Scottish Fiscal Commission

Fiscal Update

September 2020

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This publication is available at www.fiscalcommission.scot

Any enquiries regarding this publication should be sent to us at: Scottish Fiscal Commission, Governor's House, Regent Road, Edinburgh EH1 3DE or info@fiscalcommission.scot

ISBN: 978-1-911637-20-2

Published by the Scottish Fiscal Commission, September 2020

Laying Number: SFC/2020/10

Foreword

The coronavirus (COVID-19) pandemic has had a profound effect on the fiscal and economic outlook in Scotland and the UK. In April we published our first Fiscal Update, setting out how the Scottish Budget had changed since the passage of the Budget Bill in February. This second Fiscal Update sets out the latest position of the Scottish Budget, discussing the potential variations in the Scottish Budget which the Government will have to manage this year, and the levers available to do so. We also consider the effects of COVID-19 on the economy. We are publishing this information to provide the Scottish Parliament and the wider public with transparent information on the scale of changes to the Scottish Budget.

This Fiscal Update is released at the same time as two other publications. Our Forecast Evaluation Report looks back at our forecasts for 2019-20, evaluating their accuracy. As always, we ask ourselves what we can learn from our evaluation to improve our forecasts, while recognising COVID-19 will significantly alter the world in which we are forecasting. We are also publishing our annual Statement of Data Needs which sets out areas where we believe improved information would support our work. It highlights our work on the Scottish Budget, further developed in this Fiscal Update, and a variety of ways our work would be improved through better or timelier provision of data and information.

We welcome feedback on our work. If you have any questions or comments, please get in touch with us at info@fiscalcommission.scot.

Dame Susan Rice DBE

Professor Francis Breedon

Professor Alasdair Smith

Professor David Ulph

2 September 2020

Summary

1 In April we published our first Fiscal Update, setting out how the Scottish Budget had changed since the passage of the Budget Bill in February.[1] That first update took account of changes arising from the UK Budget in March and some initial increases in spending associated with COVID-19.

2 Since then there have been further announcements by the UK Government which have increased the Scottish Government's funding. As well as new spending announcements the Scottish Government has announced a number of new tax policies relating to Non-Domestic Rates (NDR), Land and Buildings Transaction Tax (LBTT) and Additional Dwelling Supplement (ADS).[2]

COVID-19 and the UK public finances

3 The COVID-19 economic crisis has been unusual in both its depth and nature. It largely arose as a consequence of decisions by the UK and Scottish governments to lockdown large parts of the economy for varying periods of time in order to limit the spread of infection and help the NHS cope with those who fell ill.

4 This has a very significant effect on the UK public finances. Tax revenues have fallen as a consequence of the contraction of activity but also through the granting of new reliefs and some payment holidays for UK-wide taxes such as VAT. Spending has risen, again in part as a consequence of the contraction and associated rising claims for Universal Credit, but also because of additional spending on the NHS and the creation of new UK-wide schemes such as the Coronavirus Job Retention Scheme (CJRS) and the Self-Employed Income Support Scheme (SEISS).

5 These increases in spending at a time of falling tax revenue are being funded by UK Government borrowing. UK Government borrowing in the first four months of the financial year reached £150.5 billion and at the end of July 2020 debt had increased by 20.4 percentage points compared to the year before, reaching 100.5 per cent of GDP.[3] The Office for Budget Responsibility (OBR) notes that the economic and public finance outlook has been significantly affected by the crisis but observes that "the outlook would have been much worse without the measures the Government has taken. These have provided additional financial support to individuals and businesses through the lockdown. They should also help to limit any long-term economic 'scarring', by keeping workers attached to firms and helping otherwise viable firms stay in business."[4]

[1] Scottish Fiscal Commission (2020) Fiscal Update – April 2020 (link)
[2] We published costings of these policies when their legislation was introduced to Parliament. Scottish Fiscal Commission (2020) Supplementary Costings: Non-Domestic Rates Measures – March 2020 (link), Scottish Fiscal Commission (2020) Supplementary Costings: Coronavirus (Scotland) (No. 2) Bill – May 2020 (link) and Scottish Fiscal Commission (2020) Update to Additional Dwelling Supplement costing – 20 May 2020 (link). The Scottish Government has also announced social security policy changes with smaller monetary values.
[3] ONS (2020) Public sector finances, UK: July 2020 (link)
[4] OBR (2020) Fiscal Sustainability Report – July 2020 (link)

COVID-19 and the Scottish Budget

6 The largest increase in spending in Scotland has been through UK-wide schemes such as the CJRS and SEISS. These schemes have been funded by borrowing by the UK Government on behalf of the UK as a whole.

7 The Scottish Budget has increased by 14 per cent, £6 billion, since it was set in February 2020, largely driven by extra funding from the UK Government reflecting spending in the rest of the UK in devolved areas, such as health. In normal circumstances, such funding received from the UK Government can vary during the year depending on how spending by the UK Government changes.

8 In our April Fiscal Update, we highlighted how there was uncertainty about the level of funding being received from the UK Government as well as the required level of spending in Scotland. This might make it difficult for the Scottish Government to balance spending against available funding within the financial year. Recognising the unusual circumstances this year and the need for the Scottish Government to have certainty about the level of funding being received, UK Government has guaranteed that the Scottish Government will receive a minimum of £6.5 billion of additional funding related to COVID-19. This guaranteed level of funding provides the Scottish Government with a degree of certainty as it manages its response to COVID-19 for the remainder of this financial year. Overall the Scottish Budget has increased by £3.0 billion since the Scottish Government presented its Summer Budget Revision to Parliament in May.

9 The Scottish Government does not have the fiscal powers to borrow to fund such increased spending; the UK Government is borrowing for the UK as a whole.

10 In this update we show how the changes in UK Government funding have been applied to the Scottish Budget. We also show the effects of tax changes the Scottish Government has made since February 2020, including new reliefs for NDR, a temporary increase in the nil-rate threshold for residential LBTT and temporary changes to the rules for repayment for the ADS. These tax changes, to some extent, mirror changes made to UK taxes such as Stamp Duty Land Tax (SDLT) to stimulate the property market.

11 This assessment does not cover the full range of COVID-19 related changes in Scottish tax revenues, public spending and funding from the UK Government. The income tax component of the Scottish Budget is fixed for 2020-21, based on our forecast at the time of the Budget and the latest OBR forecasts available at the same time. Income tax revenues both in Scotland and the rest of the UK will be considerably affected by COVID-19, but the income tax component will not be adjusted until 2023-24 when outturn data are available.

12 The other taxes and social security payments devolved to Scotland affect the in-year Scottish Budget. Overall we expect tax revenues to fall and social security spending to increase, but because of the Block Grant Adjustments, the net effect on the Scottish Budget depends on how these changes in Scotland compare with changes in the rest of the UK and at this stage it is still too early to know how these relative changes will turn out. We will produce updated forecasts to accompany the 2021-22 Scottish Budget, expected in December.[5] These forecasts, combined with the OBR's updated forecasts for the UK Government's Autumn Budget, will provide a more comprehensive assessment of the position of the 2020-21 Scottish Budget as well as for future years.

[5] Letter from Cabinet Secretary for Finance to Dame Susan Rice with an update on fiscal events – 25 August 2020 (link)

Managing the 2020-21 Budget

13 Before the COVID-19 crisis, the Scottish Budget had already increased in size and complexity because of the devolution of tax and social security powers to Scotland. The Budget is also subject to much greater in-year variability than in the past, as devolved tax revenue and social security spending can vary over the course of the year. The Scottish Government must manage any shortfall in tax revenues and any increases in social security spending during the financial year. These budget management risks remain despite the funding guarantee from the UK Government.

14 The Scottish Government's resource borrowing powers are for managing variations in tax and social security funding and spending or revenues. It can borrow for forecast error up to a limit of £300 million in normal times. The Scottish Government already plans to borrow £207 million in 2020-21; predominantly to manage the income tax reconciliation from 2017-18 which has been applied to this year's Budget. This leaves £93 million which the Scottish Government could borrow for forecast error. The Scottish Government can also borrow for capital spending up to an annual limit of £450 million, which it planned to use in full in February 2020 when it set the 2020-21 Budget.

15 The resource borrowing limit can be doubled to £600 million if a 'Scotland-specific economic shock' is triggered.[6] This occurs when Scottish GDP growth is both below 1 per cent and 1 percentage point below UK GDP growth. While the current economic volatility makes it more likely that these criteria will be met than in a typical year, the evidence to date suggests it is far from certain so the Government cannot rely on this additional scope for borrowing becoming an option.

16 The Scottish Government's borrowing powers were not designed to manage fiscal stabilisation which is the responsibility of the UK Government, who borrow on behalf of the UK and either allocate spending for reserved areas or transfer proportional funding to the Scottish Government for devolved areas. The Scottish Government is not able to borrow to fund proportionally greater spending on its COVID-19 response than the rest of the UK.

17 The Scotland Reserve can be used to manage variations in revenues and spending between years. The Scottish Government can still draw down a further £70 million from the resource reserve in 2020-21 and £56 million from the capital reserve. It should, however, consider that the remaining balance in the Scotland Reserve may be required to manage variations in future years. For example, outturn income tax data for 2018-19 will be published later this month and will show the scale of the reconciliation which will be applied to the 2021-22 Scottish Budget. The reconciliation depends on both Scottish and UK Government income tax revenues. In February 2020 we forecast this reconciliation would reduce the 2021-22 Scottish Budget by £555 million.[7]

18 The Scottish Government requested a number of additional flexibilities from HM Treasury this year, to allow easier management of the 2020-21 Budget. These requests were for: fixed funding from the UK Government for the remainder of the financial year, flexibility to transfer capital spending to resource spending, an increase in the borrowing limit for all spending variation (not just social security and tax) to £500 million and an increase in the drawdown limit for the capital reserve.[8]

19 In the past HM Treasury and the Scottish Government have agreed temporary changes to the rules of the fiscal framework. These include changes in the Reserve drawdown limits and arrangements

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[6] The resource borrowing can only be used to manage variations in tax and social security. These variations can be in the devolved tax revenues and social security spending or variations in corresponding UK Government funding.

[7] Scottish Fiscal Commission (2020) Scotland's Economic and Fiscal Forecasts – February 2020 (link)

[8] The increase in the borrowing limit for all spending variation is intended to replace the Scottish Government's current £500 million annual borrowing limit for cash management which has never been used.

for changes in funding to be applied the next financial year, effectively bypassing the Scotland Reserve. As discussed above, the UK Government has provided the Scottish Government with £6.5 billion of guaranteed minimum funding for COVID-19.

Fiscal effects in future years

20 The increase in UK Government borrowing and debt is designed to address the immediate crisis by supporting the economy, households and public services. For the time being, the position of the UK Government is that borrowing is the appropriate way to finance the increased spending needed to tackle COVID-19 and support the economy when tax revenues have reduced and spending increased. In future, depending on the evolution of the public health crisis, the UK Government may wish to return to more usual levels of expenditure and borrowing and just as increased levels of UK Government spending have increased the Scottish Budget, any future reductions in UK spending in devolved areas will reduce the Scottish Budget.

21 The Scottish Budget is also affected by UK Government decisions relating to devolved taxes. If the UK Government decides to rebalance its fiscal policy by raising revenue through any of the taxes devolved to Scotland this would reduce the Scottish Budget. For example, if the UK Government increased income tax rates, the increased revenue from income tax in England and Northern Ireland would increase the Block Grant Adjustment (the amount removed from the Scottish Budget in respect of income tax). Since tax rates in Scotland are devolved, it would be for the Scottish Government to decide how to respond to this reduction: by adopting similar increases in income tax rates, raising revenue from another devolved tax, cutting spending or using any funds in the Scotland Reserve.

Economic outlook

22 The Scottish Government is moving through the phases of lifting the COVID-19 lockdown, allowing a gradual resumption of some economic activity, which is not evenly spread between sectors. The Scottish economy has moved from the initial shock of COVID-19 to the start of what is likely to be a long and unpredictable recovery process. COVID-19 has led to a large fall in GDP, but because of the job retention schemes, this effect is not yet reflected in the unemployment rate. We might expect more significant effects on unemployment to emerge later in the year as the job retention scheme winds down.

23 GDP is likely to rise rapidly over the coming quarters as economic activity resumes. However, for some time to come GDP will remain below the level seen before the COVID-19 crisis began, and it may take until 2023 for GDP to recover to its pre-crisis level. During this time, unemployment is likely to be elevated, and earnings will be lower for many. We expect some permanent damage to the Scottish economy, with the effects still felt in the years ahead.

24 So far, there is no evidence that COVID-19 is having a significantly different effect on the Scottish economy compared to the UK. Data on the economy, labour market and the property market show a similar scale of effect in Scotland as the UK.

25 There remains a significant risk that both the Scottish and UK economies will be further negatively affected if COVID-19 cases and deaths start to rise again and tighter lockdowns have to be implemented.

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Chapter 1
Introduction

1.1 Since the Scottish Budget in February 2020, the COVID-19 pandemic has dramatically changed the outlook for the economy and public finances. The economy contracted by 20 per cent in the second quarter of 2020, while public spending has increased significantly; the 2020-21 Scottish Budget has increased by 14 per cent since February.

1.2 In this Fiscal Update, we consider the outlook for public finances and discuss how the Scottish Budget is affected by UK public spending decisions. We examine the options available to the Scottish Government to manage its Budget during this period of uncertainty. Chapter 2 sets out the latest estimate of the 2020-21 Scottish Budget, with a discussion on how tax revenues and social security spending have been affected. Chapter 3 considers how the Scottish Government could manage the Budget in 2020-21, including borrowing and using the Scotland Reserve. It also examines the Scottish Government's requests for further flexibilities, the reconciliations the Government need to plan to manage and how the UK Government's longer-run fiscal response will affect Scotland. Chapter 4 discusses the economic developments since the start of the pandemic and what this means for the Scottish economy.

1.3 Our next forecasts will be published alongside the Scottish Budget, currently planned for December 2020.[9] At that point there should be updated Block Grant Adjustments (BGAs) for 2020-21 based on updated OBR forecasts incorporating the effects of COVID-19. As we discuss in Chapter 4, at the moment we have some data showing the effect of the pandemic and lockdown on the economy. Over the next few months, data will begin showing in greater detail the effects of COVID-19 on revenues and spending since the lockdown started in March. All this information will be incorporated into our forecasts and can be used for monitoring the 2020-21 Budget position and for planning the 2021-22 Scottish Budget.

[9] Letter from Cabinet Secretary for Finance to Dame Susan Rice with an update on fiscal events – 25 August 2020 (link)

Chapter 2
COVID-19 and the Scottish Budget

2.1 The COVID-19 pandemic has had a profound effect on the fiscal outlook in Scotland and the UK. The 2020-21 Scottish Budget has increased by 14 per cent since February 2020, reflecting increased spending to mitigate the effects of the pandemic on households, businesses and public services. The scale of the increase has been determined by the UK Government's overall response, reflecting the current devolution arrangements as we discuss in the first section of this chapter.

2.2 The COVID-19 spending response also increases the level of uncertainty for the Scottish Budget. This presents the Scottish Government with a difficult task to ensure a balanced budget by the end of the financial year. In response, the UK Government has guaranteed a minimum level of additional COVID-19 funding for the Scottish Government in 2020-21 of £6.5 billion.[10] We discuss this arrangement and the latest 2020-21 Scottish Budget position in the second part of this chapter.

2.3 The third section of this chapter discusses aspects of the Scottish Budget which are still variable, then the fourth section examines the outlook for tax revenues and social security spending.

Scale of the fiscal response

2.4 The COVID-19 pandemic and the associated public health measures have resulted in an enormous shock to the economy and public finances in Scotland and the UK as a whole. The COVID-19 economic crisis has been unusual in both its depth and nature, since it largely arose as a consequence of decisions by the UK and Scottish governments to lock down large parts of the economy in order to limit the spread of infection and help the NHS cope. There have also been significant policy measures announced to support public services, household incomes and businesses, and these measures have increased both Scottish and UK government spending in Scotland.

2.5 The UK Government retains responsibility for the overall economic and fiscal response to the crisis so the level of public spending in the UK, including to a considerable extent spending in Scotland, is determined by the UK Government. The OBR's latest estimate is that the UK Government's policy measures in response to COVID-19 amount to an expenditure increase of £192.3 billion in 2020-21.[11] Taking a population share of this figure results in an estimated £16 billion of COVID-19 related spending in Scotland.[12]

2.6 Most of this expenditure is on UK-wide schemes. The OBR estimates the Coronavirus Job Retention Scheme (CJRS) will cost £47 billion in 2020-21 and the Self-Employed Income Support Scheme (SEISS) is estimated to cost a further £15 billion. Business loans and guarantees are estimated to cost around £20 billion.[13] These schemes apply across the whole of the UK including

[10] HM Treasury (2020) Scotland provided with unprecedented additional funding guarantee to respond to COVID-19 (link)
[11] Office for Budget Responsibility (2020) Coronavirus policy monitoring database – 14 July 2020 (link)
[12] Based on an 8.2 per cent population share from ONS (2020) Population estimates for the UK, England and Wales, Scotland and Northern Ireland mid-2019 (link)
[13] Office for Budget Responsibility (2020) Coronavirus policy monitoring database – 14 July 2020 (link)

companies and individuals in Scotland but the expenditure in Scotland does not appear in the Scottish Budget.

2.7 In other areas which are devolved to the Scottish Parliament, for example health, the UK Government has announced planned increases in spending in England which result in additional funding for the Scottish Government known as 'consequentials'. At the time of our April 2020 Fiscal Update the estimate for this additional COVID-19 related funding was around £3.5 billion in 2020-21. Since April there have been further announcements by the UK Government. The UK Government has now announced a guaranteed minimum level of funding of £6.5 billion for the Scottish Government in 2020-21.

2.8 When the Scottish Government receives consequential funding as a result of a UK policy decision it does not have to replicate the same policy. It can choose to spend a smaller or larger amount on a similar policy or spend the funding on a different policy area. In a recent report, Audit Scotland highlighted how the Scottish Government has announced £5.3 billion of spending related to COVID-19, of which £3.3 billion is grants and reliefs for business, and £2 billion is for public services. The Scottish Government has broadly mirrored the pattern of UK expenditure by spending on health and social care, local authority funding and support for transport operators.[14]

UK Government borrowing

2.9 The increases in Scottish and UK spending are funded by UK Government borrowing. The Scottish Government has only limited power to borrow for capital expenditure and cannot borrow to fund higher resource spending.

2.10 UK Government borrowing in the first four months of the financial year reached £150.5 billion. This is £128.4 billion more than in the same period last year and the highest borrowing in any April to July period since records began in 1993.[15] UK Government debt as a proportion of GDP had, by the end of July, increased by 20.4 percentage points compared to the year before, reaching 100.5 per cent. The OBR's central scenario sees the debt-to-GDP ratio increase above 100 per cent this year and during the next four years, peaking at 106.1 per cent in 2023-24.[16]

2.11 Governments borrow for several reasons. First, borrowing can be used to manage short-term uncertainty and variations in revenue and spending unrelated to macroeconomic performance. Second, when economic growth slows, borrowing may be required. Tax revenues fall and spending tends to rise, even with fixed tax and spending policies, so borrowing can act as an automatic fiscal stabiliser. Third, governments borrow to fund increased expenditure on new or existing policies. Finally, governments borrow to invest for the future and support longer-term economic growth. The current expansion in UK Government borrowing mainly reflects a combination of the second and third reasons. Automatic stabilisers have kicked in as tax revenues have fallen and spending on areas such as income-related social security payments has increased. In addition, there has been a significant increase in public spending on new policies to support the economy, businesses and individuals.

2.12 The OBR noted that the economic and public finance outlook has been significantly affected by the crisis but commented that "the outlook would have been much worse without the measures the Government has taken. These have provided additional financial support to individuals and

[14] Audit Scotland (2020) Implications for public finances in Scotland (link)
[15] ONS (2020) Public sector finances, UK: July 2020 (link)
[16] OBR (2020) Fiscal Sustainability Report – July 2020 (link) Note these figures do not include the measures announced by the UK Chancellor in his 8 July Summer Economic Update.

businesses through the lockdown. They should also help to limit any long-term economic ‘scarring’, by keeping workers attached to firms and helping otherwise viable firms stay in business.”[17]

2020-21 Scottish Budget: latest position

2.13 A large part of the increased UK expenditure described above has been on UK-wide programmes, and so does not appear in the Scottish Budget. However, to the extent that the increased spending is in areas devolved to the Scottish Government it increases the size of the Scottish Budget. In this section we discuss the changes to the Scottish Governments resource and capital funding in 2020-21 since the Budget in February and our Fiscal Update in April.[18]

2.14 The Scottish Government’s resource funding position is shown in Figure 2.1, overall it has increased by around £5.8 billion since February 2020 reflecting the Scottish share of increased UK COVID-19 expenditure in devolved areas and Scottish Government policy changes. The initial £2.7 billion of the resource funding increase was reported in our April Fiscal Update. Since then the Summer Budget Revision included £120 million of additional resource funding and changes since then have added a further £3 billion of resource funding.

[17] OBR (2020) Fiscal Sustainability Report – July 2020 (link)

[18] Scottish Fiscal Commission (2020) Scotland’s Economic and Fiscal Forecasts – February 2020 (link) and Scottish Fiscal Commission (2020) Fiscal Update – April 2020 (link)

Latest resource funding position

Figure 2.1: Latest resource funding plans for 2020-21

£ million	6 February 2020	SFC April Fiscal Update [1]	Summer budget revision (SBR)	Changes since SBR	Latest position
Barnett-determined Block Grant [2]	29,569				29,569
COVID-19 consequentials		+3,520	+60	+2,920	6,500
All other consequentials	142	+84		+21	247
SFC tax revenue forecasts [3]	13,123			-37	13,086
Tax and non-tax BGAs [4]	-12,991			+60	-12,931
Social Security BGAs	3,203				3,203
Reconciliations [5]	-177				-177
Resource borrowing	207				207
Drawdown from Scotland Reserve	106	+25	+18		149
Other [6]	736		+42		778
NDR Distributable Amount [7]	2,790	-922			1,868
Total resource funding	36,707	+2,707	+120	+2,964	42,499

Source: Scottish Government, Scottish Fiscal Commission.
[1] Some of the funding changes reported in our April 2020 Fiscal Update were not formally included in the Scottish Budget until the Summer Budget Revision (SBR).
[2] Agreed with HM Treasury based on September 2019 Spending Round.
[3] Scottish Fiscal Commission tax revenue forecasts cover income tax, Land and Building Transaction Tax, and Scottish Landfill Tax, the £37 million reduction reflects changes to LBTT. Non-Domestic Rates are not included in the revenue forecasts as these are used separately to set the Distributable Amount for Non-Domestic Rates.
[4] The £60 million increase in the BGAs is estimated on the OBR's costing of the UK Government's SDLT cut. The OBR estimate that the SDLT change would reduce revenues by £1.3 billion, this increases the LBTT BGA by around £60 million.
[5] Includes final reconciliations for: 2017-18 income tax revenue and BGA (-£204 million), 2018-19 Land and Building Transaction Tax BGA (-£3 million), 2018-19 Scottish Landfill Tax BGA (-£2 million), 2018-19 fines, forfeitures and fixed penalties (FFFPs) BGA (£2 million), 2018-19 Carer's Allowance BGA (£0 million), and indicative in-year reconciliations deferred from 2019-20 (£30 million).
[6] Includes Rail Resource Grant (£80 million), Fiscal Framework administration costs (£66 million), Migrant Surcharge (£22 million), deferred consequentials from 2019-20 Supplementary Estimates (£58 million), Queen's and Lord Treasurer's Remembrancer (£5 million), Machinery of Government Transfers (£8 million), Pillar 1 Farm payments (£472 million), Scottish Government's forecast of revenues from FFFPs (£25 million) and increased by £42 million at the Summer Budget Revision to reflect the residual balance from the Scottish consolidated fund.
[7] NDR Distributable Amount was increased by £50 million as part of the Budget deal, following the COVID-19 consequentials to the Scottish Government to fund NDR reliefs the Distributable Amount was reduced by £972 million.
Figures may not sum to totals because of rounding.

Resource Consequentials

2.15 The largest single change to the resource budget is caused by changes in funding received from the UK Government. These 'consequentials' are generated when the UK Government increases spending allocations in devolved areas such as health. If the UK Government later reduces these allocations either because it diverts unused funding from elsewhere or doesn't deliver the planned policies, the consequentials can be revised down at a later date. As we noted in our April 2020 Fiscal Update, this risk of downward revisions creates uncertainty for the Scottish Government in managing the Budget.

2.16 At the time of our April Fiscal Update we noted two main sources of uncertainty; whether all the announced consequentials from the UK Government would materialise, and how the pandemic would evolve and affect the economy and public finances in Scotland. To reduce the uncertainty faced by the Scottish Government, the UK Government has guaranteed a minimum £6.5 billion of funding related to COVID-19 to the Scottish Government. If the funding the Scottish Government should have received is greater than this then additional consequentials will be provided. If the funding the Scottish Government should have received is lower there will be no reduction in the Scottish Budget. This level of guaranteed funding significantly reduces the risk to the Scottish Budget of funding being revised down later in the financial year and provides the Scottish Government with greater certainty about the budget for the remainder of this financial year.

2.17 We do not yet know how COVID-19 will progress over the course of the year. Any COVID-19 second wave or return of restrictions on activity could result in the UK Government having to increase spending further, which may lead to positive consequentials for the Scottish Government.

Other resource funding changes

2.18 In May and July 2020 we provided costings for two residential Land and Buildings Transaction Tax (LBTT) policy changes; an extension to the length of time in which buyers can claim back the Additional Dwelling Supplement, and an increase to the nil-rate of LBTT. We estimated that these policies cost £4 million and £33 million respectively, reducing the Budget by £37 million in 2020-21. The UK Government previously announced a similar policy by increasing the nil-rate of Stamp Duty Land Tax (SDLT). The OBR estimates this will cost £1.3 billion in 2020-21.[19] Using the OBR's estimate, this should increase the LBTT Block Grant Adjustment (BGA) by £60 million this year, which more than offsets the cost of the Scottish Government's policy changes. We also expect that LBTT and SDLT revenues will fall in 2020-21 because of the lockdown period reducing transactions. The effect of these changes has not yet been forecast and will be reflected in our, and the OBR's, next forecasts.

2.19 The Scottish Government still plans to borrow £207 million in 2020-21, leaving £93 million available against the annual £300 million resource borrowing limit which can be used for any forecast errors relating to tax and social security. Since the Budget in February the Scottish Government has increased its planned drawdown from the Scotland Reserve, first by £25 million when the Budget deal was agreed, then by £18 million at the Summer Budget Revision, taking the total planned drawdown to £149 million.

Latest capital funding position

2.20 The Scottish Government's capital funding position has increased by £174 million since the 2020-21 Scottish Budget was presented to Parliament, as shown in Figure 2.2. This increase is driven by a revision to the number of consequentials generated at the UK Budget. The Scottish Government is also drawing down slightly more from the capital reserve. Capital borrowing plans remain unchanged, with the Scottish Government planning to borrow the maximum £450 million in 2020-21.

[19] Office for Budget Responsibility (2020) Coronavirus policy monitoring database – 14 July 2020 (link)

Figure 2.2: Latest capital funding plans for 2020-21

£ million	6 February 2020	April Fiscal Update [1]	Summer Budget Revision (SBR)	Changes since SBR	Latest position
Barnett-determined Block Grant [2]	4,408				4,408
Assumed or actual consequentials	326	+83	+69	+9	487
Financial Transactions (FTs)	606	+5		+1	612
Capital borrowing	450				450
Drawdown from Scotland Reserve (capital and FTs) [3]	37		+7		44
Other [4]	-10				-10
Total capital spending	5,817	+88	+76	+10	5,991

Source: Scottish Government, Scottish Fiscal Commission.

[1] Some of the funding changes reported in our April 2020 Fiscal Update was not formally announced by the Scottish Government until the Summer Budget Revision (SBR).

[2] Agreed with HM Treasury based on September 2019 Spending Round.

[3] Includes planned drawdowns of £5 million for general capital spending and £32.2 million for FTs.

[4] Includes Glasgow City funding (£15 million) and repayment of Financial Transactions to HM Treasury (-£25 million).

Variation in funding from the UK Government through Block Grant Adjustments

2.21 The tax and social security powers devolved to the Scottish Government result in adjustments to the Scottish Budget, called Block Grant Adjustments (BGAs). Tax BGAs remove funding from the Barnett-determined Block Grant where the Scottish Government is now raising its own tax revenue. Social security BGAs provide additional funding where the Scottish Government has become responsible for social security payments. The BGAs included in Figure 2.1 were based on the latest OBR forecasts at the time of the Scottish Budget in February.

2.22 The income tax component of the Scottish Budget is fixed for 2020-21, based on our and OBR forecasts at the time of the Budget, and will only be adjusted in 2023-24 once outturn data are available. However, the BGAs relating to the other taxes and social security payments devolved to Scotland affect the Scottish Budget in-year. These will be updated following the OBR's next forecasts for the UK Autumn Budget.

2.23 We expect UK Government tax revenues to fall and social security spending to increase, which will lead to an increase in Scottish Government funding through the BGAs. The net effect on the Scottish Budget will depend on the relative differences between Scotland and the rest of the UK.

Outlook for tax and social security

2.24 At the time the Scottish Budget is set, it depends on forecasts of tax revenue and social security spending both in Scotland and the rest of the UK. Differences between forecast and outturn revenue or spending in the rest of the UK generate a funding transfer, called an in-year reconciliation. If tax revenue or social security spending is similarly affected in Scotland and the rest of the UK the in-year reconciliation should largely offset any changes in Scottish revenues and spending.

2.25 Our next forecasts will accompany the 2021-22 Scottish Budget, expected in December,[20] and the OBR's next forecasts will accompany the UK Government's Autumn Budget. At that time we will be

[20] Letter from Cabinet Secretary for Finance to Dame Susan Rice with an update on fiscal events – 25 August 2020 (link)

better placed to know how COVID-19 will affect Scottish revenue and spending compared to the rest of the UK. When we and the OBR produce updated forecasts for 2020-21, it will be possible to compare the corresponding BGAs to our forecasts of Scottish revenue or spending.

Income tax

2.26 The data on how COVID-19 has affected tax revenues are limited. In aggregate we may expect significant declines in income tax revenue, mainly because of the decline in employment expected once the furlough scheme ends. This change is discussed in further detail in Chapter 4. Other factors that will affect income tax revenue include:

- Take-up and distribution of the furlough schemes for employed and self-employed individuals
- Wage rises for employees in both public and private sectors
- The effect of the UK Government decision to delay reforms to off-payroll working rules by 12 months.[21]

Fully devolved taxes (NDR, LBTT, SLfT)

2.27 COVID-19 will reduce NDR revenue in 2020-21. The Scottish Government has announced additional reliefs at a cost of £875 million.[22] Many businesses had to cease trading temporarily because of COVID-19. Revenue will be reduced further if businesses become bankrupt or go into liquidation and claim empty property relief, or if businesses that are struggling financially do not make payments.

2.28 COVID-19 will reduce property transaction tax revenues in Scotland and the rest of the UK, mainly because of a reduction in the number of purchases. Revenue Scotland transactions data show that residential transactions in Scotland in April to July 2020 have been 59 per cent below the same period in 2019, and HMRC data show residential transactions in the UK have been 41 per cent below 2019 over the same period.[23]

2.29 The latest monthly transactions data show the number of property transactions in Scotland is starting to rise. Residential transactions in July were 20 per cent higher than in June.[24] The phased lifting of lockdown and the Scottish Government's temporary reduction in LBTT will both be contributing to the rising number of transactions. We expect the number of property transactions to continue to increase gradually from their current low level, but to remain lower than we previously forecast for the year as a whole.

2.30 There are several ways in which COVID-19 might affect Scottish Landfill Tax (SLfT). The drop in Scottish business activity since March will have caused large reductions in commercial waste. The increase in home working, the closure of schools and restrictions on travel and movement in response to the virus will all have led to a significant increase in household waste. Some recycling services were temporarily suspended during the lockdown, which may increase the volume of waste diverted to landfill. The change in SLfT revenues will depend on the balance of all these factors. Revenue Scotland will release its SLfT statistics for the second quarter of 2020 on 25 September,

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[21] UK Government (2020) Off-payroll working rules reforms postponed until 2021 (link)
[22] Scottish Fiscal Commission (2020) Supplementary costings – Non-Domestic Rates Measures March 2020 (link)
[23] Revenue Scotland (2020) Land and Buildings Transaction Tax Monthly Statistics – July 2020 (link), HMRC (2020) Monthly property transactions completed in the UK with value of £40,000 or above (link)
[24] Revenue Scotland (2020) Land and Buildings Transaction Tax Monthly Statistics – July 2020 (link)

which will give us our first indication of the effect of the pandemic. We note that Landfill Tax revenues for England and Northern Ireland are down 31 per cent when comparing April to July 2020 to April to July 2019.[25]

Social Security Spending

2.31 The largest social security benefits are funded through Block Grant Adjustments – which will change directly in response to changes in UK Government spending on the same benefits. In February we forecast £3.2 billion would be spent in 2020-21 on these benefits. Other social security payments such as the Best Start Grant, the Scottish Child Payment and employability service are funded through the Scottish Government's general block grant, so there are no direct changes in funding from the UK Government to cover any increase in spending in these areas.

Social Security funded by Block Grant Adjustments

2.32 Most of the people who have died of COVID-19 have been people aged 75 or over with underlying health conditions.[26] It is likely that a significant proportion will have been receiving disability benefits, usually Attendance Allowance, and that spending on disability assistance will be lower as a result. There is also some evidence of lower numbers of new applications for disability benefits in April, perhaps because of potential applicants having less access to support with the application process during lockdown and less diagnoses of new conditions.

2.33 We expect that these effects will be smaller than the additional spending because of policy and operational changes by the Department for Work and Pensions, which has suspended face-to-face assessments and postponed reassessments and award reviews. It is also possible that COVID-19 may increase the need for disability or carer assistance, for example through long-term health effects for survivors, or through greater reliance on care from family members in response to the large number of deaths in care homes.

2.34 Statistics have been published up to April 2020 for Personal Independence Payment, but only run to February 2020 for the other caring and disability benefits, so it is too soon to tell how big the effects will be or how they may vary between Scotland and the rest of the UK.

Social Security not funded by Block Grant Adjustment

2.35 The Scottish Government has already announced £69 million of extra funding in 2020-21 for the Scottish Welfare Fund, Carer's Allowance Supplement and Discretionary Housing Payments (DHPs).[27] The pandemic has also delayed the Scottish Child Payment launch, which we estimate will reduce spending in 2020-21 by at least £10 million compared to our February 2020 forecast.

2.36 We expect to see increases in eligibility and take-up for low income benefits such as: Best Start Grant and Funeral Support Payments and higher spending on DHPs to mitigate the bedroom tax.

2.37 The data published so far do not show a big increase in spending but we do expect the rise in Universal Credit claims to start to feed through to Social Security Scotland, with a further rise expected as the UK Government's furlough scheme and support for the self-employed are phased out. We'd expect this effect to peak in 2021, and for the subsequent decline to be slow with spending likely to remain elevated through most of our five year forecast horizon.

[25] HMRC (2020) HMRC tax receipts and National Insurance contributions for the UK – August 2020 (link)
[26] National Records of Scotland (2020) Deaths involving coronavirus (COVID-19) in Scotland (link)
[27] We produced a costing of the Coronavirus Carer's Allowance Supplement in May. Scottish Fiscal Commission (2020) Supplementary Costings – Coronavirus (Scotland)(No. 2) Bill – May 2020 (link)

Chapter 3
Fiscal levers and future planning

3.1 As outlined in Chapter 2, the COVID-19 pandemic has significantly altered the Scottish Budget. The Budget has increased in size and, despite the guaranteed funding from HM Treasury, there are still components of the Budget which will vary over the course of the year. In this Chapter we first discuss the levers available to manage the current year Scottish Budget and discuss the additional flexibilities the Scottish Government has requested.

3.2 The current focus has been on managing the COVID-19 crisis and the changes to the 2020-21 Budget, but the Scottish Government will have to consider how to manage future reconciliations. We discuss this in the second section of this Chapter.

3.3 At some point in the future the UK Government will also have to consider if and how to repay the debt accumulated during the crisis. We discuss the effects of this on the Scottish Budget in the final section of this Chapter.

Managing the 2020-21 Budget

3.4 Before the COVID-19 crisis, the Scottish Budget had increased in size and complexity because of the devolution of tax and social security powers to Scotland. The Budget is subject to much greater in-year variability than in the past, as devolved tax revenue and social security spending can vary over the course of the year. The Scottish Government must manage any shortfall in tax revenues and any increases in social security spending during the financial year. This year we would expect even greater variability than in a typical year.

3.5 The Scottish Government has a difficult task balancing its budget during the current financial year. Here we discuss the options it has available to manage any variations in funding, and the additional flexibilities requested by Scottish Government and others.

Resource borrowing powers

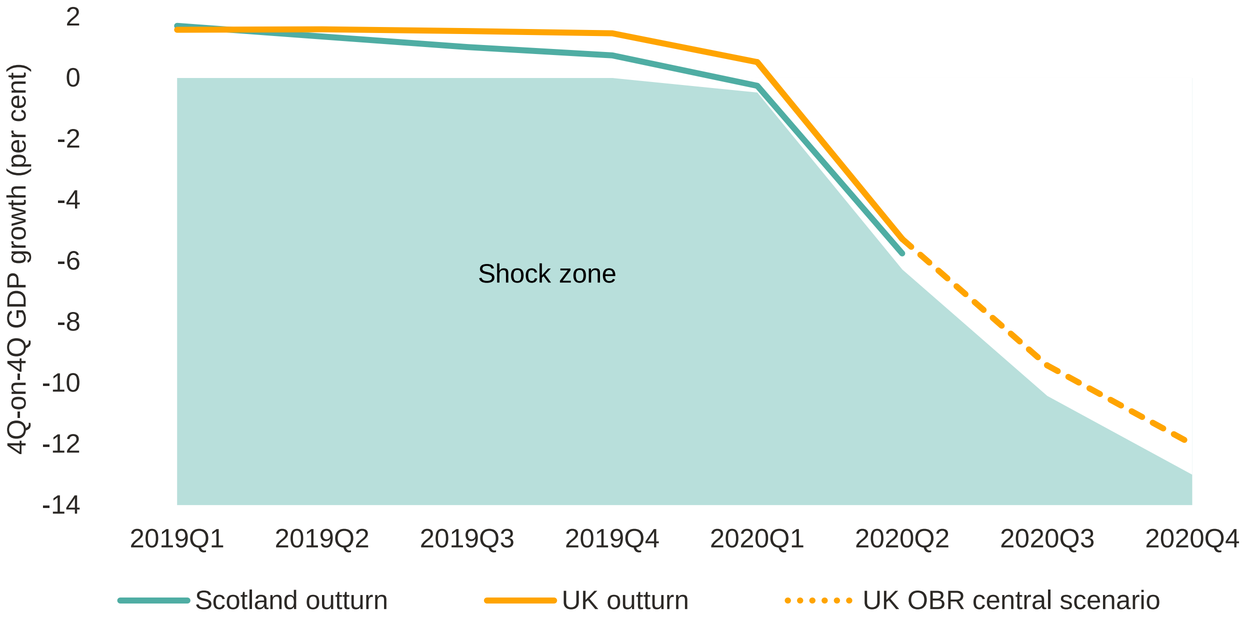
3.6 The Scottish Government's borrowing powers are for managing variations in tax revenues, social security spending and funding. It can borrow up to a limit of £300 million in normal times to manage the financial effects of forecast errors. The Scottish Government already plans to borrow £207 million in 2020-21 to manage the income tax reconciliation from 2017-18 which has been applied to this year's Budget. This leaves £93 million available to manage forecast errors.

3.7 A 'Scotland-specific economic shock' occurs if two criteria are met: Scottish GDP growth below 1 per cent, and Scottish GDP growth 1 percentage point below UK GDP growth, where growth rates are calculated as on a four-quarter rolling basis, comparing Scottish and UK growth over a total of eight quarters, If the criteria are met, the Scottish Government's borrowing powers to manage forecast errors increase from £300 million to £600 million. These borrowing powers can only be used for forecast error in tax and social security forecasts but apply to the year of the shock, and the next two financial years.

3.8 This year, the first criterion of GDP growth below 1 per cent will almost certainly be met, but it is still uncertain whether the second criterion of GDP growth in Scotland being 1 percentage point below the UK will hold. On the latest available data, four quarter rolling GDP growth in Scotland is minus 5.8 per cent compared to minus 5.3 per cent for the UK, so the second criterion is not met.[28]

3.9 While the likelihood of a Scotland-specific economic shock being triggered is greater than in a typical year, it is far from certain and the Government should not rely on the additional borrowing powers becoming available. Figure 3.1 shows where the latest Scottish GDP outturn data sits relative to where a Scotland-specific economic shock would be triggered.

Figure 3.1: Scotland specific economic shock



Source: Scottish Government (2020) Gross Domestic Product – monthly estimate: June 2020 (link), Office for National Statistics (2020) GDP first quarterly estimate, UK: April to June 2020 (link), OBR (2020) Fiscal Sustainability Report – July 2020 (link).

Scotland Reserve

3.10 The Scotland Reserve allows the Scottish Government to save any underspends from one financial year and draw them down in another financial year. The Reserve can also be used to manage variations in tax revenues and social security spending.

3.11 A maximum of £700 million can be held in the Reserve and is split between resource and capital. The resource drawdown limit is £250 million each year, of which the Scottish Government is currently planning to draw down £149 million in 2020-21. This leaves £70 million remaining, which could all be drawn down in 2020-21. The capital drawdown limit is £100 million; applying to all capital spending including financial transactions, which are treated as a subset of capital spending. The Scottish Government is planning to drawdown £44 million capital in 2020-21, including £32 million in financial transactions, which leaves £56 million remaining against the annual limit.

3.12 There have already been three occasions when HM Treasury has agreed to flexibilities to effectively allow the Scottish Government to by-pass the limits of the Reserve.[29]

[28] Scottish Government (2020) Gross Domestic Product – monthly estimate: June 2020 (link), Office for National Statistics (2020) GDP first quarterly estimate, UK: April to June 2020 (link)
[29] Letter from the Convener of the Finance and Constitution Committee to the Chief Secretary to the Treasury – 24 June 2020 (link)

- Barnett consequentials of £148 million were received late in 2018-19. The Scottish Government agreed with HM Treasury that these would be held within UK reserves and re-allocated to the Scottish Government in 2019-20, rather than pass through the Scotland Reserve for 2018-19.

- In 2019-20, HM Treasury agreed to allow the Scottish Government to draw down a total of £181 million in capital and financial transactions, well above the £100 million capital drawdown limit. This was to address negative Barnett consequentials of £128 million that arose from a UK budget capital spending decision.

- The in-year reconciliation for the fully devolved taxes and benefits in 2019-20 was deferred until 2020-21 and included in the Scottish Budget based on the position at February 2020. This avoided a late in-year reconciliation after the UK Budget in March.

3.13 There are precedents for flexibility being allowed in respect of the Scotland Reserve.

Flexibilities to manage the Scottish Budget in 2020-21

3.14 The Scottish Government is required to balance its budget, meaning that apart from using the Reserve and borrowing powers set out above, the amount spent has to match the available funding. HM Treasury have given the Scottish Government a minimum level of funding in 2020-21, providing a level of certainty with which the Scottish Government can manage its budget. Prior to this agreement the Scottish Government requested other additional flexibilities in 2020-21 to manage the uncertainty around funding from the UK Government and the scale of response required by the Scottish Government. The requests include:

- Flexibility to transfer capital spending to resource spending.

- Greater resource borrowing powers

- Increasing the drawdown limit for the capital reserve

3.15 The proposal to transfer capital spending to resource spending reflects the reduction in construction activity caused by the lockdown. Both the UK and Scottish Governments are likely to see reductions in capital spending. Ordinarily, a reduction in UK Government capital spending would result in negative capital consequentials, but because of the funding guarantee for 2020-21 there will be no reduction in the capital budget this financial year. Under this proposal the Scottish Government could reduce capital spending in Scotland and use this funding for other purposes.

3.16 The Scottish Government has requested the annual limit for resource borrowing should be temporarily increased to £500 million from £300 million and should not be limited to forecast error relating to tax and social security spending.[30] The Finance and Constitution Committee envisaged the Scottish Government using this borrowing power to fund new policy measures in response to COVID-19.[31] The Scottish Government has also requested the maximum repayment term be extended from five to ten years.

3.17 The Scottish Government has requested the annual capital drawdown limit is increased to £220 million to allow access to all remaining funds in the capital reserve. The Scottish Government's request is focused on the capital reserve as the resource reserve had a balance of £218 million at

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[30] The increase in the borrowing limit for all spending variation is intended to replace the Scottish Government's current £500 million annual borrowing limit for cash management which has never been used.

[31] Letter from the Convener of the Finance and Constitution Committee to the Chief Secretary to the Treasury – 24 June 2020 (link)

the start of 2020-21, the Scottish Government can draw this full amount down under the current arrangements.

3.18 The Finance and Constitution Committee recognised the difficulties faced by the Scottish Government in managing the budget and wrote in a letter to the Chief Secretary to the Treasury (CST), that "the unprecedented levels of uncertainty and volatility inevitably means that the existing fiscal rules including the operation of the Barnett formula are under considerable strain".[32] Under the fiscal framework the Scottish Budget would normally be adjusted in-year following the Autumn Budget, reflecting changes in UK Government tax revenues (excluding income tax) and social security spending. The Committee asked CST to consider allowing any negative reconciliations arising from the Autumn Budget to be 'unwound' over a longer time period rather than all being applied in 2020-21.

Planning for future reconciliations

3.19 Reconciliations are becoming a more important factor affecting the Scottish Budget as the fiscal framework becomes fully operational. The budget is set in advance of the financial year based on forecasts. As information on actual tax revenues and social security spending becomes available the forecasts are updated and the Scottish Government's funding is changed accordingly. The first significant reconciliation saw the 2020-21 Scottish Budget reduced by £204 million following the publication of income tax revenue data for 2017-18 for Scotland and the rest of the UK.

3.20 Over the course of 2020-21 there will be reconciliations reflecting the changes in UK Government revenues for the fully devolved taxes – LBTT and SLfT – and social security benefits. Possible changes in the BGAs have been discussed in Chapter 2.

3.21 Income tax is a major component of the Scottish Budget, accounting for over £12 billion in 2020-21. We expect income tax revenues to be heavily affected by COVID-19, but the arrangements in the fiscal framework mean there will be no effect on the 2020-21 Scottish Budget as this funding is fixed for the year. Any changes to income tax funding for 2020-21 will be applied to the Scottish Budget in 2023-24 through a reconciliation. The expected reduction in Scottish income tax revenues in 2020-21 because of COVID-19 should largely be offset by the change in funding based on UK Government revenues. There could be a sizeable positive or negative effect on the Scottish Budget depending on relative Scottish and UK income tax performance in 2020-21. For example, if revenues fall relatively more in the rest of the UK compared to Scotland, then the Scottish Budget would benefit through a positive reconciliation, despite the drop in Scottish revenues. If revenues fall relatively less in the rest of the UK compared to Scotland, then the Scottish Budget would receive a negative reconciliation.

3.22 The 2021-22 Budget will include the income tax reconciliation for 2018-19. At the time of the Budget in February 2020 we estimated this reconciliation would reduce the Scottish Budget in 2021-22 by around £555 million. The actual number could be significant different and will be known on 23 September when HMRC publishes the outturn data for Scottish and UK Government income tax revenues in 2018-19.[33]

3.23 The Scottish Government will have to plan for this reconciliation in the 2021-22 Scottish Budget. The options available to the Scottish Government are to borrow, up to £300 million, to draw down from the Scotland Reserve or to use funding from elsewhere in the Scottish Budget. The current position

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[32] Letter from the Convener of the Finance and Constitution Committee to the Chief Secretary to the Treasury – 24 June 2020 (link)

[33] HMRC (2020) Official statistics announcement: Scottish Income Tax Outturn Experimental Statistics 2018-19 (link)

of the Scotland Reserve would not provide much to support this reconciliation as the latest estimate is for £70 million to be remaining in the resource reserve at the end of 2020-21. We will publish our evaluation of the final reconciliation following the release of the income tax outturn information.

Fiscal effects in future years

3.24 The increase in UK Government borrowing and debt is financing support for the economy, households and public services. The UK Government is borrowing to tackle COVID-19 and supporting the economy through higher public spending and lower tax revenues. It is not certain how and when the UK Government will choose or be able to return to more usual levels of spending and revenue.

3.25 The UK Government is currently borrowing at historically low interest rates. The OBR's recent Fiscal Sustainability Report noted that borrowing costs have fallen during the COVID-19 crisis which, all else equal, allows the UK Government to continue borrowing while keeping debt stable as a share of GDP, albeit with the debt-to-GDP ratio remaining above 100 per cent.

3.26 Financing conditions may not always remain so favourable, and an increase in the cost of borrowing would have a larger effect on the public finances with this elevated level of debt. The OBR warns that "it seems likely that there will be a need to raise tax revenues and/or reduce spending (as a share of national income) to put the public finances on a sustainable path".[34]

3.27 Although the Scottish Government has policy responsibility for devolved spending, the Scottish Budget is affected by UK Government decisions in these areas and the Scottish Government has to respond, although not necessarily in the same way, to reductions in the Scottish Budget arising from any future reductions in UK Government departments' spending.

3.28 The Scottish Budget is also affected by UK Government decisions relating to devolved taxes. If the UK Government decides to rebalance its fiscal policy by raising revenue through any of the taxes devolved to Scotland this would reduce the Scottish Budget. For example, if the UK Government increased income tax rates, the increased revenue from income tax in England and Northern Ireland would increase the Block Grant Adjustment (the amount removed from the Scottish Budget in respect of income tax). Since tax rates in Scotland are devolved, it would be for the Scottish Government to decide how to respond to this reduction: by adopting similar increases in income tax rates, raising revenue from another devolved tax, cutting spending or using any funds in the Scotland Reserve.

[34] OBR (2020) Fiscal Sustainability Report – July 2020 (link)

Chapter 4
Effect of COVID-19 on the Scottish Economy

4.1 We are now moving through the phases of lifting the COVID-19 lockdown. This is allowing a gradual resumption of some of the economic activity that was restricted by the measures to prevent the spread of the virus. The Scottish economy has moved from the initial shock of COVID-19 to the start of what is likely to be a long and possibly volatile recovery process.

4.2 In the first part of this chapter we look at the latest data on the Scottish economy. COVID-19 has led to a large fall in GDP, but because of the job retention schemes, this effect is not yet mirrored in headline labour market indicators such as the unemployment rate. We might expect more significant effects in the labour market later in the year as the schemes wind down. Overall, Scotland appears to be facing a similar economic shock to the UK as a whole. The data available are subject to significant uncertainty and there may be large revisions in later releases.

4.3 The second part of this chapter explores the longer-term outlook for Scotland. Over the next few years, as lockdown lifts and economic activity continues to resume, there remains significant scope for Scottish GDP to rise from its current low. We expect Scottish GDP to remain below its pre-lockdown level for some time to come, with our illustrative analysis suggesting that GDP won't return to its 2019 Q4 level until 2023. In the next few years, unemployment is likely to be elevated and earnings will be lower for many. Our illustrative projection of Scotland's potential output suggests Scottish GDP might be around 4.0 per cent lower in 2025 than it would have been without COVID-19. Significant downside risks to the economy remain if stricter lockdowns have to be re-implemented. Economic growth will be contingent to the trajectory of bringing the virus under control and is therefore difficult to predict with any certainty at this point.

Review of latest economic data

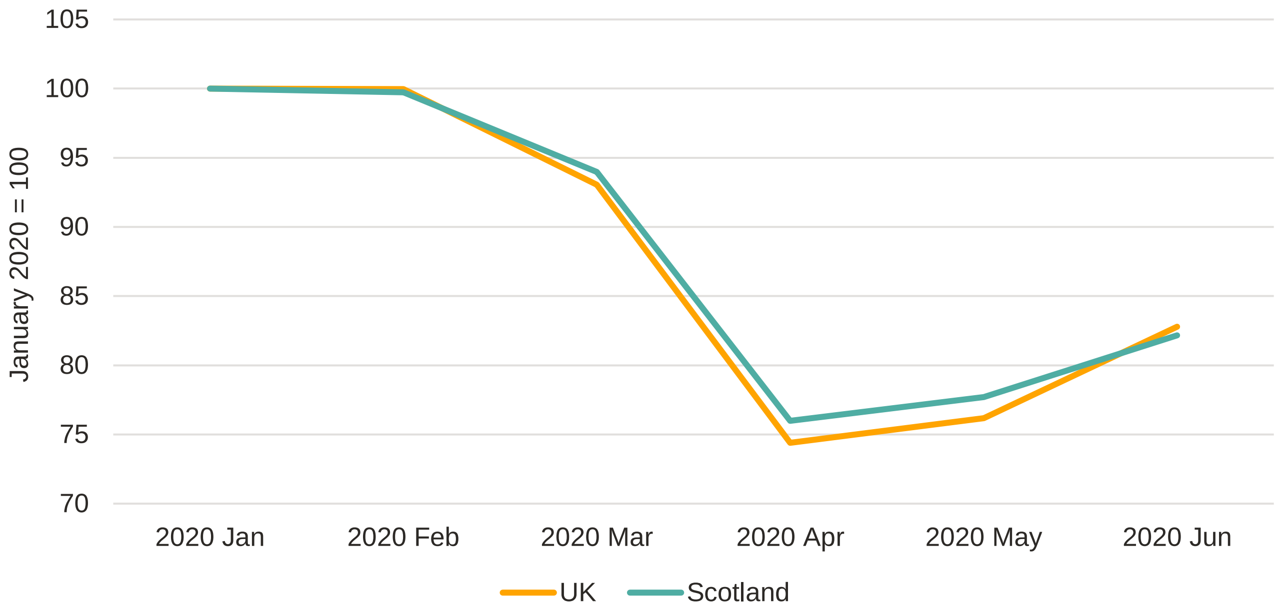
GDP, sentiment indicators and sectoral effects

4.4 Economic activity, as measured by GDP, fell sharply in March and April 2020 as the COVID-19 lockdown was imposed. Since May, as the lockdown started to lift, activity began to rise again. Assuming no significant reversals to the phased lifting of lockdown, we expect economic activity to continue to gradually increase for the rest of this year, but the level of GDP will remain significantly below where it was at the start of the year for some time to come.

4.5 The effect of the COVID-19 lockdown on GDP has been similar in Scotland and the UK as a whole. Figure 4.1 shows that Scottish and UK GDP fell by around a quarter between January and April, a decline in economic activity without precedent in modern times.

4.6 Scottish and UK GDP growth were then positive in May and June, broadly in line with when lockdown started to lift. The level of GDP remains substantially below where it was at the start of the year in both economies. These GDP estimates are uncertain, and may be subject to greater revisions than usual.

Figure 4.1: GDP index level, Scotland and UK



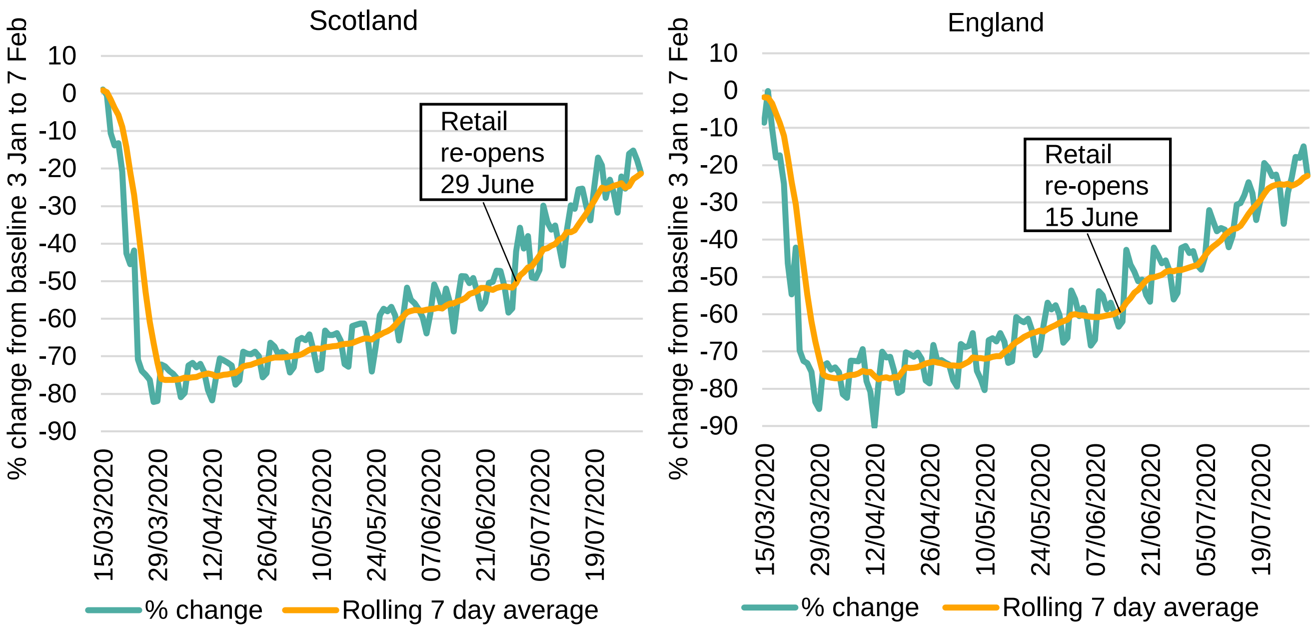
Source: Scottish Government (2020) Gross Domestic Product – monthly estimate: June 2020 (link), Office for National Statistics (2020) GDP monthly estimate, UK: June 2020 (link).

4.7 More up-to-date data on economic activity are available from other sources. The Royal Bank of Scotland Purchasing Managers' Index (PMI) measure of sentiment amongst Scottish businesses recovered in July 2020 to 49, from a low point in April of 11.[35] We think this indicates a continued but gradual recovery in economic activity. Businesses surveyed in manufacturing industries are now reporting improving activity, with a reading of 58, while sentiment for those in services remains below 50 which suggests ongoing pessimism about economic activity compared to earlier periods.

4.8 Some recovery is also observed in the timely recent and entertainment footfall data based on Google mobility trends. As illustrated in Figure 4.2, consumer mobility remains below its level at the start of the year but has started to pick up since the re-opening of non-essential shops on 15 June in England and on 29 June in Scotland. Retail footfall is now around 20 per cent lower compared to the same time last year in both regions, a significant improvement on the near 80 per cent reduction observed in April.

[35] IHS Markit and Royal Bank of Scotland (2020) PMI releases (link)

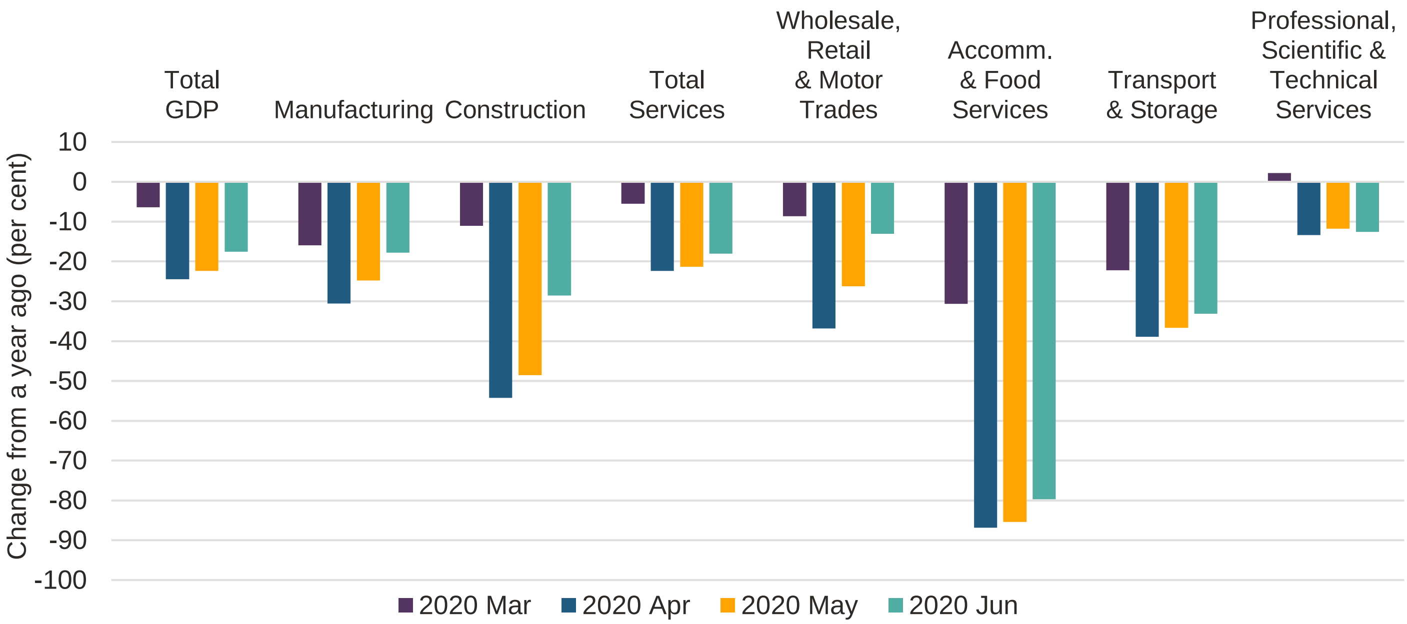
Figure 4.2: Visits to retail and entertainment hubs up to 31 July 2020, Scotland and England



Source: Scottish Fiscal Commission, Google mobility data (link).

4.9 Figure 4.3 shows that lockdown caused contraction in all industries in the period March to June 2020, compared to the same month in the previous year, although some industries are affected more severely than others. The largest effect was on food services and accommodation, which showed large and continuing declines. Other sectors, for example wholesale, retail and motor trades and manufacturing, showed signs of recovery in the May and June data.

Figure 4.3: Sectoral analysis of effect on Scottish GDP



Source: Scottish Government (2020) Gross Domestic Product – monthly estimate: June 2020 (link)
For reasons of space the figure covers selected sub-sectors from the monthly GDP table.

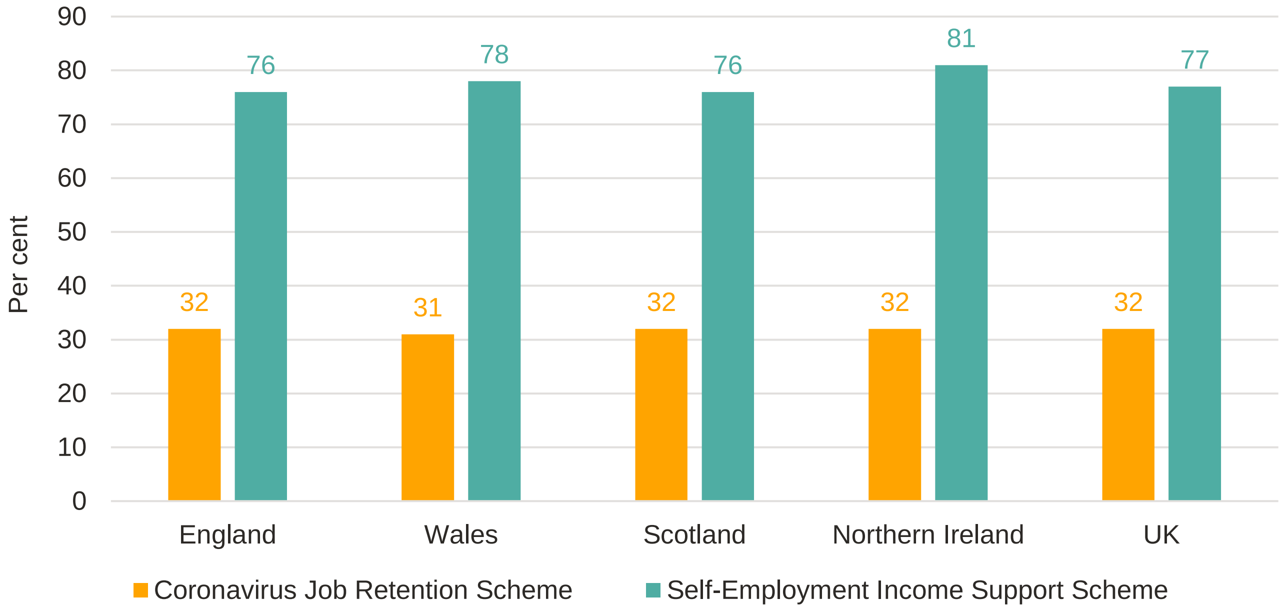
4.10 In the latest monthly estimates, GDP in Scotland grew by 2.3 per cent in May (revised up from 1.5 per cent) and by 5.7 per cent in June. The higher rate for June – double the May figure – is likely to reflect the easing of lockdown restrictions which helped boost GDP. We think the rate of 2.3 per cent seen in May is likely to be more representative of the average pace of monthly growth over the remainder of 2020. Assuming this rate continues over the second half of the year, we could expect

GDP growth for 2020 as a whole of -11.7 per cent. While this is a large fall, it is significantly less than if the near 25 per cent contraction in GDP between January and April were sustained over the course of the year. The downside risk to this simple estimate is the possibility of an increase in COVID-19 cases and deaths leading to the reintroduction of stricter lockdowns.

Furlough and the labour market

4.11 The schemes to support workers and firms throughout lockdown have had similar take-up in Scotland and the UK, as shown in Figure 4.4. The Coronavirus Job Retention Scheme (CJRS), which pays up to 80 per cent of the salary of furloughed workers, has seen take-up of around a third of all eligible employees. The Self-Employment Income Support Scheme (SEISS) has a take-up rate of just over three quarters of those eligible, with Scotland accounting for 6 per cent of claims which reflects its lower level of self-employment. Also at sectoral level, there are no significant differences in CJRS take-up rates between Scotland and the UK, except for Construction which had notably higher take-up in Scotland.

Figure 4.4: Take-up of Coronavirus Support Schemes, Scotland and UK



Source: HMRC (2020) Coronavirus (COVID-19) statistics – August 2020 (link)

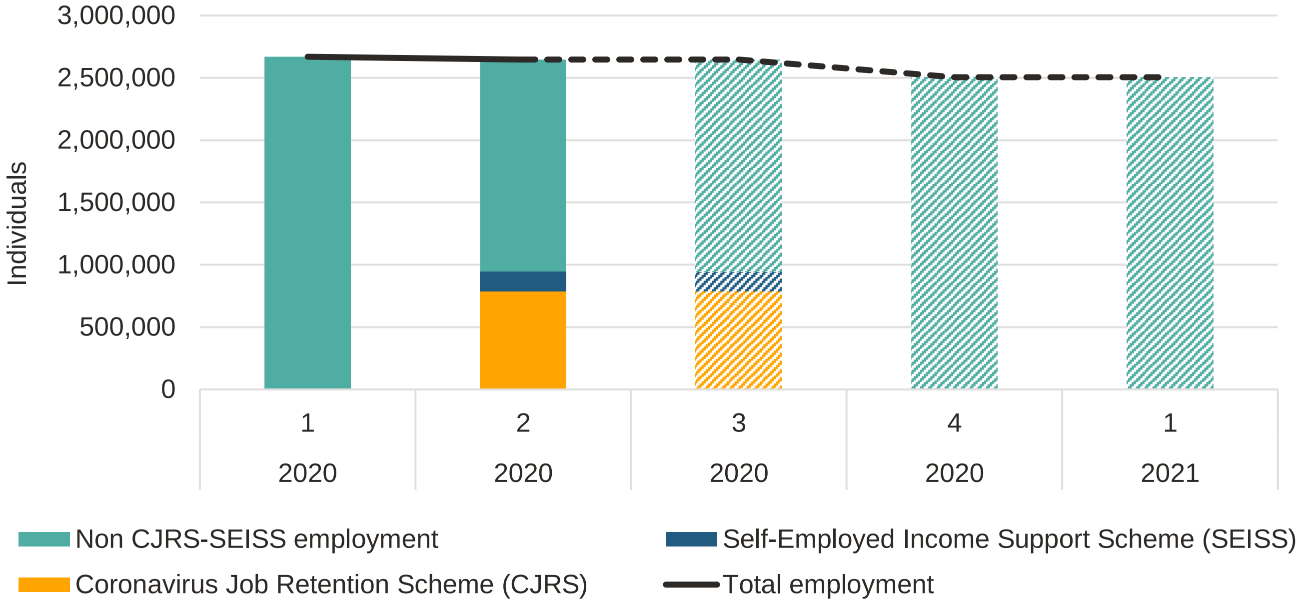
4.12 In the period April to June, total employment in Scotland fell by around 15,000, or 0.6 per cent, compared to the first quarter of the year.[36] This is a moderate fall in employment given the scale of the economic shock. Employees who have been furloughed under the CJRS and are not working any hours continue to be counted as in employment. Similarly, self-employed individuals who have applied for the SEISS and might not otherwise have had any income are also still part of the total employment figures. This has limited the effect of lockdown on headline employment and unemployment figures so far.

4.13 In Scotland, we estimate that since the start of lockdown around 788,044 employees have been furloughed at some point and 157,423 self-employed individuals have applied for SEISS, around 36 per cent of total employment. Stripping out the CJRS and SEISS schemes, we estimate that

[36] Office for National Statistics (2020) Labour market in the regions of the UK: August 2020 (link)

around 1.7 million individuals in employment have not applied to either scheme.[37] This is shown in Figure 4.5.[38]

Figure 4.5: Employment, Coronavirus Job Retention Scheme and Self-Employed Income Support Scheme



Source: Scottish Fiscal Commission, HMRC (2020) Coronavirus (COVID-19) statistics – August 2020 (link), Office for National Statistics (2020) Labour market in the regions of the UK: August 2020 (link).
Solid lines represent outturn, dashed lines represent our illustrative projection.

4.14 As lockdown lifts and the CJRS and SEISS schemes end, we may expect many of those covered by the schemes to return to work and remain in employment. However, it is unlikely that everyone will, as some businesses may close or choose to make redundancies when the schemes end. The OBR's central scenario, published in July, assumed that 15 per cent of those in CJRS won't return to employment immediately.[39] Applying the same rate in Scotland, to both CJRS and SEISS, we estimate that employment could fall to 2.5 million in 2020 Q4, a fall of 164,000 individuals or around 6.2 per cent from the start of the year. This compares to our February 2020 forecast of employment ending the year 2020 at 2.7 million.

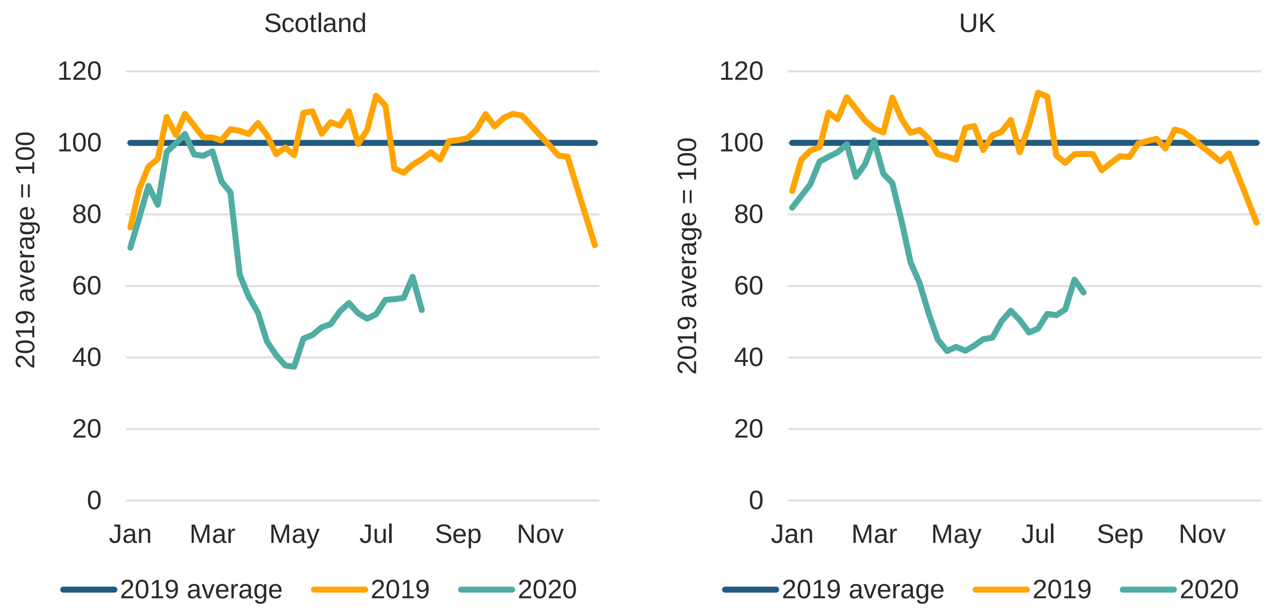
4.15 Assuming these individuals become unemployed, and that economic activity levels remain flat, this suggests unemployment in Scotland could rise to 267,000, or 9.6 per cent, by the end of the year. This compares to our February 2020 forecast of 111,000, or 4.0 per cent. This simple analysis, using an OBR scenario, is subject to significant uncertainty and only provides an indication of the potential scale of the effect.

4.16 We can look at other indicators to get a broader sense of what is happening in the labour market. Weekly vacancies data published by the Office for National Statistics using data from Adzuna, an online job search engine, suggest vacancies are still around half their 2019 level but have improved

[37] LFS employment measures the total number of individuals in employment. Individuals with multiple jobs only count as being in employment once. The CJRS figures measure the cumulative total number of employments that have been furloughed. An individual with multiple jobs can be furloughed from multiple employments, and so could be counted under CJRS multiple times. This means, strictly speaking, it is incorrect to compare LFS employment to CJRS employments, as we do in Figure 4.5. However, at the aggregate level, we think that the number of individuals with multiple furloughed employments is likely to be small enough that Figure 4.5 and the accompanying analysis is still helpful and informative in broad terms.
[38] We have included a Scottish share of 'region unknown' furlough cases in these estimates.
[39] OBR (2020) Fiscal Sustainability Report – July 2020 (link)

since early May. As shown in Figure 4.6, these trends are similar both in Scotland and across the UK. The low number of vacancies suggests it will be harder for people to find work.

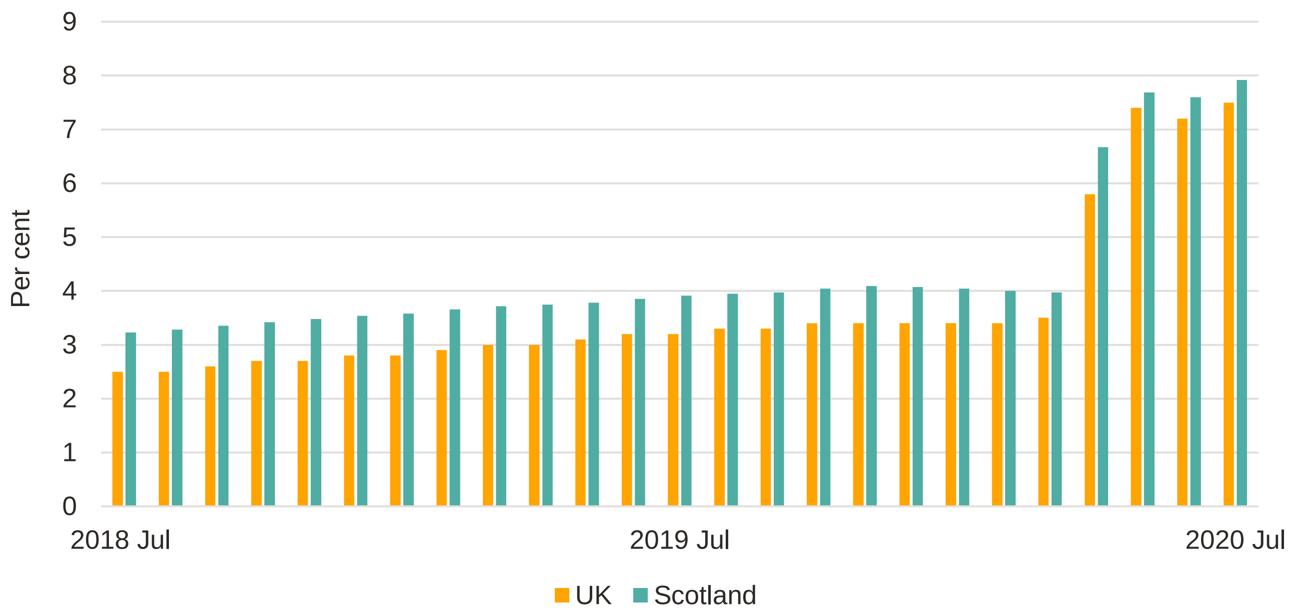
Figure 4.6: Total weekly online job adverts on Adzuna, Scotland and UK



Source: Office for National Statistics (2020) Online job advert estimates (link)

4.17 The claimant count in Scotland has risen by around 100,000, a similar relative increase to the UK. This is considerably greater than the 10,000 increase in unemployment we've seen so far. This may suggest a large number of people have remained in employment but have seen their incomes fall to the point where they become eligible for Universal Credit.

Figure 4.7: Claimant count rate, Scotland and UK

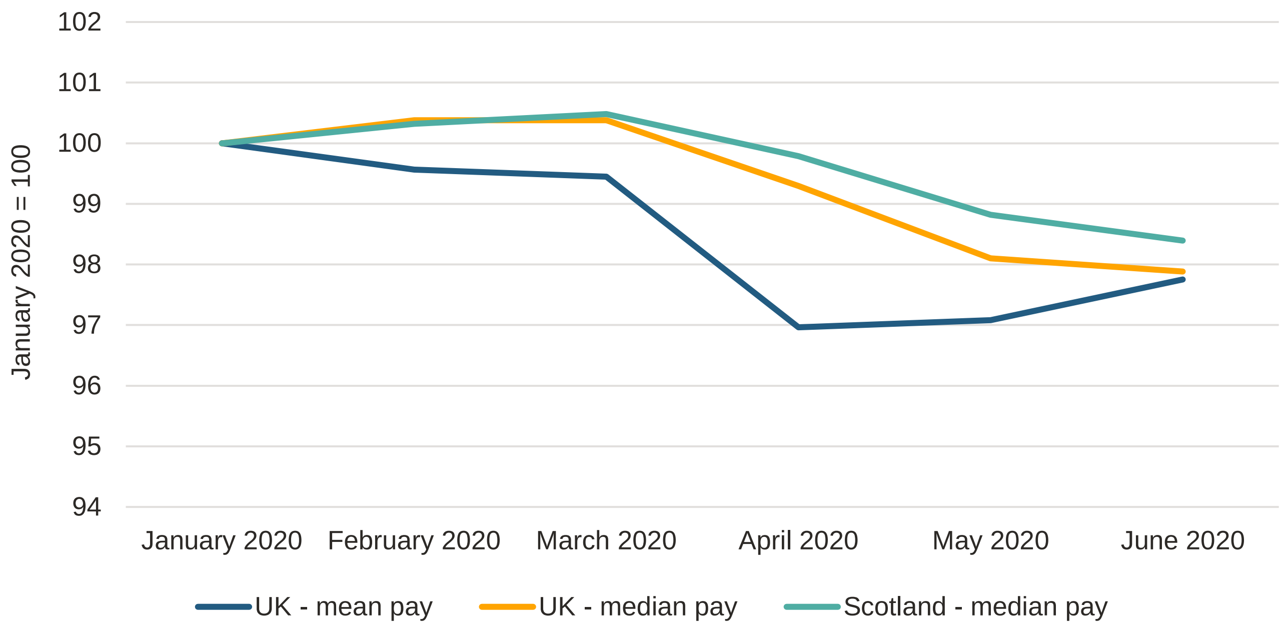


Source: Office for National Statistics (2020) Labour market in the regions of the UK: August 2020 (link), Office for National Statistics (2020) Claimant count and vacancies time series – August 2020 (link).

4.18 According to HMRC's PAYE Real Time Information (RTI) data, total pay in the UK fell by 4.3 per cent in June compared to the start of the year. A decline in the number of people in employment and a decrease in the average pay of those remaining in employment both contributed to this fall. From

RTI data we only get a measure of median pay in Scotland. As Figure 4.8 shows, median pay in Scotland has fallen slightly less than in the UK according to RTI data. So far, the fall in total earnings appears significantly less than the fall in GDP.

Figure 4.8: RTI mean and median pay, Scotland and UK



Source: Office for National Statistics (2020) Earnings and employment from Pay As You Earn Real Time Information, UK: August 2020 (link)
Median pay for Scotland and the UK is a three-month moving average while UK mean pay is monthly.

4.19 Because of schemes such as CJRS and SEISS, the effect of COVID-19 on the labour market has so far been much smaller than on the economy as a whole. The CJRS and SEISS have limited the effect on the labour market as measured by the LFS with up to one third of employed individuals in Scotland remaining in employment but not working any hours. Once the schemes are removed, there is likely to be a much bigger effect of COVID-19 on the labour market but, given the data lags, it will be some time before this effect is fully reflected in the labour market headline figures.

The economy and Scottish tax revenues

4.20 Scottish tax revenue data following the start of lockdown is so far limited, but we do have some information on what determines tax revenues. In Chapter 2 we discussed the potential effects of changes in tax revenues and socials security spending as a result of COVID-19 on the Scottish Budget. Here, we look in more detail at the effect of the economic shock on tax revenues and what data are available so far.

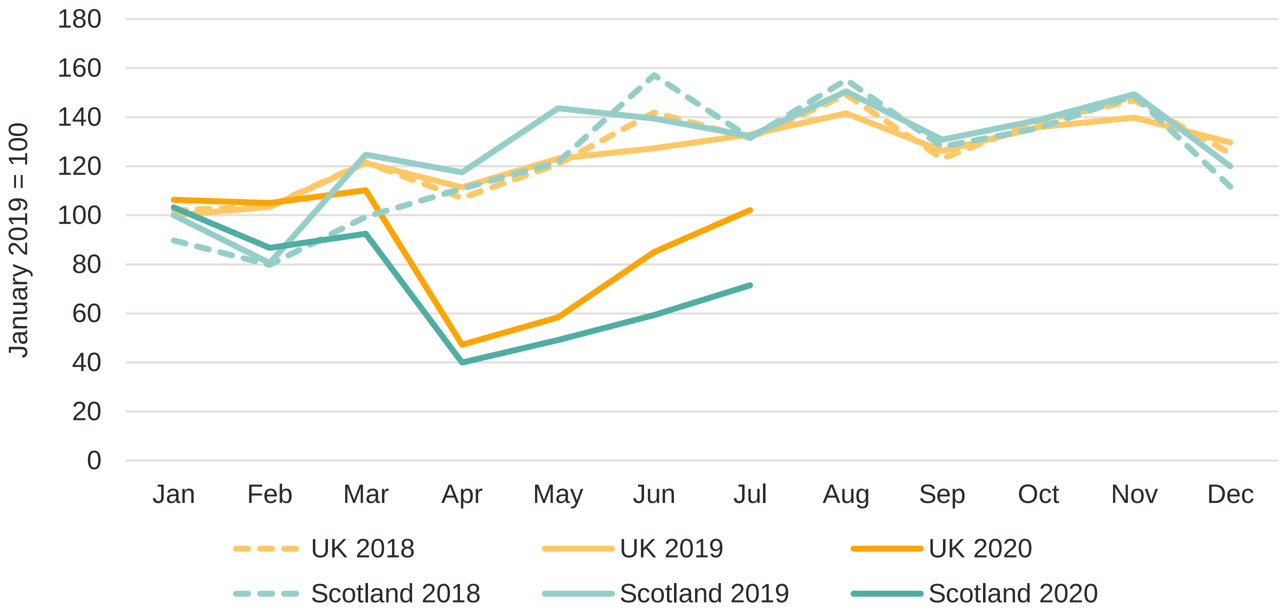
4.21 Under the fiscal framework, the effect of income tax on the Scottish Budget depends on the relative growth of income tax revenues in Scotland compared to the rest of the UK. So far, the available data on earnings and employment don't suggest any significant divergence in income tax revenue growth between Scotland and the UK.

4.22 The COVID-19 economic shock appears to be disproportionately affecting those on lower incomes. Between January and June 2020, UK RTI data shows pay falling by 2.4 per cent for those at the

10th percentile, compared to only 1.2 per cent for those at the 90th percentile.[40] Work by the Resolution Foundation shows that 42 per cent of the lowest paid fifth of employees had either been furloughed, lost their job or had their pay and hours reduced because of COVID-19, compared to 15 per cent of the highest paid fifth of employees.[41] Because those on higher incomes have a far greater effective tax rate than those on lower incomes the expected decline in income tax revenues in 2020-21 is likely to be less than the decline in total income in both Scotland and the UK.

4.23 Turning to the effect of COVID-19 on the property market, timely data are available on property transactions in both Scotland and the UK. As Figure 4.9 shows, residential transactions have fallen to a similar extent in Scotland as the UK. The property market reopened a few weeks earlier in England than in Scotland, which has led to a more rapid increase in transactions in the UK in June and July. Given this difference in timing, we don't believe the faster UK increase is necessarily indicative of a significantly faster pick-up in transactions for the rest of the year.

Figure 4.9: Scottish and UK residential property transactions



Source: HMRC (2020) Monthly property transactions completed in the UK with a value of over £40,000 – August 2020 (link) Data are indexed to January 2019.

4.24 The total effect on the property market will depend on how long transactions and prices take to return to pre-lockdown levels. Both the Scottish and UK Governments introduced tax cuts in July to encourage transactions. As it will take time for transactions to be completed, it is likely the market won't return to its pre-lockdown trend until September or October at the earliest. Even if the property market had returned to normal levels in August, we estimate that transactions in Scotland in 2020-21 would still be 10 per cent lower than we had forecast in February. Some transactions that would have happened during the lockdown will be delayed until later in the year, but others may no longer take place depending on the effects of the pandemic on the wider economy.

40 Office for National Statistics (2020) Earnings and employment from Pay As You Earn Real Time Information, UK: August 2020 (link)

41 Resolution Foundation (2020) The Full Monty – Facing up to the challenge of the coronavirus labour market crisis – 29 June 2020 (link)

Looking ahead to our next forecasts

4.25 Our economy forecasts start from a forecast of potential output, in which the size of the economy is determined by the size of population and labour force, and the productive potential of that labour force. In the short-term, actual GDP can vary around this potential level, sometimes quite significantly, following shocks to the economy. In time, following a shock, we'd expect actual GDP to return to match the level of potential output.

4.26 COVID-19 will have an effect on both short-term actual GDP and long-term potential output. We can think about the pathway of the economy during and following the COVID-19 shock in three stages. These illustrative economic stages are not directly related to the Scottish Governments lockdown phases.

- **Stage 1 – lockdown**: COVID-19 and the resulting lockdown have a significant and negative effect on GDP. Economic activity is greatly suppressed as long as the early phases of lockdown are in place. Potential output is also reduced as a result of COVID-19, though actual GDP is reduced by far more.

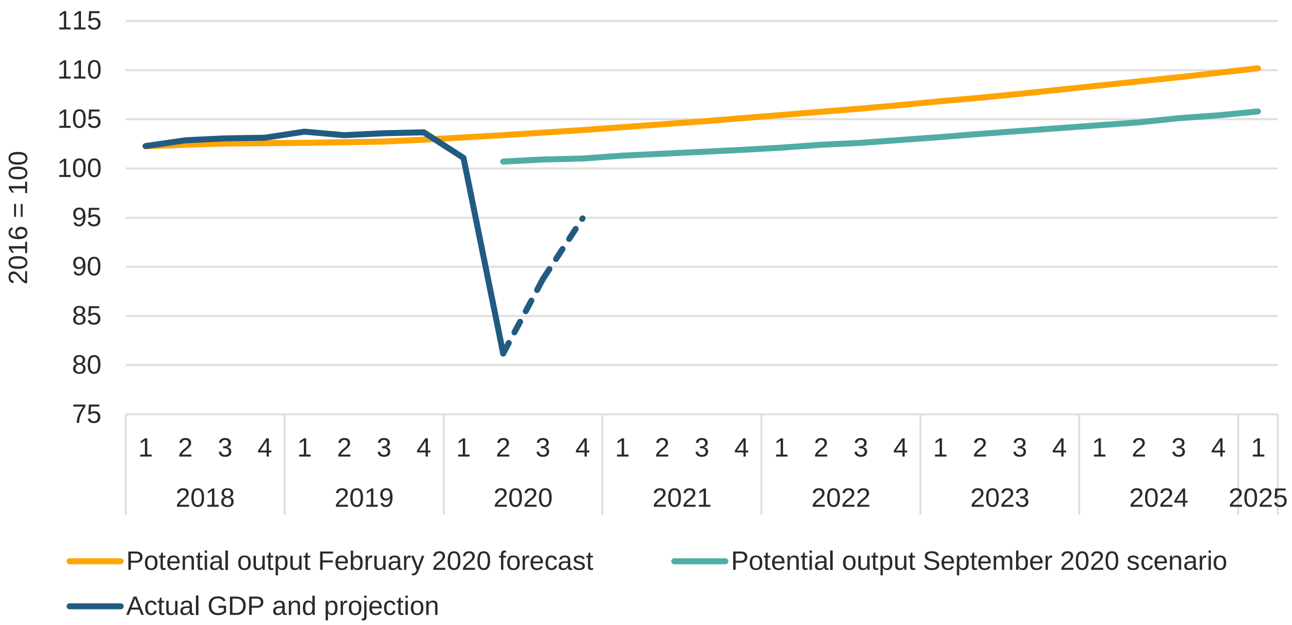
- **Stage 2 – lockdown lifting**: the phased lifting of lockdown gradually allows more and more economic activity to resume. GDP rises to the point where actual GDP is close to potential output. However, potential output has been reduced relative to the pre-COVID-19 pathway.

- **Stage 3 – recovery of potential output**: Actual GDP gradually increases in line with potential output. COVID-19 has caused lasting damage to potential output which may never fully recover to the pre-COVID-19 pathway.

4.27 Significant downside risks remain which would slow down a recovery. For example, if COVID-19 cases and deaths were to start to rise again, further lockdowns may be necessary, possibly rapidly reducing GDP to the levels seen in April 2020 and further diminishing the long-run productive potential of the economy. Alternatively, a disruptive end to the Brexit transition period in December 2020, without trade deals and other agreements secured with the EU and other nations, could also disrupt Scottish and UK economic growth.

4.28 We have constructed an illustrative projection of potential output in Scotland by looking at the effects of COVID-19 on the population, labour market participation and productivity in turn. Figure 4.10 shows our February 2020 forecast of potential output, our illustrative pathway for potential output taking account of COVID-19 and the latest outturn GDP data combined with our illustrative in-year GDP estimate for 2020 presented in the previous section.

Figure 4.10: Potential output COVID-19 scenario



Source: Scottish Fiscal Commission

4.29 In the months of full lockdown from March to April, what we've called stage 1, economic activity in Scotland fell by around a quarter.

4.30 Since May, we have been in stage 2, with economic activity starting to resume. During stage 2, we are likely to see very high levels of GDP growth as economic activity resumes, though with significant sectoral variation. Even if GDP rises rapidly to meet our potential output scenario, the economy would not return to its pre-lockdown level until the second half of 2023.

4.31 Looking further ahead to stage 3, our illustrative estimate of potential output is 4.0 per cent lower in 2025 than in our February 2020 forecast and would mean there has been a permanent hit to the size of the Scottish economy. This is equivalent to reducing annual GDP growth between 2020 and 2025 by 0.8 percentage points. This reduced growth will not be spread evenly over the period and much of it has already occurred by mid-2020.

4.32 Significant risks remain to all stages of recovery if a stricter lockdown has to be re-implemented.

4.33 Our judgements on potential output also affect the labour market forecast including prospects for employment and wages, which in turn affects our forecasts of income tax revenues. All else equal, slower growth in potential output means slower growth in the labour market and earnings, and in turn slower growth in income tax revenues.

4.34 In its July 2020 Fiscal Sustainability Report, the OBR presented three scenarios for the UK economy. [42] Their central scenario was a 3 per cent reduction to their March forecast of potential output by the first quarter of 2025. This is broadly in line with the analysis presented in this section, and the small difference between our illustrative scenarios and those presented by the OBR should not be seen as a prediction of the relative effect of COVID-19 on Scotland compared to the UK. The uncertainties around these figures are too great for such fine comparisons.

[42] OBR (2020) Fiscal Sustainability Report – July 2020 (link)

4.35 In the following sections, we discuss in more detail how we have created our illustrative projection of potential output, looking at population, participation and productivity.

Population

4.36 Scotland's economy will be most affected by changes in the population of those aged 16 to 64, who have the highest employment rates. This age group was already shrinking before COVID-19, and we expect COVID-19 to lead to more rapid declines. Population change is determined by three factors: births, deaths, and migration.

4.37 Low and declining fertility rates are a longer-term issue for Scotland which COVID-19 may have exacerbated. Any changes to the number of births in Scotland as a result of COVID-19 will have a negligible effect on our economy forecasts over our five year forecast horizon, though it will affect some of our other forecasts, such as social security spending.

4.38 Since mid-March there have been nearly 5,000 excess deaths in Scotland, over and above the average of recent years.[43] This represents around 0.1 per cent of the Scottish population or an 8 per cent increase above the average number of deaths over a year. The number of weekly deaths has been declining since a peak in April and currently is close to what would normally be expected at this time of year.

4.39 From an aggregate economic perspective, we do not expect the number of excess deaths to have a significant direct effect on the economy. We will include an adjusted mortality projection in our next forecasts, but this will not be the greatest determinant of changes to potential output.

4.40 Of the three population change factors, we expect changes in migration to have the greatest effect on the economy because it has the greatest effect on the economically active part of the population. Scotland's natural population change, which excludes migration, has been below zero for some time, and so Scotland's population has only been increasing because of positive net migration from the rest of the UK and the rest of the world. As yet, there are no data on migration since the start of lockdown.

4.41 We expect Scotland's international net migration to be close to zero in 2020, with certain groups particularly affected. For example university students from overseas form a significant proportion of Scotland's annual migration figures.[44] With ongoing lockdown restrictions, we might expect international students to come to Scotland in 2020 in lower numbers or for a shorter period.

4.42 Net migration from the rest of the UK has been positive for Scotland's population growth in recent years. The effect of lockdown on net migration with the rest of the UK is unclear, though in general we would expect lockdown to suppress moves both into and out of Scotland.

4.43 To illustrate the possible population effects of COVID-19, we have adjusted our previous population projections for the latest deaths data. We have also set international net migration to zero, leaving net migration with the rest of the UK unchanged. Figure 4.11 compares this to our February 2020 population projection and shows the Scottish 16 to 64 year old population to be 2.1 per cent smaller in 2025-26 compared to 1.3 per cent smaller in our previous forecast, around 30,000 fewer 16-64 year olds in Scotland than we'd previously forecast. All else equal, slower population growth or population decline will mean slower growth in the economy. We'll finalise our population forecast when we publish our next forecasts.

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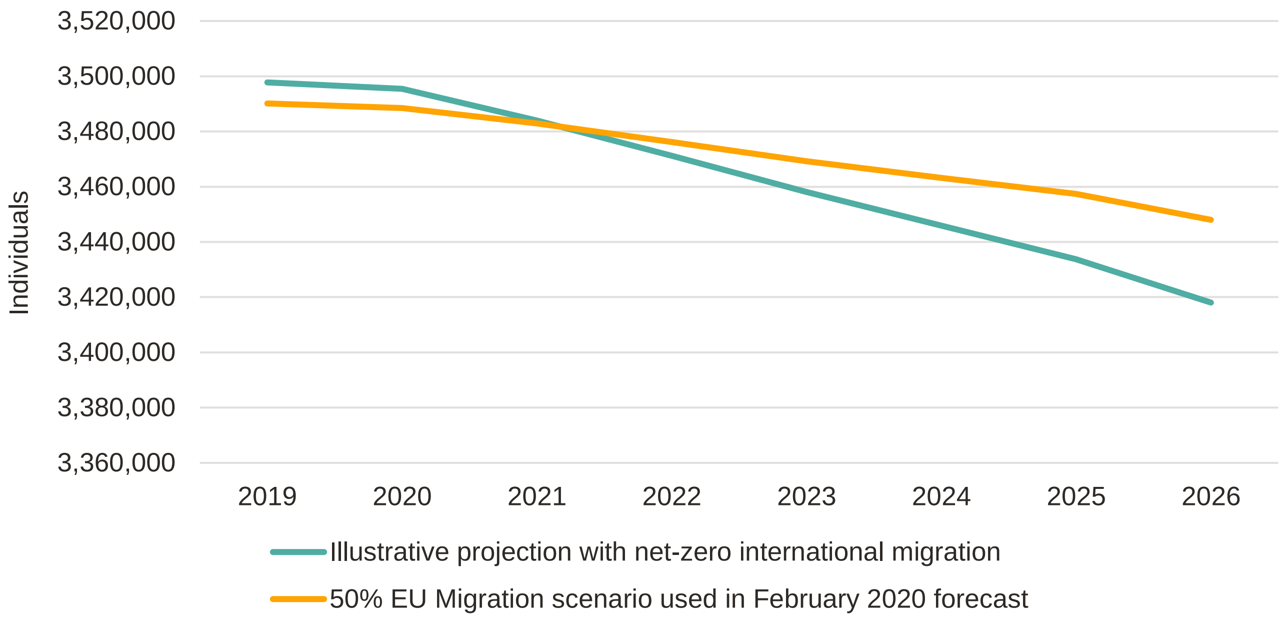
[43] National Records of Scotland (2020) Deaths involving coronavirus (COVID-19) in Scotland (link)

[44] Office for National Statistics (2020) Migration Statistics Quarterly Report: May 2020 (link)

Figure 4.11: Population projections of Scotland 16-64 year old population



Source: Scottish Fiscal Commission

4.44 Using this illustrative zero net international migration population projection, potential GDP in 2025 is reduced by 0.7 per cent, equivalent to reducing GDP growth by 0.1 percentage points per year.

Participation

4.45 Following the 2008 Global Financial Crisis (GFC) Scotland's unemployment rate rose to around 9 per cent, and only gradually declined over the next decade. The experience for younger people was more severe, with unemployment rates reaching 21.8 per cent for those aged 16 to 24. The COVID-19 economic shock is different in scale and nature to the GFC. The initial economic shock of COVID-19 has been greater than the GFC, though it is uncertain how persistent the economic shock will be and how it will affect the labour market.

4.46 As with the GFC, we expect younger peoples' labour market prospects to be more adversely affected by the COVID-19 lockdown. Young people are at risk in times of downturn partly because they are more junior and inexperienced, but also because they more likely to be employed in sectors and occupations that make use of flexible employment. Periods of unemployment for younger people can have negative longer term effects on future employment, earnings and productivity.

4.47 As discussed in the first part of this chapter, the UK Government's employment support schemes CJRS and SEISS are helping to limit the effect of COVID-19 on the labour market. We expect unemployment and economic inactivity to rise as these schemes are removed. On 8 July the UK Government has also announced a package of job creation initiatives – the Plan for Jobs – which are intended to offset some of the negative effects of unwinding the CJRS and SEISS schemes.

4.48 The potential output September 2020 scenario in Figure 4.10 is based on modelling a 1 percentage point increase in our long-term trend unemployment rate assumption. This is not the immediate effect of COVID-19 on the labour market, but represents how much unemployment rates could still be elevated over our full five-year forecast. We have also included a 2 percentage point reduction in labour market participation of those aged 16 to 24. These labour market adjustments to our potential output model, all else equal, reduce the level of potential output by 0.3 per cent in 2025 compared to our previous forecast.

Productivity

4.49 The growth rate of productivity in Scotland has been gradually slowing since around 2004, and the GFC exacerbated this.

4.50 Economic shocks can have somewhat unexpected effects on productivity. For example, in the short term a large fall in employment in particular sectors of the economy can lead to productivity appearing to increase.

4.51 Over the next five years, we expect productivity growth to be lower than in our pre-COVID-19 forecasts. There are a number of reasons for this:

- Lower capital investment
- Lower research and development spending
- Scarring effects on labour productivity from periods of unemployment
- Lower global trade and foreign direct investment
- Lower migration
- Potentially tighter net fiscal position of government in future after increased spending in 2020-21

4.52 Productivity is the most important determinant of longer-term growth in the economy. In its last pre-COVID-19 forecast the OBR forecast productivity in the UK to grow at an annual rate of 1.4 per cent over the next five years. In its Fiscal Sustainability Report scenarios, the OBR projected productivity growth of 1 per cent, resulting in productivity being 2 per cent lower in 2025 in the central scenario than in its March forecast. As an illustration, if we reduce our productivity growth judgement by a similar amount then potential output in Scotland would be 2.0 per cent lower by 2025 than we forecast in February.

Additional information

Abbreviations

ADS	Additional Dwelling Supplement
BGA	Block Grant Adjustment
COVID-19	Coronavirus
CJRS	Coronavirus Job Retention Scheme
CST	Chief Secretary to the Treasury
DHP	Discretionary Housing Payments
FFFP	Fines Forfeitures and Fixed Penalties
FT	Financial Transaction
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HMRC	Her Majesty's Revenue and Customs
HMT	Her Majesty's Treasury
LBTT	Land and Buildings Transaction Tax
LFS	Labour Force Survey
NDR	Non-Domestic Rates
NHS	National Health Service
OBR	Office for Budget Responsibility
ONS	Office for National Statistics
PAYE	Pay As You Earn
PMI	Purchasing Managers' Index
RTI	Real Time Information
SBR	Summer Budget Revision
SDLT	Stamp Duty Land Tax
SEISS	Self-Employed Income Support Scheme
SFC	Scottish Fiscal Commission
SLfT	Scottish Landfill Tax
VAT	Value Added Tax

A full glossary of terms is available on our website:

http://www.fiscalcommission.scot/about-us/glossary-of-terms/

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Correspondence and enquiries

Press enquiries should be sent to press@fiscalcommission.scot or call Caroline Rham 0131 244 0929; Mob: 07547 674277

For technical enquiries about the analysis and data presented in this paper please contact the responsible analyst:

Economy	Silvia Palombi	Silvia.palombi@fiscalcommission.scot
Income tax and public funding	Chris Dunlop	Chris.dunlop@fiscalcommission.scot
Fully Devolved Taxes	Rupert Seggins	Rupert.seggins@fiscalcommission.scot
Social security	Claire Mellor	Claire.mellor@fiscalcommission.scot

For general enquiries about this publication or the commission and how we work please contact info@fiscalcommission.scot

This publication is available at www.fiscalcommission.scot

ISBN: 978-1-911637-20-2

Published by the Scottish Fiscal Commission, September 2020