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Potential Budget scenario

This note considers:

1 A potential budget cuts scenario, with emphasis on dealing with 2011-12 difficulties
2 Double dip concerns

1 Potential budget cuts scenario

Earlier in August CPPR published a paper outlining 3 different scenarios for how this cut might be met[1]. Each of these scenarios was an 'extreme' version, in order to highlight some of the trade-offs involved.

Below we set out a more 'realistic' scenario of what might lie ahead for budget holders. However, this is simply a guide scenario as there are many possibilities that could finally emerge.

Assumptions:

- ring-fencing of the Health budget, to the extent that it receives the Barnett Consequentials attached to Health spending in England;
- a flat cash wage deal (0%) in the first two years, followed by a 2% cash rise in each of the next two years;
- a cut in capital spend in line with that outlined in the Independent Budget Review Report (IBRR), i.e. consistent with Scottish Government's projection for the Barnett Consequentials for DEL capital over the period, resulting in a fall of £0.7 billion in cash terms.

As Table 1 illustrates, this scenario means the total savings required between 2010-11 and 2014-15 will actually be nearer £1.7 billion (cash terms), or an increase of £0.6 billion (net) over the £1.1 billion cash (£3.7 billion real terms) cut projected by the Scottish Government.

Table 1 also highlights the impact of effectively protecting ever larger amounts of the overall budget, resulting in disproportionately higher cuts, now 28%, that need to be delivered by the 'unprotected' rump.

[1] See "Three possible scenarios for the Scottish Budget" available on the CPPR website: www.cppr.ac.uk.

Table 1: Contributions to proposed DEL budget cuts, 2010-11 to 2014-15, £billion (cash)

		2010-11	2014-15	Change £ billion	Change %
Total DEL		29.2	28.1	-1.1	-4%
Of which	- Wages	9.1	9.5	+0.4	+4%
	- Health	10.7	11.6	+0.9	+8%
	- Capital	3.3	2.6	-0.7	-21%
	- Remainder	**6.1**	**4.4**	**-1.7**	**-28%**

Sources: IBRR, Table 2.1, for Total DEL and Capital, others calculated by authors.

Notes: a) The Health total is assumed to apply to the Health DEL total of £11.3 billion (£10.7 billion resource and £0.6 billion capital) rather than the NHS DEL total of £8.5 billion.

b) The Scottish Health budget per capita is roughly 15% higher than the English equivalent, hence, if the English figure rises in line with inflation, the Scottish figure will rise at a slightly lower rate.

c) The Wages line refers to non-Health wages only, as Health wages are included in the Health line.

d) See Annex for comparability with previous projected changes.

However, as Table 2 shows, the future pain will not be evenly spread over the spending review period but will be front-loaded, with 2011-12 facing particularly large cuts.

Table 2: Contributions to proposed DEL budget cuts, 2010-11 to 2014-15, % change (on Cash totals)

		2011-12	2012-13	2013-14	2014-15	Total change over 4 years
Total DEL		-4	+½	+0	+0	-4%
Of which	- Wages	0	0	+2	+2	+4%
	- Health	+1¾	+2	+2¼	+2¼	+9%
	- Capital	-18	0	-7	+4	-21%
	- Remainder	**-13**	**0**	**-6**	**-11**	**-28%**

Note: a "+" means the total DEL budget contribution is increasing to fund the area concerned meaning additional cuts will be needed elsewhere to ensure the overall budget balances.

Source: CPPR calculation

Given this skewed cuts requirement, additional budget reducing measures, over and above those highlighted in the above set of assumptions, will need to be found and will need to be initiated quickly. For example, it would seem unlikely the benefits from moving Scottish Water to a mutualised model could make any meaningful contribution to the 2011-12 budget if there is also a wish to maximize the value of doing so to the Scottish Government.

Where might one potentially find the Year 1 savings required?

Table 2 highlights the 13% (or £0.8 billion) cash terms cut required in 2011-12. There are a variety of potential sources to find such a saving.

Cash releasing efficiency savings

In the above scenario, cash releasing efficiency savings of 2-3% a year, in relation to the non-wage, non-capital element of the DEL budget, for the next four years are estimated by the IBRR to be worth £0.6 billion to 0.9 billion by 2014-15. The contribution to year 1 cuts could be worth around £150-225 million.

However, these are assumed to match, and therefore only offset, inflation rises in non-wage, non-capital costs like energy, water, food etc. Net, therefore, they are assumed to make no contribution to the cash cut required.

Revenue increases

Currently most discussion in Scotland has revolved around cutting spending rather than raising taxes. Equally, the UK government is targeting spending cuts over tax rises in a ratio of around 3:1 up to 2014-15, i.e. 75% coming from spending cuts.

However, there is potentially more scope on the revenue side for quick changes, as tax rates can be changed with almost immediate effect. This could include:

- Council Tax
- business rates i.e. non domestic rates income (NDRI)
- bridge tolls, parking fines, prescription charges etc.

The degree to which these different tax sources are altered would affect the distribution of their impact on different income levels. For example, if council tax rates were raised in an asymmetric manner, with expensive properties paying relatively more, they could be made more 'progressive' in their effects.

If the Council Tax were to rise in line with inflation, for example, this would contribute around an extra £40-70 million (depending on whether the GDP deflator, CPI or RPI was used) in 2011-12, and each year thereafter.

A similar amount would be raised annually if NDRI were to rise with inflation although the potential impact such increases could have on private sector jobs may also need to be assessed.

The list above excludes the use of the Scottish Governments tax varying power (TVP – which allows for a variation of +/- 3p on the basic rate of income tax) as it is likely to take over a year to introduce and, indeed, any associated set-up costs could add to the budget challenge in the early years. However, based on UK Budget 2010 (March 2010) figures, the use of this tax in 2011-12 would raise £400 million for each penny increment, i.e. up to £1,200 million if all 3p were used. The actual worth per penny, year by year, will depend on UK government decisions over basic rate income tax thresholds and allowances.

Health

A slight weakening of the protection which is currently being offered to the Health budget, could also contribute to meeting the necessary Year 1 budget reduction. If the wages element of the Health budget (roughly two-thirds of its resource budget) is subject to the same wages policy as the rest of the public sector, and only the remainder (non-wages element) of the budget rises in line with inflation, then this would reduce the extra cash needed by around £150 million.

Job cuts

Any remaining Year 1 savings will probably need to come via job cuts.

If we assume that both NDRI and the Council Tax rise with (RPI) inflation and that Health savings relating to a wages freeze are realised, then the remaining gap amounts to around £500 million, or job cuts of around 18,000 based on an average wage cost of £28,000.

So, even with the above level of wage restraint, significant job losses will still be needed to balance the books in the first year of the next spending review period.

It is worth noting that further job cuts may be associated with the very large cut in capital shown in Table 1.

Also, the efficiency savings shown above relate only to the non-wages, non-capital element of the total DEL budget (in line with the IBRR) and hence imply the avoidance of any further job losses.

However, depending on what approach is taken to finding overall savings, the number of jobs lost could vary considerably. But it is not clear what level of efficiency savings might prove consistent with any particular level of job cuts. It seems reasonable to assume that any non-wage related efficiency savings would be, to some extent, directly linked to the number of jobs that are lost. As a result, the final rate of efficiency savings that should be sought (2%, 3% or higher) would need to be revisited in light of the number of jobs ultimately being lost.

Rising demand pressures

There is another important, but less well understood, budgetary impact that needs to be taken into account which relates to the rising demand for some services (e.g. in relation to rising concessionary travel and care for the elderly costs as outlined in the IBRR).

In the scenario outlined above it is assumed that some weakening of universal benefits occurs and that such partial charging for services is assumed to be enough to cover rising demand-related costs, but no more. The IBRR report (Chapter 5) outlines a number of ways this outcome could be achieved.

Year 2 and beyond

The above difficult decisions could deliver the necessary Year 1 budget adjustments.

Year 2 is currently the least demanding year given the above budget projections, although rising demand pressures in particular will still need to be accommodated.

By Years 3 and 4, the more complicated structural changes, such as the streamlining of services, greater use of shared services or the mutualisation of Scottish Water could be introduced, having had the necessary time for effective planning and implementation.

In making these more structural changes it will be important to recognise that the pain does not stop in 2014-15 but could continue, in a less severe fashion, for many more years thereafter. Rising demand pressures that outstrip funding increases will be the new norm in the world of public finances.

Local Government position

The Local Government position is complicated by uncertainty over what will happen with regards to Council Tax.

In the event that the Scottish Government no longer seeks to cap the Council Tax, or indeed encourages increases over time, this could provide Local Government with more funding. However, such an approach could also allow the Scottish Government to reduce the cash grant it makes to Local Government accordingly. In this situation, Local Government may be faced with the worry that its total projected receipts are lower than expected as more Council Tax payers fall into arrears.

Overall, savings in the Local Government Budget will need to emerge from a mixture of efficiency savings, job cuts and revenue increases.

2. Double dip risks

The latest Bank of England (BoE) growth projections (see Table 3) suggest that (real terms) GDP growth will be 1.6% in 2010, 2.7% in 2011 (down from previous estimate of 3.4%) and 3.1% in 2012 (down from 3.5%). These estimates are still well above the consensus of independent forecasters, see Table 3. However, these central BoE projections are shown within a range (covering 90% of likely outcomes), which in 2011 and 2012 extends from +5½ to –½ %.

In the real world the chances of a double dip, i.e. negative annual growth sometime in the next few years is thought to be a realistic possibility. On the other hand, no forecasts that we are aware of have even considered the possibility of UK growth reaching or exceeding 5%. (Note: annual UK GDP growth has only reached or exceeded +5½% once since 1970, in 1973 (+5¾ %.) Furthermore, both the IMF and Reinhart and Rogoff (see their recent book, "This Time is Different", PUP, 2009) have highlighted that recoveries from recessions associated with financial crises in advanced economies tend to be more sluggish than normal.

This highlights the problem with such economic models, as the BoE use, at times of great change. They are built to reflect steady past relationships, but when those relationships break down they are largely lost and tend to drift back to a past equilibrium position. They are also built to show central forecasts with an even risk distribution both on the up and down side of this central forecast.

In a sense this is the difference between dealing with **risk,** which can be quantified and modelled based on known distributions of outcomes, and with **uncertainty**, which relates to events that cannot be accurately predicted or modelled as there are too many unknown elements involved.

An example of this difference can be seen in motor insurance. An insurance company can calculate the risk attendant in insuring a well-known make of car. However, it is faced with uncertainty when a new, completely unknown, make of car is introduced and, initially at least, would be uncertain what sort of risks were attached (how reliable are the brakes or engine?) and so what insurance premium is appropriate to apply.

As well as being next to useless at predicting severe turning points, models also find it difficult to predict the shape of any growth immediately after such a down turn, due to the change in relationships that have occurred as a result of the structural changes to the economy associated with the downturn. For example, it is very difficult to tell whether lost output will be easily reused, suggesting a fast bounce back, or whether the lost skills and capital is now largely redundant, suggesting a slow return towards using up the spare potential output capacity.

Furthermore, all of this is taking place against a background of households, governments and financial companies rebalancing their balance sheets. It is hardly surprising therefore that economic models find it hard to do anything than suggest a drift back to normality.

As a result, if a double-dip arrives it will simply emerge, fast or slow, it will not be predicted by any model (Table 3 provides a range of the latest UK GDP growth forecasts with none predicting a double-dip recession). That may not be very reassuring news but at times such as these too strong a belief in certainty is unhealthy. Uncertainty will prevail for some time to come and that should be the basis on which future plans are made i.e. with acceptance of the need for flexibility.

Table 3: UK GDP (real terms) growth forecasts (%)

	2010	2011	2012	2013	2014
H. M. Treasury/OBR (June Budget)	1.2	2.3	2.8	2.9	2.7
Bank of England (August, central)	1.6	2.7	3.1	-	-
Independent average	1.3	2.0	2.2	2.4	2.4
Independent highest	*1.8*	*3.4*	*3.2*	*3.8*	*3.7*
Independent lowest	*0.7*	*0.9*	*1.3*	*1.4*	*1.5*

Sources: H.M. Treasury – 'Forecasts for the UK economy, No. 280, August 2010; Bank of England.

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ANNEX - comparability with previous projections

In comparing the 28% cut shown in Table 1 to other independent estimates it should be remembered that this figure is a cash terms figure (ie, it includes inflation). By way of comparison:

- IBRP show a 20% real terms cut in non-health Scottish DEL (or around a 10% cash terms cut);
- IFS show a 25% real terms cut in non-protected UK DEL (or around a 15% cash terms cut).

The reason that both these other estimates are lower than 28% in Table 1 for unprotected DEL cuts is principally because the latter includes a degree of protection to the wages element of the Scottish Budget.

In comparison to Table 2 of *Public Finance Advisory Note 2*, the -28% is considerably higher than the -7% cash, health protected, figure, as the Table 1 figure above now incorporates even more protected spending areas (e.g. wages) and consequently further shrinks the unprotected rump from which these cuts have to be found.