Finance and Public Administration Committee

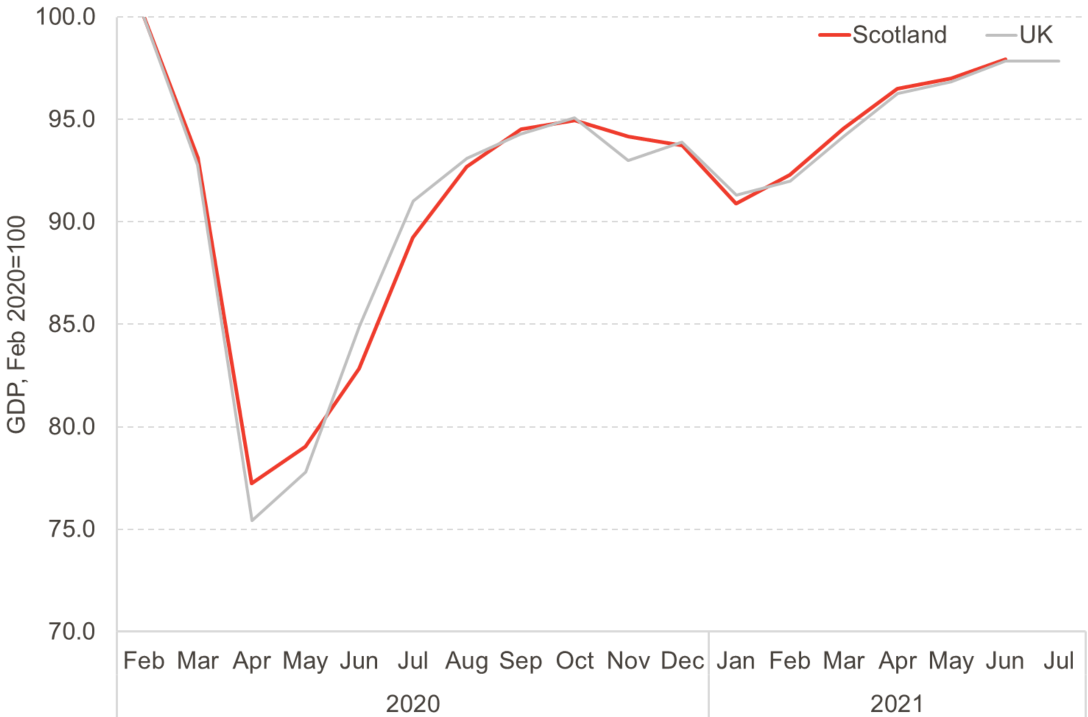
Pre-Budget Scrutiny: Scotland's Public Finances 2022-23 and the Impact of COVID-19

Briefing Paper from the Committee's Budget Adviser

How has the Scottish Economy fared throughout the pandemic?

In general, the experience of the Scottish Economy throughout the pandemic has broadly tracked the UK. Output remains around 2% below pre-pandemic levels, with certain sectors (like accommodation and food) being hit the hardest.

One of the data innovations due to the pandemic has been the Scottish Government moving to produce monthly GDP data, much improving the information available with a much smaller lag so we can understand what is going on in the Scottish economy. The monthly GDP data is shown in the chart below. We'll get the next data for Scotland on 22nd September.



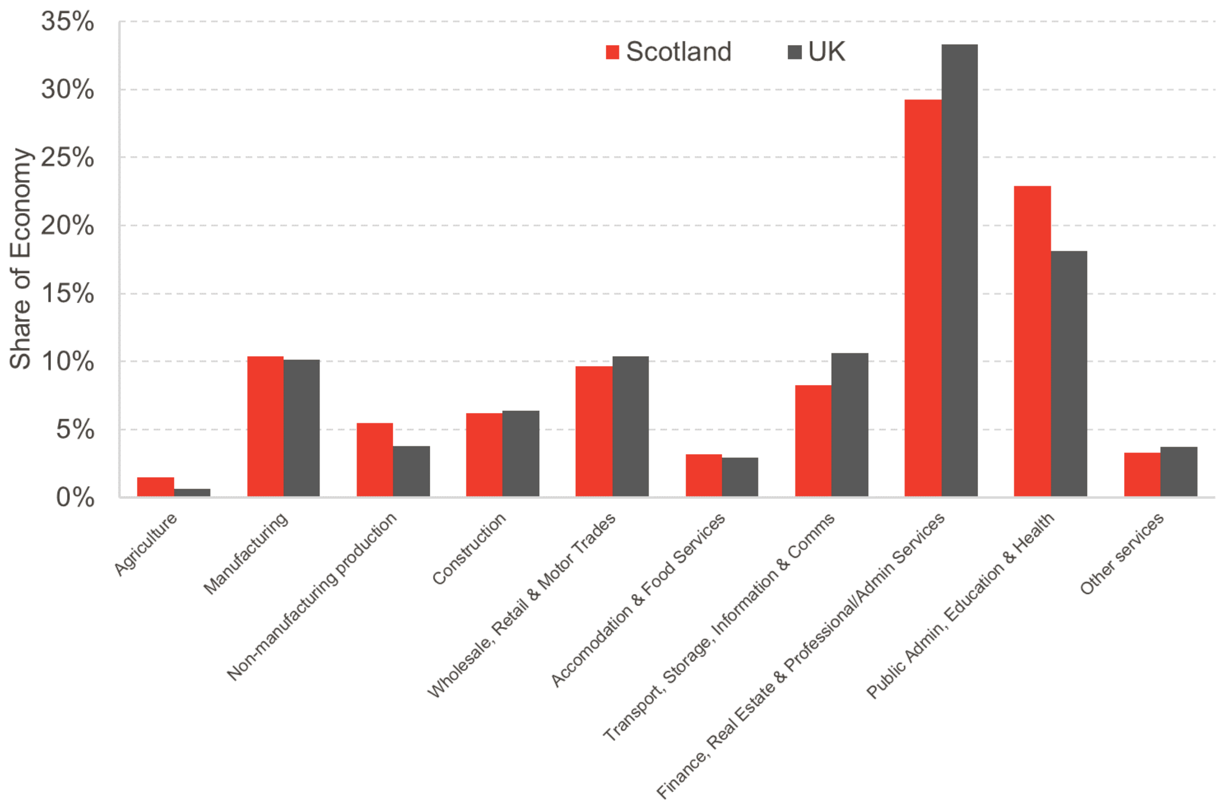
This data, and most other indicators we examine around the labour market, suggest a broad story of a very similar pandemic experience.

A couple of things to flag about this data however:

- The Scottish Government themselves say that estimates are subject to a much higher degree of uncertainty right now, due to the difficulties of collecting some of the data used to estimate GDP and of course the faster timetable of production of these estimates.
- In the short term, in some cases UK data is used as a proxy for the Experience of Scottish firms where Scottish specific data is not available.

Both of these factors mean we can expect revisions to these data in the coming months and years as our understanding of the experience of the Scottish Economy throughout the period of the pandemic.

The underlying nature of the Scottish economy is different to the UK as a whole: while we have a similar proportion of the economy devoted to manufacturing (around 10%) the makeup of our largely services based economy is more dominated by public services than the UK as a whole. The chart below compares the structure of the UK and Scottish economies.



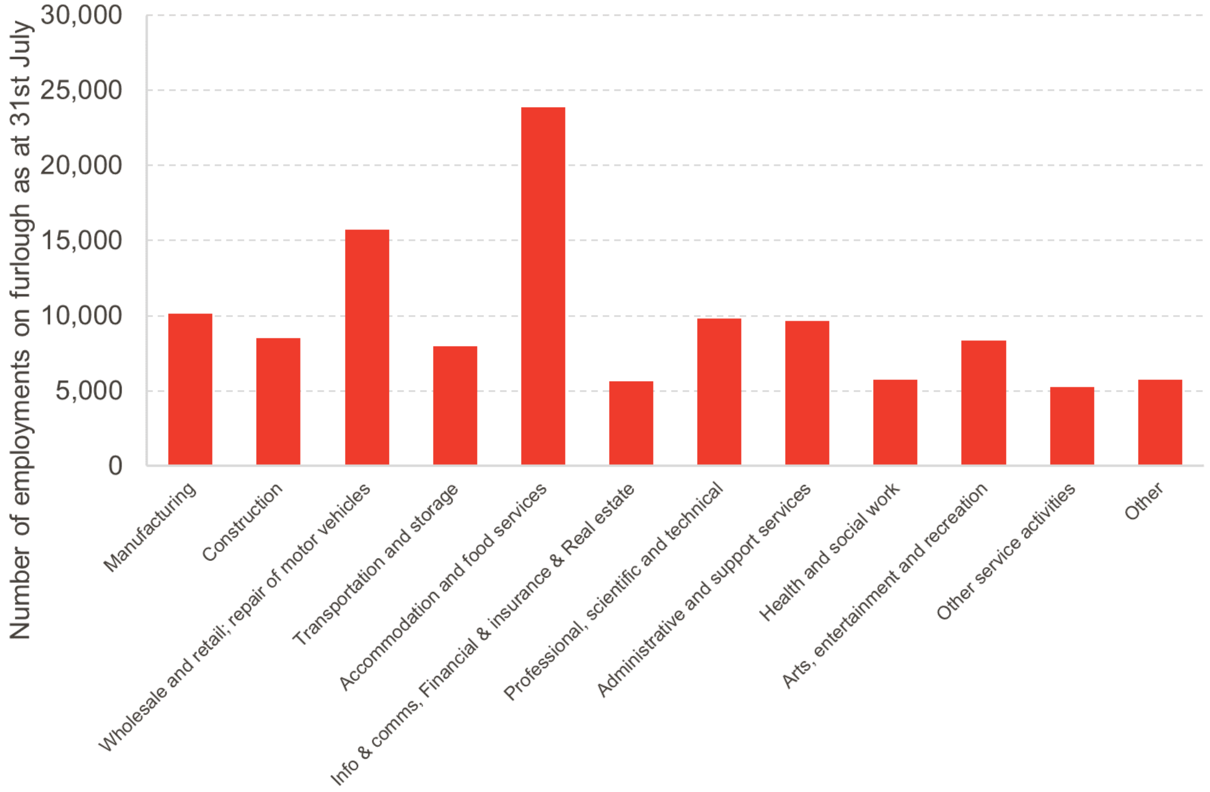
This data for Scotland is onshore only: it does not include extraction activity that happens in the North Sea. This represents around 5% of GDP in the latest year if it is included.

The issues coming up for the Scottish Economy include the end of furlough at the end of September, the cancellation of the UC uplift in the same time period, and concerns over inflation.

Inflation has been discussed widely as a concern for the economy. While demand is rising at a fast pace as the economy reopens, supply is constrained in some sectors because of both supply chain issues and labour shortages. This situation will raise the rate of inflation. The Bank of England is still taking the view that this is transitory, and that while inflation is likely to peak at the end of the year at 4% before tracking back to the 2% target over the course of 2022.

The end of furlough may free up some labour supply which can help to ease some pressures on the labour market. However, our supply of labour is also constrained due to structural issues, which I discuss below.

Statistics published on Friday show that as at 31st July, there were still 116,500 people on furlough in Scotland. 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.



Longer term pressures for the Scottish Economy

The longer term pressures on the potential for the Scottish economy to grow have not gone away, and many of these have been exacerbated by the pandemic. Demographic change is a serious concern for the Scottish population, with the latest forecasts from the Scottish Fiscal Commission suggesting that the 16-64 population could fall by 60,000 people over the next five years. Their expectation is that migration will recover from the extreme low levels in 2020 and 2021, but will remain below pre 2019-20 levels for the foreseeable future, due to the UK's exit from the EU.

The outlook for the working age population and increasing older population present challenges for the long-term in terms of funding and providing public services. Given this outlook, fiscal sustainability is an important consideration for demand–led services or social security payments.

Recent analysis by the Scottish Fiscal Commission suggest that the new social security payments that are being introduced to replace PIP, Adult Disability Payments, are likely to generate additional spending over and above what would have been paid through PIP of £0.5 billion. While these estimates are currently uncertain, this flags some potential issues with fiscal sustainability in the future.

How has the Fiscal Framework Operated throughout the pandemic?

As many of the responders to your call for evidence have set out, 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.

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