

## **Submission from Audit Scotland Pre-budget scrutiny 2021-22**

The public health crisis caused by Covid-19 has had a significant and profound effect on every aspect of Scottish society. At the heart of this are the personal tragedies of the thousands of people who have died or lost loved ones.

The pandemic has been the biggest fiscal and policy challenge facing the Scottish Government over the past two decades of devolution. It has required substantial and continuing amendment to the 2020/21 budget, and is likely to have significant implications for Scottish budgets for 2021/22 and years to come.

Covid-19 has changed our lives and it will change the way that public services need to be delivered. Public audit has an important contribution to the recovery and renewal of public services. High-quality, independent and evidence-based audit supports accountability and learning about how the government and public bodies have responded to the crisis. Central to this will be providing transparency, supporting parliamentary scrutiny and sharing good practice and innovation.

We welcome the opportunity to submit our views to support the Finance and Constitution Committee's 2021/22 pre-budget scrutiny. Our submission focuses on the spending and fiscal challenges that 2021/22 may bring, and how the Scottish Government can respond to this through the budget.

Covid-19 will continue to put pressure on the Scottish budget in 2021/22. There may be further economic uncertainty arising from the UK's withdrawal from the EU. How the Scottish economy responds to these events relative to the UK continues to be of central importance to the budget, alongside the tax and spending decisions of both the UK and Scottish Governments.

Our [response](#) to the Committee's previous inquiry on Covid-19 and the Fiscal Framework remains pertinent as the Committee considers future budgets. Later this month Audit Scotland will also be publishing a briefing on the implications of Covid-19 for the public finances in Scotland and we will share this with the Committee once it is available.

In recent years the Scottish budget has become increasingly complex, and subject to more uncertainty as a result of the new tax raising and social security powers. This was a consequence of the 2012 and 2016 Scotland Acts, the implications of which were already a feature of the Scottish budget prior to the current pandemic.

The Scottish Government is required to operate a balanced budget, matching its spending to available funding each year. As we have shown in our previous [Operation of the Fiscal Framework briefing papers](#), this can be challenging. This challenge has intensified in 2020/21 due to significantly increased demands on Scottish Government spending in light of the Covid-19 pandemic, and changes to funding and revenue sources, including the devolved taxes.

Budget volatility is likely to continue into the 2021/22 budget year, as the impact of the pandemic on the economy and public services develops. Pressures on public spending are likely to continue and be varied in nature. These include:

- Future Covid-19 developments and what extra spending may be required.
- The aftermath of the initial response; for example, costs involved in dealing with the delays to social security powers and the extension of early learning and childcare hours, non-Covid-19 related healthcare backlogs and ongoing support for schools returning from lockdown.
- Considering the impact of non-Covid-19 related economic changes, such as the effect of EU withdrawal; this includes the effect on taxes and social security benefits as well as demand for other services.
- Managing the spending pressures to the NHS and other public bodies that pre-date the Covid-19 crisis.

The Scottish budget will therefore need to address a number of risks that can affect portfolio budgets, perhaps significantly. Not only does this mean understanding where potential spending pressures exist within portfolios, but also understanding the flexibility that exists and which spending programmes can be increased, decreased or delayed quickly in response to in-year changes in other areas of the budget.

The block grant will remain a major component of funding to the Scottish budget in 2021/22. In 2020/21 the Scottish budget has seen unprecedented levels of additional Barnett consequential as a result of UK spending decisions.

To date, the majority of UK spending on Covid-19 has been funded by additional borrowing, which generates Barnett consequential. If the UK government chooses to fund some of the continuing Covid-19 spending through reprioritising spending in other budgets in devolved areas, the Barnett consequential are reduced. In such circumstances, the Scottish Government would also need to decide whether to reprioritise its own budgets accordingly.

Tax revenues will depend on the relative performance of the Scottish economy to the rest of the UK, but it is too early to say what this will be. Forecasts from the Office of Budget Responsibility and the Scottish Fiscal Commission (SFC) will be produced alongside the UK and Scottish budgets respectively. The SFC's updated May forecasts were not produced this year due to Covid-19. Any divergence in tax policy by the Scottish Government will be factored into the SFC's forecasts.

The way that the Scottish and rUK economies respond to Covid-19, EU withdrawal and other factors matters to the budget. If the SFC forecasts a slower return to growth and therefore less tax take than the OBR forecasts for the rest of the UK, this will reduce the Scottish budget, as the block grant adjustment will be greater than the forecasted revenues. If the SFC forecasts a faster recovery, then the Scottish budget will benefit.

A significantly different pattern from the rest of the UK could have a large effect on the Scottish budget. There are structural differences between the Scottish and rUK economies, as well as differences in the shape of the taxpayer base. Both of these factors could point to different economic responses to the pandemic.

The timing of when the different taxes impact on the budget will have a bearing. For example, Land and Buildings Transaction Tax (LBTT) revenues are known in-year, with budget reconciliations both during the year and shortly after the year-end. It is possible that LBTT revenues may be lower than before the pandemic in Scotland. However, if stamp duty revenues in the rest of the UK are also lower the relative impact on the Scottish budget, upwards or downwards, is reduced.

For Scottish income tax, outturn information is known 15 months after the end of the financial year, and the difference between outturn and forecasts for 2021/22 will affect the 2024/25 budget. This illustrates how the relative economic response to current uncertainty will affect the Scottish budgets for years to come. Under the current circumstances, accurate forecasting will be particularly challenging, presenting the risk that forecast errors in the future could be larger.

The assignment of Scottish VAT revenues to the Scottish budget was due to take place in April 2020 but was delayed. VAT is now due to be assigned to the Scottish Government from 2021/22. When it is introduced, the assignment of VAT is likely to add an additional element of uncertainty to the Scottish budget. As this will be the second largest tax after Scottish income tax, the Scottish Government will need to manage the implications for VAT on the Scottish budget very carefully.

Overall, the uncertainty facing the Scottish budget for the next financial year is significant, and maintaining good budget management will be more important than ever. The 2020/21 budget process was disrupted by the delay to the UK budget; if the UK budget is produced before the Scottish budget for 2021/22, this will give more certainty to the block grant and help ease pressures on the timescales for budget scrutiny. 2020/21 has seen substantial in-year budget movements, both in terms of spending and funding. This highlights the importance of year-round budget scrutiny as envisaged in the Budget Process Review Group (BPRG) recommendations.

Alongside this cyclical approach, other BPRG recommendations remain pertinent, such as:

- a focus on the outcomes that have been achieved and are planned
- a long-term outlook on fiscal responsibility
- a focus on prioritisation to addressing fiscal constraints

The Summer Budget Revision in 2020/21 provided additional information around how the budget had changed in response to Covid-19. This budget revision is in addition to the anticipated autumn and spring budget revisions. Additional in-year budget reporting is valuable to both track changes to spending plans and to outline the the impact on revenues and demand-led spending during the year.

Fiscal Flexibilities

On 24 June the Cabinet Secretary for Finance wrote to the UK Chief Secretary to the Treasury to request flexibilities to the Fiscal Framework to allow in-year cash management to be used for revenue borrowing and to draw down money from the Scotland Reserve above current limits. The Cabinet Secretary for Finance stated that this would help meet the financial pressures that the Scottish Government faces in the 2020/21 financial year. The use of any such additional flexibilities would also have an impact on 2021/22 and subsequent financial years. To date, there has been no formal response from the UK Government to this request.

In recent years, the Scottish Government has committed funds from the Scotland Reserve to its original budget. This decreases the “headroom” available within the reserve to support in-year movements in the budget. Drawing down more of the Scotland Reserve in this financial year means that there will be less money available in the Scotland Reserve to support the 2021/22 budget. Judgements will have to be made about when available reserves are best applied.

Any increased borrowing would need to be repaid, currently over a three to five year period as set out in the Fiscal Framework. Increased borrowing repayments would also decrease the net budget available to spend on services in 2021/22 and in subsequent years. This would be alongside the reconciliations caused by the outturns of Scottish Income Tax and its Block Grant Adjustment for 2018/19, currently forecast to lead to a £555 million deduction to the budget. The Cabinet Secretary for Finance has requested flexibilities to repayment periods and to budget reconciliations.

Managing a balanced Scottish budget may mean reducing or reprioritising spending away from some areas while protecting spending on other government priorities. This will need to be done in a way that minimises the disruption to individual public bodies and services, ensures value for money is maintained and avoids unintended consequences.

High quality budget management information is needed to do this, such as updated cost forecasts, detailed understanding of where underspends and overspends could occur in portfolios, and information about which spending programmes are central to government priorities and progressing National Performance Framework Outcomes.

The Scotland’s Wellbeing annual report of progress against outcomes publication was delayed due to Covid-19. When it is published, information on both how pre-pandemic spending in 2018/19 contributed to outcomes, and how Covid-19 has affected this progress will be a key component of improved understanding of the impact of public spending on outcomes.

The variety of spending, funding and revenue uncertainties and volatilities emphasise the importance of medium term financial planning. The Scottish Government to date has produced two Medium-Term Financial Strategies (MTFS), in May 2018 and May 2019. The Scottish Government did not produce a MTFS in May 2020 because of the pressures of Covid-19. The Scottish Government still intends to publish a medium-term plan, but has not confirmed the timing of this.

The medium term financial plan will need to consider and describe the risks over the medium term. It should include scenario planning covering demand for services and

indicative costs of government plans as well as scenarios of taxes and other sources of funding. Sensitivity analysis of the impact of the assumptions made should also be included. Making the direct link between potential spending and the outcomes that the spending intends to achieve is also important to maintaining accountability for the performance of services towards these goals.

An NHS medium-term strategy was also expected to be published in May. It will be increasingly important that overall plans and strategies clearly align with those of large portfolio areas such as health.

We continue to emphasise the need for the Scottish Government to publish a public consolidated account to provide a comprehensive and transparent assessment of the state of Scotland's public finances. This is important for decision making over the longer term as it will provide important information about the impact of past decisions on future budgets, the scale of liabilities, and potential risks to financial sustainability.

The Covid-19 crisis has brought significant risk to Scottish public finances and the performance of public bodies. The impact on people, public services and the economy has been immediate and severe, with some groups in society disproportionately affected. It is likely to have continuing consequences for public spending programmes and people's health and wellbeing outcomes are likely to be affected over the longer-term.

In setting out the 2021/22 budget the Scottish Government will need to respond to the big changes to tax revenues and spending programmes currently happening as a result of the crisis and look to the future. This is likely to require a strategic and joined up approach. It will mean balancing immediate pressures with longer term priorities to improve the wellbeing of the people of Scotland and secure a positive future for generations to come. The rationale for tax and spending decisions and how spending programmes will work together must be clear, with full transparency over the financial challenges ahead and how these are being addressed.

Audit Scotland is committed to helping Parliament and the public understand how public money is used to rebuild the economy and repair the damage to communities over the longer term. Public audit has a key role in reporting on the quality and effectiveness of public services, considering the extent to which the Scottish Government's financial measures are delivering a fairer, more just and equal society, with better outcomes for Scotland's people.