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Rt Hon Philip Hammond MP
Chancellor of the Exchequer
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3 March 2017

Dear Philip

I am writing to set out the key issues that the Scottish Government wishes to raise ahead of the Budget on 8th March.

It is now clear that the impacts of the UK's referendum result are starting to feed through to the wider economy. Rising inflation is expected to weigh on household finances over the coming year and the pursuit of a hard Brexit is a source of significant uncertainty and risk to the economic outlook.

It is therefore imperative that the Budget sets out measures to support economic growth and protect households from further austerity.

Implications of Brexit

There is a clear consensus that leaving the European Union will damage the UK economy and the costs of a hard Brexit have been outlined by a wide range of economic forecasters and think tanks – including HM Treasury. This could have a serious impact on the Scottish economy. It has been estimated that leaving the Single Market could reduce Scotland's GDP by around £8 billion per year and result in 80,000 fewer jobs in the Scottish economy after 10 years, compared to a scenario in which the UK remained in the EU.

At the same time it is increasingly clear that alternative trade agreements will not only take time to develop but are a considerable distance from offering the same value of trading opportunities as the single market currently provides for the Scottish economy, making the approach of a "Global Britain", a poor substitute for our current position within the single market.

It is therefore vital that the UK Government continues to engage meaningfully with the Scottish Government on our proposals for keeping Scotland in the Single Market, as set out in *Scotland's Place in Europe*, and on the emerging economic and financial implications of exiting the EU.

Free movement of labour is of particular importance to Scotland's economy, and non-UK EU nationals make a vital contribution across a wide range of sectors. There are currently around 181,000 non-UK EU nationals living in Scotland, bringing new skills and expertise across a wide range of sectors and in turn helping to underpin future productivity growth and making a positive contribution to the public finances. It is therefore vital that the UK Government clarify the immigration status of non-UK EU nationals living in the UK as a matter of urgency.

Free movement is also crucial in relation to the growth of our population, and ultimately the growth of our economy. In Scotland inward migration makes a significant and positive contribution to population growth. For example, we know that the population of Scotland is projected to increase by 7% between 2014 and 2039, and that 90% of the increase in Scotland's population over the next ten years is projected to come from migration. And so, any move which limits migration, whether from within or beyond the EU, has the potential to seriously harm Scotland's economy.

We are also seeking greater clarity on how the UK Government will arrive at decisions on post 2020 funding programmes currently supported by the EU, a significant proportion of which relate to devolved areas of responsibility.

Scotland, and Scottish Higher Education Institutions in particular, benefit disproportionately well from Horizon 2020 in comparison to the UK as a whole, with Scottish HEIs securing a total of €217.5 million under Horizon 2020 (up to September 2016) based on our world-class research. While the UK Government's guarantee on Horizon 2020 funding was welcome as far as it goes, it failed to recognise what we would otherwise have received as continuing members of the EU.

Finally, we are seeking confirmation that, under Pillar 2 of the CAP, the annual *Less Favoured Area Support Scheme* (LFASS) 2019 will be honoured in full, if the date that the UK leaves the EU predates the closure date of the application window in 2019. We are also seeking consideration of guaranteeing support for 2020, in line with CAP Pillar 1 guarantees, as it provides vital income support for farmers and crofters in Scotland.

Fiscal Consolidation and Impact on Households

Earlier this week, you asked Government Departments to draw up proposals for spending cuts of up to 6%, with the aim of saving an additional £3.5 billion in 2019-20 as part of the UK Government's Efficiency Review. In addition, recent analysis by the Institute for Fiscal Studies highlights that austerity could stretch well into the middle of the next decade. This increased austerity would pinch at precisely the point when the UK government's planned departure from the EU is expected to take place. The Scottish Government has long opposed the UK Government's austerity agenda which disproportionately hurts the poorest and most vulnerable in society. With Brexit posing an unprecedented risk to the UK economy, the public finances and consumer confidence, this is certainly not the time for more austerity but for supporting economic growth through further investment.

The level of discretionary budget available to the Scottish Government is already facing a real terms cut of 9% over the ten years to 2019-20, and that is before the impact of the additional £3.5 billion of cuts that the UK Government has yet to make in 2019-20 are taken into account. Further cuts of this magnitude will have a significant impact on our budget and spending priorities.

We therefore require reassurances that you will not pass on any further austerity and make additional budget cuts on top of the real-terms reductions in spending power already imposed on Scotland.

Moreover, the £12 billion of planned welfare cuts is expected to have a severe impact on the most vulnerable people in Scotland. We are also very concerned that changes to Personal Independence Payment legislation announced just last week could exclude tens of thousands of disabled people from the financial help they need. Rising inflation, in combination with the freeze to working age benefits, will put further pressure on households' budgets, pushing more households into poverty and debt and the need for other services including emergency crisis grants and charitable aid.

In the light of these challenges, I hope that you use the Budget to change course. In particular, I would urge you to halt the proposed changes to limit the individual child element of Child Tax Credit and the Child Element of Universal Credit to a maximum of two children, and also reverse the reduction in the benefit cap which impacts hardest on low income families. Further, I also ask you to reconsider the proposed reduction to the ESA work-related activity component which will inflict further pain on this group of claimants, who are already subject to the ongoing freeze to working age benefits.

As previously requested in my letter of the 12 November 2016, I would again urge you to overturn the policy on the changes to work allowances in Universal Credit which results in financial suffering for families and consider the hardship being caused by the in-built delay of six weeks and the seven day waiting period for Universal Credit payments.

Fiscal Framework

Your decision to move the date of the budget to an annual Autumn publication has implications for the Scottish Government's budget cycle. I welcome David Gauke's commitment to engage with us in developing the new timetable and ensuring that steps are taken to support and respect our budget processes. The Block Grant and Block Grant Adjustment have a material impact on our spending power and delayed publication of the Autumn Budget would have serious implications for budget preparation and parliamentary scrutiny in Scotland. To this end, I would welcome your own support for future engagement between our administrations on these matters and ask greater clarity on your intentions with regard to when and how financial and tax information will be published as part of your intended changes to the UK Government's fiscal calendar. You will be aware that the Scottish Government's budget process and timings require agreement with the Scottish Parliament which is currently reviewing the budget process. As such early engagement is essential.

Industrial Strategy, Energy and North Sea Oil and Gas

The Prime Minister has put considerable focus on the importance of industrial strategy to the UK Government. As you will be aware the Scottish Government's Economic Strategy includes a focus on key areas of our economy for example through our manufacturing strategy and support for industries such as life sciences and financial services.

As part of your consideration of an industrial strategy, we have raised on a number of occasions the importance to the Scottish and UK economy of the energy sector, and the negative impact of your government's decisions in relation to renewable energy. Onshore wind – as the lowest cost renewable technology – should be a vital component of the UK's Industrial Strategy and plans for emissions reductions. Alongside this, there is a need to maintain support for the North Sea, and the Scottish Government stands ready to work with the industry, the regulator and the UK Government to develop a 'sector deal' for this crucial industry.

There are encouraging signs that the oil and gas industry is beginning to emerge from its downturn thanks to the efforts of the industry and its workforce. Production is increasing and costs are falling. However, it is clear that the long-term sustainability of the sector continues to require urgent action from the UK Government.

In order to Maximise Economic Recovery from the North Sea, it is essential that assets are in the right hands – with no barriers to late life asset transfers – there is access to capital for investment, and that critical pieces of infrastructure remain operational to allow the full potential of existing and new production to be realised.

This is of particular significance when fields are maturing and opportunities exist for companies with a competitive advantage, or focus in operating late-life assets, to assume ownership. Recent Merger and Acquisition activity has highlighted the appetite of such companies to invest in North Sea assets. Reforms should be made by the UK Government to help encourage such behaviour through improving access to decommissioning tax relief, which could extend field life and reduce decommissioning costs.

Another key priority is ensuring that critical offshore infrastructure remains operational. One year on from the announcement at the March 2016 Budget, the UK Government should deliver on its commitment to provide loan guarantees to the industry. This could unlock capital and stimulate new investment – providing a much needed boost to the supply chain, which is being hardest hit by the recent slowdown.

Exploration activity also remains low – with only 15 exploration and 8 appraisal wells drilled in 2016. Initiatives such as the Oil and Gas Authority's seismic programmes and the £180 million Oil and Gas Technology Centre will have a positive impact on activity in the long term, however, given the levers held by the UK Government, further support for exploration is required to help ensure the 20 billion barrel potential of the North Sea is realised.

While Maximising Economic Recovery should remain our key priority, the emerging decommissioning market also presents significant economic opportunities. With more than £17 billion expected to be spent over the next decade, action is required to ensure that the domestic supply chain has the capacity to secure as much of this work as possible. The Scottish Government has published our Decommissioning Action Plan and recently launched a £5 million Decommissioning Challenge Fund (DCF) to identify key developments for further investment. In response, I urge the UK Government, having been a significant beneficiary of the North Sea, to work with us, the Oil & Gas Authority and industry to also consider funding those projects that demonstrate they can improve the capacity of Scottish sites for securing decommissioning, dismantling and disposal contracts.

City Deals

I would also like to take this opportunity to welcome your announcement in the Autumn Statement of the UK Government's willingness to join us in developing city region deals for Stirling/Clackmannanshire and for the TayCities. You will be aware that Scottish Ministers have been consistent that these should be available to all Scotland's cities and I am glad that tripartite discussions are now imminent.

I understand that the three Ayrshire Councils have written to you to seek UK Government investment in a regional Ayrshire Growth Deal. I am fully supportive of the ambitions of the Ayrshires and we are already working with them on their growth deal proposals. I believe that a shared approach offers the best opportunity to deliver a package of measures for the region that will result in better regional economic outcomes for the benefit of both the Scottish and the UK economies and I invite you to join us in tripartite discussions.

I am also aware that the three Islands Councils' of Orkney, Shetland the Western Isles have just recently submitted draft proposals to the Scottish and UK Governments for 'A Deal for the Islands'. I would hope you would enter into positive tripartite discussions with us and the Islands Councils' on how best to take these proposals forward, honouring the commitment given to the Councils in the UK Government's Framework document, agreed with them in August 2014.

I trust that you will consider the issues I have outlined above, and that you will reflect them in your Budget on 8th March.

Yours

DEREK MACKAY

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