



The Scottish Parliament
Pàrlamaid na h-Alba

Finance and Constitution Committee

Rt Hon Steve Barclay MP, Chief
Secretary to the Treasury;
By email

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24 June 2020

Dear Chief Secretary to the Treasury,

The impact of COVID-19 on the public finances and the Fiscal Framework

The Finance and Constitution Committee has recently carried out a short inquiry on the impact of COVID-19 on the public finances and the Fiscal Framework. The Committee agreed to write to both the Cabinet Secretary for Finance and to you setting out some of our findings. It is hoped that this will be useful in informing your ongoing discussions with the Scottish Government and the other devolved governments.

The Committee welcomes the comments we heard from the Cabinet Secretary regarding the constructive conversations which the Scottish Government is having with HM Treasury and the other devolved administrations regarding the need for additional flexibilities and powers to manage the volatility and uncertainty arising from COVID-19. In particular, her comments that there is a general appetite to look at what the flexibilities and powers might be because of the scale of the volatility and uncertainty.

Summer Budget Revision (SBR)

The Scottish Government's SBR amends the Budget (Scotland) Act 2020 and provides transparency in relation to the exceptional level of additional resource flowing to the Scottish budget in response to the COVID-19.

The Committee notes that the Scottish Government is allocating over £4 billion to its COVID-19 response. Almost £1 billion of this (£972 million) is not direct spending, but is income foregone through not increasing non-domestic rates as intended and by offering reliefs to certain sectors. This is funded through the £3,581 million in estimated Barnett consequentials, £255.2 million from the re-prioritisation of existing Scottish Government expenditure, and £178 million of additional central funding allocated. The £178 million is £112 million of unallocated non-COVID related

consequentials from the UK Budget in March, and £66 million from central funds (Scotland Reserve).

The Committee welcomes that the Scottish Budget has been significantly increased as a consequence of Barnett consequentials resulting from a huge increase in public expenditure, much of this funded through increased borrowing at a UK level, in response to COVID-19. The Committee also welcomes the benefits to the Scottish economy from the substantial financial support from the UK Government directly, primarily through the furlough scheme as well as the additional support committed by the Scottish Government.

The Committee notes, however, that £500m of the £3.5 billion in Barnett consequentials shown in the SBR is not expected to be added to the Block Grant until the UK supplementary estimates are published at the beginning of next year. However, SPICe point out that HM Treasury is exploring with UK departments the capacity for them to meet additional COVID-19 related costs from within existing budgets. If this happens, as you are aware the consequentials flowing to the Scottish budget may turn out to be lower than the current estimates indicate.

The Committee also notes that some of the Barnett consequentials that have been allocated in the SBR have been revised downwards. Specifically, £60 million for additional business support measures and £10 million for charities funding have now been removed from the consequentials. At the same time, SPICe point out that since the SBR was published a further £139m of consequentials have been added to the Scottish Budget.

The Committee recognises that the figures in the SBR represent a snapshot of a highly fluid and evolving fiscal response and that further substantial changes are likely at the Autumn and Spring Budget Revisions.

The Committee recognises the significant challenges which the Scottish Government faces in delivering a balanced budget in extraordinary circumstances. The unprecedented levels of uncertainty and volatility inevitably means that the existing fiscal rules including the operation of the Barnett formula are under considerable strain. The Committee notes that the Cabinet Secretary has written to you requesting that on-going notifications of consequentials will be robust and reliable enough to act upon.

The Committee's view is that consideration should be given to examining whether the existing fiscal rules could be relaxed on a temporary basis in order to allow the devolved governments to deal with unprecedented levels of uncertainty and volatility. The Committee notes, for example, that the OECD has suggested relaxing or suspending the requirement for sub-national governments to balance their budgets as a result of the current crisis.

At the same time the Committee also emphasises that the Scottish Government needs to make full use of its existing powers in responding effectively to the pandemic.

Capital to Resource Switches

Under HM Treasury's fiscal rules the Scottish Government is able to switch funding from its resource budget to its capital budget but it is unable to switch funding from capital to resource. The Committee recognises that given the impact of COVID-19 on construction work a lot of the capital budget this year will not be spent.

The Committee's view is that it may make sense, therefore, to consider whether some of the Scottish Government's capital budget could be used to alleviate the pressures on the revenue budget and we encourage HM Treasury to consider the requests from the Scottish Government and the Welsh Government to have greater flexibility on capital to resource switches.

Reconciliations

The Committee has previously noted our concern that the Scottish Government is likely to need to find around £1 billion across the current and the next two financial years as a consequence of reconciliations in relation to Scottish income tax. This includes £207m in the current financial year which the Scottish Government is addressing through its borrowing powers and a forecast reconciliation of £555m which needs to be repaid in 2021-22.

The Committee recognises that there are now further additional risks to the Scottish Budget arising from the need for additional reconciliations arising from COVID-19. First, there is an immediate risk arising from the shortfall in revenues from the fully devolved taxes which are collected by Revenue Scotland. Second, the longer term risk from a negative reconciliation resulting from COVID-19 having a disproportionate impact on income tax receipts in Scotland relative to England.

Given the impact of COVID-19 on the housing market there will be an immediate impact on LBTT receipts which will be much lower than the SFC forecasts. While this shortfall is likely to be at least partially offset by an adjustment to the block grant due to lower stamp duty receipts in England this won't happen until the in-year reconciliation at the time of the next UK Budget. Some of our witnesses suggested that the borrowing powers within the Fiscal Framework could be temporarily increased to address the shortfall in LBTT receipts.

The extent of a differential impact of the pandemic on the Scottish economy on income tax receipts will not be fully clear until outturn data for 2020-21 are available in July 2022. Any reconciliation will then need to be addressed in the Scottish Budget 2023-24.

The Committee notes that the Cabinet Secretary has asked HM Treasury to consider the potential to unwind any negative consequentials and tax and social security reconciliations over a longer time period. The Committee would welcome, while recognising discussions are ongoing, your views on whether this proposal is being actively considered by HM Treasury.

Borrowing

The level of borrowing powers within the Fiscal Framework is an issue which the Committee has considered previously. In our report on Budget 2020-21 the Committee noted the Scottish Government's view in a letter to HM Treasury that that "the level of volatility in the operation of the Fiscal Framework is far greater than was anticipated" and that "it is clear that the Scottish Government's borrowing and reserve powers are insufficient to manage" that volatility. The Committee recommended that HM Treasury should carefully examine the issues raised in this report in considering the Scottish Government's request for additional resource borrowing and reserve powers.

One of the main themes which emerged from the evidence we received is whether the borrowing powers within the Fiscal Framework are adequate in responding to a crisis such as COVID-19. Primarily, the discussion focused around whether a short-term adjustment to these powers would be appropriate to assist the Scottish Government's response to the crisis. One of our witnesses suggested that consideration should be given to temporarily relaxing the fiscal rules to allow the Scottish, Welsh and Northern Irish Governments to borrow not only in relation to forecast errors but to fund short-term spending measures.

At the same time our witnesses recognised that both the Scottish economy and the Scottish Budget have significantly benefited from the unprecedented levels of government borrowing by the UK Government. This led one of our witnesses to conclude that leaping to the idea of additional borrowing powers for the Scottish Government as the answer is premature.

A number of reasons were discussed in our evidence as to why temporary changes to the Scottish Government's borrowing powers may be appropriate as follows –

- The rules on borrowing were not designed for the current situation including the need to develop, cost and announce new measures very rapidly and the potential for each of the four nations of the UK to be affected by coronavirus in very different ways;
- The Fiscal Framework is behaving as it was intended to do, though there are some respects in which the Scottish government might seek to negotiate temporary alleviations from HM Treasury;
- The rules preclude borrowing to fund new policy measures in response to the health pandemic which means the devolved governments are very reliant on Barnett consequentials arising from the UK Government policy response;
- Giving the devolved governments greater access to borrowing via the National Loans Fund, at least temporarily and for coronavirus related measures would allow devolved governments to develop, cost and announce plans more quickly than if they have to wait until UK government plans for England have been announced before a tailored support for Scotland can be developed;
- To address an immediate shortfall in receipts from Land and Buildings Transaction Tax which is collected by Revenue Scotland and which will be much lower than the SFC forecasts due to the crisis;

- To address a differential public finance impact in Scotland compared to rest of the UK arising a different policy response in Scotland or a differential impact of the pandemic on the Scottish economy or a combination of both;
- The existing provisions within the Fiscal Framework to address a Scotland-specific economic shock¹ may not be sufficient within a crisis such as COVID-19.

The Committee recommends that consideration is given to each of these reasons by the Scottish Government and HM Treasury in discussing whether the borrowing powers within the Fiscal Framework are adequate in responding to a crisis such as COVID-19.

At the same time the Committee recognises that the discussion about additional borrowing powers for the Scottish Government needs to take account of the impact in Scotland of substantial government borrowing at a UK level.

Scotland Reserve

The Scottish Government is able to hold reserves of up to £700 million in total, and draw down up to £250 million a year for day-to-day spending, plus up to £100 million for capital spending. The Scottish Government is planning to make use of £66 million of reserves as set out in the SBR which leaves a balance of £165 million in the reserve.

The Committee notes that the Cabinet Secretary has asked you for greater flexibility on reserve carry-over. In doing so we also recognise that the Scottish and UK Governments have previously agreed some additional flexibility in the operation of the Scotland Reserve including –

- Barnett consequentials of £148 million were received late in 2018/19. The Scottish Government agreed with HM Treasury that these would be held within UK reserves and re-allocated to the Scottish Government in 2019/20, rather than pass through the Scotland Reserve for 2018/19;
- In 2019/20, HM Treasury agreed to allow the Scottish Government to drawdown a total of £181 million in capital and financial transactions, well above the £100 million capital drawdown limit set out in the Fiscal Framework. This was to address negative Barnett consequentials of £128 million that arose from a UK budget capital spending decision.

The Committee would welcome, while again recognising discussions are ongoing, your views on whether this proposal is being actively considered by HM Treasury.

¹ Is triggered when onshore Scottish GDP is below 1% in absolute terms on a rolling 4 quarter basis, and 1 percentage point below UK GDP growth over the same period. The shock may be triggered from outturn data or forecasts.

Inter-Governmental Working

Some of our witnesses also emphasised the importance of the Scottish Government working closely with the UK Government in tackling economic recovery following the crisis. The Committee heard that the Scottish Government should seek to influence the UK approach to business support and economic recovery. The priority should be to deliver a co-ordinated response through agencies such as Scottish Enterprise and the new Scottish national investment bank, along with the UK Government's approach.

We heard that economic development is a function of both the UK Government and the devolved governments and that the tools that each level of government has to influence the economy needs to be coordinated. Examples are the UK Government's furlough scheme and how it is phased out, and the UK Government's business loans and how they are phased out, guaranteed or repaid. At the same time the Committee recognises that the Scottish Government has limited macro-economic powers.

The Committee sought to explore with our witnesses how a more co-ordinated approach could be delivered including whether more formal structures may be required. One of our witnesses acknowledged that the existing formal structures which are the joint ministerial committees have a chequered history. However, more importantly and given the scale of the crisis there is an expectation that the respective governments of the four nations need to put their political differences to one side and work together in managing the economic recovery across the UK.

The Committee was encouraged to hear the comments from the Cabinet Secretary that she is having constructive conversations with HM Treasury and the other devolved administrations as part of the Finance Ministers quadrilateral.

The Committee would welcome your views as to whether the existing inter-governmental machinery is sufficient to deliver a co-ordinated approach across the four nations of the UK in tackling economic recovery following the crisis.

Fiscal Framework Review

The Committee considered the work of the Fiscal Framework Working Group at our meeting on 18 March 2020. The remit of the group was to report to this Committee, the Social Security Committee and Scottish Ministers on issues relating to the operation of the Fiscal Framework which should help to inform the scope and terms of reference of the body tasked with delivering the independent report.

While the Committee welcomes the work of the Group it has been overtaken by events given that it predates the impact of COVID-19. The Committee would therefore welcome your views on the following –

- 1) Whether there is still an expectation that an independent body will be established in 2021 to review the operation of the framework?**
- 2) To what extent the experience of addressing COVID-19 will now be part of that review?**

3) Whether there needs to be a more urgent review of the framework to consider temporary adjustments to deal with COVID-19?

Conclusion

The Committee recognises that constructive discussions have been taking place between the governments of the devolved nations and the UK Government regarding the need for additional flexibilities and powers to manage the volatility and uncertainty arising from COVID-19. However, the lockdown restrictions have now been in place for 3 months and are likely to continue in some form for much longer. There is, therefore, a pressing need to agree what additional flexibilities and powers are needed so that each of the devolved governments can more effectively manage their respective budgetary response to COVID-19.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Bruce Crawford".

Bruce Crawford MSP, Convener