

***THE SCOTTISH GOVERNMENT'S 2008 BUDGET - UPDATE***

**Executive Summary**

- In its 2008 draft budget report, the Scottish Government proposed to spend more than the budget allocated to it by HM Treasury. To help balance the books, it is drawing on its large reserve at HM Treasury; £300 million in 2008-09, £400 million next year and £174 million in 2010-11. This will mean over 90% of its reserve has been utilised. Any further drawdown will require approval from HM Treasury
- In addition to utilising reserves to balance the budget the Scottish Government also need to over-allocate annual unspent programme funds. The budget assumes an over-allocation of £100 million in both 2008-09 and 2009-10 falling to £24 million in 2010-11. Relying on such budgeting arrangements may now need to be reviewed given that programme managers appear to be getting better at utilising their budget allocations; underspends have been falling sharply in recent years and were less than £100 million in 2007-08.
- A number of spending programmes assume additional income will be generated to part fund spending commitments. Such 3<sup>rd</sup> party income is forecast to exceed £200 million in each of the next three years, based on assumptions made before the current recessionary uncertainty was felt. In the event they are not achieved they simply add to the strain on the Scottish budget and limit the Scottish Government's ability to reallocate funds to help boost the economy.
- The £100 million acceleration of funding for more affordable housing has been made possible by delaying capital spending elsewhere in the Scottish budget. It is not clear there will be no negative knock-on effects in those areas where funds have been contributed. It is also not clear to what extent the Scottish Government can ensure the £40 million from Local Government will be made given the greater levels of autonomy now in place.
- The Scottish Government's ability to balance its Budget for each of the years 2008-09 to 2010-11 may now be at greater risk due to concerns over:
  - expected income shortfalls
  - sufficiency of budget underspends

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<sup>1</sup> This Note is subject to revision if and when data/further information becomes available.

- no significant reserves remaining from past savings through EYF<sup>2</sup>
- uncertainty over Local Government's ability to meet its own commitments in light of (i) income uncertainty (e.g. Glasgow) and (ii) lack of contingency savings (e.g. Aberdeen)

In addition, there is uncertainty over what increased services can be delivered with any new Barnett driven funding post 2010-11 given that some of this money will be needed to replace existing one-off funding sources.

- This is a worrying position to be in at this stage of an economic downturn. It also emphasises the problems with the existing budgetary process in Scotland that has worked up to now, where considerable extra funding has been made available at every funding round but where the current tightness of funds may put great strain on past practices.
- The tightness puts a strain on not only existing funding but clearly also on the ability to find any funds to help counter recessionary forces. It may be that harder decisions, than have so far been the norm, will need to be taken in order to provide any respite. For example, the Government may wish to revisit the Howat Report from 2006 or consider the recent Irish government move away from universal to targeted benefits.
- It is essential that these issues are addressed in full and modifications made where necessary as part of the current Budget round which is underway in the Scottish Parliament. The top priority for now must be to ensure that all existing planned expenditure commitments are met.

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<sup>2</sup> We are currently assuming that the £952.3 million reserves (i.e. EYF) total as of July 2008 includes the 2007-08 underspend, although we have not been able to clarify this to our satisfaction. Regardless, the future position regarding potential use of EYF will be much tighter than in the past.

## Introduction

To counter the negative impacts of the growing recession, the Scottish Government is investigating all means possible to boost the Scottish economy. Accelerating spending plans are being proposed in both Whitehall and Scotland and the Scottish Government has already announced it wishes to accelerate £100 million of expenditures to secure more affordable housing. With a discretionary budget of over £28 billion this year, rising to over £30 billion by 2010-11, the ability of the Scottish Government to do yet more may appear possible. However, as the following brief highlights, any budget flexibility that exists will be extremely limited and severely curtailed the longer and deeper the recession remains.

## The Scottish Government's discretionary spend

As Table 1 confirms, the Scottish Government's discretionary spend (largely determined by its DEL<sup>3</sup> allocation from Whitehall) is set to rise by £2.6 billion between 2008-09 and 2010-11 (see line 4 below).

**Table 1: Scottish Government forecast DEL, £ million (nominal prices)**

	2008-09	2009-10	2010-11
1 SR2007 <sup>4</sup> Scottish DEL	27,602	28,756	30,141
2 Scottish Water revised cost of capital allowance <sup>5</sup>	20	40	60
3 2008 UK Budget consequentials <sup>6</sup>	19	3	5
4 Revised HM Treasury allocation in 2008	27,641	28,799	30,206
5 Actual 2008 Scottish Government budget <sup>7</sup>	28,022	29,298	30,473
6 In-built over-spend	-381	-499	-267
<u>Funded by:</u>			
7 Released reserves <sup>8</sup>	300	400	174
8 Over-allocation allowances <sup>9</sup>	100	100	24
9 Final balance	-19	-1	69

<sup>3</sup> Departmental Expenditure Limits (DEL) are the discretionary funds the Scottish Government receives from the UK Treasury via the operation of the Barnett formula.

<sup>4</sup> Spending Review 2007 (SR2007) was the UK Treasury's allocation to the Scottish Government for the three years 2008-09 to 2010-11.

<sup>5</sup> This additional allowance was allocated to the Scottish Government to cover previously un-funded cost of capital associated with a revision to Scottish Water's cost of capital charge.

<sup>6</sup> As a consequence of increased spending commitments in the 2008 HM Treasury Budget, the Scottish Government's budget was increased via the operation of the Barnett formula. The resultant additional Barnett consequentials amount to £19 million in 2008-09, £3 million in 2009-10 and £5 million in 2010-11.

<sup>7</sup> This is the actual spending commitment as stated in the Scottish Government's Draft Budget 2008 report.

<sup>8</sup> The total value of previously unspent budget remains with HM Treasury, to be drawn down by each spending Department in joint agreement between it and HM Treasury. The balance on the Scottish Governments' account as at July 2008 was £952.3 million, £70.8 million capital and £881.5 million resource. Note, we are assuming that this £952.3 million EYF total as of July 2008 includes the 2007-08 underspend, although we have not been able to clarify this to our satisfaction. Regardless, the future position regarding potential use of EYF will be much tighter than in the past.

<sup>9</sup> The Scottish Government manages its budget by over-allocating funding each year. This allows it to minimise any underspend by reallocating such funds to spending programmes which can use them within the financial year. This budgeting approach has been utilised by previous administrations, although it is not clear when such an arrangement was introduced.

Whilst substantial, the Scottish Government's budget report clearly shows all funding is allocated and no explicit contingency exists to fund additional economy-boosting programmes. What, perhaps, is less clear is the extent to which current services may be facing testing times, even before any re-profiling of the budget.

In its 2008 draft budget report, the Scottish Government proposed to spend more (ie, line 5) than the budget allocated to it by HM Treasury (line 4). To balance the books, HM Treasury has allowed it to draw on its large reserve (line 7). This will contribute £300 million in 2008-09, £400 million next year and £174 million in the last year of this spending review period. However, this additional income does not balance the budget. This is done by over-allocating unspent budgets within the year (line 8) amounting to £100 million in both 2008-09 and 2009-10 and £24 million in 2010-11. Together, these two budgeting approaches allow the budget to balance each year, as it must (although there is a small deficit in 2008-09 which still needs to be eliminated). How reasonable such a budgeting approach is depends on whether historic trends will continue. As Table 2 suggests, this may now be open to question. Over the period 2003-04 to 2007-08 large underspends were recorded. However, the forecast underspend for 2007-08 was only £42 million and although the outturn figure of £96 million was larger, it is still less than the in-built underspend for each of the next three years. Moreover, accessing these funds will require a separate negotiation with HM Treasury.

**Table 2: Scottish Government budget under spends, £ million (nominal prices)**

	2003-04	2004-05	2005-06	2006-07	2007-08
DEL underspend - Forecast <sup>10</sup>	623	382	139	135	42
DEL underspend - Outturn	427	181	196	103	96

Sources: (a) Forecast: [www.scotland.gov.uk/News/Release/2008/06/19095030](http://www.scotland.gov.uk/News/Release/2008/06/19095030); (b) Outturn: Scottish Government, Consolidated Accounts, various years

## Non-Scottish Government revenues

A number of spending programmes assume additional income will be generated to part fund spending commitments (see Table 3). Additional, 3<sup>rd</sup> party income in excess of £200 million is forecast to be raised in each of the next three years with the NHS expected to deliver between 68%-76% in each year. These income forecasts were based on assumptions made some time before the true nature and possible extent of the recession was known. The sustainability and deliverability of such 3<sup>rd</sup> party income may now be worth testing. In the event that they cannot be achieved, this will put additional strain on the Scottish budget and limit yet further the Scottish Government's ability to reallocate funds to help boost the economy. Examples of such pressures in local government are now appearing, with incomes likely to fall short of expectations for those relying on land sales as such an income source<sup>11</sup>.

It should be noted that a number of other spending programmes are dependent on the EU for funds<sup>12</sup> (eg, ERDF, ESF and CAP). Although the value of these programmes is assured, they are nonetheless fixed in Euros. The current weakening of the £ against the € could be offering a fillip if the €£ rate used in the Scottish Government's draft budget assumed a stronger

<sup>10</sup> This is the estimate for the level of underspend associated with the Scottish Government's discretionary budget ie, its DEL budget. The Scottish Government's Consolidated Accounts also shows the variance in spend on both AME and Other Expenditure categories. Any underspend in either of these does not increase the Scottish Government's claims to reserves sitting at HM Treasury for future use.

<sup>11</sup> See [http://news.bbc.co.uk/2/hi/uk\\_news/scotland/glasgow\\_and\\_west/7722272.stm](http://news.bbc.co.uk/2/hi/uk_news/scotland/glasgow_and_west/7722272.stm)

<sup>12</sup> These incomes line amount to £594 million in 2008-09 and £622 million in both 2009-10 and 2010-11.

Sterling exchange rate. Alternatively, recipients of such funds will be exposed to any remaining exchange rate risk.

**Table 3: Non-Scottish Government income forecasts, £ million (nominal prices)**

	2008-09	2009-10	2010-11
NHS Income – Revenue	112.5	116.1	119.8
NHS Income – Capital	32.4	92.1	16.7
Housing & Regeneration	30.0	30.0	30.0
Historic Scotland	24.6	26.0	26.9
General register Office for Scotland	5.1	5.1	5.1
Repayment of public dividend capital	4.3	0.0	0.0
National Archives of Scotland	0.7	0.6	0.5
Roads cost of capital credit	0.0	4.3	4.3
	209.6	274.2	203.3

Source: Scottish Government Draft Budget 2008

### Funding for more affordable housing

The Scottish Government's £100 million acceleration of funding for more affordable housing has been made possible by delaying capital spending elsewhere in the budget (see Table 4).

**Table 4: Sources of funding for additional affordable housing**

Portfolio	Contributing programme	£ million
E&LL	SFHEFC* Admin	20.0
Health	n/a	16.0
Housing & Regeneration	n/a	10.0
Justice	Prisons capital	10.0
ERAD	Environment Protection & Sustainable Development	4.0
Local Government	n/a	40.0
		100.00

\* Scottish Further and Higher Education Funding Council  
Scottish Government, Draft Budget 2008

On the assumption that contributing programmes were going to struggle to spend their full funding commitment in 2008-09 and 2009-10, this reallocation will have limited adverse knock-on effects. However, if these programmes were able to utilise these funds in the year allocated, then the economy-boosting effect of the Scottish Government's actions may not be wholly positive. Moreover, when the funds are repaid in 2011-12 no inflationary adjustment will be made, reducing the real value of these funds to the contributing programmes.

Finally, this acceleration programme assumes Local Government will contribute £40 million from their own resources. It is not clear to what extent the Scottish Government has full agreement to this action given its wish to allow Local Government greater autonomy over their spending commitments. This simply adds to the uncertainty facing the Scottish Government around how to secure spending for economy-boosting programmes.

## **The budget in 2011-12 and beyond**

The current spending review covers years 2008-09 to 2011-12. Assuming the Barnett formula continues to determine much of the Scottish Government's budget and the UK is able to maintain increases in UK public spending post 2010-11, the then Scottish Government may anticipate receiving a discretionary budget in excess of £30.5 billion for 2011-12 and beyond. However, as Table 1 indicates, almost £200 million of the 2010-11 expenditures are to be funded from non-recurring sources. Consequently, £200 million of any new Barnett funding post 2010-11 will be needed simply to maintain service levels at their 2010-11 level<sup>13</sup>. Alternatively, services may need to be reduced, new ones delayed and/or there may be a need to look at additional revenue raising options to fund any potential budget deficit.

## **Alternative sources of Budget flexibility**

Given the tightness of the current budget from which to find funds that might help counter the negative impacts of the growing recession, what alternatives sources exist?

If we assume that the existing financial arrangement (based around the Barnett formula) is unlikely to change in the next year, then both increased public expenditure or tax cuts funded via increased government borrowing are ruled out. (Note: Scotland, as part of the UK is already implicitly borrowing at quite high levels so any such "Scottish" borrowing allowance would be on top of this UK element.) This removes the two most discussed tools in the current debate over how to dampen recessionary trends.

Within the current set up then the basic rate of income tax could be increased or reduced by 3p in the £. However, in the case of the former the extra public spending cash would be at the expense of higher personal taxes and in the latter case the higher individual spending through lower taxes would be at the expense of less money for the government to spend. Hence, without changing the Scottish Government's ability to raise additional levels of debt, the net affect of either of these changes is unlikely to be very significant. (The same argument largely applies to changes in business rates or local taxes.)

Further options do exist that might prove beneficial, but probably in the medium term. For example:

- the Howat Report of 2006 "Choices for a purpose"<sup>14</sup>, could be revisited and some of the bolder issues discussed therein reconsidered e.g. mutualisation of Scottish Water (possibly releasing around £180 million per annum); moving to fixed 3 year degree courses etc.
- a move to a more targeted, as opposed to universal, approach in some public spending areas. This approach has been followed by the Irish government in their latest Budget, targeting resources at those in greatest need. For example, health costs, child benefit payments and student contribution to Higher Education are to be considered. Clearly the same could be done in Scotland with respect to health charges, transport charges for the elderly and student contributions.

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<sup>13</sup> This assumes all underspends are either fully drawn in pervious periods or HM Treasury has utilised them in its budget allocations at the UK level.

<sup>14</sup> The Scottish Government (2006), Choices for a Purpose: Review of Scottish Executive Budgets: Report of the Budget Review Group, [www.scotland.gov.uk/Publications/2007/05/23114346/0](http://www.scotland.gov.uk/Publications/2007/05/23114346/0)

These are not going to be windfall solutions but they offer scope for improving efficiency and for helping those most in need. And they are not easy options, but perhaps this is a time for such difficult choices to be made.

## **Summary and Conclusions**

Scotland's public services have benefited from substantial increases in funding since devolution. With a discretionary budget in excess of £28 billion rising to £30.5 billion by 2010-11, boosting the Scottish economy through the recession may appear possible. However, the Scottish Government's flexibility now appears quite constrained.

To fund current spending plans the Scottish Government needs to drawdown over 90% of the reserves sitting with HM Treasury. It also needs spending programmes to continue to underspend to allow it to over-allocate around £100 million per annum. However, if last year is anything to go by, programme managers are becoming more adept at utilising their budget allocations. The recession simply adds to budget pressures should forecast revenues from 3<sup>rd</sup> parties fail to materialise. Rather than being able to reallocate underspends as a route to boosting the economy through the recession, the current programme of activity may be under pressure. This simply increases the need for the public sector to deliver greater levels of efficiency savings not only to boost the economy but to ensure the current programme remains affordable.

Finally, in our budget briefing last year we questioned the budgeting approach that has been applied for some years<sup>15</sup>. Failing to utilise funds in any one year is effectively penalised as any underspend is retained by HM Treasury and can only be released once HM Treasury has given its approval. Adopting an over-allocation approach has provided the Scottish Government with a greater degree of control and helped to minimise the build-up of reserves at Whitehall. However, with budgets becoming tighter and demand for services growing, a new approach to budgeting now seems essential; over-allocating budgets to minimise the underspends that effectively revert to Treasury may need to be adapted such that any underspends are used to ensure priority projects are fully funded or projects that would otherwise be funded in future years accelerated. The growing budget constraint will also mean more difficult budget decisions will need to be faced ie, schemes that are mainly redistributive in nature (ie, the abolition of road tolls or universal free bus travel for over 60s) may need to compete more vigorously with spending programmes that have a greater potential to deliver longer-term economic growth benefits (eg, R&D support or major infrastructure projects).

It is essential that these issues are addressed in full and modifications made where necessary as part of the current Budget round which is underway in the Scottish Parliament. The top priority for now must be to ensure that all existing planned expenditure commitments are met.

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<sup>15</sup> [http://www.cppr.ac.uk/media/media\\_54616\\_en.pdf](http://www.cppr.ac.uk/media/media_54616_en.pdf)