

RESPONSE TO THE SCOTTISH PARLIAMENT FINANCE  
AND PUBLIC ADMINISTRATION COMMITTEE  
SCOTTISH BUDGET 2022/23 AND FISCAL FRAMEWORK

# Summary

The pandemic has significantly altered spending priorities, leading to high levels of public spending to address challenges within the health care system and support the economy. The scale of public expenditure during the pandemic will increase UK public sector debt to its highest peacetime level. This increased level of debt, combined with a probable decrease in tax receipts, will place significant pressure on the UK and Scottish budgets.

There are several risks that the Scottish Budget may need to address; notably, there is still a risk of a fourth wave of the pandemic, which, if it occurs, will lead to further increases in public spending. Other risks include high levels of inflation beyond 2%, impacts from adverse weather conditions due to climate change, falling tax receipts due to businesses failing and rising unemployment as furlough ends.

The pandemic has led to vast backlogs and challenges within the health care system; the backlog in appointments and diagnosis will need particular attention in the short term. However, equal or more attention may have to be given to the social care sector, as this is where the pandemic has exposed some of the greatest weaknesses. This will be a key spending priority for the Scottish Government, but it's unclear what demands this will place on the Scottish Budget in the short-medium term. Another key spending priority will be education to ensure that any lost education resulting from the pandemic is addressed.

Despite the pressures that health and education will place on the Scottish Budget, the Scottish Government should not lose sight of its aspirations to recover by improving growth, achieving net-zero, and establishing economy focused on wellbeing. Key aspects of a wellbeing economy are access to a high standard of employment which offers the minimum of a living wage, skills development, and low inequality. The RSE believes that a spending priority will be to support the economy through investing in early-stage companies (spinouts and start-ups), which are crucial to job creation, and aiming to fulfil the recommendations presented in the Social Renewal and Economic Recovery reports.

Our previous responses noted that the fiscal framework offers significant flexibilities and provisions to support the Scottish Budget. In the lead up to the renegotiation of the fiscal framework, the state of intergovernmental relations has declined. The RSE has previously recommended that intergovernmental relations be improved by creating an Independent Secretariat, which would help enhance the structure, formality and relationships of intergovernmental relations rather than create new mechanisms. A similar proposal has been put forward by the Dunlop Review and the joint review of intergovernmental relations by the UK Government and devolved administrations. The RSE is concerned that new initiatives from the UK Government, including the Shared Prosperity Fund, Levelling Up Fund, and Community Renewal Fund will bypass the devolved administrations. To ensure that such funds are as successful as possible, it will be crucially important that there is coordination and cooperation across the governments of the UK.

## Introduction

- 1 The Royal Society of Edinburgh (RSE), Scotland's National Academy, welcomes the opportunity to respond to the Scottish Parliament Finance and Public Administration Committee inquiry on the Scottish Budget 2022/23. We enjoyed a strong working relationship with the previous Scottish Parliament Finance and Constitution Committee and look forward to working with the newly formed committee for the 2021-26 parliamentary term.
- 2 As Scotland's National Academy, the RSE has consistently provided comment and advice on Scottish public finances and constitutional affairs. Our work includes responses to the former Scottish Parliament Finance and Constitution Committee last year on the impact of the Covid-19 pandemic on the Scottish Budget and the fiscal framework.<sup>1,2</sup> Additionally, the RSE has provided advice and comment on constitutional affairs to the UK Government<sup>3</sup> and committees within the House of Commons<sup>4</sup> and House of Lords;<sup>5</sup> these responses will be of interest to this committee.
- 3 This response was facilitated through an RSE working group, which included members of our Economy and Enterprise Committee<sup>6</sup> and RSE Fellows with expertise in economics, finance, and constitutional affairs. In responding to the inquiry, we have addressed our comments under the following main headings: *The Impact of Covid on the Budget and Future Challenges, Spending Priorities and Revenue Raising, and Fiscal Framework and Intergovernmental Relations.*

## General Comments

- 4 The pandemic has created significant uncertainty, and there is a lack of data around key statistics, making it difficult to respond directly to the questions in the inquiry. At the time of writing, we do not know the timing of the UK Spending Review or the Scottish Budget or the prevailing circumstances at the time of these announcements.

For example, a fourth coronavirus wave would likely keep public spending high, but if cases continue to decline, the Chancellor may have more latitude to contain public spending and hence reduce the rate of growth of borrowing. Furthermore, there is a lack of data around the impact of Covid-19 on tax revenues, business growth, and the labour market. While there is some information on the immediate impact, there is a lack of clarity on key statistics, including the level of business debt and the ability to pay it back, which may affect public finances.

- 5 Before the pandemic, an asymmetric tax system was established as Scotland and Wales had specific arrangements on fiscal policy resulting from different political experiences and spending priorities. This means that an increase in spending within England has different consequences for the devolved administrations via the Barnett Formula. However, during the pandemic, with a public health and economic emergency, spending across England happened quickly to cope with pressures on the system and this spending was not passed on to the devolved administrations via the Barnett Formula. Funds were provided to the devolved administrations via a 'Barnett Guarantee', which ensured that principles of the Barnett Formula were preserved.

## The Impact of Covid on the Budget

### Immediate Impact

- 6 In our previous response,<sup>7</sup> the RSE noted a problem with income tax estimations identified before the pandemic. Income tax revenue forecasts from the Scottish Fiscal Commission<sup>8</sup> were overly optimistic, as revealed in the UK Budget in 2019. However, the Scottish Government decided not to adjust the budget in 2019/20 but to carry forward adjustments to future budgets. Therefore, there remains a potential shortfall of around £500m, which will need to be accounted for in future budgets, and this will be on top of further public finance pressures resulting from the pandemic.

1 Royal Society of Edinburgh, (2020). 'Impact of COVID-19 on Public Finances and the Fiscal Framework'. URL: <https://www.rse.org.uk/advice-papers/impact-of-covid-19-on-public-finances-and-the-fiscal-framework/>

2 Royal Society of Edinburgh, (2020). 'Budget 2021/22: Supporting the COVID-19 Recovery – Scotland's Taxes and Fiscal Framework' URL: <https://www.rse.org.uk/advice-papers/budget-2021-22-supporting-the-covid-19-recovery-scotlands-taxes-and-fiscal-framework/>

3 Royal Society of Edinburgh, (2020). 'UK Internal Market'. URL: <https://www.rse.org.uk/advice-papers/uk-internal-market/>

4 Royal Society of Edinburgh, (2020). 'Scotland and Coronavirus'. URL: <https://www.rse.org.uk/advice-papers/coronavirus-and-scotland/>

5 Royal Society of Edinburgh, (2021). 'Future Governance of the UK'. URL: <https://www.rse.org.uk/advice-papers/future-governance-of-the-uk/>

6 <https://www.rse.org.uk/policy/standing-committees/economy-enterprise/>

7 Royal Society of Edinburgh, (2020). 'Impact of COVID-19 on Public Finances and the Fiscal Framework'. URL: <https://www.rse.org.uk/advice-papers/impact-of-covid-19-on-public-finances-and-the-fiscal-framework/>

8 Scottish Fiscal Commission, (2020). 'Scotland's Economic and Fiscal Forecasts'. URL: [fiscalcommission.scot/forecast/scotlands-economic-and-fiscal-forecasts-february-2020/](https://www.fiscalcommission.scot/forecast/scotlands-economic-and-fiscal-forecasts-february-2020/)

- 7** Over the last year, governments have had to dramatically increase expenditure via borrowing in response to the pandemic. The scale of public expenditure during the pandemic will increase UK public sector debt to its highest peacetime level. This increased level of debt, combined with a probable decrease in tax receipts, will place significant pressure on the UK and Scottish budgets.
- 8** We understand that the Scottish Fiscal Commission is currently completing its forecast of tax revenues, and this may provide a clearer indication of some of the impacts of Covid-19 on the Scottish Budget.

### *Current and Future Risks*

- 9** In the short to medium term, several risks may impact the Scottish budget, and the Scottish Government should plan to meet them.
- 10** Despite the success of the vaccine rollout across the UK, there is still a risk of a fourth wave of the pandemic, which, should it occur, will subsequently increase public spending. If there is a fourth wave, some restrictions are likely to return and continue into 2022. These will reduce the profitability of many businesses, which will be reflected in lower government revenues via income tax and business rates.
- 11** Furthermore, the Bank of England is forecasting that inflation will rise beyond the 2% target in 2021.<sup>9</sup> The Scottish Government will have to consider the effects of rising wages and increased prices caused either by the pandemic and Brexit.
- 12** The impact of climate change means that the UK and Scotland will likely experience more adverse weather conditions in future, which could cause severe disruption. Building our resilience to adverse weather conditions and achieving net zero will take time; therefore, in the meantime, there may be impacts on the budget to respond to and repair damage from adverse weather. The risks of adverse weather conditions may add weight to the argument for having a longer time horizon on budgets rather than the current practice of a single year. The RSE has frequently supported the introduction of multi-year budgets, as the current process restricts longer-term prioritisation of expenditure.
- 13** Throughout the pandemic, significant public resources were used to support the private sector through business support loans and the job retention scheme. The business support loans have led to high levels of debt across the private sector, and as restrictions ease and the pandemic ends, there may be an expectation for this to be repaid sooner rather than later. However, it is uncertain how many businesses will be able to repay loans quickly or at all. Slow payback or writing off loans could impact public finances in two significant ways:
- lack of repayment will lead to the government fronting the cost, although most of this cost will fall on the UK Government;
  - businesses with high debt levels will have reduced growth prospects, consequently impacting tax and business rate revenue. It is unclear on the level of private-sector debt in Scotland, how this differs from the rest of the UK and how it impacts public finances. The RSE believes that more research needs to be undertaken in this area to understand the potential impact on future budgets.
- 14** The job retention scheme has been crucial in supporting businesses and the workforce through the pandemic. It still supports many workers and businesses that cannot operate at full capacity due to ongoing restrictions. With the scheme expected to end in September, there is a risk that those still furloughed could lose their jobs. This would result in a rise in unemployment, increasing the need for higher public spending and reducing tax revenues. However, there are reported labour shortages in some sectors, including transport and logistics, hospitality, manufacturing and construction. There is a challenge for the Scottish Government to manage labour shortages and unemployment, particularly where skills (and expectations) are not matched with the available jobs. The Scottish Government working with businesses and training providers, should provide more reskilling and upskilling opportunities to support people to smoothly transition from a declining sector to a growing one.

<sup>9</sup> <https://www.theguardian.com/business/2021/jun/30/bank-of-englands-andy-haldane-warns-of-inflation-rises>

## Spending Priorities and Revenue Raising

### *Current Circumstances and Challenges*

- 15** Since the beginning of the pandemic, government spending priorities have been focused on supporting the health service and economy. While it is uncertain if there will be a fourth wave of the pandemic, health will likely be the biggest spending priority in the immediate future. At the same time, spending in the economy will be repurposed to focus on recovery.
- 16** The pandemic has created several backlogs in areas of the public sector which will need to be addressed and present a challenge to the 2022/23 Scottish budget. Notably, there are significant backlogs and challenges in health and social care across the UK and Scotland. The backlog in appointments and diagnosis will need particular attention in the short term. However, equal or more attention may have to be given to the social care sector, as this is where the pandemic has exposed the greatest weaknesses. The Scottish Government has made clear its intention to integrate social care into the health system through establishing a National Care Service and has recently launched a consultation on this. However, it is currently unclear how much this will demand from the Scottish Budget in the short-medium term. The underlying issue within the care sector is resourcing and attracting suitably skilled people to meet the steadily growing demand for care, which will require additional resources, potentially in the order of billions, direct from the Scottish Government, from fees paid directly by users, or through insurance. Within its pre-budget scrutiny, the Committee should examine the potential costs of social care to the Scottish Budget in the short term and medium-long term.
- 17** The pandemic has significantly impacted the education sector, with learners missing out on lessons and face-to-face contact with teachers and peers. Alternative assessment models have to be implemented to assess learners' performance. There is a risk that learners may not have acquired the knowledge and skills they would otherwise

have gained pre-pandemic. There will be an urgent need to ensure that every learner has the opportunity to access the education they need. This may mean significantly higher spending on education and training than would otherwise be the case. Through its Education Committee,<sup>10</sup> the RSE will continue to engage on the Scottish Government's education recovery plans, including reform of Education Scotland and SQA, and implementation of the OECD's recommendations on Curriculum for Excellence.

### *Future Spending Priorities and Objectives*

- 18** Considering the above comments, the RSE would assume that there are significant constraints placed on future Scottish budgets due to the impact of the pandemic; and this will restrict the ability of the Scottish Government to manoeuvre to support areas the economy which are critical to growth and wellbeing.
- 19** Despite the pressures that health and education will place on the Scottish Budget, the Scottish Government should not lose sight of its aspirations to recover by improving growth and establishing an economy focused on wellbeing. The OECD defines a wellbeing economy as the *'capacity to create a virtuous circle in which citizens' well-being drives economic prosperity, stability and resilience, and vice-versa, that those good macroeconomic outcomes allow to sustain well-being investments over time.'* There is a need for greater research around what a wellbeing economy in Scotland would look like and the key factors to wellbeing.
- 20** The RSE believes that a key aspect of a wellbeing economy is high employment levels in jobs that offer a living wage or higher coupled with opportunities for personal and skills development. Research has shown that early-stage companies (start-ups and spinouts) are more likely to create new jobs than larger, well-established companies. On average, young firms account for about 20% of employment across OECD countries but create almost half of the new jobs.<sup>11</sup> Therefore, given the importance of job creation to recovery and wellbeing, a spending priority could be to invest in innovation and commercialisation.

<sup>10</sup> <https://www.rse.org.uk/policy/standing-committees/education-committee/>

<sup>11</sup> OECD, (2020). 'DynEmp: Measuring job creation by start-ups and young firms'. URL: <https://www.oecd.org/industry/dynemp.htm>

- 21** We note that the Scottish Government has changed its approach to funding enterprise via the development of the Scottish National Investment Bank (the Bank). Given that the Bank will focus on providing large funds to businesses and projects, and the enterprise agencies will provide smaller-scale funding, there is a risk of a funding gap within the investment ecosystem between larger and smaller-scale funding that may need to be addressed. The RSE supported the development of the Bank, emphasising that there must be a coherent approach set out in a strategy to support the entire enterprise and innovation ecosystem. The strategy should seek to address any funding gaps in the market from the enterprise agencies to the Bank.
- 22** Within a coherent strategy, the Bank will have a strong role in economic recovery by focusing on high-level and large-scale investments based on the mission-oriented approach. Focusing on the big challenges such as net-zero, demographics and public health can help crowd investment in these areas and create a supply chain of new companies in Scotland.
- 23** The impact of the pandemic will have been felt differently across the regions of Scotland; for instance, those areas with a higher number of businesses involved in or connected to hospitality and tourism may have been disproportionately impacted compared to other regions. City regions will also be impacted differently, with Glasgow's economy shrinking more than Edinburgh's.<sup>12</sup> Therefore, tailored spending may need to be targeted in different areas across different regions. However, a lack of data on regional economies across Scotland may mean there is a lack of understanding of regional markets and where investment should be targeted. The RSE believes there is a need for a coherent regional policy across Scotland and the UK, which targets investment, and we expand on this in paragraph 32.
- 24** The pandemic has highlighted and exacerbated inequalities within our society. Reports from advisory groups for the Scottish Government, including the Social Renewal Advisory Board and the Advisory Group for Economic Recovery, recommended that the Scottish Government

prioritise policies to reduce inequality. These reports have 20 and 25 recommendations, respectively, ranging from introducing Universal Basic Income to developing a Scottish jobs guarantee. It is assumed that these reports will influence the spending priorities of the Scottish Government. However, given that there are limited resources, a review of the allocation of spending and redistribution of resources may be necessary to fulfil the recommendations of these reports.

- 25** The RSE fully recognises the difficult decisions the Scottish Government will need to make to address competing demands on limited resources. As we have set out above, health and education will require significant resources to address healthcare backlogs and ensure learners can access the education they need. This severely limits the Scottish Government's ability to manoeuvre and spend significant resources in other policy areas. If policies are to achieve public support, the Scottish Government needs to be transparent about how and why they are deciding spending priorities.

### *Taxation and Revenue Raising*

- 26** Due to the pressures on the Scottish and UK finances and the need for additional spending to fuel the recovery, governments may need to consider tax rises or new taxes. It has been reported that the UK Government may be considering a rise in National Insurance, and the Scottish Government will need to consider how it reacts to this. If, as suggested, it is used to increase spending on care for the elderly, the Barnett consequential would deliver extra funding to Scotland.
- 27** Taxation will have a major impact on addressing the major challenges we face, such as climate change, demands on public health and the need to address structural inequalities. Governments may seek to raise taxes to raise revenue and use them to influence behaviour. The Scottish Government may need to choose how best to raise revenue whilst addressing key challenges, and certain taxes may be increased or new taxes introduced.

<sup>12</sup> Demos-PWC, (2021). 'Good Growth for Cities.' URL: <https://www.pwc.co.uk/industries/government-public-sector/good-growth.html>

**28** The RSE understands that the Scottish Government will soon publish its draft Framework for Tax. The framework will seek to embed a more strategic approach to tax policy and how the devolved powers over taxation can help address Scotland's challenges. The framework should present how the Scottish Government could develop new taxes to address economic, social, and environmental challenges.

## Procedural Arrangements

- 29** The fiscal framework is due to be reviewed and renegotiated by the end of 2022. Our previous responses noted that the fiscal framework offers significant flexibilities and provisions to support the Scottish Budget. As a result, the current year's Scottish Budget will be unaffected by any possible reductions in income tax revenue due to the pandemic. For future years, the Scottish Budget is protected from falls in income from tax revenue if these are the same per head across the UK. Thus, any falls in revenue from income tax due to the pandemic will only impact the Scottish Budget if they are more severe per head in Scotland than in England. It is unclear if there will be a disproportionate impact on taxes in Scotland which will be felt in future Scottish Budgets.
- 30** The RSE has raised concern around the intention of the UK Government to finance projects via new spending initiatives such as the Shared Prosperity Fund, Levelling Up Fund, and the Community Renewal Fund. These initiatives will bypass the devolved parliaments and governments and mean a direct transfer of money from the UK Government to local authorities and other agencies. For instance, the UK Community Renewal Fund deals directly with local authorities, in which they are expected to compete for a £220m fund. Many local governments have little capacity and expertise to apply for and distribute funds of this scale. In a response to the former Finance and Constitution Committee, we noted that the level of compliance associated with the administration of EU Structural Funds was an issue for local governments.<sup>13</sup> Therefore, it will be important to ensure that new funds from the UK Government take into account capacity limitations within local government and, as such, the bureaucracy associated with the new funds should be kept to a minimum.

The RSE would recommend that new funding initiatives of the UK Government are distributed in cooperation with the Scottish Government and its development agencies, and where possible local authorities. If not, there is a risk that funds will not be as successful as hoped, and there will be a lack of coherence as spending may become complex and duplicated.

- 31** The City Region Deals were a reaction to changing political circumstances but have injected large amounts of money into local communities. In some cases, this has led to local schemes being developed with a lack of coherence and poor management, as found by the Scottish Parliament Local Government and Communities Committee<sup>14</sup> and Audit Scotland.<sup>15</sup> However, the local authorities have established their roles in City Region Deals, and progress has, so far, improved. Progress has been achieved through capacity building to improve spatial and regional development. In developing new initiatives like those listed above, the UK Government should learn from the City Region Deals and work with the Scottish Government and local authorities to ensure they are developed with coherence and are properly managed. If not, there is a chance that these will face the same challenges that the City Region Deals did when they were first established in Scotland.
- 32** Across the UK and Scotland, a proliferation of new initiatives and bodies involved in economic and social development will further complicate the environment. As mentioned in paragraph 23, there is a pressing need for a coherent regional policy for Scotland and the UK, which presents an understanding of regional economic, social and spatial development. New initiatives need to build on the experience of EU Structural Funds in their design, implementation and evaluation. The UK and Scottish Governments should develop a coherent strategy for regional and spatial development in Scotland.
- 33** There are examples of the UK and Scottish Governments working well together to deliver large projects, usually where the capacity of the local authority and economic agency cannot deliver on their own. Successful cooperation will lead to increased efficiency and better outcomes.

<sup>13</sup> Royal Society of Edinburgh, (2019). 'Structural Funds post-Brexit'. URL: <https://www.rse.org.uk/advice-papers/rse-response-on-the-funding-of-eu-structural-fund-priorities-in-scotland-post-brexit/>

<sup>14</sup> The Local Government and Communities Committee, (2018). 'City Regions - Deal or No Deal?' URL: <https://sp-bpr-en-prod-cdnep.azureedge.net/published/LGC/2018/1/8/City-Regions--Deal-or-No-Deal-/LGCS052018R1.pdf>

<sup>15</sup> <https://www.audit-scotland.gov.uk/news/city-deals-lack-measures-of-success>

## *Intergovernmental Relations*

- 34** As we have said in previous responses linked above, the current intergovernmental experience within the UK may be detrimental to the union itself. As the devolution settlements have evolved and changed, UK Government departments' imperfect knowledge of the role of devolved governments has affected intergovernmental relations. At the same time, political divergences have also contributed to growing mistrust. There is widespread and longstanding recognition that the system of intergovernmental relations is not fit for purpose, especially in light of the implications of Brexit for devolution and the UK's territorial constitution. Furthermore, while provisions may have been needed to secure trade across the UK, parts of the Internal Market Act are likely to further damage intergovernmental relations.
- 35** The RSE has previously recommended that intergovernmental relations be improved by creating an Independent Secretariat, which would help enhance the structure and formality of intergovernmental relations rather than create new mechanisms. As it is independent, the body would arrange regular meetings of the Joint Ministerial Committees, draft and publish minutes, handle disputes and conduct research. The body should have ring-fenced funding, which would be provided proportionally from each government.
- 36** The recently published Dunlop Review into UK Government Union Capability<sup>16</sup> presented several recommendations on improving intergovernmental relations, including:
- A new Great Office of State in the UK Government Cabinet.
  - A new structure supporting the separate offices of the Secretaries of State for Scotland, Wales and Northern Ireland with a single Permanent Secretary.
  - A new fund for UK-wide projects, including joint projects with devolved governments.
  - A new UK Intergovernmental Council (replacing the Joint Ministerial Committee), supported by an independent secretariat and a new, clear dispute handling process.
- 37** Additionally, the UK Government and the devolved administrations are jointly reviewing intergovernmental relations.<sup>17</sup> The review is continuing, and proposals include:
- Revised principles
  - Replacing the Joint Ministerial Committee with a three-tiered structure incorporating:
    - i. portfolio engagement at official and ministerial level
    - ii. engagement on cross-cutting issues, including an Inter-ministerial Standing Committee and a Financial Inter-ministerial Standing Committee; and
    - iii. a plenary-style intergovernmental council
  - A standing secretariat, operating independently of the administrations
  - Revised procedures for dispute avoidance and resolution
- 38** These reviews and reports are welcomed, and some of their findings and recommendations align with the RSE's earlier representations. There is a weakness with the UK's intergovernmental system, amplified with Brexit. Therefore, improvements to the system are welcome, but they must only be implemented when all four national authorities of the UK agree on them.

<sup>16</sup> Dunlop, A. 2021. 'The Dunlop Review Into UK Government Union Capability'. URL: <https://www.gov.uk/government/publications/the-dunlop-review-into-uk-government-union-capability>

<sup>17</sup> <https://www.gov.uk/government/publications/progress-update-on-the-review-of-intergovernmental-relations>

### *Additional Information*

Any enquiries about this advice paper should be addressed to Paul Stuart, Policy Advice Officer (pstuart@therse.org.uk).

Responses are published on the RSE website (<https://www.rse.org.uk/>)

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