Report on the Draft Scottish Budget 2012-13

Professor David Bell
Stirling Management School
University of Stirling

September 2011

Contents

Introduction

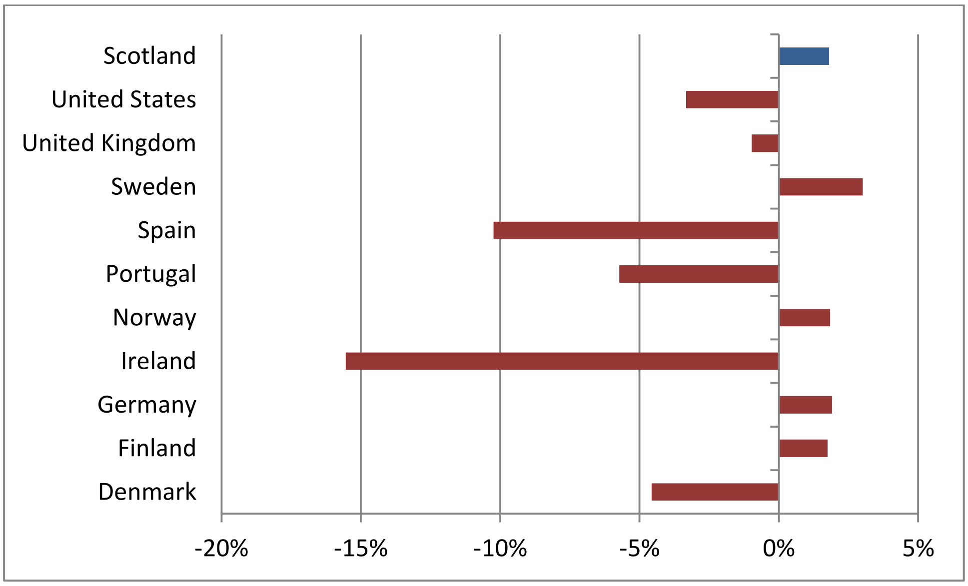
This report has been prepared for the Finance Committee of the Scottish Parliament. It analyses the 2012-13 Draft Budget and Spending Review.

Context

The 2012-13 Scottish Budget is set against a world of increasing economic uncertainty. There are significant risks of further financial collapse along the lines of 2008. This would inevitably impact significantly on the Scottish economy, increasing the likelihood of a further recession. The performance of the Scottish economy since 2008 has been weak, but not nearly as bad as that of some other developed countries.

Figure 1 shows that the Scottish labour market has performed comparatively well since the beginning of the recession. Figure 1 gives the percentage change in employment since the first quarter of 2008. This is generally accepted as the period when the recession started in most countries. Figure 1 shows that Scottish employment increased between early 2008 and mid-2011. This compares well with many European countries and particularly those that have been affected by large scale financial difficulties. It is also better than the UK as a whole.

Figure 1: Change in Employment (Per cent) Since 2008 Q1

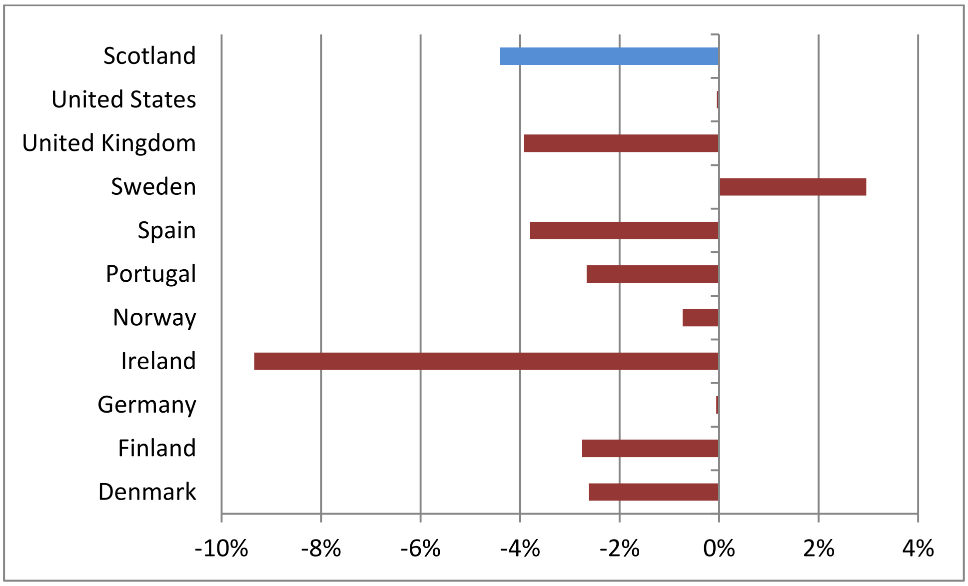


Source: OECD and ONS

However, although the labour market performed reasonably, growth has been relatively weak. Figure 2 shows the percentage change in output since the first quarter of 2008. The level of output in Scotland at the start of 2011 was more than 4% below its value at the start of 2008. The combination of increasing employment and falling output suggests that productivity in Scotland, already low by international standards, has further declined.

The Scottish jobs market has performed somewhat better than the rest of the UK and other parts of Europe since the beginning of the recession. On the other hand, the economy has notably failed to recover to 2008 levels of output.

Figure 2: Change in Output since 2008 Q1



Source: OECD and Scottish Government

Comparing UK spending deficit reduction plans with those of other countries, the Institute for Fiscal Studies (IFS) has argued that: "There is no escaping the fact that the UK was affected relatively badly by the crisis and the government's plans will need to be harsher than those of most other advanced economies if we do not want the UK to remain with relatively high levels of public sector borrowing"[1]

However, the medicine may have been rather harsh, particularly when growth is stagnating around the world. Reviewing public sector borrowing data for August 2011, Rowena Crawford of the IFS commented that "The bad news is that, for a third consecutive month, tax receipts have been weak. The latter increasingly suggests that borrowing this year could overshoot the official forecast. That said, with only five months of data currently available, much uncertainty remains. A significant pick-up in tax receipts over the coming months or an undershoot on investment spending could lead to the OBR's forecast still proving correct, but it is also possible that the deficit this year could even exceed the deficit last year."[2] This suggests that the outcome of the current austerity programme, as measured by its effectiveness in actually reducing the debt, is subject to considerable doubt.

If the UK does not achieve its deficit reduction objectives, it is not clear what the policy response from the UK government will be. Though unlikely, there could be a slowing down in the rate at which austerity measures are introduced. This would inevitably affect the profile of public spending in Scotland over the Spending Review period.

---

[1] How Does the UK Fiscal Consolidation Compare?, Institute for Fiscal Studies, 2011
[2] Rowena Crawford, Institute for Fiscal Studies, commenting on the August 2011 UK borrowing data

The 2012-13 Budget

The 2011 Scottish Spending Review and 2012-13 Draft Budget lays out the value of Total Managed Expenditure (TME), Departmental Expenditure Limits (DEL) and Annually Managed Expenditure (AME) for Scotland from 2011-12 to 2014-15. These aggregates are close to expectations. This is due to the April 2011 UK budget not deviating significantly from the previously announced UK Spending Review figures. Consequently, the magnitude of Barnet consequentials arising from the 2011 UK budget is small and the aggregates listed in the Scottish Spending Review do not deviate substantially from those announced in the UK Spending Review 2010.

This is confirmed by Table 1, which shows that the estimated size of the resource and capital budgets for the spending review period has changed little since January 2011 when Mr Swinney, the Cabinet Secretary, offered indicative spending plans for the Spending Review period to the Finance Committee.

Table 1: differences between indicative budget (January 2011) and draft budget (September 2011)

		2011-12	2012-13	2013-14	2014-15
Resource					
	Indicative	25,400.7	25,642.9	25,929.3	26,206.9
	DB	25,400.6	25,788.4	26,079.4	26,286.6
	Difference	-0.1	145.5	150.1	79.7
Capital					
	IB	2,606.6	2,536.0	2,299.0	2,380.0
	DB	2,606.7	2,471.4	2,238.4	2,319.6
	Difference	0.1	-64.6	-60.6	-60.4
Total					
	IB	28,007.3	28,178.9	28,228.3	28,586.9
	DB	28,007.3	28,259.8	28,317.8	28,606.2
	Difference	0.0	80.9	89.5	19.3

Source: SPICE

Table 2 shows that the differences are of a second-order magnitude, implying that estimates of Scottish Government budgets for the next four years have been stable since the UK Spending Review 2010. As suggested above, these plans are likely to remain in force so long as Britain's economic recovery is not driven substantially off course by external instability.

Capital and Revenue Spending

The real value of Scotland's DEL allocation will decline by 12.3% over the Spending Review period. This assertion is based on the UK GDP deflator, which is subject to change. This is partly due to inflation being somewhat higher than expected. In November 2010, the Office of Budget Responsibility forecast that prices would increase by 11.2% between 2010 and 2015. By March 2011, its forecast had risen to the 13.3%. These estimates are of very similar magnitude to the estimated real decline in the Scottish DEL allocation. This is consistent with a "flat cash" Scottish budget over the spending review period. And indeed, this is how Mr Swinney framed his indicative spending review proposals to the Finance Committee in January 2011. It is also of relevance to the proposal to freeze public sector pay, since this would hold portfolio budgets constant in cash terms.

The largest part of the real decline is occurring in 2011-12. During the present financial year, the real value of public spending in Scotland will fall by 7%. The remaining 5.3% of the real cuts will be spread from 2012-13 to 2014-15. Though the cuts may be less dramatic in future years, it will become increasingly difficult to find efficiency savings, given that those most easy to achieve will be selected first.

The most dramatic falls will be in the capital budget. The reason for this is due to the Barnett formula. Spending departments in England that are important in the calculation of Barnett consequential have experienced much more severe cuts in their capital budget than in their resource budget. Thus, the Scottish resource DEL is expected to grow in cash terms by 1% between 2010-11 and 2014-15. On the other hand the capital DEL will *fall* in cash terms by 29.6% over the same period.

To partially offset this effect, the Scottish government has decided to switch £200 million per year from resource spending to capital spending. As can be seen from Table 1, this measure will increase public sector capital spending in Scotland by around 8% above what it would otherwise have been. This may well make sense in terms of promoting economic growth in Scotland by improving transport and digital infrastructure. Yet it is not clear from the Draft Budget how precisely this transfer will be implemented.

Annually Managed Expenditure

One important aspect of the Spending Review is the increase in Annually Managed Expenditure (AME) over the period 2011-12 to 2014-15. AME is that part of spending which cannot be easily planned except on the year-to-year basis. Adjustments to AME are funded separately by the Treasury and have no effect on the DEL settlement. They do count against UK borrowing requirements.

Between 2011-12 and 2014-15 the AME budget increases from £5.6 billion to £6.7 billion. This is a significant contrast with Scottish DEL. It is partly explained by an increase in provision of over £300 million to Scottish Public Pensions Agency which provides pensions to public sector workers in Scotland. There is also a significant increase in the AME budget in the Education and Lifelong Learning Portfolio which has to do with changes in student loan arrangements. A £500 million increase in non-domestic rate income is also encompassed by the AME budget.

Council Tax Freeze

The council tax freeze will continue to benefit those in the middle of the income distribution and make little difference to poorer or richer households. The distributional aspects of the Council tax freeze - its relative effects on the rich and the poor - have not been commented on in the Draft

Budget. This issue has previously been raised in reports to the Parliament and would seem to be relevant for the Equalities Report.

The Draft Budget does not reference the imminent change in Council Tax Benefit arrangements arising from the UK Welfare Reform Bill. In England, council tax benefit is to be replaced by grants to local authorities in April 2013. In Scotland, the grant will be made to the Scottish Government. The value of the Council Tax Benefit in Scotland in 2009-10 was £368 million. Although this change lo localised rules governing CTB has been criticised, for example by the Institute of Fiscal Studies, nevertheless if it proceeds, it will have significant implications for local authority funding over the course of the spending review period.

Public Sector Pay

Control over public sector pay continues to be a key part of the budget strategy. The importance of controlling pay is due to its dominant role in the Scottish budget. It is clear that this is the view of the Cabinet Secretary.

"Pay is a significant issue, given that it accounts for at least 60 per cent of Scottish departmental resource expenditure - in fact, it is the key variable. The pay policy that we will set out will be driven by the budget numbers that we receive. It will be a heavily constrained pay policy. ... I think there will be a loss of public sector employment in the years going forward."

John Swinney MSP, Cabinet Secretary for Finance and Sustainable Growth, oral evidence to the Scottish Parliament Finance Committee, 18 May 2010[3]

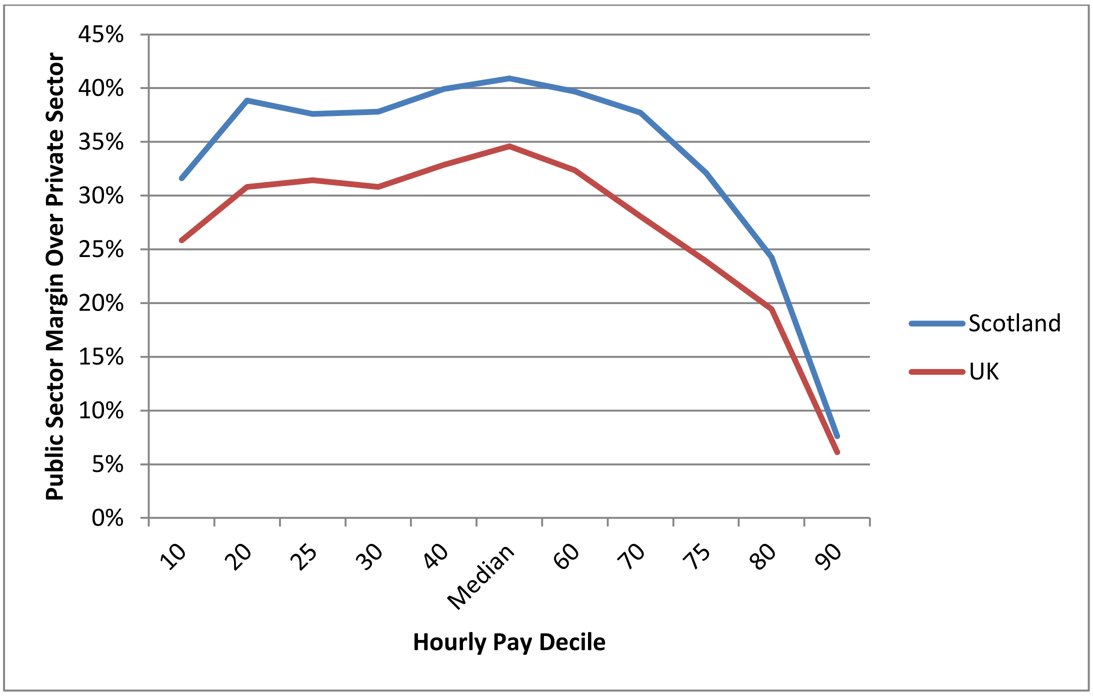
It is also clear that the current pay policy, which protects low paid workers earning less than £21,000 does have differential effects across the workforce. In the Budget Adviser's report on the 2011-12 Draft Budget, it was argued that a freeze on public sector pay for those earning over £21,000 will mainly benefit relatively poorly paid women and younger people. Pay policy also affects differentials between the private and public sectors. Figure 3 shows the margin between the hourly wage of private sector and public sector workers in Scotland and the UK as a whole in 2010. Thus for example if the going rate in the private sector is £10 per hour and in the public sector is £12 per hour, then the margin in favour of the public sector is 20%. These margins are calculated for each earnings decile. So the calculation is done across the spectrum from the relatively poorly paid to the relatively well-paid. The results are shown in Figure 3.

The figure illustrates a number of points. First, hourly pay in the public sector is higher than that in the private sector right across the hourly earnings distribution. Thus, for example, the hourly wage of those in the lowest 10% of earners in the UK public sector have an hourly wage that is 25% higher than the lowest 10% of earners in the UK private sector. Second, the margin between public and private sector pay only starts to fall at around the seventh income decile. It is those in the public sector with the highest pay that have the lowest margin above their private sector comparators. Third, it is clear that the margin by which hourly wages in the public sector exceeds those in the private sector in Scotland is higher than in the UK as a whole. A market-based conclusion from this

[3] http://www.scotland.gov.uk/Publications/2010/07/29082838/18

finding would be that the productivity of public sector workers must exceed those in the private sector by more in Scotland than in the UK as a whole. If this is not the case, then perhaps public sector workers are earning a "premium" in Scotland relative to those in the private sector. If the latter interpretation is correct, implying a degree of inefficiency in Scotland's public sector, then perhaps existing bargaining arrangements are leading to this outcome. A move towards bargaining at Scottish level might be an appropriate policy response.

Figure 3: Margin of Hourly Earnings in the Public Sector over Those in the Private Sector Scotland and the UK 2010



Source: Annual Survey of Hours and Earnings 2010, Office of National Statistics

The importance of this issue is shown in Table 2, which is drawn from the independent budget review (2010). It firstly shows projections of the reduction in resource DEL that would be available for pay, assuming that the people accounts for 59% of resource DEL. Second, it shows the projected increase in people costs assuming that past trends in pay increases continued. Thus, in 2014-15, the continuation of past trends in pay within the Scottish public sector would have resulted in an increased DEL funding requirement of £2 billion. Clearly, a "pay freeze" consistent with the Cabinet Secretary's current policy will substantially diminish the need for such an increase.

Table 2 Projected Changes in Resources Available for Pay (£m)

£ million, cash terms	2011-12	2012-13	2013-14	2014-15
Impact of Resource DEL projections on resources available to meet the pay bill. This assumes the pay bill continues to account for 59% of Resource DEL.	-320	-230	-200	-260

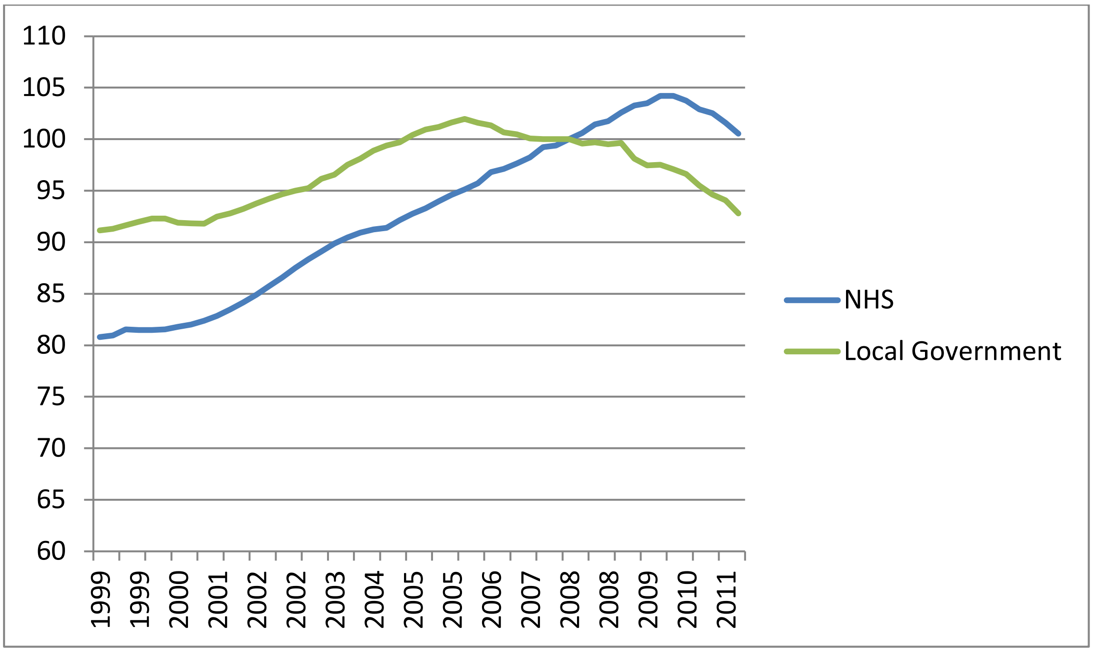
Theoretical pay bill increases, calculated in line with historical movements	+420	+900	+1,430	+2,000

Source: Independent Budget Review (2010)[4]

Public Sector Employment

it is worth noting that public sector employment is already falling in Scotland. This is shown in Figure 4, which plots indices of employment for the Scottish NHS and Scottish local authorities. The indices take the value 100 in 2008 Q1. Two findings are evident. First employment in both sectors has been falling. In fact the reduction in local authority employment predated the beginning of the recession in 2008. The reduction in NHS employment came later and has been milder than the decline in local authority employment. Second, overall employment in the NHS has grown at a much more rapid pace than in Scotland's local authorities. Employment in the local authority sector is now close to where it was in 1999. These outcomes also reflect the growth in the NHS budget relative to that in local government, particularly in recent years.

Figure 4: Employment in the National Health Service and Local Government



Source: Scottish Government

Public Sector Pensions

The Scottish government is to implement the public sector increases in pensions mandated by the UK government. On average, pension contributions will increase by 3.2% over the next three years. The Scottish Government argument is that not to introduce these pension increases would cause cuts in its own budget leading to falls in employment and/or further pressure on public sector wages. It has also been informed by HM Treasury that if it does not introduce the changes, its block

[4] http://www.scotland.gov.uk/Publications/2010/07/29082838/6

grant will anyway be cut. Clearly this is a somewhat unsatisfactory situation. It reinforces the argument that the Scottish Government should be responsible for the pension arrangements of public sector employees in Scotland.

Non-Domestic Rates

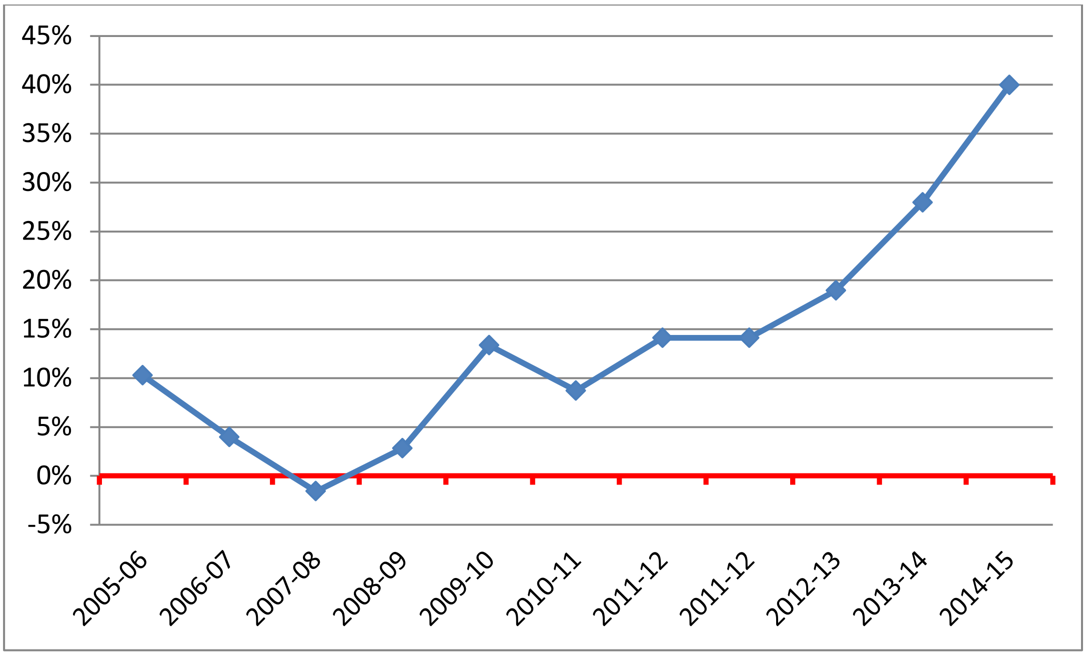
Non-domestic business rates bills are calculated by applying the "non-domestic rating multiplier", also known as the Uniform Business Rate, to the rateable value of the property. The multiplier is increased each year in line with the Retail Price Index. Hence yields tend to increase with prices. In recent years, the Scottish Uniform Business Rate has been harmonised with that in England. This is a policy choice.

The Scottish Government is committed to not raising the business rate poundage in Scotland above that in England during this Parliament. In answer to a parliamentary question, John Swinney, the Cabinet Secretary responded:

“The Scottish Government is committed to the Scottish poundage rate not rising above the English poundage rate during the current Scottish Parliament. The calculations underpinning the Draft Budget 2011-12, published on 17 November 2010, were based on a then anticipated inflationary uplift in the poundage rate of 2.5 per cent. The UK Government announced on 14 December 2010 that the uplift for the poundage in England would be 4.6 per cent, and this is now the rate used for the Scottish poundage.”
John Swinney, Cabinet Secretary for Finance and Sustainable Growth, Parliamentary Answer, 4th February 2011

This means that local government finance will become increasingly dependent on contributions from non-domestic rate relative to those from council tax. Note however that Scottish Government takes up any shortfall on NDRI receipts. Thus it takes the risk if the receipts do not match the forecast contained in the Spending Review. The burden of funding local government will switch from households towards businesses during the spending review period. This is illustrated in Figure 5, which shows the extent to which revenue from non-domestic rates exceed those from council tax from 2005-06 to the end of the spending review period.

Figure 5: Difference between Non-Domestic Rate Revenue and Council Tax Revenue, Scotland 2005-06 to 2014-15 (as Per cent of Council Tax Revenue)



Thus, for example, in 2007-08 non-domestic rate revenue exceeded that from council tax. By 2014-15, assuming that the Council tax freeze remains in place and therefore that the nominal value of council tax revenue stays profit constant, nondomestic rates will be providing 40% more revenue to local government and will council tax.

This raises a number of issues. Firstly, revenue from nondomestic rates is somewhat less than the estimates of Corporation tax revenue provided by the GERS analysis. Thus in 2009-10 the estimated yield from corporation tax (excluding the North Sea) in Scotland was £2.6 billion while the revenue from non-domestic rates was £1.8 billion. Both are taxes on businesses. Their effect is somewhat different since the yield from corporation tax will be focused on more profitable businesses, while the yield from nondomestic rates is concentrated on those businesses that use valuable properties. Non-lump sum taxes have negative effects on incentives. Therefore both of these are likely to deter business activity.

There is also the traditional public finance argument that taxes have a less distortionary economic impact if the tax base is kept as wide as possible. The switch to increasing dependence on businesses for local government revenue generation and away from households does not seem to accord with this principle.

Climate Change

In the budget document, spending on climate change is taken as an exemplar of preventative spend. This is different from the usual definition of preventative spend. Some detail on how this will result in lower spend on firefighting services in Scotland would have been useful. It would also be useful to have some evidence of the costs, as well as the benefits of climate change interventions.

Issues Arising from Previous Finance Committee Reports

This section considers some issues that have previously been raised by the Finance Committee and looks at how they have been addressed in the 2012-13 Draft Budget and Spending Review. Some of these have already been raised in the text, but there are some further issues to discuss.

Preventative spending

The budget focused attention on initiatives relating to preventative care which have been highlighted by the Finance Committee during the last Parliament. Spending in this area is projected to increase by some £500 million over the next three years. In particular, programmes involving adult social care, early years intervention and re-offending will be targeted. This does imply shifting resource from "firefighting" services into prevention, though the mechanisms whereby this might happen are not clarified. Together these funds provided over £500 million over the course of the Parliament. This amounts to £167 million per year. This is a rather small share of the overall budget.

What would be useful would be some indication as to what evidence would be necessary to extend preventative budgets and to include them in the "baseline" budget. If preventative spending is effective, then its use will improve the efficiency of public sector delivery in Scotland. The key is to understand what evidence would demonstrate increased efficiency and what process would lead to a shift in budgets towards preventative services and how the Scottish Government might put such a policy change into effect.

Linkage of budgets to policy priorities and outcomes

The current budget documents do show an increase in the linkage between resource inputs and hoped for outcomes. Thus this budget has witnessed an increase in the number of specific funds devoted to particular purposes. For example the £250 million Scottish Futures Fund (SFF) will comprise a "Young Scots" fund focusing on sport, enterprise and creativity and additional Sure Start funds. It will also support the development of superfast broadband, energy-efficient homes and low carbon travel. However, the "Futures Fund" title seems to be a wrapper for a disparate group of activities, some of whom also seem likely to appear under the "preventative spending" rubric. With many separate funds being established, there is a danger of double counting.

There is an argument for "ring fenced" funding although the trend in the recent years seems to have been against such initiatives. However, there also has to be a clear understanding of where these targeted funds are intended to lead and what decision process might result in their continuation on the one hand or abandonment on the other.

One of the main arguments against ring fencing is that it reduces local autonomy. If local authorities become even more dependent on central government grants, then Scottish politics become more centralised. Without ring-fencing, the Scottish public has largely to rely on the ex-post analyses of Audit Scotland to establish how resources have been allocated to priorities.

Budget process timescales

Following the UK spending review, the Scottish budget last year only covered a single year budget. Mr Swinney published indicative figures in January 2011. But now, with the publication of the spending review, public sector bodies now have a longer time horizon over which to plan their resource and capital spending which must be welcomed.

Government's Purpose

The Finance committee questioned whether the 2011-12 budget prioritised economic growth. Scotland's economic growth over the last 12 months has so far been disappointing. How far do the measures taken within the budget support the process of economic growth and recovery? There is little reference in this Spending Review to the National Performance Framework, which featured very heavily in the 2007 Spending Review.

Efficiency savings

Efficiency savings are not particularly emphasised in the Draft Budget. However, if services are to be maintained in the light of reduced resource inputs, efficiency gains must be made. The current target of 3% efficiencies is implicit in portfolio budgets. Some examples of success are quoted in the Draft Budget. But a more systematic approach to reporting the outcomes of policies to increase efficiency would surely be welcomed by politicians and the public.