CIPFA The Chartered Institute of Public Finance & Accountancy

The Scottish Parliament Finance and Constitution Committee

The Impact of Brexit on the Scottish Budget

A Submission by:

The Chartered Institute of Public Finance and Accountancy

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the people in public finance

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1. Executive Summary

1.1 The Committee inquiry into the impact on the Scottish budget from Brexit is timely. There is now only one full financial year between now and the expected date of the UK's exit from the European Union in April 2019.

1.2 The defining factors associated with Brexit are outwith the direct control of the Scottish Government and of civic Scotland generally. Most of the factors are consequential. In practice, it is challenging to identify the definitive financial impact at this point. There are however a series of likely and identifiable indicators which, taken together with a summary of available research, enables a broad estimate of the likely scale of the financial impact to be made. These factors include:

- Scotland's historic disproportionate benefit from EU funding;

- restricted access to EU workforce, likelihood of EU workers leaving the UK with an adverse effect on the total number of future taxpayers with a consequential reduction in revenue from taxation;

- the existing complexity of incomes growth calculations will be compounded.

1.3 These factors and a summary of available research indicate that:

- The adoption of an alternative trading relationship with the EU is expected to have an adverse impact upon the UK economy. It is estimated that Scottish GDP could be reduced by up to £11.2 billion by 2030.

- There could be a reduction in Scottish tax revenues between £1.7 billion and £3.7 billion annually. As an indicator of scale, this is equivalent to a reduction to the Scottish Government budget of between 6% and 11%.

- A new funding mechanism for farmers requires to be identified before 2020. Any funding mechanism using the Barnett

Formula could result in a significant reduction in funding post - 2020.

- While negotiation on the settlement of the financial obligation between the UK and EU are underway, we understand that a single negotiated financial settlement with the EU is expected (generally referred to as the 'divorce bill'). There has been no debate to date on what share, if any of the liabilities that the UK government will apply to the devolved administrations.

1.4 CIPFA has established an advisory Commission on Brexit (see section 5 below).[1] The Commission will provide advice on the finance and policy implications for public services in the UK. We will ensure that the Committee is kept informed on the work of the Commission.

[1] The Brexit Advisory Commission for Public Services: http://www.brexitcommission.org/

2. Background and Context

2.1 The Committee's inquiry into the impact of Brexit on the Scottish Budget raises both short and longer-term issues that should be explored. In this submission CIPFA will focus on the following:

- The identifiable short-term issues and their impact; and
- the long-term funding and public financial management issues.

2.2 We consider that the Committee should consider both with regard to future financial planning and risk management.

2.3 The wider background is the increase in devolved fiscal powers available to the Scottish Government since the Scotland Act 1998. Increased fiscal responsibility has fundamentally changed the nature of public financial management and planning required in Scotland. The Scottish Government from 2017/18 will be in control of approximately 40% government of revenues.[2]

2.4 This proportion will be raised from taxes devolved to Scotland following implementation of the Scotland Acts of 2012 and 2016. It should also be noted that further fiscal powers are due to be implemented with the assignment of a proportion of VAT in April 2019.[3]

2.5 The increase over the control of revenue raised in support of spending on public services, increases the accountability of the Scottish Government as well as increasing the potential for greater volatility in future revenues. While this inquiry is focused on the impact of Brexit, it is one of a range of factors that will impact on the public spending in the short and longer-term. These factors include:

- Demographic changes[4] and;

[2] Scottish Government: Scotland's Budget: Draft Budget 2017-18, Table 1.01 – December 2016
[3] Through powers contained in The Scotland Act 2016, Section 16
[4] National Records Scotland review of demographic changes shows both an increasing and aging population, Aug 2015

- the UK Government objective of a balanced budget in the medium term.[5]

2.6 Any commentary at this stage on the impact of Brexit on Scottish Public Finances has the important caveat that the negotiation process for withdrawal from the EU is in its early stages. The detail is dependent on the outcome of those negotiations and on what the final nature of the future relationship with the EU will be.

2.7 At this point, while both parties to the negotiations have set out their positions,[6] there is no certainty as to what the final agreement on future relationships with the EU, access to markets and EU customs union will be. Therefore the Committee would be strongly advised to promptly review its assessment of the impacts once these details emerge. CIPFA has summarised an indicative timeline for the Brexit negotiations as follows:

Timeline	**Milestones**	**Notes**
By the end of 2017	Significant progress completed on status of British nations in the EU and EU citizens in Britain; Status of the Ireland-Northern Ireland border and; Settling Britain's outstanding liabilities to the EU.	Phase 1 of UK EU negotiations. *Note,* the EU Council will meet during this period to assess progress made to date and whether negotiations can move onto phase 2.
By the end of October 2018	Deadline indicated by Mr Barnier for talks on the transitional arrangements	Phase 2 of the UK EU negotiations (trade relationships).

[5] UK Government Spring Budget 2017 – 'the government will reduce the structural deficit to less than 2% of GDP and get debt falling as a percentage of GDP by 2020-21', March 2017
[6] The UK Government's negotiating objectives for exiting the EU PM speech, January 2017 and European Council (Article 50) guidelines for Brexit negotiations, April 2017

	and future EU/UK relationship to be concluded. This is in order to allow ratification of the proposed deal by EU member states.	*Note,* this means that there is approximately 18 months to complete phase 1 and 2 of the negotiations from triggering Article 50.
March 2019	Ratification by EU member states, the European Council and Parliament must have taken place by this point. The UK parliament has also been promised a vote on the deal signed before it takes effect.	Note: any extension to the talks would need to be agreed unanimously. This may also be complicated by European Parliament elections scheduled for May 2019
April 2019	UK departure from the EU to be complete	

3. Short-term Budget issues

3.1 The revenue to support public spending in 2017/18 and beyond in Scotland will be primarily raised from two sources:

- Taxation powers and;
- UK Government block grant adjusted via the Barnett Formula

3.2 It is important to consider if volatility exists in both either through the impacts of Brexit and/or through a range of other uncertainties or economic impacts not directly related to Brexit.

Income from Earnings

3.3 The forecasts for non-savings and non-dividend income tax (NSND) paid by Scottish Taxpayers incorporate a range of factors in order to provide a projection of revenue levels. This results in a distribution of NSND income forecast for each age group and then combined to arrive at the aggregate NSND distribution of income.[7]

3.4 In practice the level of NSND income has two important factors to consider for income budgeting purposes, firstly earnings growth and secondly growth in the number of taxpayers. It will be important for the Scottish Government to consider the possible Brexit implications and financial risks associated with both these factors.

3.5 In regard to earnings growth, survey information from the Office of National Statistics[8] demonstrates that in 2016 Scotland has the third highest annual income of the regions of the UK, behind London and the South East. However, Scotland encountered the weakest growth in salaries across the UK, but this still equated to a real terms increase.

[7] Scottish Fiscal Commission: Report on Draft Budget 2017-18, Section 4. Income Tax Forecasts, December 2016

[8] Scottish Parliament Information Centre (SPICe), information taken from the Financial Scrutiny Unit Briefing – Earnings in Scotland 2016 , November 2016

3.6 One particular sector highlighted was the Mining and Quarrying sector, which includes the Oil and Gas industries. The reduction in oil prices has affected average wages. Consequently, Aberdeen Council Area saw the second biggest fall in workplace wages while the Mining and Quarrying sector saw the biggest fall in wages by sector.[9]

3.7 Public sector pay accounts for approximately a quarter of the sources of NSND income in Scotland.[10] This income source has been subject to pay restraint for a number of years and if continued would also factor in an assessment of overall earnings growth. Scottish Government forecasts indicate that public sector pay growth will be 2.2%, reflecting actual growth from 2009/10 to 2013/14.[11] This element of overall Scottish wages may grow higher if the current pay cap is lifted through policy intervention. CIPFA notes the recent announcement by the Scottish Government to lift the 1% pay cap for public sector workers.[12]

The EU Workforce in Scotland

3.8 The position on assessing the impact of Brexit on earnings growth will therefore be complex. It can be seen that there are a range of factors that will impact earnings growth, some not related to Brexit, and these are likely to be different across sectors.

3.9 Growth in the number of taxpayers presents a further challenge to Scottish Tax levels. Evidence to the House of Lords European Union Committee[13] noted that since 2000, EU immigration is estimated to have contributed 50% of the net population growth in Scotland. EU nationals were also a higher proportion of foreign nationals (61%) compared to the UK average (56%).

3.10 Access to EU labour is important to Scotland across a range of sectors and industries both public and private sector. The House of Lords European Union Committee report concluded that the Scottish

[9] Scottish Parliament Information Centre (SPICe), Financial Scrutiny Unit Briefing – Earnings in Scotland 2016 – executive summary key points, November 2016
[10] Scottish Government Draft Budget 2017-18, Devolved Taxes Methodology – Table 13, December 2016
[11] Scottish Fiscal Commission: Report on the Draft Budget 2017/18 – Table 7. December 2016
[12] Nicola Sturgeon to end 'unsustainable' 1% pay cap in Scotland – Civil Service World, May 2017
[13] House of Lords European Union Committee – 4th Report of session 2017-19, Brexit: Devolution evidence sessions, July 2017

economy has particularly pressing needs, including its reliance on access to EU labour. This is particularly acute in sectors such as health and social care, agriculture, food and drink and hospitality. The report also noted Scotland's demographic needs in relation to EU migration to enable its population (and in particular, that of working age) to grow.

3.11 The uncertainty surrounding the status of EU citizens and future UK and EU trading relations has led to a shift in attitudes towards the UK as an attractive place to work. Recent research[14] suggests that Brexit has shifted perceptions. For those based outside the UK, 21 per cent now find the UK less attractive, compared to 48 per cent for those based in the UK. Overall, 36 per cent of non-British workers based here are considering leaving in the next five years. Further, high-skilled EU workers are most likely to leave - 47 per cent over the next five years.

3.12 While this survey is UK based and not specific to Scotland, the risk presented is one that requires consideration in Scotland due to its reliance on EU labour and the implications for growth in the workforce and resulting tax base. Evidence is also available that some of this shift in attitudes is materialising in advance of the UK's formal exit from the EU in 2019.[15]

The Block Grant

3.13 The other element in income for spending on public services within the Scottish Budget is the Block Grant allocation from the UK Government. This is adjusted to take account of the transfer of revenue from the UK Government, reflecting the devolution of tax powers to Scotland. There is a baseline adjustment at the point of transfer, based on tax levels from the year prior to devolution. This is then indexed going forward and the indexing system will be reviewed following the next Scottish Parliamentary elections in 2021.

Assessing the Financial Impact

[14] Deliotte – 'Power up the UK workforce report', 2017
[15] 96% drop in EU nurses registering to work in Britain since Brexit vote, Nursing and Midwifery Council (NMC) statistics reported in the Guardian, June 2017

3.14 The financial risks outlined above in relation to earnings growth and growth in the number of taxpayers means that there could be a detrimental impact on Scottish revenues if the actuals are lower than forecast and less than the block grant adjustments. Conversely the level of Scottish revenues will be favourable to the Scottish Government if actual levels exceed forecasts and the block grant adjustment levels.

3.15 Quantifying the specific impact on the budget is challenging. In a spirit of assistance however, we have reviewed and summarised available research. Recent studies into the impacts of the UK leaving the EU can be applied to Scotland's long-term economic performance. The results suggests that if the UK adopted an alternative trading relationship with the EU, it could potentially reduce Scottish GDP by up to £11.2 billion per year by 2030, compared to what it could be if Brexit did not take place.[16]

3.16 Such an impact would reduce tax revenue, and in turn public spending. These studies suggest that leaving the EU could reduce Scottish tax revenues by between £1.7 billion and £3.7 billion a year by 2030. This is equivalent to a reduction in the Scottish Government budget of between 6% and 13%.[17]

3.17 It is clear that the importance of accurate revenue forecasting cannot be overstated. The Scottish Fiscal Commission have assessed the Scottish Government methodology for tax forecasts as reasonable. Nevertheless it is a new system and will require monitoring and refining through experience.

3.18 The level of block grant itself is also subject to the fiscal policies of the UK Government. As outlined in the Draft Budget for 2017/18, between 2010-11 and 2019-20, the Scottish Government's Departmental Expenditure Limit (DEL) from HM Treasury will fall by over nine per cent in real terms – the equivalent of over £2.8 billion.[18]

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[16] Scottish Government: Potential Implications of the UK Leaving the EU on Scotland's Long Run Economic Performance, August 2016. Assessing data based on European Economic Area membership, Free Trade Agreement with the EU and World Trade Organisation rules.
[17] UK level estimates taken from HM Treasury (2016) - The long-term economic impact of EU membership and the alternatives. Per capita impact is assumed for Scotland. Scottish Government budget refers to fiscal DEL budget for 2015-16
[18] Scottish Budget: Draft Budget 2017-18 – Strategic Context Chapter 1. December 2016

In regard to the overall revenue levels from block grant and taxation, this does place a greater emphasis on ensuring that forecast levels of taxation are monitored and reviewed.

3.19 Should the Scottish Government make policy interventions in the area of taxation levels, it would need to be mindful of any potential spill over effects. The Fiscal Framework[19] agreement does allow for directly observable effects to be taken into account resulting in compensatory transfers between the Scottish and UK Governments.

3.20 The fiscal framework also notes that compensatory transfers can come into play for material and demonstrable behavioural effects in exceptional circumstances. Decisions on any behavioural effects to take into account will be made by the two Governments. In this context, materiality is not defined.

[19] The Agreement between the Scottish Government and the United Kingdom Government on the Scottish Government's fiscal framework – paras 44-53, February 2016

4. Longer-term Budget issues

4.1 During the period prior the UK's exit from the EU and for longer-term planning there are a number of financial management and budget issues which need to be considered, these include:

- The potential for Scotland to contribute to the UK's divorce final settlement from the EU (generally referred to as the divorce bill);
- the continuation of EU Funding streams, both structural funding and CAP payments;
- core competences of the Scottish Government; and
- the impact of the final deal on the future relationship with the EU

The EU Settlement Bill

4.2 In regard to the EU settlement bill (the 'divorce' bill) which will arise as a result of departure from the EU, it is, at the time of writing unclear what the final amount will be or what the UK governments position is in relation to funding any settlement. The EU has been clear that when the UK leaves, it is expected to pay off its share of the liabilities.[20] In the opening negotiations both sides will seek to agree on the methodology for calculating the bill, and the actual figure will be finalised at the end of negotiations.

4.3 We highlight whether there will be any requirement for devolved administrations to recognise a share of this liability. If it is determined that there is a requirement to share the liability across the UK devolved governments, the question will become how this might be allocated. What we do know from the EU, is that it is

[20] The Council of the European Union: Directives for the negotiation of an agreement with the United Kingdom of Great Britain and Northern Ireland setting out the arrangements for its withdrawal from the European Union, May 2017

seeking a single financial settlement as outlined in their position paper.[21]

4.4 EU funding streams of course play an important role in the overall support for public services, important sectors of the economy and research and innovation. Prior to the EU referendum in June 2016, Scotland expected to receive €5.6 billion over the seven year period from 2014 to 2020.[22] Scotland was set to receive 14% of the UK funding between 2014 and 2020 compared to its population share of 8.3%.[23]This meant that EU funds were proportionately more important to Scotland than to any other part of the UK.

4.5 EU funds include payments to farmers through CAP Pillar 1 programme, allocations towards economic development through structural funds of €941 million, CAP Pillar 2 rural development of €478 million and European Maritime Fisheries Fund of €108 million. There are additional competitive funds, separate to the allocated funds above, that are open to bidding such as Horizon 2020, supporting research, and Eramus+ supporting education and youth training.

4.6 The UK Government have given short-term certainty over this funding as the Chancellor of the Exchequer, Phillip Hammond, announced[24] that the UK government will guarantee EU funding for structural and investment fund projects, including agri-environment schemes, signed up to the point at which the UK departs the EU and which continue after we have left the EU.

4.7 Any funding decisions in 2020 and beyond once the UK has exited the EU remains unclear. These decisions will need to be made by the Scottish and UK Governments as many structural funds are likely not to be available for projects and organisations in Scotland. The precise nature of the future relationship with the EU will also determine whether Scotland can access any competitive funds or not.

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[21] European Commission: Position paper transmitted to the UK: essential principles on the financial settlement, June 2017

[22] Scottish Parliament Information Centre (SPICe): European Union Funding in Scotland 2014-2020, November 2016

[23] Based on 2015 population data

[24] Further funding certainty for hundreds of British projects which are reliant on EU funding, announced by the Chancellor.. HM Treasury – October 2016

4.8 Consideration and planning for the replacement or alternative funding needs to take place during this parliamentary period in order to be understood and in place prior to EU exit. There is the potential for implications for the Scottish Fiscal Framework as this alternative funding is likely to come from the UK Government in a form yet to be agreed.

4.9 How CAP payments will be allocated after 2020 is also unclear. What is known is that Scotland will receive approximately 16.3% of CAP pillar 1 payments allocated in the period 2014-2020, compared to its population share of 8.5% noted above.[25] If this were to be administered via the population share based Barnett formula going forward, this would result in a significant reduction in funding post 2020. Between now and 2020 an agreed mechanism of funding farm payments must be found.

Long Term Planning

4.10 At a more strategic planning level for public finances, there is the questions of the final agreed deal on the future relationship with the EU. The Scottish Government has set out is position in relation to its preferred relationship with the EU post Brexit. This is within the operation of the single market in the EU. However, this contrasts with the position of the UK government which has outlined its intention to leave both the single market and customs union as they currently operate.

4.11 As noted above, the Scottish Government's own research[26] into the long-term implications of leaving the EU, indicate that anything less that staying with current arrangements could reduce Scottish tax revenues by between 1.7bn and 3.7bn a year by 2030. Resulting in a reduction between a 6% and 13% to the Scottish Government budget based on the 2015/16 fiscal Departmental Expenditure Limit (DEL) level.

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[25] Figures obtained from Department for Environment, Food and Rural Affairs press release: UK CAP allocations announced, November 2013. https://www.gov.uk/government/news/uk-cap-allocations-announced

[26] Scottish Government: Potential Implications of the UK Leaving the EU on Scotland's Long Run Economic Performance, August 2016. Assessing data based on European Economic Area membership, Free Trade Agreement with the EU and World Trade Organisation rules.

4.12 While much will depend on the final deal between the UK and EU, it does not detract from the need to assess potential financial risks and the need to ensure the long-term sustainability of public services and supporting finances. The recommendations from the recent report published by the Budget Process Review Group[27] proposes a number of budget process changes that would facilitate long-term budgetary planning. These include:

- Introduction of a Medium-Term Financial Strategy (MTFS). This would involve the Scottish Government setting out its expectations and broad financial plans/projections for at least the next five years following the UK Government's Spring Budget Statement.

- Publication of a framework document setting out the economic and political context, the criteria which will govern the assessment of budgets and the process and timetable for the review.

4.13 The MTFS should be published annually following the UK Spring Statement on a five year ahead rolling basis. This would enable a medium-term perspective on the public finances to be maintained throughout each parliamentary session.

5. Brexit Advisory Commission for Public Services

5.1 The Brexit Advisory Commission for Public Services was established in 2017 to develop the case for the best possible Brexit deal for the public sector based on analysis of the risks and opportunities. The Commission consists of independent commissioners, all experts in their field. The Brexit Commission will also collaborate with organisations in the sector to ensure Brexit results in public services becoming more empowered, self-sufficient and sustainable thereby reducing regional disparities and boosting the quality of services for those that rely on them.

5.2 Throughout the Brexit negotiation process, the Commission will share practical insight on the risks and opportunities for the sector and will develop recommendations on how Brexit can be a success for public

[27] The Scottish Parliament Finance and Constitution Budget Process Review Group: final report, June 2017

services and the people who rely on them. The Commission, in its work to protect and boost the sustainability the sector, will explore the following three themes:

- The fiscal and funding landscape;
- policy choices within the sector; and
- capacity to deliver and transform services.

5.3 Further information on the Brexit Advisory Commission can be found here.