# Finance and Public Administration Committee

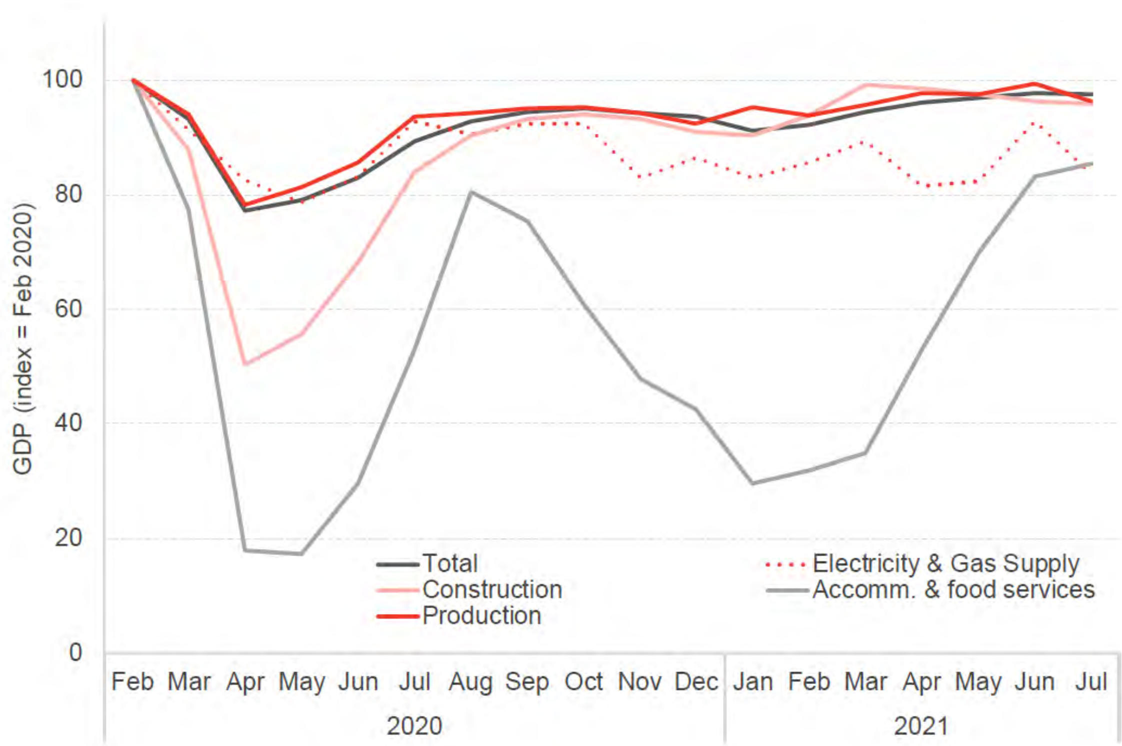
# Pre-Budget Scrutiny: Scotland’s Public Finances 2022-23 and the Impact of COVID-19

# Briefing Paper from the Committee’s Budget Adviser

## Latest Position of the Scottish Economy

The latest GDP data for the Scottish economy (up to July) shows that the Scottish economy contracted slightly during July, by 0.2%. This compares to a slight expansion in the UK economy of 0.1%. In both cases, it is a significant slowing compared to the growth we have seen since restrictions were eased in April.

*Chart 1: GDP in Scotland, selected sectors, Feb 2020=100*




*Source: Scottish Government*

There are two factors driving this negative growth:

- Construction has been on the decline for the last couple of months. We are hearing from the industry that both supply constraints and price rises have

been constraining the output of the industry. This is a feature of both the Scottish and UK economies.
- The Electricity and Gas generation sector. In summary, July was not very good for renewable generation (not very windy) and so this had a negative contribution to growth. This had a much great impact on the Scottish figures than the UK as a whole.

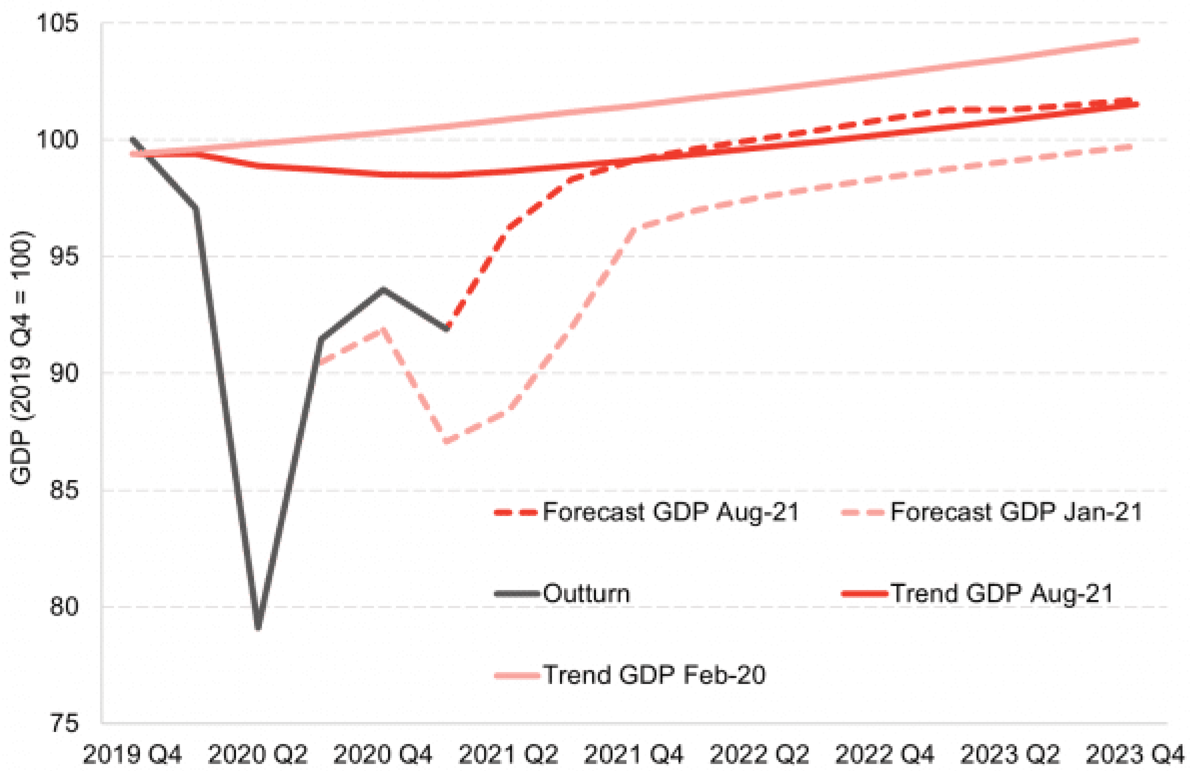
## Economic and Fiscal Outlook

The Scottish Fiscal Commission published their new set of forecasts in August. As expected, there was been a huge improvement in Scotland's economic outlook since the previous forecasts in January 2021, reflecting the success of the vaccine rollout and efficacy.

The SFC forecasts now predict growth of 10.5% in 2021/22, with economic output reaching its pre-pandemic levels by 2022 Q2; around two years sooner than forecasted at the start of the year.

These improvements to the economic outlook add almost £900m to income tax forecasts for 2021/22. But it is critical to remember that this does not mean an extra £900m of spending for the Scottish Government; similar improvements in the UK outlook will offset these forecast upgrades to a large extent (we will need to wait until the OBR forecasts on 27 October to get a more detailed picture).

*Chart 2: Trends and forecasts in Scottish GDP, 2019 Q4 – 2023 Q4*



*Source: SFC; Scottish Government*

The vaccination programme has significantly reduced COVID-19 hospitalisation rates which has allowed our economy to swiftly open again. But it is not just the vaccine rollout that has driven optimism. Sectors of the economy have bounced back faster than anticipated. Education began its phased return in February meaning that economic output in this sector was higher than expected in January's forecasts.

Additionally, household savings have increased massively throughout the pandemic. With the economy now reopened, it is expected that households will spend some of the savings that they have accumulated over the year. The SFC forecast savings to fall to 8% in 2021 Q4, down from its peak of 28%, and then decrease further to an average of 6% for the rest of the 5-year forecast period.

The furlough scheme has supported the labour market significantly throughout the pandemic however, with the job support scheme due to end on the 30th of September, the SFC forecast unemployment to peak at 5.4% in 2021 Q4. This is a downwards revision from its January forecast peak of 7.6% in 2021 Q2 – equivalent to 58,000 fewer unemployed.

Whilst the economic outlook has improved since the start of the year, there still remains a great deal of uncertainty, particularly around employment.

Similar to other forecasters, the SFC stresses an uneven nature of recovery across sectors and regions. Some sectors, particularly those that have rebounded strongly in recent months, face recruitment difficulties which are adding to wage pressures. Mismatches in labour supply and demand across sectors and places will take time to resolve. Ensuring these mismatches are tackled promptly will be a major focus for policy in the months to come.

The SFC's forecasts for the remainder of 2021 and early 2022 are broadly in line with the August forecasts of the Bank of England and NIESR. The SFC follows its tendency to be slightly more cautious about the speed of recovery in economic output, but not to any major extent.

Forecasts of the economy are exactly that, forecasts. Just as the projections have significantly improved since January 2021, they could also significantly worsen, depending on Scotland's recovery path from COVID-19.

Since the SFC published its forecasts, there have been a number of increasingly concerning signs of risks to the downside to the forecasts. While the SFC cited the possibility of the re-imposition of COVID restrictions, which of course would change the outlook, there have also been more concerns about the impact of inflation on consumer spending and an emerging energy crisis. It feels at the moment that the risk to the downside may have increased since the end of August.

# Impact on the Fiscal Framework

The fiscal framework has mostly worked as envisaged throughout the period of the pandemic. When we consider the large shock that has happened to the economy at both the UK and Scottish level, both the outlook for tax revenues and the outlook for the block grant adjustments have worsened, ensuring that the net impact on the Scottish budget roughly will be neutral (assuming that there is not a disproportionate impact on Scotland).

However, the large volume of unforeseen spending that happened throughout 2020-21 did flag issues with the operation of the Barnett formula itself. At times throughout the year, we were in the position where devolved governments were having to respond very quickly to policy announcements by the UK Government in relation to devolved spending in England, having to decide whether to quickly to follow suit. This led to funding guarantees from the UK Government, so that devolved administrations had certainty about their funding floor. These guarantees have been increased throughout the year. Additional flexibilities, such as the UK Government allowing devolved administrations to take some 2020-21 funding into 2021-22, were also introduced due to the large monies that were allocated late in the financial year.

If this had not been done, the monies allocated to the Scottish Budget would have breached the limit in the reserve of £700 million. This reserve is fixed in cash terms, and represents a much smaller proportion of the budget then when the FF was agreed in 2016.  Given the Scottish Government needs to have a balanced budget (which in practice generates underspends) the reserve is designed to allow them to carry over money left over at the end of the year.

These flexibilities highlight weaknesses in the current system that may need to be considered in the fiscal framework review.

In January (due to a quirk in timing of the OBR and SFC forecasts) a Scotland-specific economic shock was triggered. This gives the SG more scope to borrow to cover forecast error over the next few years. It also helpfully removes the £250m drawdown limit, to allowing the government (on current plans) to take out almost £400 million in the current year.

One of the main issues that the experience of the pandemic highlighted is inter-governmental relations. There was the issues around policy announcements as I discuss above: but there is no independent arbiter of these issues to reach resolution when conflict arises.

With the UK Government looking to increase spending in devolved areas as part of its programme to replace EU funding and “Level Up” the country, the possibilities for tension seem to be increasing. The Community Renewal and Levelling up funds are already in operation, with the UK Shared Prosperity Fund coming down the line in 2022.

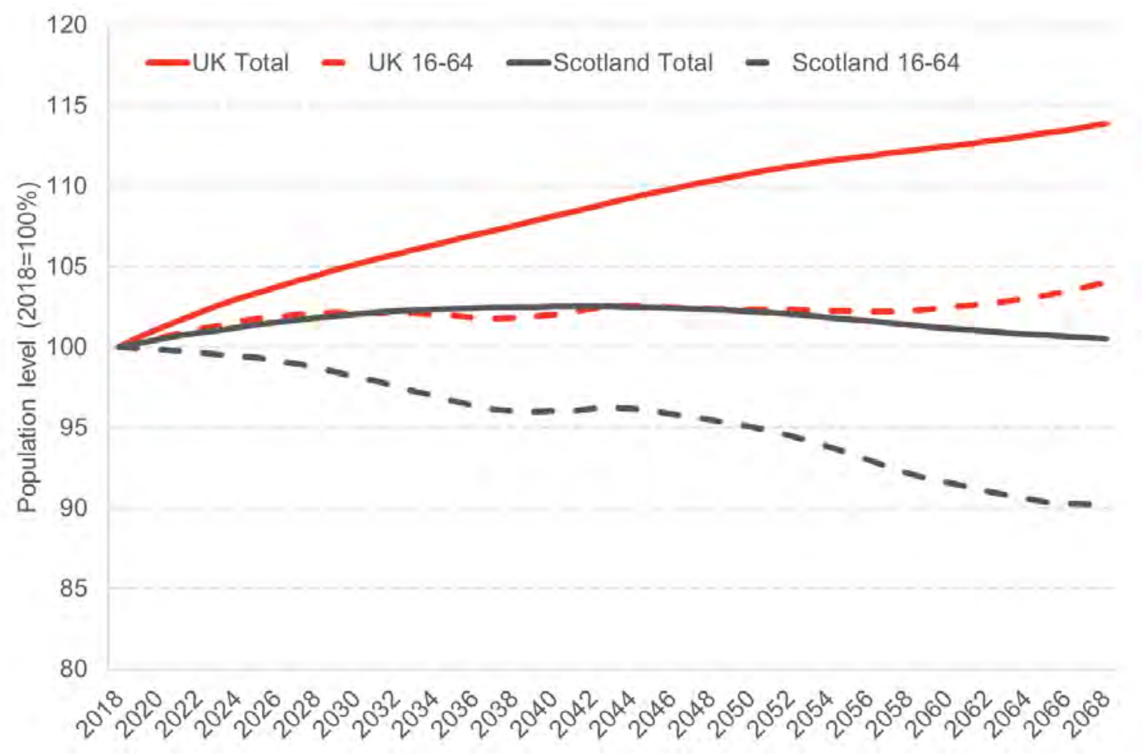
## Demography

Over the next few decades, Scotland's population will grow more slowly than in the past, and it will age.

The population of Scotland is crucial to the sustainability and vibrancy of its economy. We can be pretty confident of what drives population change over the long-term. That is, rates of migration from overseas and within the UK; and natural change (i.e. births vs. deaths). The outlook for both of these looks challenging over the next 25 years.

The chart below sets out the **pre-pandemic and pre-Brexit** projections which were set out for the Scottish and UK population.

*Chart 3: Population projections for the Scottish Economy*

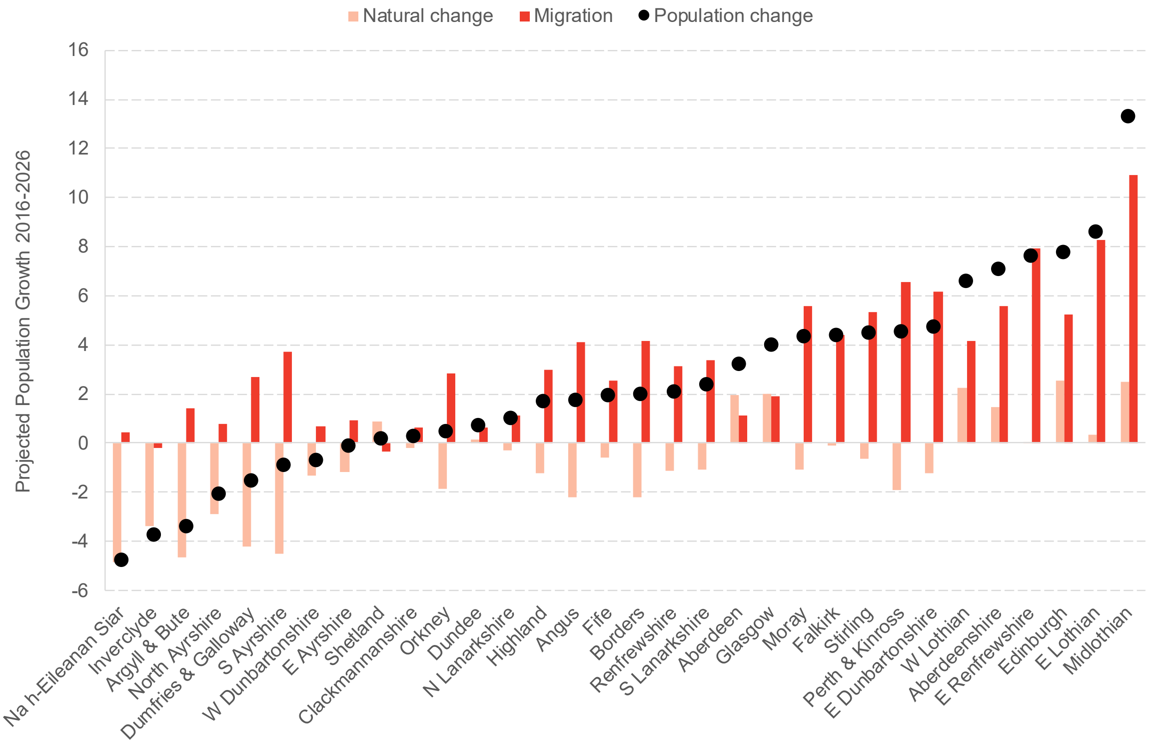



*Source: National Records Scotland*

Of course, an ageing population brings some challenges as more pressure is put on government budgets with a potentially shrinking tax base. Caring for those who are living increasingly longer, but often with some health issues, will fall on both the paid for care sector, and unpaid carers. Finding a way to better manage this future reality was part of the reason for the Independent Review of Adult Social Care, published earlier this year and the new government will face the challenge of implementing change.

This impact is not spread evenly across Scotland. The chart below shows the local authority impact. Many of the more fragile economic areas in Scotland are projected to see further population declines in the years ahead. This is a series concern for many local authorities in Scotland.

*Chart 4: Population projections for Scottish local authority*




*Source: National Records Scotland*

Of course, these are projections, not forecasts. The projections produced by ONS and NRS end to assume the continuation of past trends. If various Council areas are to arrest this population decline and ensure there is housing and good quality jobs for local people, investment will be required to ensure economic resilience.

Given that these projections involve continuation of past trends, they do not take account of policy decisions which could disrupt migration more than has been the case in the past. The obvious issue here is Brexit: given the migration policy adopted by the UK Government, there are likely to be disruptions to migration flows which make the outlook even more challenging. Added to this is the impact of the labour market of the pandemic.

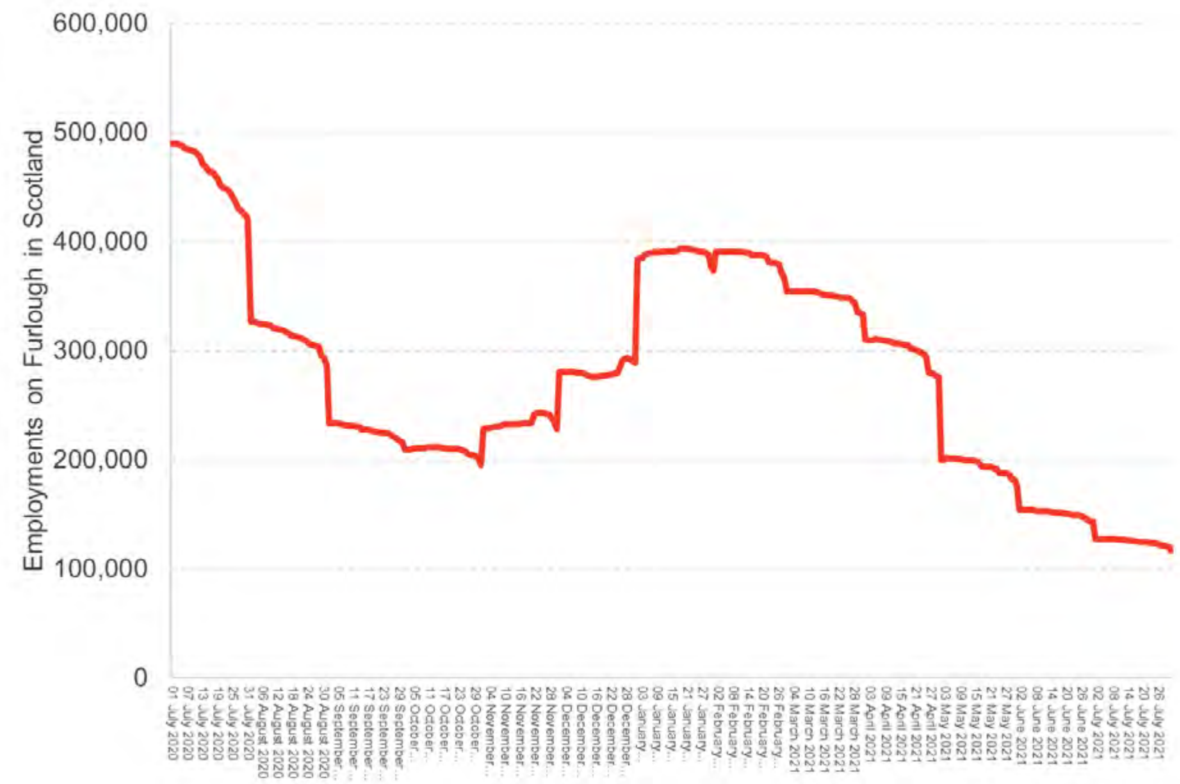
Taking account of these issues, over the next five years the Scottish Fiscal Commission expect the Scottish population to decline by 15,000. They also project the Scottish population aged 16-64, who make up the majority of the labour force, to fall by around 60,000 people between 2020 and 2026, an average fall of 10,000 people per year.

After a drop in migration in 2020 and 2021, they expect net migration to slowly increase but to be lower than pre-pandemic and pre-Brexit levels for the foreseeable future.

## The Coronavirus Job Retention Scheme

As the scheme draws to a close today, we know that there were over 116,000 people on furlough at the end of July. Around half of these are full furlough, with the remainder on flexible furlough. The largest sector is still accommodation and food services, with almost 24,000 people still on furlough, which represents 17% of eligible employments.

*Chart 5: Employments on furlough in Scotland to end July*




*Source: HMRC*

The evidence suggests that at first, young people (more likely to work in the hospitality industry, for example) were more likely to be on furlough at the start of the scheme, but as time has gone on, that they have been more likely to return to work.

## Inflation

Economy wide inflationary pressures have intensified in recent weeks, with increases in energy prices feeding through to prices across the economy. Constrained supply for particular products has also pushed up prices. The Bank of

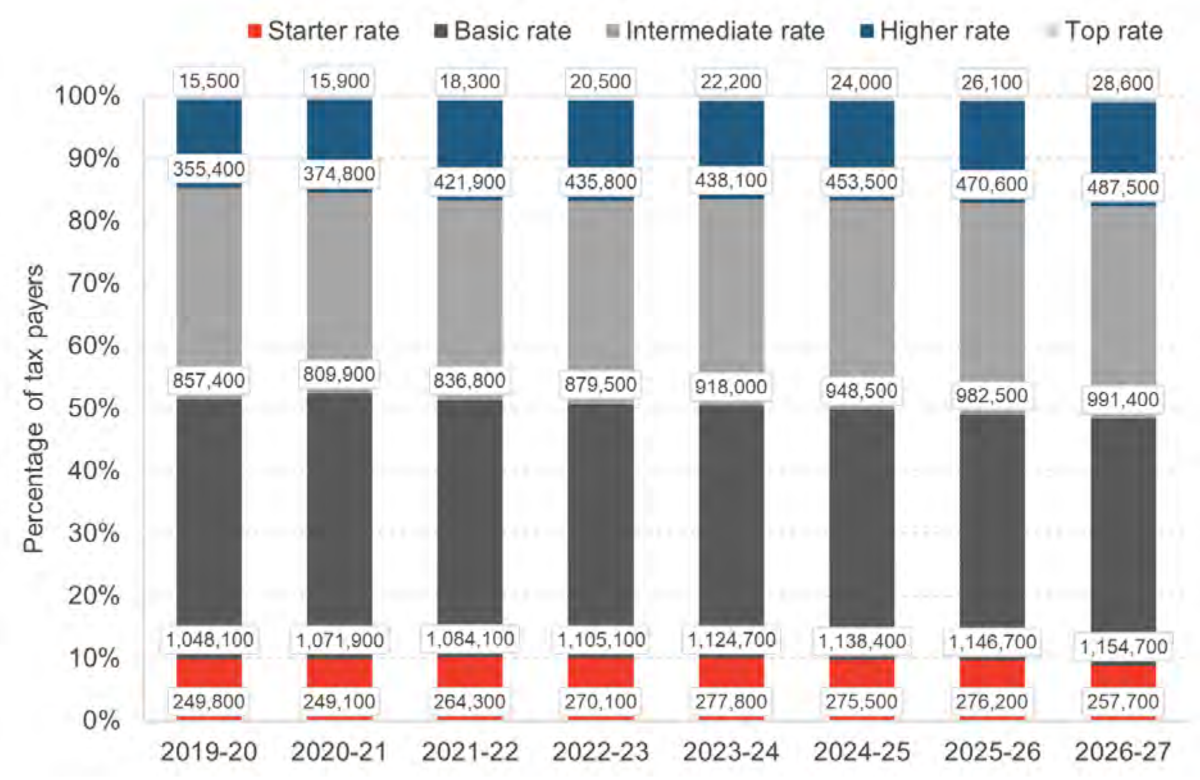
England have, to date, described the inflation rises as transitory: but there has been a noticeable change in recent days, with a risk of a rate rise in 2022 being flagged more prominently.

*Chart 6: CPIH Inflation, UK*


*Source: ONS*

The increase in inflation has a significant impact on the forecast for income tax in particular. In future years, as thresholds are likely to be frozen in real terms, fiscal drag is likely to both bring more Scottish earners into tax, and more earners into the top rates of tax.

*Chart 7: Percentage and numbers of tax payers in Scotland*



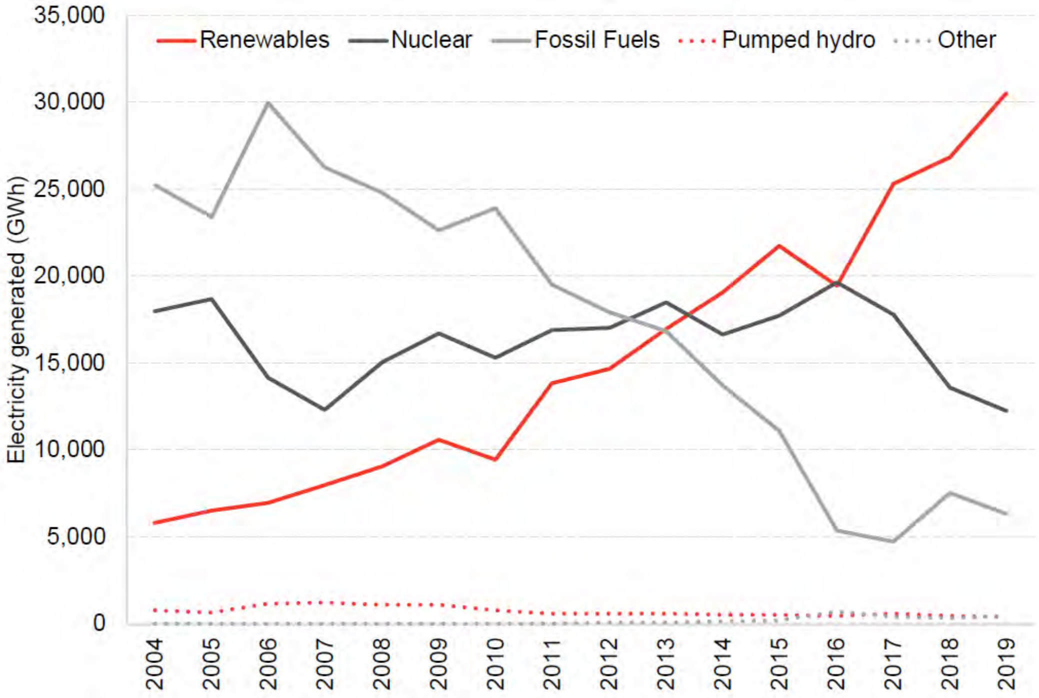

*Source: Scottish Fiscal Commission*

# Net Zero

It is now widely accepted that the global economy needs to fundamentally change if climate change is to be tackled. The UK and Scottish Government's commitments to net zero by 2050 and 2045 respectively is likely to require that the transformation of the economy is at the heart of economic recovery.

Firstly, it is clear that if Scotland (and the UK) are to meet their climate change ambitions, there will need to be a drive towards ever more renewable energy production. Significant progress has been made. In 2020, around 97 per cent of Scotland's electricity demand was met from renewables - well above figures for the EU and UK.

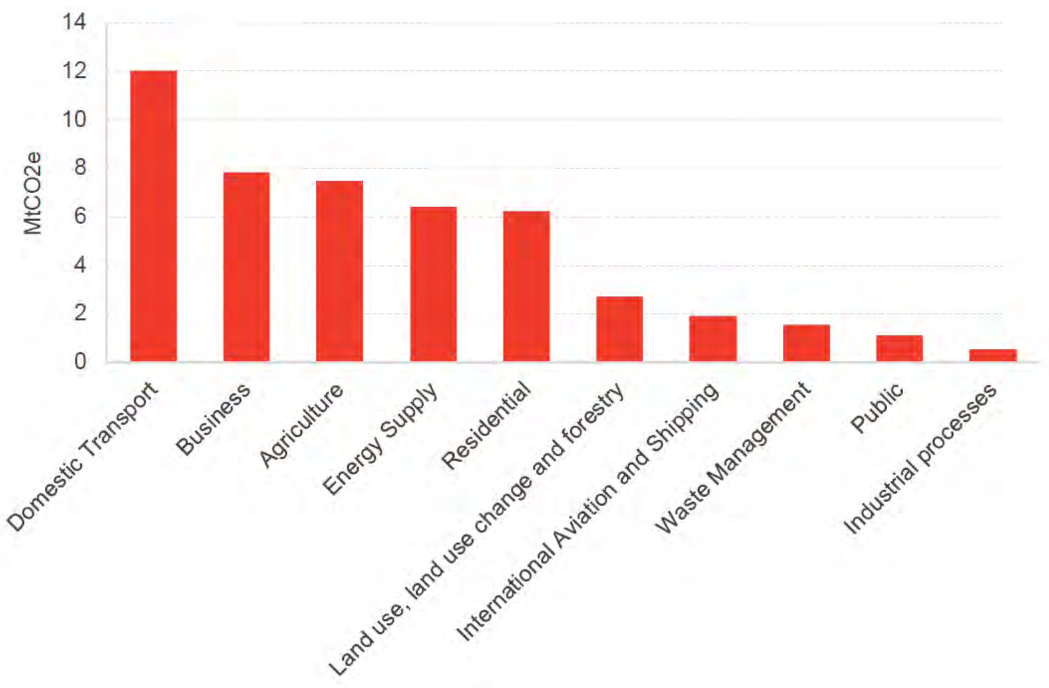
*Chart 8: Generation of Electricity by Fuel, Scotland, 2004 to 2019*




*Source: Scottish Government*

For all of Scotland's recent successes in renewables, we have much distance to travel. We lie bottom in the EU for renewable heat production, for example. And surface transport – road, aviation and shipping – is now an increasing source of emissions. With COP26 in Glasgow this Autumn, all eyes will be on Scotland and the nature of the green recovery.

*Chart 9: Sources of GHG Emissions in Scotland, 2019*




*Source: Scottish Government*

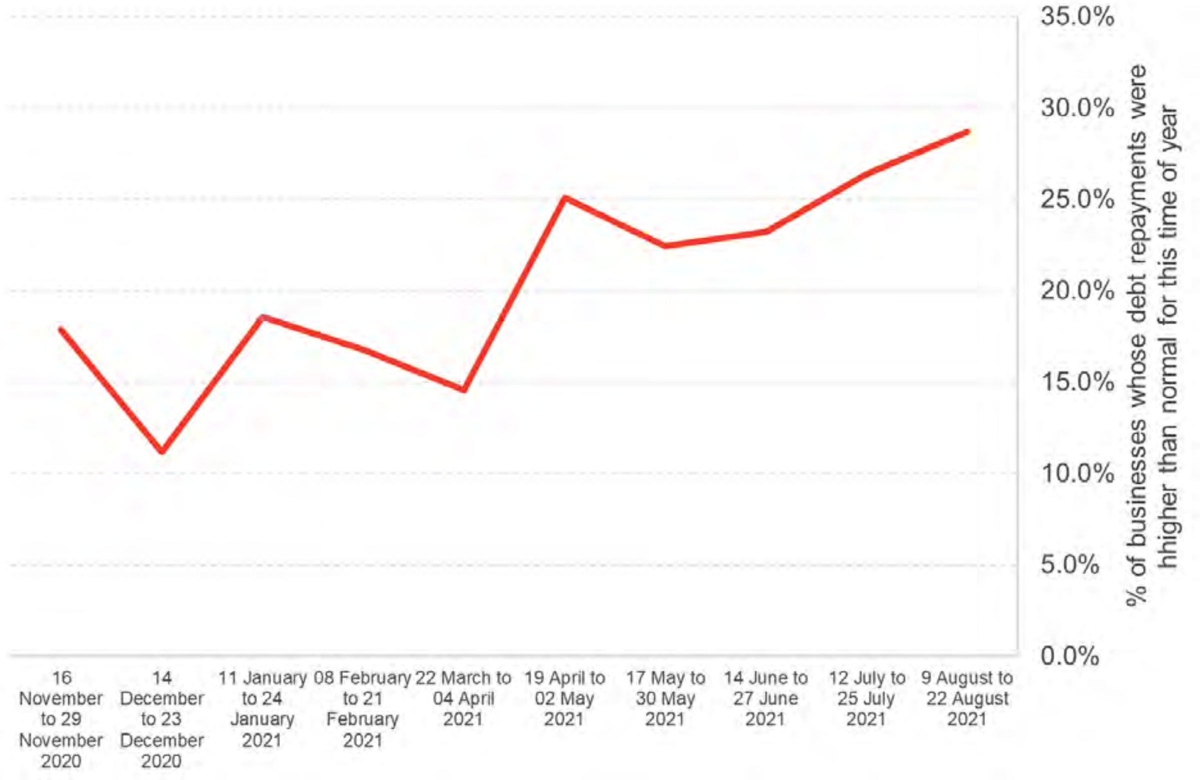
## Debt Burden of Businesses

One of the potential risks to recovery is the potential resilience of the economy to further shocks. A consistent message throughout the pandemic is that a significant proportion of businesses have taken on an increased debt burden.

In the face of rising prices for inputs, potential upward pressure on wages, a potential squeeze on consumers, and more government support mechanisms being rolled back, the resilience of the business base could be tested soon.

Data from the Scottish portion of the Business Insights and Conditions Survey in the chart below, shows that the cost of debt repayment is already higher for many businesses than normal.

*Chart 10: Debt Repayment Cost compared to normal levels*




*Source: BICS*

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