The outlook for the Scottish budget in 2020 and beyond

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Abstract. *The outlook for the Scottish budget in 2020/21 has changed substantially since it was published in March. Higher spending and lower revenues will largely be offset by increased grant from the UK Government. The pandemic also accentuates the scale of several fiscal risks that the Scottish budget was already exposed to, leading to calls for the Scottish Government to have access to additional fiscal flexibilities to manage these risks. The Covid-19 health crisis and its aftermath poses a range of substantial fiscal challenges for the Scottish budget in 2021/22 and beyond. But the outlook for the Scottish budget is extremely uncertain beyond 2020/21, creating challenges for the Scottish parties as they begin preparing their manifestos for next May's Holyrood elections. This paper assesses the risks to the Scottish budget this year; appraises the scope for additional budget flexibilities to manage these risks; and considers the longer term outlook for the budget in the next parliament, both in terms of the key fiscal issues to be addressed and the likely level of resources available.*

I An evolving budget picture for 2020/21

When the Scottish draft budget was published in February, it contained no mention of Coronavirus or Covid-19. By May, the outlook for the budget in 2020/21 had changed so much that the Scottish Government published, exceptionally, a Summer Budget Revision (SBR).

The SBR details total gross spending on the Covid-19 response in 2020/21 of £4bn[2]. Of this, almost £2.8bn represents an increase in total spending from that set out in the budget that was finalised in March. At the same time, revenues from Non-Domestic Rates are anticipated to be almost £1bn (just over one third) lower than anticipated when the budget was published, as a result of the reliefs provided to businesses in the tourism, leisure and hospitality sectors[3]. The

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[1] I am grateful to Andrew Goudie for insightful discussion and comment that helped shape this paper.
[2] Scottish Government, Summer Budget Revision 2021/22 https://www.gov.scot/publications/2020-21-summer-budget-revision/pages/1/
[3] References from Non Domestic Rates are treated as a negative expenditure in the operation of the Barnett Formula.

remainder of the Covid-19 budget response (£250m) comes from reallocation of spending plans within portfolios.

The vast majority of the £4bn gross funding requirement is anticipated to come from a higher block grant from the UK Government. At the time of the SBR, £3.6bn of 'consequentials' were anticipated to flow to the Scottish budget as a result of spending on the Covid-19 response in England, (in addition to £100m of consequentials that were announced at the UK budget in March). The remainder comes, as already noted, from some reprioritisation of existing spending plans.

Around £2.3b of the £4bn gross funding package is directed at business support, through the business rates reliefs and business grants. Just over £600m has been allocated to health and social care budgets. A Community Support Fund of £350m targets support and low income and vulnerable groups, almost £350m of support has been made available to support public transport providers, and £150m has been made available to local authorities to help them cover additional costs associated with Covid-19. A range of smaller interventions include funding for charities, to support higher claims for Council Tax Reduction, and student support grants.

In broad terms the Scottish Government has allocated its Covid-19 funding in a similar pattern to the UK Government in England. The Scottish Government committed to 'pass on' health related consequentials to the health budget, and business support related consequentials to business support interventions. But at a more granular level of detail there are differences at the margin in how eligibility criteria for some business support schemes have been designed, and in some of the smaller support packages. The Scottish Government has for example provided additional funding support for the self-employed, fishermen, and to support higher payments of Carer's Allowance.

The Summer Budget Revision is of course a snapshot in time of what will be a continually evolving picture. By early June, the anticipated Covid-19 Barnett consequentials had increased by a further £200m, to £3.8bn, much of which was allocated to health and social care. On 16 June, the Scottish Government announced a new 'Return to Work' package of £230m, which reallocates capital spending in the 2020/21 budget – in areas where slippage is likely to occur – to projects which are intended to help support the economic recovery.

II Spending pressures and budget risks in 2020/21

The budget is exposed to a number of risks which mean that the resources available to the Scottish Government could rise or fall compared to latest estimates. And pressures will certainly emerge for further additional spending in some areas as the economy moves out of lockdown and into the recovery phase.

The areas where there is likely to be further spending pressure this financial year are many and varied. Speaking at a debate in parliament on 16 June, Cabinet Secretary for Finance Kate Forbes said that the need for additional spending to address the Covid-19 response would run into the 'hundreds of millions of pounds'. She highlighted the likely need for adaptations in transport and education systems to accommodate physical distancing requirements. Mitigating the labour market impacts of the crisis will inevitably require more investment skills and employability programmes that were designed for a different world (Scotland's existing flagship employability scheme, Fair Start Scotland, was designed for a world of sub-4% unemployment, where the focus could concentrate on the 'hardest to help' groups). There will be further immediate spending pressures in relation to enterprise, supporting local government to deliver key local services, and so on.

The extent to which this additional funding requirement will come from further consequentials, reallocation within the existing budget, or through securing additional 'budget flexibilities' (discussed subsequently) remains to be seen. Budget decisions taken between now and late summer will be set out in the Scottish Government's Autumn Budget Revision, although this will not set out the strategic basis for decisions made or the outlook for the remainder of the financial year.

What about the budget risks in 2020/21?

One risk is that the Scottish block grant does not increase by the full amount of the consequentials that have been indicated by the UK Government. This could arise if the UK Government manages to meet some of its Covid-19 spending commitments through reprioritisation of existing budgets rather than through 'new' spending. If it does so, it is possible that the final consequential uplift to the Scottish block grant will be lower than the amount currently estimated. However the likelihood that the final uplift is materially lower than the currently estimated figure seems low.

A second risk is that devolved Scottish revenues do not raise as much as forecast. Of course, it goes without saying that Scottish income tax revenues, which were forecast to raise just over £12bn at the time of the budget, will raise significantly less than this. The same can be said of revenues from LBTT, which was forecast to raise £640 million.

However, given the way the fiscal framework operates, the Scottish budget will be largely protected against these revenue falls in absolute terms. The risk the budget *is* exposed to is that Scottish revenues fall proportionately more (relative to forecast) than rUK revenues.

The risk that Scottish revenues fall proportionately more than equivalent rUK revenues is very real. If economic restrictions are lifted more slowly in Scotland on the basis of health advice, or if downturn in the offshore sector disproportionately affects the Scottish economy, then the Scottish budget may face a revenue shortfall that could conceivably run into the hundreds of million pounds.

However, the timing of budget reconciliations from these forecast errors, if they arise, may provide the Scottish Government with some breathing space. Whilst LBTT shortfalls during 2020/21 would impact the Scottish budget in 2020/21 and 2022/23, income tax shortfalls in 2020/21 will not impact the Scottish budget until 2023/24 (although this clearly should not absolve the government from monitoring emerging revenue data and making contingency plans – which might include setting aside some reserves – in the interim if required).

III A case for additional budget flexibilities: 'The right power for the wrong fiscal risk'?

On 16 June, the Scottish Parliament passed a motion that stated that 'additional short-term flexibilities in the Fiscal Framework should be negotiated with the UK Government'. The precise nature of the flexibilities sought was not explicitly set out in the motion nor in the opening statement by Cabinet Secretary for Finance Kate Forbes. But Ms. Forbes had set out her aspirations for additional budget flexibilities (to manage the spending pressures and budget uncertainties described above) while giving evidence to the Finance Committee the week previously.

These flexibilities include the ability to transfer capital budget to resource; increasing borrowing limits and/or extending the circumstances under which the government can borrow; and deferring tax forecast reconciliations or spreading them over a longer period. Kate Forbes has argued in parliament that a request for additional fiscal flexibilities '*is not a proxy debate for the constitution, but an appeal to common sense*'[4].

The logic behind a request to allow capital to resource transfers is clear. Capital investment projects are likely to slip this year given that the construction sector has effectively been shut down for a quarter of the year already. And whilst there will inevitably be calls to invest in 'shovel-ready' projects as part of the recovery, such projects are harder to identify in practice than in theory. Why then shouldn't capital funding be used to support additional public services spending to meet the exceptional requirements of the crisis?

A request to defer tax forecast reconciliations also has a clear appeal. The Scottish budget faced an income tax reconciliation of just over £200m this year (reflecting forecast error in 2017/18), and is likely to face a reconciliation of around £600m next year (reflecting forecast error in 2018/19). Deferring these reconciliations would boost spending power in the short-term, at a time when the economy is particularly weak. And there is a chance that at some point in future, forecast errors might go the other way, so that deferred negative reconciliations will offset future positive reconciliations. But there is no guarantee that things would work out this way, so deferring tax reconciliations is transferring further budget risk into the future.

The arguments around additional borrowing powers are more complex. Since the Covid-19 crisis began there have been growing calls for the Scottish Government to have additional scope to borrow. As well as the government itself, calls to consider borrowing rules have come from the IFS and the recent Report of the Advisory Group on Economic Recovery[5], which argued that there is 'a strong case for the Scottish Government to have greater autonomy to use targeted fiscal measures to stimulate demand or incentivise behavioural change in the recovery period'. However the Advisory Group's main call was to bring forward the scheduled review of the Fiscal Framework as a whole, rather than recommending specific flexibilities that should be sought.

[4] Debate in the Scottish Parliament, 16 June 2020
http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12697&i=114863
[5] Towards a robust, resilient wellbeing economy for Scotland
https://www.gov.scot/binaries/content/documents/govscot/publications/strategy-plan/2020/06/towards-robust-resilient-wellbeing-economy-scotland-report-advisory-group-economic-recovery/documents/towards-robust-resilient-wellbeing-economy-scotland/towards-robust-resilient-wellbeing-economy-scotland/govscot%3Adocument/towards-robust-resilient-wellbeing-economy-scotland.pdf

Currently, the government can borrow up to £450m per annum to fund capital investment, within a total cap of £3bn. On resource spending, the government can borrow up to £600m annually (within an overall cap of £1.75b), although only under restricted circumstances. Of this £600m annual limit, the government can borrow up to £300m to address forecast error (increasing to £600m if there is a 'Scotland-specific economic shock'), and up to £500m for 'cash management'. The government cannot borrow to fund discretionary resource spending (e.g. it cannot borrow to pay the salaries of additional nursing staff) or to provide an additional stimulus in Scotland.

It has been clear for some time that the borrowing limit for forecast error is unlikely to be adequate (the income tax reconciliation is likely to be around £600m next year, whilst the borrowing limit of £300m is in due course supposed to also accommodate forecast errors for other devolved taxes and newly devolved social security payments).

Conversely, the cash management borrowing facility seems unlikely ever to be used. The idea behind it is that, once it is fully responsible for delivery of the 11 social security payments being devolved, the government might need more flexible access to cash to deal with the lumpiness of spending throughout the year. But the Scottish Government has subsequently decided that it is unlikely to ever need to borrow for 'cash management', mainly because it can drawdown as much cash as it needs from HM Treasury (within its annual budget limit of course) with 48 hours notice.

One of the Scottish Government's arguments will be that, rather than asking for 'new' borrowing powers, what it would benefit from is a change in circumstances under which it is allowed to exercise its existing borrowing limits. The government's argument is likely to be that, if the Treasury has previously agreed to a £500m annual limit for cash management, then allowing the Scottish Government to borrow £500m instead for a different purpose – specifically discretionary spending – constitutes only a minor additional flexibility, and should therefore be easier for the Treasury to acquiesce to. This is what Kate Forbes referred to when she said that the Scottish Government has '*the right power for the wrong fiscal risks*' when giving evidence to the Scottish Parliament's Finance Committee[6]. To date, the Scottish Government has drawn down just £200m of its £1.75bn resource borrowing limit.

[6] Scottish Parliament Finance and Constitution Committee, 12 June 2020
http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12695

There is no especially strong reason why the Scottish Government should not have scope to borrow to fund discretionary, temporary increases in resource spending (although the question of how and when such powers should be used is more challenging - assuming it has to be paid back, borrowing cannot increase the government's spending on a permanent basis, but rather can be used to transfer spending across time to periods when it is most needed). The fact that no provision was made in the fiscal framework for discretionary resource borrowing mainly reflects the Scottish Government's priorities at the time the framework was negotiated (the Scottish Government's priority was to secure its preferred mechanism for adjusting the block grant, which it appears to have traded off against limited borrowing powers).

Whilst it is true that the sorts of flexibilities the Scottish Government seeks look on paper to be minor, they could in combination substantially increase the government's spending power in the short term. (As noted, flexibilities are sought in relation to the £500m cash management borrowing limit, the income tax reconciliation for next year is likely to be around £600m, before we get into a discussion about increasing the borrowing limits).

This raises questions about the sustainability (or prudence) of borrowing more in the short term whilst simultaneously putting off borrowing repayments (tax reconciliations) that are about to fall due. The Scottish Government has committed to a target that borrowing repayments will not exceed five per cent of its resource budget per year. The target has been adopted 'to ensure we do not place an undue financial burden on future policy choices' (Scottish Budget 2020/21).

When the 2020/21 budget was published, the government forecast that its repayments would total around 3% of its resource budget this year (largely a result of legacy investments through Public Private Partnerships, and more recent capital investment through traditional borrowing). Viewed in the context of this target, the government does therefore have a reasonable degree of headroom to accommodate additional borrowing (the 2 per cent headroom is equivalent to around an additional £600m in annual borrowing repayments).

The 5 per cent ceiling is of course arbitrary. But the point is that even if the Scottish Government's aspirations for additional borrowing flexibilities are realised, the question of how those flexibilities should be used is more challenging. The benefits of additional spending today will need to be weighed against the costs of reduced spending in future budgets. Given the uncertainties over how long the post Covid economy may remain weak, the issue of the repayment terms for any borrowing will be material to this assessment. But clearly the ability to borrow more will not in itself be a panacea for the government's fiscal challenges.

It remains to be seen what the Treasury view of these arguments will be, although HM Treasury has historically been reluctant to cede control over the UK fiscal aggregates (Scottish Government borrowing counts against the UK's overall fiscal targets). Arguably, the UK Government might be more willing to permit additional borrowing by the Scottish Government now that UK borrowing is already in the hundreds of billion £, as opposed to the days when it was targeting a fiscal surplus (a target which in theory could have been knocked off course by a few hundred million of Scottish borrowing). But it seems unlikely that material new flexibilities will be agreed to without some quid pro quo.

IV The outlook for the Scottish budget in the next parliament

The 2021/22 budget will be the last one set in this parliament. It will set the scene for the launch of the Scottish parties' manifestos for the May 2021 Holyrood elections.

The set of fiscal issues that will need to be grappled with in the 2021/22 budget and by the parties in their subsequent manifestos would have been challenging without Covid but now begins to look rather daunting. At a minimum some of the key issues are likely to include, but will not be limited to:

- The response to concern over pay and conditions among public sector key workers;
- The financial implications of a renewed emphasis on resilience rather than efficiency in health and social care;
- The vision for newly devolved social security payments for the sick and disabled;
- Increasing capacity in the education system to accommodate ongoing social distancing if required (and addressing pre-existing performance challenges in school education which are likely to have been accentuated during the crisis);
- The policy proposals for making progress towards the Scottish Parliament's child poverty targets, including proposals for Scotland-specific top-ups to welfare payments;
- Actions to support the economic recovery in relation to business support, skills and employability;

- Supporting the higher education sector in the face of major disruption to student numbers and revenue streams; and
- The role for local government in contributing to many of these challenges at local level.

There will also be important questions for tax policy, particularly how to balance revenue raising with the need to support the economic recovery. The current environment surely strengthens the argument for reform of property tax – providing scope to increase revenues progressively and without damaging growth prospects. But it might also point to a rethink about current sources of tax revenue – wealth and carbon seem better prospects for tax than tourism or parking spaces at the current time – and the Scottish Government in principal has scope to introduce new taxes under the current constitutional settlement.

Next year's manifestos will have the chance to frame these specific issues (and others) within parties' broader visions for the post-Covid 'new normal' – including the vision for a renewed social contract, new perspectives on the ultimate objective of public policy. Whilst these are to an extent challenges for the future, there is an urgency to begin the debate now.

But substantial uncertainty hangs over a critical question: what level of resource is the Scottish Government likely to have at its disposal to address these challeges?

Despite significant tax devolution, the key factor determining the size of the Scottish budget remains the decisions of the UK Government regarding its overall fiscal stance, and in particular how it decides to prioritise departmental spending. It is this that influences the broad size of the Scottish Government's spending envelope as it determines the Scottish block grant via the Barnett formula (a spending envelope which can be varied through Scottish Government tax choices or other factors that influence the strength of devolved Scottish revenues relative to rUK revenues).

If Covid-19 hadn't come along, we would by about now have had a Spending Review from the UK Government and a Medium Term Financial Strategy from the Scottish Government. Taken together, these would have given the political parties a good indication of the sorts of levels of resources they could shape their manifesto plans around, and the ways in which changes to tax policy might enable them to vary this envelope.

Without these routemaps, there is more uncertainty around the outlook for the Scottish budget and thus the constraints that might face the Scottish Government in 2021/22 and beyond, and what these constraints might imply for various policy trade-offs.

V Beyond 2020/21: the UK fiscal outlook

What can we say about the outlook for the UK Government's fiscal position, the likely direction of its fiscal choices, and the implication for the Scottish budget? What follows is not a prediction, and certainly not a view about what 'should' happen, but an attempt to assess the likely broad direction of travel for fiscal policy, taking into account the economic outlook, prevailing political discourses and the likely standpoint of the incumbent UK government.

The UK Government's fiscal position will depend heavily on the evolution of the health crisis over the next 12 months and beyond. But it would be misleading for anyone to claim they had a clear sense of what is likely to happen in this context. Will there be a second wave of the virus in autumn, a series of localised outbreaks, or will the virus mutate into something more (or less) benign? The outcomes of these highly uncertain questions will in turn influence the extent of the economic restrictions, and by consequence the scale of the economic support measures.

Nonetheless, it goes without saying that UK Government borrowing will increase substantially. In May, the OBR estimated that Public Sector Net Borrowing could be around £300bn in 2020/21 alone (compared to a March forecast of £56bn) as a result of higher spending and lower receipts[7]. Subsequent public finance data has revealed that the UK Government had borrowed over £100bn in April and May alone[8]. Combined with a fall in the size of the economy, this could take borrowing as a percentage of GDP in 2020/21 to 15%. By May Public Sector Net Debt had risen to just over 100% of GDP, the first time that net debt has exceeded the size of the economy since the 1960s.

Looking slightly further ahead, the IFS estimates that borrowing is likely to remain elevated at around 5-6% of GDP for several years due to enduring economic weakness[9]. A second wave of the virus and second lockdown could see borrowing exceed 20% this year and 10% in 2021/22.

There is considerable uncertainty around such scenarios, but the numbers are stark. Just over ten years ago, politicians across a broad political spectrum fretted about debt numbers that looked considerably more benign than this. Debt as a percentage of GDP increased from 34% in

[7] OBR: Coronavirus reference scenario. https://obr.uk/coronavirus-analysis/
[8] OBR: Public Sector Finances, May 2020 https://obr.uk/docs/June-2020-Commentary-on-the-public-sector-finances.pdf
[9] The outlook for the public finances under the long shadow of COVID-19, IFS Briefing Note BN295 https://www.ifs.org.uk/uploads/BN295-The-outlook-for-the-public-finances-under-the-long-shadow-of-COVID-19.pdf

2007/8 to 69% in 2010/11, and a prevailing political narrative emerged that this ratio needed to be brought back down if the UK was to be resilient to future economic shocks – although there was of course plenty of disagreement about the timescales over which consolidation would be required and how it should be balanced between tax increases versus spending cuts.

Currently, the prevailing view – and not just within the UK – is justifiably more relaxed about the possibility that debt and deficits might remain elevated for some time. The change in prevailing perspective is attributable to a variety of factors. Partly it is from necessity – with a likelihood that further fiscal stimulus masures will be announced later this year to support the economy to recover as it emerges from lockdown. It is also because the prophecies of those who argued in 2010 that higher debts would be punished in the markets by higher interest rates on that debt have failed to be realised. The UK Government has not struggled to finance the huge increase in borrowing so far in 2020/21, in fact debt servicing costs have continued to fall, albeit in significant part due to the substantial purchases of government bonds by the Bank of England.

Nonetheless, feeling relaxed about living with a higher level of debt for a prolonged period is not the same as feeling relaxed about the idea that debt continues to grow indefinitely. At some point there will be moves to at least stabilise the debt ratio. This implies the need for fiscal consolidation at some point in future, although there are at least three uncertainties around this. First, there is significant uncertainty about how much fiscal consolidation might be required – this will depend on the size of the longrun hit to the economy, and the relationship between the growth of the economy and the costs of servicing the debt. Second, there is uncertainty around the timing of when consolidation might begin – which will in part depend on perceptions of the risk that interest rates might rise (without a commensurate increase in growth). Third, there is uncertainty about how any consolidation might be achieved across a balance of spending cuts and tax rises (which is relevant to the outlook for the Scottish block grant).

On the third of these points, there is a strong case that, unlike the austerity of the 2010s, the next fiscal consolidation should come much more through tax increases than spending cuts, for several reasons. Practically, it is hard to see where substantial public sector cuts could be made, coming on the back of ten years of austerity. Politically, there will be huge impetus to improve the resilience of the health and social care system to future pandemics and to recognise the value of key workers in the public sector – all of which implies higher spending. And the very unequal impacts of the health crisis and the economic restrictions further helps justify the case for using progressive taxes on income and wealth to fund the economic recovery. Proposals for tax-raising reforms have been widely discussed, ranging from significant reforms to existing taxes (such as extending NICs to those above state pension age to reforming income tax reliefs) to the introduction of more comprehensive taxes on wealth or carbon, or to windfall taxes on the businesses that are seen to have benefited from the lockdown.

A conclusion might be that, whilst the Scottish block grant is unlikely to see real terms spending cuts over the short term, the extent to which departmental budget spending will increase is very uncertain. This reflects in part the economic uncertainties, but also the inherent reticence of the incumbent UK Government to be seen as a tax-raising government.

VI Conclusions

On latest estimates Scottish resource spending in 2020/21 will be 8% higher than was set out in the budget. At the same time, devolved revenues from Non-Domestic Rates, income tax and LBTT will contribute much less than anticipated. The difference is effectively met through higher UK Government borrowing, with the Scottish budget becoming less reliant than anticipated on devolved revenues.

The Scottish budget will continue to evolve throughout 2020/21. As we move from the lockdown stage to the economic recovery phase, fiscal policy will shift from its recent focus on insurance and support to more traditional recessionary stimulus measures. This may involve further consequentials flowing to the Scottish budget in 2020/21. It may also involve some temporary tax cuts at UK level.

There is a good case for the Scottish Government to have greater flexibilities for managing its budget. The case for some of these flexibilities is strongest as a temporary measure (e.g. deferring tax reconciliations). But there may be a case for other flexibilities on a more permanent basis, particularly in relation to enhanced scope for borrowing.

Whilst an increase in budget flexibilities is useful, it is not without risk for the Scottish Government, as there is a danger that increased borrowing and deferment of tax reconciliations this year increases budget risks in future years – potentially when the economy remains relatively weak. Enhanced fiscal flexibilities are not in themselves a panacea to the substantial budgetary challenges over the medium term.

The Covid-19 crisis and its aftermath poses a number of fundamental questions for public policy in the coming years. Key questions might include but are not limited to: How can public policy support a robust, fair and tax-rich recovery? What would a fair settlement for key workers look like? What role is there for devolved social security powers or tax reform in mitigating some of the increased inequality that Covid-19 is likely to generate? How do we enhance the resilience of the health and social care systems against future disease outbreaks?

At the same time there is huge uncertainty around the outlook for the Scottish budget, which is critically dependent on the UK Government's fiscal policy decisions. Over the past few years we have become completely inured to the word uncertainty, even though – in the context of Brexit, hung parliaments and snap elections – it has not been unjustly used. But it goes without saying that the levels of uncertainty that have applied in recent years are relatively benign compared to the extreme uncertainty that we face at the moment.

Uncertainty applies not only to the outlook for the Scottish block grant (which in turn depends on UK Government fiscal policy decisions), but also on the prospects for the Scottish economy – which influences the outlook for revenues from Scottish income tax and other devolved taxes.

This uncertainty provides a very challenging backdrop to the Scottish political parties as they begin to think about their 2021 manifestos.

On the plus side, this uncertainty might allow for a stepping back from meaningless manifesto commitments to spend £x million on portfolio y, and instead to focus on the vision for broader outcomes. Nonetheless, it is clear that the Scottish political parties will need to build in a degree of flexibility to their manifesto plans. Rather than a set of specific and costed policy proposals (although when do we ever get those anyway?), the parties will need to articulate options and how these would be prioritised under different economic and fiscal policy scenarios.

The set of public policy challenges next parliament is immense, and the Scottish budget will need to be used boldly and imaginatively to rise to these challenges.

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