Report on the Draft Scottish Budget 2013-14

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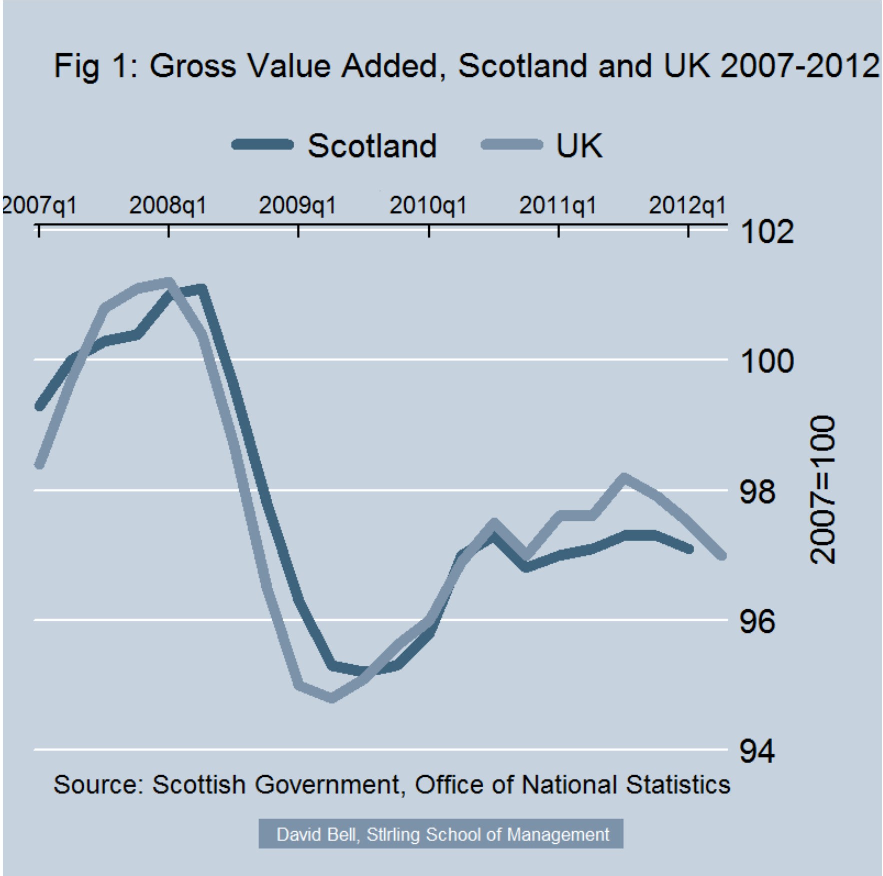
Introduction

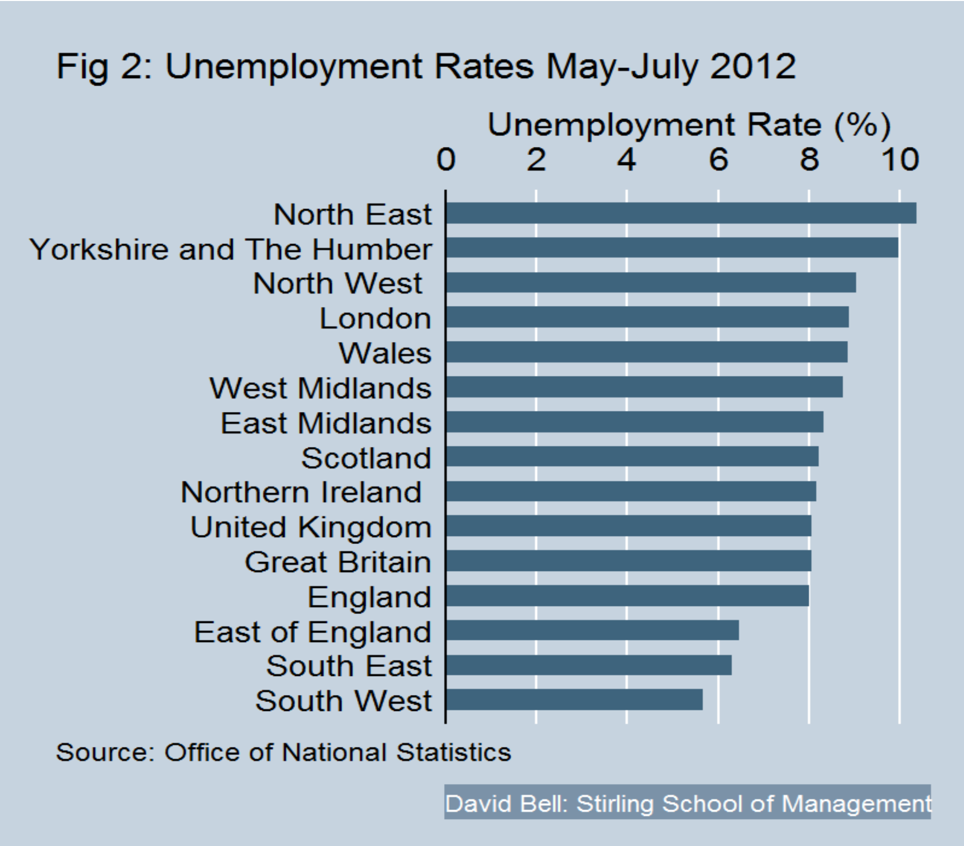
This report has been prepared for the Finance Committee of the Scottish Parliament. It analyses the 2013-14 Draft Budget and Spending Review.

Context

As with the last budget, the 2013-14 Draft Scottish Budget is set against a world of considerable economic uncertainty. In my report on the 2012-13 Draft Budget, I argued that that there was a risk of economic collapse along the lines of 2008. While a major collapse has yet to occur, many of the countries in Europe are experiencing stagnation or negative growth. The UK is now in a "double dip" recession. Scotland's next GVA data, to be released on October 17th, will reveal whether Scotland has followed suit. (see Fig 1).



Given the depth of the recession, the UK labour market has performed better than expected. If the pre-crisis relationship between output and jobs still held, employment would have fallen by 8 per cent since mid-2007. Instead employment has risen. Given the fall in output, the Scottish labour market's performance has also been surprisingly benign. The unemployment rate in Scotland is close to that of the UK as a whole (see Fig 2), indicating that its labour market performance is broadly in line with the rest of the UK.



UK Fiscal Situation

The UK government borrowed £119.3 billion in 2011-12, a reduction of £27.4 billion on the previous fiscal year. However, it seems unlikely that this improvement in the fiscal situation will continue. In August 2012, public sector net borrowing was £14.4 billion. This was the latest in a string of poor monthly borrowing figures, which together imply that it is unlikely that this year's borrowing targets will be met. The OBR March 2012 forecast for public sector borrowing was £119.9bn. After the first five months of the financial year, public sector borrowing was £10.6bn higher than in 2011-12. This is due to weaker tax receipts and an increase in spending on social benefits of £4.9 billion between April and August 2012. There is increasing scepticism that the UK government will be able to meet its target of debt reduction by 2015-16.

There is a growing body of opinion that the Coalition's spending cuts may be counterproductive as a mechanism for achieving fiscal balance because their negative effect on demand is itself weakening the public finances. There is little argument that the UK economy needs to be rebalanced in order to more closely match public spending with tax revenue. But there is strong disagreement about the correct trajectory needed to achieve this balance.

The UK borrowing requirement in 2010-11 was 9.2 per cent of GDP. For the same year, the Scottish borrowing requirement was estimated at 7.4 per cent of GDP if the geographical share of oil production is included[1]. In 2010-11, the Rest of the UK would have been in a more difficult fiscal position than Scotland. However, deficits at such levels, whether UK or Scottish, are not sustainable

[1] Scottish Government (2012) Government Expenditure and Revenue in Scotland 2010-11

in the long-run. Some form of fiscal adjustment – reductions in public spending or higher taxes – is necessary. However, such adjustment should not be so abrupt as to damage prospects for economic growth.

Discussions of fiscal deficits and growth frequently confuse the use of public spending to maintain demand and spending to enhance supply. If demand from consumers, firms or foreign buyers falls, public spending can be used in a Keynesian sense to maintain economic activity. But public spending can also be used to increase supply – enhancing the capacity of the economy to produce. Such public investment is typically long-term and involves productivity-enhancing measures such as investment in skills or in physical or digital infrastructure. Both the original Labour and Coalition deficit-reduction plans involved more savage cuts to capital than to current spending. While the short-term political cost of cutting capital spending may be lower, the long run effects on the productive capacity of the economy will be greater. It is not surprising that there is now growing opposition to these cuts and increasing support for an alternative economic strategy that would involve reversal of the cuts in public capital spending. However, the existing spending strategy includes continued reductions in capital spending until at least 2015-16. This strategy affects the size of Scotland's capital budget through the medium of the Barnett Formula. Changes in Scotland's capital allocation reflect the changes to capital allocations for Westminster spending departments set out in the 2010 Spending Review.

The 2013-14 Scottish Budget

The size of the 2013-14 Scottish Budget is consistent with the budget estimates provided in the 2011 Spending Review and the subsequent adjustments through Barnett consequentials. The 2013-14 allocation from the UK government (£28,441m) is smaller in cash terms than the 2012-13 settlement (£28,603m). However, the cash spend will actually be £28,538m through the operation of the Budget Exchange Mechanism, which permits the devolved governments to carry forward past underspends[2]. This still implies a real cut in spending.

Between 2010-11 and 2013-14, capital spending will fall as a share of the Scottish budget from 12.7 per cent (£3.3bn) to 9.1 per cent (£2.4bn). As mentioned above, this means reduced investment by the public sector in the supply side of the economy and therefore a reduction in its productive capacity. At a UK level, this is exemplified by a recent CBI/KPMG survey which showed that two-thirds of British companies fear UK infrastructure will deteriorate over the next five years.

For Scotland, the cuts in the capital allocation stem from the interaction of the Barnett Formula and the design of the UK austerity programme. However, the Scottish Government is free to vire from the resource to the capital budget. Indeed in the 2011 Spending Review, the Scottish Government claimed that it would switch £200m per annum from the resource to the capital budget between 2011-12 and 2014-15. In the 2013-14 Budget it claims that it will switch £700m from resource to capital, presumably over the same period. This suggests a £100m reduction in the commitment to reallocate spending, though even a £200m per annum commitment would still only partially compensate for the substantial reductions in capital allocations included in UK public spending plans.

[2] See Annex Table 1

It is not clear which budgets will be affected by the £700m reallocation of resource to capital. The Draft Budget includes provision for a transfer of £320m from the health resource to the health capital budget between 2012-13 and 2014-15. How the remaining £380m will be reallocated is not clear.

Enhanced capital spending is a major plank of the Scottish Government's growth strategy. It has announced plans to spend £380m between 2012 and 2015 on transport, housing, health, digital and maintenance projects. These are aimed at creating jobs and stimulating growth. In June 2012, further projects to the value of £105m were added to this initiative. If these projects are focussed on growth, as claimed, it might be of value to the Finance Committee if the Scottish Government could provide evidence as to the extent to which these particular projects stimulated economic growth and employment relative to alternative uses of this funding.

One of the mechanisms for maintaining capital spending is the NPD model. There is an intention to bring forward spending on schools of £80m using this mechanism in 2014-15. The committee might be interested in the data from the NPD contracts as they come to fruition. Note that payments based on the previous funding methodology - PFI/PPP - will total £983m in 2013-14 and £1012m in 2014-15 (Annex Table 5).

Annually Managed Expenditure

Last year's Spending Review predicted that Annually Managed Expenditure (AME) would be £6.2bn in 2013-14. The estimate for AME in the 2013-14 Draft Budget is that it will total £5.7bn. This is due to changed forecasts for NHS and Teacher's Pension schemes. This seems a relatively large change in forecasts over a very short period. However, because most of AME is funded directly by the Treasury, these savings do not affect the main Scottish spending programmes which are covered by DEL.

Funding for Local Government

Scottish local government will receive a grant of £9.91bn from the Scottish Government in 2013-14. This includes non-domestic rates income (NDRI). Thus, the Scottish Government carries the risk of any shortfall in NDRI. The Scottish Government's record in forecasting NDRI outcomes is relatively good (See Figure 3). With a yield of more than £2.2bn in 2011-12, NDRI has grown steadily as a source of income. Given that NDRI is effectively a tax on non-exempt businesses, it is not clear that expecting it to grow further is consistent with the objective of maximising economic growth.

Fig 3: Outturn and Predicted Non-Domestic Rates Income

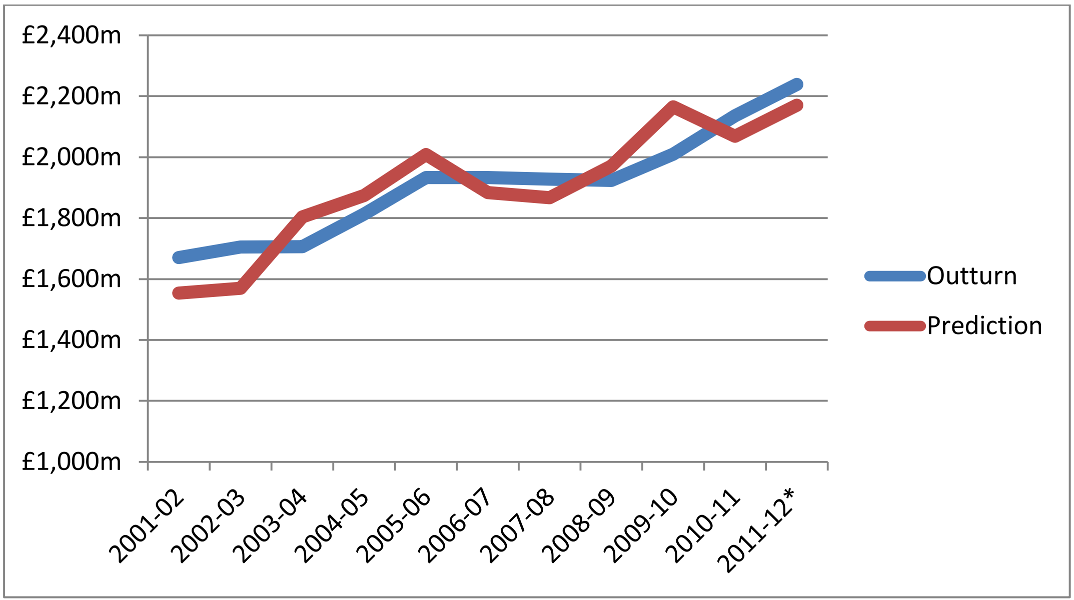
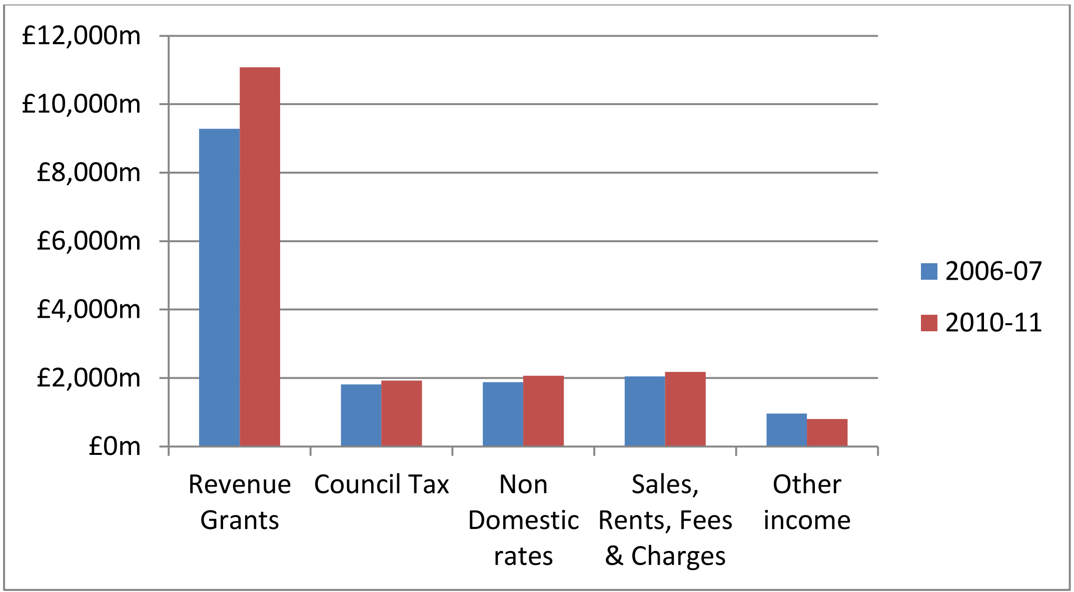


Fig 4: Local Government: Sources of Revenue Income 2006-07 to 2010-11



Through time, local government has become increasingly dependent on grants from the Scottish Government. Figure 4 compares the size of different sources of income to Scottish local government for 2006-07 and 2010-11. Over this four year-period, revenue grants grew from 54 per cent to 59 per cent of local government revenue. While ring-fenced grants may have fallen from £888m to £431m over this same period, the emerging picture is one of local government increasingly dependent on funding from the Scottish Government and therefore potentially less able to take an independent stance on policy.

Council Tax and Council Tax Benefit

The Scottish Government has made £70m available to local authorities to allow them to maintain the council tax freeze. It is useful that the issue of the distributional impact of the effects of the freeze have been discussed in the Equalities Report, as suggested in last year's Budget Adviser's report. An implicit estimate of the council tax revenue forgone by the council tax freeze can be deduced from the OBR forecast of council tax revenues, issued as part of its UK fiscal assessment. These show that the OBR expects council tax levels in England to grow at around the same rate as price inflation, implying that the council tax is held constant in real terms between 2012-13 and 2016-17. Therefore, over this period, the tax rate is expected to increase by 15.4 per cent. If Scottish local authorities increased council tax at the same rate as those in England, they would generate approximately an additional £300m by 2016-17. To maintain the council tax freeze, the Scottish Government will have to increase its compensation to local authorities for this lost income. In turn, this will increase the dependence of local authorities on Scottish Government funding.

The Scottish Government and local authorities have agreed how to deal with the abolition of Council Tax Benefit (CTB) from April 2013. The compensation from DWP for the loss of this benefit falls short of the previous value of CTB by 10 per cent. The Scottish Government and COSLA have now agreed to cover the £40 million cost of this cut in 2013-14 - the Scottish Government will provide £23 million and COSLA will provide £17 million. In effect, this means that the status quo can be maintained, again at some cost to local authorities. In England, some local authorities are consulting the public as to whether CTB could be organised more efficiently and more effectively. In addition, the UK Government plans to protect older people in England by requiring local authorities to provide the same the amount of support as under the current system. This will apply both to for those receiving benefit in 2013 when changes are due to start, and for those who claim in the future. In Scotland, there does not seem to be any pressure to vary from the status quo.

Employment and Pay

After three years of pay restraint, there appears to be a greater willingness to consider nominal pay increases for public sector workers. In November 2011, the Chancellor announced that public sector pay increases would be limited to 1 per cent after the end of the current pay freeze in 2013. Mr Swinney has announced that a similar limit will apply to Scottish Government employees. If extended across the whole of the devolved public sector, this is would cost around £150m. However, the overall wage bill in the public sector may be falling. Between 2011 Q2 and 2012 Q2, full-time equivalent employment in the devolved public sector in Scotland fell by 2.3 per cent. In calculating the aggregate wage bill paid by the Scottish Government, such cuts to employment will offset moderate wage increases for those who retain their jobs.

The distribution of employment cuts across the Scottish public sector is shown in Figure 5 and Figure 6, which show, respectively, the total change in employment since 2008 Q1 and the percentage change in full-time equivalent employment since 2008 Q1.

Figure 5: Changes in Public Sector Employment in Scotland 2008 Q1 to 2012 Q2.

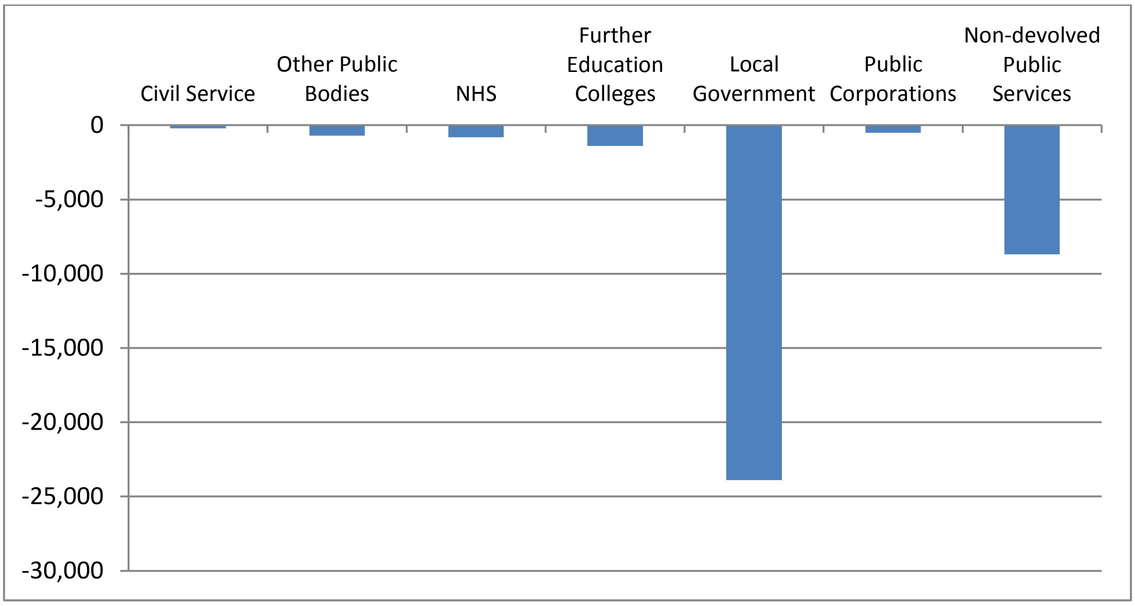
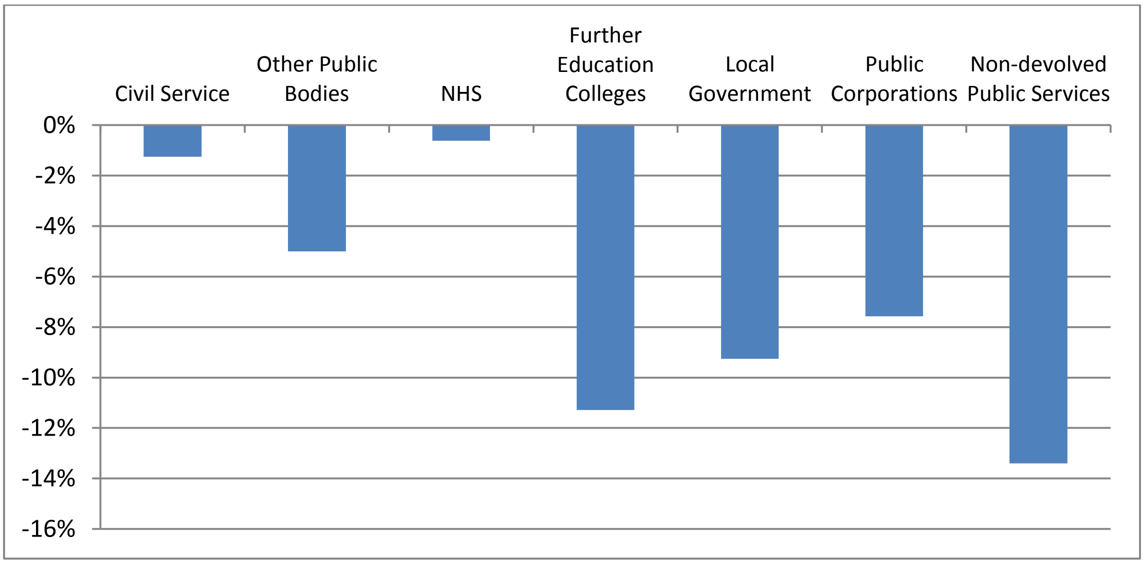


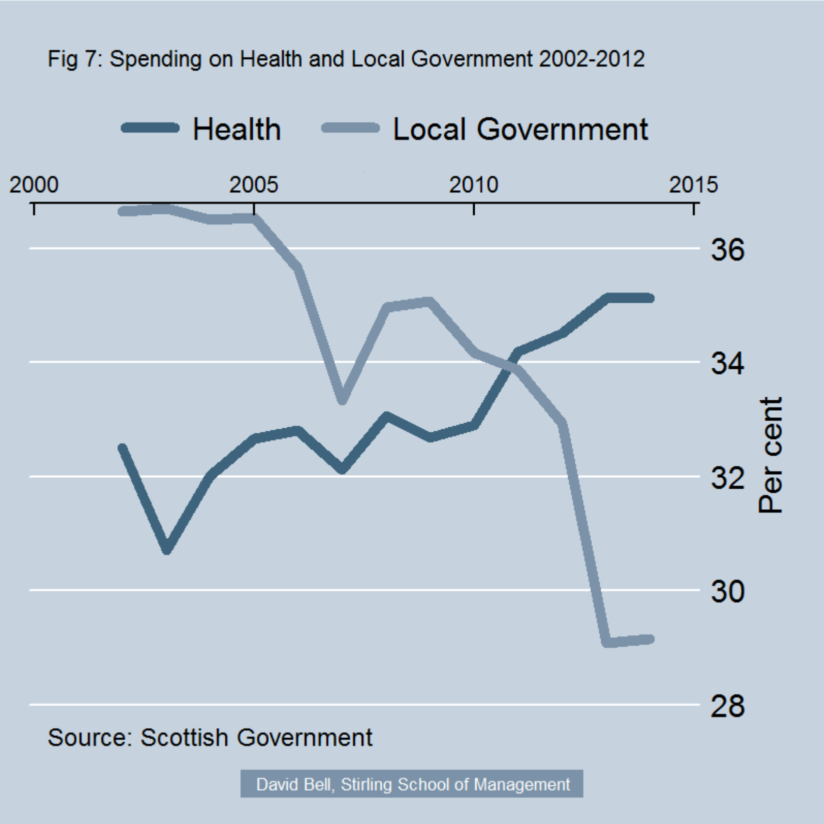
Figure 6: Percentage Changes in Public Sector Employment in Scotland 2008 Q1 to 2012 Q2.



It is evident from Figure 5 that Scottish local government has borne the brunt of job cuts. Local government employment has fallen by almost 25,000 since 2008. There also has been a significant reduction in employment among public sector employees in Scotland working for the UK government. Employment in the rest of the devolved public sector has hardly changed in absolute terms, though Figure 6 shows that in percentage terms, Further Education colleges, which are relatively small employers, have experienced a greater proportionate reduction in employment than local government. And the proportionate reduction of public service jobs in Scotland paid for by the UK government has been more rapid than in the sectors funded by the Scottish Government.

After a significant cut in 2012-13, the budget for Further Education is scheduled to increase from £507m in the current financial year to £512m next year, but is then expected to fall substantially to £471m in 2014-15. Hence, further job losses may be expected in this sector over the next two years.

The decline in local government employment reflects the declining share of spending on local government in the Scottish budget. Fig 7 shows the relative budgetary fortunes of health and local government as measured by their relative share of the total Scottish budget. The share of local government spending has declined since 2005, when it accounted for more than 36 per cent of the budget. By 2015, it will only account for 29 per cent of the total spend. In contrast health spending has been steadily increasing since 2003, and currently accounts for about 35 per cent of total spend.

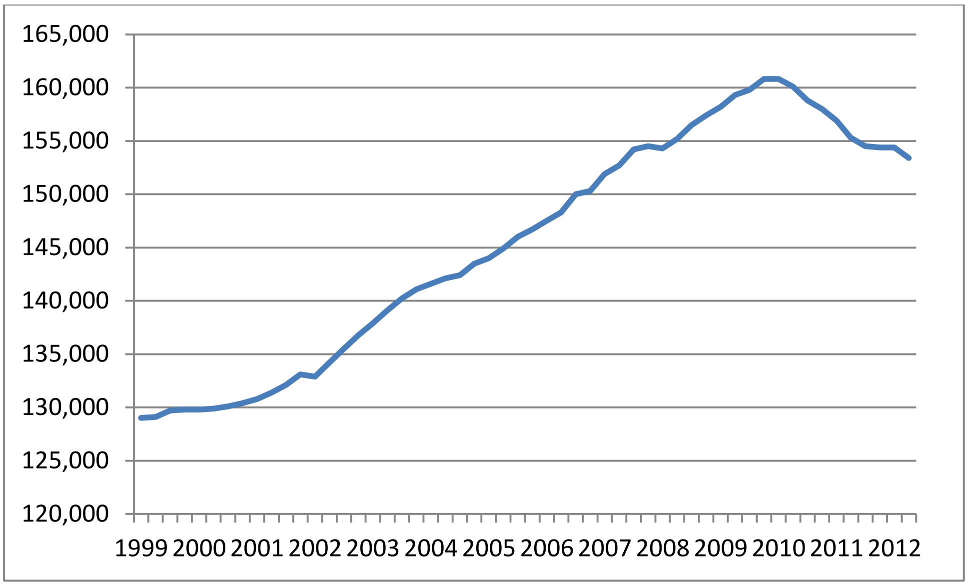


One of the main reasons for the dramatic drop in local government funding shown in 2013-14 is the establishment of the new Scottish Police Authority (SPA). It will be funded from several sources across the Justice and Local Government portfolios. The largest transfer is resource spending of £954.7 million from local government in 2013-14 and £953.9 million in 2014-15 (including £480.3 million reclassified from Central Government Grants to Local Authorities). The SPA budget also reflects savings of £42m in 2013-14 and £88m in 2014-15 expected through police reform. This seems a relatively small saving from such a large budget and the Committee may wish to monitor whether these savings are realised. This change in the organisation of the police will have consequent effects on the distribution of employment across the public sector, including a further reduction in local authority employment.

Health

Spending on health will increase by £290m between 2012-13 and 2013-14. This is the most generous settlement for any portfolio. Within this total, the resource budget will increase by £372m, while the capital budget will *fall* by £140m. Given the relative changes in other budgets, it is difficult to avoid the conclusion that maintaining current spending on health is currently the main priority of the Scottish Government. Nevertheless, even with continued large budget increases, it is clear that the health budget is under strain. Fig 8 shows the change in NHS employment in Scotland between 1999 and 2012. It is clear that there has been a decline in the number of employees since 2010. Given that wage rates have been almost static over this period, this suggests that other components of the resource budget have been growing more rapidly than wage costs.

Fig 8: NHS Employment Scotland 1999-2008



Education and Lifelong Learning

The Education and Lifelong Learning Budget will increase by £225m in 2013-14. The bulk of this increase is accounted for by increased AME spending on student loans of £167m. Direct funding for higher education and further education will increase in cash terms by £39m and £4m respectively. There will also be a £20m increase in spending on youth employability and skills and an increase of £11m in Skills Development Scotland funding, which reflects increased attention being given to the issue of youth unemployment.

Justice

The key development for the Justice Portfolio is the £1.1bn increase in funding to support the new Scottish Police Authority and £293m to support the new Fire and Rescue Service. However, some areas of the budget are being cut in real terms. An example is the Scottish Prison Service whose budget will be reduced by over 9 per cent in cash terms in 2013-14. It is not clear that demand for the prison service has fallen sufficiently for it to be able to absorb such cuts without significant deterioration in service provision. Similarly, the Legal Aid budget will continue to be significantly eroded in real terms since it is scheduled to fall in cash terms by 4 per cent in each of the next two years.

Rural Affairs and the Environment

Spending on Rural Affairs and the Environment will decrease in cash terms from £531 million in 2012-13 to £521 million in 2013-14. This is mainly due to a drop in EU support of £11 million. There are relatively small declines in the Research and Marine budgets and some increase in spending on Environmental and Rural Services (Scottish Natural Heritage).

Infrastructure Investment and Cities

This portfolio has a budget of over £2 billion, most of which is concerned with transport. In 2012-13, £249 million will be spent on concessionary fares and bus services. Spending on these programs is being held constant in cash terms in the 2013-14 and 2014-15 budgets. Given that demand for concessionary travel is rising, this suggests a continued squeeze on costs of bus companies that provide concessionary bus services.

Spending on motorways and trunk roads is being increased in cash terms. Given the downward pressure on prices in the construction sector at present, increased cash spend probably implies a real expansion of investment in motorways and trunk roads. Spending on rail will increase from £781 million in 2012-13 to £837 million in 2013-14, again a moderate cash increase.

Spending on housing and regeneration will be effectively constant in cash terms next financial year and will then decline from around £300 million in 2012-13 to £282 million in 2014-15.

Spending on Scottish Water has declined sharply in recent years, and in 2013-14 it is expected that it will provide £24 million to the Scottish budget.

Conclusion

The draft 2013-14 Scottish budget has been set broadly within the parameters defined by the 2011 Spending Review. The Cabinet secretary is largely constrained by the settlement from the UK government, which in turn reflects its policy towards the UK's current fiscal deficit.

Some projects have stayed broadly constant in cash terms, which will nevertheless imply a real decline in resource. Some are being cut in cash terms, implying a significant real terms cut. Others have experienced modest real increases. There also has been a significant shifting around of budgets associated with the establishment of the Scottish Police Authority and the Fire and Rescue Service.

Important issues that the Finance Committee may wish to consider are:

1. The long-run decline in the share of local government spending in the Scottish Budget.
2. The argument that this is really a budget for growth, when the main beneficiary appears to be resource spending on health.

3. The continued costs of the freeze on Council Tax
4. The realignment of budgets to accommodate the new Scottish Police Authority and the Fire and Rescue Service
5. The effects on public sector employment of accommodating a 1% increase in public sector pay
6. The accounting for the transfer of £700 million from resource to capital spending from 2012-13 to 2014-15.