CPPR - Briefing Note
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PRESS RELEASE

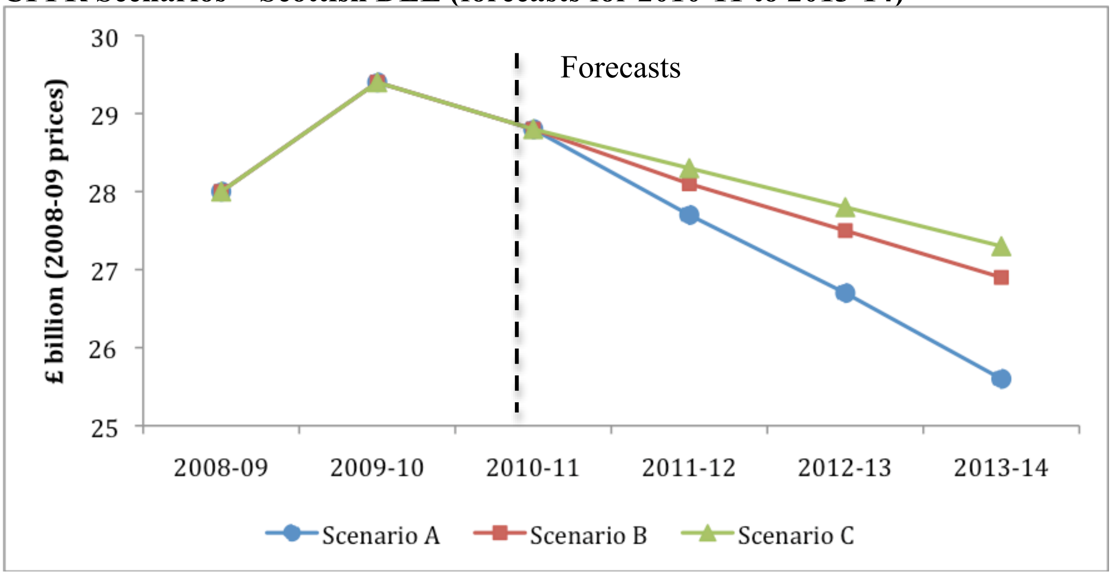
POST BUDGET 2009 UPDATE OF – *THE SCOTTISH GOVERNMENT'S BUDGET – GROWTH SCENARIOS UPTO 2013-14*

CPPR have today updated their growth scenarios for the Scottish Government's Budget in light of the worsening Budget 2009 figures for the UK economy and public sector.

Up to 2013-14 the range of outcomes suggests a real terms decline over the current years (2009-10) budget of between £2.1-3.8bn (see table and chart).

Budget	*2008-09*	*2009-10*	*2010-11*	*2011-12*	*2012-13*	*2013-14*	Difference 09/10 vs 13/14
Cash	28.0	29.7	29.5				
Real	28.0	29.4	28.8				
ScenarioA				27.7	26.7	25.6	-3.8
ScenarioB				28.1	27.5	26.9	-2.5
ScenarioC				28.3	27.8	27.3	-2.1

CPPR Scenarios – Scottish DEL (forecasts for 2010-11 to 2013-14)



This highlights how much worse the UK governments Budget 2009 projections were in comparison to those made in the Pre Budget Report of November 2008. Based on those figures, and the Institute for Fiscal Studies analysis of them broken down to Spending Departments, CPPR previously projected a real terms decline of between £0.6-2.2bn. In other words, what was the pessimistic scenario in our previous forecast has now become the optimistic scenario.

The overall likely decline in spending power puts into context the current debate over £ ½bn of "efficiency savings". Regardless of whether these savings should be made at present, in the longer term they account for a small share of the overall cut in real terms funding that the Scottish Government faces.

Further downside warnings come with these projections. Most analysts believe the Budget 2009 GDP projections to be overly optimistic. In addition, debt interest payments could eat up more of total government spend in future years, leaving less for Departments, if the current relatively low interest rates associated with this debt were to rise.

Furthermore, the bad news doesn't stop in 2013-14. If the Treasury's longer-term scenario for the public finances is achieved, Spending Departments may experience real terms positive growth over the 4 years after 2013-14, but it will still be low, perhaps around 1% per annum. And thereafter if the UK wants to get net debt as a % of GDP back down to 50% or 40%, then a further period of low real terms growth in Departmental spending can be expected stretching into the 2020's and 2030's respectively.

The message for the Scottish Government is to start planning now, for the next 5 years in particular, but also for longer term tightness of the Budget. This is especially true as the International Monetary Fund warn of a further serious fiscal threat from unfavourable demographic trends emerging over this longer term period.

A major boost to this structural change could be delivered almost immediately with the establishment of a separate new Budget Office. This would free the current Office for Finance and Sustainable Growth of any inherent conflict of interest and ensure all budgets are robustly challenged.

Budget challenge is now more than ever essential to ensure value for money from the increasingly scarce Scottish Government funds. However an independent Budget Office is not sufficient on its own to ensure effective challenge. Such a role also requires the collection of supporting evidence to justify the continuation of existing budget proposals as well as to help identify where spending may need to cease.

Quotes:

John McLaren*: "The deterioration in the outlook for the Scottish Government's Budget since last November is considerable. A cut of between 7-13% by 2013-14, on the 2009-10 peak, seems likely. Unfortunately the prospects beyond 2013-14 are also not good and although positive real terms growth rates are likely to return, they are unlikely to be very large until UK net debt as a share of GDP falls, possibly not until the 2030's."*

Director of CPPR, Richard Harris: "*Overall, the Scottish Government now faces unprecedented change in relation to it's budgetary future. Such a future may therefore require previously unprecedented changes in policy thinking and funding* *arrangements in order to steer a way through, while limiting the negative impact on the current level of provision of public services*."

Jo Armstrong: *"As a first step the Scottish Government needs to establish a new independent Budget Office separate from the Office for Finance and Sustainable Growth, boost its analysis capacity and ensure it has the authority across other Offices to impose the cuts and efficiencies needed to see us through these difficult times."*

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POST BUDGET 2009 UPDATE OF – *THE SCOTTISH GOVERNMENT'S BUDGET – GROWTH SCENARIOS UPTO 2013-14*

This update of the February CPPR Briefing Note takes into account new figures stemming from the H.M. Treasury Budget Report of 2009 and the Institute of Fiscal Studies (IFS) analysis of that Report.

The revised Table 1 below illustrates the likely profile of the Scottish Budget up to 2013-14, based on 3 different scenarios.

Table 1: Spending by Scottish Government 2008-09 to 2013-14: Scenarios A, B and C

DEL total £b	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
1. Pre PBR08	28.0	29.3	30.5			
2. Post PBR08 changes		0.4	-0.8			
3. New DEL	28.0	29.7	29.7			
4. Real Terms[1]	28.0	29.4	29.0			
5. Real Growth	-	+5.0%	-1.4%			
[3a Revised DEL 2010-11			29.5*]			
[3b Revised DEL 2010-11 real			28.8*]			
Scenario A						
6. Total DEL				29.1	28.8	28.4
7. Real Terms				27.7	26.7	25.6
8. Real Growth				-4.5%	-3.8%	-3.8%
DEL change over 2009-10, £bn (real)				-1.7	-2.7	-3.8
Scenario B						
9. Total DEL				29.5	29.7	29.8
10. Real Terms				28.1	27.5	26.9
11. Real growth				-3.1%	-2.3%	-2.3%
DEL change over 2009-10, £bn (real)				-1.3	-1.9	-2.5
Scenario C						
12. Total DEL				29.7	30.0	30.3
13. Real Terms				28.3	27.8	27.3
14. Real growth				-2.4%	-1.8%	-1.8%
DEL change over 2009-10, £bn (real)				-1.1	-1.6	-2.1

* The revised 2010-11 DEL in line 3a has been derived by excluding non-recurring budget amounts from the 2010-11 DEL figure in line 3. This reduces DEL in 2010-11 by £0.26b; £0.17b from the EYF reserves that have already been drawn down for that year and £0.09b from a budget over allocation allowance. To estimate the DEL amounts for 2011-12 and beyond, this revised DEL figure for 2010-11 is therefore the appropriate baseline figure.
Sources: Scottish Government; HMT PBR'08; IFSGB09

[1]The appropriate GDP deflator is taken from the Budget'09 report, table C1. The real terms estimate assume an end year position e.g., the 2009-10 real terms values apply the 2009-10 GDP deflator.

Three Scottish Budget Scenarios for the period 2008-09 to 2013-14

Table 1 highlights the Scottish Government's likely discretionary spend (largely determined by its DEL (Departmental Expenditure Limit) allocation from Whitehall) over the period up to 2013-14. It starts with the original DEL Budget (line 1) as it stood prior to the Pre Budget Report 2008 (PBR08), as no Scottish Government update to this figure has been published.

Line 2 incorporates the budgetary impact of the PBR08 and Budget'09 changes. These comprise 4 elements:

- *first*, an acceleration of £260m in capital spend from 2010-11 to both 2008-09 and, primarily, 2009-10;
- *second*, a one-off reduction in the Scottish Budget in 2010-11 of £129m consequent on the Barnett Formula applying to a £1.3b reduction to the English Department of Health's capital budget in that year;
- *third*, a one-off reduction in the Scottish Budget in 2010-11 of £392m consequent on the Barnett Formula applying to £5b efficiency savings related reduction to Whitehall Department's resource DEL[2].
- *fourth*, an extra £104m of funding through Budget'09 related Barnett consequentials.

The table then illustrates the impact of three different scenarios for future DEL spending totals:

- **Scenario A** – IFS "Scotland". This scenario is based on the IFSGB's real growth rate for Scottish DEL of –1.5%, taken from IFSGB, 2009 (see Chapter 9, Figure 9.10), updated for their more pessimistic Budget '09 calculations (see IFS Budget 2009 briefing, 'Public Spending" by Gemma Tetlow), giving a new real growth rate of -3.8%;
- **Scenario B** – IFS 'UK average'. This assumes a real growth rate of -2.3%. (Again by updating the 0% real growth rate that IFSGB assumes for UK DEL as a whole with their post Budget 2009 analysis for DEL);
- **Scenario C** – CPPR's 'Barnett related'. CPPR's own calculations of Scottish growth is based on applying the Barnett Formula to the IFS growth rates for Whitehall Departments which, post Budget '09, comes out at -1.8% average annual growth.

(The February CPPR Briefing Note[3] explains how the original Scenarios were calculated in greater detail.)

[2] Note: the actual disaggregation of this reduction was announced in Budget '09 and ended up being very close to the £380m for Scotland is an estimated by David Bell on behalf of the Scottish Parliament's Finance Committee, which assumes that such efficiencies were shared equally in % terms between all UK Departments.
[3] See http://www.cppr.ac.uk/media/media_110548_en.pdf.

UPDATED RESULTS

Table 1 illustrates the resultant Scottish Government discretionary spending (ie, Total DEL) under each of the 3 scenarios in terms of:

(a) the total cash budget;

(b) the budget in real terms (i.e. stripping out inflation using the Budget '09 GDP deflator projections);

(c) the real growth rate; and,

(d) the cumulative real terms forecast adjustments to Scotland's 2009-10 DEL.

For **scenario A** (lines 6-8), the Scottish budget declines by between 3.8-4.5% in real terms for 3 consecutive years post 2010-11, ending up with a Budget that is falling in cash as well as in real terms. In real terms it is 13% (£3.8b) lower than the peak year of 2009-10.

For **scenario B** (lines 9-11), the budget falls by 2.3-3.1% over the same period. This is equivalent to a Budget that is virtually flat in cash terms for 5 years and down by 8½ % in real terms (£2½b).

For **scenario C** (lines 12-14), the budget falls by 1.8-2.4%, equivalent to a 7% real terms cut, 2013-14 on 2009-10, worth £2b.

All 3 scenarios exhibit much reduced levels for the future Scottish Budget than were estimated in our previous Briefing. The only positive note is that, due to lower than expected inflation, the Budget will be higher, by £0.6b, in 2010-11 and so the real terms cut in that year is lower.

When considering these scenarios it is important to bear in mind that these are forecasts. Uncertainties over current and future allocations mean that it is difficult to be precise over the profiles. Nevertheless all 3 scenarios outline dramatic reductions in real terms spending in the Scottish Budget. If the disputed £0.5b of 'efficiency savings' were added back to the Scottish budget that would still leave a real terms cut of over £1½b by 2013-14 to be taken into account, even under the most optimistic scenario.

All in all, scenario C appears likely to be, if not a best case scenario then at least an optimistic one, and it might be prudent to build in even greater declines in spending levels, consistent with scenarios A and B, when planning future spending levels.

Beyond 2013-14

While the Scenarios outlined above up to 2013-2014 make grim enough reading this is not the end of the bad news.

In their Budget'09 briefing the IFS predict that the years up to 2017-18 will also be tight. Indeed if, as in the earlier period, reduced spending accounts for ¾ of the further tightening needed (with the remaining ¼ coming from tax revenues) then DEL's can expect, on average, an annual real terms increase of only 1% per annum over this 4 year period. (To put this into context, over the period 1999-2000 to 2007-08 the Scottish Budget grew by over 4% in real terms in each year and by an average of around 6% a year.)

And that is still not the end of the story. In 2017-18 the UK's net debt will still be over 70% of GDP. It is expected that the UK government will want this to fall, if not to the old limit of 40% of GDP, then at least to 50%.

If so, the IFS analysis suggests that this will take up to 2022-23, to reach 50%, or 2032-33 to reach 40%.

This again means DEL spending growth rates that may be positive, in real terms, but remaining very low, in historical terms. This is particularly worrying as on such a timescale the current fiscal crisis implications start to coincide with the timescale for the demographic 'crisis' timescale highlighted recently by the International Monetary Fund (IMF). In fact the IMF states that *"In spite of the large fiscal costs of the crisis, the major threat to long-term fiscal solvency is still represented, at least in advanced countries, by unfavourable demographic trends."* The IMF have highlighted the large impact of these demographic trends on health and health care by 2050, but the fiscal costs will start to emerge well before 2050.

Budgetary pressures and downside risks within a declining Budget

The potential budget decline outlined above would be difficult to accommodate in any circumstances but it is even more difficult to accommodate given the continuing expenditure pressures arising from: a very high priority for Health and Education budgets; an overall budget that consists of around 50% of wages; continuation of the council tax freeze; an ambitious transport infrastructure building programme, especially in relation to the Forth Road Bridge replacement; and many other commitments to projects like the 2014 Commonwealth Games and increased investment in public sector housing.

In addition, significant downside risks still exist even within this gloomy picture:

- the IFS highlight the risk that both the debt and the debt interest payments positions may deteriorate further in the event that the interest rate charged on this debt becomes higher than the current relatively low levels;
- many commentators and analysts believe that the GDP growth forecasts for 2010 and beyond are over-optimistic. If this turns out to be true then it could further reduce government revenues and put pressure on the government to make compensating cuts in public spending;
- the Treasury's estimate of potential losses related to the final cost of financial sector interventions is considerably lower than the IMF's estimates.

Conclusions

In terms of Scotland's Budget things have gone from bad to worse between the PBR'08 and the Budget '09.

Since Devolution the Scottish government has been principally faced with the question of where to spend the extra money, rather than where to cut back, such was the largesse available. Now the tables have turned and it is a question of who faces the largest cuts.

In order to help make the tough choices, CPPR believe that Scotland will need a strong and powerful Finance/Budget Department, a more H.M. Treasury-like body that spends little but has the greatest power amongst Departments. The establishment of a separate, new, Budget Office would free the current Office for Finance and Sustainable Growth of any inherent conflict of interest and ensure all budgets are robustly challenged.

Budget challenge is now more than ever essential to ensure value for money from the increasingly scarce Scottish Government budget. Whilst a new Budget Office is a necessary condition it is not sufficient to ensure effective challenge. Such a challenge function also requires the collection of supporting evidence to justify the continuation of existing budget proposals as well as to help identify where spending may need to cease.

Such a body would not only tightly control spending in other Offices, but it would also help make the case for what are likely to be unpopular spending decisions. It should also have a long-term mindset and have contingency plans in place for different likely outcomes. In particular, in deciding short to medium term policy it needs to bear in mind the longer-term consequences of any such changes, given anticipated unfavourable demographic trends.

Although the prospects for the Scottish look daunting, it is worth remembering that in 2013-14, the Budget will still be at a level, in Scenario A, comparable with that experienced in 2005-06. In that sense, much of the current tightening of the purse strings can be thought of as an adjustment for the unsustainable boom years which also affected public finances, and therefore similar to the adjustments that are also currently taking place in many households and businesses.

Overall, the Scottish Government now faces unprecedented change in relation to its budgetary future. Such a future may therefore require previously unprecedented changes in policy thinking and funding arrangements in order to steer a way through that limits the impact on the provision of public services.

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