



The Scottish Parliament
Pàrlamaid na h-Alba

Published 21 February 2020

SP Paper 683
1st Report, 2020
(Session 5)

Finance and Constitution Committee Comataidh Ionmhais is Bun-reachd

Report on Scottish Government Budget 2020-21



Published in Scotland by the Scottish Parliamentary Corporate Body.

All documents are available on the Scottish
Parliament website at:
[http://www.parliament.scot/abouttheparliament/
91279.aspx](http://www.parliament.scot/abouttheparliament/91279.aspx)

For information on the Scottish Parliament contact
Public Information on:
Telephone: 0131 348 5000
Textphone: 0800 092 7100
Email: sp.info@parliament.scot

Contents

INTRODUCTION	1
STRATEGIC CONTEXT FOR BUDGET 2019-20	1
Economic Outlook	4
Wellbeing Budget	7
SCOTTISH INCOME TAX	9
Income Tax Revenue Forecasts	10
Net Tax Position	11
Earnings Growth	13
Employment Rates	15
Distributional Issues	16
Demographic Change	18
Behavioural Responses	19
Forecast Error	20
SOCIAL SECURITY	22
Block Grant Adjustments	23
Forecast Error	26
MANAGING BUDGET VOLATILITY	28
Resource Borrowing	28
Scotland Reserve	29
Managing Reconciliations	30
EU FUNDING	34
EU Structural Funds	35
CAP	36
Erasmus+ and Horizon 2020	37
SCOTTISH PARLIAMENTARY CORPORATE BODY	38
Office Holders	39
Brexit	40
CONCLUSION	40

Finance and Constitution Committee

To consider and report on the following (and any additional matter added under Rule 6.1.5A)—

- (a) any report or other document laid before the Parliament by members of the Scottish Government containing proposals for, or budgets of, public revenue or expenditure or proposals for the making of a Scottish rate resolution, taking into account any report or recommendations concerning such documents made to them by any other committee with power to consider such documents or any part of them;
- (b) any report made by a committee setting out proposals concerning public revenue or expenditure;
- (c) Budget Bills; and
- (d) any other matter relating to or affecting the revenue or expenditure of the Scottish Administration or other monies payable into or expenditure payable out of the Scottish Consolidated Fund.
- (e) constitutional matters falling within the responsibility of the Cabinet Secretary for Government Business and Constitutional Relations.



<http://www.parliament.scot/parliamentarybusiness/CurrentCommittees/Finance-Constitution-Committee.aspx>



finance.constitution@parliament.scot



0131 348 5215

Committee Membership



Convener
Bruce Crawford
Scottish National Party



Deputy Convener
Adam Tomkins
Scottish Conservative
and Unionist Party



Tom Arthur
Scottish National Party



Neil Bibby
Scottish Labour



Alexander Burnett
Scottish Conservative
and Unionist Party



Angela Constance
Scottish National Party



Murdo Fraser
Scottish Conservative
and Unionist Party



Patrick Harvie
Scottish Green Party



Gordon MacDonald
Scottish National Party



John Mason
Scottish National Party



Alex Rowley
Scottish Labour

INTRODUCTION

1. The Scottish Government published its Budget for 2020-21 on 6 February 2020¹. This report sets out the views of the Finance and Constitution Committee (“the Committee”) on Budget 2020-21.
2. This is the second year of the Parliament’s new budget scrutiny process following the recommendations of the Budget Process Review Group² (BPRG).
3. An integral element of the new process is that the subject committees now undertake a year-round approach to Budget scrutiny which should be more effective in influencing the Scottish Government’s spending decisions. This approach helps committees to develop a cumulative understanding of spending decisions within their respective portfolios and the impact of these decisions on outcomes.
4. A key feature of this new approach is the publication of pre-budget reports at least 6 weeks prior to the publication of the Budget. Chapter 4 of the Scottish Government’s Budget document sets out how this pre-budget scrutiny by the Parliament’s committees has influenced the formulation of the Scottish Budget. Each committee also received a more detailed response from their respective Ministers to pre-budget reports.
5. The Committee’s own pre-budget report was published on 12 November 2019 and we received a response from the Minister for Trade, Investment and Innovation. The Committee also received a response from the Scottish Fiscal Commission (SFC).³ The Committee was supported in our scrutiny of the Budget by our Adviser on the Fiscal Framework⁴, Dr David Eiser and by the Financial Scrutiny Unit (FSU) in the Scottish Parliament’s Information Centre (SPICe)⁵.

STRATEGIC CONTEXT FOR BUDGET 2020-21

6. This year’s budget process is unprecedented. This is because there was no UK fiscal event in the Autumn and, therefore, there were no corresponding economic and fiscal forecasts from the Office for Budget

¹ <https://www.gov.scot/publications/scottish-budget-2020-21/>

² https://www.parliament.scot/S5_Finance/Reports/BPRG_-_Final_Report_30.06.17.pdf

³ https://www.parliament.scot/S5_Finance/General%20Documents/Letter_from_Dame_Susan_Rice_to_the_FCC_in_response_to_2020-21.pdf

⁴ https://www.parliament.scot/S5_Finance/General%20Documents/Fiscal_Framework_briefing.pdf

⁵ <https://sp-bpr-en-prod-cdnep.azureedge.net/published/2020/2/10/Scottish-Budget-2020-21/SB%2020-12.pdf>

and Responsibility (OBR). Consequently, there are a number of risks which the Scottish Government have had to address when deciding their budget proposals as follows –

- Uncertainty regarding the size of the Block Grant;
 - Provisional Block Grant Adjustments;
 - Uncertainty regarding the impact of UK Policy Changes.
7. The lack of an Autumn UK Budget means there is less certainty than normal regarding the size of the Block Grant. HM Treasury have agreed that the Block Grant includes Barnett consequential of around £1.2 billion⁶ from the UK Government spending round settlement in September 2019.
 8. The Scottish Government has also included a further £468m of anticipated Barnett consequential in its spending limits for 2020/21 “that could be forthcoming” in the UK Budget in March. The £468m is “derived from the costings document in the Conservative Party 2019 election manifesto.” The Scottish Government explain that the “purpose of including this estimate is to limit as far as possible the potential variance between the Budget Bill” and the “the subsequent outcomes from the UK Budget on 11 March 2020.”⁷ The SFC’s view is that this is a “reasonable” approach.⁸
 9. As required by the Fiscal Framework, HM Treasury have provided the Scottish Government with provisional Block Grant Adjustments (BGAs). The provisional BGAs for income tax have been calculated using forecasts published by the OBR in its *Welsh taxes outlook* in December 2019.⁹
 10. These forecasts are based on economic determinants from the OBR’s March 2019 forecasts and have only been revised to reflect updated outturn data including monthly PAYE data during 2019-20. The OBR did not publish restated forecasts of welfare expenditure alongside the Welsh Budget, and its forecasts from the 2019 UK Spring Statement will therefore be used to inform the provisional BGAs for the devolved Social Security benefits.
 11. The Fraser of Allander Institute’s (FAI) view is that in the absence of UKG policy change, the change to the BGAs for income tax could actually be relatively small, “as there has not been fundamental change to economic conditions and no major surprises on tax receipts.”¹⁰ Likewise, the risk of

⁶

https://www.parliament.scot/FinancialScrutiny/20190905_AdditionalFundingSince2015SR.xlsx

⁷ <https://www.gov.scot/publications/scottish-budget-2020-21/> page 245

⁸ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 11

⁹ <https://obr.uk/topics/scotland-wales-and-northern-ireland/welsh-tax-forecasts/>

¹⁰ <https://fraserofallander.org/scottish-economy/budget/the-timing-of-the-scottish-budget-2020-21-implications-uncertainties-and-risks/>

material changes between the provisional and final BGAs for social security in the absence of policy change is also fairly small according to the FAI.

12. HM Treasury have agreed that it is content for the Scottish Government to use the updated BGAs provided alongside the UK Budget on 11 March. This means that should the updated BGAs be lower than the provisional BGAs, using the former would ensure that the Scottish Budget benefited in 2020-21. The former Cabinet Secretary indicated that if the BGAs are lower, the Government will manage the changes via an in-year budget revision for 2020-21. Regardless of whether the 2020/21 Budget is informed by the 'provisional' or 'updated' BGAs, the Government will need to manage any risk arising from the outturn BGAs being higher than the provisional BGAs through the normal reconciliation process. In relation to income tax this means addressing the risk in the 2023-24 Budget.
13. The final risk which is potentially more significant is UK policy change. While there is little immediate downside risk to the Budget, as explained in the two previous paragraphs, there may nevertheless be immediate policy risks and longer term fiscal risks if the Chancellor makes significant changes to either income tax or Stamp Duty.
14. **The Committee notes that there is some risk arising from the Scottish Budget being agreed before the UK Budget especially regarding the possibility of tax policy changes in devolved areas. The Committee notes the view that there is little downside risk on expenditure.**
15. **A further risk this year is the limited time available for scrutiny of the Budget. The key theme of this report is the increasing volatility and complexity of the Budget and the need to look beyond a one-year horizon period. Key elements of the Budget which this report seeks to address are the risks and opportunities arising from –**
 - Continued economic uncertainty and subdued GDP growth arising from Brexit, the global economic downturn and low productivity growth;
 - The transfer of full financial responsibility of all devolved social security benefits in April 2020;
 - The management of increased Budget volatility including the management of reconciliations;
 - Ongoing uncertainty regarding replacement EU funding.
16. **These factors present significant challenges for parliamentary scrutiny of the Budget in the time available.**

Economic Outlook

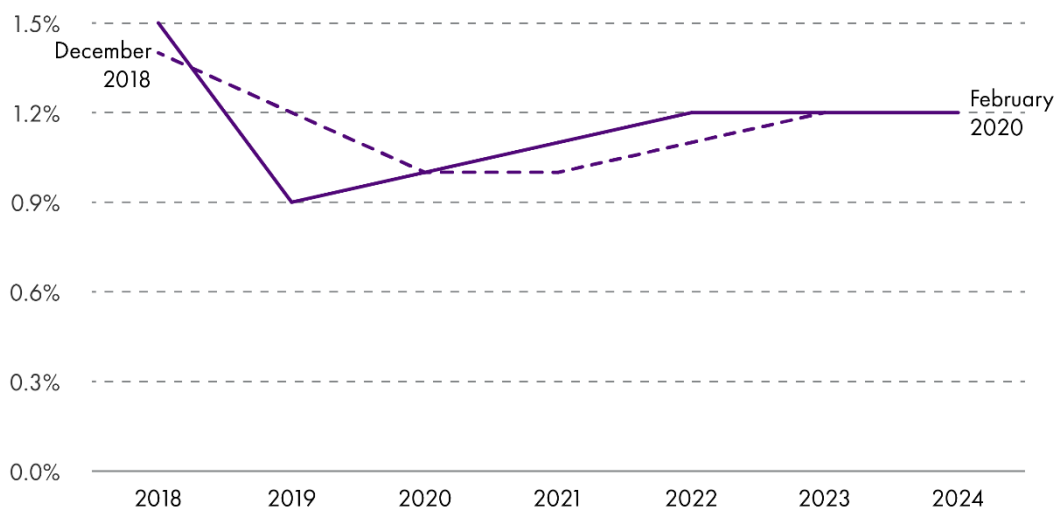
17. The SFC explain that “the Scottish Budget occurring before the UK Budget has an effect on the way we prepare our forecasts.”¹¹ While they normally use the OBR’s forecast of the UK economy they have used forecasts of the UK economy published by the National Institute of Economic and Social Research (NIESR) in November 2019.

18. The SFC state that “our forecast of headline GDP is similar to December 2018, with small upwards revisions from 2021” (Table 1).

Table 1: SFC GDP Growth Forecasts (%)

	20 18	20 19	20 20	20 21	20 22	20 23	20 24
Dec 2018	1.4	1.2	1.0	1.0	1.1	1.2	
Feb 2020	1.5	0.9	1.0	1.1	1.2	1.2	1.2

Source: SFC



19. The SFC point out that uncertainty about both the nature and timing of Brexit has resulted in subdued growth over the last year, and while the unwinding of some Brexit-related uncertainty may support some additional growth, Brexit remains a risk. There is no substantial change in the effect of Brexit on the SFC’s revised forecast since December 2018, as the future trade relationship is still to be negotiated during the transition period.

20. The SFC’s forecasts are based on an orderly Brexit, with the possibility of no free trade agreement (FTA) with the EU before the end of 2020, a downside risk. The SFC’s view is that any failure to negotiate a FTA with the EU before the end of 2020 would be similar to a no-deal scenario as it

¹¹ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 3.2

“would have many, though not all, of the negative economic effects of leaving the EU without a withdrawal agreement.”¹²

21. The SFC’s view is that “ongoing uncertainty around the new UK-EU trade relationship after Brexit is likely to weigh on economic activity, at least in the near term.”¹³ The SFC also highlight concerns about slowing global growth, particularly for the Euro area, and the potential for global trade wars.
22. Budget 2020/21 states that “the risk of failure to negotiate a trade agreement by the end of December 2020” means that there is a “potential need for substantial reprioritisation of budgets across the priorities set out in this document.”¹⁴ Nonetheless, Brexit is not the only factor underpinning a subdued outlook. The forecast for productivity growth has again been revised down, and slowing global growth is also material.
23. The SFC’s estimate of productivity growth in Scotland has remained low and they have revised down their productivity judgements by around 0.3 percentage points in 2019 and 2020. They state that their “estimate of productivity shows continuing near-zero trend growth, so we think that an immediate pick-up in productivity now looks implausible.”¹⁵ Our Adviser points out that these “structural risks are at least as important as Brexit in determining the subdued outlook.”
24. On a more positive note, forecasts for earnings growth have been revised up since this time last year, reflecting recent outturn data for earnings.
25. Differences in forecasts of GDP per capita and average earnings growth between the OBR (for UK) and SFC for Scotland in 2020 and beyond are very slight (Table 2).

Table 2: Comparison of growth forecasts, SFC for Scotland (Feb 2020) with OBR for UK (March 2019)

		2018	2019	2020	2021	2022
GDP	OBR Mar-2019	1.4	1.2	1.4	1.6	1.6
	SFC Feb-2020	1.5	0.9	1.0	1.1	1.2
GDP per person	OBR Mar-2019	0.8	0.6	0.9	1.1	1.1
	SFC Feb-2020	1.1	0.7	0.7	0.9	1.0
Average annual earnings	OBR Mar-2019	3.0	3.1	3.0	3.1	3.1
	SFC Feb-2020	2.6	2.8	3.0	3.1	3.2

Source: Adviser

¹² <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 3.15

¹³ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 3.36

¹⁴ <https://www.gov.scot/publications/scottish-budget-2020-21/> page 244

¹⁵ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 3.19

26. At the same time, the SFC's Scottish growth forecast is lower than other forecasters (Table 3).

Table 3: Comparable Scottish Growth

	2019	2020	2021	2022	2023
Scottish Fiscal Commission	0.9%	1.0%	1.1%	1.2%	1.2%
Fraser of Allander³	0.9%	1.3%	1.4%	1.4%	
Ernst and Young	1.0%	1.4%	1.5%	1.7%	1.8%
PWC⁴	1.6%	1.3%			

Source: SPICe

27. The November 2019 NIESR UK forecast is for GDP growth of 1-1½ per cent in 2019 and 2020, based on the assumption of continued uncertainty as the terms of EU exit remain unchanged but unresolved.¹⁶ NIESR's view is that the UK's economic outlook "depends critically on the nature of the trading relationship" between the UK and the EU and other countries.¹⁷

28. NIESR's revised UK growth forecast published in February is shown in Table 4 alongside the most recent OBR forecast and other comparable forecasts, including the Bank of England.

Table 4: Comparable UK Growth

	2019	2020	2021	2022	2023
OBR (March 2019)⁵	1.2%	1.4%	1.6%	1.6%	1.6%
Bank of England (January 2020)	1.3%	0.75 - 1.25%	1.5 - 1.75%	1.75 - 2.0%	
National Institute of Economic and Social Research (NIESR)⁶	1.3%	1.3%	1.6%	1.6%	1.8%
IFS (October 2019)⁷	1.1%	1.0%	1.3%	1.5%	1.4%
EY (November 2019)⁸	1.3%	1.0%	1.5%	1.7%	1.8

Source: SPICe

29. The Cabinet Secretary for Finance ("the Cabinet Secretary") was asked by the Committee, what specific policies the Government have to grow the Scottish income tax base. She responded that the Government recognises that there are two ways to grow the economy: productivity growth and earnings growth. In relation to productivity she stated that "our focus is on stimulating the economy and using our enterprise agencies to

¹⁶ https://www.niesr.ac.uk/sites/default/files/publications/Monthly_GDP_%20Tracker_Nov2019_FullDocument.pdf

¹⁷ <https://journals.sagepub.com/doi/10.1177/002795011925000103>

ensure that we are investing in the economy.”¹⁸ In relation to earnings she highlighted “the impact not just of our tax policies but of our public sector pay policy.”¹⁹

- 30. The Committee stated in our report on last year’s Budget that we were strongly of the view that a no-deal Brexit would be damaging to the Scottish economy and public finances and therefore clearly not in the national interest. The Committee notes the SFC’s view that any failure to negotiate a Free Trade Agreement with the EU before the end of 2020 would be similar to a no-deal scenario as it “would have many, though not all, of the negative economic effects of leaving the EU without a withdrawal agreement.” We strongly remain of the view that such a scenario would be economically damaging to Scotland and not in the national interest.**
- 31. The Committee also notes that the SFC’s estimates of trend productivity growth are still near zero and below expectations and that “an immediate pick-up in productivity now looks implausible”. The Committee invites the Scottish Government, recognising it has limited macro-economic powers, to explain how its priorities in this year’s budget seek to address this long-running problem.**

Wellbeing Budget

- 32. The Budget document states that the “Scottish Budget in 2020-21 will improve Scotland’s national wellbeing” and that taking a wellbeing approach “prioritises investment in areas that will have the greatest impact on both improving lives across Scotland now and creating the conditions to ensure wellbeing for future generations.”²⁰**
- 33. The Cabinet Secretary announced that “it is a budget that has wellbeing and fairness at its very heart” and this approach “prioritises actions that have the greatest impact in improving lives across Scotland now and creating the conditions that are required to ensure the wellbeing of future generations.”²¹**
- 34. The FAI has said that a wellbeing approach “could, through viewing the outcomes of spending through a different lens, help refocus priorities more effectively.” However, they also suggest there is a risk that “such a shift is little more than a presentational exercise with no material impact on how funds are allocated in practice.”²²**
- 35. Scotland is part of a newly established Group of Wellbeing Economy Governments which also includes Iceland and New Zealand. The latter**

¹⁸ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.25

¹⁹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.25

²⁰ <https://www.gov.scot/publications/scottish-budget-2020-21/> page 1

²¹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12507&mode=pdf> Col. 67

²² <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 58

published its first 'wellbeing budget' in 2019. The FAI point out that this related to additional areas of spending rather than existing spend and was introduced within the context of a budget surplus. The FAI explain that it was an "evidence-based process, analysing indicators of wellbeing and understanding where there were particular gaps that needed attention."²³ New budget proposals were considered by the New Zealand Treasury on the basis of each bid's "alignment to priorities and the evidence of impact on wellbeing."²⁴

36. The FAI recommend that an approach to wellbeing budgeting, building on the approach to wellbeing should –

- Identify what the government means by wellbeing
- Identify how the case for spending on a particular budget element is anticipated to contribute to wellbeing
- And most importantly, set out an approach to monitor changes in wellbeing, and to appraise and evaluate the contribution of policy to those changes.²⁵

37. The FAI told the Committee that²⁶ –

“ unless there is more definition of what is meant by terms such as 'prioritising wellbeing' or 'a wellbeing economy' that are linked to specific actions and to budgets that are to be spent on achieving those aims, it is difficult to see such language as anything other than a bit of a public relations exercise.

38. The Committee asked the Cabinet Secretary to provide examples of shifts in policy direction or expenditure in Budget 2020/21 as a result of the strategic focus on wellbeing. She responded that "everything starts with the national performance framework" and "the investment and tax decisions that are taken in the budget must reflect the NPF."²⁷ When asked to provide a specific example she highlighted the Scottish Government's public sector pay policy of a 3 per cent uplift for those who earn up to £80,000 and a limit of £2,000 on any uplift for those earning more than £80,000. She stated that the policy will "contribute directly to supporting the budget through helping lower-income earners and ensuring that we support a healthier, more prosperous and more economically active population."²⁸

39. The Committee notes that there is a risk, as highlighted by the FAI, that a wellbeing approach to budgeting is ultimately used to justify pre-existing policy choices. The Scottish Government states that

²³ <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 63

²⁴ <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 63

²⁵ <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 62

²⁶ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12492&mode=pdf> Col. 13

²⁷ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.38

²⁸ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.39

taking a wellbeing approach to the budget means prioritising spend which delivers on multiple outcomes across the NPF.

- 40. The Committee invites the Scottish Government to provide specific examples of how its wellbeing approach has resulted in a shift in policy direction and expenditure from previous Budgets.**

SCOTTISH INCOME TAX

41. The Scottish Government's proposals for income tax rates and bands for 2020-21 are shown in Table 5 below.

Table 5: Proposed Scottish tax rates and bands, 2020-21

Bands	Band name	Rate (%)
Over £12,500* - £14,585	Starter	19
Over £14,586 - £25,158	Basic	20
Over £25,159 - £43,430	Intermediate	21
Over £43,430 - £150,000**	Higher	41
Above £150,000**	Top	46

*Assumes individuals are in receipt of the Standard UK Personal Allowance. **Those earning more than £100,000 will see their Personal Allowance reduced by £1 for every £2 earned over £100,000.

Source: Scottish Government

42. All income tax rates are unchanged. The Higher Rate and Top Rate thresholds will be frozen in cash terms, whilst the thresholds at which Scottish taxpayers begin to pay the basic and intermediate rates will increase slightly (but not by as much as inflation). Our Adviser points out that "there is the potential for some confusion around what is happening to the basic and intermediate rate thresholds." Rather than raising the thresholds by the rate of inflation, the Scottish Government is increasing the size of the relevant band by inflation.
43. In the case of the basic rate, the government is not increasing the threshold from £14,549 by 2 per cent. Instead it is increasing the difference between £14,549 and the Personal Allowance (£12,500) by 2 per cent. This means that the proposed increases to the basic rate and intermediate rate thresholds are below inflation, but have the effect of ensuring that the amount of income at which starter rate tax and basic rate tax is paid increases in line with inflation. For example, in 2019-20, the first £2,049 of taxable income was taxed at 19%. Under these proposals, the first £2,085 will be taxed at 19%, which represents an inflationary increase of 1.7%.
44. The Scottish Government explains that the policy objective of its approach to income tax policy is to ensure that taxes do not rise for lower- and

middle-earners while ensuring progressivity and additional revenue to invest in public services and the Scottish economy.

45. The Scottish Government have assumed that the UK Government will freeze the Higher Rate threshold in the rest of the UK in cash terms at £50,000 on the basis that this was the policy intention announced in the 2018 Autumn Budget. Table 6 below shows the bands and rates for rUK²⁹ income tax for 2019-20.

Table 6: rUK tax bands and rates , 2019-20

Bands	Band name	Rate (%)
Over £12,500* - £50,000	Basic	20
Over £50,000 - £150,000**	Higher	40
Above £150,000**	Additional	45

* Assumes individuals are in receipt of the standard UK personal allowance (£12,500 in 2019-20)

** Those earning more than £100,000 will see their personal allowance reduced by £1 for every £2 earned over £100,000

Source: Scottish Government

46. The SFC was asked what impact any future changes to personal allowances and national insurance contributions could have on Scotland's income tax take. Responding the SFC explained that the personal allowance directly affects the size of the Scottish income tax base, whereas "national insurance contributions work in a much more indirect way. They affect the marginal rate in total, but not the size of the Scottish tax base. It is more of a behavioural effect and would probably be more muted."³⁰

- 47. The Committee recommends that in future Budgets, the Scottish Government should make it clear if it is increasing the size of the relevant band by inflation rather than the thresholds.**

Income Tax Revenue Forecasts

48. The SFC's forecasts for Scottish income tax receipts determine the revenue that the Scottish Government will be able to draw down from HM Treasury during the year ahead. The published forecasts for income tax across the forecast horizon are shown in Table 7.

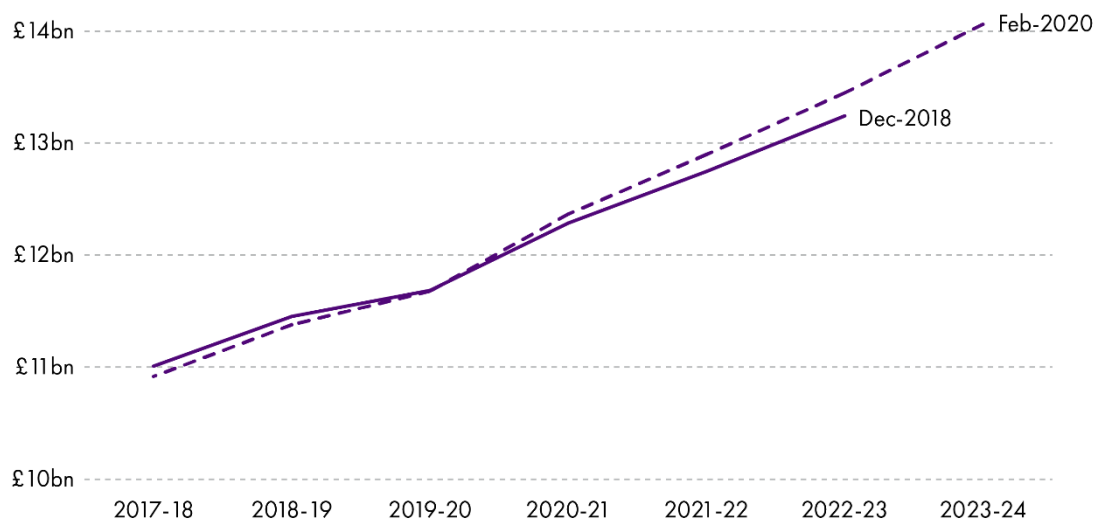
²⁹ UK income tax rates will be reduced by 10p in each band, on top of which the Welsh Government sets its own Welsh rate of income tax for each band.

³⁰ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf>, Col 10

Table 7: SFC Scottish Income Tax Forecasts

£million	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Dec 2018	11,008	11,452	11,684	12,285	12,746	13,242	
Feb 2020	10,916 (outturn)	11,378	11,677	12,365	12,897	13,447	14,059
Change	-92	-74	-7	80	151	205	

Source: SFC



49. The forecast for 2020-21 is £12,365m which is £80m higher than the forecast in December 2018. Improvements in the outlook for earnings growth has resulted in an upwards revision of £273 million in 2020-21. But other factors have also resulted in downward revisions to the forecasts. The outturn figures for 2017-18 published by HMRC in July 2019 result in a downward revision of £110m in 2020-21 and the re-costing of UK Government policy on pensions auto-enrolment reduces the forecast by £120m in 2020-21.

50. The SFC also forecast that the Scottish Government's tax policy changes for 2020-21, relative to their baseline assumption of an inflationary uplift to all thresholds except the Top Rate, will raise an additional £51m.

Net Tax Position

51. The impact of forecast income tax revenues on the size of the Budget is determined by the net tax position. This is calculated as follows –



52. The forecast for the BGA is based on OBR forecasts of rUK income tax revenues. These are normally produced at the time of the UK Autumn Budget. However, as noted above, in the absence of these forecasts a provisional BGA has been published based on an updated OBR forecast for UK NSND income tax as part of its work in producing a forecast for Welsh income tax in December 2019 (Table 8).

Table 8: OBR forecast of UK NSND income tax liabilities (£ billion)

	2017-18 (Outturn)	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
March	166.9	175.6	176.8	187.4	194.6	202.3	210.4
December	165.1	173.3	177.2	187.1	194.3	201.9	210.3
Change	-1.8	-2.3	0.4	-0.2	-0.3	-0.3	-0.1

Source: OBR

53. The OBR state that they have revised down the UK income tax forecast in 2017-18 and 2018-19 “to reflect the downside surprise in HMRC’s final outturn for UK NSND liabilities in 2017-18, the detailed composition of SA liabilities reported in the latest tax returns and new repayments data.”³¹ From 2019-20 onwards the OBR’s UK income tax forecast “is little changed as strength in PAYE income tax receipts this year has largely offset those other sources of downward revision.”³² Table 9 below show the net income tax effect on the Scottish Budget.

Table 9: Forecast net income tax effect on the Scottish Budget (£m)

		2018/19	2019/20	2020/21	2021/22	2022/23
Revenues	Budget 2019/20	11,452	11,684	12,285	12,746	13,242
	Budget 20/21	11,378	11,677	12,365	12,897	13,447
BGA	Budget 2019/20	11,495	11,501	12,089	12,478	12,954
	Budget 2020/21³³	11,505	11,705	12,319	12,742	13,194
Net tax	Budget 2019/20	-43	183	196	268	288
	Budget 2020/21	-127	-28	46	155	253

Source: SPICe

54. The net income tax effect on the Budget is shown to improve from -£127m in 2018/19 to £253m in 2022/23. This means that while income tax revenues in rUK are expected to grow more quickly than in Scotland in 2018/19 there is a more positive outlook from 2020/21 onwards. However,

³¹ https://obr.uk/docs/dlm_uploads/Welsh-taxes-outlook-December-2019.pdf paragraph 2.35

³² https://obr.uk/docs/dlm_uploads/Welsh-taxes-outlook-December-2019.pdf paragraph 2.35

³³ Provisional BGAs as explained earlier in the report.

this needs to be viewed within the context of tax policy divergence between Scotland and rUK.

55. Given tax policy in Scotland it would be expected that the net tax position would be substantially positive. This is because a combination of tax policy changes in Scotland and rUK mean that revenues in Scotland as a result of those changes are forecast to be higher than in rUK. But the benefits of those additional revenues has not resulted in a strong net tax position (Table 10).

Table 10: Net tax position compared to policy divergence

	2018-19 (£m)	2019-20 (£m)	2020-21 (£m)
Net tax	-127	-28	46
Policy divergence	350	500	650
Difference	477	528	604

56. The FSU noted that, rather than generating an additional £600 million or more for the Scottish Budget, the Scottish Government's income tax policy for 2020-21 is forecast to only just manage to offset the net tax position. Likewise in 2018-19 and 2019-20 the net tax position is much lower than would be expected given the tax policy differences. The FSU suggest that in "budgetary terms, we are effectively running to stand still."³⁴

57. The Cabinet Secretary told the Committee that if the Scottish Government "were to follow and entirely replicate the UK Government's approach to tax, £460 million less would go into the public sector than we have been able to provide."³⁵

58. Why is this happening especially when we see that income tax revenues are forecast to rise in Scotland from £11,378m in 2018/19 to £12,365m in 2020/21, an increase of 8.67%? One possible explanation which the Committee has monitored closely is differences in earnings growth between Scotland and rUK, and this is discussed below.

- 59. The Committee invites the Cabinet Secretary to provide a breakdown of the £460m in lost revenue if the Scottish Government were to entirely replicate the UK Government's approach to tax.**

Earnings Growth

60. The OBR states in its latest devolved taxes forecast in March 2019 that "the path of total employee earnings growth (i.e. combining the effect of growth in employee numbers and average earnings per employee)" "shows that growth in Scotland has been consistently slower than the UK average, particularly in 2015-16 and 2016-17."³⁶

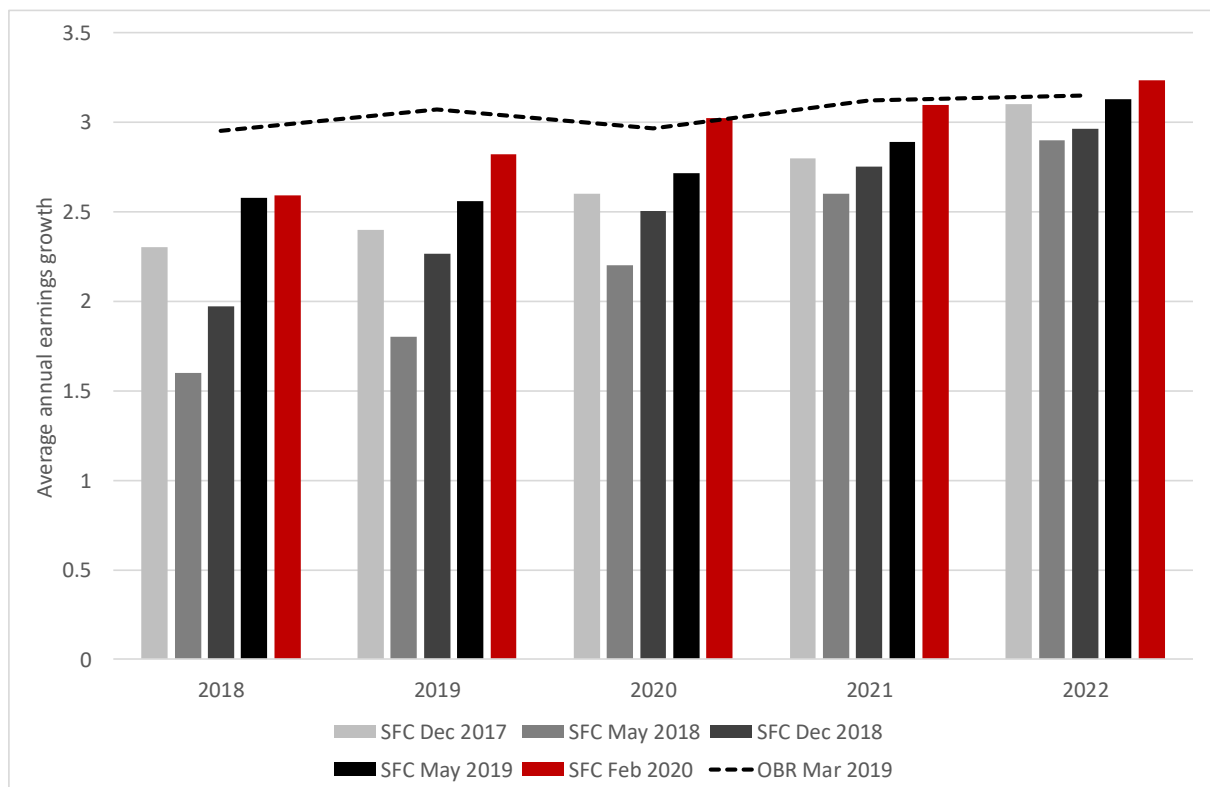
³⁴ <https://spice-spotlight.scot/2020/02/07/budget-2020-21-tax-proposals-running-to-stand-still/>

³⁵ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.24

³⁶ https://obr.uk/docs/dlm_uploads/DevolvedMarch2019.pdf

61. The SFC provide a more positive outlook in their February 2020 forecasts. They state that earnings growth in Scotland “has continued to exceed our earlier expectations. After a period of subdued growth, earnings finally appear to be responding to tight conditions in the labour market.”³⁷ This has resulted in an upwards revision of £273m to their income tax forecast for 2020-21 compared to the December 2018 forecast.
62. Earnings growth is now forecast to be higher each year than it was in December 2017, and much higher than it was in May 2018 (Figure 1).

Figure 1: Evolution of SFC earnings forecasts



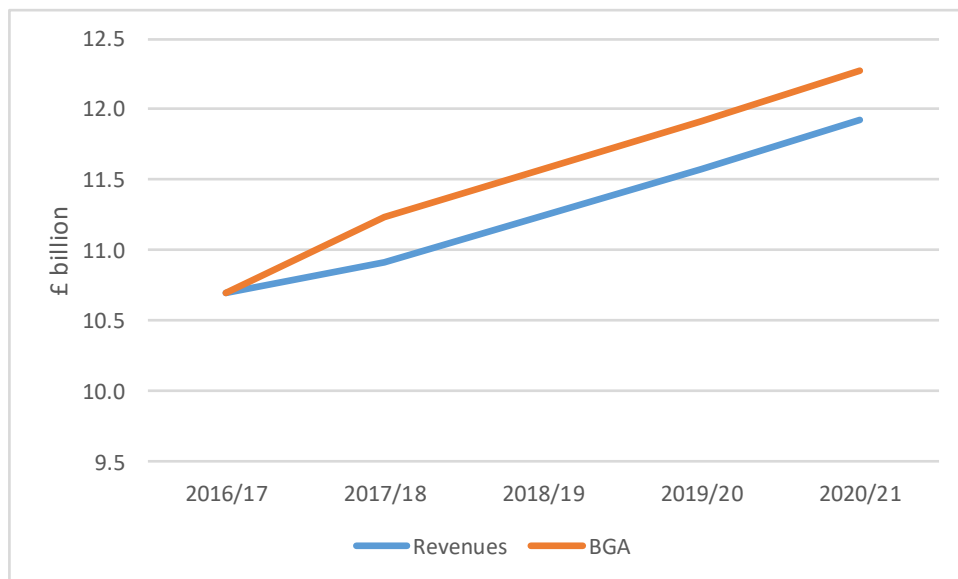
Source: Adviser

63. Despite these upward revisions to the forecasts of Scottish earnings growth, it remains the case that average earnings grew less quickly in Scotland than in rUK in 2017 and 2018, and this trend is forecast to continue in 2019. Our Adviser explains that this is largely why Scottish income tax revenues are forecast to be below the BGA in those years, despite the different tax policy in Scotland. The OBR’s latest revenue forecasts imply that rUK revenues will grow 5.1% between 16/17 and 18/19 whereas the SFC are now forecasting growth in Scotland of 4.2% over the same period.

³⁷ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 33

64. The latest forecasts imply that Scottish earnings growth will match UK earnings growth in 2020. But, as highlighted by our Adviser, the effect of relatively weaker earnings growth in Scotland between 2017-19 will continue to be felt on the budget in future years. This is because slower growth between 2017/18 – 2019/20 influences the size of the tax base that subsequent growth applies to. An illustration of how this works is shown in Figure 2. In this hypothetical example, in 2017/18 the BGA is assumed to grow 5% whilst Scottish revenues grow 2%. In all subsequent years, revenues and the BGA grow at 3%.

Figure 2: Revenues and BGA under a hypothetical growth scenario



Notes: in 2017/18 the BGA is assumed to grow 5% whilst Scottish revenues grow 2%. In all subsequent years, revenues and the BGA grow at 3%.

Source: Adviser

65. The latest forecasts assume something similar is happening in reality. Even if Scottish and rUK revenues per capita grow at the same rates from 2020 onwards, this will merely maintain the proportionate size of the existing gap between Scottish revenues and the BGA, rather than helping to close it. Because of slower Scottish earnings growth in 17/18 and 18/19, Scottish revenues are only slightly surpassing the BGA, despite the presence of a tax policy that raises an additional £600m in revenues compared to the rUK policy.

Employment Rates

66. The Committee also raised the potential impact of recent employment data on tax revenues with the SFC. The most recent set of labour market statistics shows that the Scottish employment rate is now 2% lower than the UK rate. The SFC explained that they have reduced their income tax

forecast for 2020-21 by £48m compared to their December 2018 forecast as a consequence of the employment data.³⁸

67. Scottish Government officials told the Committee the difference in employment levels in Scotland relative to the UK “is explained by a higher rate of inactivity in Scotland, which is caused by two factors.” These are –

- More people in education and training at the lower-age end of the workforce;
- More people leaving the workforce earlier at the higher-age end, in part because of health issues.

68. The Cabinet Secretary was asked what the Government’s priorities are in seeking to increase the tax base. She responded that there are two ways to grow the tax base. First, through immigration and “the recent proposition for a Scottish visa was right at the heart of that.”³⁹ Second, “is to tackle non-participation, or inactivity, and to try to get more people into work.”⁴⁰

69. The Cabinet Secretary was asked why, if a priority is to get more people into work, the budget line for employability and training has been cut. The Cabinet Secretary responded that she did “not accept that we are cutting budgets to support people into work.” She does not think that “you can look at those specific lines in isolation from everything else that we are doing to support people into work, including through real terms increases for higher and further education.”⁴¹ Following the Committee meeting, the Cabinet Secretary wrote explaining that “Whilst small savings have been made against the level 4 employability and workforce skills budget, increases have also been made within the level 4 employability Fair Start Scotland budget.”⁴²

70. The Committee requests that the Scottish Government provides a detailed breakdown of each of the small savings within the employability and workforce Skills budget as well as the increases within the Fair Start Scotland budget.

Distributional Issues

71. In previous budget reports the Committee has explored whether there may be distributional issues within the tax base in Scotland relative to rUK which may have a structural impact on how the Fiscal Framework operates. These are –

³⁸ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.7

³⁹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> col.26

⁴⁰ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> col.26

⁴¹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> col.54

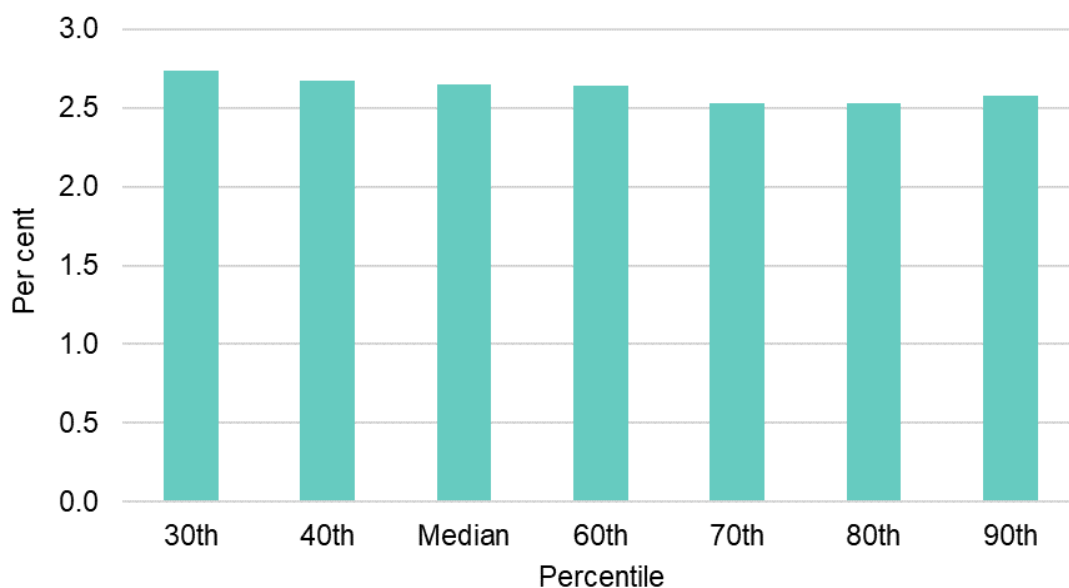
⁴² [Letter from the Minister for Public Finance and Digital Economy to the Committee, 14 February 2020.](#)

- The extent to which the distribution of the tax base is more unequal in rUK relative to Scotland;
- The extent to which annual earnings growth is more unequal in rUK relative to Scotland.

72. The Committee recommended that the SFC reflect on these issues in advance of the next round of income tax forecasts. The SFC “acknowledge the significant concerns about distributional issues” and have committed to write to us with more detailed and specific findings on distributional issues in summer 2020 once further data are available. This will include a comparison of Scotland to the UK to show how distributional issues could affect the Scottish budget over the longer term.⁴³

73. In previous forecasts, the SFC have assumed that growth in income occurs evenly across the income distribution and they have retained this assumption for the current forecasts. They point out that while growth in Scotland can be quite variable across the income distribution from one year to the next, they do not see evidence of a persistent pattern over the longer term. This is demonstrated in Figure 3 below.

Figure 3: Average annual growth in gross annual earnings by percentile, Scotland, 2003 to 2019



Source: SFC

74. The Scottish Government highlights the importance of higher earners in driving overall income tax receipts. Although Higher Rate and Additional Rate taxpayers represent only the highest earning 7% of Scottish adults, they contributed 56% to Scottish income tax. The Scottish Government also cites evidence of an increasing geographical concentration of Higher

⁴³ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 4.13

Rate and Additional Rate taxpayers in London and the South East as pointing to a structural risk to the Scottish Budget. The Cabinet Secretary's view is that this means that "the problem under the fiscal framework is not that we are raising less tax but that we are being punished for rising inequality south of the border."⁴⁴

75. The Scottish Government have also stated that, while it is too early to draw firm conclusions, it "means that growing Scotland's tax revenues as quickly as revenues in the rest of the UK could be challenging over the medium to long run." In their view this is an important area for further analysis with important implications for the upcoming review of the Fiscal Framework.

76. The Committee welcomes the initial work which the SFC has carried out in examining distributional issues in the Scottish tax base and looks forward to considering its comparison of Scotland to the UK on how distributional issues could affect the Scottish budget over the longer term.

Demographic Change

77. As shown in Table 2 above differences in forecasts of GDP per capita and average earnings growth between the OBR (for UK) and SFC for Scotland in 2020 and beyond are very slight. However, as previously highlighted by the Committee, the annual adjustment to the block grant using the indexation per capita method is based on the overall population growth in Scotland and the rest of the UK. It does not account for the relative growth in the working age population or the 'old-age dependency' ratio⁴⁵.

78. The Committee has previously noted that there is a strong evidence base that suggests there is a real risk to the size of the Scottish Budget arising from Scotland's population ageing faster than the rest of the UK. In particular, there is a real risk from a higher growth in the old age dependency ratio in Scotland relative to the rest of the UK. The SFC told us that GDP growth in Scotland and in the rest of the UK is much more equal when comparing per capita GDP growth among the working-age population.⁴⁶ The Committee has recommended that this issue is considered as part of the review of the Fiscal Framework.

79. The Scottish Government has also raised concerns about the impact of Brexit on Scotland's population due to lower levels of immigration. Budget 2020-21 points out that the SFC highlights "partly as a result of EU exit, Scotland's working-age population is set to decline, which will feed through to lower GDP growth."⁴⁷ As discussed above, the Scottish Government has called for immigration powers to be devolved through a Scottish Visa.

⁴⁴ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.24

⁴⁵ The ratio between the number of people aged 65 and over (the age when people are generally 'economically inactive') and the number of people aged 16-64.

⁴⁶ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.5

⁴⁷ <https://www.gov.scot/publications/scottish-budget-2020-21/>

80. The Committee has previously noted that given the way in which the Fiscal Framework operates there is a real risk to the size of the Scottish Budget if there is a fall in Scotland's working age population due to a disproportionate decline in immigration relative to the rest of the UK. The Committee also noted that migration policy is a reserved matter and that the UK Government does not agree with the need for a specific migration policy for Scotland. However, within the context of Brexit and a different demographic dynamic within Scotland relative to the rest of the UK, the Committee recommended that the review of the Fiscal Framework should fully consider the impact of immigration policy following the UK's departure from the EU.⁴⁸

Behavioural Responses

81. The SFC forecast that the Scottish Government's tax policy changes for 2020-21, relative to their baseline assumption of an inflationary uplift to all thresholds except the Top Rate, will raise an additional £59m, but that changes in taxpayer behaviour would reduce the actual amount generated to £51 million. However, they point out that the size of the behavioural response is highly uncertain given that we do not yet know what UK income tax policy will be in 2020-21. They point out that if "the gap between the tax system in Scotland and the rest of the UK does increase, the behavioural response to this is a risk to Scottish income tax revenues."⁴⁹

82. The Scottish Government's view of the existing tax policy divergence between Scotland and the UK is that "it may affect taxpayers' behaviour and, in particular, their location decisions although the behavioural response is expected to be low."⁵⁰ But there "is currently no data which would allow us to evaluate the comprehensive changes to income tax implemented in 2018-19."⁵¹

83. The SFC explain that there "are various analytical approaches to trying to isolate behavioural change in response to changes in tax policy" but this "can only be attempted when detailed taxpayer data are available for a large number of taxpayers over a long period of time." However, even "where a long run of detailed taxpayer data are available, the behavioural change estimate will still be uncertain and subjective."⁵²

⁴⁸ <https://sp-bpr-en-prod-cdnep.azureedge.net/published/FCC/2018/11/7/Pre-budget-scrutiny-report-2/FCCS052018R12Rev.pdf> paragraph 51

⁴⁹ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 4.21

⁵⁰ <https://www.gov.scot/publications/scottish-income-tax-2020-2021/>

⁵¹ <https://www.gov.scot/publications/scottish-income-tax-2020-2021/>

⁵² <https://www.fiscalcommission.scot/wp-content/uploads/2019/11/How-we-forecast-behavioural-responses-to-income-tax-policy-March-2018.pdf>

84. One possible behavioural response which the Committee has considered previously is tax-motivated incorporations. Those who work for themselves may choose to be self-employed or have the option to incorporate and manage their business as directors of a limited company. ICAS suggest that the divergence in tax policy between Scotland the UK “may encourage incorporation by Scottish taxpayers at an earlier stage in the business’s evolution than compared to those in the rest of the UK.”⁵³ They suggest that “the possible behavioural reactions to increasing costs for higher earners, relative to those in the rest of the UK, will need to be factored into decision making.”⁵⁴

Forecast Error

85. A further challenge for the Scottish Government is the emerging picture on the size of forecast errors. As the Committee has previously discussed the impact of forecast error is relative. If both the OBR and the SFC are too optimistic or too pessimistic then the effect of the forecasts will be largely negated. But there is more of an issue if the forecast errors diverge. This is what now appears to have happened in the first few years of income tax devolution.

86. While the SFC now appears to have been slightly optimistic in their forecast of Scottish revenues the OBR has been much more pessimistic in forecasting UK revenues. The OBR’s November 2017 Forecast implied that rUK revenues would grow 2.2% between 16/17 and 18/19 while the SFC’s December forecasts implied Scottish tax revenues would grow 5.1% over this period. The OBR’s latest revenue forecasts imply that rUK revenues will grow 5.1% between 16/17 and 18/19 whereas the SFC are now forecasting growth in Scotland of 4.2% over the same period.

87. The impact of this forecast error is illustrated by the size of the actual reconciliation figure for income tax for 2017-18 and indicative reconciliation figures for 2018-19 and 2019-20 (Table 11).

Table 11: Outturn and Forecast Income Tax Reconciliations

	Outturn Data Available	Budget Affected	Reconciliation (£m)
2017-18	Summer 2019	2020-21	-204
2018-19	Summer 2020	2021-22	-555
2019-20	Summer 2021	2022-23	-211

Source: SPICe

⁵³

<https://www.strath.ac.uk/business/economics/fraserofallanderinstitute/publications/scotlands-budget-report/> page 28

⁵⁴

<https://www.strath.ac.uk/business/economics/fraserofallanderinstitute/publications/scotlands-budget-report/> page 27

88. The Committee noted in our pre-budget report that Scottish income tax receipts were £97m lower than the BGA in 2017-18 but that when the Budget was agreed the forecast was that they would be £107m higher. This resulted in a -£204m reconciliation figure. The latest forecasts for 2018-19 is that Scottish income tax receipts will be £127m lower than the BGA but when the Budget was agreed they were forecast to be £428m higher. The reconciliation figure is therefore forecast to be -£555m.⁵⁵
89. The Committee notes that following the outturn figures for 2017-18 and substantial further outturn data becoming available for 2018-19, the forecast £1 billion negative reconciliation remains largely unchanged. The SFC was asked by the Committee whether the negative reconciliations were likely to significantly change when the outturn figures for 2018-19 are published in July. They responded that “we are now close enough to having the final figure to say that we would be surprised if it was very different” and that “this year’s £204 million figure settled down into that area some time before we had the final outturn figures.” In their view, it “would certainly be wise for the Scottish Government to assume that next year’s reconciliation figure will be in the area of £550 million rather than to hope that it will turn out to be very different, which is unlikely.”⁵⁶
- 90. The Committee notes that with only initial outturn data available it is much too early to draw any firm conclusions about the size of the initial negative reconciliations for income tax. But, nevertheless it is worrying that the Scottish Government is likely to need to find around £1 billion across the next three financial years as noted in Table 11 above. This is despite Scottish income tax revenues being forecast to grow by 4.2% between 2016-17 and 2018-19 and the SFC reporting that earnings growth in Scotland “has continued to exceed our earlier expectations.” It is also concerning that these negative reconciliations will be “baked in” so that even if, as now forecast, earnings growth in Scotland matches rUK, there will be an on-going gap between tax revenues and the BGA which will have a recurring negative impact on the Budget.**
- 91. The Committee will continue to monitor this closely as further outturn data becomes available including our on-going examination of the possibility of structural risks within the operation of the Fiscal Framework.**
- 92. The Committee examines the Scottish Government’s approach to managing the reconciliations below. But first we look at the impact of the new social security powers given that the budgetary risks from**

⁵⁵ While this remains a forecast it is 11 months after the end of the financial year and significant outturn data is now available, especially with regards to PAYE which accounts for more than 80% of the revenues. This should reduce the size of forecast error. For example, the SFC’s December 2018 forecast error for Scottish income tax liabilities for 2017-18 was 0.8% compared to an error of 8.6% in the forecast which informed the 2017-18 Budget (February 2017).

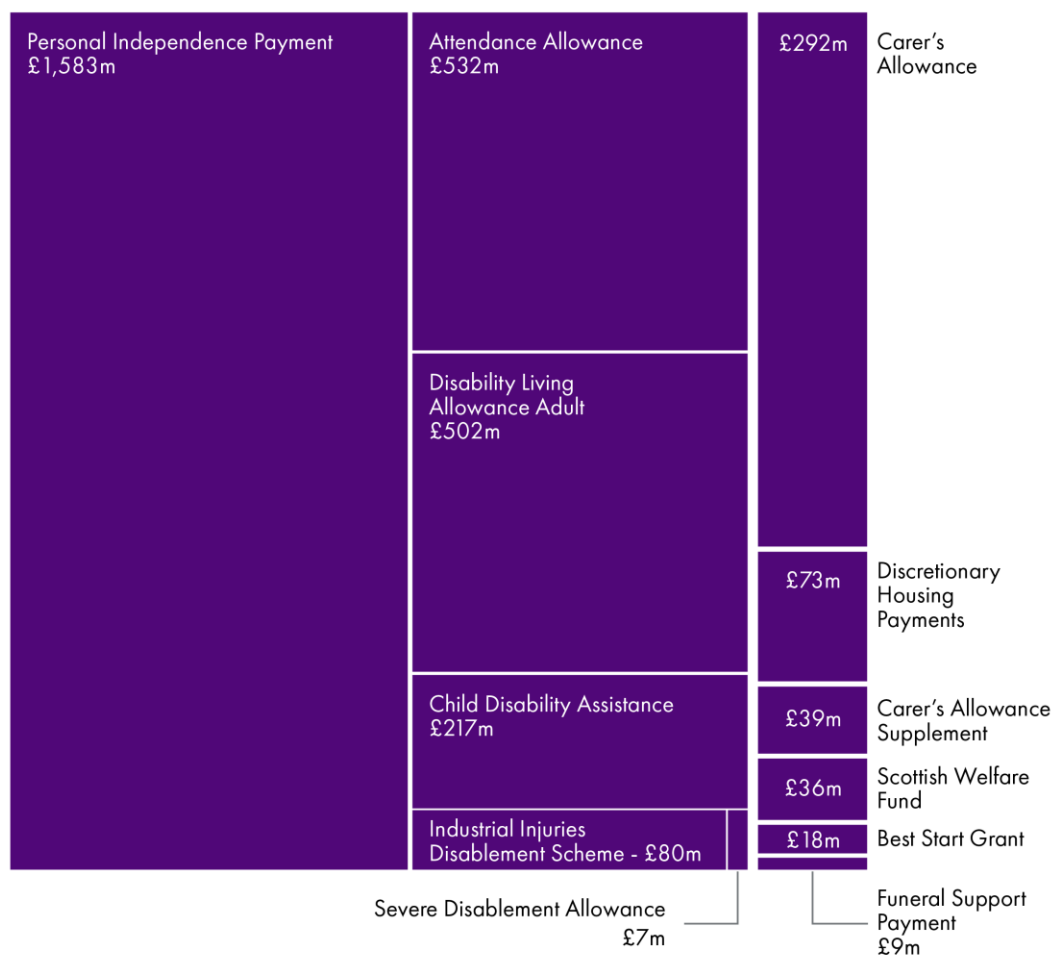
⁵⁶ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.20

how these operate within the Fiscal Framework must be managed within the same set of budget management tools as those used for tax devolution.

SOCIAL SECURITY

93. The Committee is very mindful that the Budget continues to grow in size and complexity in 2020-21. A substantial change to this year's Budget is the transfer of full financial responsibility of all devolved social security benefits to the Scottish Budget in April 2020. Under the Scotland Act 2016, eleven social security benefits are being devolved. The SFC estimate that £3.4 billion will be spent by the Scottish Government on social security in 2020-21, around 10 per cent of total resource spending. This compares with the £458 million forecast to be spent on all social security payments in 2019-20.

Figure 4: Forecast Social Security Benefit Payments, 2020/21



Source: SPICe

94. Ten of the eleven benefits being devolved to Scotland are demand-led: spending will be determined by the number of eligible people who apply for

support, all of whom must be paid at the rate set in legislation. This means that Social security spending is variable and harder to control than other areas of spending.

95. Budgets for these benefits are based on SFC forecasts, rather than spending limits but the Scottish Government will have to meet this spending as it arises, even if it differs from the forecast used to set the Budget. As highlighted by the SFC, this means that monitoring and management of the Budget through the course of the year becomes increasingly important.⁵⁷ The Scottish Government must manage any difference between forecast and outturn social security spending and any difference between forecast and outturn revenue for the fully devolved taxes throughout the financial year.

Block Grant Adjustments (BGAs)

96. As with tax devolution, the six benefits associated with illness and disability, which account for the vast majority of devolved social security expenditure, will be subject to adjustments to the block grant. The basis of these adjustments are set out in the Fiscal Framework. This adds a considerable layer of further complexity to an already complex budget process.
97. The BGA for social security payments also consists of two elements – an initial baseline adjustment and an indexation mechanism. The baseline adjustments are additions to the Scottish Budget to reflect the transfer of spending responsibility and the expenditure that the UK Government will no longer incur. The baseline addition for each benefit is equal to the UK Government's spending on these areas in Scotland in the year immediately prior to the devolution of the benefits (with the exception of the Cold Weather Payment). The indexation mechanism assumes that spending on each benefit in Scotland would have increased at the same per capita rate as in rUK in the years after transfer takes place.
98. As with tax devolution the BGAs will initially be based on OBR forecasts. For social security benefits, forecasts are of spending rather than revenues and BGAs are additions rather than deductions. At the same time, the allocations for each devolved benefit in the Scottish Budget will be based on SFC forecasts. This means that if the SFC is forecasting higher spending on benefit payments in Scotland than the OBR is forecasting for England and Wales then the Scottish Government will need to find the funding from elsewhere in the Budget.
99. Table 12 below shows the difference between the SFC forecasts for social security expenditure in Scotland for 2020-21 compared with the provisional BGAs.

⁵⁷ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 4

Table 12: SFC social security forecasts and provisional Budget-setting social security BGAs for 2020-21

£ million	SFC Spend Forecast	Provisional BGA	Difference
Attendance Allowance	532	535	3
Disability Living Allowance [1]	718	669	-49
Personal Independence Payment	1,583	1,601	19
Carer's Allowance	292	303	12
Industrial Injuries Disablement Scheme	80	85	5
Severe Disablement Allowance	7	9	1
Total	3,213	3,203	-10

Source: Scottish Government, Scottish Fiscal Commission

Differences are calculated as BGA subtract spend to show the effect on the Scottish Government's funding. The other benefits being devolved to Scotland in April 2020 are not covered by BGA arrangements and instead are funded through the Barnett formula. The SFC spending forecasts and provisional BGAs are calculated on different bases, so comparisons should be interpreted with caution.

[1] SFC spend forecast for Disability Living Allowance (DLA) includes DLA working age, DLA Child & Disability Assistance for Children and Young People (DACYP) and DLA Pensioners

100. Almost all the social security forecasts reflect current UK Government policy because the DWP will continue to administer the benefits during 2020-21. The SFC explain that this "is important because once the forecasts are based on Scottish policy, we expect the forecasts of Scottish spending to increase given Ministerial announcements and the passage of the Social Security (Scotland) 2018 Act."⁵⁸

101. The SFC highlight the risk of "a significant in-year cash shortfall to manage" if spending in Scotland increases and spending in England and Wales decreases, compared to the original figures used to determine the BGAs and the Scottish Budget.

102. Similar to the reconciliation process for the fully devolved taxes there is a two-stage process. First, an interim BGA reconciliation is carried out at the UK Autumn Budget when in-year OBR forecasts are published for budget spending in England and Wales. These in-year forecasts have the advantage of being able to draw on data of actual spending in the financial year to which they apply. Second, a final outturn BGA which is published around 7-8 months after the end of the financial year to which the forecast applies.

103. The impact on the Scottish Budget is as follows. Where UK government in-year spending diverges from forecast the BGAs will be

⁵⁸ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 14

updated at the time of UK Autumn Budget. In-year updates will not automatically apply to any policy changes introduced by the UK government after the Scottish Government's Budget. The Scottish Government may determine whether the adjustment will be made in-year to the Block Grant or whether this will be incorporated within the end-year reconciliation.

104. Once outturn figures are available these are reconciled with the forecast BGA at the time of the UK Autumn Budget. The Block Grant for the following financial year is then adjusted to account for the reconciliation figure. For example, the reconciliation figure for the BGA for 2020-21 will be addressed in the Scottish Budget 2022-23. The reconciliations for social security to date have been very small but the SFC suggest these may become more significant in future years.⁵⁹
105. The Scottish Budget will, therefore, be subject to substantial further volatility from 2020-21 which is similar to the volatility the Committee has been monitoring in relation to tax devolution. There are two main risks—
- spending on the social security benefits in Scotland is higher than the increase in the Scottish block grant that accompanies the transfer of responsibility;
 - forecast error.
106. If the Scottish Government spends more on a benefit payment than has been transferred through the BGA, it will have to find the money from elsewhere in the Budget. There is a risk, therefore, that actual spending in Scotland may be higher than the BGA which means less funding for other areas of the budget. This could be a consequence of Scottish Government policy but, similar to the fiscal risks arising from tax devolution, it could be the consequence of other factors such as socio-economic and demographic change. The FAI point out that the “budget risks here are real. Claimant rates could feasibly increase relatively more quickly in Scotland than rUK under a number of circumstances, regardless of policy decisions.”
107. The Committee has previously noted in relation to GDP growth that there is a strong evidence base that suggests there is a real risk to the size of the Scottish Budget arising from Scotland's population ageing faster than the rest of the UK. The Committee notes that the risks arising from demographic divergence also apply to the devolution of social security benefits to the extent that many of the payments being transferred are more likely to be claimed by older aged groups.
108. While the Scottish Budget is protected from the impact of relative population growth given that the BGAs are calculated on a per capita basis

⁵⁹ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 2.38

it is not protected from demographic divergence. Given that Scotland's population is forecast to age faster than the rest of the UK there is a risk that social security spending will be higher here even if there is no policy change. Our Adviser suggests that whether "this outcome would be 'fair' and whether or not it was an intended feature of the funding mechanism could be debated"⁶⁰.

109. The devolution of social security benefits will also increase the linkage between the performance of the Scottish economy and the Scottish Budget. As Audit Scotland point out –

"Economic performance also affects the demands placed on public sector spending programmes. The devolution of social security powers will increase this effect. Where the economy is doing less well, it is likely that these spending pressures will be higher, even where the policy response remains unchanged."⁶¹

Forecast Error

110. The Cabinet Secretary for Social Security and Older People has stated that analysis of the historical forecast error between the OBR statistics and the outturn for the benefits that are being devolved "shows an average error for one-year-ahead forecasts of 3.7 per cent. If you apply that to the £3.5 billion-worth of expenditure that is within the Scottish Government's responsibility, that can become a forecast error of £130 million."
111. The OBR explain that forecasting disability benefits "involves the consideration of many factors, both in the context of wider trends in the population – such as perceptions of disability and diagnoses – as well as in the administration of the benefits system."⁶² This means that they "need to make numerous assumptions and judgements, so our estimates are inevitably subject to a range of risks and uncertainties."
112. The SFC state that there "are particular challenges with social security as some factors that drive spending cannot be accurately measured."⁶³ They point out that there "are no data sources that reliably show the number of people eligible for social security support" and, therefore, "our views on eligibility and take-up will always rely on judgement, rather than being purely data-driven."⁶⁴ The Scottish Government has committed to

⁶⁰ <https://www.sbs.strath.ac.uk/embargoed/d/Fraser/201912/social-security-responsibilities.pdf>

⁶¹ https://www.audit-scotland.gov.uk/uploads/docs/report/2019/briefing_191017_financial_powers.pdf paragraph 71

⁶² https://obr.uk/docs/dlm_uploads/Welfare_trends_report_2019.pdf paragraph 5.20

⁶³ <https://www.fiscalcommission.scot/wp-content/uploads/2019/11/Statement-of-Data-Needs-September-2019.pdf> paragraph 4.1

⁶⁴ <https://www.fiscalcommission.scot/wp-content/uploads/2019/11/Statement-of-Data-Needs-September-2019.pdf> paragraph 4.1

publishing a strategy on how it aims to assess and improve benefit take-up rates and the SFC “anticipate that it will support our ability to make informed judgments for future forecasts.”⁶⁵

113. The SFC also state that they “have to produce forecasts with limited historical data and uncertainty about future plans; this explains our increasing data needs on social security.”⁶⁶ The FAI point out that “forecasting spending on social security is challenging, particularly when policy changes are being made.”⁶⁷ They explain that this is because “the data required to assess the impact of changes to eligibility criteria on claimant rates is often lacking, and the implications for benefit uptake are hard to predict.”⁶⁸ Audit Scotland also highlight significant forecasting risk “as a result of absence of historical data and the difficulty in making judgements about the costs of Scottish Government policy reforms to benefits.”⁶⁹
114. The Committee asked the SFC how well they are plugged into the development of social security policy. They responded that they have a lot of meetings with policy officials from the Scottish Government and with Social Security Scotland officials. They told us that “those are really quite important elements in our forecasts” and that they “modify their assumptions on the basis of what they hear at those meetings.”⁷⁰
115. The Cabinet Secretary told us that while the devolution of social security provides the Scottish Government with the ability to do things differently it will increase the volatility of the Budget which will need to be managed in-year. She was asked whether the powers to manage that volatility under the Fiscal Framework are sufficient. She responded that -
- “even before we consider the devolution of social security powers, we can see that the levers that we have at our disposal, which are borrowing and the reserve, are clearly inadequate to meet the potential level of budget volatility in the current system.”⁷¹
116. The extent of the Scottish Government’s budget management tools to manage this volatility is discussed below.
- 117. The Committee notes that the devolution of a significant number of social security benefits provides the Scottish Government with opportunities for policy innovation and a different approach from UK**

⁶⁵ <https://www.fiscalcommission.scot/wp-content/uploads/2019/11/Statement-of-Data-Needs-September-2019.pdf> paragraph 4.25

⁶⁶ <https://www.fiscalcommission.scot/wp-content/uploads/2019/11/Statement-of-Data-Needs-September-2019.pdf> page 2

⁶⁷ <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 41

⁶⁸ <https://www.sbs.strath.ac.uk/download/Fraser/201911/201911-BudgetReport.pdf> page 68

⁶⁹ https://www.audit-scotland.gov.uk/uploads/docs/report/2019/briefing_191017_financial_powers.pdf paragraph 66

⁷⁰ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.12

⁷¹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.37

Government policy. But with these opportunities come potential budgetary risks both in terms of the actual costs of policy divergence and from forecast error. This adds another substantial layer of complexity and volatility to the Budget which will require to be closely monitored and carefully managed.

MANAGING BUDGET VOLATILITY

118. The Fiscal Framework provides the Scottish Government with two additional budget management tools to manage the volatility arising from tax and social security devolution: resource borrowing powers and the Scotland Reserve. The SFC point out that “these tools are becoming increasingly important as the Scottish Budget becomes more complex.”⁷²

Resource Borrowing

119. The Scottish Government has the power to borrow up to £600m each year, within a statutory overall limit of £1.75bn, for the following reasons:

- for in-year cash management, with an annual limit of £500m;
- for forecast error in relation to devolved and assigned taxes and demand-led welfare expenditure with an annual limit of £300m; and
- for any observed or forecast shortfall in devolved or assigned tax receipts or demand-led welfare expenditure incurred where there is, or is forecast to be, a Scotland-specific economic shock, with an annual limit of £600m.

120. Resource borrowing is from the National Loans Fund, and the repayment period will be between three and five years, as determined by Scottish Ministers at the time of borrowing. Resource borrowing can be drawn down at any point in the financial year. The Scottish Government can change its plans at any point and draw down more or less than planned, subject to the overall limits.

121. The Scottish Government can also borrow £500m for in-year cash management. There is no explanation either in the Fiscal Framework or the MTFS regarding how this borrowing power will operate. Our Adviser points out that we have little idea as to how these borrowing powers might be used, or the extent to which they will be used. For example, it’s not clear what the distinction is between a cash-management issue and a shortfall arising from forecast error.

122. Audit Scotland point out that given the significant increase in devolved social security benefits, “in-year cash management of demand-led

⁷² <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 2.45

spending may become more complex.”⁷³ And given that the various borrowing powers are covered by the same annual cap, managing and “monitoring the interplay of borrowing purposes therefore becomes increasingly important.”⁷⁴ For example, using borrowing for in-year cash management reduces the amount of borrowing available within the limit for forecast error.

Scotland Reserve

123. The Scotland Reserve is intended to “enable the Scottish Government to smooth all types of spending and manage tax volatility and determine the timing of expenditure.” Payments may be made into the resource reserve from the resource budget including tax receipts. Annual underspends are also managed through the Scotland Reserve.

124. There are no annual limits for payments into the Reserve up to an annual cap of £700m which includes both capital and resource spending. While there are no restrictions on the balance between capital and resource that make up the Reserve, annual drawdowns are limited to £250m for resource and £100m for capital.

125. The Scottish Government explains that –

“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.”⁷⁵

126. The Scottish Government sets out, in its latest MTFS, its overall approach to the use of these budget management tools. With regards to the Scotland Reserve the MTFS states that managing expenditure across financial years often uses up a substantial proportion of the £250 million resource and £100 million capital limits. At the same time the Scottish Government aims 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

⁷³ https://www.audit-scotland.gov.uk/uploads/docs/report/2019/briefing_191017_financial_powers.pdf paragraph 122

⁷⁴ https://www.audit-scotland.gov.uk/uploads/docs/report/2019/briefing_191017_financial_powers.pdf paragraph 122

⁷⁵ <https://www.gov.scot/binaries/content/documents/govscot/publications/strategy-plan/2018/05/scotlands-fiscal-outlook-scottish-governments-five-year-financial-strategy/documents/00535972-pdf/00535972-pdf/govscot%3Adocument/00535972.pdf> paragraph 3.31

the Reserve retains sufficient capacity to have the flexibility to manage any underspend across financial years.”⁷⁶

127. And, as far as possible, to –

“smooth resource funding over time, including in relation to potential reconciliations for Income Tax under the Fiscal Framework, and to achieve a stable spending trajectory.”⁷⁷

128. This approach is intended to keep “the economic cost of revenue-funded investment and resource borrowing as low as possible, to achieve value for money.”⁷⁸

Managing Reconciliations

129. The Committee notes that a key purpose of the new budget management tools is to deal with reconciliations arising from the difference between tax revenue and social security spending forecasts and outturn figures. Reconciliations can be both negative and positive. This year’s budget is the first time that the Scottish Government has had to deal with an income tax reconciliation and therefore provides an initial indication of how it intends to employ the new budget management tools.

130. The Scottish Government has indicated that it intends to use its resource borrowing powers to address the -£207m reconciliation for 2017-18. This borrowing will be paid over the next five years. There is no discussion either in the Budget or the MTFS about how it intends to manage the indicative reconciliations for future years. However, the historic and planned use of the Scotland Reserve as shown in Table 13 does provide some indication of the Scottish Government’s approach.

Table 13 : Scotland Reserve (Resource)

£ million	2017-18	2018-19	2019-20	2020-21
Opening balance	74	440	381	206
Drawdowns	0	-250	-250	-106
Additions	366	191	75	0
Closing balance	440	381	206	100

Source: SFC

Shaded cells reflect outturn and unshaded reflect Scottish Government plans.

⁷⁶ <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/> page 24

⁷⁷ <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/> page 24

⁷⁸ <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/> page 24

131. The Scottish Government indicates that its drawdowns from the Scotland Reserve for 2020-21 are “underpinned by anticipated underspend carried forward from the prior year.” The SFC’s view is that “it would seem from these plans that the Scottish Government is not building up large reserves to mitigate the large expected income tax reconciliations.”⁷⁹
132. In our pre-budget report the Committee indicated that we were somewhat disappointed in the lack of information in the MTFS regarding the forecast £1 billion negative reconciliation. In response the Scottish Government stated its position that decisions on management of income tax reconciliations can only be taken in each Budget process when the Scottish Budget for that year, and the reconciliation applying, will be known. In relation to whether it is expected that sufficient money will be available to fund the negative reconciliations, the Scottish Government has stated that it will ensure a balanced budget each year, taking account of any reconciliations, and making use of the limited flexibility available via resource borrowing and the Scotland Reserve.
133. The SFC suggest that the Scottish Government’s response to the 2017-18 reconciliation “should be considered alongside possible future reconciliations.”⁸⁰ They told the Committee that ideally, “this year’s £204 million reconciliation should not be thought of in isolation from the further reconciliations that are coming down the line, because we need to look at the full scale of the issue.”⁸¹
134. The SFC pointed out that negative reconciliations are, in effect, “an interest free loan.” This is because the Budget was based on forecasts which resulted in the Government’s spending envelope being higher than it should have been. The negative reconciliation is essentially paying that money back. The SFC ask, therefore, “is the right response to a £204 million interest-free loan having come to an end to roll it into further borrowing?”⁸²
135. The Cabinet Secretary was asked why the Government have opted to use borrowing to address the 2017-18 reconciliation when the MTFS emphasised building up the Scotland Reserve so as to keep resource borrowing as low as possible. She responded that if the Government “were to build up a significant reserve, there would be lots of accusations that we were not using our resources as well as we could.”⁸³ She was then pressed that this appeared to be an approach based on a political judgement rather than an economic judgement. She responded that the

⁷⁹ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 2.54

⁸⁰ <https://www.fiscalcommission.scot/wp-content/uploads/2020/02/Scotlands-Economic-and-Fiscal-Forecasts-February-2020.pdf> paragraph 2.41

⁸¹ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.20

⁸² <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.22

⁸³ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.52

Government “have made a prudent judgment and determined that maintaining a reserve of £100 million is fair, as that allows us to invest in the areas that people call for us to invest in, while ensuring that there is a bit of a buffer.”⁸⁴ She also told us that using the borrowing powers “will ensure that the reconciliation will not take away from money that is being invested.”⁸⁵

136. Our Adviser points out that drawdown of £207m of resource borrowing in 2020/21 would in no way constrain the government’s ability to drawdown its maximum permitted annual amount of borrowing in 2021/22 and in 2022/23, and from that perspective it is difficult to conclude anything other than that the use of the borrowing in 2020/21 is reasonable. However, the question of whether the drawdown of £207m borrowing in 2020/21 is justifiable in the context of the principles that the government set out in its MTFS, the scale of the block grant increase this year, and the currently forecast scale of reconciliations in 21/22 and 22/23 is a more subjective point.

137. The former Cabinet Secretary wrote to HM Treasury pointing out 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. While anticipating that these issues can be addressed in full during the review in 2022, he proposed that “given their significance, action is needed before that takes place.” In particular that, in the short-term, the resource borrowing and reserve powers should be extended to give an overall annual drawdown limit of £900 million and the overall limit for the Reserve should be lifted to £1.75 billion. The Cabinet Secretary told the Committee that the Scottish Government “have yet to receive any indication that the UK Government will reconsider the borrowing or reserve powers to allow us to deal with that volatility.”⁸⁶

138. The Committee recognises the fundamental challenges which the Scottish Government faces in managing the substantial volatility arising from the operation of the Fiscal Framework while meeting its statutory obligation to balance its budget annually. The Committee is, therefore, very mindful that the extent of this volatility needs to be closely monitored.

139. The Committee notes 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 recommends 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.

⁸⁴ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.52

⁸⁵ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col. 52

⁸⁶ <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12515&mode=pdf> Col.37

140. At the same time, the Committee's view is that there needs to be a clear strategy for the use of the existing budget management tools which is proactive in addressing volatility over a number of years. The Committee notes that to some extent such an approach is set out in the MTFS where the Scottish Government sets out a number of priorities for the Scotland Reserve –

- Build up the balance to have a financial cushion available;**
- Manage underspends across financial years;**
- As far as possible, smooth resource funding including reconciliations;**
- Keep resource borrowing as low as possible.**

141. The Committee, therefore, seeks clarity over the Scottish Government's position about the management of income tax reconciliations. In particular, over its now stated position that decisions on management of income tax reconciliations can only be taken in each Budget process when the Scottish Budget for that year and the reconciliation applying, will be known. The Committee asks how this approach is consistent with the principles and priorities set out in the MTFS, which appear to provide the basis for a strategic approach to the management of reconciliations.

142. The Committee agrees with the SFC that the Scottish Government's response to the 2017-18 reconciliation should be considered alongside indicative future reconciliations as part of a longer-term strategy. This is essential given the extent of the forecast negative reconciliations and the potential impact on tax and spending if the budget management tools are insufficient.

143. While the negative reconciliation of £550m for 2018-19 remains indicative, it is likely to present the Scottish Government with a significant challenge in setting next year's Budget. The Cabinet Secretary suggested that were the Government to build up a significant reserve, there would be lots of accusations that she was not using the Government's resources as well as she could. The Committee recognises that, as stated by the Cabinet Secretary, "there is a judgement to be made on the reserve" and that maintaining a reserve of £100m ensures there is "a bit of a buffer."

144. The Committee asks the Cabinet Secretary how the Government will seek to find the appropriate balance between increasing the size of the Reserve to deal with future reconciliations and/or committing to further public expenditure. For example, if increased funding becomes available in 2020-21 through additional underspends or further Barnett consequentials.

145. The Committee recognises that there will always be political pressure to allocate all available resources on an annual basis. But both the Government and the Parliament now need to consider whether this is a sustainable approach. Given the nature of tax and social security devolution and how the Fiscal Framework operates there is a need across the Parliament and for Ministers to consider how the increased uncertainty and volatility can be managed while balancing the budget annually.

146. The Committee believes that consideration needs to be given to the possibility of a different approach to the Budget which shifts from a narrow annual focus on allocations to a more medium term approach which addresses the increased volatility. While the MTFS provides the basis for such an approach the Committee recognises that this has been significantly challenging to date given the lack of a recent comprehensive spending review both in the UK and Scotland.

147. The Committee recommends that the next MTFS should set out the basis for including a more strategic approach to budgetary management which goes beyond the current annualised approach and seeks to address medium term volatility and risk as well as the possibility of multi-annual budgets for the public bodies.

EU FUNDING

148. The Scottish Government has estimated that during the 2014-20 EU budget round, Scotland has received over £5 billion in funding from the EU. Although the UK has now left the EU, due to the transition period Scotland will continue to receive monies from a range of EU funds until the end of the 2014-2020 programme period.

149. During that period Scotland will have received-

- a. Pre-allocated funds (including funding pre-allocated to member states and regional pre-allocated funding of:
 - €4.6bn to implement the Common Agricultural Policy (CAP);
 - Up to €941m in Structural Fund support;
 - £108 m in Common Fisheries Policy Funding;⁸⁷ and
- b. Competitive funding (funds that can be bid for by governments, universities, businesses and other organisations) of:

⁸⁷ <https://digitalpublications.parliament.scot/ResearchBriefings/Report/2018/9/28/European-Union-funding-in-Scotland#>

- €650 million of Competitive research, innovation and education exchange funding (Horizon 2020) up to July 2019⁸⁸;
- €76m of Territorial Cooperation funding⁸⁹ and
- €90.7m of Erasmus+ funding up to the end of 2018 according to British Council figures⁹⁰.

150. The European Investment Bank (EIB) Group also provides finance in the form of loans outwith the 2014-20 funding programme. Since 2016, the EIB has signed loans worth €2.0 billion to projects in Scotland.⁹¹

151. The MTF5 states that in “the absence of firm commitments to the amounts that will be provided under alternative arrangements, we cannot yet quantify levels of funding in the future and any impact this will have on the Scottish Budget.”⁹² But the Scottish Government emphasise that all “lost EU funding must be replaced in full, so that the benefits that EU funding has provided to many sectors across Scotland can be maintained.”⁹³ Budget 2020-21 states that it has been “prepared on the assumption that there must be no detriment to the Scottish Budget as a result of the UK’s exit from the EU; this includes full replacement of lost EU funding.”

152. The first impacts of Brexit are already reflected in changes to the funding arrangements for Farm Payments, with £472 million of funding for this now flowing to the Scottish Government directly from HM Treasury rather than from the EU. Fisheries funding will also be provided by the UK Government in 2020-21.

EU Structural Funds

153. When the new round of EU structural fund programmes begins in 2021 the UK will not be eligible to participate having left the EU. The UK Government has indicated it intends to establish a UK-wide Shared Prosperity Fund to replace the European Regional Development Fund (ERDF) and the European Social Fund (ESF), using money returned from the EU. The previous UK Government proposed that the UK Shared Prosperity Fund will tackle inequalities between communities by raising productivity, achieved as set out in its UK Industrial Strategy.

154. In our Report on the Scottish Budget 2019-20, the Committee commented on the UK Government proposal for a UKSPF. We followed

⁸⁸

https://parliament.scot/S5_European/Meeting%20Papers/CTEEA_2019.01.09_PUBLICPaper_s.pdf

⁸⁹

https://parliament.scot/S5_European/Meeting%20Papers/CTEEA_2019.01.09_PUBLICPaper_s.pdf

⁹⁰ <https://www.erasmusplus.org.uk/file/27311/download>

⁹¹ 2019-20 Budget report (para 198)

⁹² <https://www.gov.scot/publications/scotlands-fiscal-outlook-scottish-governments-medium-term-financial-strategy-2019/pages/10/> page 16

⁹³ Ibid.

up that report with a more detailed inquiry into *Funding of European Union Structural Fund Priorities in Scotland, post Brexit*. In that report we welcomed the intention to replace structural funds but sought clarity regarding the impact of the UKSPF on devolved policy choices. We highlighted that the overall quantum, decision taking powers and flexibility which currently exists for the Scottish Government should not be reduced under the UKSPF. We also highlight concerns about how the transition from structural funds to the UKSPF will be managed and the need to ensure that valuable expertise, knowledge and capacity is not lost during that transition.

155. The Scottish Government formed a Steering Group to inform the Scottish position to any future funding. The Scottish Government also launched a consultation into The Replacement of European Structural Funds in Scotland Post EU-Exit⁹⁴ on 5 November. The consultation closed on 12 February 2020.
- 156. The Committee will continue to scrutinise the replacement of EU Structural Funding post-Brexit in 2020-21. As part of that scrutiny we will seek evidence from the Scottish Government's Steering Group on its report as well as from the Scottish Government on its response to the Steering Group.**
- 157. Following the UK general election in December 2019, the Committee wrote to the UK Government seeking a response to the recommendations within our EU Structural Funds report. We have yet to receive a response but once received we expect to take oral evidence from the relevant UK Government Minister.**

CAP

158. As CAP payments are paid in arrears, the final year of the 2014-2020 programme period will pay the claims for the 2019 claim year. It was agreed between the UK and the EU in the Withdrawal Agreement on 19 October 2019 that the CAP direct payments legislation for 2020 will not continue to apply to the UK after it left the EU. Accordingly, this specific body of legislation ceased to apply when the UK left the EU on 31 January 2020. (This was set out in Article 137 of the Withdrawal Agreement).
159. Therefore, without new legislation, after the UK left the EU on 31 January 2020, there would have been no legal basis for continuing to make direct payments to farmers in any part of the UK for claim year 2020. As a result, the UK Government introduced the UK Direct Payments to Farmers (Legislative Continuity) Bill 2020. This provides the necessary legal basis for Direct Payments to be made for claims for the year 2020.
160. In December 2019, the UK Government provided £3 billion in funding to ensure continuity of Direct Payments funding for farmers after EU exit

⁹⁴ <https://consult.gov.scot/economic-development/replacement-of-european-structural-funds/>

and maintain the level of funding for Direct Payments at the same rate as 2019. The payment for 2020 will be provided across two financial years, with the majority of the payments in 2020/21 and the remaining in 2021/21. The funding will be available from late in 2020 (as usually happens with CAP funding). The Scottish Government will receive £449 million in 2020-21 and a further £24 million in 2021-22.

161. In its pre-budget report the Environment, Climate Change and Land Reform (ECCLR) Committee highlighted its concerns that Brexit would significantly impact around £52m annual CAP funding which supports agri-environmental objectives. They asked the Scottish Government for re-assurance that funding levels in the Budget for environmental objectives would be maintained.⁹⁵ The Scottish Government responded that it shares the Committee's concerns and "continue to push the UK Government on this, and have been clear that the UK Government must replace all lost EU funding in full."

Erasmus+ and Horizon 2020

162. Following the end of the transition period, the UK will no longer be eligible to automatically participate in the EU's competitive funding programmes such as Horizon 2020 (to be renamed Horizon Europe for the 2021-27 programme) and Erasmus+. However, third country participation is possible in these programmes.

163. The Culture, Tourism, Europe and External Affairs Committee ("CTEER") Committee receives biannual reports on a range of EU funding streams including Erasmus+ and Horizon 2020. On 20 January 2020 it wrote to the UK Government about these funding streams and its impact:

- In relation to the Erasmus+ programme, the CTEER Committee's 2017 Erasmus inquiry highlighted the compelling evidence from participants and representative organisations regarding the value of these programmes and the transformational impact the programme can have, particularly for those in deprived areas.
- In relation to Horizon 2020 funding, the Committee sought clarification as to the UK Government's plans either to participate in, or alternatives to, EU programmes for research and innovation beyond 2020 as soon as possible.

164. That Committee highlighted the urgent need to clarify the UK's position with regards to Scotland's continuing participation in EU programmes for research and innovation in order to mitigate the potentially irreparable damage a loss of EU funding might cause to those sectors in receipt of these funds.

⁹⁵ ECCLR Committee Prebudget report 2020/21 <https://sp-bpr-en-prod-cdn.azureedge.net/published/ECCLR/2019/10/14/Pre-Budget-Report--Draft-2020-21-Budget/ECCLR-S5-2019-10-14.pdf>

165. The EU's draft negotiating mandate published by the European Commission on 3 February 2020 proposed that the future UK-EU relationship should provide scope for the UK to continue to participate in EU funding programmes, subject to meeting the general rules for the programmes and providing financing towards the programmes⁹⁶.
166. The UK Government's proposed approach to the negotiations with the EU about the future relationship indicated that it is prepared to consider participation in some EU programmes once the EU agree their funding for the 2021-27 financial framework. However, there has been no indication which programmes the UK Government is considering participating in⁹⁷.
167. The Scottish Government has previously indicated support for future participation in programmes such as Horizon Europe and Erasmus.
- 168. Taken together EU funding makes a significant contribution to supporting communities and organisations across Scotland. It remains unclear what funding will be available once the transition period ends in December 2020. Avoiding any 'cliff-edge' drop in funding for those Scottish communities and organisations currently benefitting from EU funding is therefore vital.**
- 169. The Committee notes that this uncertainty adds another layer of potential volatility to the Budget. The Committee invites the Scottish Government to advise on how this year's Budget addresses this potential volatility.**

SCOTTISH PARLIAMENTARY CORPORATE BODY

170. The Committee is required to consider the budget proposal from the Scottish Parliamentary Corporate Body (SPCB). The SPCB has a prior call on the Consolidated Fund, meaning that its budget is allocated before the Scottish Government makes any other allocations. The SPCB budget provides for the costs of the Parliament and also the costs of the Ombudsman and Commissioners (termed 'Officeholders') which fall within the definition of SPCB supported bodies.

⁹⁶ <https://ec.europa.eu/info/sites/info/files/communication-annex-negotiating-directives.pdf>

⁹⁷ <https://www.gov.uk/government/speeches/the-future-relationship-between-the-uk-and-the-eu>

171. The SPCB Budget⁹⁸ was submitted to the Committee on 13 December 2019 and the Committee took oral evidence on it at its meeting on 18 December 2019⁹⁹.
172. The SPCB identified a total budget requirement, including capital charges and non-cash items of £107.2m for 2020-21. Excluding capital charges and non-cash items, the SPCB 2020-21 budget submission for revenue and capital expenditure is £94.6m. This represents a £2.7m (2.9%) increase, in cash terms, on the 2019-20 budget. The Presiding Officer, in a letter to the Committee explained that this budget submission was set at the indicative forecast for the 2020-21 SPCB budget provided to the Committee last year 'with the exception of a £1.6m technical adjustment to employer's Civil Service Pension Scheme contribution rates and a £0.5m increase in Officeholders' costs for specific changes to their funding requirements.

Office Holders

173. The SPCB budget submission includes a £0.5m increase in the Officeholders' costs for 'specific changes to their funding requirements'. Schedule 3 of the submission states that¹⁰⁰—



The higher than anticipated increase in these budget bids is a result of additional functions for the Scottish Information Commissioner, the Scottish Public Services Ombudsman bid including half rent to August 2020 and full rent from then onwards for Bridgeside House (where the Ombudsman is co-located with the Children's Commissioner and the Scottish Human Rights Commission), as well as additional staffing costs.

174. The Committee asked in our report on Budget 2019-20 that the next SPCB Budget includes details in relation to the Officeholders' budget on any potential efficiencies and savings realised through the shared services agenda. The SPCB told us during oral evidence that the co-location project for Officeholders is complete and is expected to realise savings of £500,000 over the next ten years. It also allows the SPCB to look at where work can be done across the Officeholders such as in human resources and finance.
175. Some savings have also been made in the year ahead: the SPSO has made savings of around £80,000 to £85,000, while the Ethical Standards Commission and the Children and Young People's Commissioner Scotland have each saved around half that.

⁹⁸ SPCB Budget Submission 2020-21. (n.d.) Retrieved from [https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers\(4\).pdf](https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers(4).pdf)

⁹⁹ Finance and Constitution Committee, Official Report, 18 December 2019. (n.d.) Retrieved from <http://www.parliament.scot/parliamentarybusiness/report.aspx?r=12432&mode=pdf>

¹⁰⁰ Letter from the Presiding Officer, SPCB Budget Submission 2020-21, 10 December 2019. (n.d.) [https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers\(4\).pdf](https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers(4).pdf)

176. The Committee asked whether a specific efficiency target had been set for the Officeholders. The SPCB responded that this has not been done, “beyond the challenge function that we perform in assessing their budget bids in order to carry out their responsibilities.” They also pointed out that given some of the office-holders have very small numbers of staff there is a limit about what efficiencies can be looked for.

Brexit

177. The Committee noted in our report on Budget 2020/21 the ongoing uncertainty in relation to Brexit and recommended that the SPCB continues to review the resources available to Members. In his letter to the Committee, the Presiding Officer stated¹⁰¹—

” A great deal of uncertainty remains around the Brexit process and the parliamentary impact. However, the steps which the SPCB took over the past two years, ensure that we have the right level of skills and support available to Members and provide a stable platform from which to cope with the emerging legislative and scrutiny demands.

178. As is clear from this report, devolution is becoming increasingly complex and the constitutional impact of Brexit is likely to add to this complexity. This brings significant challenges for Members in ensuring that our critical scrutiny function is carried out robustly. The Committee emphasises it is essential, within the ongoing tight fiscal environment, that the priority within the Parliament’s budget is to ensure that Members are provided with sufficient resources, including for Members’ staff costs, to deliver robust scrutiny within an increasingly complex devolution settlement.

CONCLUSION

179. The key theme of this report is that as the Fiscal Framework becomes fully operational, including the reconciliation process, and the Scottish Government becomes fully financial responsible for all devolved social security benefits the Budget becomes increasingly complex and volatile. While there are big opportunities for policy divergence there are also significant budgetary risks. There are legitimate questions from the Scottish Government as to whether the budget management tools to manage these budgetary risks are sufficient. Those questions require careful consideration by HM Treasury.

¹⁰¹ Letter to the Committee, SPCB Budget Submission 2020-21, 10 December 2019. (n.d.) [https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers\(4\).pdf](https://www.parliament.scot/S5_Finance/Meeting%20Papers/public_papers(4).pdf)

- 180. But in the short-term there is a need to manage budget volatility within the existing Fiscal Framework. The Committee's view is that this requires consideration of a different approach to setting the annual Budget. The current approach of allocating all available resources was prudent when the Budget was almost wholly based on a Block Grant from Westminster and which was therefore relatively stable. It is much less clear whether such an approach is sustainable in setting a Budget which is much more volatile but still requires to be balanced annually. This is an issue that both the Government and the Parliament as a whole need to address.**
- 181. One of the key recommendations of the Budget Process Review Group was the introduction of a Medium Term Financial Strategy which would provide a means of focusing on the longer term sustainability of Scotland's public finances. This report highlights the need for such a medium-term approach. But the Committee recognises that this is challenging within the context of an annualised Budget where the expectation is that all available monies are allocated. The Committee also recognises that it has been challenging to develop this approach in the absence of a UK comprehensive spending review.**
- 182. The Committee therefore recommends that the next MTFS should set out the basis for including a more strategic approach to budgetary management which goes beyond the current annualised approach and seeks to address volatility over the medium term. While recognising the challenges involved consideration should also be given to the possibility of multi-annual budgets for the public bodies once the UK Comprehensive Spending Review has been published.**

