Scottish Government's Draft Budget 2010-11*

Briefing No. 2

SCOTLAND'S GROWING CAPITAL CHALLENGE

1. As indicated in our initial Budget briefing, the Scottish Government's draft budget 2010-11 represents something of a watershed, with the first real terms reduction in discretionary spending (ie, DEL) since devolution. The significance of this forthcoming fall can be more readily seen when compared to previous draft budget statements.[1] However, as the following analysis highlights, perhaps of greater interest is how future Scottish Governments will have to face up to and meet the growing capital challenge. **Unless otherwise stated, all figures are in 2009-10 prices[2]**.

2. The total DEL budget in 2010-11 is set to be £29.3 billion (see Figure 1), £260 million less than is anticipated for the current financial year. In its 2008-09 draft budget, the first year an estimate for 2010-11 was presented, the Scottish Government was planning to spend £29.9 billion, £600 million more than now looks likely. The 2008-09 budget clearly outlined possible new spending opportunities and signalled the likely continuation of current projects and programmes. The impact of reallocating spending from 2010-11 to allow for accelerated spending in 2008-09 and 2009-10, along with Scotland's contribution to UK budget cuts, has meant a painful reassessment of spending priorities for 2010-11.

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[1] The Scottish Government issues an annual draft budget statement that only becomes its annual budget once approved by the vote of the Parliament. In the years that are designated spending review years, these draft budgets outline what the Government is planning to spend in each of the forthcoming spending review years ie, in each of the next 3 (or 4) financial years. In non-spending review years, the draft budget indicates what is planned to be spent by department in the next financial year. In both, there will also be a re-stating of the current year budget figure and possibly also an estimate for the actual spend in the previous financial year. Spending reviews are the means by which the HM Treasury assess spending priorities for DEL for fixed 3 (and sometimes 4) year periods. Since 1997 there have been 5 spending reviews; 1998, 2000, 2002, 2004 and 2007.

[2] DEL estimates change year-on-year to reflect not only the Barnett Consequentials announced at the UK Budget and Pre-Budget report but also to reflect the allocation of monies carried forward into future spending years (ie, via end year flexibility), by additions arising outside the operation of the Barnett formula and because of variations in the Scottish Government's accounting approach that is aimed at minimising the potential for budget under spending in any one year.

Figure 1: <u>TOTAL SCOTTISH DEL</u> ESTIMATES CONTAINED IN SCOTTISH GOVERNMENT DRAFT BUDGETS (DB) 2004-05 to 2010-11, £ million (09-10 prices)

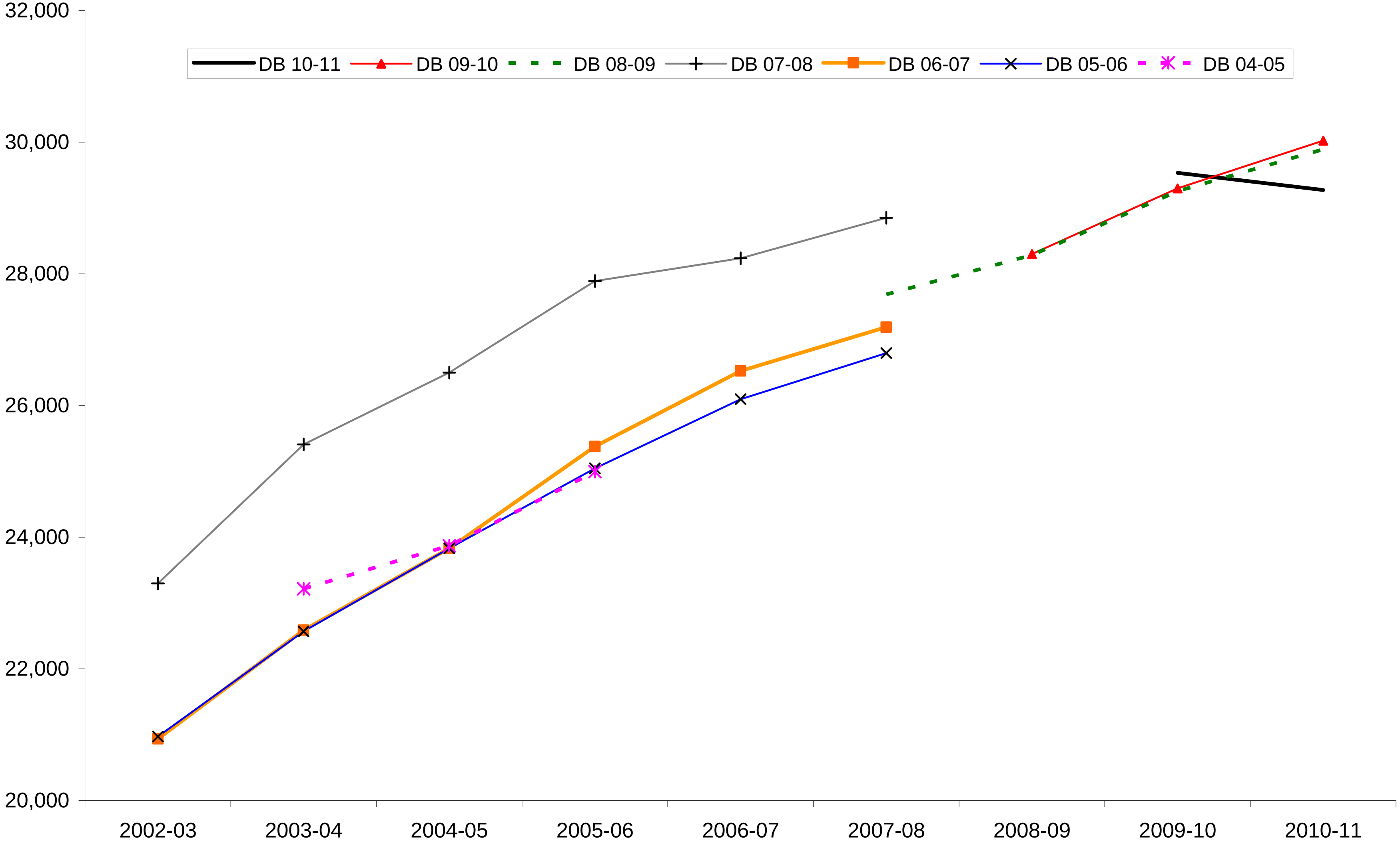
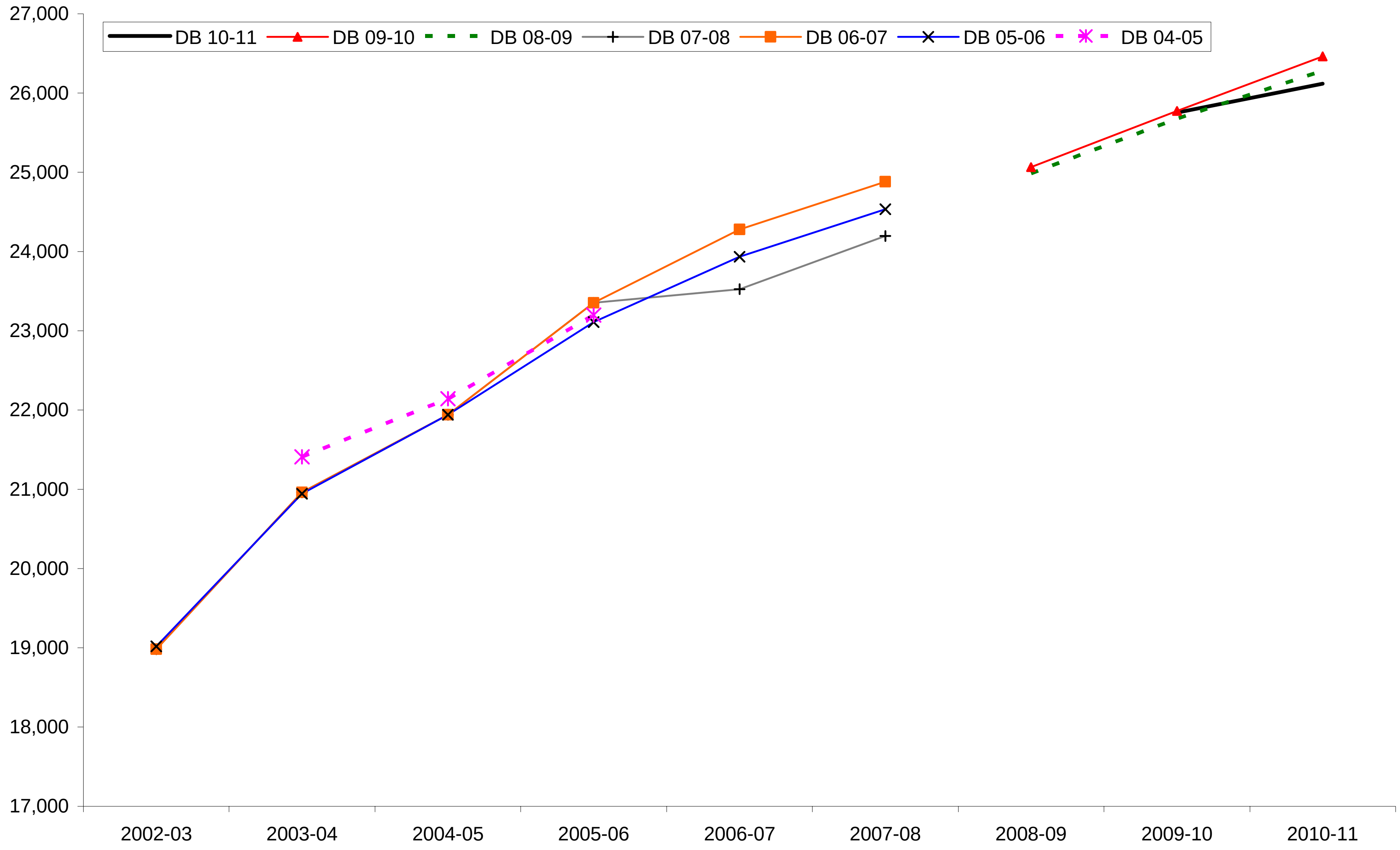


Figure 2: TOTAL SCOTTISH RESOURCE DEL ESTIMATES CONTAINED IN SCOTTISH GOVERNMENT DRAFT BUDGETS (DB) 2004-05 to 2010-11, £ million (09-10 prices)



3. Compared to what has been provided since devolution, next year's outlook could also be described differently. In the 2005-06 draft budget statement, total DEL for 2002-03 was £21 billion. Since then the Scottish Government's discretionary spending has risen over £8 billion in real terms (or a 35% increase). Indeed, next year's discretionary spending will still be higher than in all other years apart from 2009-10[3].

4. It is undoubtedly not only the level of spending that now matters but also what previous levels of spending Scotland's public services users and providers have become used to receiving. For that reason, near record levels of spending next year could still bring with it service reductions, either in absolute terms or in the quality of what is still being made available.

5. Total DEL support for current expenditures (ie, Resource DEL) has increased over 30% in real terms or by more than £7 billion between 2002-03 and 2010-11 (see Figure 2). This significant increase is even after the reclassification of capital and operating budget in 2007-08 which reduced Resource DEL by over £2.3 billion[4]. Support for current expenditure next year will be the highest level yet, reaching £26.1 billion.

6. When the current Administration set its initial 3-year budget in 2008-09, it had planned to allocate £160 million more Resource DEL than now looks possible for 2010-11. Whilst this has required adjustments to spending priorities, it translates into a shortfall of less than 1%.

7. Public sector wages account for a large proportion of what is funded by Resource DEL. Should wages rise faster than inflation, the ability to respond to increasing demand for services will be constrained; assuming wage costs account for between 50-60% of total Resource DEL and these rise at 1% above inflation, this would consume between £130-£160 million of any unallocated budget in 2010-11. Uncomfortable though it would be, freezing wages may be a necessary rather than optional means of dealing with next year's Resource DEL reduction.

DEL Capital

8. Although careful assessment of trends in Resource DEL over time is possible, the same cannot be undertaken for DEL Capital (Figure 3). The major reclassification that occurred in 2006 leads to a doubling of the DEL Capital budget line and so it is misleading to suggest that capital spending has risen 1.75 times between 2003-04 and this financial year (2009-10) even though budgets rose from £1.81 billion to £3.78 billion.

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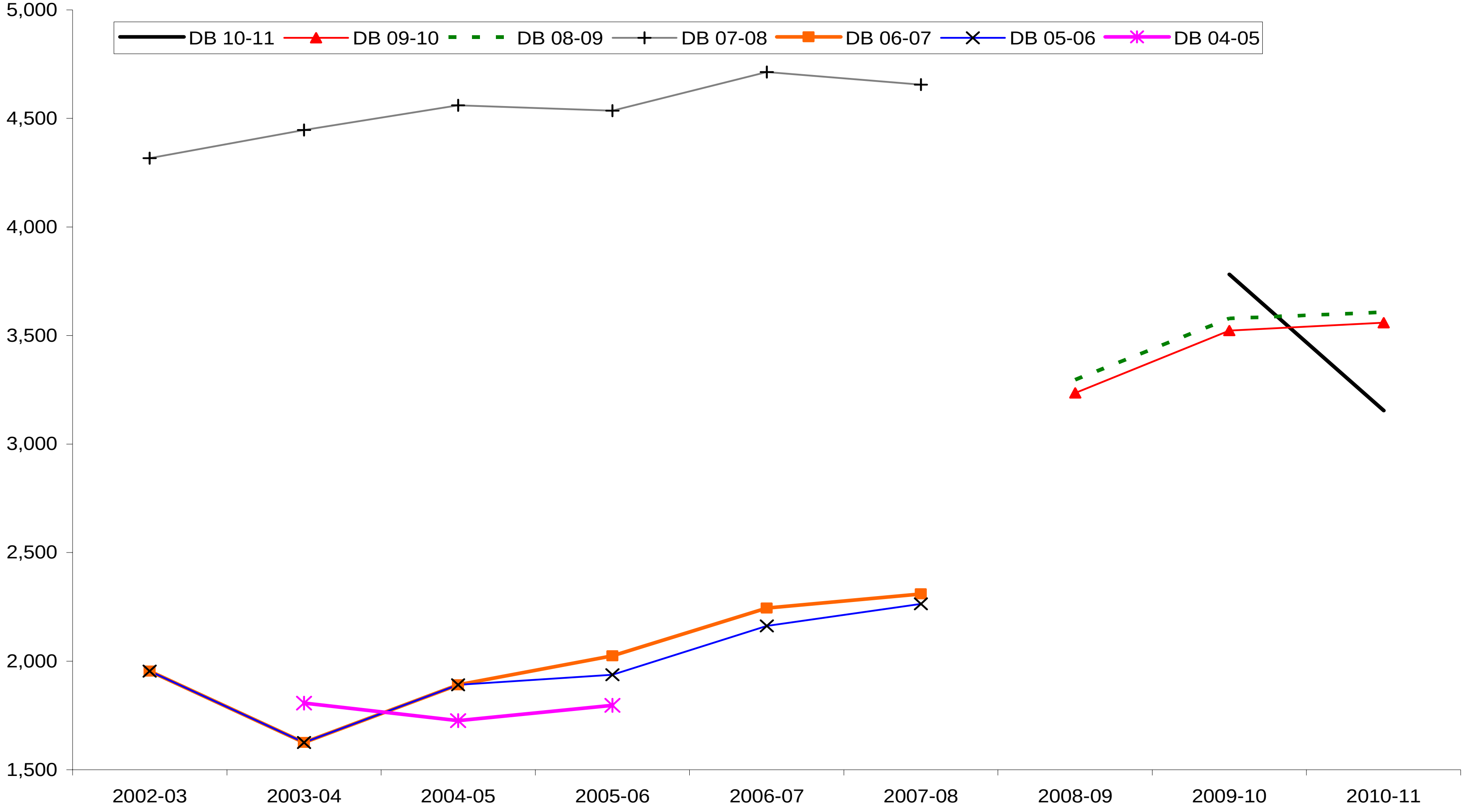
[3] The actual budget for next year is the figure in draft budget 2010-11 and supersedes the budget plans contained in both draft budgets 2008-09 and 2009-10.

[4] The UK Budget 2006 states that capital grants to the private sector were reclassified as capital spending rather than resource spending. As a consequence, Capital DEL for financial year 2007-08 in Draft Budget 2006-07 was £2.34 billion compared to £4.51 billion in Draft Budget 2007-08 (both in nominal prices). This reclassification effect amounts to an adjustment in DEL Capital of +£2.27 billion or +£2.35 billion in 2009-10 prices.

Figure 3: TOTAL SCOTTISH CAPITAL DEL ESTIMATES CONTAINED IN SCOTTISH GOVERNMENT DRAFT BUDGETS (DB) 2004-05 to 2010-11, £ million (09-10 prices)



9. With limited trend data it is difficult to know whether the balance between resource and capital spending is adequate. The 2010-11 draft budget mainly affects capital spending, with DEL Capital set to fall 17% in real terms compared to a 1.4% rise in Resource DEL. This bias against capital spending also seems set to continue.

10. The most recent UK Budget outlines net investment intentions as a percentage of GDP over the budget forecast period. The expectation is for this to fall from 3.1% in 2009-10 to 1.3% by 2013-14 (see Table 1). The 30-year high of 3.1% for 2009-10 figure is partly boosted by the effects of the economic stimulus measure of accelerating capital spend whilst the lower figures in future years stem from the UK Government's desire to lower the level of public sector spending and so lower total public sector debt. Moving from a target of 3.1% to 1.3% is a substantial reduction which might be partly reversed through asset sales. However, the outcome is most likely to be continued negative real terms growth rates in what Scotland can expect to receive for capital support between now and 2013-14.

Table 1: UK Net Investment as % GDP

08-09	09-10	10-11	11-12	12-13	13-14
2.6%	3.1%	2.5%	1.9%	1.6%	1.3%

Source: UK Budget 2009

11. Between them Transport, Health and Local Government will receive £1.8 billion of capital support next year (57% of the Scottish total Capital DEL). Housing, Regeneration and Water take £0.7 billion; together these areas account for more than 80% of the total amount available for spending on capital projects in Scotland in future years. It is these areas that are most likely to be affected should Scotland have to accommodate significant reductions in what is available for spending on capital projects in the coming years.

12. One option not so far discussed is for the Scottish Government actively to favour the funding of capital over current spending in the coming years. The Barnett formula provides Scotland with a block grant. The Scottish Government appears to have the freedom to allocate what has been provided as Resource DEL to Capital DEL, though not to move funds in the opposite direction[5]. To favour capital will mean recipients of Resource DEL losing out in terms of what they would have received but future Scottish Administrations may be faced with this as the only option for the longer-term good of the Scottish economy.

PPP Payments

13. The analysis above suggests public sector capital is likely to be more scarce in the coming years. The ability of any Scottish Administration to meet the demand for infrastructure spend will now more than ever depend on leveraging in more

[5] See Scottish Government Draft Budget 2006-07 September 2005, p1
www.scotland.gov.uk/Resource/Doc/69582/0017144.pdf

private capital. It is difficult to see how less funding will be able to meet increased demand without looking at ways of paying for such infrastructure over their asset life, or at least over a period that is longer than any individual spending review period (typically no more than 3 years).

14. Funding mechanisms that already exist could allow the Scottish Government to raise private finance by "mortgaging" the infrastructure. Unfortunately, poor financial settlements of some completed deals mean some of the most obvious options of PFI, PPP and NPD[6] are viewed with a high degree of suspicion. Added to that, the annual cost of PFI/PPP arrangements is now set to rise sharply. As Table 2 highlights, Scotland's PPP payments amounted to £421 million in 2004-05 but are now forecast to almost double to over £800 million by 2010-11 with payments for schools and hospitals accounting for the largest share.

Table 2: Estimated payments under PPP contracts, £million (09-10 prices)

	03-04	**04-05**	**05-06**	**06-07**	**07-08**	**08-09**	**09-10**	**10-11**
DB 10-11						618	723	808
DB 09-10						587	680	775
DB 07-08	418	421	452	468	490			

Source: Scottish Draft Budgets, various years

15. Much has been written about the wisdom of PPPs with a key criticism being some deals have been poor value for money for the public purse. The evidence is by no means conclusive that all such deals have been poor. Nonetheless, if the Scottish Futures Trust (SFT)[7] delivers better value for money in the future, it has to be encouraged.

16. Increasing the size of any mortgaging arrangements will inevitably mean more of the Scottish Government's budget in the future has to be earmarked to service and eventually repay the associated debt. In assessing just how much such a funding approach can and should be extended two key issues need to be addressed:

⇒ First, given the current UK debate about the sustainability of UK public debt levels, do we know what level of debt Scotland's budget could support, above which lenders will require a higher rate of return (interest) to compensate them for increased levels of risk?

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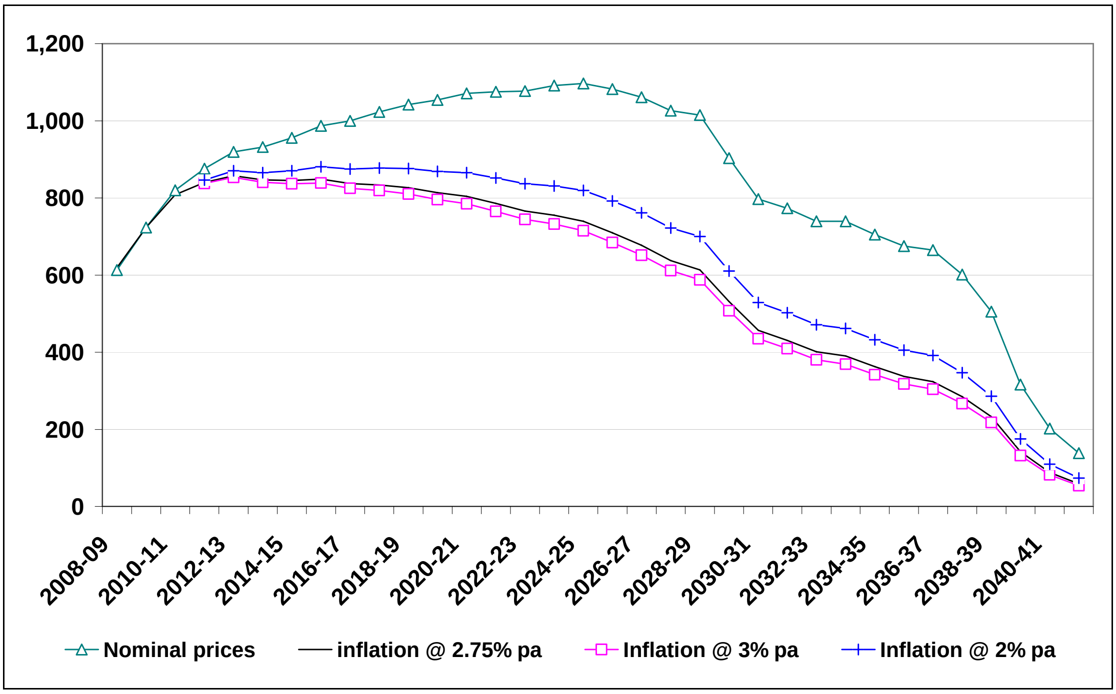
[6] The most quoted of these are PFI (private finance initiative), PPPs (public-private partnerships) and NPD (non-profit distributing) mechanisms. Bonds, securitisations, use of the national loan fund and prudential borrowing are additional variations. All such funding options are aimed at mortgaging an asset to secure the funding needed to allow building to take place earlier than would otherwise be possible. The size and length of the mortgage re-payments depend not only on the build-cost of any infrastructures project but also on whether there are associated services being provided once the asset is built and in use.

[7]The SFT is a Government-owned company and its web-site states it has been set up to improve public infrastructure investment to save £100 - £150 million each year when fully operational. See www.scottishfuturestrust.org.uk..

⇒ Secondly, what is the optimal level of PPP payment that could be supported by the Scottish budget but which does not overly constrain the spending aspirations of future Scottish Governments?

17. Finally, as can be seen from Figure 4, the current Scottish PPP payments are expected to reach a peak of £1,097 million by 2024-25. The real cost peaks much sooner, ie, around 2012-13, depending on the assumed inflation rate. The ability to add to such payments, and so increase the levels of private capital, will therefore also be limited should inflation remain low.

Figure 4: Estimated value of Scottish PPP payments to 2040-41, £ million



Source: Nominal figures are taken from the answer to Parliamentary question S3W-27557, see http://www.scottish.parliament.uk/business/pqa/wa-09/wa0930.htm

Conclusions

18. The Scottish Government's total discretionary spending available for next year needs to be seen in context. For much of the last decade spending levels equivalent to those set in 2010-11 would be viewed as being remarkable. However, if it is now accepted that government spending in the recent past has been supported in part by unsustainable tax revenues, it is reasonable to assume that future budgets – UK and Scottish - will only be feasible at levels lower than all have come to expect.

19. CPPR projections[8] for DEL over the next 3 years show that the relatively lower 2010-11 budget is likely to be followed by further real terms reductions possibly out to 2013-14. Given this outlook, budget recipients need to plan and get used

[8] See www.cppr.ac.uk/media/media_128833_en.pdf

to lower growth rates as the full effects of slower UK growth, lower tax revenues and UK budget reductions feed through to Scotland's block grant.

20. The relative importance of capital spending has fallen since 2008-09. As the 2010-11 budget suggests, cutting capital projects may be the least painful means of accommodating tight budget settlements. To increase and improve Scotland's economic infrastructure may now require the balance to be adjusted with relatively more being allocated to support capital spending. Without doing so, is the existing capital / resource allocation consistent with seeking long-term economic growth?

21. Finding ways of securing additional private capital to fund Scotland's infrastructure is now essential as is securing it at a reasonable and defensible cost. To implement such an approach also requires a far greater level of understanding of what debt levels Scotland can afford and how much of future Scottish budgets is sensible to lock away to pay for such debt.

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