Finance and Public Administration Committee

24th Meeting 2023 (Session 6), Tuesday 26 September 2023

Pre-budget 2024-25 scrutiny: The sustainability of Scotland's finances

Purpose

1. The Committee is invited to take evidence in relation to its pre-budget 2024-25 scrutiny from the following panel of witnesses:

    - Rachel Cook, Deputy Head of Policy, Federation of Small Businesses
    - Sandy Begbie CBE, Chief Executive Officer, Scottish Financial Enterprise, and
    - Louise MacLean, Business Development Director, Signature Pubs, Scottish Hospitality Group

2. This paper provides background information in relation to the Committee's inquiry and highlights key issues raised in the written submissions received from the Federation of Small Businesses and Scottish Financial Enterprise, which are attached at Annexe A, and in relation to the hospitality industry in Scotland.

3. All submissions received to the Committee's call for views are published in full on the Committee's web pages and SPICe has also produced a summary of the main themes identified in the written submissions. A summary note has been produced of the Committee's engagement event which took place in Largs on 30 August, where participants discussed their priorities for the Scottish Budget 2024-25 and beyond.

4. A summary of issues arising during the Committee's evidence sessions in relation to its inquiry into the Scottish Government's programme for public service reform is also attached at Annexe B.

Fiscal sustainability

5. In its pre-budget 2023-24 Report, the Committee said it was "not convinced that the Scottish Government is carrying out enough strategic long-term financial planning to ensure future fiscal sustainability". It also sought more evidence on how the Scottish Government was seeking to strike the right balance between responding to the immediate financial pressures and addressing long-term fiscal challenges. The then Deputy First Minister's response to the Report referred to the Scottish Government's plans for public service reform being "founded on a commitment to strategic long-term financial planning that ensures future fiscal

sustainability" and noted that its approach to the 2023-24 Budget addresses both short and long-term needs. The response went on to say that the Scottish Government "will continue to develop our approach to medium and long-term financial planning and will set this out in our next Medium-Term Financial Strategy".

6. The Scottish Fiscal Commission (SFC) published its first Fiscal Sustainability Report on 22 March 2023, projecting the Scottish Government's spending and funding up to 2072-73, with a particular focus on demographics, trends, and the cost of delivery of public services. It uses the balance between spending and funding to assess the long-term fiscal sustainability of the Scottish Government's current tax and spending policies and its "annual budget gap".

7. The SFC concluded that, "if public services in Scotland are to continue to be delivered as they are today, Scottish Government spending over the next 50 years will exceed the estimated funding available by an average of 1.7% a year". This, it notes, is equivalent to £1.5 billion in today's prices and "represents approximately 4% of average Scottish Government spending on health in each year, or 6% of average devolved income tax revenues". To address this, the SFC argues that the Scottish Government would have to consistently reduce spending or raise devolved taxes through the next 50 years".

8. Scotland's population is projected to fall by approximately 400,000 over the next 50 years, driven by a low birth rate. The proportion of the population aged 65 and over is expected to increase from 22% in 2026-27 to 31% by 2072-73, while the working age (16-64 population) and under-16 population will fall in size. Scotland has a projected net annual inflow of migration averaging 19,000, including international and domestic migration. The changes to population structure will, the SFC argues, "translate into different levels of demand for public services, with higher pressure on health services and reduced demand for services used by younger people, such as education. Total spending on devolved public services (by both the Scottish Government and local authorities) is forecast to be £54 billion in 2027-28 rising to £120 billion by 2072-73.

9. Scotland's Census 2022 – rounded population estimates published on 14 September 2023 highlighted that the population of Scotland on Census Day (20 March 2022) was estimated to be 5,436,600, a growth of 141,200 (2.7%) since the previous census in 2011. This is a slower rate of growth than between 2001 and 2011, when the population grew by 233,400 (4.6%). The statistics also confirm Scotland's ageing population. It states that "there are more people in the older age groups than ever recorded in Scotland's Census", with 1,091,000 people aged 65 and over, compared to 832,000 under 15s.

Scottish Government Medium-Term Financial Strategy and SFC May 2023 Forecasts

10. On 25 May 2023, Scotland's Fiscal Outlook: The Scottish Government's Sixth Medium-Term Financial Strategy (MTFS) was published alongside the SFC's Scotland's Economic and Fiscal Forecasts May 2023.

11. The SFC's May 2023 Forecasts set out its five-year forecasts of the Scottish economy, tax receipts, social security expenditure and an assessment of whether the Scottish Government projections of borrowing are reasonable. The SFC's most recent forecasts are slightly improved on its December 2022 forecasts, with economic growth at 0.3% in 2023-24 rising to 1.3% in 2025-26. Real disposable incomes per person are still expected to fall, by 4% by the end of 2023-24 due to high inflation. The SFC expects total spending to increase in nominal terms each year, and by 13% between years 2023-24 and 2028-29. By 2028-29, the capital budget is expected to be 14% smaller than in 2023-24. Social security spend is forecast to increase from £5.3 billion in 2028-29 to £7.8 billion in 2028-29, and by 2027-28 the SFC expects the Scottish Government to spend £1.3 billion more on social security than the funding received from the UK Government through Block Grant Adjustments. Devolved taxes are expected to raise £20.1 billion of revenue in 2023-24, £384 million more than forecast in the SFC's December 2022 Forecasts. Income tax revenues have been revised upward in line with higher employment growth and higher nominal earnings growth, driven by inflation.

12. The May 2023 forecasts estimated an indicative negative reconciliation for Scottish income tax in 2021-22 of -£712 million, which has since been revised to -£390 million. In his letter to the Committee on 6 July 2023, Professor Graeme Roy notes that—

> "The provisional reconciliation figure of -£390 million is the largest negative reconciliation so far and exceeds the Scottish Government's borrowing powers. While it is smaller than the indicative estimate of -£712 million we provided in May 2023, the Scottish Government will still need to carefully consider how to handle it."

13. In her Foreword to the MTFS, the Deputy First Minister stated that—

> "… my number one priority is to ensure the Scottish finances remain on a sustainable trajectory so that we can deliver first class public services for our communities, improve equality by reducing poverty and seize the opportunities of an economy that is fair, green and growing".

14. The MTFS states that "tough and decisive action must therefore be taken to ensure the sustainability of public finances and that future budgets can be balanced". It notes from modelling that "our resource spending requirements could exceed our central funding projections by 2% (£1 billion) in 2024-25, rising to 4% (£1.9 billion) in 2027-28".

15. It also sets out the following three pillars which will underpin the Scottish Government's strategic approach to managing the public finances—

- **Focusing spending decisions on achieving the Scottish Government's three critical missions**. Alongside the 2024-25 Budget, it will refresh multi-year spending envelopes for resource and capital and extend the Capital Spending Review and Infrastructure Investment Plan period by one year, taking these plans up to 2026-27.

- **Supporting sustainable, inclusive economic growth and the generation of tax revenues.** The Scottish Government commits, ahead of the Budget 2024-25, "to explore areas such as seizing opportunities in areas where Scotland has a competitive advantage, such as the Green economy, and supporting entrepreneurs, start-ups and scale-ups; helping businesses to raise productivity; and further boost labour market participation including through an enhanced childcare offer".
- **Maintaining and developing the Scottish Government's strategic approach to tax**. It has since established an external tax stakeholder group this summer "to consider how best to engage with the public and other stakeholders on the future direction of tax policy, including whether a 'national conversation on tax is required". The outcomes will feed into the Budget 2024-25 and development of a longer-term tax strategy to be published alongside the MTFS in 2024.

Fiscal Framework Review

16. At the time of publication, the MTFS further confirmed that "the final version of the independent report on Block Grant Adjustments (BGAs) jointly commissioned by the UK and Scottish governments [to inform the Fiscal Framework] has been submitted to both governments for consideration, but the timing and arrangements for publication are still under discussion with the UK Government".

17. On 2 August 2023, the Deputy First Minister wrote to the Committee confirming that "I have now reached agreement with the Chief Secretary to the Treasury (CST) on a package of changes to the Scottish Government's Fiscal Framework". The Deputy First Minister explained that she had judged it appropriate to concede to a narrower scope for the review (than the more fundamental review originally envisioned) "in the interest of securing long sought practical borrowing and reserve flexibilities, and to protect those arrangements that we already have in place which work in our favour".

18. Alongside the letter, the Scottish Government published an updated Fiscal Framework agreed between the UK and Scottish Governments, as well as the Independent Report commissioned to inform the review. The Deputy First Minister's letter summarises the main features of this agreement, including retaining on a permanent basis the indexed-per-capita mechanism for calculating block grant adjustments and increasing the resource and borrowing limits.

19. In his letter to the Committee of 11 August 2023, Professor Graeme Roy notes that the sustainability challenges identified in the SFC's March report—

> "are common across the UK, with the OBR projecting similar increases in health spending UK-wide. There are similar trends in other countries, with other fiscal institutions identifying rising costs in healthcare and demographic change as putting pressure on public finances. They would occur under any constitutional settlement or fiscal framework. The recent agreement by the Scottish and UK Governments on the Scottish Government's fiscal framework makes the existing arrangements for calculating the block adjustments

permanent. It therefore would not change the results of our FSR published in March."

Inquiry

20. The Committee takes a cross-cutting, overarching approach to pre-budget scrutiny, while subject committees examine in detail those spending plans in their own portfolio area. This year, the Committee agreed to focus its pre-budget scrutiny on the sustainability of Scotland's finances in both the short and longer-term, reflecting the broader strategic and societal challenges highlighted in the SFC's Fiscal Sustainability Report, the limited capital expenditure available, and the impact of financial pressures on the delivery of both national outcomes and climate change targets.

21. This 2024-25 pre-budget scrutiny, which follows the Committee's recent inquiry into the Scottish Government's Public Service Reform programme, aims—

    - to develop a greater understanding of, and to scrutinise, the Scottish Government's plans to address the financial pressures on the Scottish Budget 2024-25 and beyond,
    - to establish how the Scottish Government balances its short and long-term financial planning and to identify any improvements in this area,
    - to influence the 'refresh' of the government's multi-year spending plans for resource and capital to 2026-27, to be published alongside the Scottish Budget 2024-25, and
    - to understand how the financial pressures might impact on the delivery of national outcomes and climate change targets, both in the short and longer-term, and to identify steps that the Scottish Government could take to alleviate these impacts.

22. The Committee held a call for views from 29 June to 18 August and received 26 responses, all of which have been published on the Committee's web pages. SPICe has produced a summary of the main themes identified in the written submissions, which is attached at Annexe B.

23. The Committee's current inquiry into the Scottish Government's plans for public service reform is intended to inform its pre-budget scrutiny and the findings from this work will be included in its pre-budget 2024-25 report. The inquiry is examining Scottish public bodies' plans for reform in their sectors, how the reform programme is working in practice and how it is delivering effective and efficient services. The inquiry, which started in March 2023, included a written call for views and a series of oral evidence sessions taking place from May to September. Further information on the Committee's public service reform inquiry and a summary of the broad issues raised by witnesses during evidence is available at Annexe B.

24. Evidence sessions with the SFC on its Fiscal Sustainability Report on 28 March and Economic and Fiscal Forecasts May 2023 on 6 June, and with the Deputy

First Minister on the Scottish Government's Medium-Term Financial Strategy on 13 June, were also intended to inform the Committee's pre-budget scrutiny.

25. In line with the Budget Process Review Group's recommendation that "enhancing public and professional understanding of the budget process should be a key objective for … parliamentary committees engaged in budget scrutiny", the Committee held a public engagement event in relation to its pre-budget 2023-24 scrutiny. The engagement event took place in Largs on 30 August 2023 and the Committee heard from local representatives of public bodies, business, third sector and community organisations on their priorities for the Scottish Budget. A summary note of the discussions is attached at Annexe C.

Evidence sessions

26. Official reports of the inquiry evidence sessions will be published on the Committee's web pages once available.

27. The Committee heard from academics and the Fraser of Allander Institute on 19 September during which the following issues were raised[1]:

- Lengthy lead-in times from the proposal of new taxes to implementation, as consultation and development of administration processes and methodologies for collection are required. New taxes are therefore not a viable option for the next financial year.
- Complexity of the UK and devolved tax systems. Anomalies arising, including with National Insurance, should be resolved rather than considering changes to the higher tax rate. Another option would be to grow the tax base through increasing the number of jobs below the top rates.
- 5% of income taxpayers in Scotland pay 40% of income tax raised in Scotland, so any proposed changes affecting these taxpayers should be considered carefully.
- A more strategic approach to taxation should be taken. This should include taxing carbon to help meet net zero targets, though it was recognised that this could affect people in rural and urban areas differently.
- Proposals to change multipliers in council tax do not go far enough, with property values used still based on 1991 values. Questions about why re-evaluation has not taken place should be asked and a cross-party approach to reform agreed.
- Decisions by the Scottish Government to spend on areas that do not result in equivalent UK spend, such as some social security payments and universal provision, divert funds from 'core' spend on health, education, and local government, thereby eroding funding for public services.
- There is paralysis in addressing demographic challenges across the UK.
- More prioritisation is needed within the Scottish Government. When a new policy is announced, associated costs should also be provided. It was

[1] The Committee heard from David Bell (Professor of Economics at the University of Stirling), David Heald (Emeritus Professor and Honorary Senior Research Fellow, Adam Smith Business School at University of Glasgow), and João Sousa (Deputy Director of the Fraser of Allander Institute).

suggested that health spending may not automatically rise along with the number of older people. More broadly, greater transparency over spend is needed, alongside multi-year budgets and medium to longer-term planning. One witness suggested that local government, which is in “severe difficulty”, and prevention, should be prioritised.

- Scotland must retain those people who have been educated in Scotland to enhance the growth of the economy, make start-ups easier and provide business confidence. Increased productivity is also needed.

28. The Committee also heard from third sector organisations, public bodies and thinktanks[2] at a round-table evidence session on 19 September. Issues raised included the tax system being too dependent on income taxes and the need for a ‘serious conversation about other taxes”. It was suggested that the Scottish Government should “be brave” in prioritising spend in the longer-term to meet its climate change and poverty targets, and deprioritising other spend “for now”. Some witnesses were reluctant to revisit means testing, as they felt there was limited data on which to target spend. Health benefits of reducing spending on roads (other than for safety measures and parking charges) were highlighted, including road safety with quieter roads, reduced air pollution, and increased activity, which could save money for the NHS. More transparency over what is being spent is also needed, including around how prevention can save money in the long-term. Focus is needed on attracting talent and investment to Scotland, driving green economic growth and a high skills economy, with career pathways for all. More people should be supported into work, including older people. Witnesses agreed that multi-year budgets would maximise efficiencies, reduce staff time and enable proper evaluation of outcomes, and that spending reviews need to provide more detail than level 2 figures.

Written submissions and related information

29. The Federation of Small Businesses (FSB), in its submission (at Annexe A), urges the Scottish Government to prioritise the small business community in Scotland, including using “every lever at its disposal to keep overheads down”, in the face of “rising inflation, persistently high energy prices, supply chain disruption and staff shortages”. The FSB welcomes the Scottish Government’s three pillars strategic approach to managing the public finances and suggests that, to help achieve these pillars, statutory targets around public sector procurement should be introduced and the Small Business Bonus Scheme maintained at least at its current threshold. The FSB believes that the recommendations put forward as part of the New Deal for Business Group, “tackle head-on a range of issues that have been bedevilling businesses for years but came into sharp focus in recent months”, including a more sensible approach to regulation, engagement with business throughout the policy development cycle, a Small Business Impact Assessment, and keeping all non-domestic rates policy reforms under review. The FSB makes a number of recommendations in relation to capital spend, noting that “a declining capital budget could hamper economic advances and, in doing so, we could lose more

[2] The Committee heard from Age Scotland, Children in Scotland, IPPR Scotland, Living Streets Scotland, The Poverty Alliance, Public Health Scotland, and Universities Scotland.

small businesses". When addressing depopulation, the FSB highlights the importance of Government considering the business population and how it can play its part in growing the economy and wider tax base, noting that "more than half of the businesses who responded [to our survey] do not feel Scotland is currently an attractive place to start up a business". On national outcomes, the FSB recommend creation of an additional national outcome focused solely on entrepreneurs and small businesses and including a national indicator which measures the winning of procurement contracts by SMEs. The FSB states that, while small businesses recognise that they have a responsibility to tackle their environmental impacts, many do not have the resources to make their operations more sustainable, which "could risk Scotland reaching its net zero target".

30. Scottish Financial Enterprise (SFE), in its submission (at Annexe A), highlights September 2023 research[3] stating that the financial services industry accounts for almost 10% of the Scottish economy, with financial and professional services employing around 160,000 people in Scotland. SFE's submission notes that, while the sector is a successful and important part of the Scottish economy, "we should avoid any sense of complacency" given the ambition of other countries and cities, within an internationally competitive environment. SFE also notes that "it is right" that fiscal planning and decision-making is set against broader economic challenges that require longer-term thinking, noting longer-term population trends could present a risk to 'human capital' seen as a strength internationally. It suggests that, along with driving a wellbeing economy, the "government's priority should be on maintaining our existing strengths, thereby encouraging the economic growth that benefits households, boosts businesses and enables high quality public services". It would welcome a multi-year plan to widen the tax base through inclusive growth, in order to sustainably raise taxes and fund public services in the long term. Finally, SFE argues that "discussion around taxation and spending should … take place in the context of a need to drive economic growth, improve productivity in both public and private sectors and maintain Scotland's international competitiveness.

31. The Scottish Hospitality Group (SHG) is an industry action group formed to provide a voice to the sector during Covid-19 and aims to work with local and national governments to "help the sector grow in a time of ever-increasing pressures". In 2021, one in 14 jobs in Scotland was in the food and accommodation service sector, adding around £1.3 billion to the Scottish economy quarterly[4]. On 21 June 2023, the Fraser of Allander Institute published a report on the Future of Hospitality in Scotland, in response to its earlier findings that "food and accommodation services lost the highest proportion of revenue compared to other industries during the pandemic, on top of already having relatively low profit margins" and that "hospitality workers were more likely to be in working poverty than workers in other industries". The FAI's June 2023 report highlights a number of concerns raised by businesses and workers in the sector, including:

[3] CityUK: *Enabling growth across the UK 2023*
[4] Media release on new report on the future of hospitality in Scotland | FAI (fraserofallander.org)

- The need for government to introduce policies that ensure adequate incomes for staff, such as increasing the minimum wage or social security payments, as well as more ‘non-traditional’ childcare options.
- Challenges for businesses in navigating formal education and training, which “rarely prepares people to work in high-pressure, late-night environments”, and a modern apprenticeship scheme which “misses out on recruiting older people”.
- Better government support would provide more opportunities to improve pay, with transport and childcare also an issue for employers, while general working conditions were raised by workers, and
- Several unanswered questions such as how technology will impact the future of hospitality, how employers can improve the educational system for hospitality workers, and how the sector and government can make hospitality a viable, long-term career option.

Next steps

32. The Committee will continue taking oral evidence in relation to this inquiry at its next meeting on 3 October, when it will hear from the Deputy First Minister and Cabinet Secretary for Finance.

Committee Clerking Team
September 2023

fsb

Experts in Business

The Federation of Small Businesses (FSB) is Scotland's leading business organisation and aims to help smaller businesses achieve their ambitions. These micro, small and medium businesses comprise almost all enterprises in Scotland (99%), employ 1.2 million people and contribute £110bn to the economy.[1]

We welcome the opportunity to respond to the Scottish Government Finance and Public Administration Committee's inquiry into the sustainability of Scotland's finances.

1. **How should the Scottish Government's Budget 2024-25 and its future budgets respond to these challenges?**

While we fully appreciate the Scottish Government's need to strategically manage the public finances, we urge the Scottish Government to prioritise the small business community in Scotland, as they are a key contributor to economic growth. Micro, small and medium businesses comprise almost all enterprises in Scotland (99%), employ 1.2 million people and contribute £110bn to the economy.[2]

In practice, this means that the Scottish Government budget needs to be designed specifically to help smaller businesses weather the storm, take particular account of their needs, and use every lever at its disposal to keep overheads down.

The Scottish Budget 2024-25 will clearly be set against the backdrop of an economically challenging time for both businesses and households. Scotland's small business community has suffered significant setbacks throughout the course of the last three years and, despite the best efforts of government to mitigate the damage done by the pandemic, they are facing rising inflation, persistently high energy prices, supply chain disruption and staff shortages. Thus, the normality and stability for which the business community had hoped has not yet returned. Indeed, FSB's Big Small Business Survey showed that nearly as many businesses (37%) cited 2022 as their most difficult year in terms of trading conditions, compared to 2020 (44%).[3]

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[1] https://www.gov.scot/publications/businesses-in-scotland-2022/pages/headline-results/
[2] https://www.gov.scot/publications/businesses-in-scotland-2022/pages/headline-results/
[3] https://www.fsb.org.uk/resources-page/big-small-business-survey.html

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Survey findings also showed that over three fifths of businesses who reported a decreased turnover in the last year attributed this to either the cost-of-living crisis or overall economic uncertainty.[4] Therefore, it is essential that the Scottish Government acknowledge and reflect the ongoing cost of doing business crisis when responding to budgetary challenges, and don't risk imposing more pressures on SMEs.

There is not an abundance of breathing space for many small firms, and the position is exacerbated by the fact that, in many key markets such as energy, they have a bargaining position more akin to that of a domestic consumer but enjoy fewer protections than those afforded to households. We note that Consumer Scotland covers SMEs in its remit and would recommend that government keeps this in mind when designing policy which impacts businesses, rather than treating them as a monolith.

2. **Does the Scottish Government's 'three pillars' strategic approach to managing the public finances adequately address the scale of financial pressures expected in the Scottish Budget 2024-25 and in the medium-term? Should the Scottish Government follow a different approach instead, and if so, why would that be more effective?**

FSB welcomes the 'three pillars' strategic approach to managing the public finances in a bid to adequately to address the scale of financial pressures expected in the 2024-25 budget and in the medium term.

We have highlighted under each pillar where we believe there are opportunities for Scotland's SMEs.

Pillar 1: focusing spending decisions on achieving its three critical missions – equality, opportunity, community.

The Scottish Government must harness the ambitions of Scotland's business community and ensure spending decisions fuel growth. FSB Scotland believe there are a few developments that could be incorporated into achieving its three critical missions: Include statutory targets around public sector procurement

[4] https://www.fsb.org.uk/resources-page/big-small-business-survey.html

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spend with small businesses as part of the implementation of Community Wealth Building.

- The Small Business Bonus Scheme must be maintained at least its current threshold, in order that the scheme remains the most generous of its kind in the UK and helps SME to grow.

Our Big Small Business Survey asked about challenges and opportunities facing small businesses across Scotland.[5] The results showed that over half of all respondents cited the cost-of-living crisis as the key obstacle to growth in 2023. However, despite ongoing challenges, the small business community is resilient and innovative, hungry for growth. Our findings illustrated that more than three fifths of Scottish SMEs plan to grow their business in the next two years, with young entrepreneurs having the biggest ambitions for growth – 85% of businesses owned by 16–34-year-olds plan to grow in the next two years.

Pillar 2: supporting sustainable, inclusive economic growth and the generation of tax revenues.

Economic uncertainties and historically high inflation have created one of the most difficult trading environments for businesses to date. At a time when small business confidence is falling, we welcome the Scottish Government's commitment to pillar 2 in a bid to look at all of the levers to steer the economy back towards growth.

We believe the recommendations put forward as part of the New Deal for Business Group tackle head-on a range of issues that have been bedevilling businesses for years but came into sharp focus in recent months.[6] Taking concrete steps towards a more sensible approach to regulation and committing to engaging properly with businesses at all stages in the policy development cycle will make Scotland a better place to start and run a business. The commitment to exploring a specific Small Business Impact Assessment will make a real difference to the way policy and financial decisions which affect smaller firms are developed.

Pillar 3: maintaining and developing a strategic approach to tax

[5] https://www.fsb.org.uk/resources-page/big-small-business-survey.html
[6] https://www.gov.scot/publications/new-deal-business-group-progress-report-recommendations/pages/2/

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We believe pillar 3 embodies the strategic approach put forward elsewhere by the government, in such approaches like the New Deal for Businesses, and has the potential to deliver positive financial decisions for SMEs across Scotland. One of the main recommendations put forward as part of the New Deal for Business Group is to keep all Non-Domestic Rates Policy reforms under review to ensure that the NDR system delivers the most competitive environment to do business whilst also supporting communities. As members of the NDR subgroup, we support its recommendation that the points raised by this group, and by the forthcoming Tax Advisory Group, must be taken into consideration by Ministers when setting NDR and other fiscal policy at Budget 2024-25, and thereafter.

From the recent Fiscal Framework agreement[7], we understand that VAT Assignment is still in discussion and with this in mind, we would like to urge both Governments to consider raising the VAT threshold, particularly in response to pillar 3. While higher interest rates are a tool to control inflation, the weight of escalating costs means consumers have less disposable income to circulate in the economy. When the money in consumers' pockets is worth less, the upshot is reduced sales for businesses. To help consumers and businesses, both Governments could consider raising the VAT threshold from £85,000 to £100,000. This move could cushion the some of the hardest blows of inflation, preventing tax increases from exacerbating the impact of price hikes on businesses and in turn, their customers.

3. **Given the pressures on the capital budget, how should the Scottish Government prioritise its capital spend in the Scottish Budget 2024-25 and over the medium-term?**

Infrastructure investment is one of the strongest levers available to deliver economic wellbeing, employment opportunities and growth. Capital funding also supports growth beyond infrastructure and can invest directly in businesses to boost innovation, funding research and development, and capitalising the Scottish National Investment Bank.

Whilst we understand the pressures on the capital budget, it is important to prioritise spend in areas which can maximise sustainable economic growth, including harnessing opportunities for SMEs:

[7] https://www.gov.scot/publications/fiscal-framework-agreement-between-scottish-uk-governments/documents/

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- Given the capital spending commitments already provided to the Scottish National Investment Bank (SNIB)[8], FSB urges the Scottish Government to utilise this to its full economic potential. That is why we recommend that the Bank targets at least 20% of its investment into micro and small businesses. This should include measuring and publishing the proportion of loans given to women, disabled and ethnic minority entrepreneurs in order to improve inclusive economic growth.
- FSB would also like to see the Scottish Government prioritise capital spend toward strengthening digital connectivity across Scotland. Investing in digital connectivity and digital inclusion can help businesses, workers, and service users to accelerate the uptake of digital services and overall economic productivity.
- With the Scottish Government setting the most ambitious target of any government in the UK to reach Net Zero by 2045, any future capital investment plans must be targeted toward the Just Transition. Our survey found that three fifths of Scottish SMEs do not feel enough support is available to them with regards to the impact of the transition to Net Zero will have on their business.[9] The Scottish Government must ensure Scottish businesses can capitalise on investment in low carbon in order to be part of the wider Just Transition.
- We also urge the Scottish Government to prioritise spend toward transport in a bid to support business growth. A third of Scottish SMEs consider public transport to be limited/absent in terms of availability. [10] Availability, reliability, and affordability is key. Businesses need a level of reliability when it comes to public transport, with more frequent and regular services on routes across Scotland, particularly in more rural areas. Any capital spending measures need to be undertaken with the full recognition of local business needs.

4. What are the implications of a declining capital budget, including on the productive capacity of the Scottish economy?

A declining capital budget could hamper economic advances and in doing so we could lose more small businesses. Loss of SMEs from Scotland's communities

[8] https://www.gov.scot/publications/outcome-targeted-review-capital-spending-review-updated-spending-allocations-2023-24-2025-26/documents/
[9] https://www.fsb.org.uk/resources-page/big-small-business-survey.html
[10] https://www.fsb.org.uk/resources-page/big-small-business-survey.html

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could lead to loss of jobs, decrease social mobility and impact overall economic wellbeing. As outlined in response to question 3, infrastructure investment is one of the strongest levers available to deliver economic wellbeing, employment opportunities and growth. Capital funding also supports growth beyond infrastructure and can invest directly in businesses to boost innovation, funding research and development, and capitalising the Scottish National Investment Bank. Without this support continuing to be made available, it is difficult to see how economic growth can be maximised.

5. **The Scottish Government's spending plans for resource (day-to-day spending needed to run public services) and capital (investment in assets and infrastructure) for 2024-25 until 2026-27 are to be updated and published alongside the Scottish Budget 2024-25 later this year. Where should the Scottish Government protect or prioritise spending in these multi-year plans?**

Any multi-year plans must recognise the importance of protecting and prioritising Scotland's SMEs. Any reprioritisation of spending plans geared towards businesses could cause severe ramifications for the success of the Scottish economy, as defined in the National Strategy for Economic Transformation.[11] There is a risk that more businesses will be lost from the economy if not protected. Scotland lost almost 20,000 small businesses during a single year of the Covid crisis. [12] Spending plans, both resource and capital, must make sure the operating environment for SMEs is as conducive to survival and growth as possible.

6. **The Scottish Government plans to address the budgetary implications of the expected long-term fall in population through growing the economy and tax base, public service reform, and an**

[11] https://www.gov.scot/publications/scotlands-national-strategy-economic-transformation/documents/ - "*Success means a strong economy where good, secure and well-paid jobs and growing businesses have driven a significant reduction in poverty and, in particular, child poverty. It means a nation of entrepreneurs and innovators, with resilient supply chains and competitive advantages in the new industries generated by technological change, scientific advance and our response to the climate and nature crises.*"

[12] https://www.fsb.org.uk/resources-page/20-000-scottish-businesses-vanished-during-year-of-crisis.html#:~:text=Andrew%20McRae%2C%20FSB's%20Scotland%20policy,individuals%20and%20new%2Dstart%20businesses.

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upcoming 'Addressing Depopulation Action Plan'. Are these the right priorities to address the implications of this fall in the population and, if not, how could the Scottish Government be more effective in this area?

When addressing depopulation, it is important that the Government also considers the business population and how it can play its part in growing the economy and wider tax base. Our survey findings show that more than half of the businesses who responded do not feel Scotland is currently an attractive place to start up a business. With more than two thirds (68%) citing the state of the economy as a main barrier to starting up a business and 44% citing lack of government support. Our survey respondents also noted the below:

- *"There are huge variances between communities in Scotland, rural and urban, the support doesn't always recognise this."*
- *"Scottish Government bureaucracy and initiative which are anti-business – STL, DRS, alcohol advertising, tourist levy etc."*
- *"Economically and politically, it is the wrong time to open up a new business."*

We know from previous statistics that Scotland lost almost 20,000 small businesses during a single year of the Covid crisis.[13] Thousands of UK companies are running out of time as the burden of rising interest rates, unmanageable debt, subdued consumer confidence, higher material and labour costs, and wider economic uncertainty combine to put considerable pressure on businesses across the country, according to the latest Begbies Traynor Red Flag Alert. The Red Flag Alert from Begbies Traynor classifies businesses in significant distress as those showing deterioration in key financial ratios and indicators such as working capital, contingent liabilities, retained profits and net worth. The 6.3% year-on-year rise in Scottish businesses falling into this category compares to an 8.5% increase across the whole of the UK.[14] We need an economy which is conducive to not only business survival but growth too, therefore creating an entrepreneurial nation is key, as is stated in the Scottish Government's own National Strategy for Economic Transformation

[13] https://www.fsb.org.uk/resources-page/20-000-scottish-businesses-vanished-during-year-of-crisis.html#:~:text=Andrew%20McRae%2C%20FSB's%20Scotland%20policy,individuals%20and%20new%2Dstart%20businesses.

[14] https://www.begbies-traynorgroup.com/news/business-health-statistics/red-flag-alert-report-q2-rising-debt-and-inflation-drives-a-surge-in-companies-entering-financial-distress

The Scottish Government must also support the needs of rural businesses in order to address the implications of depopulation. Rural small businesses continue to face specific and often disproportionate infrastructural challenges compared to businesses based in urban areas. Poor digital connectivity and inadequate transport infrastructure continue to blight the prospects of small firms in rural areas. It is essential that the Scottish Government recognises this and addresses the rural productivity gap, to create a more sustainable and resilient economy that benefits everyone, no matter how small or large their rural town is.

This is why FSB supports the Scottish Government's commitment to implement a Scottish Rural Community Immigration Pilot.[15] However, for those employers becoming 'sponsors' within the scheme, they must be provided with efficient support to reduce any administrative burden for businesses, and ensure the process is simple and effective. Our members have also raised concern that there may be tension between what the Scottish Government want in terms of outcomes of the scheme (e.g., repopulation of rural/remote areas) and the needs of these areas and employers. There is a need for government to meaningfully engage with employers and communities in order to allay any potential issues.

7. **How should the Scottish Government balance its short and long-term financial planning and where can improvements in this area be made?**

As mentioned previously, FSB Scotland support the recommendations put forward as part of the New Deal for Business Group to tackle head-on a range of issues, and which should help the Scottish Government balance its short and long-term financial planning.[16] The concrete steps towards a more sensible approach to regulation and the commitment to engaging properly with business at all stages in the policy development cycle will make Scotland a better place to start and run a business.

This includes the regulatory burdens SMEs face. Regulatory compliance has been a key issue for small businesses in recent years, with concerns around the cumulative impact of different regulations coming from across different areas and spheres of government. FSB has also raised issues around regulations being

[15] https://www.gov.scot/publications/scottish-rural-visa-pilot-proposal-september-2022/documents/
[16] https://www.gov.scot/publications/new-deal-business-group-progress-report-recommendations/pages/2/

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designed without taking into consideration the specific impact on small businesses.

8. **How will long-term financial pressures impact on the delivery of national outcomes and climate change targets and what steps can the Scottish Government take to alleviate these impacts?**

FSB Scotland recently submitted a response to the Scottish Government's review of National Outcomes. Given the massive changes our economy and society has seen since the last review of National Outcomes in 2018, we were pleased that a consultation exercise was undertaken. Now is the right time to reassess what outcomes are going to be important in delivering economic wellbeing and financial stimulus for Scotland, a lynchpin of which is the small business community, and ensuring spending plans align with the Scottish Government's National Strategy for Economic Transformation. [17]

Long-term financial pressures could impact the delivery of the National Outcomes if we do not harness the opportunities available to Scotland. In our response to the review, FSB Scotland put forward the following recommendations, which we believe could help to alleviate some impacts of financial pressures on delivering national outcomes:

- Create an additional National Outcome focused solely on entrepreneurs and small businesses.
- Include a National Indicator which measures the winning of procurement contracts by SMEs.
- Set a target to reduce regulatory requirements on SMEs and create a National Indicator to measure this performance.
- Use the National Performance Framework more systematically and explicitly to influence decision making.
- Increase transparency on how business support agencies link in with the NPF to ensure they are delivering the targets set out as part of the National Outcomes.
- Explore providing time-bound milestones/objectives to provide a greater focus and assessment of the rate of progress towards achieving National Outcomes.
- Have closer and clearer alignment of those who advise and take funding decisions in both Scottish and Local Government with the NPF.

[17] https://www.gov.scot/publications/scotlands-national-strategy-economic-transformation/

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Financial pressures could also impact climate change targets. FSB research consistently demonstrates the desire and willingness of the small business community to do more for the environment and help the transition to a net zero economy. A survey of FSB members undertaken ahead of COP26 conference found that 80% believe they have a responsibility to tackle their environmental impact.[18] However, similar to the financial pressures on the Scottish Budget as a result of economic turmoil, many small businesses do not have the resources to make their operations more sustainable, which could risk Scotland reaching its Net Zero target. Our Big Small Business Survey also found almost two fifths of Scotland's SMEs have limited or no understanding of government targets related to Net Zero and how these will impact their business. Four fifths also have not engaged with any government support initiatives with regards to the transition to Net Zero.[19]

In order for the Scottish Government to alleviate this impact, business support programmes with regards to Net Zero should be reconfigured with the input of those they are intended to support. Sector-specific programmes should also be implemented. Net-zero related business support offers must be scaled up in terms of their provision of grant support and interest-free loans. The consequences of not acting on climate change are well-documented, and meeting this challenge will require the efforts of every part of society, including SMEs.

9. In follow-up to the Committee's inquiry on effective decision making, how can transparency be improved around how the Scottish Government takes budgetary decisions?

FSB Scotland submitted a response to the Committee's inquiry on effective decision making, with our key focus in this inquiry being around public finances and increased transparency in this area.

Robust and transparent financial and performance reporting on the part of government is key to supporting the long-term decision making required for economic recovery and future growth. This requires increased transparency over

[18] https://www.fsb.org.uk/resources-page/small-firms-hoping-cop26-proves-catalyst-for-change-as-report-finds-costs-weighing-on-sustainability-intentions.html
[19] https://www.fsb.org.uk/resources-page/big-small-business-survey.html

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how funding is spent, and increased government efforts to produce comparable numbers for previous budgets to enhance scrutiny.

Our full submission can be found [here.]

Further Information

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Scottish Parliament Finance and Public Administration Committee

The Sustainability of Scotland's Finances

1. Background on financial and professional services in Scotland

- Scottish Financial Enterprise is the representative body for Scotland's financial and related professional services industry. We have more than 110 member companies, ranging in size from global organisations headquartered in Scotland, to international firms with substantial operations here, through to small locally based fintechs and support companies drawn from all areas of financial and related professional services.

- According to TheCityUK's *Enabling growth across the UK 2023* report (published earlier this month), the industry accounts for almost 10% of the Scottish economy, with financial and professional services employing around 160,000. We also support many jobs in the wider supply chain, for example jobs with large tech firms like Accenture and CapCo.

- Outside of London, Scotland is the most attractive hub for inward investment in the UK, being home to 2000 financial services businesses and 200 fintechs. All key industry sub-sectors are represented in Scotland at scale, and £700bn in assets are managed from Scotland.

- Our sector is a key enabler of other areas of economy and society – from tax contributions to supporting businesses and households, community investment, and its role in financing a just transition to a net zero economy.

- Our members continue to be ambitious and innovative in helping navigate the economic headwinds that Scottish businesses and households are facing. And they are well-placed to take advantage of the key opportunities such as green finance and our burgeoning fintech sector.

2. Budget context

- Like households and businesses across Scotland, the Scottish government faces clear funding pressures, exacerbated – as in the rest of the economy - by high inflation. The recent Royal Bank of Scotland PMI noted similar challenges in the private sector with business confidence slipping to an eight-month low.

- We recognise the Scottish government has a challenge to balance its three stated economic pillars of "taking tough decisions to prioritise spending;

ensuring a strategic approach to tax; and supporting sustainable, inclusive economic growth to generate tax revenues." Business growth and recovery risks being hampered by taxation policies that place Scottish businesses at a competitive disadvantage in a UK and international context. In the current economic climate, many businesses already face huge difficulties in striving to meet rising costs, retain and look after their employees, and not pass rises on to their customers.

- Our business landscape benefits from our accessible cities, vibrant culture, high standards of living and relatively low cost-base. Maintaining Scotland's competitiveness and attractiveness as a place to do business should be at the heart of the government's ambition to deliver its political priorities and ensure high quality public services.

- While our sector remains a successful and important part of the Scottish economy, it is important to remember that we operate in an internationally competitive environment, and the ambition of other countries and cities means we should avoid any sense of complacency over the role and contribution of Scotland's private sector.

- And it is right to set fiscal planning and decision-making against the backdrop of the broader economic challenges that will require longer-term policy thinking. For example, our "human capital" asset has long been seen as a strength internationally, but the recent census points towards a potential risk on our relative longer-term population trends.

3. Priorities

- Coupled with its ambition to drive a wellbeing economy that delivers benefits for all sections of society, the government's priority should be on maintaining our existing strengths, thereby encouraging the economic growth that benefits household, boosts businesses and enables high quality public services.

- We believe the best way to sustainably raise tax revenues and fund public services over the longer term is to widen the tax base through inclusive economic growth and we would welcome a multi-year plan that seeks to deliver this outcome.

- On personal taxation, recent polling - carried out by Survation for True North - suggests that a majority of people in Scotland believe that public services do not deliver value for money, even though personal tax is higher here than in the rest of the UK.

- Given the projected funding gap, driving economic growth will become increasingly important in the coming years as a means of helping deliver our shared societal benefits.

- Discussions around taxation and public spending should therefore take place in the context of a need to drive economic growth, improve productivity in both public and private sectors and maintain Scotland’s international competitiveness.

ANNEXE B

Background to and summary of themes arising from the Committee's inquiry into the Scottish Government's public service reform programme

Background

1. This paper sets out background information in relation to the Committee's inquiry into the Scottish Government's public service reform programme and highlights themes arising from this scrutiny to inform the Committee's pre-budget 2024-25 inquiry into the Sustainability of Scotland's Finances.

Inquiry

2. On 6 March 2023, the Committee launched an inquiry into the Scottish Government's plans for public service reform, with the following remit:

    - to develop a greater understanding of the Scottish Government's public service reform programme,
    - to bring greater transparency to the aims of the programme and measures put in place by the Scottish Government to support public bodies to achieve these aims,
    - to track progress in delivering public service reform by the Scottish Government and public bodies over the remainder of this parliamentary session until 2026, and
    - to examine the outcomes of the public service reform programme, including effectiveness, efficiency, and impact on public service delivery.

3. The Committee's call for views, which opened on 6 March 2023, sought written submissions from Scottish public bodies on their plans for reform in their sectors. It also requested views from others with an interest in how the reform programme is working in practice and on the extent to which the programme is delivering effective and efficient services. The Committee received 32 written submissions to its call for views. A summary of evidence received has been produced by SPICe. The Committee held evidence sessions as part of this inquiry from May to September 2023[5]. Official reports of these evidence sessions are available on the Committee's web pages and a summary of key issues raised at each evidence session can be found in the Committee's 12 September meeting papers.

4. The Scottish Government has stated that "balancing the budget will require difficult decisions and reform". It has further indicated that "our programme of

[5] Evidence was heard at meetings on 23 and 30 May, 6, 20 and 27 June, and 12 September 2023.

reform will be accompanied by a clear financial strategy, taking account of significant changes, available resources and expected cost pressures including demographic changes, technological advances and inflation, as well as considering necessary mitigations".

5. Against this background, the Committee has agreed to use the evidence gathered as part of its public service reform inquiry to inform its pre-budget 2024-25 scrutiny on the Sustainability of Scotland's Finances, including evidence sessions and the findings in its report. A summary of the broad issues raised in evidence is therefore provided below:

   - The Scottish Government needs to provide a vision, oversight, direction and underpinning investment for its reform programme, as well as a sense of purpose and clarity on the intended outcomes. It should seek meaningful feedback from the public through an "honest conversation" about the financial challenges being faced, what the public would like to see from their public services, which reforms are required to deliver these services and which organisations are best placed to deliver them.
   - Without a 'mandate' the delivery of cost savings and improved services "will not happen". An incentive to collaborate is also needed otherwise people "tend to pick off the bits round the side that do not threaten their own jobs".
   - Achieving efficiencies as part of managing budgets is not genuine reform and carrying out reform at a time of financial pressures will not achieve effective change or sustainable delivery of services.
   - There are skills shortages in the 'digital data space' in the public sector, where "we are all fishing in the same pool for the same capability". Smaller bodies are at a "massive disadvantage in negotiating with private sector suppliers". Pooling these kinds of resources could help transform public services.
   - Data sharing, automation of processes, and using artificial intelligence and common systems across public services would enable "powerful collaboration", deliver efficiency and improve quality.
   - A wider national steer and subsidy leverage is needed to ensure robust digital infrastructure, including equity of digital position across all bodies.
   - Ring-fencing a group of experts from public bodies with reform as their primary focus would "see some really positive movement".
   - Corporate reporting should be used to demonstrate how bodies are making progress against reform objectives.
   - 'Cultural friction' can occur when bodies are brought together into one structure. Early and continued effort and engagement with staff and stakeholders is required to avoid or minimise this.
   - The cluttered landscape of public bodies needs to be addressed.
   - More focus is required on complementary reform and collaboration across local government and public bodies, focused on what services are needed and moving funding around to how they are best delivered.
   - Concerns were raised by local authority representative bodies regarding the potential for greater sharing of services across councils within what they argued was a complex structure. However, those local authorities

who gave evidence highlighted that collaboration between neighbouring councils is occurring on shared services, systems and teams. They also noted further potential to create single national functions that serve all authorities, e.g., for rates collection and public analysis, as well as on progressing a single island authority.
- A focus on prevention and early intervention is vital, however with results often not seen for several years, this can be politically challenging within electoral cycles.
- Lessons can be learned from the experience of working during the Covid pandemic where public bodies worked closely with local authorities and the third sector to deliver services more quickly, effectively, dynamically and within reduced bureaucracy. A trade-off was more limited consultation.