CPPR - Briefing Note
February 2009

THE SCOTTISH GOVERNMENT'S BUDGET – GROWTH SCENARIOS UPTO 2013-14

Executive Summary

Spending by Scottish Government 2008-09 to 2013-14; 3 scenarios for growth

DEL total £bn	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
1. Pre PBR08 DEL	28.0	29.3	30.5			
2. PBR08 changes		0.3	-0.8			
3. New Total DEL	28.0	29.6	29.7			
4. Real Terms	28.0	29.2	28.5			
5. Real Growth	-	+4.3%	-2.4%			
Scenario A						
6. Total DEL				29.8	30.1	30.5
7. Real Terms				27.8	27.4	27.0
8. Real Growth				-2.5%	-1.5%	-1.5%
Scenario B						
9. Total DEL				30.2	31.0	31.9
10. Real Terms				28.2	28.2	28.2
11. Real growth				-1%	0%	0%
Scenario C						
12. Total DEL				30.4	31.3	32.4
13. Real Terms				28.3	28.5	28.6
14. Real growth				-0.5%	0.5%	0.5%

Sources: Scottish Government; HMT PBR'08; IFSGB09

- There is likely to be a significant and prolonged real terms reduction to the Scottish Government's discretionary spending over the period 2009-10 to 2013-14, and probably beyond.
- Combining the changes to the Scottish Budget arising from the November 2008 Pre-Budget Report (PBR08), along with budget forecasts to 2013-14[1] points to 2009-10 being the Scottish Government's peak spending year for the foreseeable future.
- We present 3 possible budgetary scenarios:

  Scenario A: IFS "central"
  Here the Scottish budget declines by between 1.5-2.5% in real terms for 4 consecutive years post 2009-10, ending up with a

[1] Forecasts have been derived from both the PBR08 and the Institute for Fiscal Studies Green Budget (IFSGB), January 2009.

Budget in 2013-14 that is 7.5% lower than the peak year of 2009-10;

Scenario B: IFS zero real growth
The Scottish budget falls by 2.4% in 2010-11, a further 1% in 2011-12 and thereafter sees no real terms growth for the next 2 years;

Scenario C: CPPR "central"
The Scottish budget falls by 2.4% in 2010-11, with a further small fall in 2011-12, before increasing for each of the next 2 years by 0.5% per annum, but is still 2% below its 2009-10 real terms peak in 2013-14.

- Most of the risks around these scenarios are associated with the downside, making the two more pessimistic scenarios – scenarios A and B – eminently possible. For example, UK economic growth is now expected to be lower than that anticipated in both the PBR'08 and the IFSGB.
- It is important to bear in mind that the forecasts made here are precisely that - forecasts. Uncertainties over current and future allocations mean that it is difficult to be precise over the profiles shown, but that does not take away from the useful and worrying information being conveyed with regards to the Scottish spending limits as a whole.
- This real terms decline in the Scottish Budget comes at a time when there are considerable pressures on that Budget stemming from both traditional sources (e.g. the Health sector, Education, the public service wage bill, etc) as well as new ones (e.g. transport and energy infrastructure investment needs, the Commonwealth Games 2014, etc).
- In terms of Scotland's Budget these are uncharted waters. Recent funding tightness has been obscured in part by the near total utilisation of all past budget savings (i.e. the drawing down of EYF). However, the next few years will bring forward a very different fiscal position for Scotland (and the rest of the UK).
- In order to help make the tough choices, CPPR would argue that Scotland will need a strong and powerful Finance/Budget Department, a more H.M. Treasury-like body that spends little but has the greatest power amongst Departments. Such a body would tightly control spending in other departments and make the necessary, but possibly unpopular, spending decisions. It should also have a long-term mindset and have contingency plans in place for different likely outcomes.
- Overall, the Scottish Government now faces, to a far greater degree than ever before, some stark choices.

Introduction

This Briefing Note is an update and expansion of the CPPR November Briefing Note – *The Scottish Government 2008 Budget – Update*. Its purpose is to act as a warning over likely upcoming Budget conditions, in particular a significant and prolonged reduction in real terms Scottish spending available over the period 2009-10 to 2013-14, and probably beyond.

Starting from the previous CPPR Briefing, this Note incorporates:

- changes made to the Scottish Budget resultant from last November's UK Government Pre-Budget Report 2008 (PBR08); and,
- projections to 2013-14, based on data contained in both the PBR08 and the Institute for Fiscal Studies Green Budget (IFSGB) of January 2009.

The results illustrate the likely profile of the Scottish Budget (in terms of Departmental Expenditure Limits - DEL) for the next 5 years, up to 2013-14, based on 3 different budget scenarios.

It is important to bear in mind that the forecasts made here are precisely that, forecasts. Much could change between now and when the final budget allocations are made. In addition it is better to focus on the general profiles of the scenarios rather than concentrating too much on the details, or the nearest decimal point of the growth rates shown. Uncertainties over current and future allocations mean that it is difficult to be precise over these profiles, but that does not take away from the useful and worrying information being conveyed with regards to Scottish spending limits as a whole.

This Note also considers some of the pressures that will need to be contained within this declining (in real terms) Budget, covering Health, Education, Local Government and large capital projects. Some examples of further budgetary risks are also outlined.

Finally, the Note makes some suggestions over how the hard times that are coming might be approached, in order for the Scottish Government to live within such a declining overall Budget.

Three Scottish Budget Scenarios for the period 2008-09 to 2013-14

Table 1 highlights the Scottish Government's likely discretionary spend (largely determined by its DEL allocation from Whitehall) over the period up to 2013-14. It starts with the original DEL Budget (line 1) as it stood prior to the PBR08.

Line 2 incorporates the budgetary impact of the PBR08 changes. These comprise 3 elements:

- first, an acceleration of £260mn in capital spend from 2010-11 to both 2008-09 and, primarily, 2009-10;
- second, a one-off reduction in the Scottish Budget in 2010-11 of £129mn consequent on the Barnett Formula applying to a £1.3bn reduction to the English Department of Health's capital budget in that year;

- third, a one-off reduction in the Scottish Budget in 2010-11 of £380mn consequent on the Barnett Formula applying to a £5bn efficiency savings related reduction to Whitehall Department's resource DEL[2].

Table 1: Spending by Scottish Government 2008-09 to 2013-14: Scenarios A, B and C

DEL total £bn	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
1. Pre PBR08	28.0	29.3	30.5			
2. PBR08 changes		0.3	-0.8			
3. New DEL	28.0	29.6	29.7			
4. Real Terms[3]	28.0	29.2	28.5			
5. Real Growth	-	+4.3%	-2.4%			
[3a Revised DEL 2010-11			29.4*]			
[3b Revised DEL 2010-11 real			28.2*]			
Scenario A						
6. Total DEL				29.8	30.1	30.5
7. Real Terms				27.8	27.4	27.0
8. Real Growth				-2.5%	-1.5%	-1.5%
Scenario B						
9. Total DEL				30.2	31.0	31.9
10. Real Terms				28.2	28.2	28.2
11. Real growth				-1%	0%	0%
Scenario C						
12. Total DEL				30.4	31.3	32.4
13. Real Terms				28.3	28.5	28.6
14. Real growth				-0.5%	0.5%	0.5%

* The revised 2010-11 DEL in line 3a has been derived by excluding non-recurring budget amounts from the 2010-11 DEL figure in line 3. This reduces DEL in 2010-11 by £0.26 bn; £01.7 bn from the EYF reserves that were drawdown in that year and £0.09 bn from a budget over allocation allowance. To estimate the DEL amounts for 2011-12 and beyond, this revised DEL figure for 2010-11 is therefore the appropriate baseline figure.
Sources: Scottish Government; HMT PBR'08; IFSGB09

The table then illustrates the impact of three different scenarios for future DEL spending totals:

- **Scenario A** – IFS "central". This scenario is based on the IFSGB's real growth rate for Scottish DEL of -1.5% (see IFSGB, 2009, Chapter 9, Figure 9.10);

[2] Note: the actual disaggregation of this reduction will not be announced until Budget 2009 and so the £380mn for Scotland is an estimate made by David Bell on behalf of the Scottish Parliament's Finance Committee, and which assumes that such efficiencies are shared equally in % terms between all UK Departments.
[3] The appropriate GDP deflator is taken from the PBR08 report, table B1.

- **Scenario B** – IFS zero real growth. This assumes the 0% real growth rate that IFSGB assumes for UK DEL as a whole;
- **Scenario C** – CPPR "central". CPPR's own calculations of Scottish growth is based on applying the Barnett Formula to the IFS growth rates for Whitehall Departments which comes out at +0.5% average annual growth.

These Scenarios are explained in greater detail below.

Scenario A

This scenario is derived from the IFSGB, Table 9.10. Much greater detail of how this growth rate is arrived at can be found in Chapter 9 of that publication. However, the brief explanation is as follows:

- The PBR08 set overall Total Managed Expenditure (TME) [4] increases at 1.1% per annum in real terms over the period 2011-12 to 2013-14[5]
- Non-DEL elements of TME – principally net debt interest payments and social security related benefits – are set to rise more quickly, i.e. by 2.5% a year, and with the TME growth rate limited to 1.1% pa, this implies the remainder of spending (effectively DEL) experiences a 0% real growth rate over the period
- IFS then average this zero real growth across all spending Departments by applying an equal percentage point reduction in their annual growth rate for the period 2011-12 to 2013-14
- This means in effect that each Departments' growth rate from 2010-11 to 2013-14 is reduced by 2.5% from that experienced over the earlier period 2007-08 to 2010-11, so that traditionally high growth Departments (like Health) still grow but at a lower rate than before, while many low growth Departments experience real term reductions over the later period
- The Scottish DEL Budget falls into this latter category and so experiences a real terms annual decline of 1.5%[6].

Scenario B

Scenario B adjusts the Scottish growth rate to be in line with that used by the IFSGB for the UK DEL as a whole, that is 0% per annum.

[4] Total Managed Expenditure comprises Departmental Expenditure Limits (DEL) and Annual Managed Expenditures (AME). The Scottish Government's discretionary spending budget is DEL. AME includes items that are not within the control of the Scottish (or indeed the UK) Government including, in the main, social security payments and tax credits.

[5] IFS also indicate that current spending is expected to rise by 1.2% pa on average over the period whilst capital spending will be held constant in cash terms, and so falling in real terms. Given the importance of capital spending to the Scottish budget, the budgetary implications of this variation is something we expect to analyse in a future briefing.

[6] The figure of 1.5% is actually lower than the 2% seen in IFSGB Table 9.10, as it has been adjusted to incorporate the efficiency savings cut in 2010-11.

Scenario C

Finally, Scenario C attempts to calculate a growth rate for Scotland based on those Whitehall Department's affected by the Barnett Formula, as shown in line 12 of Table 1. This results in a small, positive, growth rate (+0.5%), due in the main to Scotland benefiting from the still positive growth in Health and Education but being excluded from the big cuts in the large UK Defence budget.

RESULTS

Table 1 illustrates the resultant Scottish Government discretionary spending (ie, Total DEL) under each of the 3 scenarios in terms of:

(a) the total cash budget;

(b) the budget in real terms (i.e. stripping out inflation using the PBR08 GDP deflator projections); and

(c) the real growth rate.

For **scenario A** (lines 6-8), the Scottish budget declines by between 1.5-2.5% in real terms for 4 consecutive years post 2009-10, ending up with a Budget in 2013-14 that is 7.5% lower than the peak year of 2009-10.

For **scenario B** (lines 9-11), the budget falls by 2.4% in 2010-11, a further 1% in 2011-12 and thereafter sees no real terms growth for the next 2 years.

For **scenario C** (lines 12-14), the budget falls by 2.4% in 2010-11, with a further small fall in 2011-12, before increasing for each of the next 2 years by 0.5% per annum, but is still 2% below its 2009-10 real terms peak in 2013-14.

If the CPPR calculated profile (Scenario C), as opposed to the more pessimistic IFS based profiles, is accurate then this is of some relief for the Scottish Government, but it still leaves an enormous set of budgetary challenges in comparison to the real terms increases experienced in earlier years. In addition, and as discussed later, most of the risks around these scenarios are associated with the downside, making either of the two more pessimistic scenarios a real possibility.

Budgetary pressures within a declining Budget

The potential budget decline outlined above would be difficult to accommodate in any circumstances but it is even more difficult to accommodate given the following continuing, or increasing, expenditure pressures:

- a consistently expanding Health budget (e.g. at over one third of the Scottish DEL total, if Health were to grow at a historically modest 2% a year then, within a zero real terms growth scenario (i.e. scenario B), all other budgets would need to be cut by 1% in real terms a year)
- an Education budget that has a high priority
- an overall budget that consists of over 50% of wages, which traditionally have risen in real terms

- continuation of the council tax freeze
- an ambitious, although still undefined, transport infrastructure building programme, especially in relation to the Forth Road Bridge replacement
- other infrastructure commitments that are likely to follow on from upcoming and urgent energy sector investment (see the SCDI report by Wood Mackenzie on investment needs, some of which will have public sector capital investment knock-on impacts)
- the Commonwealth Games of 2014
- increased promised investment in public sector housing
- Higher Education resources, related to R&D needs, in order to remain competitive, as outlined in the Universities Scotland publication (UU 2009)
- filling funding gaps brought about by lower than anticipated Scottish central and local government revenues streams, due to slower economic growth.

This would be a daunting list of competing bids at the best of times, and it is not even a complete list. However, it is one that faces the Parliament in what are clearly the worst of times, in budgetary terms, since its inception in 1999.

Risks

There are both upside and downside risks to the Scottish public spending profile outlined in Table 1. However, at present the downside risks heavily outweigh the upside risks. For example:

- PBR08 spending plans were predicated on a higher growth profile for the UK than is currently foreseen. It assumes a decline in GDP of 1% in 2009 before returning to trend growth by 2011. The IFSGB base case growth scenario is slightly more pessimistic (at -1.3% in 2009) and its 'pessimistic' scenario even more so (-3.2%). Furthermore, recent forecasts by the Bank of England and the CBI both predict a fall in GDP in 2009 nearer to this 'pessimistic' scenario, down by 3% and 3.3% respectively, and with a slower return to trend growth thereafter. This is important as a deeper and longer recession reduces government receipts (via lower taxes collected) and increases non-DEL spending (via higher unemployment related benefits for example). There is a serious risk that DEL spending will be further cut in later Spending Reviews.
- IFSGB assume that the Governments commitment to linking pensions to inflation will be delayed from 2012 to 2014 or beyond. If it is not there will be even less money available to DEL.
- IFSGB figures beyond 2013-14, up to 2015-16, suggest that any recovery in spending will not be sharp and that little, if any, real growth in DEL spending will materialise
- The Government may be forced to impose even more efficiency savings post the 2010-11 round announced in the PBR08.

All in all, scenario C shown in Table 1 looks likely to be, if not a best case scenario then at least an optimistic one, and it might be prudent to build in even greater declines in spending levels, consistent with scenarios A and B, when planning future spending levels.

Possible approaches to accommodate a declining Budget

The impending reductions in the Scottish Budget are on a scale hitherto unimagined by the Scottish Government or Parliament. They will require a new way of addressing the Budget. Some examples of what this might entail include:

- cut back and clearer prioritisation of intended capital projects described earlier
- increases in council taxes and non-domestic rates
- deeper efficiency savings, outwith those imposed via Whitehall cuts
- medium term public wage settlements at or below inflation
- a move from universal public services to more targeted ones
- increases or (re)introduction of charges e.g. bridges, medicine etc
- increased private contributions e.g. in Higher Education

Many of the above approaches are radical and controversial. Nevertheless they comprise a set of options that may well have to be seriously considered if the Budget is to be balanced in these tough financial times. The Irish government is facing its own budgetary difficulties at present and is exploring many of these avenues as ways to "*bring order to the public finances*."

So far much of the political discussion in Scotland on the future tightness of the Budget has revolved around two subjects: efficiency savings and borrowing powers.

On efficiency savings, the Scottish Government has not yet presented a case for making greater efforts in this direction. While we accept that they may be unwelcome, nevertheless in current circumstances it is important that the scale of the public sector borrowing requirement (PSBR) is kept in check, lest financial markets lose faith in the UK's credit worthiness. If confidence waned then interest payments on debt and borrowing could rise and make the position much worse. Hence, the efficiency savings can be a useful tool in helping to minimise the differential between government receipts and government spending. Whilst we recognise the difficulties, both political and practical, involved in making these efficiency savings, especially if they result in real cuts in services, there is also an argument to be made for the Scottish government to think in terms of even greater efficiency savings, and try and get ahead of the curve in terms of potential future cuts.

On borrowing, the debate over whether the Scottish Parliament should have its own borrowing powers is still at a very early stage. No real consideration has been given yet as to how these powers might fit in with the existing UK system of borrowing powers. This is important as current forecasts show UK borrowing levels (which incorporate implicitly borrowing on behalf of Scotland) at very high levels and it is not clear how any further borrowing might be accommodated, nor the impact this would have on UK finances and UK interest rates.

Furthermore if Scotland were to have its own borrowing powers it is unclear what the financial markets would make of them. For example, how would the markets determine how much debt Scotland might be able to borrow; how would they view Scotland's ability to service any such debt payments when in all likelihood its budget (i.e. income) will be under severe pressure; what is the appropriate rate of interest to charge a Scottish Government that, presumably does not have the UK Government underwriting its debt obligations; and, what would be the Scottish DEL consequence of such additional borrowing costs? Suffice to say, much more work needs to be done before we are clearer over these important issues. So for now the issue of borrowing powers is more of political than budgetary interest.

All of this presents significant challenges that will need to be met by the current and future political administrations. However, such times of crises can have the advantage of allowing more leeway to drive through radical and contentious change, as Ireland did in the late 1980's for example. Now may well be a time to reconsider the workings of Scotland's large public sector, not in order to cut it (indeed it may well have to increase in relative importance in coming years due to current economic problems) but to learn lessons over making it more dynamic, innovative and productive and appropriately incentivised. Scandinavian openness to public sector innovation, within a large state sector environment, may hold some lessons for Scotland.

Conclusions

In terms of Scotland's Budget these are uncharted waters. Recent funding tightness has been obscured in part by utilising past savings (i.e. the drawing down of EYF). However, the next few years will bring forward a very different fiscal position for Scotland (and the rest of the UK).

Since Devolution the Scottish government has been principally faced with the question of where to spend the extra money, rather where to cut back, such was the largesse available. Tricky decisions may have been made but not harsh ones. In the current situation, any tendency of highlighting the downsides of every cut, and siding with those who suffer as a result, has to change. Instead the upside of financial prudence has to be recognised more, as well as the inevitability that budgets cannot always increase. As with share prices and house prices, government spending is not a one-way bet. Clearly, they can slow and even fall, and the bad times have to be accepted and accommodated along with the good times.

Both politicians and civil servants are being faced with the need to make difficult decisions over a Budget that is likely to experience sustained falls in real terms.

In order to help make the tough choices, CPPR would argue that Scotland will need a strong and powerful Finance/Budget Department, a more H.M. Treasury-like body that spends little but has the greatest power amongst Departments. Such a body would tightly control spending in other departments and make the necessary, but possibly unpopular, spending decisions. It should also have a long-term mindset and have contingency plans in place for different likely outcomes.

Overall, the Scottish Government now faces, to a far greater degree than ever before, some stark choices.

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