# Long-term Scottish budget projections

November 2014

John McLaren
Jo Armstrong

AP/2014/003

## EXECUTIVE SUMMARY

- At present, both Scotland and the UK are roughly half way through the series of annual budget reductions intended by the UK coalition government to take the UK back to a balanced budget.

- For the first decade of the new Scottish Parliament the Scottish budget rose around 5% a year, in real terms. However, the second decade of the Parliament coincided with a likely real terms fall in its budget of around -2% a year.

- Our ‘baseline’ scenario, going from 2009-10 to 2018-19, incorporates the public service spending projections used by the UK Office for Budget Responsibility for later years. This results in an overall cash terms cut to the Scottish budget of just over -4% and a real terms cut of almost -20% over this period. At present (2014-15) the real terms cut since 2009-10 stands at -10%.

- The profile of cuts over the full nine years is: two years of deep cuts, followed by four years of milder cuts (where we currently sit), followed by the prospect of three more years of deep cuts.

- Projections from 2015-16 to 2018-19 have the Scottish Barnet Block grant falling by -1.6% a year in cash terms and -3.5% a year in real terms, which is almost the same rate of decline as experienced in the first two years of austerity. Adding in the Scottish government’s projections for Non Domestic Rates Income and Council tax revenues means the real terms fall would be ameliorated to -2.7% a year.

- While most of the intended cuts to the Capital budget in Scotland happened in the first two years of austerity (i.e., in 2010-11 and 2011-12), for spending on day-to-day services, the biggest cuts are still to come.

- Continued protection of the NHS budget will result in the cuts to non-protected areas being over 50% higher than that of the average, i.e., nearer -30% over the full period.

- Upside scenarios are possible; (i) if UK austerity measures are tempered and, (ii) the Scottish government takes advantage of its increased borrowing powers. In the event that both such boosts occurred, the budget cuts post 2015-16 could be more reminiscent of the current ‘mild’ phase of austerity rather than a return to the ‘deep cuts’ phase .

- Potential boosts to the UK and Scottish budgets would affect the Capital budget, which could improve dramatically. However, at present, there is no obvious source of extra funding for the day-to-day spending budget and its relatively steep decline looks set to continue.

- Beyond 2018-19, the UK Office for Budget Responsibility expects spending growth to return to more ‘normal’ levels. However, this very much depends on the continuing, highly uncertain, fortunes of the world, UK and Scottish economies.

- The general picture on future austerity is likely to apply regardless of the political circumstances facing Scotland, and regardless of the Smith Commission findings, at least until 2018-19.

- Stronger economic growth will however be the key to ensuring that more widespread real terms increases in the funding of public services are possible, as opposed to the existing preferential increases for some budget recipients at the expense of the rest.

## INTRODUCTION

This Fiscal Affairs Scotland Analysis Paper aims to assist those who are reliant on public funding, to plan their future spending plans by providing projections for the Scottish government's discretionary budget (otherwise known as the Barnett Block grant or Departmental Expenditure Limit (DEL)) for the years up to 2018-19.

These projections need to be seen in context. First, the rationale behind the current fiscal austerity measures needs to be understood as this helps outline any room for radical departure during the projection period (and beyond). Secondly, the extent to which any future Block grant allocation is viewed as being adequate or an improvement on past levels, necessitates a review of how Scotland's Block grant allocation has changed since its peak year in 2009-10.

Finally, while the UK and Scottish budgets are largely already fixed for 2015-16, looking further ahead offers more scope for different spending scenarios to emerge and we consider these later in the paper.

## BACKGROUND

Before examining the likely prospects for the Scottish government's future budget, it is worth reflecting on the wider context within which these year-on-year budget reductions are taking place.

### Economic and fiscal growth and decline - a recent history

From the late 1990s to 2008 the world economy grew at a fairly steady rate and with little inflationary threat. As a result, governments grew more confident that such growth was sustainable and that public spending could also rise at a similar, or higher, rate.

However, much of this growth was without firm foundations, particularly in the financial services and construction industries. When a number of national housing markets collapsed, causing great financial distress to the associated banking sector, economic growth around the main developed economies faltered or fell.

The OECD-wide economy contracted in 2009 by 3.5% in real terms; the first time this has happened since records began in 1971. Recovery has also been slow. The UK has only recently passed its previous, 2008, peak and it still below it in terms of GDP per person. Normally, given the depth of the decline experienced in the UK during the recession, the bounce-back would have been expected to be much quicker and much stronger.

As a consequence, governments around the developed world found themselves with large fiscal deficits, as declining tax revenues fell well short of existing levels of public spending. Initially this was tolerated by most governments as means of preventing further economic decline by using the public sector to stimulate demand.

However, after a few years of such fiscal boosts, most countries began to put in place fiscal targets in order to achieve something approaching fiscal balance (i.e., where taxes raised are deemed sufficient to cover anticipated public spending commitments) and to stop debt levels continuing to rise.

### The UK government's response

In 2010, the newly elected UK coalition government inherited a Labour government's manifesto plan for balancing the budget, but then sought to accelerate the pace of the fiscal tightening.

Since then, slower than expected growth of the UK economy has led to plans and targets being re-calibrated and the period of austerity has been lengthened, although the actual degree of adjustment remains roughly the same. At present, the UK government has achieved about half the level of cuts needed to achieve its long term plan of fiscal rebalancing (see also Box 1).

### The Scottish budget post devolution

As a result of these economic ups and downs, the Scottish Barnett Block grant budget has experienced very different fortunes moving between the first and the second decade, post devolution.

In the first decade it rose by an average of about 5% a year in real (i.e., inflation adjusted) terms. This was well above the longer term average growth rate seen in recent decades. For example, the annual growth in total UK public expenditure from 1972 to 1999 averaged around 2%. However, in the second decade of devolved government this exceptionally high growth rate turned into an exceptionally low one, and actually turned negative, averaging around -2% a year, in real terms.

### Differing degrees of austerity in the UK

The period since real terms spending peaked (in 2010-11 for the UK) has been characterised as one of ‘austerity’ but, the degree to which different budgets have been affected has varied widely. (Note that while **total UK public spending** peaked in 2010-11, spending on the **Public Services** element of the total peaked a year earlier, for both the UK and Scotland, and this is reflected in the starting year used in later Tables and Figures.)

Public spending can be measured in a variety of ways. As a consequence, care is needed when discussing the extent to which, and where, austerity has occurred since 2010-11. Table 1 highlights some of these different public spending measures, in both cash and real terms (2013-14 prices), for the period 2010-11 to 2018-19.

**Table 1: Changes in UK public spending totals**

| | Total % change between 2010-11 and 2018-19 | |
|---|---|---|
| | **Cash terms** | **Real terms** |
| Total Public Spending | 11.8 | -3.9 |
| Benefits & Pensions | 34.5 | 18.8 |
| Public Services | -7.8 | -23.5 |

Source: OBR, Economic and Fiscal Outlook, March 2014, Table 4.15 for real figures; cash calculated by Fiscal Affairs Scotland using UK GDP deflator.

Note: in more technical language, Total Public Spending is known as Total Managed Expenditure (TME), Benefits & Pensions as Annual Managed Expenditure (AME) and Public Services as Departmental Expenditure Limits (DEL) spending.

<u>Total Public Spending</u> has continued to rise in cash terms every year and this trend is forecast to continue. Even in real terms (i.e., after adjusting for inflation), this spending fell in only one year (2011-12). Since then it has effectively been flat-lining.

Spending on <u>Benefits and Pensions</u> accounts for half of total UK public spending. This has risen in both cash AND real terms every year, and this trend is forecast to continue due to:

- most benefits have been protected against inflation in the initial years of austerity;
- unemployment benefits have risen; and,

- pensions have risen above the rate of inflation, as a result of the triple lock commitment whereby pensions increase by the highest of, the growth in CPI, the growth in average wages or 2.5%.

Given the flat profile of Total Public Spending the rise in Benefits and Pensions means the other half of spending, on Public Services, has to be falling; it has fallen in both cash and real terms every year since 2009-10 and this is forecast to continue.

However, the discrepancies in the degree of austerity do not stop there. Within Public Services, the large NHS budget, along with funding for Schools and International Aid, have been protected against inflation. This has meant even deeper cuts for all other, non-protected, public service budgets than the near 25% reduction shown in Table 1.

Given these public spending definitions and the varying degrees of protection being afforded to individual elements within some of them, it is difficult to be categorical about what is happening to 'public spending', without first being precise about what is being referred to.

**Box 1: UK austerity in a historical context**

Historically, the non-growth profile of UK Total Public Spending is unprecedentedly bad. The Office for Budget Responsibility (OBR) estimate that "*In the 12 years from the outbreak of the global financial crisis in 2007-08 to the end of our current medium-term forecast period in 2018-19, the UK public finances will have suffered their largest peacetime shock in living memory, followed by one of the biggest deficit reduction programmes seen in any advanced economy since World War II.*".

As a result real, per capita, spending on UK public services will be cut by 23% between 2007-08 and 2018-19, which will reduce spending on public services to its lowest level, as a share of GDP, since at least 1948. Note that, due to the real terms rise of GDP over this period, this still equates to real terms, per capita, spending at twice the level seen in 1948.

UK government spending grew in real terms by an annual average of 2.8% between 1948-49 and 1999-2000, before accelerating in the 2000s (1999-2000 to 2009-10) to an annual rate of 4.5%. However, between 2009-10 and 2018-19 total government spending is expected to exhibit no growth at all.

(For sources see Note 1)

## PROFILE OF THE SCOTTISH BUDGET, 2009-10 TO 2018-19

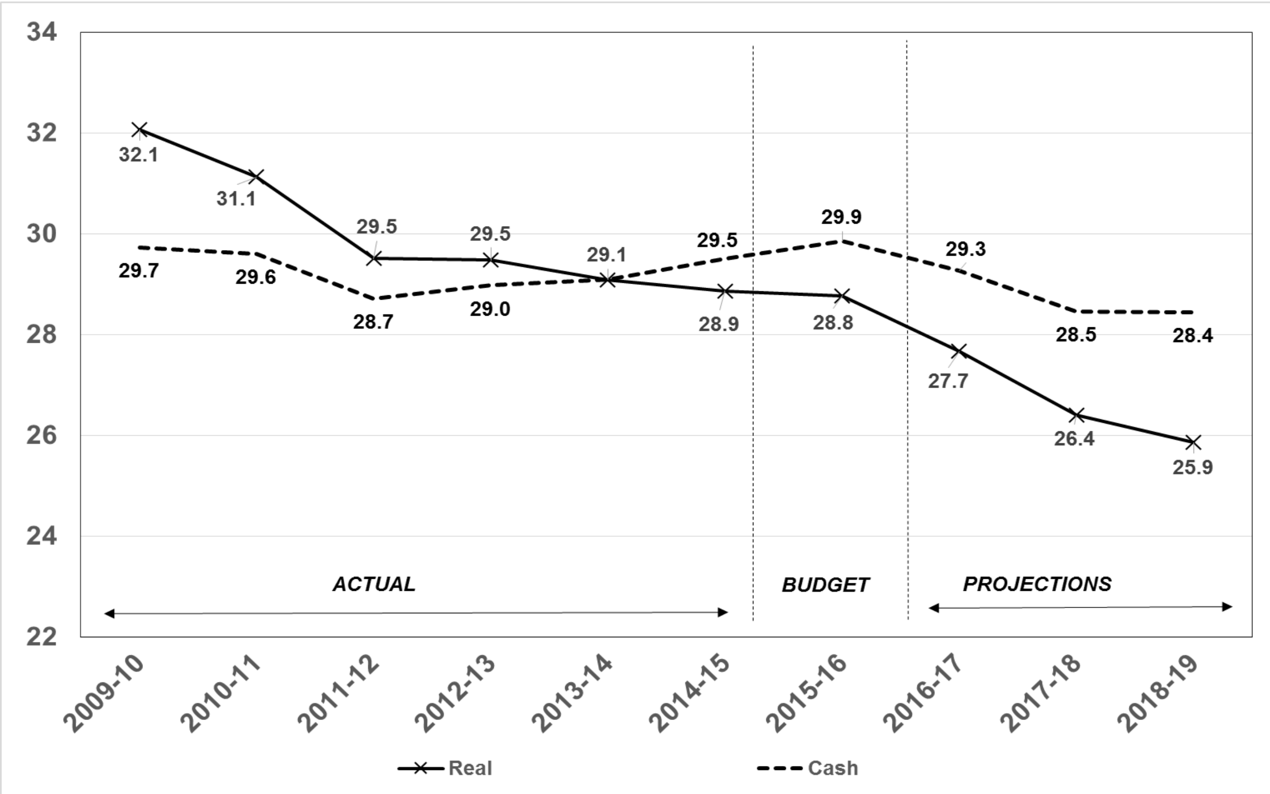
The position in Scotland is simplified by the fact that the Scottish government's budget (also referred to here as the Barnett Block grant (i.e., the money transferred from the UK to the Scottish government)) is principally focussed on public services spending which means it excludes welfare benefits and debt interest payments. Whilst simpler to understand, this does not make things easier in practice as this is the element of UK spending that has, and continues, to suffer the most.

As a result, Scotland faces similar difficult decisions to the UK in terms of how to implement the budget cuts and whether, and by how much, to protect some areas of spending within this total.

**2009-10 to 2014-15**

As Figure 1 shows, the Scottish Barnett block grant fell £1 billion in cash terms between 2009-10 and 2011-12; from £29.7 billion to £28.7 billion. By this financial year (2014-15), the grant has slowly grown to almost reach its 2009-10 cash level again. However, although now almost back at 2009-10 cash levels, the spending power of this budget, its real terms value, has fallen by £3.2 billion, or by -10%.

**Figure 1: Scottish Barnett Block Grant, £billion (cash and 2013-14 prices)**



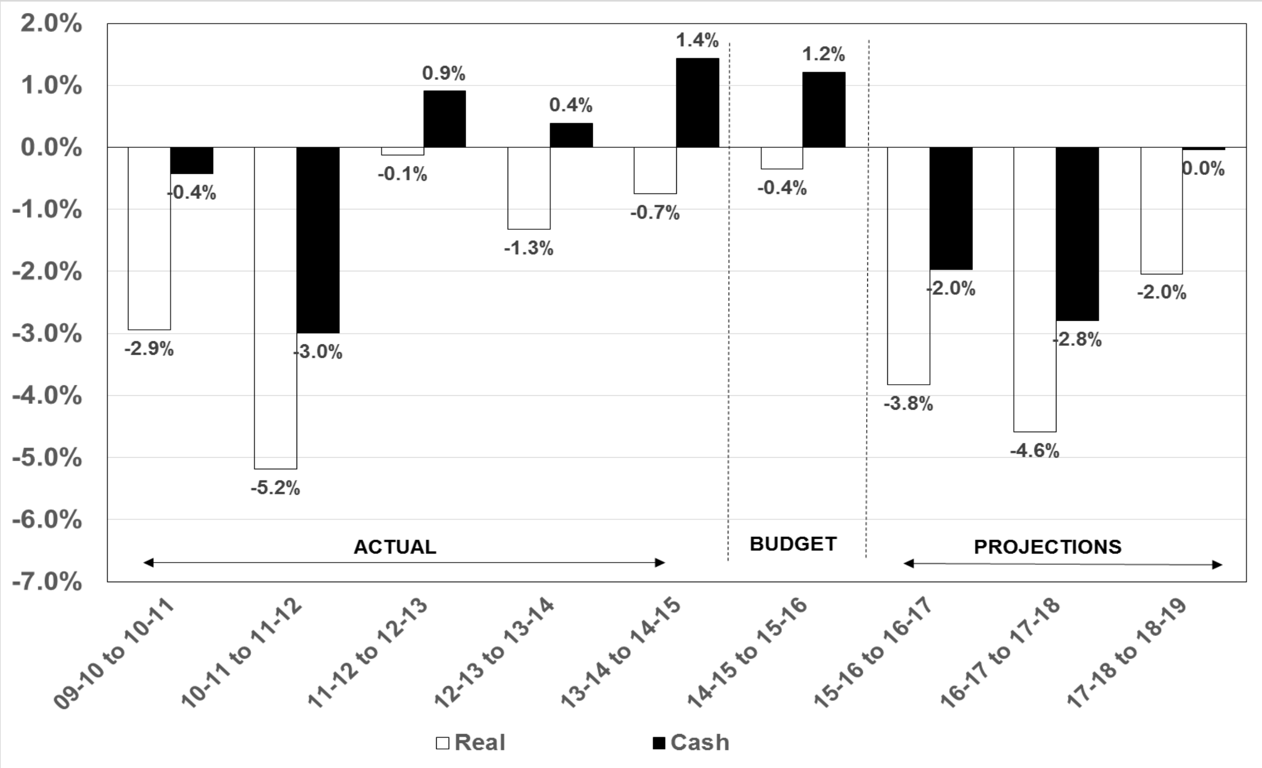

Sources: Actual and Budget - Scottish Government; Projections - own calculations (see Note 2 for methodology)
Note: The Barnett Block Grant excludes both Non Domestic Rates Income & Council Tax revenues.

As Figure 2 and Table 2 illustrate, the first two years of the period 2009-10 to 2015-16 saw some of the most severe cuts, with the budget falling in cash terms and by more than -8% in real terms. Post that initial shock, the reductions eased off, with cash terms increases from 2012-13 to 2015-16.

Our projections to 2018-19 suggest this 'easing off' period is due to end, after the next UK election, with a return to deep cuts in both 2016-17 and 2017-18 in particular.

Hence, the profile of the cuts over the full nine years is: two years of deep cuts (in cash and real terms), followed by four years of milder cuts (where we currently are), followed by the prospect of three more years of relatively deep cuts thereafter (see Table 2).

**Figure 2: Annual % change in Scottish Barnett Block Grant, 2009-10 to 2018-19**




Sources: As for Figure 1

**Table 2: Annualised % changes to the value of the Scottish budget, 2009-10 to 2018-19**

| | | Initial cut 2009-10 to 2011-12 | Easing off 2011-12 to 2015-16 | Cuts return 2015-16 to 2018-19 | Total period 2009-10 to 2018-19 |
|---|---|---|---|---|---|
| 1 | **Block Grant (cash)** | -1.7 | 1.0 | -1.6 | -0.5 |
| 2 | **Block Grant (real)** | -4.1 | -0.6 | -3.5 | -2.4 |
| 3 | **Full Budget (real)** | -3.8 | -0.3 | -2.7 | -1.9 |

Sources: As for Figure 1

Note: the Full Budget includes NDRI and Council Tax; NDRI from 2015-16 is assumed to grow at 6.4% per annum using OBR projections for GDP growth and RPI for these years.

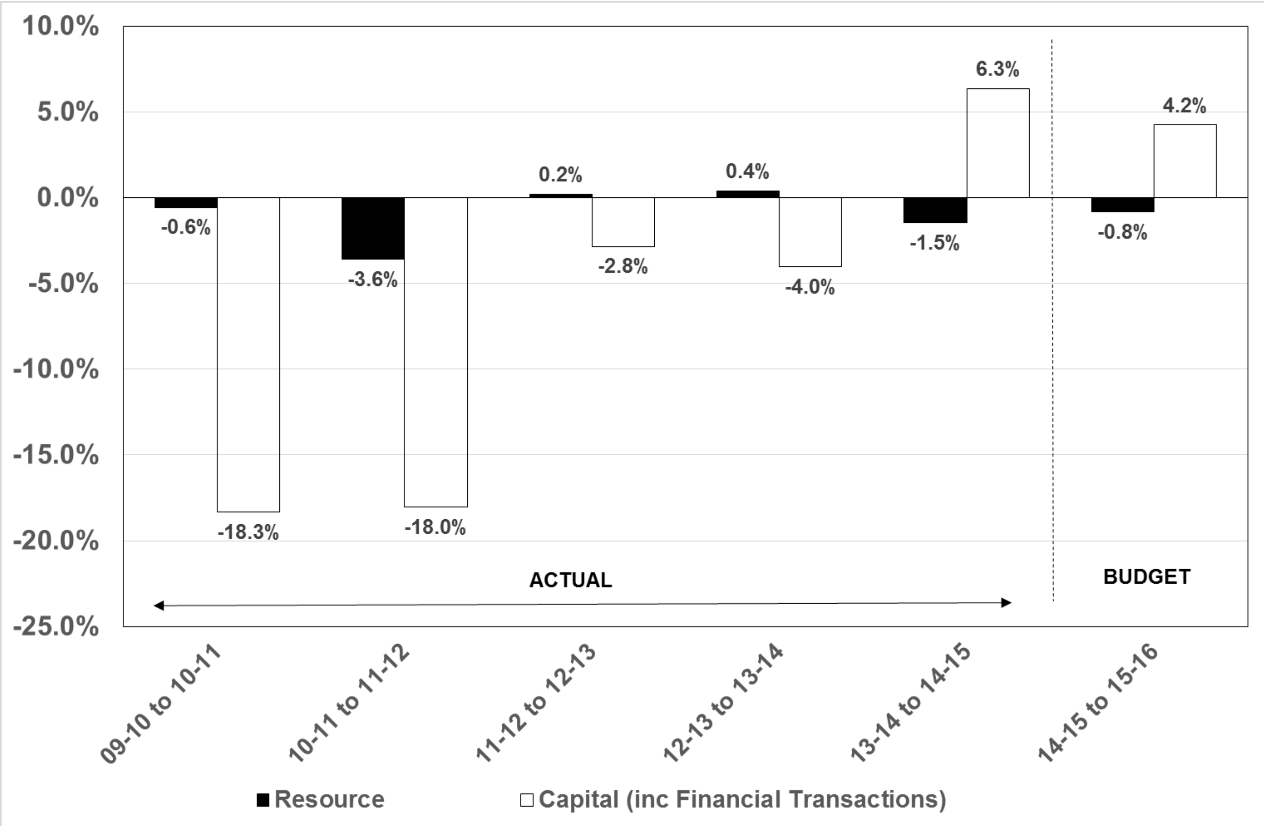
Resource and Capital grants

The Barnett grant comprises a Resource element (to fund day-to-day expenditure) and a Capital element (to fund longer-term infrastructure spending). As Figure 3 shows, Capital grants fell by over 35% in real terms in the first two years of the austerity cuts with relatively little change since.

The Resource grant is however, the largest component of the block grant (amounting to around 90% of the total). The cut in this element whilst less severe has, nonetheless, been significant, falling 5% in real terms in the last 5 years.

The Capital grant shown here does not include the £300 million of borrowing (available as a result of the Scotland Act 2012 powers) that the Scottish government has stated it plans to use, which is consistent with how the Scottish government presents the budget data.

**Figure 3: Annual real terms % changes in Resource and Capital grants, 2009-10 to 2015-16**




Source: Scottish Government

Notes: No projections have been made for Resource and Capital allocations 2015-16 to 2018-19; Financial Transactions are loan support funding from HM Treasury which much be repaid at some future date.

## Budget for next year - 2015-16

The Scottish government's budget is all but known for 2015-16; its 2015-16 UK budget allocation will take the cash level to just under £30 billion, or £28.8 billion after adjusting for inflation.

As mentioned above, the Capital grant shown here does not include the £300 million of borrowing available as a result of the Scotland Act 2012 powers. Were this sum to be included then the change to the Capital grant in 2015-16 would improve to almost 15%, while the position with regards to day-to-day spend would remain unchanged, at -0.8% (see also Box 2 for more details on Scotland Act 2012 powers).

## Budget for 2016-17 to 2018-19

In deriving Scottish projections post 2015-16 to 2018-19 we have relied on UK estimates provided by HM Treasury and the Office for Budget Responsibility (OBR). These guideline forecasts for overall spending on UK public services allow us to derive figures for the Barnett Block grant which Scotland is likely to receive (see Note 2 for more details of how these projections are derived).

These projections result in our 'baseline' scenario for the Scottish government's budget that is shown in the various Figures included here. The shifts in various different measures of the Scottish budget are highlighted in Tables 2 and 3.

As Figure 1 shows, the austerity measures currently in train in Whitehall suggest the Barnett Block grant will continue to decline in real terms; down from £28.8 billion in 2015-16 to £25.9 billion in

2018-19, a real terms fall of over -10%. There is also a projected cash cut in the Barnett Block grant over this period, from £29.9 billion to £28.4 billon (nearly -5%).

**Box 2: Barnett block grant and new Scottish taxes**

The composition of the Scottish budget is set to change, with a part of the current Barnett block grant allocation being replaced by revenues arising from the Scotland Act 2012 devolved taxes, and new borrowing powers. This adjustment is in addition to the projected cash cut in the Barnett Block grant over this period of £1.5 billion.

**Taxes**

The Scottish draft budget for 2015-16 includes the Land and Buildings Transaction Tax (LBTT) and Scottish Landfill Tax (SLfT) operating from 1 April 2015. Combined, these taxes are projected to raise £558 million in 2015-16. (Note: The 2015-16 revenue projections for these new taxes have been based on the principle that they generate the same revenues as would have been expected had they not been devolved).

The Scottish Rate of Income Tax (SRIT) will commence in 2016-17. Existing basic, higher and additional rates of income tax levied by the UK government will be reduced by 10p in the pound for Scottish tax payers from April 2016 and the tax is set to raise around £5 billion in its first year (based on OBR analysis of March 2014).

If the taxes raise less than projected, the Scottish government can borrow the difference from HM Treasury, with repayments to be made over the subsequent 4 year period. If more is raised, this surplus will be held over for spending in future years.

In controlling these tax revenues, both governments accept that the Barnett Block grant needs to be adjusted, as the revenues are no longer available for the UK Treasury to spend. At the time of the Scottish Budget 2015-16 announcement, negotiations on the appropriate adjustment mechanism were on going. However, the underlying principle outlined by the Scottish government is that it should be "*robust, transparent and deliver a fair outcome for Scotland*".

**Borrowing**

New borrowing for capital investment up to an aggregate cap of £2.2 billion is now available. HM Treasury limits how much can be used in any one year to no more than 10% of the Capital budget which means £304 million will be available for use in 2015-16.

**Impact on projections**

Given the Barnett Block adjustments are not yet known and the information on the actual revenues raised from all these Scotland Act taxes remains uncertain, the baseline budget projections produced in this analysis paper rely on the current Barnett Block grant methodology. As and when published data on both factors becomes available the projections will be revised.

Non-Domestic Rates Income (NDRI) and Council Tax (CT) revenues

As well as the Scottish government's budget, Table 2 shows the 'Full Budget' including revenues raised in Scotland, principally Council Tax (CT) and non-domestic rates (NDRI).

The Scottish budget is increasingly reliant on business taxes (NDRI) to support its spending plans. For 2015-16 they are projected to amount to £2.78 billion or 8% of total public sector spending, as compared to 6.4% in 2009-10. Applying the OBR's projections for GDP growth and RPI (factors that have driven the Scottish government's NDRI escalators historically) would mean NDRI growing at 6.4% per annum in real terms.

In contrast, revenue from the Council Tax has been frozen in cash terms (i.e., falling in real terms) since 2007.

Table 3 looks at how adding these extra resources affects the picture of austerity.

**Table 3: Changes to the value of the Scottish budget, 2009-10 to 2018-19, (%)**

| | | First period 2009-10 to 2014-15 | Second period 2014-15 to 2018-19 | Total period 2009-10 to 2018-19 |
|---|---|---|---|---|
| 1 | **Block Grant (cash)** | -0.7 | -3.6 | -4.3 |
| 2 | **Block Grant (real)** | -10.0 | -10.4 | -19.4 |
| 3 | **Full Budget, inc NDRI* & CT (real)** | -8.4 | -8.1 | -15.9 |
| 4 | **Protected budget (NHS)**** | 0 | 0 | 0 |
| 5 | **Non-protected budgets**** | -15 | -15 | -29 |

Source: Scottish Government

Note: the change shown for the two sub-periods do not add up exactly to that shown for the full period as the baseline for the second column differs from that used for in the first and third columns.

* The non-Capital spend on NHS in Scotland is assumed to be protected against inflation which accounts for a third of the overall Block Grant budget.

** The changes shown for NHS and non-protected budgets are not actuals as precise figures are not available over this time period. However, they give a good indication of the scale of the extra cuts needed to non-protected budgets when NHS is protected.

The overall cut to the Block Grant, in cash terms, for the period 2009-10 to 2018-19, is projected to be just over -4%, but in inflation adjusted real terms, the spending power of the budget will have been a fall of almost -20%.

However, when NDRI and CT are included, the overall change in the Full Budget for the period 2009-10 to 2018-19 is set to be near zero in cash terms, but around -16% in real terms.

It should be noted that this improvement in NDRI becomes part of the Scottish government's funding package for the Local Government (LG) settlement. However, it does not mean that funding for LG ends up in a relatively advantaged position in comparison to other non-protected budgets. Rather, the LG settlement is considered in the round, irrespective to what is proposed for NDRI. The impact on the LG settlement is further complicated by the inclusion of the favoured, rather than specifically protected, Schools budget within its overall funding allocation.

Whether based on the value of either the Scottish government's Barnett Block Grant allocation or the Full Budget, we are currently roughly half way through the current UK coalition government's projected process of adjustment.

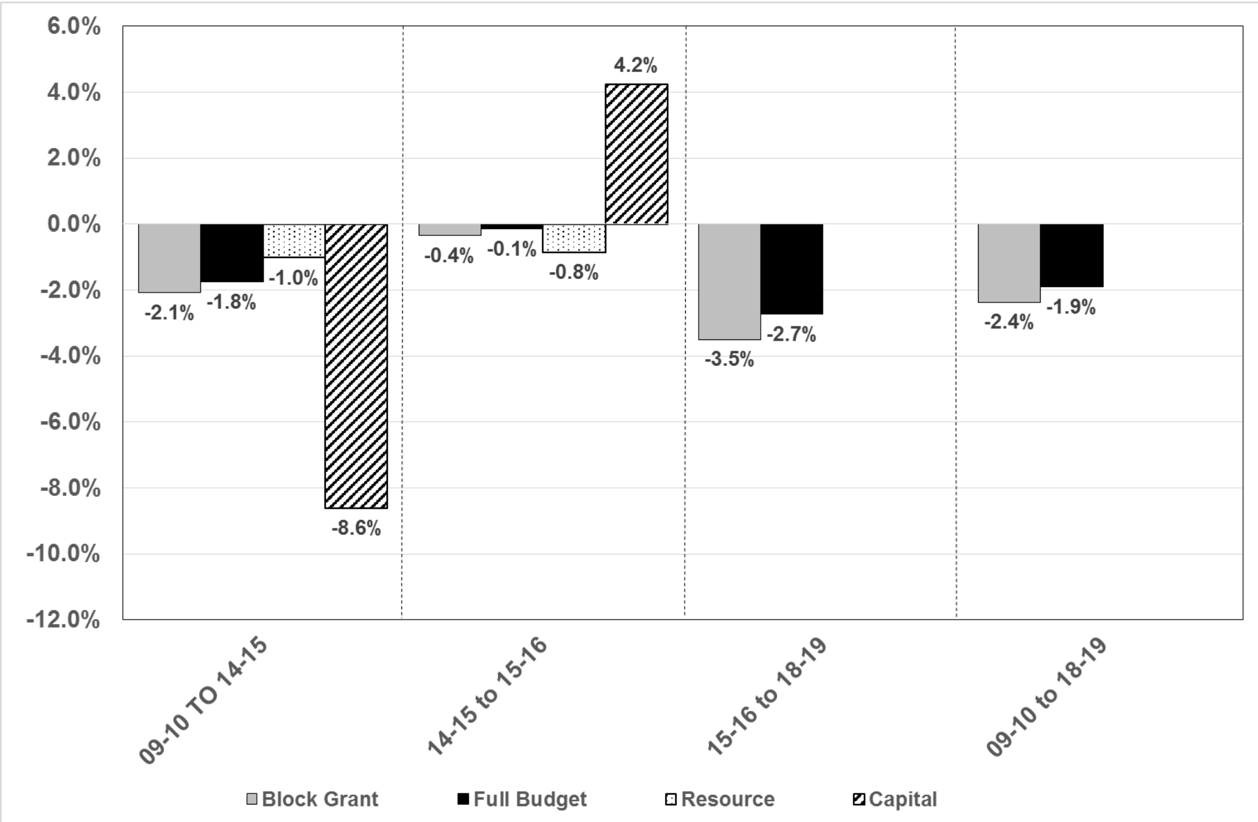
The impact of protecting the NHS on non NHS budgets

Table 3 also illustrates that the protection of the NHS budget has meant, on average, all non-NHS budgets have had to deal with cuts half the size again of the overall average, i.e., down almost -30%, rather than just under -20%, over the full period.

**Summary**

The budget reductions facing Scotland based on various measures of public spending are summarised in Figure 4.

**Figure 4: Annual real terms % changes in Barnett Block, Resource and Capital budgets over various time periods**




Source: Actuals: Scottish Government; projections; own calculations

Note: Barnett Block grant excludes both NDRI & CT, while Full Budget includes both.

## ALTERNATIVE BUDGET SCENARIOS POST 2015-16 TO 2018-19

While the previous section concentrated on a 'baseline' scenario taken from the current UK forecasts, there are a number of alternative scenarios that might emerge post 2015-16.

**UK Government options**

A new deficit target and/or timetable

At present there are two possible scenarios on the deficit target that seem pertinent. The first would be for a re-elected Conservative or Conservative-led coalition government to amend the existing forecast for the UK budget to 2018-19.Given this forecast has already been agreed between these two

Parties, it seems likely that any departure from these plans will have limited impact on what additional funds may be available to spend on public services.

Within these plans, however, the Conservative Party have highlighted their wish for a further £12 billion in cuts to the benefits bill, which could mean an easing of the public service cuts currently assumed by the OBR.

The second scenario would be if a Labour, or a Labour-led coalition, government were successful in the 2015 UK election. The best insight we have as to what might change then are Labour's plans to balance the current budget by the end of the next UK fixed term of office (i.e., in 2020), rather than the existing plan to balance the overall budget on a similar timescale. As the current budget excludes capital spending, the Institute for Fiscal Studies (IFS) estimates that this gives the Labour Party roughly £28 billion of extra leeway. The Liberal Democrats have also stated a budget target preference along similar lines to Labour.

As our variant scenarios, discussed later, show, while these alternative plans could affect the depth of cuts, they are unlikely to reverse the current direction of those cuts. Furthermore, any such boost seems much more likely to improve the position with regards to the Capital budget than the Resource (associated with day-to-day spending) budget.

A shift from spending cuts to tax rises

The IFS has highlighted the degree of cuts already experienced by those UK public services not offered some degree of protection. This averages around -17% in real terms from 2010-11 to 2014-15. Under current plans, if the same degree of protection is accorded to these services (in particular the NHS) then, by 2018-19, the extent of the real terms cuts to unprotected UK public services will rise to -36%. It remains to be seen whether cuts of this size are politically deliverable.

One way to avoid cuts of this magnitude would be to raise taxes instead. So far, very little has been proposed that would make a big dent on the degree of cost savings still needed. For example, a 'mansion tax' is only anticipated to generate an additional £1-2 billion, and even the lower end of this range is highly dependent on the starting point and on any exemptions.

Such caution over proposing tax rises might be as expected in a pre-election phase where tax increases might be perceived as unpopular. Post-election there may be greater scope for such an approach.

Less protection for the NHS and pensions

A change to the way that the NHS and/or pensions are currently protected could also offer up more scope for reductions to other budgets, although, the net cut in total public services would be unaffected.

With regards to the NHS, such a move seems unlikely, particularly in light of the recent Stevens report on future English NHS funding needs.

For pensions there may be more scope, especially to dismantle the relatively generous 'triple lock' guarantee, but any such move will not be easy given the potential for political unpopularity of making such a move.

Overall, it seems difficult to see much, if any, scope for reducing the impact of the existing, expensive guarantees of budget protection.

Potentially offsetting higher funding commitments

While there is scope for reducing the cuts to UK public services post 2015-16, there are equally commitments by each political party to higher funding that might impinge on any such extra leeway. Such commitments also tend to be more precisely defined than the ways in which any extra savings might be achieved.
Labour have made promises in relation to housebuilding, the minimum wage, energy prices and GP appointment times. The Liberal Democrats have made promises in relation to childcare and housebuilding. The Conservatives have suggested possible tax cuts.

Furthermore, within the overall public services spending total, the NHS also seems a likely candidate for extra funds than are currently envisioned. The Stevens' report suggests an extra £8 billion will be needed in England alone by 2020. This figure already allows for an ambitious 2-3% of efficiency gains over the period to 2020. The main UK political parties welcomed the Stevens report and have promised increased spending to various degrees to meet the pressures it highlights.

As a result, any possible room to reduce the extent of future cuts in unprotected public services, up to 2018-19, may be hampered by these higher funding or lower tax commitments.

**Scottish government alternative strategies**

As well as the UK government being able to implement alternative tax and spending strategies, there is likely to be increasing potential for the Scottish government to change the profile of the Scottish budget in years to come.

The Smith Commission

The Smith Commission brokered agreement across Scottish political parties is not yet known. However, its initial statement contained a key proposal that its negotiated settlement should "*Cause neither the UK Government nor the Scottish Government to gain or lose financially simply as a consequence of devolving a specific power*." This proviso appears to have been agreed to by all Parties involved in the negotiations (see Note 3).

While this statement is open to interpretation, it suggests that initially at least (i.e., covering most or all of the period discussed here), the Scottish budget is likely to be in line with what the Barnett system would have delivered. Longer term, the devolution of more tax powers may allow for greater variation in the budget, both up and down, either through changes to tax rates or through changes in Scotland's economic performance.

Once the Smith Commission has reported, we will return to look at the implications of its recommendations on Scotland's future budget.

Borrowing

As a result of the Scotland Act 2012, a facility to borrow for infrastructure investment is available to the Scottish government, worth around £300 million a year, up to a maximum of £2.2 billion. At present we know that this facility is to be utilised to its maximum in the first year it is available, 2015-16. It seems likely that a Scottish government will continue to use this facility in the years following 2015-16. If utilised to its full then such a level of borrowing could be maintained for up to seven years i.e., until 2021-22. (See also Notes 4 and 5).

It is worth noting, however, that any fiscal boost via this route will be to support investment-related spending rather than a fillip to day-to-day spending. At present we have not factored in this extra spending in the baseline scenario outlined in earlier Tables and Figures, although an estimate of its impact post 2015-16 is discussed later.

Protection of the NHS, students fees, etc

Similar questions emerge in Scotland as in England over the degree of protection needed by the NHS in Scotland, although the demand pressures will be different due to the differing demographics.

There are other spending related areas which are currently protected in Scotland, in particular in relation to student fees and to the Council Tax. The longer that such protection remains in place then the more difficult it can be to end it, as recipients become used to such protection and the political implications of a policy u-turn become increasingly difficult to manage.

The NHS day-to-day budget alone accounts for around a third of the overall day-to-day spending budget in Scotland. Not surprisingly, therefore, continued protection effectively results in a 50% increase in the size of the cuts felt across all other, non-NHS budgets.

**Possible Scottish budget scenarios**

It is most likely that UK spending levels in the future will differ from those currently being forecast. Just how different is difficult to judge. To assist those who rely on Scottish budgets to plan their spending commitments, we have outlined some plausible spending scenarios that establish possible budgetary boundaries for Scotland's Block Grant.

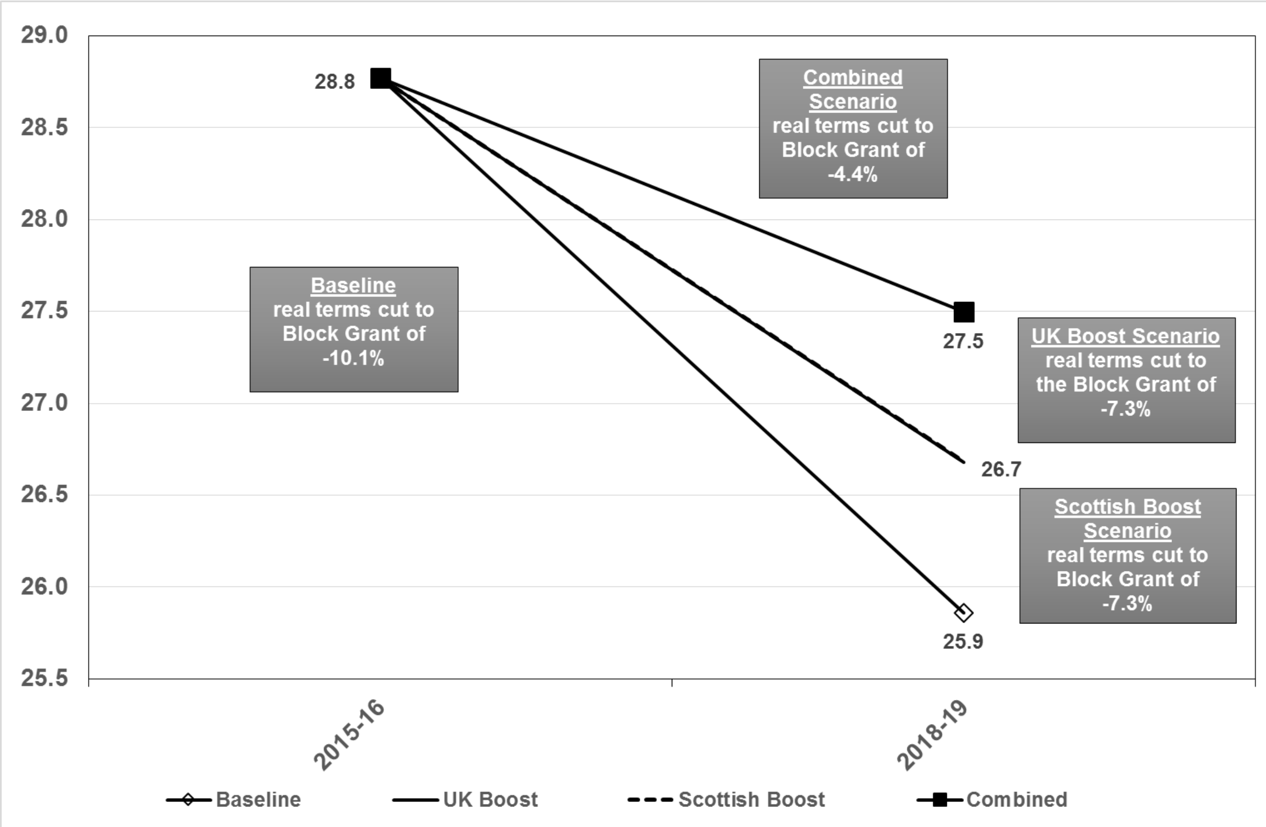
Table 4 illustrates two possible 'optimistic' scenarios (along with their combined effect) and Figure 5 illustrates what these would mean to the value of the Block Grant between 2015-16 and 2018-19.

**Table 4: Percentage changes to the value of the Scottish Block Grant, 2015-16 to 2018-19**

| | | Baseline | UK boost | Scottish boost | Combined boost |
|---|---|---|---|---|---|
| 1 | Block Grant (cash) | -4.7 | -1.7 | -1.7 | 1.3 |
| 2 | Block Grant (real) | -10.1 | -7.3 | -7.3 | -4.4 |

Source: own calculations based on IFS and Scottish Government data

**Figure 5: Scottish Block Grant, 2015-16 & 2018-19 £ billion, (real terms)**




Scenario 1 – UK Budget Boost

The first scenario is in line with the UK government meeting a current budget balance (i.e., which excludes Capital) in the UK by 2018-19, instead of the challenging total budget balance. Of the £28 billion extra this makes available by 2018-19 at the UK level, we have assumed that half goes to improve Pensions and Benefits and half to improve Public Services. This in turn would feed through to a better Scottish settlement via the current Barnett formula. Once the Barnett formula is applied this results in a boost to the Scottish Barnett Block budget of around £900 million.

Scenario 2 – Scottish Budget Boost

The second scenario assumes that the Scottish government utilises in full an extra £300 million from new Scottish borrowing every year up to 2018-19, which again allows for a higher budget of around £900 million by 2018-19. As a result, the impact is very similar in scale to Scenario 1.

Scenario 3 – Combined UK and Scottish Boost

The third scenario combines the impact of both Scenarios 1 and 2. Its impact is therefore twice as big as either of them alone. As a result, there would be a cash terms increase in the Block Grant, although still a fall in real terms.

Downside Scenarios

As well as Scenarios offering better budgetary outcomes there could, of course, be Scenarios which are even worse than the baseline presented here. However, given the unprecedented scale of the cuts already in place, the likelihood that, for reasons of political unpopularity, these would be allowed to feed through to even higher cuts in Public Services seems remote. Nevertheless, those responsible for planning budgets may need to reflect on what flexibilities might be desirable in case such downside Scenarios do materialise.

## SCENARIOS BEYOND 2018-19

The further out we go in time, the less certain we can be of the prevailing economic and financial conditions and so what their impact might be on the UK and Scottish budgets.

### OBR long term projections for UK public spending

The OBR produce annual long term economic and financial projections. The latest projections assume that, post 2018-19, spending on public services (excluding debt interest payments) would grow at roughly the same rate as UK productivity, i.e., 4.4% a year in cash terms and 2.2% in real terms. At the same time this would allow, with a balanced budget, for the UK's debt ratio to fall back to around 50% of GDP by the mid-2030s.

While still well below the rate of increases in public spending seen in the first decade of the 21st century, this is at least a return to respectable growth rates and more in line with post-World War II historical averages.

The trouble lies in navigating the years between now and 2018-19, where cuts of a similar size to those already experienced, in a shorter timespan are needed to achieve a budget balance position.

### Faster economic growth

If faster than expected world and UK economic growth were to emerge post 2015-16 then by the end of the decade this would help speed up the reduction in the debt to GDP ratio and may allow for a quicker return to rising budgets. So far, the recent improvement in the UK economic growth rate have not been matched by tax revenues rising as quickly as would normally be expected. This may be connected with the pattern of increased employment and activity, especially amongst the lower paid and self-employed.

Potentially Scotland, through appropriate use of any extra economic powers it gains, could improve its growth rate, out-with any more general world-wide improvement. However, any such gains will not be easy and may involve politically difficult decisions in areas like planning and taxation.

### Slower economic growth (aka Secular Stagnation)

A more worrying alternative to faster economic growth is slower economic growth. There are increasing concerns amongst some prominent economists (e.g. Larry Summers, Robert Gordon) that the growth rate, particularly amongst the more highly economically developed countries is slowing down and may not recover to the long term average of the past.

If this turned out to be true then it would probably have a knock on effect on the long term rate of increase of public expenditure, as lower growth equates to lower tax revenue growth potential and so lower sustainable growth in public expenditure.

### In summary

The economic and fiscal future for most countries, including Scotland, remains highly uncertain. However, for future planning purposes it seems reasonable to assume:

- cash and real terms increases in public service budgets in the UK and Scotland should return post 2018-19, so long as the tough targets for the intervening years are achieved;

- if these tough targets are not met, then real terms cuts may extend into the next decade, although the cuts in the years to the end of this decade will be less dramatic.

## CONCLUSIONS

### Coming to terms with fiscal austerity

Both Scotland and the UK are in the midst of a revolutionary change in terms of the path and composition of its public sector budget. This is the first time post-World War II that budgets have declined, in real terms, over an extended period.

At present we are only half way through this transitionary phase. Once complete, while budgets may start to rise again, most will remain in a position of funding at a very much lower level than was seen at their 2009-10 peak. This means the way that our governments think about how public services are best provided in the future will also need some revolutionary thinking. We may have to re-set our spending priorities to accord better with what we can afford, or be willing to pay more through general taxation.

Even the NHS budget, protected as it has been, appears to be under threat, in terms of its ability to keep up with underlying demand pressures and to meet key targets.

### Public service reform

As a result, ‘revolutionary’ thinking by governments will also be necessary in order to determine how future public services will best be provided. In particular, some areas of spend that are not protected may need to get used to a climate where growth in their budgets continues to be sporadic or even non-existent.

The drastic nature of the change in the funding landscape have only been partly taken on board by both the public in general and politicians in particular. There is a sense in which the current phase is seen as a temporary correction before normal service is resumed. As a result, the deeper cuts likely to re-emerge after the next UK election may come as a shock to some.

Post the next UK election the subsequent Spending Review, going as far as 2018-19, may provide some insight into a longer term strategy. If not, then the decisive moment will only be delayed.

It seems inevitable that these on-going budget challenges will dominate the political landscape both in Scotland, the UK and in many other countries, over this and the next parliamentary terms.

This scenario applies regardless of the political circumstances facing Scotland. Whether independent, fiscally autonomous or working within some reformed version of the Barnett formula the severe financial challenges are likely to remain essentially the same. While the future political landscape, north and south of the border, may allow for some degree of easing of such long-term austerity (or equally hardening of the budget challenges) it seems unlikely that they will affect the general direction of travel.

## Importance of faster economic growth

The main driver that could change this outlook is faster and more productive economic growth. However, Scotland's growth prospects need to change dramatically for this already difficult fiscal picture not to be compounded in the longer term (post 2030) by an ageing population which requires increased funding for health and age-related public services.

## NOTES

**Note 1** - See OBR publication 'Working Paper No. 7: Crisis and consolidation in the public finances' and IFS publication 'Survey of Public Spending in the UK'.

**Note 2** - For the years post 2015-16 estimates of growth in the Scottish budget are derived from the UK growth rates published in Table 4.15 of the OBR's latest Economic and Fiscal Outlook (March 2014).

It is assumed that these (negative) growth rates are applied equally across all UK Departments. In practice, the larger budgets relating to the NHS and Schools are likely to remain protected, meaning bigger cuts elsewhere. However, as the proportions of overall spend in these areas are similar in both Scotland and England, this asymmetry with regards to UK Departmental cuts should not unduly affect the final Barnett consequentials calculations.

These UK growth rates are adjusted to reflect the higher existing spend per head levels seen in Scotland, i.e., while Scotland gets the same cash terms increase per person as England for comparable areas of spend, via the Barnett formula, this is equivalent to a smaller % terms increase due to the higher per head spend that already exists.

**Note 3** – See Smith Commission, Media Statement, 22nd October 3014

**Note 4** - Whilst this offers the opportunity for the Scottish government to maintain public spending, it has the knock-on effect of reducing the 'free' spending, with regards to future day-to-day funding budgets that will be possible once increased interest and debt repayments are taken into account.

**Note 5** - In addition to this new borrowing capacity, Scottish infrastructure spending is also supported by other forms of revenue financing such as RAB, TIF and NPD. All secure capital infrastructure spending that is in effect paid for out of future Scottish revenue budgets. The knock-on effect of additional borrowing and revenue supported capital spending now is why the Scottish government has established a fiscal rule on how much it will spend through borrowing.

## REFERENCES


Centre for Economic Policy Research (CEPR) - Secular Stagnation: Facts, causes and cures, August 2014 (e-book)

HM Treasury - PESA webpage, Table 4.1, Treasury website

Institute of Fiscal Studies, ‘Survey of Public Spending in the UK’, August 2014

Office for Budget Responsibility, Economic and Financial Outlook, March 2014

Office for Budget Responsibility, Working Paper No. 7: Crisis and consolidation in the public finances, September 2014

Scottish Government, State of the Economy, July 2011

Scottish Government, State of the Economy, March 2012

Scottish Government, Scottish Draft Budget 2015-16, October 2014

Scottish Government, Scottish Local Government Financial Statistics 2012-13, February 2014

Smith Commission, Media Statement, 22 October 2014

Scottish Parliament, SPICe, Draft Budget 2015-15, Local Government, September 2013

**Contact details**

**John McLaren** m: 07429 508 596
e: john.mclaren@btinternet.com

**Jo Armstrong** m: 07740 440 766
e: jo@jo-armstrong.co.uk

**Charity details**

**Fiscal Affairs Scotland SCIO**
**SC044827**

**Website:** fiscalaffairsscotland.co.uk