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RESPONSE TO THE SCOTTISH PARLIAMENT FINANCE AND CONSTITUTION COMMITTEE
IMPACT OF COVID-19 ON PUBLIC FINANCES AND THE FISCAL FRAMEWORK

Introduction

1 The Royal Society of Edinburgh (RSE), Scotland's National Academy, welcomes the inquiry by the Scottish Parliament Finance and Constitution Committee into the impact of COVID-19 on the public finances and fiscal framework. Since 1783 our core mission has remained the same, the advancement of learning and useful knowledge; our work is underpinned by two principles, a broad understanding of knowledge and application of that knowledge for public good – which translates into ***knowledge made useful***.

2 As Scotland addresses the significant challenges posed by COVID-19 and begins to recover towards a 'new normal', the RSE, harnessing our multidisciplinary Fellowship and using our convening power, is well placed to provide evidence-based advice and support to government and parliament. Our work in this area will be led by our Post-Covid-19 Futures Commission[1] which brings together leading thinkers and practitioners from across academia, business, public service and the creative arts. The Commission will help identify and address some of the immediate policy implications and challenges arising from the coronavirus outbreak and support thinking around the longer-term questions it raises.

3 We appreciate the urgency around the inquiry given the imminent publication of the Scottish Government's Summer Budget Revision as a consequence of the outbreak of COVID-19, which we note was published on 27 May.[2] Given the short timeframe this response provides an overview of what the RSE believes to be the key impacts on and considerations for the future of public finances and the economic recovery. This response was facilitated through a short life working group of RSE Fellows with expertise and experience in economics, public finance, local government, inter-governmental relations and constitutional law.

Public Finances

Short term and medium-term impacts

4 The scale of UK state intervention to support the economy during the pandemic is unprecedented and will consequently lead to the highest level of public debt as a percentage of GDP in peacetime history. These immediate costs, combined with a decrease in tax receipts and other revenues as a consequence of increased levels of unemployment, reduced consumption and business inactivity/closure, will reduce the amount of money available from tax revenue for both the UK and Scottish Governments. At the same time there will be pressure for increased spending on the health sector, not only to enhance the state of preparation for any future events of this ilk but also to deal with the urgent and non-urgent demands across the health sector which have built up during the pandemic. The expected (seemingly inevitable) significant rise in unemployment and the pressure for action to reduce the marked inequalities (such as wealth, health and gender inequalities) that have been highlighted in recent months will also ratchet up demands upon the public purse. Taken together we must anticipate a dramatic increase in pressure on the public finances, requiring extremely difficult decisions to be made on public spending and taxation.

1 Royal Society of Edinburgh, (2020). 'What Lies Beyond? Post-COVID-19 Commission formed by the RSE to support a positive future.' URL: https://www.rse.org.uk/lies-beyond-post-covid-19-commission-formed-rse-support-positive-future/

2 Scottish Government, (2020). 'Summer Budget Revision 2020'. URL: https://www.gov.scot/publications/2020-21-summer-budget-revision/

5 So far as both the economy and the public finances are concerned, the impact will be long lasting. The Scottish Government and Parliament will face very difficult choices on both the allocation of scarce public funds and the structure and level of taxation going forward.

6 It is impossible to forecast with any certainty the economic impact that this pandemic will have in the months and years ahead. The responses to date from both the UK and Scottish Governments have, understandably and appropriately, related to coping with the immediate impact upon businesses and households. Now consideration is turning to the issue of minimising the medium-term impact, by working towards a return to a broader base of business activity and restoring consumer confidence to encourage a pick-up in consumption spending and private sector investment.

7 A question of balance applies. To what extent can a return to more normal levels of activity be encouraged, without risking a bounce back in COVID-19 cases, let alone a second spike, and hence adding substantially to the health and welfare and economic downside in the medium to longer term? The Scottish Government has taken a somewhat more cautious approach on this issue, with more detail around the UK and Scotland approaches emerging daily. However, this is likely to imply higher net costs for Scotland's public finances in the short term, as under the fiscal framework this would fall on the Scottish Government as it is increasing the spending on a UK programme as a result of a devolved decision. That will be both because the costs of remedial policies (e.g. of furloughing) will be relatively higher and because a slower return to economic activity will lead to a slower growth in tax revenues. If the more cautious approach results in a more sustainable recovery, involving stronger growth in 2021 and beyond, then there should be a relative positive impact on the Scottish public finances over that period. But as noted above nobody is able to forecast even on a scenario basis with any degree of confidence. Under such circumstances a risk-averse stance is usually desirable.

8 The immediate interventions were applied across all four nations of the UK. The UK Government initially led the economic response and hence bore the brunt of the impact on the public finances. The initial economic stimulus across the four nations has been facilitated through revenues and borrowing from the UK Treasury, with funding then distributed to the devolved nations through the Barnett Formula. The initial impact on the Scottish Budget is described in the 2020-21 Summer Budget Revision document published by the Scottish Government.

9 This helps to demonstrate that the Scottish public finances are likely initially to be insulated as the interventions came from the UK Government. As briefly discussed above, the scope for differential public finance impacts in Scotland compared to rest of the UK, will result from either different policy and programme responses decided upon in Scotland or a differential impact of the pandemic on the Scottish economy or a combination of both. These effects are more likely in the medium term.

10 The majority of spending from government intervention to mitigate the impact of the pandemic comes in the form of business support, particularly the job retention scheme and business support loans. The job retention scheme is likely to be required to some extent and in some form through much of the remainder of 2020. The share of the cost of the scheme met by the UK Government is set to decline. It is acknowledged that differences across nations could now emerge. The scheme might be extended for certain sectors in Scotland, or operated differentially in Scotland, as Scotland adopts a different approach to unlocking different types of activity than in England in particular. Either unilateral extension or differential operation would result in the differential costs falling upon the Scottish Government, leading to an adverse impact on the public finances in Scotland, this will have an opportunity cost as some funds will not be used to meet other priorities.

11 These interventions have provided essential support in the short term, but they are not designed as measures of medium or longer-term support. Looking forward the Scottish Government will need to determine the best and most cost-effective means of easing business and consumers back towards what will inevitably be a 'new normal' of economic activity. So far as individuals and households are concerned, there will be a requirement to cope with a higher level of unemployment, at least over the coming months, and at the same time work towards encouraging job creation (or recovery) from existing and developing businesses. Impacts here may differ in Scotland from elsewhere in the UK both because of the differential policy decisions on unlocking the economy and because variation in the sectoral structure will result in differential impacts on business activity and employment across the nations and regions of the UK. Scotland will be disproportionately impacted, at least in the short term, for both the oil-related sector, tourism and hospitality. Special measures of support may be needed for tourism, hospitality, and cultural activities, especially as the impact is likely to be felt more strongly over specific, largely rural, areas of the nation.

12 One other labour market requirement may well be re-training and indeed a change in focus for training generally. There could be shifts in skill requirements as businesses adjust to the changes resulting from experience during the pandemic. There could also be structural shifts in business activity in Scotland. That will be on top of the increase in unemployment, with those entering unemployment for no fault of their own seeking assistance to develop the skills required in the post pandemic world. This will be another challenge for the public finances, especially as the Scottish university sector is likely to be one of the sectors worst hit, in the short and longer term, because of the adverse impact on demand for courses from overseas students with international fees cross-subsidising teaching for home students and research activities.

13 There is a clear risk of large numbers of business closures, despite the job retention scheme and the business interruption loans. Many businesses will have lost a very high percentage of revenues over an extended period, without the scope for fully commensurate reductions in costs. Many will have taken on additional debt, from the government schemes or elsewhere. For many (probably most) there will be no dramatic bounce back and recovery of lost revenues, such as to enable businesses to repay debt rapidly. Most businesses will face heavy debt service costs for an extended period. The difficulty of meeting such costs would be enhanced if the recovery in demand for their goods and services is slow and drawn out. A 'V' shaped recovery would suit business best but is not guaranteed and seen by many commentators as unlikely.

14 That implies three challenges for both the public sector and the public finances. First, how can businesses be best assisted to service debt and return to a sustainable financial situation? Will government need to step in at times to ease the debt burden by extending the period of loans; or extending interest free periods; or even writing off some debt? Second, and on a more positive note, how can government encourage increased and innovative business investment to help the Scottish economy move forward? Third, what could be the role for the banking sector and others willing to invest in businesses? Could public funds be used to help lever in more private investment?

15 We suggest that the initial focus, of Scottish Government, should be on working with the UK Government to consider such assistance, as this would tend to mean that additional funding might be available under the Barnett Formula. We also note that the UK Government will be able to borrow more cheaply than the Scottish Government, even if the constraints on the extent of permitted borrowing for the latter were to be eased. However, both governments must explore new and imaginative ways of using funds to encourage forward-looking investment. The Scottish Government should consider carefully the role of the Scottish National Investment Bank (the Bank) and the Enterprise and Skills Agencies in this context. It may well be that the focus of the Bank as it starts up should be entirely on encouraging forward-looking investment while contributing to the wider policy objective of achieving a net zero economy. This whole area merits urgent and careful consideration by the Advisory Group on Economic Recovery and others.

16 We also accept that the crisis presents an opportunity to consider how the structure of our economy can be rebalanced, tackling issues such as income, spatial, ethnic and wider inequalities. These inequalities have been shown up sharply during the period of the pandemic. This task will again be immensely complex and difficult. Public finance will be the scarcest of scarce commodities and priority must also be given to encouraging strong and sustainable recovery in order to support employment and the welfare of households across Scotland. Priorities must be explicit and clear; and reflected in the allocation of these scarce resources. Consideration will be needed as to how these priorities might be identified and agreed within Scotland.

Fiscal Framework

17 The fiscal framework is due to be reviewed in 2021. This provides an opportunity to consider the performance of the framework during a time of crisis. The review will provide the UK and/or Scottish Government with an opportunity to propose improvements and flexibilities to the framework that can help provide certainty around spending and budgets in a time of crisis. We recognise that there may be a willingness to bring the 2021 review forward so that flexibilities on spending can be added. However, we believe that this would be ill-advised as this would involve undertaking a complex review during a crisis at a time when there would be a lack of full and analysed evidence on how the framework had actually worked over that period. Such evidence should be available in 2021 and should be used to inform any proposed changes to the framework and negotiations between the UK and Scottish Governments.

18 The fiscal framework offers several flexibilities and provisions that can protect the Scottish budget from sharp decreases in revenue at short notice. The fiscal risk in the current year is limited as the framework aims to provide the Scottish Government with clarity on its in-year spending. As a result, the current year's Scottish Budget is unaffected by the sharp reduction in income tax revenue due to the pandemic. For future years, the Scottish budget is protected from falls in income tax revenue if these are the same per head across the UK. Thus, any falls in revenue from income tax as a result of the pandemic will only impact the Scottish budget if they are more severe per head in Scotland than in England. The UK Treasury, and hence UK taxpayers as a whole, bear the absolute risk. There is a problem with income taxes that was identified pre-COVID-19. Income tax revenue forecasts from the Scottish Fiscal Commission,[3] as included in budgetary decisions by the Scottish Government, have proved to be systematically overoptimistic. That was revealed in the UK March 2019 Budget, but the Scottish Government decided not to adjust in 2019/20 but to carry forward forecast errors. As a result, there is a potential shortfall of around £500m, which will have to be addressed by the Scottish Government in future budgets and this will be on top of further public finance pressures resulting from the pandemic.

19 For the smaller devolved taxes, unlike income tax, the absolute amount of any shortfall falls upon the Scottish Government and has to be allowed for in the year that it transpires. Consequently, there is clear potential for an immediate impact from the pandemic on Scottish finances resulting from the revenue from the Land Buildings and Transactions Tax (LBTT) falling well below the forecast level. The revenue from this tax has fallen markedly, as transactions have been stopped over lockdown. Revenue looks set to continue to stay low if property values decrease. This could lead to a shortfall amounting to hundreds of millions of pounds. It was understood that under the fiscal framework a shortfall in revenue from such smaller taxes was an absolute risk to the Scottish budget; but this shortfall is much larger than anticipated. There will also be falls in similar taxation (Stamp Duty Land Tax) elsewhere in the UK and it is not expected that this would lead to UK departmental budgets being cut as the UK Exchequer will likely borrow to meet the shortfall. Therefore, it might be advisable for the Scottish Government to ask the UK Government to allow borrowing to offset this equivalent shortfall in Scotland rather than make further spending reductions.

3 Scottish Fiscal Commission, (2020). 'Scotland's Economic and Fiscal Forecasts'. URL: fiscalcommission.scot/forecast/scotlands-economic-and-fiscal-forecasts-february-2020/

20 It has yet to be seen if Scotland will experience a differential impact from COVID-19 policy responses and economic impacts. As discussed above the scale and duration of such a differential impact will be dependent on several factors and the impacts so far have been felt across the UK. If the differential impact is significant to qualify under the framework as an 'asymmetric shock', then the provisions in the fiscal framework could protect the Scottish budget accordingly. However, it is not yet clear whether the extent of the differential impact in Scotland will be sufficient to trigger this provision.

21 For reasons briefly discussed above, it is highly likely that in the medium term, the Scottish Government will need to look at other ways of raising revenue to compensate for lower revenues and cater for higher demand for public finance as a result of the pandemic. This implies that an increase in taxation, introducing charging in other public sector areas or spending cuts will be necessary.

22 The issues for local government may prove relatively severe, as local revenue is set to fall (e.g. due to more empty commercial properties) and possible shortfalls in council incomes from services as well as additional costs associated with responding to the pandemic. Local government finance may require special attention particularly in the context of pre-existing and ongoing pressures on council budgets.

Actions and Priorities

23 As stated, the biggest impact on the public finances has been the level of state interventions in the economy, particularly the job retention scheme and business support. The first priority in the recovery will be the reduction of state intervention where and when necessary, alongside the regeneration of economic activity and support for businesses and households across Scotland. This will present difficult but necessary decisions as furloughing and supporting businesses cannot last indefinitely.

24 The crisis presents an opportunity to address the problems and inequalities within the current system. As far as possible, the economic recovery should focus on achieving sustainable regeneration of the economy while also addressing strategic priorities which aim to reduce inequalities and create a more resilient economy.

25 For years the UK has been involved in the EU Framework for State Aid, this presented clear rules and guidelines for state intervention. The subsequent pandemic has resulted in the EU Commission introducing a temporary framework so that governments can support their economies. Going forward as the UK leaves the EU, it will be for the UK Government to decide whether to stay involved with the EU framework or go its own way. If the latter, then the UK Government must work with the devolved governments to agree and establish a new framework for state intervention within the UK, as nothing like this exists in the constitutional settlement.

26 We refer above to the still embryonic Scottish National Investment Bank. The scheduled creation of the Bank later this year is now very timely. We believe that the Bank should be established sooner rather than later and with a new clear mission; assisting the renaissance of the Scottish economy while also contributing to the wider policy objective of transitioning to a net zero economy. The Bank should now be expected to play a key role in supporting the Scottish economic recovery; investing, both directly and with partners, in Scottish businesses, spinouts and start-ups. It should be prepared to invest in viable businesses in areas that historically have been avoided by investment banks and venture capitalists, such as tourism, leisure, hospitality and the creative arts. As in certain regions these businesses are major employers and contributors to the local economy. It will remain crucial that the oversight of the Bank and decisions on its investments are taken at arms-length from government, albeit in full awareness of government's stated and agreed priorities.

27 We appreciate that the Bank will be just one participant in this process. As discussed above the Scottish Government should work closely with the UK Government to develop a UK wide approach to supporting business through the aftermath of the pandemic. There will also be a role for the financial sector, e.g. in converting debt to equity in some instances, and the operation of bankruptcy procedures to avoid the inappropriate destruction of productive capacity for potentially viable businesses. If the state (UK or Scotland) taking equity stakes is under consideration, then care will be required in defining when this might be appropriate and justified on broader economic grounds.

28 The need for supportive investment for business will be substantive and long term and will merit a broad-based response. There is now a good deal of evidence to suggest that inequality is a drag on economic growth – rebutting the old ideas of an efficiency/equity trade off. Nevertheless, careful thought will be required to identify appropriate policy priorities (and the subsequent spending priorities) and careful consideration will be needed as to how these priorities might be agreed within Scotland.

Additional Information

Any enquiries about this advice paper should be addressed to Paul Stuart, Policy Advice Officer (email: pstuart@therse.org.uk).

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