FINANCE COMMITTEE

DEMOGRAPHIC CHANGE AND AGEING POPULATION INQUIRY

SUBMISSION FROM IMPROVEMENT SCOTLAND

"In the long run, we are all dead" (Keynes)

1. The IS is grateful to the committee for the opportunity to submit evidence on a topic of pivotal importance to the sustainability of public services in Scotland. Our involvement has been in modelling the relationship only between income trends and demand trends for local government services, and on analysing factors that influence the conversion of potential demand into actual demand on public services. We explore this below with respect to health and care provision.

2. The issue of demographic trends, public spending trends and 'sustainability' has been much explored recently at UK level: the Hutton enquiry on pensions (Hutton, 2011); the Dilnott Commission on long term care for older people (Dilnott, 2011); the recent Office for Budget Responsibility (OBR) report on fiscal sustainability (OBR, 2012). All have identified demographic change, an ageing population, as having major implications for fiscal sustainability across the next 20-40 years. A less consolidated approach has occurred in Scotland with attention focussed within particular sectors (Local Government, NHS etc) or on particular service areas (e.g. the Strategic Funding Review Group (SFRG) model of Local Government demand and income trends (SFRG, 2010); the Joint Improvement Team (JIT) projections of demographic change and demand on health and care services (JIT, 2010).

3. The submission makes 2 core points:

(i) Modelling is often fairly crude and greater precision is necessary about how <u>potential</u> demand converts into <u>actual</u> or <u>effective</u> demand on public services, and about what influences the <u>cost</u> of meeting that demand. Demography alone is not <u>the</u> explanation of actual demand on health and care services, but rather it is demography interacting with policy and other social and economic factors that shapes demand.
(ii) That the pressures on health and care services are acute in the short to medium term, not just the long term, and that a wider range of tools for demand management may need addressed. This may have to include a review of universal entitlements and continuing effort to reduce the cost of meeting demand.

Section 1: Demography, Demand, Cost and Income
4. The <u>first</u>, and obvious point, is that demographic change per se does not generate demand on public services: it does so solely and only if governments have legislated to give citizens entitlements, and public authorities duties, that activate actual demand and provision. For example, the changing number of children in a council area over time creates a demand effect solely and only because children have a right to public education, and councils have a duty to make provision. <u>The</u>

key point is that the relationship between demographic trends and demand on public services is mediated through legislated entitlement, and duty.

5. Sometimes, the conversion of demography into demand is automatic because of the nature of the entitlement, in other cases it is more complex. For example, where entitlement is based on membership of an age category, and nothing else, the conversion is automatic (e.g. state pensions, travel concessions, winter fuel allowance). Clearly, individuals can choose not to exercise their entitlement but, for planning purposes, demography converts completely to demand. In other cases, the conversion is fairly complete, but not wholly so. For example, parents can send their children to private schools, or educate them at home. The historical trend in Scotland is that relatively few do so, well under 10%, but it does diminish actual demand on the public education system.

6. In other cases, the relationship between demography and demand is much more complex: for example demand on health and care provision for older people. It is certainly true that the 75+ age range makes greater demands on health and care services than younger age cohorts, but it is also true that at any point in time the vast majority of the 75+ cohort are making no demand at all. If they all did, the health and care system would collapse. Demography, statistically, generates potential demand but that is mediated by other factors. Three such factors are worth noting:

(i) The precise nature of the entitlement involved is important. For example, the move from means tested to universal free personal care brought new demand on the public service system and increased the cost of meeting that demand by limiting cost recovery.
(ii) Practices within public services themselves: for example, the balance of preventative and reactive effort or the nature and application of assessment and eligibility criteria.
(iii) The living circumstances of older people themselves. For example, older people living with a partner, or with family, are less likely to use publicly provided care services than those living alone. Equally, all of the statistical evidence we can access demonstrates a strong, significant statistical relationship between deprivation in old age and enhanced patterns of demand on health and care services.

7. It is sensible therefore to recognise what we might call ‘conversion factors’: factors that materially influence the conversion of demographic trends into actual demand on public services and spending. The key point for the Committee to note is that the (often spectacular) projected impact of demography on public spending and services they will be presented with assumes that these ‘conversion factors’ remain in place and remain relatively constant over time. The OBR projection that £80 billion more would be necessary by 2060 to accommodate the costs of ageing on public services assumes the conversion factors remain ‘as is’. (OBR, 2011:8) The Scottish Government ‘Joint Improvement Team’ projection that £1.1 billion per annum more would need to be spent on health and care services by 2016/17 (against 2008/09), and £3.5 billion per annum more by 2030, again assumes the conversion factors remain constant. (JIT, 2010:10) The Institute of Fiscal Studies projection that over 50% of all UK government spending would have to be on health and pensions by

2060 because of aging again assumes the conversion factors remain constant. (IFS, 2012)

8. The Christie Commission's focus on reducing inequality, and on prevention and early intervention, and the 'four pillars of reform' that have followed, involve targeting and changing some of these 'conversion factors': particularly the focus and practice of public services. (Christie Commission, 2011) (Renewing Scotland, 2011) The long-range projections through to 2030 and 2060 noted make it clear why a long-term strategy of improving outcomes for vulnerable groups and reducing inequalities through prevention and early intervention is critical for long term sustainability. However, if we take the 3 types of conversion factors noted above, (entitlement; public service practice and peoples living circumstances), the current reform strategy addresses predominantly the second of them, is beginning to focus on the third, and ignores the first altogether. The third section of this submission demonstrates that this is unlikely to be sufficient to get us through the public expenditure pressures of the next 5 years.

9. The sustainability of public services financially depends critically not only on the actual demand faced, but also on the <u>cost</u> of meeting that demand. Again, the long term projections noted above are rarely explicit about their assumptions about costs, and seem to assume either that costs will be constant as a percentage of budget over time, or will rise in line with GDP growth. In principle there is no reason why that should be the case, albeit historically that has most often been the case. (That history, however, was one of rising budgets and trend level economic growth.) Clearly if costs could be reduced over time through wage strategies, greater efficiency and better procurement, the volume of demand a given level of budget could support would increase.

10. 'Income' in any projection is in essence measuring <u>spending capacity</u> over time against demand, and therefore is expressed in 'real' terms i.e. adjusted for cost and wage inflation. This links to the points raised about costs above. If cost and/or wage inflation can be controlled and managed down, the spending capacity within the system will be better sustained than if they cannot be controlled. For example, projections of the real terms reduction in spending capacity faced by Scottish councils from a 'cash flat' settlement in 2011 were mitigated by staff reductions and a wage 'freeze'. It is noteworthy that existing wage strategies across the Scottish public sector finish at the end of this financial year. Some implications of this are teased out in the final section.

11. To conclude this section, 3 mains points are emphasised:

(i) There is no automatic conversion of demography into actual demand on public services and public spending. That is always mediated by 'conversion factors' which include the nature and extent of the entitlements citizens have and the consequential duties on public authorities, and the living circumstances of individuals, families and communities.
(ii) A particular volume of demand does not automatically translate into a specific cost to public services. The cost at any point in time of dealing with demand is also a function of wage and cost structures, and ability to reduce <u>net</u> cost through charging.

(iii) Demographic change does not automatically create a crisis of sustainability. If real income (spending capacity) grows at the same rate as actual demand, there is no crisis. Crisis occurs when policies that drive demand through entitlement are dislocated from economic and financial policies that reduce the ability to fund demand. That has nothing to do with demography or older people: it is to do with the dynamics of public policy itself.

Section 2: Demography; Health and Social Care

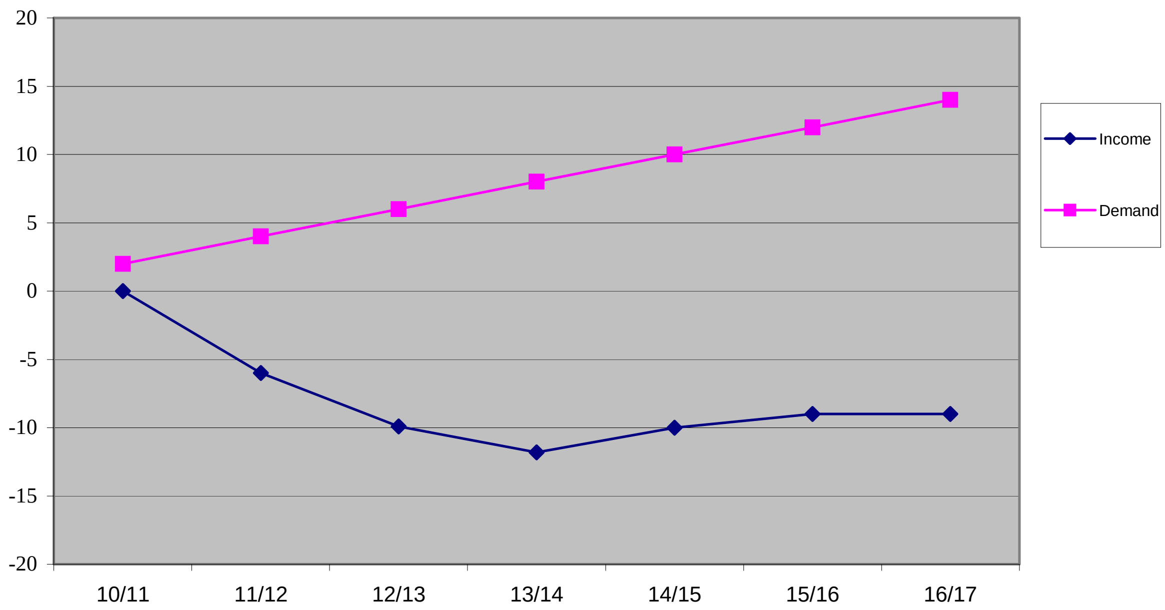
12. As noted above, the long-term implications of demographic change on public services and public spending, assuming the conversion factors remain 'as is', are spectacular. There is an automatic pressure on state provided pension entitlements and on public sector pension schemes. The Hutton enquiry has concluded, supported by the analysis of the OBR, that current arrangements are unsustainable and has targeted the entitlement conversion factor: the age of retirement will have to rise; public service pension fund members will have to pay more during working life and final salary schemes will need replaced by schemes based on average earnings across working life. (Hutton, 2011)

13. The Dillnot Commission, examining care for older people in England and Wales, has similarly concluded that current arrangements are unsustainable. Their major conclusion is that the service users contribution to the cost of care needs standardised and, subject to means, people would be expected to contribute up to £35,000 to the cost of their own care. (Dilnot, 2011:5) Subsequent policy discussion at UK level has explored figures of up to £100,000, again subject to means. Again, the entitlement conversion factor is targeted by the Dillnot recommendations. Scotland's free personal care scheme is unique within the UK and creates potentially greater exposure to demography than elsewhere.

14. The downside of the demographic, demand and public expenditure forecasts in Hutton, Dillnot and the OBR report is that they are very long term: scenarios built around 2030 and 2060. We still have to get there. Their utility is in reinforcing the scale of the long term problem of demand growth against public expenditure trends that are constrained by the long term impact of the current recession. (It is worth noting that UK action to reduce the net cost of care and to reduce public sector pension costs would feed into Barnet. If entitlements in Scotland remain higher than elsewhere in the UK, post the implementation of the new Scotland Act in 2016, the difference would have to be funded by additional taxes raised in Scotland (see below).)

15. There are, however, short to medium term forecasts available in Scotland that allow demographic demand to be explored against projections of income. The Strategic Finance Review Group model (SFRG, 2010) modelled demand and income projections for local government, assuming entitlements and service models remained the same. It showed a growing gap between real income (projected from the Spending Review) and the cost of meeting demand through current service models: it produced an iconic graph charting the forecast Total Funding Gap (TFG) reaching over £1.5 billion in 2013/14 and rising to almost £3 billion in 2016/17 (see Figure 1 below). Over 50% of the demand growth is accounted for by demographic change interacting with current entitlements (free personal care, etc).

Figure 1



16. The Joint Improvement Team analysis of demographic trends and demands on Health and Social Care in the medium and longer term is equally stark. To quote**:** **"**Assuming current service models remain the same, we will require an estimated annual increase in investment in health and social care services for older people of £1.1 billion by 2016 and £3.5 billion by 2030, a real increase of 24% and 74% respectively over 2007/08 levels. This represents an average real increase in the NHS budget (total for all ages) of 1.2% per year, every year; and of 2.7% per year, every year to local authority older people's social work budgets." (JIT, 2010:10)

17. The short and medium term problem in Scotland is therefore well scoped. The response in Scotland to date was well captured in the report of the Christie Commission: the need to target and reduce 'failure demand' (demand arising from preventable negative outcomes in peoples lives) through prevention, early intervention and focusing on the most vulnerable communities suffering the greatest inequalities in outcomes across life. (Christie Commission, 2011) The emphasis in the Government's response on 'place' and 'prevention' reinforces the Christie Commission's conclusions (Renewing Scotland, 2011). The I.S. undertook substantial statistical analysis for Christie that evidenced the interaction of demography and deprivation across Scotland (subsequently published as 'Making Better Places: Making Places Better). That work showed that older people living in deprived neighbourhoods made more recurrent, extensive and expensive use of health and care services than those living in better circumstances (e.g. had over double the rate of emergency admissions to hospital). (Mair, Zdeb, Markie, 2011)

18. We support the Christie emphasis, therefore, and endorse a long term shift from a service base that is reactive to one that is preventative and promotes positive outcomes first time round. However, four points need underscored to ensure realism:

(i) The Christie Commission was proposing a long term strategy for addressing deep seated and embedded inequalities of life outcome in Scotland, not a short to medium term fix.
(ii) That negative outcomes are in principle preventable does not mean we know precisely how to prevent them. We are at an exploration and innovation stage just now and that requires investment.
(iii) Even if we hit the ground running, the SFRG and JIT figures indicate that success means we would not have to create <u>more</u> hospitals, nursing homes, etc. It will not mean we can save on the ones we have across the next five years.
(iv) As is discussed below, we are entering the worst 5 years in post war UK public spending history and substantial <u>cash</u> cuts may be necessary between now and 2017/18.

19. To sum up this section, in Scotland a very serious short to medium term problem of income and demand has been scoped, and a long term strategy adopted to address it: reducing inequalities and developing a preventative orientation. In England, a very serious long term income and demand problem has been scoped and a short term strategy proposed to address it: change entitlements now. Both address 'conversion' factors' and seek to change them, but selectively so. Our strong sense it that both types of strategy are necessary to survive the medium term and to be sustainable in the long term.

Section 3: Demography and Short to Medium Term Spending Pressures

20. Appendix 1 provides a detailed analysis of the short to medium term economic and public finance outlook for the UK, so only major points are rehearsed here: These are:

(i) Forecasts for economic growth in the UK have been seriously downgraded across the last two years, and GDP growth has been in aggregate 3.7% less than forecast in the 2010 Spending Review.
(ii) As a consequence, Government borrowing is much higher than forecast in 2010, revenues lower and AME spending higher than was forecast (social security, debt servicing, etc.)
(iii) Government and OBR medium term forecasts remain well above the average of independent forecasts, but even then indicate that the deficit reduction plan could not now be delivered by 2014/15 and that further significant cuts will be necessary to achieve the planned reduction by 2017/18.
(iv) Assuming the OBR forecast to be correct (and it never has been – see Appendix 1), at least £17 billion of cuts would be necessary in 2015/16 and 2016/17 to meet the deficit reduction target by 2018. If the independent forecasts are more accurate, that would imply cuts of £20 billion plus. (The Institute for Fiscal Studies (IFS) favours the latter figure.)

21. As a consequence, the UK Spending Review in 2014 will either have to abandon the Government's deficit reduction target or re-phase it and plan for £17 to £22 billion of further cuts or tax increases in 2015/16 & 2016/17. Add to that the IFS estimate that in 2012/13 we are only 40% through the cuts to current spending planned in the 2010 UK Spending Review, and the CPPR estimate that in Scotland in 2012, we are only 20% into the reductions to current spend planned in the 2011

Scottish Spending Review. (IFS, 2012) (CPPR, 2012:2) In short, we still have previously planned real reductions in current spending to achieve, and further cash cuts to follow from the UK Spending Review. Both OBR and IFS analysis show that 2015/16 and 2016/17 will be the two hardest public spending years since the credit crunch in 2008.

22. Precisely what this means for Scotland is hard to scope as it will depend on decisions in the 2014 Spending Review and the post Referendum Constitutional circumstances. For planning purposes, we have suggested that a prudent assumption would be for cash cuts of at least £1 billion in Scotland as a consequence of the UK Spending Review. This would coincide with the implementation of the new tax powers for the Parliament in 2016, and therefore in principle cuts through Barnet could be offset by fiscal decisions taken for the first time in Scotland. (However, the income tax provision is inflexible as it requires equal treatment across all tax bands and the bulk of Scots are relatively low income basic rate tax payers.)

23. The demography and demand issue will, therefore, interact with the need to make short to medium term cuts to public spending. The preventative focus developing in Scotland is critical to medium to long-term sustainability and needs to be pursued now. The key questions, however, are whether it will have impact on the short to medium term and, if not, how we handle the forthcoming period.

24. Purely evidentially, we can find little support for prevention leading to short to medium term (3–5 years) savings on scale. The evidence does show prevention working in terms of improved outcomes in the short to medium term, but as a result of additional spending not as a saving against existing spending (for example, Kings Fund 2009). The backlog of entrenched poor outcomes at all ages and stages of life identified by the Christie Commission make it profoundly unlikely that significant resources would be freed by preventative action across the next 5 years. It is more likely that resources will be freed 10 years hence by preventative action now. Again, performance data from the Health and Care Change Fund indicates some significant preventative achievements but they have required new investment and do not create immediate savings.

Pulling the Strands Together

25. Demographic change does, and will, generate severe pressures on public services and public spending because of the conversion factors in place. This will interact across the next period with other demand pressures generated by recession, unemployment and welfare reform. These will coincide with continuing downward pressure on public spending, including potentially two years of sharp cash reductions in public budgets in 2015/16 and 2016/17. From 2016, Parliament would have greater powers to offset UK determined cuts by tax increases but the powers available are inflexible.

26. A long-term strategy for altering conversion factors is in place through reducing inequalities that drive public spending through prevention, early intervention and a more integrated approach to vulnerable communities. There is good evidence that this can have payoff in the medium to long term, but very little evidence that it

would allow significant savings in the short term. Put simply, success in the medium term means not having to invest significantly more in reactive services; it does not mean not achieving savings against current spend.

27. The short to medium term response may, therefore, need to re-examine the entitlement conversion factor as a way of addressing immediate as well as long-term pressures. The most obvious areas would be travel concessions for older people and universal free personal care: the former has an automatic conversion from ageing to demand: the latter links age incapacity and need for support. Neither takes income and ability to contribute to cost into account. The argument is not with these policies all other things being equal: they were introduced at a time when public budgets were growing at 4%+ per annum and were quite proper for their time. The question is their sustainability and priority in a period where budget will decline in cash and real terms.

28. We accept this is a contentious option and that almost all parties in the last election supported universal, non-means tested, entitlements for older people. However, the alternatives may be just as contentious in the short, medium and long term. (For example, increasing taxation of people working age with low incomes to fund free entitlements for older people with higher incomes.) It is worth noting the conclusion of Lord Sutherland, the designer of the free personal care system, in his 2008 review of the system. To quote: “The uncertainty associated with projecting future costs of long-term care and other factors of uncertainty described in our report, means demand and costs must be reviewed and remodelled regularly. That coupled with the demographic projections and the rapid growth in the numbers of older people – including growth in the numbers of the ‘oldest old’ and all the implication that will have – mean the position should have the benefit of a further review within 5 years. If our recommendations are accepted, we believe that – with action to address the funding shortfall which has emerged in the past few years and that problems with variability of provision we describe – the policy can be stabilised and maintained at the level originally envisaged for the immediate future, until the demographics really begin to bite, <u>from around 2013 onwards</u>.” (our emphasis) (Sutherland, 2008:5)

29. A move from universal to means related entitlement would reduce the conversion rate and reduce the cost of the system by around £500 million per annum. (Sutherland 2008, updated for inflation and demand growth). The honest alternative would be to fully fund the demand growth this entitlement will generate due to demographic change, and make corollary cuts in other service areas. There are powerful simplicity and solidarity arguments for universal entitlements but the arguments for reconsidering these entitlements are also substantial: non-means tested entitlements are less progressive than tested means entitlements and preserve rather than reduce inequality; no other country in the UK or Europe has such a system of personal care, and most are reviewing their current systems in the light of demographic pressures; the cost of the universal care entitlement is so great that eligibility criteria are very tight and this creates a reactive rather than preventative orientation. As importantly, it is achievable in the medium term and is probably necessary for sustainability in the long term.

30. The cost of meeting demand may also need addressed. The wage freeze of the last 3 years has padded the impact of demand growth by reducing cost. There is an open question about what happens next. Many public service workers are relatively low paid and have already had a significant real reduction to their wages. It is unclear they could absorb a further wage freeze, particularly as their required pension contributions are likely to rise, reducing their disposable income further. However, this would not preclude a continuing freeze or even cuts for higher paid staff to minimise impact on the aggregate wage bill. The alternative, given the financial constraint, may well be job losses and service cuts.

31. These options are not particularly palatable, but the alternatives are probably less so. There is a rapidly developing and powerful long-term strategy in Scotland with the capacity to alter the factors that convert demography into demand. However, there also needs to be a strategy for the short to medium term if we are to have a long term. The entitlement conversion factor is critically important to both the volume of demand faced to the cost of meeting that demand. These are policy choices but options need considered against a realistic estimate of the pressures across the next 5 years and a realistic assessment of what prevention can deliver across that period.

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Appendix 1

The Budget 2012 and the Public Finances

1. Introduction

This note explores the implications of the budget statement and OBR report in March 2012 for spending pressures in Scotland. We do so under 3 headings:

(i) Analysis of the financial and economic forecasts and comparison with the forecasts in the previous year's budget, and the 2011 autumn forecast.
(ii) Identification of factors directly relevant to income, cost and demand pressures that councils may face.
(iii) Medium to long-term challenges.

2. Analysis of Economic and Financial Outlook

Details on projected economic growth and public borrowing are appended (Tables 1 – 3). They call into question two elements of the UK Government's presentation of the budget. First, that it is a 'budget for growth' and second, that the Government is on track with its medium term economic and financial strategy.

On growth, the forecast for the 2012 – 2015 period is identical to the forecast in the Autumn Statement, i.e. all the measures in the Budget 2012 taken together are deemed by the OBR to have no aggregate impact on output at all (See Table 1). The forecast again exhibits the tendency of all OBR forecasts since 2010. The outlook for the short term (years 1–2) is downgraded from previous forecasts whereas the longer term remains optimistic in comparison to independent forecasts. For the 5 years (2012 – 2016), the OBR are forecasting growth per annum of 2.4%, as against the analysis of independent forecasts of around 1.8% (See Tables 1 & 2). If outliers are excluded from the average of independent forecasts, that forecast per annum growth falls to 1.5%. The main disparity between OBR and independent forecasts arises from the later years of the forecast.

The more optimistic forecast by the OBR rests on critical assumptions about components of growth. Government consumption and investment will definitely decline across the period by 7.5%, and this will reduce growth by 2.5% in comparison to a situation where public spending was maintained at 2011/12 levels. So where will growth come from in the OBR model? Real household incomes are forecast to rise slowly across the period (under 2% per annum), and disposable income more slowly still. Although the savings ratio is projected to fall across the period, it does so very slowly, and will remain above trend, suggesting households are still lacking confidence and are inclined to save rather than spend. There is little to suggest significant consumer led growth in the domestic economy.

The major differences between the OBR and independent forecasts are:

(i) The OBR views global economic growth more optimistically than most independent forecasters: 4% - 4.5% per annum as opposed to 3% - 3.5%.
(ii) This leads the OBR to forecast higher export growth than others: from a declining trend across the last 3 years (7.9% to 2.3%) to average export growth of

5.5% per annum across the next 4 years. The oddity of this is that over 60% of UK exports go to the eurozone which the OBR forecasts to grow sluggishly.

(iii) International and export growth result in an optimistic forecast for business investment which is forecast to rise by over 9% per annum between 2013 and 2016. Even allowing that there is spare capacity to be brought into productive use, this is a highly adventurous assumption and would require substantial domestic and international market growth.

(iv) Investment in private housing is forecast to rise at a rate of over 10% per annum which contradicts the recent analysis by Oxford Economics, and other commentators, who forecast a flat market and static real values outside London.

In summary, the most generous interpretation of the OBR forecast is that there is spare and pent up capacity in the UK economy, and pick up in world markets, and in corporate and domestic confidence, which will drive a sharp pattern of growth. The less charitable view is that, on past performance, the long term forecast will be wholly inaccurate and will be revised down. Whatever the case, our view would be a more cautious medium term forecast is warranted, and certainly no more than the average of independent forecasts at March 2012 (See Table 2).

The issues with the growth forecast have been emphasised because it conditions the outlook for tax receipts, borrowing, unemployment and employment growth. For example, the projected growth in income tax receipts from £155 billion in 2012/13 to £190 billion in 2015/16 assumes the OBR forecast for growth is correct (for income tax, so also for corporation tax, VAT, etc.). If the projected tax receipts do not materialise, projected borrowing would have to rise or further reductions be made to spending, or both. As is discussed in the final section of the note, even on an optimistic growth forecast, substantial further cuts are necessary to bring the current budget into balance by 2017. If the forecast is over optimistic, the cuts would have to be more severe post 2015.

The final point to make in this section is that the UK Government's view that its strategy is 'on track' is true only if the comparison made is with the 2011 Autumn Statement, which included a massive downgrade of all previous forecasts (See Tables 1 & 2). If the comparison is made with the 2011 budget forecasts (March 2011), forecast growth for 2012 and 2013 is now 2.6% lower and forecast borrowing is 5% (£47 billion) higher. If the comparison is made with the OBR 2010 forecast, the growth forecast is now downgraded by 3.7% and the current deficit is now £64 billion larger than forecast then. This reinforces our view that the outer years of any forecast are wholly speculative. This does not show in any meaningful sense a strategy 'on track'. Indeed, it reinforces the question of whether there is a strategy at all for growth or deficit reduction.

3. Implications for Income, Costs and Demand

The Budget announcement makes little difference to the known parameters of the Scottish Block. The Scotland Office Budget Statement indicated the budget had Barnet consequentials of only £20.3 million, and devoted the bulk of its length to general fiscal measures that may impact beneficially on the Scottish economy. The Budget measures, therefore, have no implications for planned spending in Scotland which will remain in line with the 2011 spending review.

The OBR forecasts have a number of elements that do have potential implications for short-medium term pressures faced by Scottish public services. Real wages are forecast to rise at over 2% per annum from 2013/14 to 2015/16 (nominal wages at over 4%), and that puts real pressure on wage strategy. The UK Government response is the proposal for differential regional pay structures in the public sector. There is no evident support for that in Scotland but there will need to be a coherent alternative strategy in place (with a wage bill in councils of over £7 billion, a 1% or 2% increase has a significant cost impact). The proposed UK Government approach would control the pressure on the aggregate by reducing the bill in low cost regions, and using the saving to meet the bill in higher cost regions.

Realistically, such an approach will take significant time to design and implement, and nothing is likely to come of it within this Parliament at UK level (cynically, it may be part of a strategy for selling a much more conventional wage strategy post 2012/13). The key point is that neither Scottish Government nor local government presently has any wage strategy beyond 2012/13. That is understandable at this juncture, but real cuts to spending have been minimised through the current pay policy and will be more severe if wages rise significantly. This needs addressed.

Despite the budget emphasising investment and growth, net public sector investment actually declines by £5 billion across the period. At UK level this decline in public investment is assumed to be offset in two ways:

(i) Improved reliefs on capital investment for business to encourage investment.
(ii) Opening up the whole range of infrastructure historically regarded as public to 'off the balance' sheet investment through the private sector.

New financial models and options for this will be reported by the Treasury in autumn, but will certainly include charging users directly for access to infrastructure (roads, bridges, etc.).

The Scottish Government will have new borrowing powers as part of the Scotland Bill, but these will be within UK borrowing totals and limits. The agreement between the UK and Scottish Government on the Scotland Bill requires that the Scottish Government is consulted on these limits, but gives it no unilateral power. If the rest of the UK goes for an 'off the balance sheet' privately financed route that implies continuing constraint in Scotland if that route is rejected here across the next period. The UK Government's commitment to consulting on empowering the Scottish Government to issue its own bonds might provide a way of alleviating constraint, but no time scale is placed on that at present. There is, therefore, a need to look at a range of options to support local investment, including driving value out from the existing asset base.

A final point worthy of note is that the OBR, in anticipation of the Scotland Bill becoming law, has for the first time modelled tax receipts in Scotland as part of their forecasts. The forecast assumes that the 10p reduction in UK tax liability for Scottish taxpayers would be fully recovered, but no more than that, so a full 10p rate would be set in Scotland. The forecast shows that the Scottish yield would grow across the next 5 years but more slowly than for the rest of the UK, so the Scottish share of UK income taxation would fall (see OBR: Scottish Tax Forecasts Table 1 – 3). The Scottish Government would have a capped power to borrow up to £200 million to support current spending against fluctuation in tax receipts, but the forecast implies that either:

(i) Lower growth and tax receipts in Scotland would need to be fully compensated for in the block grant from Westminster (in which case, the changes to the system in the Scotland Bill become virtually pointless) or;
(ii) Income Tax rates would have to be higher in Scotland to sustain our current level of spending relative to the UK.

As council income disproportionately comes through the Scottish Parliament, any pressures following implementation of the Scotland Bill pass down the system. The limited ranges of taxes devolved by the Bill, interacting with the higher spending base in Scotland, may create quite rapid pressures for either tax increases or spending cuts or both.

4. Medium – Long Term Challenges

The sting in the tail of the 2012 Budget report, and the OBR forecasts, is the acceptance of the point made in the IS note on the Autumn Statement: that the Chancellors aim of a balanced budget in 2014/15 was unachievable, and that substantial further spending cuts would be necessary in the next spending review to achieve balance by the end of 2016/17. This is because social security spending will continue to run at a much higher level than forecast in the spending review 2010. The net effect would be 3.8% real reductions in spending in both 2015/16 and 2016/17. This is equivalent to a further £18 billion cash reduction in the next UK spending review.

It should be emphasised that this assumes that the OBR's optimistic forecasts for growth, employment and tax receipts are correct. If a more cautious projection proves accurate, cuts of £22 billion + might be necessary. It will be for the UK Government at the next spending review to decide whether it still wishes to eliminate the deficit by 2016/17. Given the public commitments made to calm markets, and the fact that this is already behind schedule, it is likely they will.

The decision is likely, therefore, to be about whether cuts are made to public service spending, or further cuts are made to welfare, or whether cuts are made to both. On the pattern of the current spending review, the balance would be 1/3rd welfare cuts, and 2/3rd public service spending cuts implying, at minimum, at least £1 billion further cash cut to the Scottish Block. As welfare has already been hit hard, and defence spending has already been sharply cut, the services that determine the Scottish Block (Health, Education, etc.) may be reviewed and targeted for reduction.

It would be prudent, therefore, for longer term planning, to assume, at minimum, cash cuts in Scotland at the next spending review of £1 - £1.5 billion (for local government, £300 - £400 million). If the OBR growth and employment forecasts are overoptimistic for the next 4 years, cuts would need to be more severe.

Appendix 1

Table 1

Office of Budget Responsibility GDP Growth Forecast					
	2012	2013	2014	2015	2016
March 2011	2.5	2.9	2.9	2.8	
Nov 2011	0.7	2.1	2.7	3	
March 2012	0.8	2.0	2.7	3	3

Table 2

GDP Growth: Independent Forecasts (average)					
	2012	2013	2014	2015	2016
March 2011	2.1	2.5	2.5	2.5	
Nov 2011	1.1	2.1	2.3	2.4	
March 2012	0.7	1.6	2.1	2.3	2.4

Table 3

Public Borrowing (billions)				
	2012/13	2013/14	2014/15	2015/16
March 2011	101	70	46	29
Nov 2011	120	100	53	24

March 2012	120 (92*)	98	52	21

* We have adjusted the 2012/13 borrowing figure as the Government intends to sell the assets of the nationalised Post Office pension fund for an estimated £28 billion and use the receipt to off-set borrowing. However, as the liabilities of the fund are to be placed on the current account, this is equivalent to borrowing so we have maintained the previous figure.