Finance and Public Administration Committee
25th Meeting, 2024 (Session 6)
Tuesday 10 September 2024

Pre-Budget Scrutiny 2025-26 - Managing Scotland's Public Finances: A Strategic Approach

Purpose

1. The Committee is invited to take evidence from the following witnesses in relation to its inquiry into Pre-Budget Scrutiny 2025-26 – Managing Scotland's Public Finances: A Strategic Approach.

   Panel 1: Setting the scene
   - Richard Robinson, Senior Manager, Performance Audit and Best Value, Audit Scotland,
   - Professor David Bell, Fellow, Royal Society of Edinburgh, and
   - Professor David Heald, Emeritus Professor and Honorary Senior Research Fellow, Adam Smith Business School, University of Glasgow.

   Panel 2: Business and skills
   - Vikki Manson, Deputy Head of Policy Scotland, Federation of Small Businesses,
   - David Lonsdale, Director, Scottish Retail Consortium, and
   - David Lott, Deputy Director (Funding, Reform and Accountability), Universities Scotland.

The inquiry

2. The Committee has agreed to focus its Pre-Budget 2025-26 scrutiny: Managing Scotland's Public Finances: A Strategic Approach on the following three key areas—

   - Progress with the Scottish Government's public service reform programme,
   - The Scottish Government's approach to taxation, including what its Tax Strategy should include and how potential behavioural responses impact business and individuals, and
   - How the Scottish Government is using its capital expenditure to achieve innovation, productivity, and growth.

3. As part of this inquiry, the Committee is also considering whether the First Minister's four priorities (set out below) are the right priorities for the Scottish Budget 2025-26—

   - Eradicating child poverty,
   - Growing the economy,
   - Tackling the climate emergency, and

- Delivering better public services.

4. The Committee's call for views ran from 10 June until 12 August 2024 and received 44 submissions. The questions asked in the Committee's call for views can be found at Annexe A.

5. To inform its Pre-Budget 2025-26 scrutiny, the Committee held an engagement event with young people and business organisations in Dundee on 28 August 2024, with the aim of hearing views on what devolved taxation and spending policies would best ensure Scotland retains more of its younger working age population. Following a discussion, participants were asked to vote for their three main priorities, the results of which can be found at Annexe B. The Committee also held a fact-finding visit to the School of Life Sciences at the University of Dundee on 29 August to discuss opportunities to achieve innovation, productivity, and growth.

Scottish Budget 2025-26: context

Future publications

6. The Chancellor of the Exchequer has confirmed that its 2025-26 Budget will be published on 30 October 2024 and that a multi-year Spending Review will conclude in Spring 2025 "to embed mission-led government and transform public services".

7. Discussions between the Committee and the Scottish Government are ongoing regarding the publication date of the Scottish Budget 2025-26. The Cabinet Secretary for Finance and Local Government, in a letter to the Committee dated 20 June 2024, confirmed that the Scottish Government will publish a final Tax Strategy alongside the Scottish Budget 2025-26. In her letter of 23 August 2024, she indicated that "given the announcement of a UK Government multi-year Spending Review, due to conclude in the Spring, it is my intention not to publish a Medium-Term Financial Strategy (MTFS) alongside the 2025-26 Budget". She went on to say that "it is instead my intention to return to the usual schedule for the MTFS and publish a full MTFS in good time ahead of the Budget 2026-27; recognising the precise timing will depend on the timing of the UK's multi-year Spending Review". It is currently unclear whether the Scottish Government's Investment Infrastructure Plan pipeline refresh or its Pay Policy for 2025 will be published alongside the Scottish Budget 2025-26.

8. The Committee is awaiting the Scottish Government's second update on its public service reform programme, after publication was delayed from May when the UK general election was called. The Committee has asked for this to be provided as early as possible to inform its Pre-Budget 2025-26 Scrutiny.

Economic and fiscal developments

9. The Committee heard evidence from the Scottish Fiscal Commission (SFC) on 3 September 2024 in relation to three publications it had published on 27 August 2024 – a Fiscal Update, Forecast Evaluation Report (FER), and Statement of

Data Needs 2024 (SDN). Its Fiscal Update, intended to support Parliament's pre-budget scrutiny, highlights the following economic and fiscal developments since its December 2023 forecasts—

- The overall economic context for 2024-25, including Gross Domestic Product (GDP) "is broadly in line with our December 2023 forecast", while Consumer Price Index (CPI) inflation fell back to the 2% target in 2024 Q2, "around a year earlier than we expected in December 2023".
- Latest Real Time Information data shows that Scotland's earnings growth in the first part of 2024-25 has slowed and is now similar to the UK average, following a period where "tighter labour market conditions in Scotland" had pushed up Scottish earnings relative to the UK.
- Latest data relating to real disposable income per person show an increase in 2023-24, mainly as a result of lower inflation, following a record fall in 2022-23. The SFC suggests, however, that "the outlook in the near term remains challenging as the downward pressure from higher prices and the recent period of higher interest rates may continue for some time".
- Statistics showing annual productivity growth in Scotland averaged 0.6% from 2011 to 2023 compared to 1.7% from 1999 to 2010. In December 2023, the SFC forecast annual productivity growth of 1.1 per cent by 2028-29, broadly in line with the OBR's forecast for the UK, with the underlying assumption that productivity growth in Scotland and the UK "will remain subdued and will not return to the pre-global financial crisis average".
- An 'economic performance gap' in Scottish income tax revenues of £624 million in 2022-23, once taking account of different policy choices in Scotland. The SFC states that, "in addition, the latest data suggests Scottish earnings growth is slowing relative to the UK, meaning the period of catch-up in Scottish income tax revenues may be coming to an end in 2024-25".

10. The SFC also comments on the recently published outturn data as follows—

- 2022-23 "was a relatively positive year for growth in Scottish income tax revenues, with the provisional income tax net position reaching £257 million". As this net funding position is higher than the projected negative £190 million when the 2022-23 Scottish Budget was set, there will be a positive reconciliation of £447 million applied to the 2025-26 Scottish Budget. The SFC explains that this figure "is less positive than the £732 million we expected in December 2023", and that this reduction is "mostly because of revisions in historical income tax data, which have lowered Scottish revenues relative to UK Government revenues". Income tax forecasts from the OBR and SFC (which are published alongside the UK Budget on 30 October 2024) will provide a more complete picture for income tax funding in the 2025-26 Scottish Budget.
- Social security spending in 2023-24 was £5.3 billion. The SFC estimates that spending exceeded the Block Grant Adjustment (BGA) funding by around £0.9 billion and that this gap will grow to £1.1 billion in 2024-25 and £1.5 billion in 2028-29.

11. The SFC's Fiscal Update further highlights that "since December 2023 there have been no significant confirmed changes in the Scottish Government's funding, but the pressure on spending has increased with public sector pay offers in Scotland now coming in higher than the pay policy published in May 2024", adding "there is significant uncertainty on the level of funding the Scottish Government will receive from the UK Government ahead of the UK Budget" on 30 October 2024. The SFC highlighted that the total public sector pay bill for 2023-24 was around £25 billion, over half of Scottish Government resource spending, and that the public sector in Scotland accounts for 22.6% of total Scottish employment compared to 17.6% for the UK overall. The SFC further suggests that—

    > "If a Budget is set based on pay assumptions which are lower than those that materialise, this creates challenges with in-year management of the Budget, requiring the Government to reduce its planned spending on services. The recent emergency spending controls the Scottish Government has put in place for 2024-25 are the result of those challenges".

12. The SFC notes that "policy commitments the Scottish Government has made, such as the council tax freeze in 2024-25, social security spending and more generous pay deals in Scotland contribute to the growing pressure on the Scottish Budget". It also repeats a call made in its December 2023 forecasts for "the Scottish Government to plan its Budget over the short, medium, and long-term".

Scottish Government's Fiscal Statement

13. On 29 July 2024, following a public spending audit 2024-25, the Chancellor announced a series of measures aimed at alleviating a forecast overspend of £21 billion above the resource departmental expenditure limit totals set by HM Treasury in the UK Spring Budget 2024.

14. The Cabinet Secretary then, in a letter to the Committee dated 27 August 2024, stated that she is "working with my Cabinet colleagues to agree the necessary actions to reduce expenditure and ensure our finances are on a sustainable footing". She went on to say that "further to this, additional measures are now necessary following the UK Treasury's recent audit of public spending and lack of clarity over whether their decision to deliver Pay Review Body recommendations will be fully funded". The Cabinet Secretary highlighted the Scottish Government's decision to replicate the UK Government's decision to restrict eligibility for the Winter Fuel Payment to older people and that "the Scottish Government has also introduced a set of spending controls with the intention of further reduction spend in 2024-25".

15. Following her Pre-Budget Fiscal Statement in Parliament on 3 September, the Cabinet Secretary wrote to the Committee setting out further reductions and reprioritisation of spending which, alongside implementation of emergency spending controls, would help "to balance the 2024-25 Budget". These measures, she explains, are necessary to fund the public sector pay bill,

demand-led activities, and a significant health and social care backlog. The letter notes that "in total up to £500 million savings measures have been taken" across portfolio areas, including reintroduction of peak train fares, not progressing a pilot on concessionary fares for asylum seekers, and restrictions on recruitment, overtime, travel, and marketing across the Scottish Government. The Cabinet Secretary also plans to utilise up to £460 million of ScotWind revenue funding. The measures taken therefore total up to £1 billion in-year changes. A full breakdown of the savings can be found in the Annexe to the Cabinet Secretary's letter.

16. In its immediate response to the Cabinet Secretary's announcement of in-year spending cuts, the Institute for Fiscal Studies (IFS) notes that "the last few years have seen the Scottish Government increase public sector pay, and roll out new, more generous social security benefits", which "reduce the amount available for other areas of spending and add to budgetary pressures". The IFS adds that "more difficult decisions are likely next year and beyond given the difficult fiscal outlook", adding that "the Scottish Government should use its forthcoming Budget and subsequent Scottish Spending Review to be clear about priorities – and which areas will see cuts – in order to reduce the need for in-year cuts, which are often more damaging". In its blog, Filling in fiscal cracks … again', SPICe also notes that "this is the third year in a row that the Scottish Government has made in-year changes to the Budget passed by Parliament just a few months previously", adding "it may also not be the end of the story", with some pay deals still to be settled.

17. Commenting in the Holyrood magazine on 17 August 2024, Professor Mairi Spowage, Director of the Fraser of Allander Institute (FAI), highlights the Scottish Government's decision not to publish a public sector pay policy alongside last year's budget "due to uncertainty about funding". She suggests that "in order to put any sort of budget together, the Scottish Government must have assumed something about how public sector pay would change in 2024-25", adding "so, not publishing a public sector pay policy essentially means that they were not being transparent about what was being assumed". The Scottish Government's Pay Policy 2024 was published in May, with assumptions for "an effective 2.3% pay increase for the full year" for central government. Professor Spowage notes that "given the lack of transparency, we're not sure if the pay policy is in line with the assumptions made at the budget".

Written submissions

18. Written submissions received are available on the Committee inquiry webpages. Key issues raised in the submissions of those witnesses giving evidence on 10 September are set out below.

Audit Scotland

19. In its written submission, Audit Scotland recommends that, in the absence of an MTFS, the spending and taxation decisions in the Scottish Budget should "have a clear read across to the Scottish Government's medium-term plans", including assessments of how spending over a longer period is contributing towards

achieving its priorities and of financial sustainability risks. It argues that the annual budget would benefit from an approach similar to mandate letters[1] to Cabinet Secretaries "showing how the Scottish Government's priorities are met by overall portfolio spending". The Scottish Government, it argues, must in the short-term "be clear about where the budget could flex if spending on priority areas is higher than originally estimated".

20. The Auditor General for Scotland (AGS) is due to publish a report on financial sustainability and reform in November 2024, which "will give an assessment of the Scottish Government's progress in this area more fully". The Audit Scotland submission notes that "the AGS has been clear on the urgency of reform" and has highlighted that better data on public bodies' workforces is urgently needed to ensure its workforce is sustainable". The submission goes on to say that "if reform is to be used as a tool to move the Scottish Government towards an affordable medium-term financial position, its financial plans should assess to what extent this is the case". Audit Scotland further states that the Scottish Government needs to demonstrate how its infrastructure and investment decisions support its goal of tackling climate change and contribute to its target of net zero by 2045.

Royal Society of Edinburgh

21. In its written evidence, the Royal Society of Edinburgh (RSE) welcomes the Scottish Government's four priorities, in particular the focus on economic growth, and recommends that "any road map to economic growth addresses the key issues that are causing stagnation in productivity". The RSE goes on to say that "it is important that the government clearly communicates how they intend to address the key priorities, demonstrate what policy options are achievable and moves away from vague commitments".

22. It goes on to state that "in recent years there has been a tendency for policymakers across the UK to focus on short-term political objectives rather than developing policy levers that can address long-term challenges, such as the move to net zero, inequality, etc". The RSE indicates "it is important that decisions are made to secure future change, even if they don't have the benefit of an immediate positive effect", adding "cross-party collaboration will be vital in addressing long-term issues". It calls for all tax options to be considered rather than focusing primarily on income tax. It also sets out two principles for capital spending – transparency and evidence-based - and argues that "carefully planned public sector investments will be crucial to help to achieve the increase in productivity growth that is critical for the future of our economy and the public finances".

23. On tackling the climate emergency, the RSE argues that a consistent and predictable policy/regulation framework and public investment in infrastructure will be needed to secure private investment. Finally, it notes the 'implementation

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[1] Mandate letters were sent by the then First Minister to all Cabinet Secretaries in September 2023 setting out how priority commitments in his Policy Prospectus will be delivered. Following the appointment of the current First Minister, the status of these letters is unclear.

gap'[2] and asks whether there is capacity and resources within government to implement plans and recommendations.

Professor David Heald

24. In his submission, Professor David Heald notes that the Government's priorities "are entirely reasonable but provide limited guidance for actual budget decisions" and states that they would be more likely achieved "if there were now a period of collaborative working between the UK and Scottish Governments and between the Scottish Government and Scotland's local authorities".

25. He argues that "going back to multi-year spending reviews is particularly important for the devolved governments, which lack the tax and borrowing flexibility of the UK Government". He also suggests that "being 'progressive' on social security and other cash benefits at the expense of public services expenditure will have an 'anti-progressive' effect because lower income groups have less access to substitute private services if satisfactory public services are not available". On capital spend, Professor Heald notes that UK Governments have in the past been criticised for cutting back on capital expenditure when faced with budgetary pressures and indicates that "repetition would be a serious policy mistake and very damaging to the First Minister's priority of growing the economy, because investment, both public and private, is one of the levers for economic growth".

26. Professor Heald suggests that the Scottish Government's upcoming Tax Strategy should focus on the main revenue-raisers – Scottish income tax, non-domestic rates, and council tax – and tax decisions made by the Scottish Parliament "should at the very least not magnify the faults of the UK tax system, instead offsetting them when the UK Government is not willing to address them". On council tax, he argues that "unless the nettle is grasped the situation will further deteriorate, with valuations already 33 years out of date, becoming even older, more inefficient and more inequitable".

Federation of Small Businesses (Scotland)

27. The Federation of Small Businesses (Scotland) (FSB), in its written evidence, said it supports the Government's four priorities and considers growing the economy to underpin the achievement of every other priority, including eradicating child poverty. It highlights the challenges experienced by Scotland's small businesses in recent years, including "staggeringly high inflation, persistently high energy prices, supply chain disruption and staff shortages". In addition, it notes further regulations and requirements that are currently being considered by Government which, it argues, will have an impact on small businesses, including the visitor levy, circular economy requirements, and restricting alcohol advertising and promotion.

28. The FSB argues that reducing strategy and consultation documents and assessing the disproportionate impact of new policies on small businesses

[2] This is the gap between strategies and plans and their delivery.

through comprehensive Business and Regulatory Impact Assessments, "will mean that there are less administrational and regulatory burdens placed on small businesses". It states, "it is simply impossible to expect to see an increase in economic activity when the proposed economy national outcome [which refers to a 'wellbeing economy'] intends to deprioritise economic growth". It would therefore like this national outcome to be rewritten "to recognise how vital small businesses are to the wellbeing of Scotland's economy".

29. The FSB restates its previous recommendation that targeted reliefs should be reintroduced to help small firms in retail, leisure, and hospitality. It also asks that, to support small businesses on the transition to net zero, the Scottish Government should undertake further analysis into how engagement with small businesses will be structured and whether there are other models of financial support and incentives which could be implemented.

Scottish Retail Consortium

30. In its written evidence, the Scottish Retail Consortium (SRC) said it had previously argued that economic growth should be the Scottish Government's 'priority of priorities' and it is therefore encouraged by the focus on this area. It is calling for an economic growth plan which "eases the burgeoning regulatory burden, scraps the mooted business rate surtax on grocery stores, and finally delivers on the pledge to restore business rates parity with England for medium-sized and larger commercial premises". It further recommends no more income tax rises "to bolster consumer spending to aid the economic recovery". It further repeats its calls for the Scottish Government to pursue a programme of structural reform, including potentially reducing the number of public bodies, to reduce the cost of running the government to ease financial pressures.

31. The SRC argues that the principles set out in the Framework for Tax 2021 should be retained in the Scottish Government's Tax Strategy, but highlights that the principles have not, however, been followed in setting tax policy in relation to business rates, and consideration of a possible public health surcharge or linking business rate reliefs to paying the real living wage. It suggests that the Tax Strategy should include an additional principle of competitiveness to stimulate greater levels of private sector investment and consumer demand, to ensure a strong economic recovery. The submission also calls for a clear roadmap setting out the intended tax reforms and likely changes which are set to impact on individuals and firms over the next decade, to increase transparency and predictability on tax policy making.

32. On net zero, the SRC suggests that easing the tax and regulatory burden on retailers would allow these firms to invest in growing and decarbonising their businesses.

Universities Scotland

33. Universities Scotland, in its submission, argues that universities are "uniquely placed to apply cutting-edge research to deliver major societal change and benefit", adding that "investment in university research and development

generates an average economic return eight times the original investment". Universities, it suggests, can also contribute to the delivery of the Scottish Government's priorities, for example, by identifying, through their research, solutions to societal challenges such as poverty and climate change. The submission sets out a number of examples of successful partnerships between universities and with other partners.

34. Universities, it explains, subsidise research costs with other income generating activities such as international student fees, but recent falls in international student revenue "have detrimentally impacted universities' abilities to cross-subsidise research costs". The submission explains that Scottish Funding Council's Research Excellence Grant funding has fallen in real terms by 20.1% over the last 10 years (using the GDP deflator), Scottish universities are at a disadvantage compared to English counterparts, which receive greater funding for Quality-related Research and for knowledge exchange and innovation activities. Private investment in research and innovation assets is, it suggests, often dependent on associated public funding, and that funding for innovation infrastructure via Scotland's enterprise agencies or investment bodies would help to grow the innovation economy.

Next steps

35. The Committee will continue taking evidence in relation to Pre-Budget 2025-26 scrutiny on 17 September.

Committee Clerking Team
September 2024

ANNEXE A

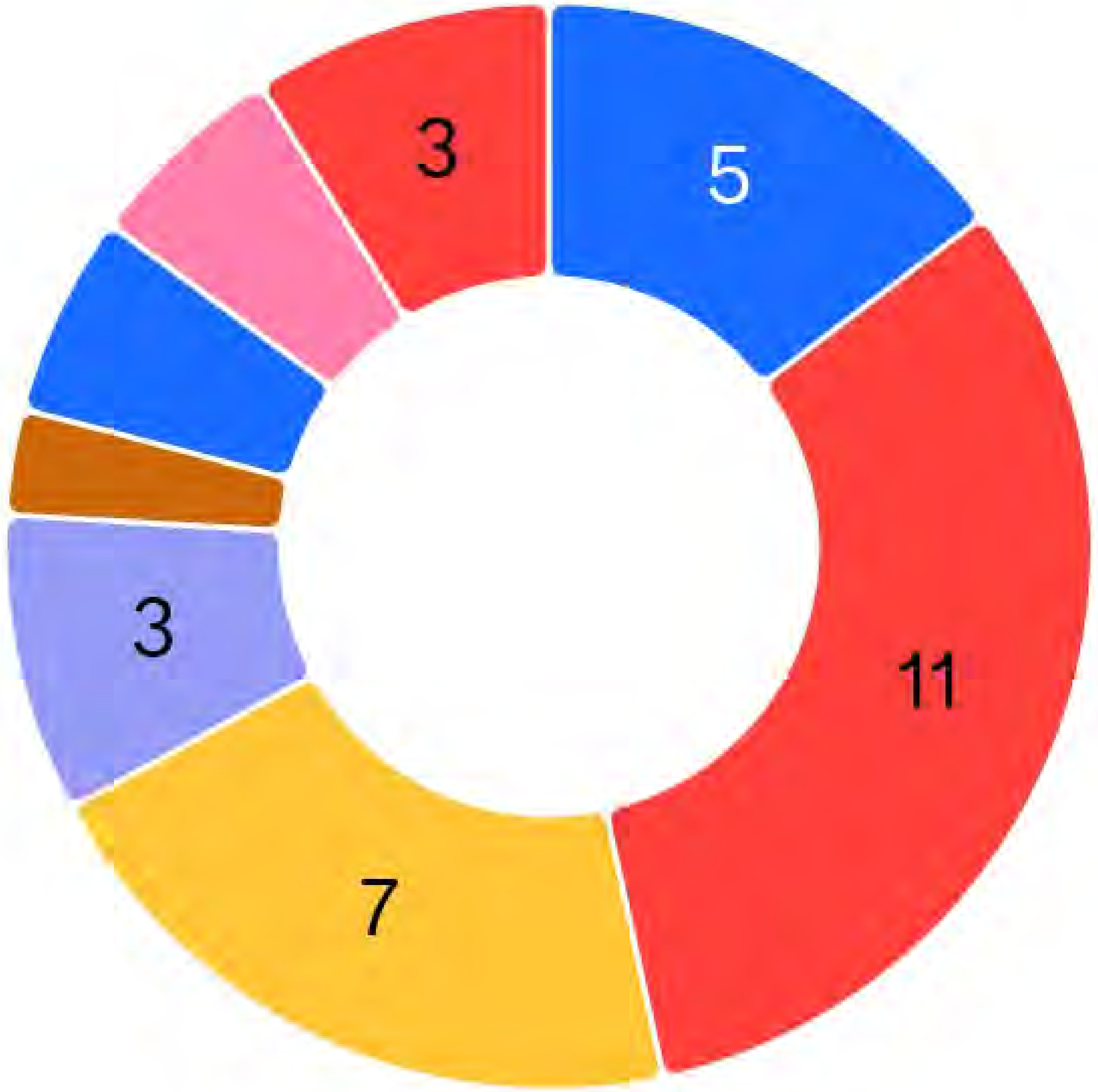
Managing Scotland's Public Finances: A Strategic Approach

The Committee's call for views included the following questions—

1) Are the First Minister's four priorities the right priorities for the Scottish Budget 2025-26 and, if not, where should the Scottish Government focus its attention?
2) What taxation and spending decisions should the Scottish Government take to make most progress against each of the First Minister's four priorities, within the current financial climate?
3) What are the potential impacts of focussing budget decisions on these four priorities on those groups of society who traditionally experience inequality?
4) What progress has the Scottish Government made against its specific goals in relation to public service reform?
5) Are there any improvements that can be made to achieve faster progress with public service reform and improved outcomes?
6) The Scottish Government recently published its Public Sector Pay Policy 2024-25 which offers pay metrics above forecast levels of inflation. What are the implications of its multi-year framework on public sector bodies and on the Scottish Budget for 2025-26? And for the subsequent two years?
7) What elements should a new draft[3] tax strategy include to achieve such a tax system?
8) How should a new draft tax strategy address potential impacts of behavioural change on individuals, businesses, and the overall tax take?
9) What actions should the Scottish Government take to grow the tax base and increase labour market participation, productivity, and Scotland's economic growth?
10) What steps should the Scottish Government take, in its Budget, for 2025-26, to grow the economy by tackling the climate emergency?
11) Given the limited capital budget available, in which areas should the Scottish Government prioritise its capital spend in the Scottish Budget 2025-26 to deliver increased productivity, innovation, and growth?

[3] At the time of publishing the call for views the Scottish Government's position was to that it would publish a draft tax strategy rather than a final tax strategy.

What devolved taxation and spending policies would best ensure Scotland retains more of its younger working age population?



5	Affordable housing
0	Better and faster public transport
11	Employment opportunities
7	Access to education (free tuition, non-university pathways)
0	Reputation (quality of learning)
3	Financial support as you grow (e.g. ISAs)
1	Universal services that are available and accessible (e.g. access top free dental care)
2	Sector-based incentives
2	Flexible pathways to work
3	Increased student support in schools and universities
0	Incentives for employers (via tax system)

34