Fiscal Affairs Scotland

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Scotland's future funding arrangements: implications of the 2014-15 first-half North Sea tax revenues out-turn and longer term forecasts

The implications for Scotland's future public finances of the level of North Sea oil tax revenues (NSOR) may be less important now, given the No vote at the Referendum. Nevertheless, they could still be highly significant depending on what is agreed over the future funding mechanism for Scotland, post the Smith Commission deliberations.

North Sea Tax Revenues - April to September 2014

- The first half of the financial year 2014-15 has seen North Sea Oil & Gas related tax revenues (NSOR) for the UK amount to £1.1 billion. This is almost £1 billion less than was received for the same period in 2013-14, ie, just over half of last years level.
- Corporation Tax (CT) payments in September (the first of this financial years three CT payments, with subsequent payments due in December 2014 and March 2015) were £860 million, a fall of £446 million (-34%) on last year, while payments of Petroleum Revenue Tax (PRT) for the first half of the financial year were £247 million, a fall of £455 million (-65%) compared to the first half of 2013-14..
- The Office for Budget Responsibility's (OBR) estimate of UK NSOR for the full financial year 2014-15 is £3.7 billion, while those by the Scottish government go as high as £6.1 billion.
- It will take a considerable bounce back in the second half of the financial year for anything approaching the Scottish government's top of the range forecast to be reached. Production levels have been flat for the first five months of the financial year compared to the same period last year, and the oil price has recently fallen below $90 per barrel, which suggests such a bounce back is currently unlikely.

Implications for Scotland's fiscal balance and for the Smith Commission's negotiations

- If, as part of its deliberations, the Smith Commission were to consider the impact of a move to something approaching full fiscal autonomy, then fluctuations in NSOR will need to be taken into account as they could have a significant impact on Scotland's budget. By fiscal autonomy we mean that all taxes are either controlled by, or assigned to, the Scottish government.
- To highlight the potential impact, Table 1 illustrates the effect on Scotland's fiscal balance position based on two different funding scenarios. The first scenario is consistent with the current (Barnett formula related) system, where Scotland's fiscal budget is implicitly based on its

population share of the UK's fiscal balance (see Line 4 of Table 1). The second scenario is consistent with full fiscal autonomy for Scotland, which includes receiving its geographical share of NSOR.

- Given the lack of certainty over the future level of NSORs, the second scenario utilises two possible ranges for this:
  (i) the OBR's forecast used in the 2014 UK Budget (see Line 2 of Table 1),
  (ii) the Scottish Government's highest forecast, as shown in its latest oil and gas analytical bulletin (see Line 3 of Table 1).
- Even after incorporating such a wide range of oil revenue forecasts, the related fiscal outcomes suggest that Scotland would have a bigger deficit (see Lines 6 and 7 of Table 1) under full fiscal autonomy, as it increasingly replies on NSORs, than under the current Barnett arrangement (see Line 4 of Table 1).
- Table 1 shows that, if such an arrangement had applied for the current fiscal year (ie, 2014-15), then the negative differential would be worth between almost £5 billion, using OBR's estimates, and £2.6 billion, using the Scottish government's own top-of-the-range estimate. The latest NSOR figures, for the first half of this financial year, discussed earlier, suggest the differential is likely to be nearer to the former than the latter.
- Using the OBR's forecasts this negative differential grows a little larger by 2016-17, when it rises to over £5 billion (Line 6 minus Line 4 in Table 1) whilst using the Scottish government's uppermost NSOR forecast (well over double what OBR forecast) it is still over £0.5 billion (Line 7 minus Line 4 in Table 1).
- What this analysis illustrates is that movement away from the current Barnett arrangement to one which relies more on the retention of taxes generated in Scotland could put the existing level of Scotland's public spending at risk.
- The analysis clearly illustrates the significant variability currently facing Scotland if these taxes were to include NSORs. Under the most recent NSOR forecasts, produced either by the OBR or by the Scottish government, full fiscal autonomy would result in Scotland continuing to have a negative fiscal balance in 2018-19 even though by then the UK is projected to be in fiscal surplus.

This analysis may need to be taken into consideration by the Smith Commission when considering how best to change the existing arrangements.

Quotes:

Jo Armstrong: *"North Sea oil-related tax revenues have continued to decline in the first half of this financial year, following on from a disappointing performance in the last two years. At these levels even the Office for Budget responsibility's forecast for such revenues in 2014-15 may prove to be over optimistic. Given the recent decline in oil prices, it is difficult to see how any substantial bounce back will come about this year."*

John McLaren: *"The latest oil revenue data brings into focus Scotland's future fiscal position under different funding scenarios. In particular, the Smith Commission needs to take into account the potential impact of continuing relatively low levels of North Sea revenues on Scotland's budget,* *if North Sea revenues are to be part of any negotiated package. Our calculations suggest that, across a wide range of assumptions, full fiscal autonomy could lead to a significant shortfall in funding over what the current system delivers."*

Table 1: North Sea Oil revenues and Fiscal Balance projections for Scotland

		Out-turn			Forecast		
	(all figures shown in £, billion)	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2016-17** **	**2018-19**
	North Sea Oil Revenues						
1	Outturn	9.7	5.2	4.0			
2	OBR forecast*				3.3	2.9	3.2
3	Scottish government forecast (top end)*				5.6	7.8	8.0
	Fiscal Balance						
4	Assuming population share of UK position	-9.8	-9.6	-9.0	-8.0	-3.7	0.4
5	Under Fiscal Autonomy	-8.9	-12.4	-13.1			
6	Under Fiscal Autonomy (inc OBR NSOR)				-12.9	-9.3	-5.2
7	Under Fiscal Autonomy (inc SG NSOR)				-10.6	-4.4	-0.4

Sources:

1 SNAP Table J, Scottish government website;

2 Consistent with OBRs 'Economic and Fiscal Outlook' (March 2014) and with Scottish governments 'Scottish Oil & Gas Analytical Bulletin' (May 2014), scenario 1;

3 Scottish government's 'Scottish Oil & Gas Analytical Bulletin' (May 2014), scenario 6;

4 Consistent with OBRs 'Economic and Fiscal Outlook' (March 2014);

5 Consistent with GERS, adjusted for latest NSOR data;

6 Estimated by Fiscal Affairs Scotland based on past trends for onshore revenues and expenditure and consistent with the OBR's NSOR forecast;

7 Estimated by Fiscal Affairs Scotland based on past trends for onshore revenues and expenditure and consistent with the Scottish government's highest (scenario 6) NSOR forecast.

* Assumes a Scottish geographic share of 90% of the UK total post 2013-14.

** The Scottish government also published figures for 2016-17 which are similar, but not identical to, those shown above (this can be calculated from data in 'Outlook for Scotland's Public Finances and the Opportunities of Independence' document (May 2014)). Their forecast is consistent with a slightly smaller Scottish deficit, by around £0.6 billion in that year.

Background Notes

Under the present Barnett block grant system, annual changes to Scotland's budget are roughly in line with those seen for the UK; where the level of UK public spending is determined by UK-wide revenues, the level of borrowing (which is currently falling) and an overall UK fiscal target. This helps to perpetuate, in cash terms, Scotland higher level of spending per person compared to the UK as a whole.

However, the nearer Scotland gets to fiscal autonomy then the more its annual budget will rely on Scottish-based taxes which, at existing levels of projected oil revenues, would be insufficient to sustain this spending per person differential.

The fiscal balance outcome could of course be further affected by choices made in relation to tax rates and bands. However, the outcome of such changes is difficult to know in advance and, at present, very few such differences have been proposed.

Some areas of potential fiscal policy variation that were advocated at the time of the Referendum seem less likely to play a significant role any more. For example, previously understanding Scotland's fiscal balance position was complicated by competing claims over Scotland's share of UK debt and its related interest payments post-independence. Under the current Barnett arrangement it seems reasonable to assume that Scotland continues to support its population share of both (as is assumed in the data analysis contained in the Scottish government's GERS publication).

Equally, the ability of the Scottish government to alter spending in reserved areas such as Defence and International Aid is diminished, meaning Scotland is likely to continue to bear a population share of the UK's projected expenditures for both.

Given this continued debt and reserve spending arrangement, the range within which Scotland's future fiscal position is likely to lie is, therefore, somewhat easier to determine.

The scenarios outlined here warn of the potential dangers to the size of Scotland's budget from moving towards fiscal autonomy. While this danger is lessened the further we move from full fiscal autonomy, the risk of Scotland's budget being lower than under the existing (Barnett related) system remains.

This danger arises because, while Scotland's share of onshore UK tax revenues is roughly in line with its population share, its share of UK public expenditure is well above this population share. Historically, such a funding gap has often been matched, or more, by Scotland's assumed geographic share of NSOR. However, future levels of NSOR (as forecast by either the OBR or the Scottish government), suggest that this is unlikely to remain the case.

This analysis illustrates the pivotal role that erratic NSORs might play in Scotland's finances, should they explicitly feature in a future Scottish funding settlement. It also highlights the difficulties and possible dangers of moving towards full fiscal autonomy when NSORs are expected to remain below the 'break-even' point, ie where the revenues raised fail to compensate for the higher per capita expenditure Scotland currently receives under the existing Barnett system.

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