

Finance and Public Administration Committee

Pre-budget scrutiny: Scotland's public finances in 2022-23 and the impact of COVID-19

Scottish Government response to the Committee's report

Dear Kenneth

Thank you to the Committee for your pre-budget scrutiny report ahead of the 2022-23 Scottish Budget. I have carefully considered the points raised by the Committee and a detailed response is set out in the annex to this letter.

Given the enormity of the economic and fiscal challenges the Scottish Government is facing in preparing its Budget, I welcome the Committee's acknowledgment of the UK and Scottish economic outlooks, and the impact of having no COVID funding guarantee in 2021-22. I recognise the Committee's views on the need for effective intergovernmental relations, greater transparency and scrutiny, and improving public awareness and understanding of the budget process. The Scottish Government will continue to work together with the Parliament to meet these challenges, to ensure that we take effective action to support economic recovery and manage the risks around the public finances.

I welcome the Committee's ongoing input into the forthcoming review of the Fiscal Framework, and its recommendations and support for the issues that need to be considered. I view contributions from parliamentary committees and wider stakeholders as an integral part of the review process, which is why I am pleased to have agreed with the Chief Secretary to the Treasury that input will be sought at both the report and review stages of the process. I welcome views from the Committee on how best to obtain its input and engage throughout the process, while acknowledging that the review is a joint undertaking with UK Government.

On the independent report, my officials continue to work with HM Treasury counterparts to finalise the terms of reference and to consider potential authorship options. I will keep the Committee updated on progress, which I hope can be made swiftly, to enable commencement of the review as early in 2022 as possible.

Personal Allowance Spillover Dispute

I would also like to provide you with an update on the outstanding dispute with the UK Government in relation to their increases to the income tax personal allowance (PA), and the disproportionate impact these have on Scottish revenues through the operation of the Fiscal Framework. At official level, both governments have signed off a joint analytical framework which agrees that a direct spillover effect arises from the UK Government's changes to the PA, and so a transfer of funding from the UK

Government to the Scottish Government is due. However, our Governments are disagreed on the size of the spillover effect.

The period covered by the dispute dates back to 2017-18 and is depriving the Scottish Budget of a material level of funding while it remains unresolved. I am therefore seeking to resolve the dispute without further delay. On that basis, the Scottish Budget 2022-23, published today, includes a funding assumption relating to several different funding sources, one of which is a funding transfer relating to this dispute. This does not pre-judge the outcome of the dispute resolution process. The Scottish Government will continue to engage with that process in good faith, with an expectation of reaching a swift resolution in 2022. I have therefore written to the CST today to request a discussion early in the new year to consider this dispute and to discuss next steps, with a view to progressing the matter to an agreeable resolution.

I hope that the Committee finds this information helpful. I will keep the Committee updated once an agreement is reached with the CST.

Yours sincerely

Kate Forbes

ANNEX – DETAILED SCOTTISH GOVERNMENT RESPONSE

Para	Comment/Recommendation	Response
35.	As we turn our attention to recovery from the pandemic, the Committee understands that it may become more challenging to identify and track the flow of Covid-19 spend. However, the Committee asks the Scottish Government to commit to providing transparent and timely information on all Covid-19 allocations to allow proper scrutiny of where, and how effectively, the money has been spent, so that any lessons can be learned for the future.	The Scottish Government understands the importance of this information and will continue to provide transparent information on all Covid-19 funding allocations through timely provision of information to the Committee and through the formal budget revision process.
38-39.	The Committee acknowledges that the minimum funding guarantee of 2020-21 provided welcome certainty for the Scottish Government to announce policies and spending to support those most affected by the pandemic. We note that, despite the pandemic's ongoing impact, no such guarantee was in place in 2021-22, which has made budget management more challenging. Our predecessor Committee's recommendation was that the UK Government should, if the fiscal position rapidly evolves, commit to providing a similar funding guarantee. Longer-term, we believe that there would be merit in both governments reviewing whether this type of guarantee could provide greater certainty for devolved budget planning in the future.	Scottish Ministers recognise the benefit of this guarantee and have continued to seek a formal guarantee of Covid funding for 2021-22. The Government will take forward the possibility of securing similar guarantee arrangements in future.
42-44.	The Committee welcomes the recent announcement that the Cabinet Secretary for Finance and the Economy and the Chief Secretary to the Treasury have agreed to commission an "independent report on the Block Grant Adjustment arrangements, including a call for stakeholder input, prior to a broader review of the Fiscal Framework". We note the Cabinet Secretary's plans to undertake a programme of analysis to inform the broader fiscal framework review, building on the independent report and other key publications and evidence, including last session's joint report. We request regular updates on the commissioning and progress of this independent report. The Committee further recommends that the independent report should be presented to both the UK and Scottish parliaments, as well as the two governments, as recommended in the Legacy Expert Panel report 23 to our predecessor committee at the end of last session.	<p>Scottish Government officials are continuing to work with HM Treasury officials to finalise the terms of reference and consider the potential authorship for the report, to enable us to swiftly commission and complete the report, and commence the review as early in 2022 as possible.</p> <p>Once the arrangements are finalised, we will confirm the authorship and publish the terms of reference. We will keep the Committee updated.</p> <p>The Committee's recommendations on the presentation of the report are noted. As the Committee will be aware, the arrangements for the independent report are subject to joint agreement with HMT. We would welcome the opportunity to present the report and its findings to both Parliaments as well as both Governments.</p>

Para	Comment/Recommendation	Response
48-49.	<p>The Committee concludes that the fiscal framework broadly worked as intended during the pandemic, though this was more by accident than design. Whether this remains the case in relation to Scotland's recovery from the pandemic is something that the Committee will want to return to in future budget scrutiny.</p> <p>We recommend that the review of the fiscal framework should look at how it can be strengthened to withstand the risk from any future health or economic shocks that could disproportionately affect one part of the UK.</p>	<p>The Scottish Government agrees that the Fiscal Framework review must reflect on the experience of COVID-19 and the operation of the framework to date, to ensure that it is robust to future shocks and provides the Scottish Government with the necessary powers and flexibilities to manage associated risks. This should include consideration of the potential for future shocks to disproportionately impact Scotland through the operation of the Fiscal Framework, for example, on account of differences in the sectoral composition of the two economies. The review must consider solutions to address this potential issue.</p>
53-54.	<p>The Committee believes that the fiscal framework review presents an opportunity to consider how communication and transparency between the UK and Scottish governments can be improved, to allow more effective management of public finances in Scotland.</p> <p>We also seek an update from both governments on progress with the ongoing review of intergovernmental relations, the timetable for concluding this work, and how its outcomes will impact on the fiscal framework review.</p>	<p>The intergovernmental relations (IGR) review proposals deliver many elements of what the Scottish and Welsh Governments set out to achieve from the review and offer the prospect of improvements to current processes. The First Minister has written back to the UK Government to indicate she is content to use the proposals detailed in the review as the basis for engagement but that these must be kept under review. It has also been made clear that procedural improvements alone are not enough to reset the relationship.</p> <p>The Fiscal Framework review will provide the opportunity for both governments to embed the IGR principles for collaborative working and reflect on the findings of the IGR review, considering what improvements can be made to support better intergovernmental engagement, coordination and dispute avoidance and resolution.</p>
57.	<p>The Committee believes that the fiscal framework review should look at ways to simplify, and clarify the workings of, the fiscal framework where possible, to improve public understanding and public accountability. We believe that, as a starting point, both governments should commit to providing transparency and enabling Parliamentary scrutiny of their decision-making at key stages during the review process.</p>	<p>The Scottish Government is committed to a transparent review process, while acknowledging that the review is a joint endeavour undertaken with the UK Government, and some elements of the process will require shared, private space for intergovernmental discussion.</p>

Para	Comment/Recommendation	Response
71-76.	<p>The Committee considers that the Scottish Government should have more flexibility to carry forward and manage its budget across years in normal times. We look forward to exploring this matter further. We believe that the limits on the Scottish Government's resource borrowing powers to cover forecast error and cash management, and the Scotland Reserve, are not currently sufficient. We consider that these should, as a minimum, be linked to inflation.</p> <p>The Committee agrees with our predecessor that the two governments should consider the extent of the risk arising from potential divergence in forecast error between the SFC and the OBR, learning any lessons from the experience of an economic shock being triggered due to a quirk in timings.</p> <p>Recent publication of the UK and Scottish government budgets has followed a different timeline than was envisioned when the fiscal framework was agreed, which has created additional volatility and uncertainty for the budget process. We believe that greater co-ordination regarding the two governments' budget timings is needed.</p> <p>Noting recommendations from both the Smith Commission and our predecessor committee, as well as evidence gathered during our inquiry, we consider that it is now time to revisit the merits of a prudential borrowing scheme for capital borrowing. The Committee recommends that these issues are considered as part of the upcoming fiscal framework review.</p>	<p>The Government welcomes the Committee's views and support on these issues. As the Committee's report identifies, there is emerging consensus in Scotland around the inadequacy of the current borrowing and reserve powers compared to the volatility and risks to which the Scottish Budget is exposed.</p> <p>The Fiscal Framework review must consider and make changes to these powers, to support sound financial planning and management for future years. In making those changes, the review should reflect on the issues the Committee has identified, including ensuring that the limits are increased over time to reflect growth in tax revenues and the economy, and improving intergovernmental co-operation and co-ordination. We also agree on the need to look again at the case for a prudential borrowing regime for capital. More broadly, we appreciate the part the committee has played in highlighting these issues and illustrating where there are deficiencies in the current arrangements.</p>

Para	Comment/Recommendation	Response
86-89.	<p>The Committee notes that the demographic projections present a double ‘whammy’ to fiscal sustainability, as the proportion of working age people falls while the number of over 65s continues to grow. The provision of public services and welfare payments would, in this scenario, need to be funded from a smaller and more productive working population.</p> <p>We recognise that reversing these demographic trends will require a focused and sustained approach to policy-making over a number of years. We therefore seek clarification from the Scottish Government as to how this challenge will be addressed in its Budget 2022-23, and its next Medium-Term Financial Strategy, which looks ahead to the next five years.</p> <p>The Committee also notes publication of the Scottish Government’s strategy ‘A Scotland for the future: opportunities and challenges of Scotland’s changing population’ in March 2021. We seek an update on progress in delivering its recommendations, including its proposal for a Demographic Commission.</p> <p>The Committee welcomes the Scottish Fiscal Commission’s preparatory work to start producing a fiscal sustainability report each session, which would look ahead to the next 30 to 50 years and identify “particular pressures on spending or revenue arising from, for example, population growth”. We agree with the SFC that this presents a real opportunity to “consider whether major alterations will be required to adjust for changing circumstances” and we therefore ask the Scottish Government to support the SFC in this important work.</p>	<p>The Scottish Government is conscious of the significant impact that demographic change may have in Scotland, in common with many advanced economies. This was highlighted clearly in the January 2021 Medium-Term Financial Strategy, which also made clear the constraints that the current Fiscal Framework places on our ability to manage these impacts.</p> <p>In October 2021, the Cabinet Secretary for Constitution, External Affairs and Culture chaired the most recent meeting of the Scottish Government’s Ministerial Population Taskforce. The Taskforce discussed its cross-portfolio approach to Scotland’s demographic challenges ahead, and the arrangements we are putting in place to deliver the initial 36 actions identified in the Population Strategy – across vital areas including talent attraction, migration, housing, and public finance.</p> <p>Exploring a Demographic Commission was one of the Strategy’s identified actions, and the Scottish Government will continue to explore this option further into 2022. In the meantime, the Scottish Government’s Independent Expert Advisory Group on Population and Migration will continue its work to produce analysis to inform Scottish Government policy development in relation to demographic change in Scotland.</p> <p>The December 2021 MTFs has continued to highlight demographic factors, notably the impact of ageing as a driver of public service expenditure.</p> <p>Scotland’s population has increased in past years, and is projected to continue to rise. The largest medium-term trends relate to the significant increase in our older population, and changes in where and in what household size people choose to live. All local authority areas will see an increase in pensioners with implications for services such as health, or the nature of housing required. The biggest change is</p>

a 71% forecast increase in the number of people aged over 75 in the next 25 years.

The Infrastructure Commission for Scotland focused on a range of strategic long term drivers for infrastructure, including how best to optimise the impact of infrastructure in enabling sustainable places. The Scottish Government's response to the Commission, our latest Infrastructure Investment Plan (IIP) for 2021-22 to 2025-26, has building resilient and sustainable places at its heart. The IIP invests in projects and programmes that meet the needs of older people; provide services and homes where people choose to live and regenerate areas of working-age population decline.

In addition to this, the Resource Spending Review Framework reflects on the impact that demographic change could have on public finance and need for public services. The Framework highlights changing demographics as one of the key factors which will have a substantial impact on public spending over the Resource Spending Review period – seeking views on this and other trends which the Scottish Government should consider. The demographic outlook will continue to inform decisions made by the Scottish Government.

The Scottish Government is fully committed to fiscal sustainability. Accordingly we will support the Scottish Fiscal Commission in the preparation of a fiscal sustainability report, including providing the resources requested, as is reflected in their increased budget allocation.

Para	Comment/Recommendation	Response
93-94.	<p>We believe that more efficiency can be achieved by streamlining and linking up the various strategies and plans which have an impact on growing the economy and fiscal sustainability as we move out of the pandemic. We ask the Scottish Government to outline how it will make progress on this matter.</p> <p>The Committee considers that the upcoming statutory review of national outcomes provides an opportunity to reposition the National Performance Framework at the heart of government planning, from which all priorities and plans should flow. We also ask the Scottish Government to consider how the NPF could be more closely linked to budget planning.</p>	<p>The Scottish Government recognises the importance of streamlining and linking up various strategies and plans impacting on growing the economy and fiscal sustainability.</p> <p>The Scottish Government recognises the opportunity that the upcoming Review of the National Outcomes presents to further embed the National Performance Framework (NPF) in government planning and will work to ensure that progress is made on positioning the NPF at the heart of government. The Review is planned to commence in 2022.</p>
100-101.	<p>The Committee believes that multi-year budgets are crucial to securing certainty for Scottish public finances, including for local government, the third sector, and other key bodies. We acknowledge that it can be more challenging to deliver this approach in situations where the Scottish Government does not have confirmed multi-year block grant funding from the UK Government. We therefore recommend that both governments consider how multi-year budgets can be achieved more routinely as part of the fiscal framework review.</p> <p>The Committee asks the Scottish Government to set out in its framework document due in December further details of its resource spending review and how this might bring more certainty and efficiency to budgeting arrangements in the future.</p>	<p>The Scottish Government agrees with the Committee that multi-year budgets offer greater certainty and stability for the Scottish public finances, and would encourage the UK Government to provide substantially greater clarity than it has in the past. I will continue to press for this in my regular meetings with my devolved counterparts and HM Treasury.</p> <p>As noted in response to the recommendation at paragraph 49, the Scottish Government agrees that the review of the Fiscal Framework must reflect on the experience of COVID-19 and the operation of the framework to date, to ensure that it is robust to future shocks and provides the Scottish Government with the necessary powers and flexibilities to manage the associated risks.</p> <p>The Scottish Government's Resource Spending Review Framework, published alongside Budget 2022-23, provides more detailed information on the context, objectives and process of the multi-year Resource Spending Review.</p>

Para	Comment/Recommendation	Response
110-113.	<p>The Committee understands that public finances will be under significant pressure in the next few years and that the Scottish Government faces difficult decisions on how it prioritises spend and raises revenue. We further realise that it will not be possible to address the consequences of Covid-19 within the short planning horizon of just one budget round. We therefore recommend that the Scottish Government explores within its next resource spending review and Medium-Term Financial Strategy, which policy interventions would have the greatest impact on cross-cutting issues such as addressing inequalities and poverty.</p> <p>We can see real economic and societal benefits in prioritising spend for preventative measures, whether that be to protect the environment or the health of the nation in future years. We believe that the resource spending review provides an opportunity to introduce bold preventative measures to protect funds and create a wellbeing economy for the long-term.</p> <p>Many of our other recommendations in this report are intended to achieve greater fiscal sustainability, which we believe would allow more preventative spend to be identified and allocated in future years.</p> <p>The Committee asks the Scottish Government to set out in the Scottish Budget 2022-23 and Medium-Term Financial Strategy how it intends to manage the economy to meet its net zero commitments by 2045. Examining the finances behind the net zero targets is an issue we intend to return to in early course. This may also be an area which the Scottish Fiscal Commission will wish to consider as part of future fiscal sustainability reports.</p>	<p>The Scottish Government's Resource Spending Review Framework identifies an outcomes focus as one of the key principles underpinning the spending review process. The focus of the review is to ensure that public spending delivers the best outcomes for our citizens.</p> <p>As part of the Resource Spending Review, three priorities have been identified;</p> <ul style="list-style-type: none"> • To support progress towards meeting our Child Poverty targets. • To address climate change. • To secure a stronger, fairer and greener economy. <p>These three key, cross-government priorities will inform the assessment and development of future spending plans as the process progresses.</p> <p>The Medium Term Financial Strategy focused on longer-term sustainability. It sets out the economic and fiscal outlook, and the Scottish Government's approach to managing fiscal volatility and risk.</p>

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131-132.	<p>We note that the Scottish Government's Covid Recovery Strategy sets out a range of commitments to reskill and retrain people, as well as support for the creation of jobs. In view of the evidence we received, we believe that the Scottish Government should also look to provide targeted schemes to support older workers into work, to ensure a fair and equal recovery.</p> <p>We recognise that addressing skills shortages is only one half of the challenge; ensuring businesses provide secure, good quality employment is equally important. In line with the Scottish Government's stated priority of building a wellbeing economy, the Committee seeks an update on how it will broaden access (including for older people) to a high standard of employment through its Budget 2022-23 and next Medium-Term Financial Strategy.</p>	<p>The Medium Term Financial Strategy focuses on longer-term sustainability with spending decisions being taken as part of the Scottish Budget and Scottish Government Spending Reviews.</p> <p>In the absence of powers over the employment legislation the Scottish Government will continue to use the levers at our disposal to promote Fair Work principles that improve pay, conditions and opportunities for all workers including older workers. Fair Work First criteria are being applied to public sector grants and procurement and have been expanded this year to include specific promotion of flexible working practices</p> <p>Our Employability in Scotland website brings together information on available employability support schemes. Services such as No One Left Behind, which helps people gain skills and confidence, and Fair Start Scotland, which offers tailored, flexible, person-centred support to find and stay in work, are available to people of all ages.</p> <p>Apprenticeships are another route to supporting people of all ages into sustainable and rewarding careers. Scotland's Modern and Graduate Apprenticeships, of which there are over 100 apprenticeship frameworks available, are accessible to people aged sixteen or older.</p>

Para	Comment/Recommendation	Response
143-144.	<p>The Committee recognises that higher inflation can bring with it increased income tax revenue, but that this must be balanced in the Scottish Budget with higher costs and spend on pay and social security.</p> <p>We ask the Scottish Government if it has assessed the implications for the Scottish Budget of higher inflation rates continuing into the medium-term, particularly given Scotland’s demographic position. We would also welcome clarification as to how the Scottish Government intends to reflect the uncertainty of inflation rates in its public sector pay policy.</p>	<p>The Medium Term Financial Strategy economic outlook sets out the outlook for inflation in some depth. The outlook for inflation is also an integral part of SFC forecasts of the fiscal position.</p> <p>The impact of higher inflation on public spending is set out in the Resource Spending Review framework document. The SFC’s forecasts also discuss the potential impact of higher inflation on the economy as a whole.</p> <p>The Scottish Government has in recent years stated its preference for an inflation proofed pay uplift, balanced with affordability and value to the public purse. The Scottish Government considers inflation impacts as at September CPI (3.1%) - in line with income tax threshold and pension payment uplifts - in determining headline pay uplifts. The Scottish Government acknowledges the transient nature of inflation and will continue to prioritise progressive, fair pay awards, that provide additional protection to the very lowest paid, where cost of living impacts are felt most profoundly.</p>
157-160.	<p>The Committee recognises the impact of the pandemic on many businesses, including the hospitality, retail, leisure and travel sectors, some of whom have built up significant debt. We ask the Scottish Government to consider how it might best support these sectors to recover, rejuvenate the high street and grow the economy.</p> <p>We recognise that the two non-domestic rates reliefs put in place by the Scottish Government for the year 2020-21 provided much-needed support to those businesses struggling the most. While we appreciate that it may not be sustainable to plan for similar reliefs within the 2022-23 Budget, we welcome the Cabinet Secretary’s commitment to be “cognisant of the need to ensure taxation enables businesses to fully recover and fully trade”.</p> <p>The Committee understands the continuing pressures on local government finance, with lost income during the pandemic and additional</p>	<p>The continuing pressures on Scotland’s local authorities caused by the pandemic are well known and fully acknowledged. In addition to the additional general support the Scottish Government has provided so far we also provided £249 million last year specifically to compensate councils for the loss of income from sales, fees and charges. This extra funding was included in the additional £1.2 billion in direct COVID-19 support provided during 2020-21 through the local government finance settlement – over and above local authorities’ regular grant payments. This was supplemented by another £259 million of general support this year.</p> <p>Decisions on local government budget allocations are subject to the outcome of discussions with COSLA and individual local authorities. These discussions include asking local authorities what funding flexibilities could be provided to</p>

	<p>reliance on reserves expected in 2022-23. The Committee asks the Scottish Government to explore whether greater flexibility can be afforded to councils to respond to local priorities and fund local services in the next budget round.</p> <p>The Committee would welcome regular updates throughout the session on how the local government fiscal framework is progressing.</p>	<p>help them fund local services at a time when they are likely to face a very challenging financial settlement.</p> <p>Work to develop a rules based fiscal framework had been delayed at the onset of the pandemic. However Scottish Government and COSLA officials have now recommenced discussions. We still think that it is essential for Local Government to contribute specific proposals to inform these considerations and more substantive work is proposed to be taken forward in the first part of 2022. It can be expected that the development of a fiscal framework will have a direct relevance to the Scottish Government's Resource Spending Review and also have a bearing on the Local Governance Review.</p>
168-169.	<p>The Committee looks forward to exploring evidence from Scottish local authorities on their experiences in relation to the UK Government's replacement for EU funds and to hearing from the Secretary of State for Levelling Up, Housing and Communities on this important matter.</p> <p>In the meantime, we recognise, in line with other findings in this report, that greater communication and sharing of information between the UK and Scottish governments is needed to enable effective public spending in areas where there may be a shared interest.</p>	<p>The Scottish Government welcomes and shares the committee's concerns around the lack of and poor quality of engagement from the UK Government regarding the replacement EU funding and the development of new UK-wide funds being deployed in areas of devolved competence.</p> <p>The UK Government is choosing to use the Internal Market Act powers without the engagement or consent of the Scottish Government and Scottish Parliament. This approach introduces considerable additional uncertainty to future devolved funding settlements, and risks duplication and waste in the delivery of policies and services.</p> <p>Despite years of promises that the UK Spending Review would reveal all about the nature of the replacement for EU Structural Funds – the UK Shared Prosperity Fund – there is still no clarity on Westminster's plans for this Fund. We have had no input into its development, and have seen no evidence that it will meet the needs of Scotland's places and people.</p>

Para	Comment/Recommendation	Response
172.	The Committee notes a lack of clarity as to whether the Scottish public sector will incur additional costs as a result of the proposed increase in employer national insurance contributions, under the UK Government's Health and Social Care Levy. We invite the Scottish Government to provide an update on this issue and any consequences for the Scottish public finances following discussions with HM Treasury.	The Scottish Government estimates that the public sector will incur additional costs of around £150m per annum in Scotland as a result of the increase to employer National Insurance Contributions under the Health and Social Care Levy. HM Treasury have confirmed that the Scottish Government is receiving Barnett consequential on equivalent spend to cover these costs in England, though have yet to provide an exact breakdown.