FINANCE AND CONSTITUTION COMMITTEE

AGENDA

9th Meeting, 2016 (Session 5)

Wednesday 2 November 2016

The Committee will meet at 10.00 am in the David Livingstone Room (CR6).

1. **Decision on taking business in private:** The Committee will decide whether to take item 3 in private.

2. **Public Finances and Economic Performance:** The Committee will take evidence from—

   Professor David Bell, Professor of Economics, University of Stirling;

   Professor David Heald, Professor of Public Sector Accounting, University of Glasgow.

3. **Work programme:** The Committee will consider its work programme.

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Finance Committee  
9th Meeting, 2016 (Session 5), Wednesday 2 November 2016  

Public Finances and Economic Performance  

Introduction  

The evidence session on ‘public finances and economic performance’ is intended to form part of the Committee’s pre-budget scrutiny. The Committee will take evidence from:  

- Professor David Bell, University of Stirling; and  
- Professor David Heald, University of Glasgow.  

A written submission has been received from Professor Bell and this is attached at Annex A to this paper.  

In addition, there are two Fraser of Allander reports which Members may find useful for this evidence session. Firstly, the Fraser of Allander report on ‘Scotland’s Budget 2016’ which considers the outlook for the Scottish economy and public finances which the Committee has previously taken evidence on. Secondly, a Fraser of Allander report on the ‘Long-term economic implications of Brexit’ upon the Scottish economy which was commissioned by the Culture, Tourism, Europe and External Relations Committee. Links to both reports are provided below:  

http://strathprints.strath.ac.uk/57763/8/Fraser_of_Allander_Institute_Scotlands_Budget_2016.pdf  

https://www.sbs.strath.ac.uk/economics/fraser/20161006/Long-term-Economic-Implications-of-Brexit.pdf  

Clerking Team  
28 October 2016
Annex A: Written Submission from Professor David Bell

Pressures on UK public finances and potential impact on the Scottish budget

Paper for the Finance Committee, Scottish Parliament

David Bell
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November 2016
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1. Introduction

This paper examines the current state of the UK economy, linking it to potential pressures on the Scottish budget. It begins by examining the main macroeconomic trends, then focuses on the fiscal outlook for the UK before exploring the implications of these trends for Scotland. It also considers whether rumoured changes in the UK budget process will give the Scottish Parliament and the Finance Committee more time to analyse and scrutinise the Scottish budget.

2. General Outlook

The UK economy continued to grow during the second quarter of 2016, preceding the BREXIT referendum (see Figure 1). However, growth during 2015 and the first three quarters of 2016 has been much slower than the strong performance recorded during 2014.

![Figure 1: UK Economic Growth 2014-2016](image)

Recently released provisional estimates show the UK economy growing by 0.5% during the third quarter, after the BREXIT referendum. This suggests that there was no collapse of economic activity following its outcome. This is perhaps not surprising, given that the momentum in the economy takes time to change and no change in trading arrangements will take place for some time.

The UK economy has grown by 1.6% during the first three quarters of 2016. This means that it will have to grow by a further 0.4% in the last quarter to achieve the OBR forecast of 2% growth for the year as a whole, which should be achievable. Growth is important for the public finances since increases in economic activity increase tax revenues. But will continued growth be maintained?

Some would argue that there will be some further slowing in economic growth during the fourth quarter as the effects of the negative business climate following the referendum feed through. These include the substantial increase in uncertainty about...
the direction of economic policy. A huge spike in the index of economic policy uncertainty occurred just after the referendum (See Figure 2), with a further, smaller, increase recorded around the time of the Conservative Party conference when the debate around government objectives in the BREXIT negotiations peaked. Uncertainty undermines business confidence.

Figure 2: Economic Policy Uncertainty Index for the UK 2016

![Graph showing Economic Policy Uncertainty Index for the UK 2016](chart.png)


However, business confidence was already falling prior to the referendum. This may have reflected the weakness of demand, as already evidenced by the slowing growth rates in 2015 and 2016, but it has also fallen further since the referendum (see Figure 3). This uncertainty is likely to further weaken investment, already 1.4% lower in the first half of 2016 compared with the first half of 2015.

Figure 3: UK Business Confidence 2012-2016

![Graph showing UK Business Confidence 2012-2016](chart2.png)

Source: UK Business Confidence Monitor
3. Decline in Sterling

The clearest of the economic signals that followed the referendum was the sharp decline in the value of the pound. Following the referendum, its value declined from $1.47 to around $1.30. After a brief period of near stability, it declined further to below $1.25. This decline was a clear reaction by those in the financial markets to the perception that BREXIT would adversely affect the U.K.'s long-term economic prospects.

Figure 4: Value of Pound Sterling in US dollars

While the fall in sterling will increase opportunities for exporters and make British products more competitive in domestic markets, its main effect is to make UK citizens poorer by reducing the value of their production on world markets. This has caused speculation that, somewhat ironically, that the UK will fall below France to become the sixth largest, rather than the fifth-largest, economy in the world\(^1\).

How will the decline in sterling affect workers’ real purchasing power? This depends on the wages they are being paid and the prices that they pay for goods and services. Between June and August 2016, pay was 2.3% higher than over the same period in 2015. Between these periods, the new National Living Wage of £7.20 per hour was introduced. There is evidence that some low paid workers - part-timers, women and young people - have received larger than average increases recently\(^2\),

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\(^1\) BBC October 27, 2016. Even this conclusion is somewhat in doubt, since it relies simply on GDP converted to dollars at the current exchange rate rather than at the current exchange rate adjusting for purchasing power. On this measure, the UK was the ninth largest economy in the world in 2015.

\(^2\) Financial Times, October 25, 2016
probably as a result of the introduction of the National Living Wage. Nevertheless, if the average increase is 2.3%, these above-average gains for the lower paid must have been offset by weaker wage growth among other groups of workers.

Now consider the effect of devaluation on the prices of goods and services. With some goods, price rises will follow after the devaluation relatively quickly: for others, where suppliers have hedged their currency risk or where price hikes can be effectively resisted, increases will be delayed. We discussed the implications for inflation in the next section.

Inflation increased sharply to 1% in the year to September 2016. In contrast, a year earlier, prices were falling. Further price increases will occur. The consensus forecast\(^3\) is that CPI inflation will rise to 2.5% in 2017. Note that this is above the 2.3% rate at which wages are currently rising. Thus, if wage growth does not pick up, real incomes will fall in 2017. But the increase in minimum wages caused by the introduction of the National Living Wage will not be repeated in 2017, therefore removing one of the main drivers of wage increases. Without any other obvious source of wage increases, workers real purchasing power is likely to decline in 2017. This will make it difficult to sustain the recent pattern of UK economic growth, which has largely been driven by increased spending by consumers, rather than by government, by businesses (investment) or by foreigners buying UK goods and services.

Figure 5: UK Consumer Price Inflation 2015-16

![UK Consumer Price Inflation 2015-16](image)

Source: Office of National Statistics

Although prices for food and energy have not yet risen substantially, their costs are linked to world markets. Price rises are therefore almost inevitable. These will have a more negative effect on the living standards of the poor\(^4\). One commodity whose

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\(^3\) *Forecast for the UK Economy: A Comparison of Independent Forecasts, HM Treasury, October 2016*

\(^4\) *Institute for Fiscal Studies (2014) Faster Cost of Living Increases for Poor Households Means More People in Absolute Poverty Than Thought*
price has already risen is transport fuel, to which the Scottish economy is relatively sensitive.

In 2012, the price of a litre of unleaded fuel (see Figure 6) reached £1.40. Towards the end of 2015, following the collapse of the oil price and the relative strength of sterling at the time, it fell to £1.00 per litre. A modest recovery in the oil price (which is measured in dollars) and the depreciation of sterling have pushed the price to just below £1.20.

How will the rise in inflation affect government finances? There will clearly be pressure on public sector employers to match private sector wage growth, though this has been relatively muted in recent years. The growth in prices will also affect public sector costs and will have an effect on benefit rates. For the latter, price changes are generally measured by the September CPI – i.e. 1%. Note that this will be a significant underestimate of the inflation rate that is likely to apply from the start of the next financial year in April 2017. The then Chancellor announced in the 2015 budget that child benefit rates would be frozen until 2017-18. Hence, families whose earnings have not increased and receive child benefits will be worse off due to the effects of inflation. However, the state pension will be protected by the so-called “triple lock”, which is used to set its increase by 2.5%, the rate of price inflation, or the rate of wage inflation, whichever is the highest. Given our previous discussion, most likely outcome is that the state pension will be increased by 2.5%, which will be sufficient to maintain pensioners at the same standard of living as inflation accelerates.

![Price per litre Unleaded Petrol](image)

Higher inflation will also increase tax receipts, particularly indirect taxes such as VAT and excise duties. But, as we have seen, inflation also increases the cost of the goods and services that the government buys and a proportion of the benefit payments that it makes. It will also lead to claims by public sector workers for higher wages, though the government has managed to contain such pressures in recent years.
4. Borrowing Costs

Interest charges on government debt are an important component of government expenditure. The current “interest rate” on newly issued government debt (10 year bond yield) is just over 1%. It has risen from 0.7% in early September. The increase perhaps reflects their assessment of the increased risk associated with lending to the UK following the EU referendum. Historic debt interest charges and OBR forecasts of their future evolution are shown in Figure 7. The increase in borrowing costs from around £30 billion to £50 billion in 2009-10 was associated with the increase in government debt caused by the financial crisis. Borrowing costs have since remained relatively stable, though the OBR forecast shows these rising to around £55 billion by 2020-21. Even though the cost of new borrowing is relatively low, the UK Government has to pay interest on historic debt that was issued at higher rates. Though the issuance of new debt is relatively cheap, the government’s bill for debt interest will only decline slowly as older debt matures and is replaced by lower-cost newly issued bonds.

Thus the OBR expects debt interest charges to increase slightly up to 2020-21. Nevertheless, the expected increase in debt interest charges of around £5 billion over this period is relatively modest given that Total Managed Expenditure by the UK Government is expected to be around £772bn in 2016-17.

These increases in debt interest costs were built into the OBR’s March 2016 forecast. But government expenditure for fiscal year 2016-17 is currently running below this forecast. Yet the projected fiscal deficit is well above forecast. We discuss this issue in the next section and the potential implications that this will have for the Scottish 2017-18 budget.

5. Public Sector Borrowing: Year-To-Date

The most recent published data for UK public sector borrowing refer to September 2016. Figure 8 shows net borrowing for each financial year from 2013-14 to the forecast for 2016-17. It also shows how much had been borrowed between the start of each fiscal year in April and the following September.
Figure 8 shows the decline in net borrowing from around £100 billion in 2013-14 to a forecast of £55.5 billion for 2017-18, which would be equivalent to 2.9% of GDP. Figure 8 also shows the amount of annual borrowing up to September for each fiscal year from 2013-14 to 2016-17.

In 2013-14, only 53% of the forecast annual borrowing took place between April and September, leaving the remaining 47% to be borrowed between October and March. In 2016-17, by contrast, 81% of the target borrowing had already been incurred by September. If this year’s target deficit of £55.5 billion is to be met, then only £10 billion can be borrowed between October 2016 and March 2017. This seems an unlikely outcome, leading one to suspect that borrowing in 2016-17 will substantially overshoot the OBR forecast.

As noted in the previous section, the explanation for this overshoot is not that spending has exceeded the limits set in the March 2016 Budget. Instead, tax receipts have been significantly lower than predicted in March. The main culprits are PAYE payments, National Insurance and VAT. Whereas the OBR forecast that PAYE payments would increase by 5% for the year as a whole, they had only increased by 1.6% in the year to September. Similarly, payments of National Insurance were expected to increase by 10.9%, but had only increased by 7% up to September. The undershoot of VAT in the year to date was more modest at 2.3% compared with a forecast growth of 3.3%. Taking these weak revenues into account alongside expected receipts from other taxes, the Institute for Fiscal Studies expects\(^5\) that the overall deficit for 2016-17 will be around £10 billion above the OBR forecast.

Tax revenues are not growing as fast as had been expected given the moderately strong growth in the UK economy. This should be of concern both to the UK and Scottish Governments. In particular, weak growth in income tax revenues is

\(^5\) IFS Analysis of Today’s Public Finance Figures, October 21, 2016
concerning when these revenues (except those linked to savings and investment) are about to be transferred to Scotland.

Mr Hammonds policy for the budget deficit will be laid out in the Autumn Statement in November 23rd. He has already hinted that he will abandon Mr Osborne’s plan to run a budget surplus in 2019-20. His public statements thus far seem to indicate a desire to balance the budget, though not perhaps to go into surplus. And he has given no indication of when he might hope to achieve budget balance. Nevertheless, as we have seen, he will have to deal with a number of competing pressures:

1. likely failure to meet previously set deficit reduction targets
2. severe spending pressures in parts of the budget, particularly health
3. arguments that planned benefit reductions for working age families should be abandoned
4. arguments that a period of historically low borrowing costs provides an ideal opportunity for increased infrastructure spending
5. likelihood of further slowing of growth in 2017 and potentially even weaker growth in tax revenues
6. commitments that he has made to balance the budget

The Resolution Foundation has argued that due to the existing difficulties in meeting current targets and the slowdown in the economy following BREXIT there will be an £84 billion deterioration in the public finances over the next five years. In consequence, the Treasury should be willing to soften its fiscal stance, focusing on balancing its current, rather than its overall, budget, allowing increased latitude for capital spending. It argues that achieving a current budget balance by 2019-20 is quite feasible and would leave a margin of £17 billion for errors in forecasting spending and/or revenues.

Of course, it is present impossible to predict the course of action that the Chancellor will take in his Autumn Statement. But if he does follow broadly the strategy outlined by the resolution foundation, there would be significant implications for Scotland’s budget. The rate of contraction in the block grant will be less than that implied by the March 2016 budget. Its exact size will depend on the spending decisions and announced in November. In particular, greater generosity towards working age benefit claimants will improve the circumstances of Scotland’s benefit recipients without changing the Scottish budget. On the other hand, decisions to increase the level of resource to health and social care in England would have clear consequential effects for Scotland through the Barnett formula.

One issue that is important for Scotland at present is the weakness in the growth of tax revenues. These are worrying at a time when Scotland is about to take control of new revenue raising powers. However, the key issue for the Scottish budget is the relative growth of income tax revenues in Scotland compared relative to those in the

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6 “Pressing the Reset Button” Resolution Foundation, October 2016
rest of the UK (per head). It is this ratio that has a direct effect on the size of the block grant adjustment - the reduction from Scotland’s budget to take account of its revenue raising capabilities.

6. The Future of the Autumn Statement

This topic is not directly relevant to the pressures on Scotland’s 2017-18 budget: nevertheless it marks a potential development that might affect the rather complex timing associated with appropriate scrutiny of future Scottish budgets. It concerns the status of the Chancellor’s Autumn Statement.

There have been simmering concerns over the process of forming tax policy in the UK for some time. It has numerous flaws including its complexity, lack of consultation and administrative burden. The formation of tax policy in the UK compares badly with that in other jurisdictions. Having a new Chancellor has provided an opportunity to once again raise these issues. Thus, on September 28, 2016 the Chartered Institute of Taxation, the Institute for Fiscal Studies and the Institute for Government wrote to Mr Hammond suggesting an important simplification of existing procedures. Specifically they argued that:

“The time has come to revert to one principal fiscal policy event a year (while recognising there may still be a need for technical changes at other times of the year). Reducing the frequency of new significant changes of direction would release resource for better consultation, produce higher quality legislation and more effective implementation, make life simpler for taxpayers, and potentially increase the impact of measures concluded upon. We also think that Budgets should return to being principally a vehicle to announce revenue measures, rather than spending or other policy changes.”

This would be a radical change from recent practice, and would both curtail the power of the Chancellor to interfere with spending decisions and would force the Treasury to take a more considered view of changes to the tax system.

The proposal seems to have found some favour within the Treasury. The Financial Times recently suggested that the Chancellor is “looking at the possibility that the Autumn statement would - in future years - return to its original function of fiscal forecasting.” However, previous chancellors have failed to live up to stated intentions to reduce the frequency and complexity of budget events.

This change, if adopted, would have significant implications for the Scottish budget process. The fiscal forecasts to which the Chancellor refers would presumably be made by the OBR. Ideally these would involve consultation with the Scottish Fiscal Commission and be produced halfway through the fiscal year - in September. The Cabinet Secretary has recently argued to the Finance Committee that the Draft Budget should not be published until after the Autumn Statement itself is published. Clearly, a move to remove policy measures from the Autumn Statement and publish it in the early autumn would substantially reduce the complexities associated with the timing of the Scottish Budget and enable the Finance and other committees of the

Scottish Parliament to take a more measured approach to its scrutiny. It would provide more time to calculate the block grant adjustment.

The downgrading of the Autumn statement is a potential change which would both improve the tax policy process both in the UK and in the devolved administrations. It deserves support.