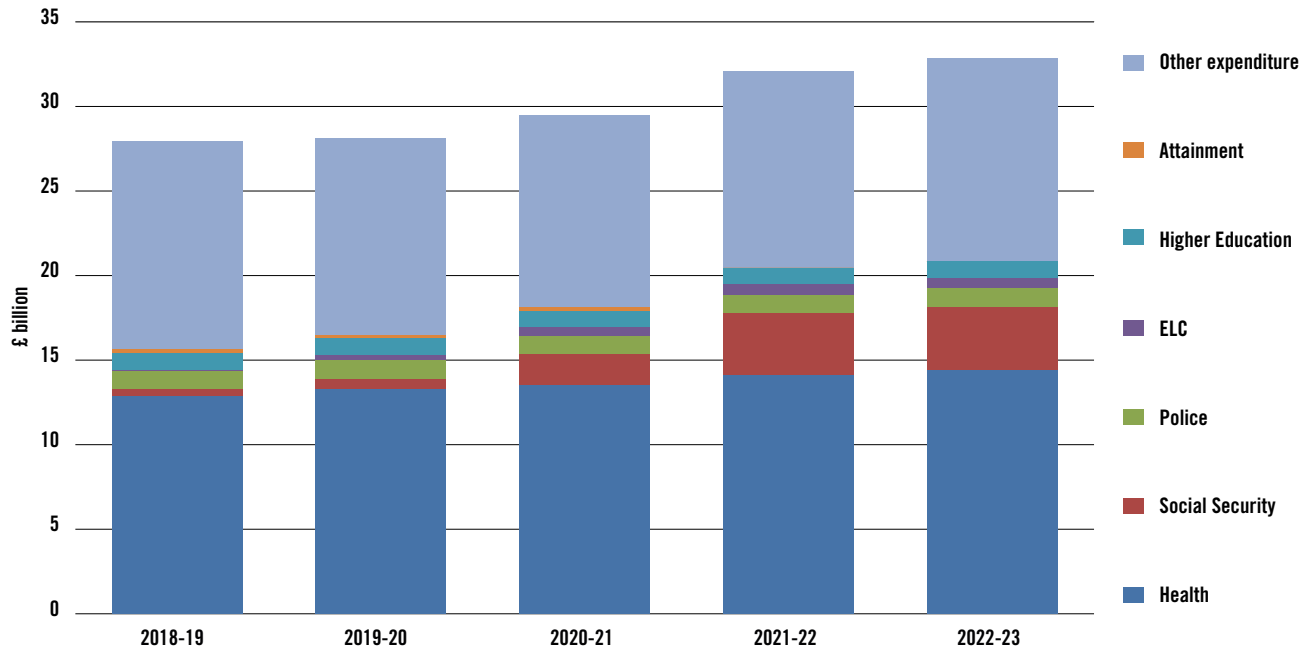
7.89. Despite the UK's exit from the EU not being Scotland's choice, the Scottish Government is working hard to press the UK Government to fully consider its implications for Scotland's public finances, in order to mitigate the worst effects in Scotland and to ensure that Scotland's finances are not detrimentally impacted.

Future shape of the resource budget

7.90. As is the case in any organisation, the setting of budgets to meet the organisation's commitments and obligations requires careful choices, decisions and prioritisation. As part of that process, we will be exploring a wide range of options, looking to deliver efficiency savings across portfolios, carefully prioritising expenditure to ensure that it has maximum impact on delivering key outcomes and priorities, including options to reduce demand through earlier intervention, looking at options for generating additional revenues and considering options for further public service reform to allow us to protect the delivery of public services at a time of financial constraint.

7.91. Looking at the central scenario for the resource budget, and taking account of the key policy commitments outlined above, this shows that in future years the proportion of the overall resource budget that is utilised by these commitments grows from 56 per cent in 2019-20 to 64 per cent in 2022-23, with overall health spending making up between 68-82 per cent of that share across the five year period. All other funding commitments will need to be met from the remainder of the budget. This position is summarised in Chart 7.1 below.

CHART 7.1 – RESOURCE EXPENDITURE CENTRAL SCENARIO



7.92. Clearly, the other two funding scenarios set out in Chapter 6 of this paper result in different shares of the overall budget being committed to these key government priorities. Under the “upper scenario” the proportion of the budget utilised by the commitments grows from 55-62 per cent over the period and under the “lower scenario” it grows from 57-66 per cent. These positions are set out in Chart 7.2 and Chart 7.3.

CHART 7.2 – RESOURCE EXPENDITURE UPPER SCENARIO

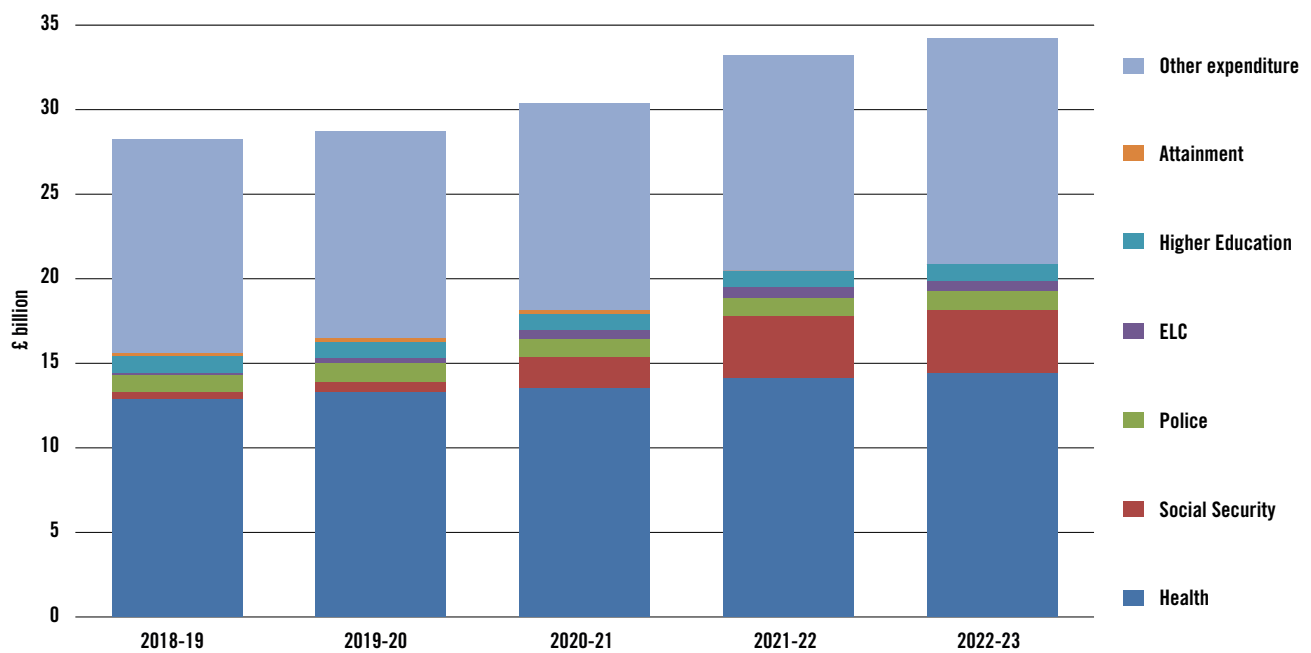
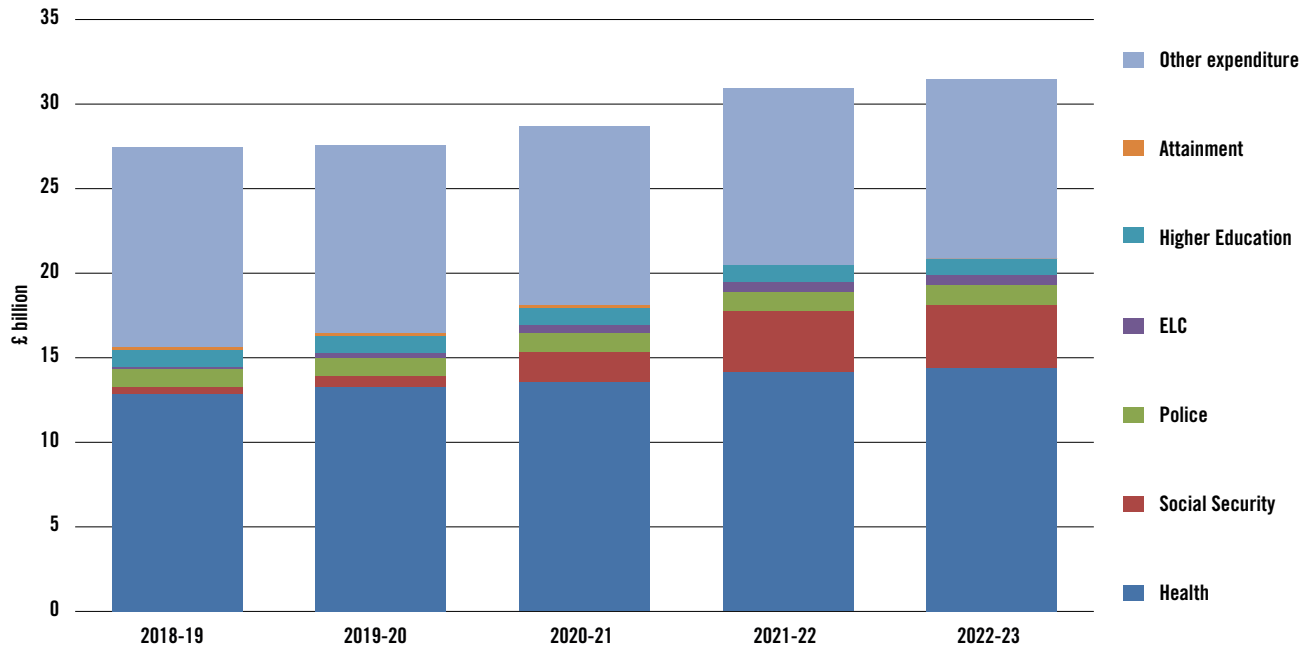


CHART 7.3 – RESOURCE EXPENDITURE LOWER SCENARIO

7.93. 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 – which has been delivered in every year since the Scottish Parliament came into existence.

7.94. That process will continue over the years covered within this document, and the decisions that will be taken will include consideration of the balance of funding that will be allocated to the range of priorities, to local government and to support other key public services across Scotland.

7.95. The central funding scenario that is set out in this document indicates that, as is the case in almost all annual budget processes, that decisions around prioritisation of spending, options for increasing revenues, delivery of efficiencies across all budget areas and considering options for reform will need to be undertaken to accommodate these priorities and continue to support high quality public services across Scotland.

7.96. The required level of efficiency will vary depending on the choices that are made as to the extent of reform and reprioritisation that is undertaken, and the final level of funding that is available in each year – all key considerations that will form part of annual budget processes and the next Spending Review. It is, however, clear that even under the most optimistic scenario, if no reprioritisation or reform were agreed and no additional revenues generated, then efficiency savings of 5 per cent per year could be required. While future efficiency targets (rightly) will be challenging, the decisions we take will ensure they are manageable. The Scottish Government's Efficiency Outturn report for the last 3 years indicate that efficiency savings within a range of 3-6 per cent annum are deliverable. The most recent report was published in May 2018.¹⁶

16 <http://www.gov.scot/Resource/0053/00535569.pdf>

7.97. The decisions taken in setting the budget will ultimately be dependent on the size of the overall budget for each financial year. We will gain greater certainty on the block grant that the Scottish Government expects to receive from the UK Government through the 2019 UK Spending Review and anticipated levels of tax receipts will continue to be refined.

7.98. This paper provides a range of potential funding scenarios that may emerge in future years. The next budget setting process will be taken at a time when there is greater clarity and certainty on funding levels.

7.99. The Scottish Government will be carefully considering the prioritisation choices required as part of the forthcoming 2019-20 annual budget process (and those that follow) and crucially through the next Spending Review which is expected to take place following the UK Government's Spending Review in 2019. The Scottish Government will set out its approach to the next Spending Review following the conclusion of the UK process next year.

Choices on capital budget and other forms of infrastructure investment

7.100. A crucial foundation to building and supporting a successful and economically buoyant Scotland is maximising investment in infrastructure. This is central to the Scottish economy and the Scottish Government's vision for a prosperous, fair and well-connected Scotland.

7.101. In addition to the capital grant from HM Treasury, there are a number of additional approaches which the Scottish Government uses to support the economy through infrastructure investment.

7.102. This includes utilising borrowing powers to provide additional investment to support the overall capital programme and a revenue-financed hub programme to deliver schools and community health facilities. This provides additional investment and is paid for through resource budgets over a long-term period.

7.103. Non-Profit Distributing (NPD) and revenue-financed hub programmes provide ways of financing additional projects over and above those that could be supported through capital grant alone. Such projects may also have a capital funded element. The revenue-funded element is paid through unitary charges for a period of 25-30 years once the project is completed and is funded from resource budgets.

7.104. The annual estimated unitary charges are published on the Scottish Government website.¹⁷

7.105. As part of the assumptions that underpin this paper, the Scottish Government currently plans to borrow a further £450 million in 2019-20 to support additional infrastructure investment. Final decisions on future borrowing levels will be taken as part of the 2019-20 and subsequent budget processes. These decisions will be taken annually in light of the economic outlook at the time, weighing the cost of borrowing and the opportunity cost of using up more of the overall £3 billion borrowing limit against the potential benefits of economic stimulus.

17 <http://www.gov.scot/Topics/Government/Finance/18232/12308/NPDhubPipelinepayments>

7.106. Innovative financing approaches such as Tax Incremental Financing and Growth Accelerator are also used in partnership with the Scottish Futures Trust and local authorities to attract private investment. This is paid for through increases in non-domestic rates or other economic growth metrics and the provision of guarantees to boost investment such as the Rental Income Guarantee Scheme to increase the supply of houses available for rent.

7.107. In order to maximise the government's investment in infrastructure, leverage of other funding is pursued where possible. Examples of this include the City Region Deals where it is estimated that the Glasgow City Region Deal will lever in an additional £3.3 billion of private sector investment into the proposed infrastructure investment programme, the Inverness Deal which is expected to unlock an additional £800 million of private sector investment and the Aberdeen City Region Deal anticipating around a further £500 million of leverage from the private sector and other economic partners.

7.108. Publicly funded social housing and mid-market rented (MMR) housing also attracts matching private investment. There will be variations for individual projects but social housing grant pays approximately half the unit build cost with the remainder being funded by lenders. For many MMR schemes the private finance leverage can be much higher, generating significant investment at scale.

7.109. The Scottish Government's planned investment in infrastructure is set out in the Infrastructure Investment Plan¹⁸ which was published in December 2015 and is refreshed regularly.

7.110. This plan sets out why the Scottish Government needs to invest; how it will invest and what strategic investments are planned over the medium to long term. The following guiding principles are applied to infrastructure investment:

- delivering sustainable economic growth through increasing competitiveness and tackling inequality;
- managing the transition to a more resource efficient, lower carbon economy;
- supporting delivery of efficient and high quality public services; and
- supporting employment and opportunity across Scotland.

7.111. Key commitments in the 2015 Scottish Government Infrastructure Investment Plan include:

- transforming Early Learning and Childcare - expansion to 1,140 hours per year;
- increasing housing supply in Scotland - 50,000 affordable homes;
- creating a new, overarching energy strategy for Scotland;
- delivery of super-fast broadband across Scotland;
- investment in healthcare infrastructure, including the establishment of several new diagnostic and treatment centres;

18 [Infrastructure Investment Plan 2015](#)

- continued investment in Scotland's *Schools for the Future* Programme – which will deliver 117 new schools by March 2020; and
- investment to improve transport infrastructure including measures to improve journey times and connections (e.g. through the dualling of the A9), reduce emissions and improve the quality and accessibility of public transport.

7.112. A number of these commitments already have published multi-year profiles of anticipated capital expenditure, including long term resource planning assumptions for the affordable housing programme (out to 2020-21), and capital funding to support the expansion of Early Learning and Childcare (until 2020-21). The profile of these two key commitments is set out in Table 7.5 out to the end of their existing commitment periods. Decisions beyond 2020-21 will be taken in future budget processes once capital budgets for that period have been provided by the UK Government.

TABLE 7.5 – MULTI-YEAR CAPITAL FUNDING ALLOCATIONS

£m	2018-19	2019-20	2020-21	2021-22	2022-23
Affordable Housing Resource Planning Assumptions	532	592	630	-	-
ELC Expansion	150	175	121	-	-
TOTAL	682	767	751	-	-

7.113. Other capital commitments have a total quantity of investment confirmed for them, but the profile of that expenditure will be confirmed as part of future annual budget processes – examples include expenditure on the R100 Broadband project (£600 million by the end of 2021-22); a four year investment commitment in energy efficiency and heat decarbonisation (£500 million over 2017-18 to 2020-21); a commitment to expand the Golden Jubilee Hospital and develop five elective care centres in Aberdeen, Dundee, Edinburgh, Inverness and Livingston (£200 million); and planned investment in the Building Scotland Fund spread over 2018-19 to 2020-21 (£150 million – of which £70 million was allocated in 2018-19).

7.114. There are also a range of other commitments that are time-bound, but funding profiles for future years beyond 2018-19 have still to be agreed in future Scottish Budgets. These commitments principally relate to individual significant projects (e.g. the final profile of the remaining work to dual the A9) and detailed information on project costs and spend, and anticipated costs for future planned projects in the pipeline is released every six months, including to the Scottish Parliament Public Audit and Post-legislative Scrutiny Committee and is placed on the Scottish Government website.¹⁹

Local government capital

7.115. The Scottish Government funds capital investment for local authorities through providing a General Capital Grant and a small number of specific grants. In addition to the settlement, other specific grants are paid to local authorities by Scottish Government agencies and other public bodies such as Non-Departmental Public Bodies.

7.116. Specific Capital Grants are paid for specific projects or to fund specific policy objectives. The terms and conditions of each grant are set out in the offer letters for these grants. The General Capital Grant supports the delivery of a council's Single Outcome Agreement and contributes to the National Outcomes. Councils determine how they use these resources to meet local and national priorities.

7.117. In 2018-19, the amount of capital funding provided to local authorities was £876 million. The level of local authority capital grant for future years will be considered alongside all other capital requirements in the 2019-20 budget process.

Financial Transaction budgets

7.118. In recent years the Scottish Government has also made use of Financial Transactions (FTs) as part of its overall approach to capital investment. FTs can only be used to support loan or equity investment in bodies outside the public sector. FTs also need to be repaid to the Scottish Government for onward repayment to HM Treasury. Agreement has been reached with HM Treasury that only 80 per cent of the total needs to be repaid, with the remainder available for recycling into other FT funded schemes. The current planned FT repayment profile to HM Treasury is set out at **Annex A**.

7.119. FTs have been used to support a number of housing initiatives, including equity stakes in Help to Buy and other shared equity schemes, as well as innovative financing schemes to increase the supply of homes available for mid-market rent. We have also used FTs to provide loan funding to small and medium enterprises, to provide support for energy efficiency programmes, to establish the Building Scotland Fund and to increase loan funding available for low carbon vehicles.

7.120. The Scottish Government's 2017 Programme for Government committed to establishing a Scottish National Investment Bank to boost Scotland's competitiveness and realise the Scottish Government's ambitions for the economy by providing patient capital to finance growth. This commitment was made on strong international evidence that national investment banks of scale can lead to a strong, positive impact on investment, innovation and long-term economic growth.

7.121. In 2018-19, it was announced that £340 million of FTs would be set aside over 2019-20 and 2020-21 (profile of investment still to be confirmed) to provide the initial capitalisation of the Scottish National Investment Bank. The Implementation Plan for the Bank (which was published in February 2018) indicated that there should be an aim to provide a target level of public capital for the Bank at a minimum of £2 billion over the first 10 years (2019-20 to 2028-29).

7.122. Taking the sums above along with the £150 million of planned investment in the Building Scotland Fund (as a precursor to the establishment of the Bank in 2019), the overall plan is therefore an initial investment in the Bank of almost £0.5 billion in the first three years.

7.123. It is our intention to continue to support similar types of schemes into the future through the use of the on-going profile of Financial Transactions out to 2022-23 (subject to confirmation in the 2019 UK Spending Review that the funding will continue beyond 2020-21).

7.124. The Scottish Government has an ambitious capital expenditure programme and it is simply not possible to progress everything at once due to the size of the overall capital budget. Projects will be prioritised and progressed both to deliver upon the key commitments that have been made and to align with the overall availability of the approximately £4 billion per year of capital funding in the Scottish Budget.

7.125. Decisions on the content of the capital programme for 2019-20 and beyond will be made up of a combination of expenditure on maintaining our existing asset stock, continuation of projects that are currently underway and the commencement of new projects. Final details of the content of the programme (for both capital and Financial Transactions) will be confirmed in the 2019-20 Scottish Budget, in December 2018.

8 Conclusions

8.1. This financial strategy describes the Fiscal Framework, policy environment and spending pressures that the Scottish Government and its public services face over the next five years, and the financial consequences that arise from specific policy interventions.

8.2. The data and modelling that underpin this document are based on the information available in May 2018 and will be subject to change as new and updated information becomes available.

8.3. This forward look does not set out any new decisions or policy commitments, particularly in relation to the public sector, and only seeks to explore and explain the range of factors and variables which require consideration by the Scottish Government when making financial decisions and undertaking longer-term budget planning.

8.4. There are a number of strategies available to be adopted to meet the financial challenges ahead and these will include:

- continuing our core focus of growing the economy and our tax base;
- securing additional or increased revenues and income to support the overall budget;
- reprioritising expenditure in areas across the budget; and/or
- reforming how public services are delivered across Scotland in a manner that maintains or improves outcomes in ways that moderate future demand pressures on these services.

8.5. The use of each of these options will be actively considered and explored by the Scottish Government as it develops the 2019-20 budget and those that follow.

8.6. Consideration of the key aspects of this document and the options available to address the financial circumstances that we face are relevant not only for the current Scottish Government (and for any future Scottish Government), but also for the Scottish Parliament as a whole as it undertakes its scrutiny of Government decisions.

8.7. The next major considerations of spending will be made by:

- the Scottish Government as it develops the 2019-20 Scottish Budget; and
- the Scottish Parliament in undertaking its budget scrutiny during 2018 and when it considers the 2019-20 Scottish Budget later this year.

Annex A Financial Transactions Repayment Profile

Annual Scottish Government return to HM Treasury (July 2017)

REPAYMENT PROFILE AT 31 MARCH 2017

Year	£m	%
By 2019-20	51	6
2020-21	15	2
2021-22	22	3
2022-23	37	5
2023-24	37	5
2024-25	48	6
2025-26	88	11
2026-27	106	13
2027-28	71	9
2028-29	56	7
2029-30	24	3
2030-31	28	4
2031-32	26	3
2032-33	26	3
2033-34	26	3
2034-35	27	3
2035-36	26	3
2036-37	25	3
2037-38	15	2
2038-39	15	2
2039-40	15	2
2040-41	1	0
2041-42	6	1
2042-43	21	3
2043-44	1	0
TOTAL	812	100

Note: Figures may not sum due to rounding.

Annex B Further Detail on Economic Modelling

Constructing the central scenario

B.1. The central scenario of Scottish Government funding is built up by forecasting separate elements of funding and then aggregating these to produce a path for the total level of potential funding. The elements of income are:

- the resource budget limit (excluding new social security funding);
- new social security funding;
- the capital budget limit;
- Financial Transactions;
- net Block Grant Adjustment (BGA) income;
- non-domestic rates income; and
- capital borrowing.

B.2. For the years up to and including 2019-20, the central forecast is taken from the Scottish Government Draft Budget 2018-19, adjusted for Scottish Rate Resolution tax changes. Beyond 2019-20, the approach to forecasting each component is set out below.

Fiscal resource budget limit excluding social security

B.3. In general, the fiscal resource budget limit is assumed to grow in line with overall UK Resource Departmental Expenditure Limit (RDEL) from the UK Office for Budget Responsibility (OBR) March 2018 Economic and Fiscal Outlook.²⁰ However, there are a small number of additional sources of income which are treated separately. These relate to: non-domestic rates; Scotland Act Implementation; the Migrant Surcharge; the Queen's and Lord Treasurer's Remembrancer (QLTR); and the Rail Resource Grant. Separate forecasts of these sources are available out to 2022-23. Therefore, the fiscal resource budget limit is projected excluding these items, and then combined with the forecast of these individual elements to produce the overall projection.

New social security funding

B.4. The forecast for social security funding is based on projections produced by Scottish Government analysts.

Capital budget limit

B.5. UK spending plans for capital have been set out to 2020-21, one year further than for resource, so a figure is available for the capital budgets which is used as the baseline for future growth. The capital budget limit is then assumed to grow in line with the overall UK Capital Departmental Expenditure Limit (CDEL) from the OBR March 2018 forecast.

Financial Transactions

B.6. Financial Transactions in 2020-21 are expected to fall in line with plans set out at the last UK Spending Review. Beyond 2020-21, there is no new lending and Financial Transactions are kept constant in cash terms. The risk around loss of Financial Transactions is reflected in the scenarios for the capital budget.

20 http://cdn.obr.uk/EFO-MarCh_2018.pdf

Net Block Grant Adjustment

B.7. Beyond 2019-20, the net Block Grant Adjustment for Scotland is forecast to grow in line with the SFC's forecast for devolved taxes, relative to the OBR's forecast for the rest of the UK.

Non-domestic rates income

B.8. Non-domestic rates income is forecast to grow in line with the SFC's forecast.

Capital borrowing

B.9. Capital borrowing powers are assumed to be fully utilised in 2019-20, but no capital borrowing is currently planned after this.

B.10. This approach is summarised below in Table B.1.

TABLE B.1 – FORECASTS OF INDIVIDUAL INCOME COMPONENTS (£ MILLION)

	2019-20	2020-21	2021-22	2022-23
	Latest estimate	Forecast using:		Final estimate
Total budget excl non-cash	£33,024	Sum of individual series		£37,555
Fiscal resource budget limit	£27,440	UK departmental resource spend ¹		£28,709
New social security funding	£507	Scottish Government projections		£3,602
Capital budget limit	£3,926	UK departmental capital spend ¹		£4,226
Financial Transactions	£519	2020-21 budget figure then held flat		£505
Net Block Grant Adjustment	£182	Relative devolved tax growth per head		£513
Capital borrowing	£450	No decision on borrowing beyond 2019-20		£0

¹ Source: OBR, series Public Sector Current Expenditure (PSCE) in RDEL and Public Sector Gross Investment (PSGI) in CDEL

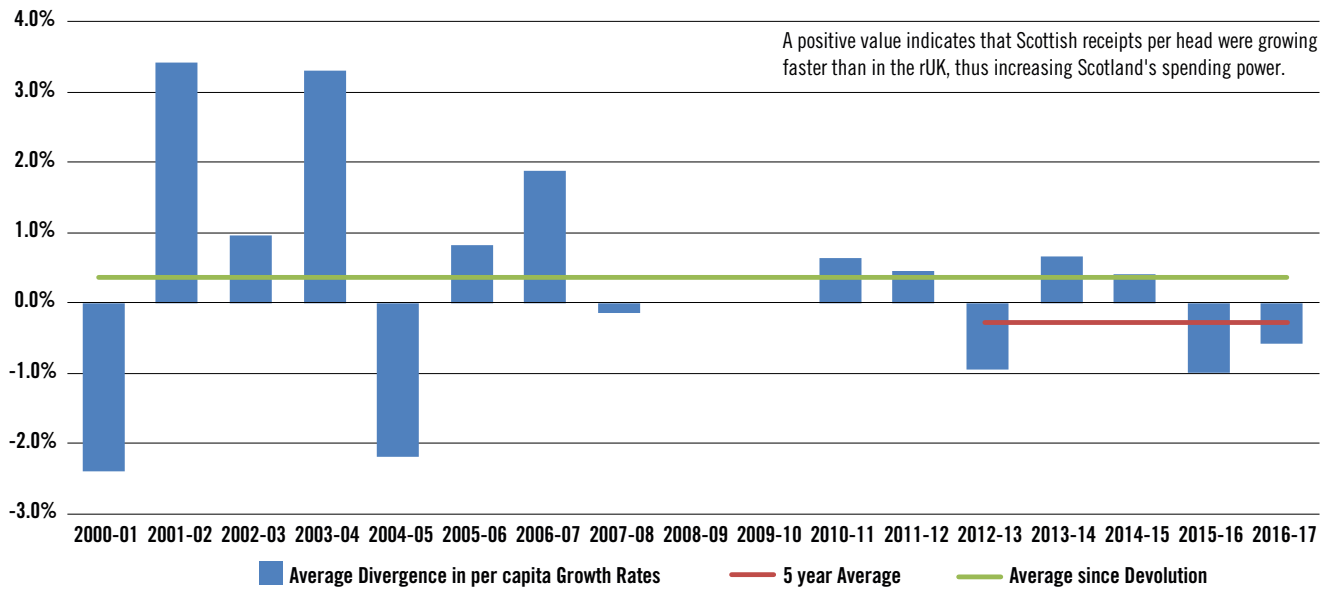
Assumptions on historical performance and uncertainty

B.11. The impact of devolved taxes on the Scottish Budget is determined by changes to the accompanying Block Grant Adjustment (BGA). As the BGA grows in line with tax receipts per head in the rest of the UK, the Scottish Budget will only be better off if Scotland can grow its tax revenues per head more quickly than the rest of the UK.

B.12. To understand the risks around this, we consider how tax receipts in Scotland have performed historically. The section below shows how this approach is implemented using income tax as an example.

B.13. As indicated in Chart B.1, non-savings and non-dividend (NSND) income tax liabilities per head have grown faster in Scotland than the rest of the UK in nine out of the 15 years for which data is available. However, this is partly due to a relatively strong performance in the years immediately following the 1999 devolution settlement.

B.14. Two patterns can be observed from Chart B.1. Firstly, the divergence between tax per head growth appears to have decreased quite significantly and has not exceeded 1.0 percentage points since 2009-10. Secondly, looking at the performance over the past five years, the UK has grown more strongly in three out of the past five years, with the differential averaging -0.3 percentage points over this period.

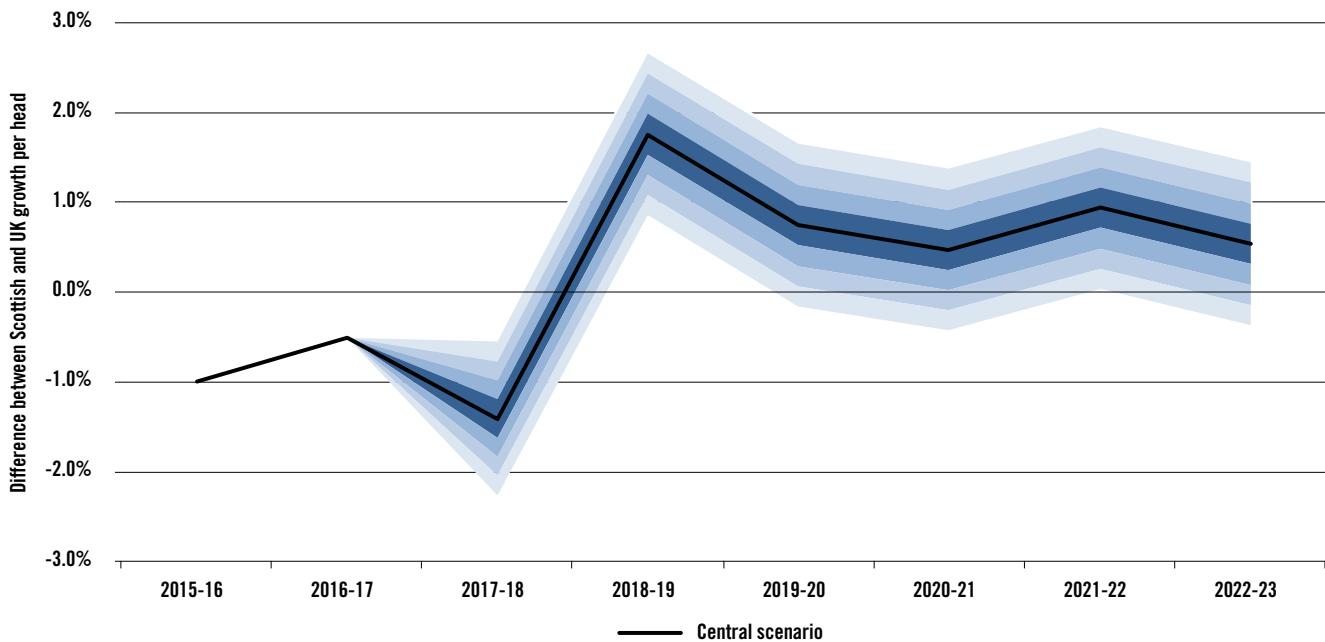
CHART B.1 – DIFFERENTIAL GROWTH IN INCOME TAX LIABILITIES

Source: GERS 2016-17. Figures up to and including 2014-15 are provided by HMRC. Figures for 2015-16 and 2016-17 are OBR estimates.

Uncertainty analysis

B.15. The OBR and the Bank of England (BOE) both use fan charts to present uncertainty around their central forecasts.

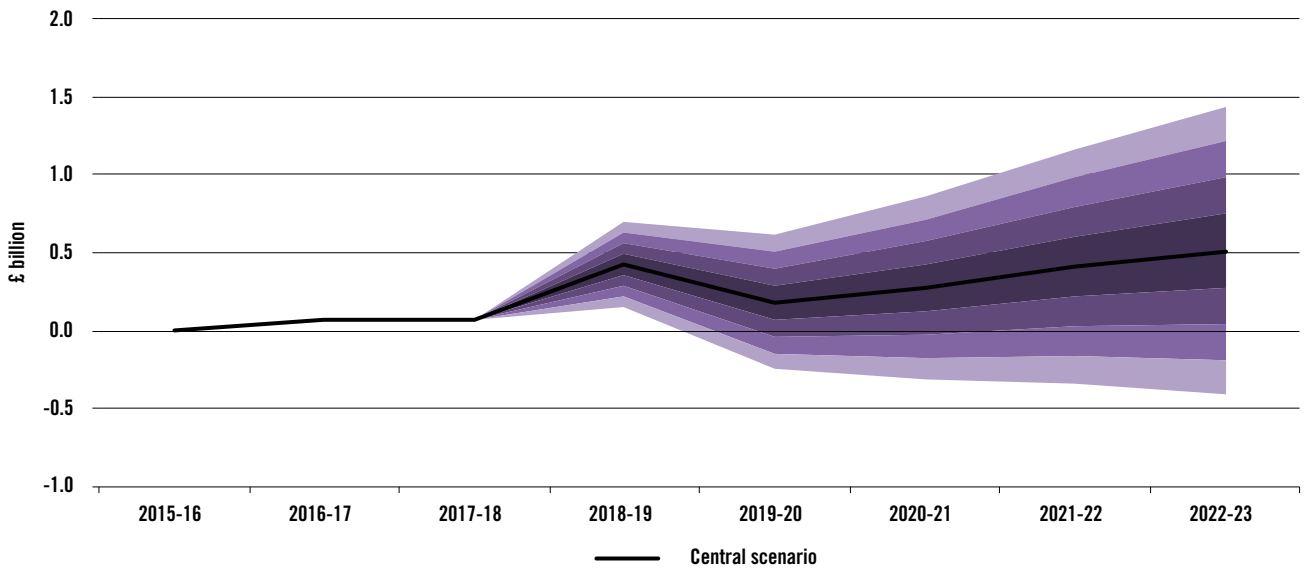
B.16. Chart B.2 illustrates Scottish Government estimated uncertainty about the SFC's central forecast for the difference in Scottish and UK growth in income tax liabilities. The SFC currently forecasts that per person NSND income tax receipts in Scotland will grow faster than in the rest of the UK from 2018-19. This is primarily due to different choices about the future path of income tax policy in Scotland. For example, in the chart below, Scottish receipts are forecast to grow faster than the rest of the UK by 1.8 percentage points in 2018-19 largely due to the Scottish Government's decision to introduce a new five band income tax regime in that year.

CHART B.2 – UNCERTAINTY AROUND DIFFERENTIAL GROWTH IN NSND INCOME TAX LIABILITIES

B.17. A variety of ways exist to estimate this uncertainty. The approach used by the OBR is to draw lessons from the accuracy of previous forecasts as a guide to the accuracy of any current forecast. However, as forecast errors are not available for Scottish income tax, we currently take an alternative approach in estimating the level of uncertainty. This approach will be reviewed in future, and it is expected that further information will be built into the modelling in future years as information and understanding of the uncertainty in the Fiscal Framework increases.

B.18. The Scottish Government modelling approach is to base the future uncertainty on the historical variation in the data. Looking at the range of different values that have occurred in previous years allows us to construct a range of possible values that may occur in the future. This approach has a number of advantages. First, the process is relatively non-subjective, as the future values are drawn from available historical data. Second, we can adjust the model to capture the fact that uncertainty grows as the length of the forecast horizon expands. We base this adjustment on work undertaken by the OBR, who allow the variance of their distributions to expand year-on-year.

B.19. This is illustrated in Chart B.3 which shows the impact and level of uncertainty for Scotland's net spending power in relation to all the devolved taxes. Forecasts inevitably become more uncertain the further we look ahead. This means that by 2022-23 Scotland's net spending power could be between -£414 million and +£1.4 billion, with the SFC's central estimate at £513 million (based on Scottish Government forecasts of the BGA and the SFC central tax forecasts).

CHART B.3 – FORECAST OF SCOTLAND'S SPENDING POWER: NET BLOCK GRANT ADJUSTMENT

Annex C Illustration of Alternative UK Government Spending Paths

C1. This section discusses the path for UK fiscal policy (as announced in the UK Government's Spring Statement 2018) and illustrates alternatives that would keep the public finances on a sustainable path, while also allowing for an increase in investment in public services above the levels currently planned by the UK Government.

Alternative Spending Paths

C2. As an illustration, two alternative paths for public spending are set out below:

1. Use the fiscal space available within the existing fiscal rules in full. Under current UK Government plans there is a degree of flexibility to increase spending while remaining on track to meet the Chancellor's fiscal mandate to reduce the structural deficit below 2 per cent of GDP and have net debt falling as a share of GDP in 2020-21.
2. Balance the current budget in 2021-22. This means that public sector receipts are sufficient to fund day to day spending on public services, but that limited borrowing is still undertaken to support capital investment, reflecting the fact that such expenditure will both produce an asset which will generate benefits for future generations and increase the country's productive capacity.

C3. Using the available fiscal space in full (Example 1) could free up around £60 billion over the next five years, relative to the UK Government's current plans, while remaining on course to meet the UK Government's 2020-21 fiscal targets.

TABLE C.1 – EXAMPLE 1 – ADDITIONAL FUNDING UNDER CURRENT FISCAL MANDATE

Additional Funding (£bn)	2018-19	2019-20	2020-21	2021-22	2022-23	Cumulative
UK	8	12	15	19	7	60
Scotland	0.6	0.9	1.2	1.5	0.5	4.7

C4. Example 2 could release up to £86 billion over the next five years, relative to the UK Government's current plans, with Scotland's share of this estimated at almost £7 billion over the same period.

TABLE C.2 – EXAMPLE 2 – ADDITIONAL FUNDING UNDER BALANCED CURRENT BUDGET IN 2021-22

Additional Funding (£bn)	2018-19	2019-20	2020-21	2021-22	2022-23	Cumulative
UK	13	17	23	26	7	86
Scotland	1.0	1.4	1.8	2.0	0.6	6.8

C5. The UK Government's recent commitment to increase NHS pay, which is not yet incorporated above, shows that there is scope for fiscal policy to be eased within the existing fiscal rules.

Implications for public finances

C6. Charts C.1 and C.2 illustrate the potential path for the UK public finances under the current UK Government's plans compared to the alternative spending plans detailed above.

C7. Under the two examples outlined above, the deficit does not exceed the pre-crisis average of 2.4 per cent and debt, as a share of GDP, starts falling from 2020-21 onwards.

CHART C1: IMPACT OF ALTERNATIVE SPENDING PATHS ON DEFICIT

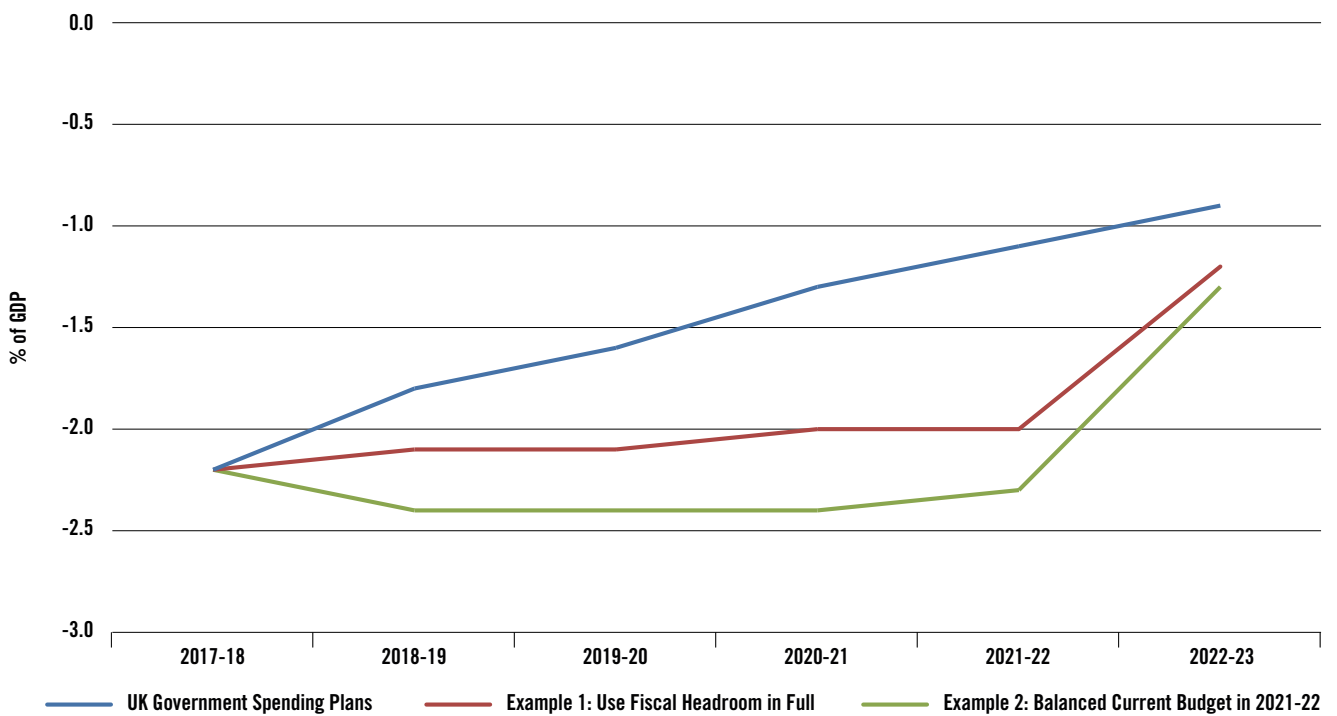
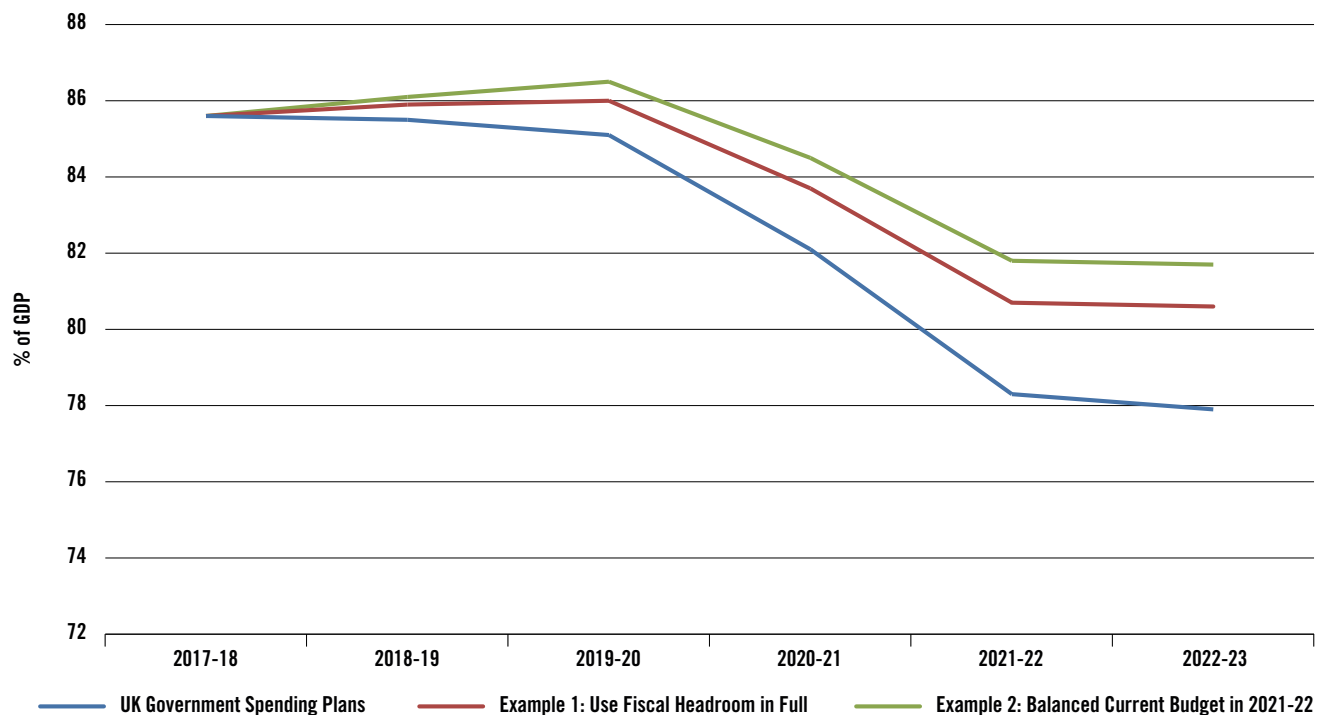


CHART C.2 – IMPACT OF ALTERNATIVE SPENDING PATHS ON DEBT

Constructing the alternative spending paths

C8. The UK Government's plans for borrowing and debt, as published in the Spring Statement 2018 (OBR Economic and Fiscal Outlook (EFO), Table 4.40), have been used as the baseline for the analysis. In addition, the following assumptions were made:

- under Example 1, we assume that the UK Government utilises the headroom of £15.4 billion in full in 2020-21 and the deficit is reduced more gradually to its target of 2.0 per cent in that year. Beyond this point, an illustrative path for public spending is chosen which ensures that debt falls as a share of GDP;
- under Example 2, we assume that the current budget is in balance in 2021-22, allowing for an extra £27 billion of borrowing in that year, with the deficit falling gradually to achieve this target. Beyond this point, an illustrative path for public spending is chosen which ensures that debt falls as a share of GDP; and
- the analysis incorporates the impact that alternative fiscal paths would have on public sector debt interest costs. This is taken into account in the analysis by multiplying the additional cumulative borrowing in each year by the market gilt rate (EFO, Table 4.1). The spending figures presented in Tables C.1 and C.2 are therefore net of the change in debt servicing costs.



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