# Written Submission from David Heald
# COVID-19 and the Devolved Fiscal Settlement

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1. Contrary to pre-1999 expectations, the first devolution decade (2000s) was one of fiscal plenty, followed by a decade of austerity (2010s). It was uncertain what the 2020s would bring, particularly as:

   > Since the 2014 Independence Referendum, Scotland has effectively sacrificed fiscal certainty for (a) the notion that greater fiscal powers are always one more step on the journey to independence (the 'Yes' side); and (b) the notion that they provide greater political legitimacy for devolution (the 'No' side) (Heald, 2020, p. 539).

   Then the coronavirus crisis transformed the fiscal landscape. Public spending is surging, tax revenues are collapsing, public borrowing is soaring, and the UK net public debt ratio is likely to rise by at least 10 percentage points. The financial damage at the UK level in April 2020 is recorded in the monthly *Public Sector Finances* data release (Office for National Statistics, 2020). For example, Public Sector Net Borrowing (excluding public sector banks) was £62.1 billion in April 2020, compared to £10.9 billion (April 2019) and £62.7 billion (financial year 2019-20).

2. This constitutes a dramatically changed context for the forthcoming review of Scotland's Fiscal Framework. The 'Magic Money Tree' is gushing forth fruit, with encouragement from international financial institutions: "spend as much as you can, but keep the receipts. We don't want accountability and transparency to take a back seat in this crisis" was the advice from the Managing Director of the International Monetary Fund (Georgieva, 2020). The inequality-increasing consequences of COVID-19 have been emphasised by Jonathan Ostry, Deputy Director of the IMF's Research Department (Ostry, 2020). Nevertheless, removing the surging fiscal deficit will, in time, bring what feels like renewed austerity and/or tax increases.[2] The much higher debt (which the UK Government currently has no difficulty in funding) raises fiscal sustainability concerns in the longer term (particularly if interest rates were to rise sharply, thereby increasing the proportion of public spending taken by debt interest).

3. In terms of the revision of Scotland's Fiscal Framework (HM Government and Scottish Government, 2016), it is useful to distinguish between (a) structural issues which preceded coronavirus, and (b) issues which derive from the economic and fiscal impact of coronavirus.

**Structural Issues**

4. Neither the Scotland Reserve nor the Scottish Government's borrowing powers are sufficiently large to deal with the volatility of revenue sources, particularly given the role of Block Grant Adjustments (BGAs) for taxes and devolved social security benefits. The Scottish Fiscal Commission (2020a) forecast negative BGA reconciliations for income tax to be £204 million (2017-18, to be met from the Scottish Budget in 2020-21), followed by £555 million (2018-19) and £211 million (2019-20). Without clarity about enlarged facilities, the Scottish Budget becomes increasingly difficult to manage. A problem is that the UK Government may regard the devolved

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[2] Whenever 'confidential' Treasury documents listing possible spending cuts and tax increases appear in newspapers, there is uncertainty about whether they were leaked by a dissident or planted there with ministerial consent in order to shape the public debate. A *Daily Telegraph* exclusive on 12 May 2020 (Rayner and Mikhailova, 2020) falls into this category.

Parliament and Assemblies as spendthrift unless constrained, and therefore be reluctant to relax control.

5. Another feature is the timing of UK spending events, with the Scottish Budget for 2020-21 having to be delivered (6 February 2020) before the UK Budget (11 March 2020).[3] Despite efforts by the UK Parliament to urge changes in budgetary timetables (House of Commons Procedure Committee, 2017), successive UK governments have not acted because the present arrangements confirm Executive supremacy. The circumstances in the devolved Parliament and Assemblies are different, characterised by more effective financial scrutiny and the necessity of securing cross-party agreement to pass the Budget. The UK Budget moved to October/November in 2017, but back to March in 2020. The implications for the devolved institutions were disregarded when that decision was taken.

6. An issue scheduled to be addressed in the review of the Fiscal Framework is the method of calculating BGAs, on which the Scottish Government secured a better deal in 2016 than might have been expected. However, the Treasury insisted that the present method should not be regarded as either permanent or as the default.

**COVID-19 Issues**

7. The COVID-19 pandemic has economic and fiscal dimensions which transform the context of the Fiscal Framework revision. There are two aspects, for which the funding consequences are quite different. First, if the fiscal effects on Scotland and the UK are symmetric, Scotland has some protection from the COVID-19 shock. Changes to the BGAs act as buffers on fully and partially devolved taxes and on devolved social security benefits. Second, if Scotland were more adversely affected (asymmetric shock), then the tax BGAs would be larger than the realised Scottish revenue. Four possible reasons can be identified:
   (a) Scotland is behind England on the pandemic curve, so the lockdown is released more slowly on epidemiological grounds, depressing relative economic activity and tax revenues
   (b) Scottish ministers prioritise public health over economic recovery to a greater degree than UK ministers, depressing relative economic activity and tax revenues
   (c) Scottish residents return to economic activity more slowly than English residents, depressing relative economic activity and tax revenues
   (d) Differences in economic structure (for example, the importance of hospitality, tourism, and oil and gas), though this might be partially offset by a larger Scottish public sector

   Disaggregating these effects would be difficult and contested, with *de facto* Brexit on 31 December 2020 a complicating factor. If such conditions held in net terms, revenues raised in Scotland would be lower than the tax BGAs.

8. A strength of the 1999 devolution settlement, continuing on from the creation in 1980 of the Scottish block, was the unhypothecated devolved block, with increments determined largely through the Barnett formula. There has been considerable erosion over time, with the Treasury now separately controlling Resource Departmental Expenditure Limit (RDEL), Capital DEL and Financial Capital DEL, thereby making operational management of the block more difficult. Moreover, the Scottish Government has undertaken to pass on Barnett health consequentials to health and local government consequentials to local government. The politics of this are understandable, but this practice severely reduces the budget flexibility of the Scottish Parliament

[3] This timing resulted in some future Barnett consequentials being 'anticipated' in the 2020-21 Scottish Budget.

and of Scottish ministers. With proliferating announcements of UK spending changes, lobby groups will clamour for 'their share' of Barnett consequentials.

9. The UK is one of the most fiscally centralised democracies in the world, and the COVID-19 emergency may further tighten the grip of the centre. Provided that it maintains market credibility, the UK Government can presently borrow long-term and cheaply, without a binding limit. As noted by the Scottish Fiscal Commission (2020b, paragraph 2.6), "The Scottish Government cannot borrow to fund any additional COVID-19-related spending". The differential access to borrowing as a policy instrument alters the power balance between the UK Government and the Devolved Administrations.

10. As well as urging "spend as much as you can" to deal with the public health crisis and to limit damage to the long-term productive capacity of economies ("scarring"), Georgieva (2020) urged the keeping of receipts. In the context of constrained management resources, a focus on cash control is imperative. Accounts preparation and audit might be delayed. There is a much greater fraud risk than under normal circumstances, as a result of, *inter alia*, (a) the extreme urgency of disbursing money to individuals and firms, (b) weakened internal controls on procurement, grants and loans, in part due to homeworking where there is often lower IT security, and (c) the magnetic appeal of abundant public money to those with criminal intentions. Reputational damage will be done to governments if programmes are later revealed to have suffered extensive fraud. It seems possible that UK Government schemes (eg furloughing, self-employment subsidies, and business loans) are more vulnerable than most Scottish Government programmes, but the increase in fraud opportunities does raise operational issues for the Scottish Government and Audit Scotland and scrutiny issues for the Parliament and its Committees.

11. Government accounting attracted much political attention in relation to Public-Private Partnerships. Well before the coronavirus crisis, concern was mounting about other 'unconventional' instruments of public policy that either do not score against budgetary numbers or are very difficult to score. Attention has been drawn to the growing use of government guarantees and other forms of contingent liabilities (Heald and Hodges, 2018). In particular contexts, these might be the optimal policy instrument, but there are well-founded suspicions that sometimes the motive is to manipulate fiscal numbers. Another risk to future budgets comes from the likelihood of contractual claims against government or funded bodies and legal claims, for example in relation to clinical and other negligence during the coronavirus crisis.[4]

**Scottish Budget Update on 27 May 2020**

12. Commendably, the Scottish Government (2020a) has published a 2020-21 Budget Revision to demonstrate the effects-to-date of the budgetary responses to COVID-19. This shows the scale and complexity of these effects, and also indicates that uncertainties about funding remain:

> £3,063m of these [£3,581m] consequentials have been added to the Scottish Government Block Grant at the UK Main Estimate. The balance of these funds would be expected to be added to the Scottish Government budget at UK Supplementary Estimate. However HM Treasury have made clear that they are exploring with UK departments the capacity for them to meet additional Covid related costs from within existing budgets. This implies a risk that not all the consequentials set out here will actually be provided (Scottish Government, 2020b, paragraph 6).

[4] The provision for clinical negligence at 31 March 2018 in the UK Whole of Government Accounts (Treasury, 2019, Note 22 on page 145) was £78.4 billion. The 2018-19 WGA has not yet been published.

**Conclusion**

13. The Fiscal Framework revision was always going to be a significant event, for which the Scottish Parliament and Government were making preparations through their joint Working Group. The expected issues still apply, but the context has been transformed by the pandemic. It is essential that the devolution settlement is not undermined.

14. Gushing public expenditure will come to an abrupt halt, even assuming that the UK Government wishes to stabilise net public debt at the higher ratio rather than reduce it to the pre-crisis level. The aftermath of the 2008 global financial crisis (including reduced trust in government) indicates that the economic, fiscal and political consequences of coronavirus are uncertain. After COVID-19, governments will find it difficult to convince their electorates that the public finances have to be restored in face of reduced revenues and pressures for more spending, including on public sector pay, particularly for 'key workers'.

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***Glasgow, 29 May 2020***

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