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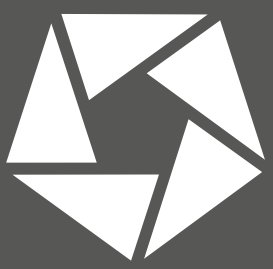

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Scottish Budget in 2021/22: budgeting for a recovery

David Eiser and Emma Congreve

Summary

Recent positive news on vaccine development raises expectations that 2021/22 will herald the beginnings of a recovery from both the health and economic shocks caused by Covid in 2020. But the precise path of that recovery remains very uncertain. It will depend on the pace of the vaccination programme, the effectiveness of the vaccine and test-and-trace programmes in containing the virus, and the pace at which health restrictions can be lifted as a result.

As well as the pace at which restrictions can be lifted, the outlook for the economy will depend on the degree of structural damage wrought by the crisis, and the extent to which households unwind significant savings increases during 2020.

A key implication of this uncertainty is that budgets and fiscal policy will need to take a flexible and adaptive approach to supporting the health and economic recovery during 2021/22. The Scottish Government's budget for 2021/22 is due to be published on 28 January.

The UK Government's Spending Review 2020 implies that the Scottish budget will receive £1.3bn of funding to address health and economic implications of Covid in 2021/22. This is significantly lower than the £8.2bn received in 2020/21.

It is likely that further Covid resources will flow to the Scottish budget if the recovery across the UK is more protracted than is implicitly assumed by the UK Government in its current spending plans. But until then, the Scottish Government has to set its plans on the basis of confirmed resources. In setting its budget, it will have to decide which elements of Covid support it can unwind most quickly, and which it must continue to fund in some way in the early part of 2021/22. Health is likely to absorb much of the Covid funding in 2021, leaving difficult decisions about how to balance remaining support between different sorts of businesses, household and organisations.

There is a case for saying that the Scottish Government should have greater funding certainty and/or additional funding flexibility. This could come through some combination of enhanced commitments on intergovernmental coordination and communication on funding decisions; an extension of the guaranteed funding approach during 2021/22; and enhance powers over borrowing or use of cash reserves.

The Scottish Government's block grant for core (i.e. excluding emergency covid support) resource spending is set to increase by £1.2bn in 2021/22, implying average annual real terms growth of 3.8% since 2019/20. The Scottish resource block grant will therefore be back to pre-austerity real terms levels next year, although this is not the same as saying its spending power will be back to pre-austerity levels (Scotland's population is larger and the government's 'core' responsibilities are wider).

The Scottish budget is determined by a number of factors beyond the block grant itself (which include devolved tax revenues, use of reserves, additional resources for social security). The budget faces a number of upside and downside risks, but there is no strong reason at the moment to think that these factors will materially influence the outlook for spending growth in 2021/22, beyond the impact of the block grant.

As well as the challenging decisions on how to allocate diminished Covid-related spending, the government faces the usual spending decisions of 'normal times' too. Despite the fact that there are few 'new' spending commitments for 2021/22, funding settlements for some portfolios may not feel particularly generous if health consequentials – which account for the majority of the £1.2bn increase in the block grant – are passed on to health. It will be interesting too to see whether the Scottish Government will feel able to provide a more generous public sector pay settlement than set out by the Chancellor Rishi Sunak for the UK.

In deciding how to use its income tax powers to support the economic recovery in 2021/22, the Scottish Government will need to navigate a complex range of economic and political factors, all underpinned by significant uncertainty. Some may argue that tax cuts are an effective strategy to stimulate the economy. But in a devolved context such arguments are likely misplaced. The government must run a balanced budget, and any increase in private spending as a result of tax cuts would likely be more than offset by falls in government spending. Given these complexities and uncertainties, a hedge-the-bets policy of 'no change' is perhaps therefore the most likely.

Decisions on council tax invariably feel unsatisfactory. Freezing the tax deprives local authorities of much needed revenue. But tax increases are invariably unfair. The tax is poorly related to property value and regressive with respect to income.

These trade-offs are particularly acute at the current time. The case for reform of the tax remains clear. Until then, council tax decisions leave the government stuck between a rock and a hard place. A further rise this year seems inevitable. But as a mechanism to raise revenue for public spending, it is difficult to avoid the conclusion that income tax rises would be objectively fairer.

The Scottish Government's block grant for capital spending is on track to increase by less than £100m in 2021/22 according to Spending Review plans. Nonetheless, coming on the back of a substantial uplift in 2020/21, this will take the capital block grant back to its pre-austerity high in real terms by 2021/22. And there is reason to believe that additional capital consequentials will be added to the block grant for 2021/22 in due course, as the UK Government has not yet set formal allocations for its vaunted 'Levelling up fund'. This fund will apply in England but generate consequentials for Scotland.

An expectation of the UK Government's Spending Review 2020 was that it would set out further detail of the UK Shared Prosperity Fund (UKSPF), the replacement for EU Structural Funds in a post-Brexit world. The Scottish Government has two concerns about the UKSPF. One relates to the level of UKSPF that will flow to Scotland, and the extent to which this offsets the loss of EU Structural Funds. The other is that the fund will be managed at a UK level, with the Scottish Government potentially having limited influence on the design and operation of the funding in Scotland.

The UK Spending Review did little to allay these concerns. 2021/22 is treated as a transitionary year, with UKSPF funding significantly lower than under predecessor funds – although with an expectation will ramp up in subsequent years to match current EU funding levels. And Spending Review 2020 reiterated the UK-wide aspect of the scheme's delivery.

The backdrop to the Scottish budget will be significant uncertainty around the economic and health outlook; ongoing intergovernmental tensions on a variety of matters including funding flexibility and certainty, potentially exacerbated following a no-deal exit from the EU transition agreement; and the Scottish elections in May. The inevitable politicking around all this will hopefully not detract from a focus on the core issues the budget must address.

1. Introduction

Fiscal policy has played a huge role in mitigating the response to Covid-19

The health and economic crisis caused by Covid has upended the budget plans set out at the start of the financial year, both for the UK and Scottish Governments. The UK Government is forecast to borrow around £400bn more in 2020/21 than anticipated in March. Scottish Government resource spending is on track to be £7bn higher than planned at the budget, on top of which revenues from business rates and income tax could in combination be up to £2bn lower than forecast.

The expectation is that 2021/22 should be a year where a recovery of sorts is possible. But what is the outlook, how much uncertainty is there around that outlook, and what does that imply for budget setting?

Its worth starting by considering where we are today. The Scottish economy contracted by a fifth in the second quarter of 2020, an unprecedented decline, due to the widespread shutdown that was necessary to contain the virus. Whilst there was some bounce-back in the third quarter as restrictions were lifted, by September the economy was still 7.5% below its pre-pandemic size. This is well below what we would think of as being the trough of a normal recession.

In this context, what remains remarkable is the apparent resilience of the labour market. By October, the employment rate was still 74%, significantly higher than observed following the financial crisis.

That apparent success owes a lot to the comprehensive package of fiscal support made available to mitigate the effects of restrictions. This support includes of course the CJRS furlough scheme and Self-Employment Support Scheme, but also significant investment in business grants and loans, as well as tax reliefs and cuts.

But there remains plenty to be gloomy about. The strong headline performance of the labour market masks rising youth unemployment and a big drop in self-employment. The partial recovery in economic output in quarter 3 is unlikely to be retained in quarter 4 given the reimposition of major restrictions. And fiscal support can only protect major job losses for so long in the face of such an unprecedented stop in economic activity – recent weeks have[1] seen substantial announcements of significant job losses and high profile business closures.

Despite recent good news, there remains significant uncertainty over the economic outlook, and hence what type of fiscal support will be needed when

Just a few weeks ago, the OBR's central forecast for the UK anticipated the unemployment rate could reach 7.5% by the middle of next year[2]. That would equate to an additional 60-70,000 unemployed in Scotland relative to the 5% unemployment rate currently. The OECD's recent global economic outlook was similarly gloomy, forecasting that UK GDP would contract by 11% in 2020, more than in any other European country, and recover less than half of that decline in 2021.

[1] OECD Economic Outlook, December 2020
[2] OBR: Economic and Fiscal Outlook, November 2020

There is of course substantial uncertainty around any forecast at the moment, a point that both the OBR and OECD readily acknowledged. Both forecasts were prepared slightly ahead of the recent positive announcements about vaccine effectiveness, and both were prepared before rollout dates of the Pfizer/BioNTech's vaccine were announced.

So, there is a case for saying that these particular 'central' forecasts are pessimistic. If vaccines are rolled out rapidly and are as effective as hoped, perhaps governments will be in a position to lift most restrictions by very early in the 2021/22 financial year. This could in turn herald a major consumer led recovery, driven by an unwinding of the significant increase in household saving during 2020.

Equally however, there are also grounds for pessimism. Vaccine roll-out will entail a major logistical effort, and it may take longer than hoped to supress the virus to levels that are consistent with complete lifting of health restrictions. Whilst the UK appears to be at the forefront of the vaccine roll-out, many other parts of the world face a much longer wait and this will hamper the global recovery.

Perhaps more significantly is the impact of permanent structural economic change. A legacy of the virus will almost certainly be some structural shifts, as consumer preferences for things such as online retail, business travel, commuting and eating out evolve.

But economies inevitably take time to adjust to these structural changes: people, business and capital cannot necessarily reallocate quickly from declining to growing sectors. And so even if there is relatively good news on the health front, the possibility of economic scarring and structural unemployment cannot be discounted.

And of course, we cannot ignore the possibility of a new deal Brexit which would create further economic headwinds in both the immediate term (in the form of border disruptions) and in the longer term (in the form of trade barriers and weaker growth). Both the recent OBR and OECD economic forecasts for the UK assume that a trade deal with the EU is agreed – but that 'no deal' would imply weaker growth and higher unemployment in 2021.

Budget plans will need to be flexible and adaptive

What does all this mean for budgets and fiscal policy? The most obvious point is that there is a need for flexibility, and the scope to adapt budget plans. Beyond that, fiscal policy needs to work to support the recovery. In the UK context, this means ensuring that policy remains expansionary until recovery is firmly embedded – the size of the deficit is a secondary concern. In terms of specific policies, there will be a need to support businesses and the labour market to adjust to the new normal through skills and employability programmes.

This paper discusses the level of resources that the Scottish Government is likely to have to address these challenges, and the sort of budget issues it will need to confront.

2. The resource block grant in 2020/21 and 2021/22: outlook and issues

The Scottish budget has received £8.2bn in Covid-consequentials during 2020/21

The key factor determining the overall size of the Scottish resource budget remains the block grant from Westminster.

At the time the 2020/21 budget was set out in February, the Scottish Government's core resource block grant was anticipated to be £29.7 billion. This represented a 5.5% real terms increase on the previous year[3]; the most 'generous' annual uplift in recent times, but nonetheless not quite sufficient to take the size of the block grant back to 2010/11 real terms levels.

Since then, the Scottish budget has received a guaranteed uplift of £8.2bn in additional consequentials to mitigate the health and economic impacts of Covid. The allocation of these consequentials is discussed in Box 1.

Box 1: The allocation of the Scottish Government's £8.2bn of Covid consequentials

Our previous paper has discussed issues around the allocation of the government's £8.2bn of Covid consequentials in 2020/21[4].

At that point, the government had set out in detail how £6bn of its £8.2bn Covid-consequentials had been allocated when it published its Autumn Budget Revision (ABR).

The ABR sets out that health spending has received a major share of that Covid-spending (at least £2.4bn). Businesses have received significant support, both in the form of Non Domestic Rates reliefs (to the tune of £900m), business grants (upwards of £1.5bn) and subsidies to the transport sector (£350m). A range of support has been targeted at low income and other vulnerable groups, much of it packaged up in a £350m welfare fund, and there has been support on top of that to local authorities to help mitigate loss of income from fees and charges. Additional funding of at least £300m has also been made available to support skills, training and education.

More recently the government has published an update of Covid-related funding decisions since the Autumn Budget Revision[5]. This provides welcome additional clarity on the use of the £8.2bn of consequentials, albeit at a fairly aggregate level.

The additional funding allocated since the ABR includes a further £600m for health and social care and welfare support (including further funding for test-and-trace, and the £180m cost of the £500 thankyou payment to health and care workers announced at the SNP conference, and a £100m Winter Support Fund for families and children). It also includes a further £500m to support transport providers and address funding shortfalls in various public agencies, and almost £600m of further support to businesses. Some £300m of the £8.2bn is currently left unallocated, to provide a reserve throughout the remainder of the financial year.

[3] This calculation compares the block grant for 2019/20 when the 2019/20 budget was set with the block grant for 2020/21 when the 2020/21 budget was set. This strips out the effect of in-year funding changes during 2019/20, without which the uplift in the block grant would appear smaller. New funding for farm payments and social security in 2020/21 is not included. Nonetheless, some of the increase in block grant does reflect increased government responsibilities and costs (e.g. in respect of pension contributions), and thus does not indicate a 5.5% increase in spending power.

[4] https://fraserofallander.org/scottish-economy/fiscal-policy-tax/the-evolution-of-the-scottish-budget-2020-21-and-a-look-forward-to-the-spending-review/

[5] https://www.gov.scot/news/latest-covid-19-funding-allocations/

The core block grant will increase significantly in 2021/22, but Covid funding will phase-out relatively abruptly

What is the outlook for the Scottish block grant in 2021/22? The answer to that question was provided in the UK Government's Spending Review, published on 25 November. From a Scottish perspective, the two big questions that the Review was expected to answer were:

- How much would Scotland's 'core' block grant – to cover normal devolved public services – increase in 2021/22 compared to last year?; and
- How much of the additional monies to mitigate the effects of Covid-19 during 20/21 would persist into next financial year?

In terms of 'normal' public services, the Spending Review shows Scotland's core resource block grant increasing by £1.2bn, to £31.7bn, in 2021/22. This implies real terms increases of 3.8% per year between 19/20 and 21/22(Table 1).

In terms of the second question, the Scottish budget is due to receive £1.3bn of additional resource consequentials in 21/22 as a result of the UK Government's *currently anticipated* Covid-related spending interventions in England.

Table 1: Changes to Scottish Government resource spending, 2019/20 – 2020/21, £bn

	19/20	20/21	21/22	Average annual real terms change, 19/20 - 21/22
Core resource block grant	28.3	30.4	31.7	3.8%
Covid-19 resource funding	0	8.2	1.3	n/a

Source: HM Treasury – Spending Review 2020; FAI analysis. Notes: real terms changes are presented as an annual average between 2019/20 and 2021/22 because of volatility in the GDP deflator which makes annual comparisons between 2020/21 and 2021/22 misleading.

The Scottish Government's core resource block grant is back to its pre-austerity real terms level

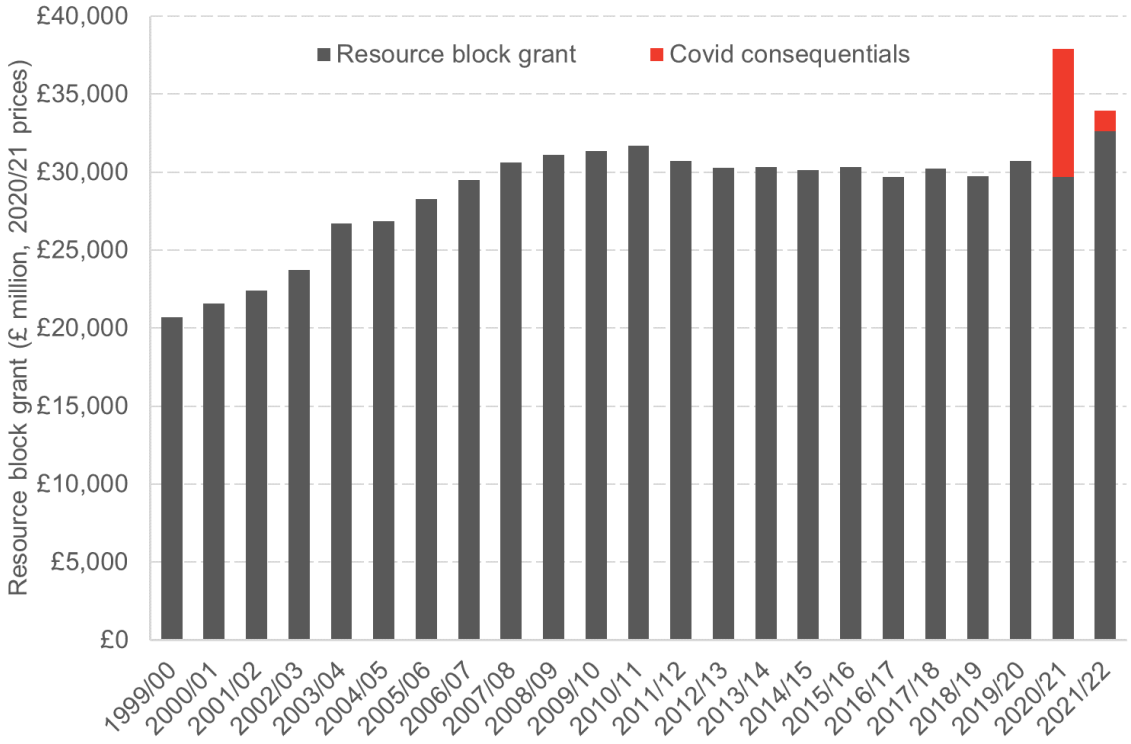
As a result of these changes, the Scottish Government's block grant for core resource spending in 2021/22 will exceed the previous real terms high of 2010 for the first time since the period of austerity (Chart 1[6]).

This is not quite the same as saying that 'spending power' will be as high as in 2010. The Scottish budget has gained new responsibilities in the intervening period (like responsibility for Council Tax Reduction, and higher pensions contributions). Furthermore, the size of the Scottish population has grown by 230,000 – with the over 65s accounting for three quarters of this growth.

[6] Do not pay too much attention to the apparent jump in real terms funding between 2020/21 and 2021/22 – this is an artefact of volatility in the deflator. The average change between 2019/20 and 2021/22 is a better reflection of budget changes.

The block grant for core resource funding will exceed pre-austerity levels in 2021/22.

Chart 1: Outlook for the Scottish resource block grant, 2020/21 prices



Source: Scottish budgets, various years; Public Expenditure Statistical Analysis, various years; FAI analysis.

The Scottish Government's £1.3bn allocation of Covid-consequentials in 2021/22 can be thought of as a lower bound…

In the context of the £8.2bn Covid consequentials received by the Scottish Government in 2020/21, the £1.3bn of Covid-consequentials in 2021/22 represents a big fall – and implies that the vast majority of the Scottish Government's Covid spending in 20/21 will not persist into 2021/22.

How realistic is this? Effectively it is a judgement that presupposes that most if not all health restrictions will be able to be lifted in the very early part of the 2021/22 financial year. Most of the Covid consequentials for 2021/22 are associated with health, and the need for vaccination and test-and-test programmes, together with some additional spending on skills and employability programmes to support the labour market recovery.

But the Spending Review assumes that business rates reliefs will be unwound in full from the start of the financial year; there will be no further need for business grants to adapt premises; and little further need to support local authorities for lost revenue, or to provide additional support for vulnerable groups.

Even taking into account recent positive news around vaccine rollout, these assumptions do feel on the optimistic side. In fact, this point is tacitly recognised in the Spending Review, which sets aside an unallocated covid reserve of £21bn which the UK Government can draw on as and when required.

In this perspective, the Scottish Government's £1.3bn of Covid-related allocations for next year should be thought of as a lower bound. If the UK Government does end up allocating additional funding for Covid activities, this will generate additional consequentials at that point.

…but the Scottish Government can only work with the resources that have been committed

But this isn't entirely helpful for the Scottish Government which must set out its budget plans by the end of January. Take the example of business rates.

The Spending Review works on the assumption that 100% business rates reliefs for businesses in tourism and hospitality sectors in England will cease completely from the start of 2021/22. As such it would be difficult for the Scottish Government to plan differently at this point in time. But the Spending Review notes that the UK Government is

'considering options for further Covid-19 related support through business rates reliefs. In order to ensure that any decisions best meet the evolving challenges presented by Covid-19, the government will outline plans for 2021-22 reliefs in the New Year.'

A gradual unwinding of reliefs in England by the UK Government, rather than a sudden withdrawal in April, could potentially deliver several hundred million pounds of additional consequentials to the Scottish budget. Whether the Scottish Government can offer reassurances to leisure and hospitality businesses that their rates reliefs will not be withdrawn completely in April will depend in part on whether the UK Government makes its own announcement before the 28 January.

During this time of heightened economic uncertainty, the Scottish Government needs greater funding certainty and enhanced fiscal flexibilities

The reasonable desire of the UK Government to be flexible about its fiscal plans should not preclude the Scottish Government having greater certainty about its funding, nor to have additional flexibility to adapt to evolving circumstances.

Earlier in 2020, Scottish Finance Minister Kate Forbes wrote to HM Treasury setting out a case for the Scottish Government being able to use its existing budget management tools more flexibly. The asks included:

- Being able to use the Scottish Government's existing 'cash management' borrowing limit of £500m to fund discretionary resource spending;
- Being able to transfer up to £500m capital funding to the resource budget; and
- Increasing drawdown limits from the Scotland Reserve.

To the extent that these flexibilities are not requests for additional funding or new powers, there is a strong case for them, or something like them, to be agreed to.

The case for having greater flexibility around the Scotland Reserve is particularly compelling. Under current rules, a maximum of £250m of resource spending can be drawn down from the Reserve in any year. As a tool for addressing forecast errors, transferring funding between years and managing general funding uncertainty, it is hard to avoid the conclusion that this limit is inadequate. The limit should be extended and there should be scope for the balance on the Reserve to be negative for a temporary period.

If HM Treasury is reticent about extending flexibilities, then the case for providing greater funding certainty becomes stronger. At a time when budget plans may need to evolve rapidly, the idea that the Scottish Government should be able to set out detailed budget plans – whilst UK Government policy decisions on issues such as business rates and other tax changes such as LBTT are evolving – risks constraining the Scottish Government's response to the pandemic.

At the very least, better communication and coordination between the UK and devolved governments is required to support devolved policy-making, as set out in a letter from the devolved governments to the UK Government earlier this year[7].

3. Other factors influencing the outlook for the Scottish budget

The outlook for the Scottish Government's total resource budget depends on more than just the core block grant. Revenues from devolved taxes, additions to the block grant to account for the Scottish Government's new responsibilities in relation to social security, and 'reconciliations' – to address past years' tax forecast errors – also influence the size of the resource budget.

This section considers how these factors might influence the size of the Scottish budget, even in the absence of any policy changes. It is slightly technical. Some readers may wish to note the conclusion – that at the moment there is no strong reason to think that these factors will materially influence the growth of the resource budget between 2020/21 and 2021/22, over and above the outlook for the resource block grant; but there are some risks on both the upside and downside – and move on to the next section.

There is no strong reason to think that devolved revenues will contribute significantly more or less to budget plans than in 2020/21, but there is greater than usual uncertainty associated with forecasts

Working out the contribution of devolved revenues to the Scottish budget is slightly complicated. What matters is how the forecast for revenues raised in Scotland compares to the forecast of the block grant adjustments (BGAs) for tax. The BGAs are estimates of the revenues that the UK Government would have raised from a given tax if it had not been devolved – on the assumption that tax policy would therefore be the same in Scotland as in rUK, and the assumption that the tax base had grown at the same per capita rate since the date of tax devolution.

In the 2020/21 budget, the difference between devolved revenues and tax BGAs was forecast at £160m. In other words, devolved taxation boosted the resource budget by £160m. This boost was due to devolved tax decisions (higher tax rates for income tax and LBTT than the corresponding taxes in rUK). But the budget boost was not as great as it would have been had the Scottish income tax base grown at the same rate as that in rUK.

Will devolved taxes contribute more or less to the Scottish budget in 2021/22 than in 2020/21? There is one reason why the contribution may be a little higher. Outturn income tax data for 2018/19, published in the summer, surprised somewhat on the upside relative to the most recent forecasts, and this may feed through to subsequent forecasts[8].

[7] See submission from devolved finance ministers to Treasury Select Commission inquiry into tax after coronavirus (Sep 2020): https://committees.parliament.uk/writtenevidence/11474/pdf/

[8] Outturn data published in September 2020 revealed Scottish income tax revenues were £178m higher in 2018/19 than had been forecast in February 2020. See the SFC's Forecast Evaluation Report Income Tax Supplement (October 2020): https://www.fiscalcommission.scot/wp-content/uploads/2020/10/Forecast-Evaluation-Report-September-2020-Income-Tax.pdf

Beyond this, there is no strong reason to believe that devolved revenues will perform substantially differently from comparable rUK revenues in 2021/22. Analysis by the OBR shows that the structure of the Scottish economy is no more or less concentrated in the sectors most affected by Covid and the related restrictions[9]. And the extent of restrictions – and the associated economic support – has not been fundamentally different in Scotland from rUK.

Therefore, at this stage, there is no strong reason to think that the contribution of devolved taxes to the Scottish budget will be materially different in 2021/22 from the position in 2020/21.

But what ultimately matters here is the perspective of the two official forecasters, the OBR for the UK and the SFC for Scotland. And herein, risks do lie. Consider the following possibility. The SFC, preparing its forecasts during January 2021, takes into account positive news on vaccine development that was not available to the OBR when it prepared its UK forecasts in November 2020. As such, the differing assumptions could lead to a relatively larger gap (in Scotland's favour) between devolved revenues and BGAs. In the short run, this would be good news for the Scottish budget, boosting spending power in budget 2021/22. But once outturn figures eventually caught up with reality, there would in due course be a downwards reconciliation to the Scottish budget.

The possibility for tax revenue forecasts to alter the outlook for the Scottish budget – even in the absence of tax policy change – can therefore not be completely discounted.

Spending on recently devolved social security powers will be offset by additions to the block grant

For social security, the story is similar to the one on tax. What matters for the budget is the difference between forecast expenditure on social security spending in Scotland, and forecasts of the block grant adjustments that are added to the Scottish budget to reflect the spending on equivalent benefits by the UK Government in England and Wales.

Given that there are not yet any substantive policy differences between Scotland and rUK for the social security payments being devolved, there is again no strong reason to think that expenditure on the payments in Scotland during 2021/22 will be significantly different from the BGAs (the amount that is added to cover those payments).

The 2021/22 budget will face a £300m downward adjustment for previous' years forecast error, but the government will offset the immediate impact of this by borrowing

One thing that could in theory reduce the spending power of the Scottish budget in 2021/22 is the £319 million downward reconciliation that will be applied to the Scottish budget to reflect income tax forecast error in relation to the 2018/19 Scottish budget, and smaller forecast errors in respect of the 2019/20 budget[10].

[9] OBR, Devolved tax and spending forecasts, (Nov 2020)

[10] See letter from Kate Forbes, December 2020 https://www.gov.scot/binaries/content/documents/govscot/publications/correspondence/2020/12/fiscal-framework-letter-to-the-finance-and-constitution-committee/documents/fiscal-framework-letter-to-the-finance-and-constitution-committee/fiscal-framework-letter-to-the-finance-and-constitution-committee/govscot%3Adocument/Letter%2Bfrom%2BCabinet%2BSecretary%2Bfor%2BFinance.pdf

However, considering the precedent set in last year's budget, the Scottish Government is likely to offset this reconciliation by borrowing, spreading the cost of that reconciliation over the subsequent five budgets. This would protect spending in 2021/22, but it would also bring risk – by using up its total forecast error borrowing limit at the start of the year, the government would potentially have to deal with any subsequent in-year forecast errors through its overall budget.

The scope for the Scotland Reserve to transfer significant amounts between years is very limited

Spending plans in 2021/22 can be supported by drawdown from the Scotland Reserve. The Scottish Government is highly likely to have underspends from 2020/21 which it will want to utilise in 2021/22. There is a case therefore to expect that the Scottish Government will make close to full use of the Reserve during the 2021/22 year. But it remains to be seen how much of the Reserve it will use 'upfront' when its sets its budget plans, and what proportion if might keep back to maximise flexibility in its budget plans.

But whilst the government can 'bank' up to £700m in the Reserve, it can only draw down £250m in any one year. In last year's budget, spending plans were supported by £130m of drawdown from the Reserve. The scope to use the Reserve to materially alter the real terms growth of the resource budget from 2020/21 to 2021/22 is therefore limited.

4. Implications for spending choices

The government faces a range of challenging policy decisions when it comes to spending. On the one hand, as alluded to already, it will need to decide how to prioritise its temporary but much diminished Covid-19 funding. Much of this will support the health portfolio with immunisation and test-and-trace. But how much of the remainder to allocate to businesses or vulnerable groups?

There will also need to be serious investment in skills and employability programmes. The design of employability support will provide potentially new challenges. Employability services were technically devolved following the Smith Commission, but have so far remained relatively small scale. Ramping up these programmes will raise challenges of design, delivery and operation alongside the reserved elements of social security support.

Alongside these issues are all the 'normal times' issues of resource allocation. This section considers two broad issues: the allocation of core funding between portfolios, and issues around public sector pay.

Funding settlements could be constrained for some portfolios

The conclusion from the previous discussion is that there is no strong reason to think that issues around devolved tax revenues, forecast error reconciliations, social security spending, and the Scotland Reserve will fundamentally alter the outlook for the growth of the Scottish Government resource budget between 2020/21 and 2021/22, over and above the impact of the block grant.

So, an uplift to the core block grant of £1.2bn looks like a reasonable first assumption for how much we might expect core resource spending (excluding social security) to increase, if there are no policy changes on tax. But even so, depending on the precise detail of the SFC forecasts and the way the government uses its Reserve, the uplift could end up being several million pounds above or below this.

What then might this imply for the government's spending choices in 2021/22?

The budget for 2021/22 applies in an election year. Partly as a result, (and partly because of the distraction of Covid), relatively few new spending commitments have been announced for next year. Perhaps the most high profile of these is the rollout of the Scottish Child Payment, which is forecast to be associated with costs of around £70 million (the commitment to expand free school meal provision made at the SNP Conference envisaged rollout 'from 2022' and it is not clear how much additional expenditure, if any, might be profiled in 2021/22).

One option available to government therefore would be to allocate its additional core resources for 2021/22 relatively evenly across portfolios, implying a cash uplift of around 4% (assessments of the year-on-year real terms increase are rendered meaningless by annual volatility in the GDP deflator – an unanticipated side-effect of economic shutdowns during 2020).

But the government has committed to 'pass on' health-related consequentials to the NHS in Scotland. Of the £1.2bn uplift in resource consequentials in 2021/22, £700m flow from increases in health spending in England. If these consequentials are 'passed on' to the health portfolio in Scotland, then that could leave around £500m additional funding for spending on core services outside health and social security.

A £500m cash uplift for public spending outwith health and social security may not feel particularly generous for some portfolios (in 2020/21, the uplift to portfolios outwith health and social security was slightly higher than this). And as noted already, the actual budget uplift might be slightly higher or lower than £1.2bn depending on what happens with tax forecasts.

Public sector pay: how much more generous will the Scottish settlement be?

In its Spending Review, the UK Government announced that public sector pay would be frozen in cash terms in 2021. There are two exceptions to this rule: NHS workers (who are exempt from the freeze) and public sector employees earning below £24,000, who will see pay rises of a minimum of £250.

The UK Government's rationale for freezing public sector pay for most public sector employees is based on two arguments. First, the issue of parity between public and private pay during the pandemic (SR2020 notes that private sector pay between April-September 2020 was 1% lower than the previous year, but was 3.9% higher for the public sector). Second, the contribution of public sector pay to overall government spending (public sector pay accounts for 25% of total UK Government expenditure).

Both arguments are questionable. On the first, it seems odd to want to constrain public sector pay to follow the path of private sector pay during a period when private sector trends are likely to be skewed by furlough. On the second, the IFS has pointed out that the policy is likely to save between £1-£2bn, and therefore risks picking a fight 'over not very much money'[11].

The Scottish Government does not directly determine the pay settlement of all public sector employees in Scotland (in fact it only directly controls the pay of around 9% of employees at the Scottish Government and various public agencies). In other areas, pay settlements are the outcome of negotiations between employers, government and unions. But the Scottish Government pay policy plays a significant role in setting the tone for these negotiations.

[11] See Paul Johnson's remarks on the 2020 Spending Review https://www.ifs.org.uk/spending-review-2020

The devolved public sector pay bill in Scotland was around £17bn in 2019/20 (including NICs and pension costs)[12]. Thus each 1% across the board increment adds about £170m to that bill.

Around 40% of devolved public sector employees in Scotland work in the NHS. Making a simple assumption that NHS staff account for 40% of the paybill implies that a one per cent pay increase for NHS staff only – with a freeze for other public sector employees – would cost around £68m, rather than the £170m required for an across the board rise of one per cent. A two per cent pay increase would cost around £140m if applied to the NHS only, or £340m if applied across the devolved public sector.

These costs clearly are significant. But to the extent that the quality of public services is partly a function of staff remuneration, then it is a fallacy to think of a pay freeze as providing a 'saving'.

The Scottish Government will certainly match the UK Government's commitments on NHS pay (in fact the Scottish Government can augment but cannot go below the recommendations of the NHS Pay Review body that operates at UK level). It will almost certainly also match the UK Government's pay increases for relatively low paid public sector workers. It may also go further than the UK Government, either in breadth or generosity of pay increases to the relatively low-paid – this is, after all, an election year. But it will be interesting to see exactly how far the Scottish Government will feel able to depart from the broad approach outlined by the UK Government.

5. Difficult choices on tax

What role can Scottish income tax play in supporting the economic recovery?

What role can Scottish income tax policy play in supporting the recovery? It is tempting to assert that income tax rates should be cut to provide a boost to consumer incomes and hence spending.

But this argument ignores the important fact that the Scottish Government has to run a balanced budget. In this context, arguments about the role of tax in economic policy are very different at a Scottish level compared to a UK level. The Scottish Government cannot implement a fiscal stimulus by cutting tax and offsetting its revenue losses through borrowing. Instead, any cut in Scottish income tax would be associated with a fall in Scottish Government revenues *and* spending.

It is therefore unlikely that a cut in Scottish income tax would provide any stimulus in the round. *If* Scottish taxpayers spent all of their income (i.e. they had no savings), then a tax cut would result in an increase in private consumption, but at the cost of reduced government consumption. Whether or not this created any stimulus would depend on the multiplier of private consumption relative to government consumption, plus any behavioural impacts the tax cut might have on inducing individuals to work more. Some pretty generous assumptions would be needed to make the case that a balanced budget tax cut would stimulate, even if households did not save.

[12] Source: SPICe analysis

But households do save, particularly those with higher incomes. A tax cut would reduce Scottish Government revenues and therefore spending. But this reduction in government spending would not be completely offset by increased private consumption, as a (potentially large) proportion of the increased household income would simply be saved. In a balanced budget context therefore, the impact of a tax cut is likely to be to reduce aggregate demand in the economy rather than increase it. This is particularly the case at the current time, when household saving has increased substantially[13].

If a tax cut is not the answer, what about a tax increase? It is again important not to conflate the issues facing the Scottish Government with those facing the UK. At UK level, many have argued against tax increases in the immediate future. The implicit assumption here is that UK tax increases would be intended merely to reduce the size of the government's deficit. Thus, a tax increase would result in a fall in private consumption that would not be offset by any increase in government spending.

From a balanced budget perspective, a tax increase that caused private consumption to fall would potentially be more than offset by increased government spending. Of course, it would be too simplistic to conclude from that the tax rises would necessarily be the right thing to do – they may have negative supply-side responses for individuals or firms which could offset the impact on aggregate demand. And beyond a certain point, people may value an additional pound of private consumption more highly than they would value an additional pound of public spending.

Indeed, from a political perspective it may be very difficult to make the case for tax increases given both the existing difference in income tax rates between Scotland and rUK and the proximity of the Holyrood elections in May.

The other consideration for the Scottish Government in setting its own income tax policy for 2021/22 is how it thinks the UK Government might vary UK income tax at the UK Budget in March. It seems very unlikely that the UK Government will increase income tax rates (or reduce thresholds) given party political commitments and the economic arguments outlined previously. A cut in UK income tax would provide additional windfall resources for the Scottish budget (via the block grant adjustments), but would widen the gap between Scottish and UK rates at a time of particular political sensitivity.

In deciding on its income tax policy for 2021/22, the Scottish Government therefore needs to navigate a complex range of economic and political factors, all underpinned by significant uncertainty. A hedge-the-bets policy of 'no change' is perhaps therefore the most likely.

Decisions on council tax: stuck between a rock and a hard place

One area where there has been significant policy divergence between Scotland and other parts of the UK in recent years is council tax. The council tax freeze lasted longer in Scotland than in England; Wales didn't have a freeze at all (Chart 2).

Average band D tax increases in Scotland of 2%, 3%, 3.6% and 4.7% have followed in the four budgets since the council tax freeze was ended in 2017/18. But the effect of the freeze continues to be felt: average band D council tax in Scotland in 20/21 was 21% below that in Wales and 28% below that in England. Local authorities in England with responsibility for social care will be able to increase council tax by up to 5% in 2021/22.

[13] The UK household saving ratio increased from 5% pre-pandemic to over 20% during 2020. Source: OBR EFO November 2020

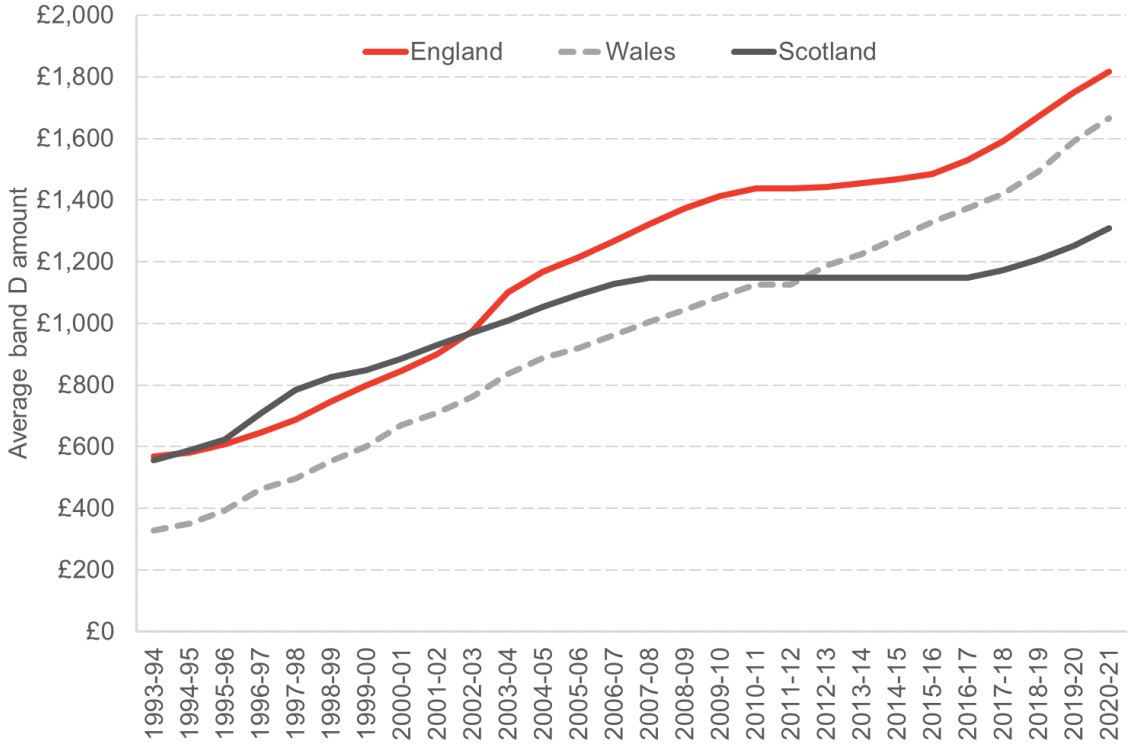
Decisions on council tax invariably feel unsatisfactory. Freezing the tax deprives local authorities of much needed revenue. But tax increases are invariably unfair. The tax is poorly related to property value and regressive with respect to income.

These trade-offs are particularly acute at the current time. Unlike income tax (where liabilities relate to income), a council tax increase is not very sensitive to the financial means of liable households: it does not distinguish well between those households who have had a hard time financially during the pandemic, and those who have remained relatively well off.

The case for reform of the tax remains clear. Until then, council tax decisions leave the government stuck between a rock and a hard place. A further rise this year seems inevitable – a 5% rise would raise around £110m net of reductions[14]. But as a mechanism to raise revenue for public spending, it is difficult to avoid the conclusion that income tax rises would be objectively fairer – and thus more effective at underpinning the recovery.

Council tax in Scotland is significantly lower than in England and Wales

Chart 2: Average band D council tax in England, Wales and Scotland



Source: IFS Fiscal Facts

[14] This calculation is based on assumptions for employment and earnings changes in 2021/22 that are broadly consistent with the OBR's latest forecasts.

6. Other issues: capital and levelling up; shared prosperity; and wellbeing

Outlook for capital budget: more consequentials to come?

The Scottish Government's block grant for capital spending is on track to increase by less than £100m in 2021/22 according to Spending Review plans (£170m of additional consequentials is applied to a lower 2020/21 baseline).

Nonetheless, coming on the back of a substantial uplift in 2020/21, this will take the capital block grant back to its pre-austerity high in real terms by 2021/22 (Chart 3).

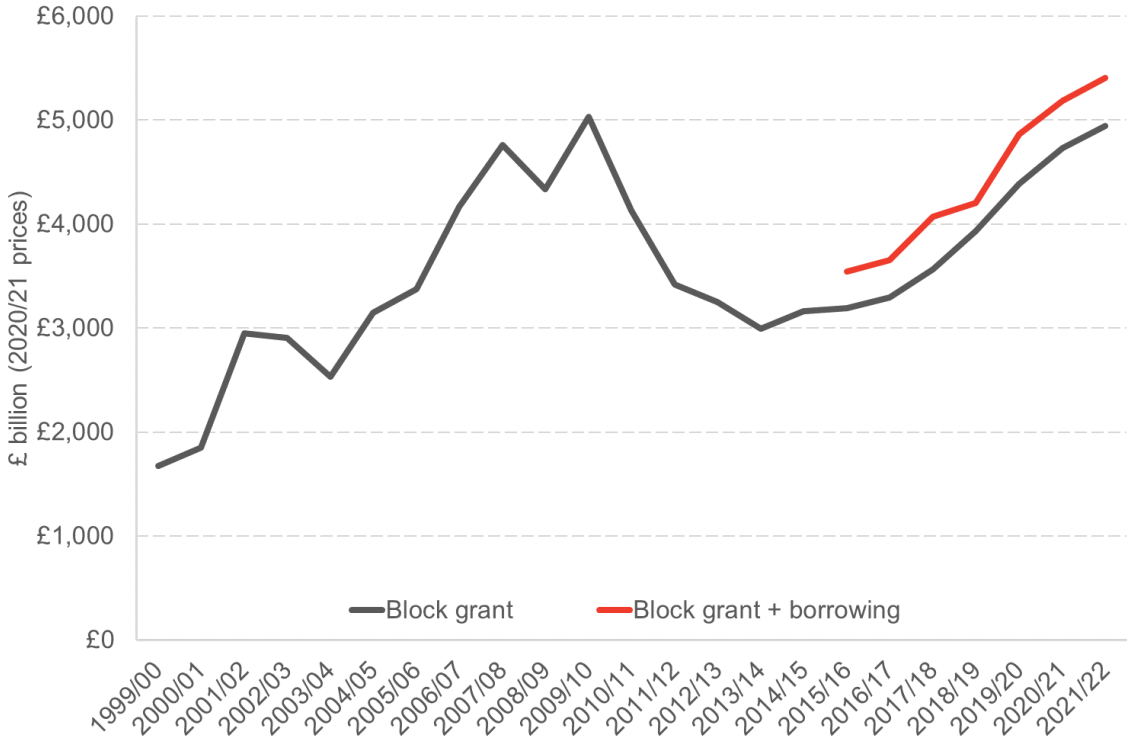
There is reason to believe that additional capital consequentials will be added to the block grant for 2021/22 in due course. In its 2020 Spending Review, the UK Government set out plans for a 'Levelling Up Fund'. This will be worth £4bn for England, generating consequentials of around £400m for the Scottish budget. This spending has not yet been formally allocated to departments or profiled over time and therefore does not yet appear in the estimates of 2021/22 consequentials. The UK fund will be used to 'invest in local infrastructure that has a visible impact on people and their communities and will support economic recovery' in England, but the Scottish Government will be free to allocate consequentials in Scotland as it sees fit.

The Scottish Government can also borrow up to £450m annually to support its capital investment plans. It had planned to use those borrowing powers in full in 2020/21, although it seems quite likely that Covid-related slippage will mean that the borrowing powers will not need to be utilised in full. If the 2020/21 borrowing powers are used in full, the government will have outstanding capital debt of £2bn by the start of 2021/22, representing just over two-thirds of its debt cap, which would be associated with annual repayments of principal of over £70m in 2021/22.

As well as core capital budget, the Scottish Government also receives a budget for 'financial transactions' (FTs) capital, which are used to support equity or loan schemes to the private sector. The Scottish Government's allocation of FTs increased to £600m in 2020/21, but will fall back to just over £300m in 2021/22. The Scottish Government primarily intends to utilise its FTs to capitalise the Scottish National Investment Bank (SNIB). The SNIB recently became operational, and will provide 'patient finance' to businesses to unlock strategically important infrastructure projects. Budget 2020/21 allocated £260m of FTs to the SNIB; a similar allocation in 2021/22 would account for virtually all of the FTs budget (other uses of FTs include equity support schemes for homebuyers, such as 'help to buy').

The capital block grant has returned to pre-austerity real terms levels

Chart 3: Outlook for the capital block grant and capital borrowing



Source: Scottish budgets, various years; Public Expenditure and Statistical Analysis (HM Treasury); Scotland's Economic and Fiscal Forecasts February 2020 (Scottish Fiscal Commission)

UK Shared Prosperity Fund: not part of the Scottish budget

An expectation of the UK Government's Spending Review 2020 was that it would set out further detail of the UK Shared Prosperity Fund (UKSPF), the replacement for EU Structural Funds in a post-Brexit world.

SR2020 did provide some details. The UKSPF will have two elements. One of these is to target regeneration of 'places most in need across the UK, such as ex-industrial areas, deprived towns and rural and coastal communities'. The second is to target 'people most in need through bespoke employment and skills programmes that are tailored to local need', with an objective to improve employment outcomes.

The devolved governments have two legitimate concerns about the UKSPF. These relate to funding and governance.

SR2020 said that funding will 'ramp up' in future years to 'at least match current EU receipts, on average reaching around £1.5 billion a year'. But the specific funding profile for future years has not yet been set out, with only £220m allocated in 2021/22 to allow for approaches to be piloted. The devolved governments will also be keen to understand whether beneficiaries in their respective territories will receive similar levels of funding from the UKSPF as they received under EU Structural Funds (Scotland received an average of around £130m per year from EU Structural Funds under the 2014-2020 round).

The concerns around governance are potentially more significant. SR2020 indicates that the UKSPF will be delivered 'UK-wide' using the financial assistance powers in the controversial UK Internal Market Bill, which will give UK ministers the power to make payments to any person across the UK for the purposes of economic development, including directly in the devolved nations, in areas of devolved competence.

The devolved governments view this design aspect as representing a centralisation of regional development policy. Indeed, the UK Government's current proposals for the UKSPF, such as they are, potentially override all five of 'principles for successor funding' that were identified by Scottish Ministers, including commitments on funding guarantees and the role of the Scottish Government in determining allocation priorities within Scotland[15].

The funding uncertainties and tensions around governance, combined with further funding uncertainties associated with the Levelling Up fund in Scotland seem likely to create further frictions and planning challenges in budgeting for the recovery.

Wellbeing 2.0

The 2020/21 draft budget statement was full of proclamations of how wellbeing and fairness was at the heart of the budget making process. The actual draft budget document repeated similar sentiments, although lacked specific actions or evidence to suggest that a shift in strategic shift towards wellbeing had occurred[16].

There remains a vagueness around what exactly the Scottish Government mean by wellbeing, but if we broadly take it to be about reducing the inequalities faced by different parts of society, then this feels as relevant as ever at this juncture.

The pandemic has only served to highlight the inequalities that exist in our society, and in many cases, it is thought to have exacerbated previous issues, for example due to loss of income for those on furlough pay in already low-paid work in hard hit sectors such as retail and hospitality.

The FAI budget report ahead of the 2020/21 budget looked at what a wellbeing budget could entail, building on the experience of New Zealand. The points we made there remain relevant to any second attempt at wellbeing in the 2021/22 budget:

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

Whether this is called 'wellbeing' or something else isn't particularly important. What is crucial is the understanding of where inequalities exist and how government spend can alleviate inequalities.

Previous budgets have looked at this in a fairly adhoc way, with certain policies highlighted for their wellbeing credentials whilst others, for example regressive council tax increases, will be justified for other, non-wellbeing, reasons (with reform no doubt pushed further into the long grass). A more systematic approach to assessing the equality impact of the budget is long overdue.

[15] https://www.gov.scot/publications/replacement-european-structural-funds-scotland-post-eu-exit/pages/3/
[16] https://www.parliament.scot/S5_Finance/Reports/Budget_report_final.version_pdf.pdf

7. Conclusions

The general expectation is that 2021/22 will herald the start of a recovery from the health and economic impacts of Covid-19. But the path of that recovery remains very uncertain. Budgets will need to be flexible in the amount and type of support that they provide.

The Scottish Government has limited scope to adapt its fiscal plans. There is a case for saying that current arrangements are not problematic – the Scottish Government has a good idea about what its likely minimum funding envelope is, and can have confidence that additional funding will flow its way given that the UK Government is very open to the idea of allocating further funding if the recovery turns out to be more protracted.

But the dependence of the Scottish budget on policy choices taken in England will continue to be a source of tension, particularly when the economic and health impacts of the pandemic remain high. There is a strong case for some combination of: greater inter-governmental coordination and communication around budgeting; further commitments to funding certainty by the UK Government; and additional fiscal flexibilities for the Scottish budget.

In terms of specific policy decisions, the government faces a wider range of challenging decisions than it does in a normal year. In relation to Covid, it must decide which elements of Covid support it can unwind most quickly, and which it must continue to fund in some way in the early part of 2021/22. Health is likely to absorb much of the Covid funding in 2021, leaving difficult decisions about how to balance remaining support between different sorts of businesses, household and organisations.

The government's core resource budget will increase relatively healthily in 2021/22, although depending on the outlook for various tax forecasts and the use of reserves, the uplift may not be as generous as in 2020/21.

Tax choices are also constrained, and there is a difficult balance to be struck between revenue raising, distributional impact and political acceptability.

The backdrop to the Scottish budget will be significant uncertainty around the economic and health outlook; ongoing intergovernmental tensions on a variety of matters including funding flexibility and certainty, potentially exacerbated following a no-deal exit from the EU transition agreement; and the Scottish elections in May. The inevitable politicking around all this will hopefully not detract from a focus on the core issues the budget must address.

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