The UK Budget Position and Strategic Implications for Public Services in Scotland

Professor David Bell
Division of Economics
University of Stirling

Budget Adviser to the Finance Committee

April 2009

Introduction

This paper reviews the current state of UK and Scottish public finances. It focuses on the deterioration in the UK's financial position and discusses its implications for Scotland's budget strategy for the short and medium terms.

In my report on the 2008-09 Scottish Budget, I argued that:

> "One consequence of the economic slowdown will be a rapid deceleration in tax receipts and some increase in government spending (through, for example, increases in the value of payments needed to support the unemployed). As a result, government borrowing is likely to increase. In the medium term, when growth resumes, countries will offset their increased borrowing by reducing the growth of public spending.[1] "

This report was posted on the 23rd of September 2008. Since then, the UK budgetary position has grown substantially worse. As a result, the resources available to the Scottish government are likely to be even more constrained than was envisaged last autumn. Put bluntly, it is unlikely that there will be any real increase in the resources to support Scottish Government spending programmes over the next five years. Indeed, they may fall. This is a marked contrast to the period since 2001 during which the real resources available to the Scottish government grew at an unprecedented rate.

This paper does not seek to analyse the cause of the deterioration in the public finances. Indeed, this is extraordinarily difficult, given the global nature of the downturn, the unprecedented impact of credit market failure, and the unexpected ways in which linkages between economies have exacerbated recessionary pressures. It does take as given what is widely accepted by most serious commentators on the British economy, namely, that it will be some time before any effective economic recovery takes place.

It also focuses on some issues that may be unpalatable politically, but which may have to be faced due to funding constraints. The ability to continue to provide public services at the level to which people became accustomed in the middle of this decade may no longer be possible. Reductions in service may meet with significant public opposition. It is therefore vital that the Parliament is aware of the issues and that it is sufficiently informed to take a strategic review of priorities. The Parliament provides a key forum for debating these priorities.

The report is structured as follows: Section 1 explains the recent deterioration in the UK public finances. In Section 2, we construct estimates of how the recession may have reduced tax revenues from Scotland. Section 3 examines the likely impact on the resources available to the Scottish Government. Section 4 considers some important strategic issues relating to pressures on the Scottish budget. Section 5 looks at individual budgets in more detail, while Section 6 concludes.

[1] http://www.scottish.parliament.uk/s3/committees/finance/budget/documents/2009-10_adviserPaper1.pdf

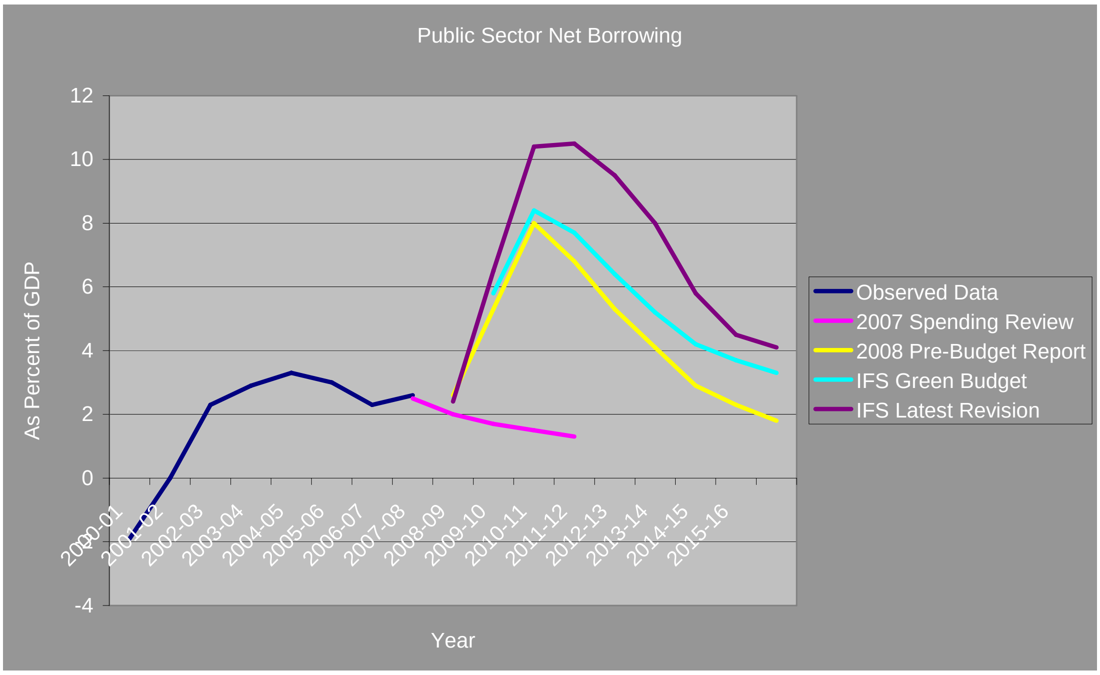
Section 1: The Deterioration in UK Public Finances

When the Comprehensive Spending Review (CSR) was published in 2007, the UK government expected that public borrowing in the UK would be around 2% of GDP in 2009-10, falling to 1.3 per cent by 2012-13 and that the UK national debt could be kept below 40% of GDP in the medium term. These forecasts were badly wrong. The deterioration of the world economy and the difficulties of the financial sector in the UK led to a substantial worsening of the fiscal outlook. The UK entered recession in the second quarter of 2008.

The deterioration in the public finances was flagged in the Pre-Budget Report (PBR2008), published in November 2008. It forecast that the 2009-10 fiscal deficit would be 5.3% of GDP, more than twice the CSR estimate. More worryingly, the estimate of the fiscal deficit 2010-11 was 8%, much higher than any recently recorded.

In January 2009, the Institute for Fiscal Studies (IFS) published its Green Budget, arguing that even these estimates were too optimistic. The IFS revised upwards the Treasury estimates of the fiscal deficit and of the national debt. Then in March 2009, the IFS published further revisions, indicating that public sector borrowing in the UK would be around 6.5% of GDP in 2009-10, 10.4% in the following fiscal year, and might still be above 4% in 2015-16. The forecasts of the fiscal deficit are shown in Figure 1.

Figure 1 : Estimates of Public Sector Net Borrowing from 2000-01 to 2016-17.



Starting from a position of a budget surplus in 2000-01, the public finances gradually deteriorated in the first half of the decade. CSR 2007 forecasts now seem wildly optimistic and each subsequent revision has suggested larger deficits, particularly for 2010-11 and 2011-12. The improvements in subsequent years are largely due to assumed economic recovery that boosts tax receipts and to much slower growth in, or to a real reduction in, public spending.

The first steps towards reduced public spending were taken in PBR 2008, where it was announced that the fiscal stimuli of £9.3 billion in 2008-09 and £16.3 billion in 2009-10 which are designed to maintain demand in the economy will be offset by reductions of £4.8 billion and £7.6 billion in the following two fiscal years. The increases in spending in 2008-09 and 2009-10 are relatively modest fiscal stimuli. The fiscal stimuli applied by governments in many of the G20 countries including China, the USA and Germany are larger. Indeed, the UK is proposing a much weaker fiscal stimulus during 2010 than almost all of the other G20 countries (IMF 2009)[2]. The main reason for increased borrowing in the UK is therefore nota associated with fiscal expansion, but with the unexpected reduction in tax receipts and the costs of dealing with the failure of some financial institutions.

The taxpayer costs of dealing with the financial sector are potentially huge. Table 1 below, which is reproduced from IFS (2009a)[3] illustrates the potential liabilities associated with interventions in Northern Rock, Bradford & Bingley, Royal Bank of Scotland and the Lloyds Banking Group. According to the IFS, the amount paid for RBS and Lloyds is around £37 billion, but by insuring the assets of these institutions, the UK government has taken on huge potential liabilities that amount to almost twice the value of UK GDP.

Table 1: Actual and possible impact on public sector net debt from recent financial sector interventions

			Gross liabilities net of short-term financial assets	
Nationalisations	**Amount paid**	**Equity**	**£bn**	**% of GDP**
	for acquisition	**acquired**		
Northern Rock	To be decided	100%	£81.90	5.6
Bradford & Bingley	To be decided	100%	£41–51	2.8–3.5
Bank Recapitalisation Fund				
Royal Bank of Scotland	£15bn ord. Shares	63%	Up to £1,845	Up to 125%
	£5bn pref. shares			
Lloyds Banking Group	£13bn ord. Shares	44%	Up to £1,017	Up to 70%
	£4bn pref. shares			

Since the publication of this report, the public sector stake in RBS increased to over 70 percent due to private sector investors largely shunning its sale of new shares. And as the IFS also notes, the absorption of some of the banks' liabilities within the public sector will have a dramatic effect on the national debt:

> "The ONS has announced that the Royal Bank of Scotland and the Lloyds Banking Group (comprising Lloyds TSB and HBOS) will be classified as part of the public sector (from 13th October 2008). The ONS is still assessing the assets and liabilities of these institutions and has yet to incorporate them into the official figures. The ONS's indicative analysis, published last month, suggests that the impact of including these institutions will be to increase public sector net debt by somewhere between £1

[2] IMF (2009), "Global Economic Policies and Prospects", March
[3] Institute of Fiscal Studies (2009) "Budget 2009: tightening the squeeze?"

trillion and £1.5 trillion – or about 70–100% of national income. This figure will dwarf the existing stock of net debt." IFS (2009b)[4] p2

The Chancellor revealed the likely size of the UK fiscal deficit until 2013-14 in his recent budget. In 2009-10, the Treasury estimate of UK government borrowing is £175 billion. The forecast, based on quite optimistic forecasts of UK economic recovery, still has a deficit of £97 billion in 2013-14 – almost three times as much as was borrowed in 2007-08. This level of borrowing is unprecedented in peacetime and will undoubtedly have serious consequences for the growth in public spending across the whole of the UK, including Scotland. Financial stringency will undoubtedly be necessary beyond this date if the government debt is to return to its current share of GDP.

The costs of meeting the interest payments on this debt are manageable so long as long-term interest rates remain low. Any significant increase in interest rates could have a dramatic effect on debt interest payments, which would further squeeze UK public spending with inevitable consequences through the Barnett Formula on the resources available to the Scottish Parliament. One possible cause of increased interest rates is any reduction in market confidence that that the UK government's plans to meet its debt obligation is credible. Any downgrading of the UK's credit rating means that lenders will demand higher returns on their loans. And the UK taxpayer will have to foot this higher bill. IFS estimates suggest that with interest rates at 5.3 per cent, interest payments will cost more than 6 per cent of national income over the long-run, whereas interest rates at 3.3 per cent will incur much reduced payments of around 2 per cent of national income. For Scotland, the difference between the upper and lower debt interest charges would be worth around £5bn in lower spending or higher taxes.

Thus, the increase in UK borrowing and indebtedness will have long-term consequences for public spending in Scotland. The immediate effect will come through a reduction in government revenue associated with a slowdown in economic activity. But because of the role of the financial sector in this recession, the potential implications for the medium-term spending outlook are worse than they would be in a "normal" recession. This is because the increased uncertainty caused by the absorption by the UK government of the risks associated with RBS and Lloyds TSB liabilities could substantially increase the costs of UK borrowing. In addition, this or the subsequent UK government may wish to reduce the national debt to a lower share of GDP to improve its resilience to the kind of shock experienced in recent months. At the beginning of this decade, interest payments on the national debt were easily affordable because the debt only accounted for 30 per cent of GDP. However, attempts to reduce debt to such a low level would require very rapid economic growth, which appears unlikely, or significant cuts in public spending.

The £9 billion efficiency savings announced at the 2009 budget will certainly be part of a continuing process constraining growth in public sector spending. Reflecting the savings already announced Scottish Resource DEL for 2010-11 has been reduced from £26.5 billion to £26.1 billion between the 2008 and 2009, while capital DEL has dropped from £3.6 billion to £3.2 billion – a total reduction of £0.8 billion on 2008 plans.

A number of changes have affected Scotland's DEL since the publication of the Comprehensive Spending Review in 2007. The Scottish Government has chosen to reprofile (bring forward) some of its capital spending to support the Scottish economy during a significant economic downturn. The 2009-10 Scottish Budget reprofiled £347m of capital

[4] Institute of Fiscal Studies (2009) "IFS analysis of the February 2009 public finance figures"

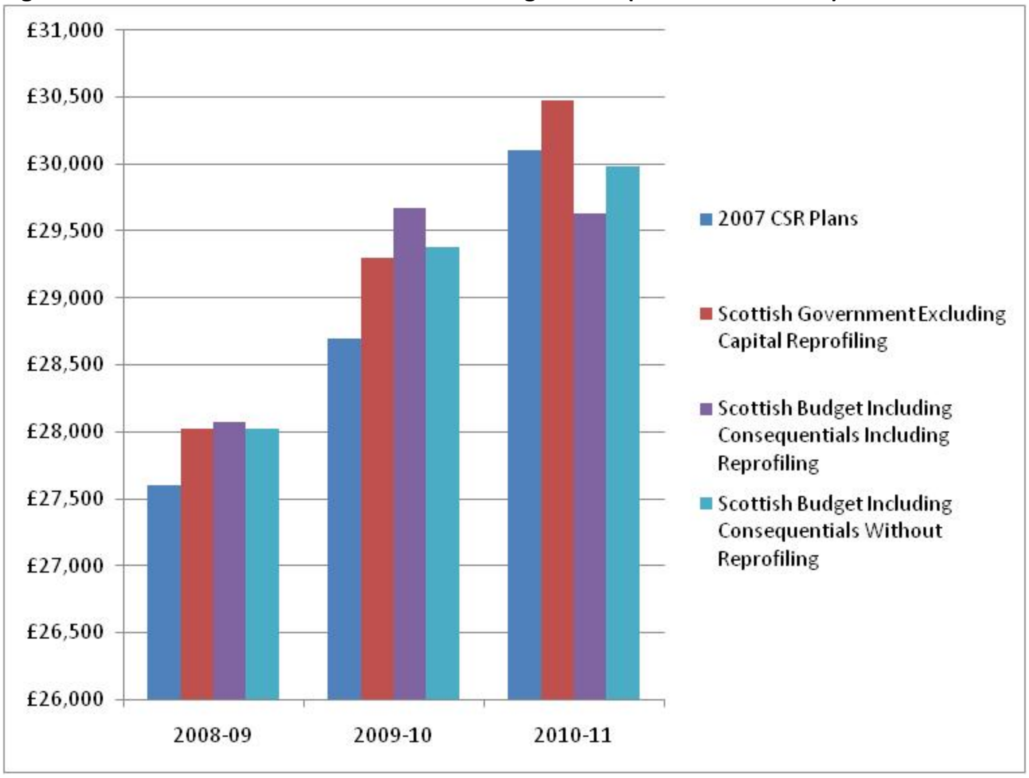
spending to 2008-09 and 2009-10. This sum was taken from the 2010-11 budget, reducing the amount available for capital spend in that year.

In addition, there have been changes in Scotland's DEL due to "Barnett Consequentials", such as the efficiency savings announced at the 2008 Pre-Budget Report and the 2009 UK Budget.

The net effect of these changes may be interpreted in different ways. Figure 2 is helpful in understanding these interpretations, as is the Scoping Paper on Strategic Scrutiny of the Scottish Government's Budget published by SPICE. It shows planned Scottish DEL for 2008-09 to 2010-11 based on the 2007 Comprehensive Spending Review (CSR 2007). It also shows planned Scottish DEL based on the 2009-10 Scottish Budget excluding the effects of capital reprofiling, which increases the 2008-09 and 2009-10 budgets, while reducing that for 2010-11.

Figure 2 also shows the effect of the Barnett Consequentials with and without capital reprofiling on Scottish DEL.

Figure 2: Scottish DEL from CSR 2007 to UK Budget 2009 (£m Current Prices)



The interpretation of whether DEL has, or has not, increased depends very much on the interpretation of capital reprofiling. It is unclear to what extent any Barnett consequential changes will affect Scotland's baseline budget going forward, because the form of the next Comprehensive Spending Review is as yet unknown.

The recession will also have brought about a significant reduction in tax receipts, particularly as the Scottish economy now seems to be performing worse than the rest of the UK[5]. In the next section, we construct some estimates of these reductions.

[5] Scotland now officially in recession http://www.scotland.gov.uk/News/Releases/2009/04/22101441

Section 2: Impact of Reduced Tax Revenues in Scotland

This section estimates reductions in tax revenues from Scotland as a result of the recession. The purpose of this exercise is to be able to measure reductions in spending and cuts in tax revenues on a consistently Scottish basis. Estimates of the reduction in tax revenue from Scotland use the Government Expenditure and Revenue in Scotland (GERS)6 methodology. Estimates of changes in expected tax receipts are shown in Table 2

As well as GERS, four other sources of information are used to construct these estimates. These are: (1) HMRC estimates of tax revenues up to 2008-09; (2) the March 2008 UK budget (3) PBR 2008 and (4) the 2009 IFS Green Budget. The GERS methodology allocates tax revenues to Scotland, using fixed shares of UK revenues. These shares are estimated from survey or other evidence. Table 2 and Table 3 assume that these ratios have not changed since 2006-07, the last financial year for which GERS estimates are available.

The assumption that the shares have remained fixed is open to question. For example, the recession may have impacted more heavily on the rest of the UK than in Scotland, in which case income tax receipts in Scotland may have risen as the share of those in the UK as a whole. Similarly, house prices may have fallen less rapidly in Scotland and turnover in the housing market have been relatively higher, in which case stamp duty may be underestimated.

Nevertheless, changes in these shares are likely to be relatively slow, given that year to year changes in the relative performance of the Scottish and rest of the UK economies are typically small. For example, there has been very little difference in the rate of growth of unemployment in Scotland and England, since the onset of recession. Thus, for most taxes the use of the 2006-07 GERS ratios will yield reasonably accurate estimates.

However, corporation tax revenue is relatively volatile, since it is linked to firm profits[7]. Depending how different sectors of the economy are performing, Scotland's share of UK corporation tax revenues may change significantly from year to year. Allocating Scotland its GERS share (8.1%) of UK corporation tax revenue (excluding the North Sea), suggests that this tax yielded around £3.6 billion in Scotland during 2008-09. However, this does not make allowance for the losses incurred at the Royal Bank of Scotland and HBOS (now Lloyds), which would substantially reduce these revenues. Last year, RBS recorded a loss of £28 billion, the largest corporate loss in UK history. Hence actual corporation tax revenues in Scotland may have been substantially lower than the most pessimistic of the estimates shown.

Table 2 shows how tax revenue forecasts for Scotland would have been revised between the March 2008 UK Budget and the November 2008 Pre-Budget Report as a result of the deterioration in economic conditions. It estimates the effect on tax revenues in Scotland of the change in expected UK revenue between the March 2008 Budget and the November PBR using GERS 2006-07 ratios. The revised projections for the UK imply lower tax revenue in Scotland for 2008-09 of around £1.1 billion. This is the result of rapidly falling expectations of receipts from income tax, national insurance, VAT, corporation tax and stamp duty.

[6] Scottish Government (2008) Government Expenditure and Revenue in Scotland, http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/GERS

[7] In the USA, the profits of the top 500 US corporations fell by 85 percent in 2008 (Fortune Magazine April 19th 2009)

However, these are offset by a £750m rise in PRT resulting from the increased oil price during 2008. This would be partially offset by a fall of around £250m in 2009, as a result of its subsequent fall.

Table 2: Variance between Budget 2008 and PBR 2008 Estimates of Tax Revenues Applied to Scotland

	Outturn	Estimate
Tax	2007-08	2008-09
Income Tax	-256	-277
National Insurance	246	-566
Capital Gains	41	-8
VAT	9	-102
Corporation Tax	-8	-518
PRT	17	750
Fuel	0	-58
Tobacco	0	72
Alcohol	19	-29
Stamp Duty	-10	-265
Betting	0	0
Air Passenger Duty	0	-8
Insurance Premium	0	-8
Landfill	0	-18
Climate Change	0	0
Aggregates	0	-15
Inheritance Tax	-6	-6
Total	**51**	**-1059**

Petroleum Revenue Tax (PRT) is highly volatile, reflecting the particular economics of the oil and gas industry. Our estimates use the geographic share (83.3%) approach to determining Scottish revenues from this source, as described in GERS. Based on PBR 2008, Scottish revenues rise by £700m between 2007-08 and 2008-09 and then fall by £900m in the following financial year, mainly as a result of the spike in oil prices during 2008.

But the overall fiscal position may be even worse than shown in Table 2. The IFS argues that the UK government is overoptimistic about the size of the revenue flows. If correct, this would have knock-on effects to revenues generated from Scotland. Both PBR 2008 and the IFS Green Budget imply tax revenue in Scotland falling in cash terms between 2008-09 and 2009-10. Table 3 shows that using the PBR data, tax revenues in Scotland would fall by £1.46 billion, while the Green Budget implies a reduction in revenues in Scotland between 2008-09 and 2009-10 of £1.96 billion as a result of the recession. Again, the drop in tax revenue is mainly driven by falls in income tax, VAT, stamp duty and inheritance tax.

Just as the implied reductions in UK tax revenues are large in relation to UK spending levels, so the implied reductions in revenue at a Scottish level are also substantial in relation to the Scottish budget. To put this in context, the reduction in tax revenues between 2008-09 and 2009-0 10 implied by the Green Budget is equivalent to 7 per cent of the Scottish Government's 2009-10 Departmental Expenditure Limit (DEL). As already discussed, such a reduction was simply not foreseen less than 12 months ago.

The consequences of the massive unexpected increase in government borrowing will be some combination of higher taxes and lower government spending. Under the Barnett

Formula, the consequences for Scotland will depend on the extent to which the UK government makes efficiencies in "comparable programmes"[8] that are covered by the formula. In the next section, we consider how large the consequences for public spending in Scotland might be. This commentary adds to the discussion contained in the SPICE Scoping Paper.

Table 3: Revenue Estimates for Scotland Based on PBR 2008 and IFS Green Budget Using GERS Methodology

Based on:	HMRC Estimates (£m)		PBR 2008 (£m)		IFS Green Budget (£m)	
			Estimate	Projection	Estimate	Projection
Tax	2007-08	2008-09	2008-09	2009-10	2008-09	2009-10
Income Tax	10755	11037	11038	10600	10738	10468
National Insurance	8234	8008	8011	8266	8011	8241
Capital Gains	427	398	397	194	316	194
VAT	6851	7017	7021	6171	6928	5993
Corporation Tax	3757	*3632*	*3637*	3378	*3645*	3240
PRT	1399	2174	2166	1250	2165	1250
Fuel	2067	2079	2083	2175	2083	2175
Tobacco	971	981	984	984	984	984
Alcohol	805	813	825	844	825	844
Stamp Duty	720	423	423	352	388	342
Betting	178	177	149	139	149	139
Air Passenger Duty	167	163	160	160	160	160
Insurance Premium	194	195	193	210	193	210
Landfill	80	82	82	109	82	109
Climate Change	72	75	73	73	73	73
Aggregates	52	54	61	46	61	46
Inheritance Tax	241	195	195	151	195	151
Total	**35571**	**35329**	**35331**	**33852**	**34831**	**33369**
Change PBR 08-09 to 09-10				**-1461**		**-1963**

Section 3: Reduced Resources for the Scottish Government

Because of the adverse effect of the credit crunch on growth, UK output is around 4 per cent lower than it would otherwise have been. We have already seen that the 2009 Budget implies that there will be a £0.8 billion reduction on previously announced spending plans for Scotland in 2010-11.This is a 2.7 per cent reduction in the resources available to the Scottish Government. However, the IFS Green Budget argues that if the government wants to return public spending to the same share of GDP as was the case before the credit crunch occurred, public spending would have to be reduced by 4 per cent each year until 2013-2014. Other courses of action are possible, such as holding public spending constant and focussing growth on the private sector. This would bring public spending down as a share of GDP, but much more slowly.

[8] These comparable programmes are listed in HM Treasury "Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy" http://www.hm-treasury.gov.uk/d/pbr_csr07_funding591.pdf

However, during a recession, the Barnett Formula should work slightly in Scotland's favour. Because the formula operates in the same way when public spending is being cut as it does when spending is increasing, there will be a "reverse Barnet squeeze". This is best explained using an artificial example.

Suppose that aggregate UK spending on comparable programmes is set at £1000. The UK population is 1000. Of this total, £110 is spent in Scotland, though it accounts for only 10% of the UK population. Thus spending per head in Scotland is 10% above the UK average. UK aggregate spending is then cut to £800. Scotland must take its population share (10%) of this £200 cut, reducing its budget to £90. Spending per head in Scotland is now (90/100)/(800/1000) – 1 = 12.5% above the UK average. Thus, although spending per head in Scotland falls as a consequence of the overall cut in UK expenditure, the proportionate cut is smaller in Scotland because its population share is less than its share of aggregate spending. Thus, although cuts in spending will undoubtedly be difficult, spending per head in Scotland may not fall as rapidly as in other parts of the UK, so long as the Barnett Formula is not significantly varied or its coverage changed.

Nevertheless, the economic difficulties associated with the recession suggest that the medium term outlook for spending in Scotland is fairly poor, perhaps lying somewhere between stagnation and an annual 4 percentage cut. For public services this implies either: (1) withdrawing from provision, (2) increased rationing, (3) charging for services, (4) increasing taxes (including council tax or the Scottish Variable Rate[9]) (5) cutting costs. It is therefore vital to take a strategic view of priorities since these actions will undoubtedly affect the welfare of Scottish citizens. It is worth also bearing in mind that the Scottish Government's latitude for action is somewhat restricted by the contractual commitment of future funding to particular spending programmes. These would include, for example, future PFI/NPD payments that are shown in the associated SPICE paper.

Section 4: Strategic Public Spending Issues

This section covers some general areas that the committee might wish to address during its deliberations. From the SPICE paper it is clear that the recession is bringing particular budgetary pressures on public bodies in Scotland. These include:

Local Authorities	Reduced user charge income (e.g. recreation, care and planning)
	Reduced income from asset sales
	Reduced direct council tax income – if householders become unemployed, they will be unable to meet their council tax bill, but the shortfall will be paid for by the Department of Work and Pensions through Council Tax Benefit
	Reduced income from business rates as businesses close
Justice	Higher crime rates
Health Boards	Additional costs associated the poorer health outcomes of the unemployed
Education	Reduced ability to pay for tuition fees, where applicable

Some of these budgetary pressures will be alleviated as the recession eases. But because the long-run budgetary outlook for the UK will be tightly constrained for the foreseeable future,

[9] A one penny change in the Scottish Variable Rate would be worth plus or minus £400m in 2009-10. (http://www.hm-treasury.gov.uk/d/bud08_completereport.pdf p 113)

as discussed above, there will be no return to the previous growth path of public spending. The Scottish parliament, perhaps for the first time since 1999, will have to make some very unpopular choices. However, such choices should be based on strategic analysis of options. The remainder of this section discusses some of the areas that are worthy of detailed examination, before the time for decision arrives. It begins by looking at the components of the largest component of Scottish Government expenditure – the wage and pensions bill.

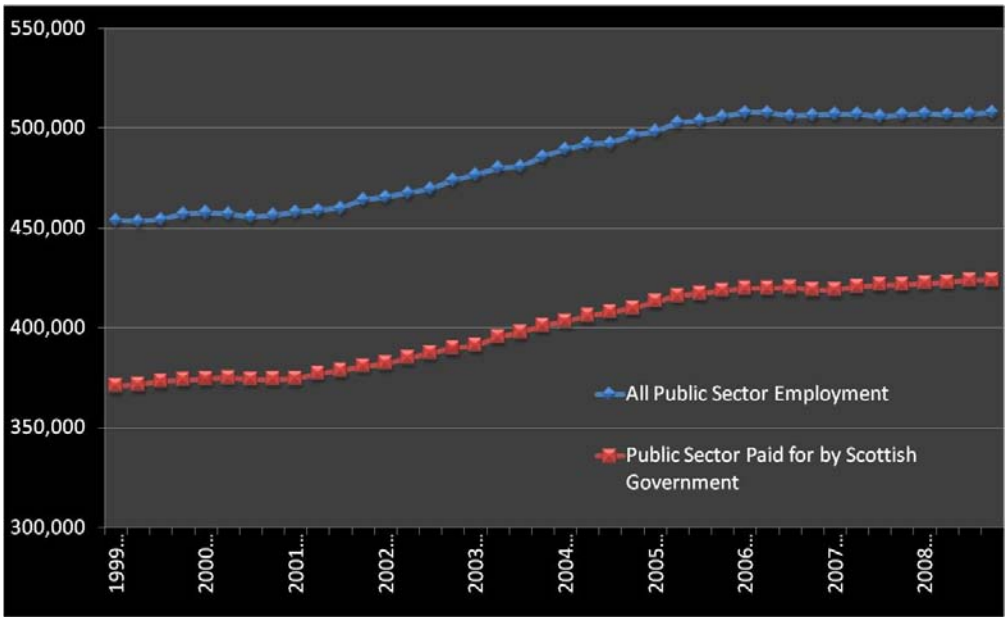
Public Sector Employment

One way of managing costs would be to seek savings through reductions in public sector employment. Figure 3 shows the headcount of public sector employees in Scotland from 1999 to 2008[10]. It includes both those public sector employees paid for by the Scottish Government and those employed by UK departments, such as the Department for Work and Pensions.

It is evident from the figure that there was a significant expansion in the number of public employees paid for by the Scottish Government during the period 2001 to 2006. There was no concomitant rise in the numbers employed in Scotland by the UK government. The rise was a result of past policy choices. How far were these increases in employment consistent with the primary objective of maximising Scotland's rate of sustainable economic growth? This is the kinds of issue that a closer examination of strategic priorities in the new economic environment might usefully address.

One way of maintaining employment while controlling overall costs is to manage wages more closely. We now look at the Scottish Government wage bill.

Figure 3: Public Sector Employment in Scotland 1999-2008



Public Sector Wages

One area of potential saving is through economies on public sector wages. Weekly wages in the private and public sectors for 2008 is shown in Table 4 below. These estimates cover both full-time and part-time workers. These indicate that public sector wages in Scotland are

[10] Scottish Government (2009) http://www.scotland.gov.uk/Publications/2009/03/17163412/0

slightly lower than public sector wages in the Rest of the UK (RUK). The narrow difference may reflect the fact that many groups in the public sector have their wage determined by UK-wide bargaining systems. Private sector wages are more likely to reflect local labour market conditions. Private sector RUK wages are £8.60 less per week than those in the RUK public sector. But in Scotland, public sector wages outstrip those in the private sector by £42.50 per week, a much larger differential. This may reflect differences in skill or experience, but may be worthy of closer examination during this review since, as we shall see, wage costs comprise a very significant proportion of Scottish Government expenditure.

Table 4: Weekly Wage Estimates

2008	Private	
RUK	£431.0	£439.6
Scotland	£396.2	£438.7

Source: Labour Force Survey 2008

Public Sector Wage Bill

Combining the information from employment with that on weekly wages, we can construct estimates of public sector wage costs in Scotland that are paid for by the Scottish Government. These are shown in Table 5. To the wage data, we add estimates of non-wage costs such as employers' national insurance contributions and pension payments that are derived from the 2004 Labour Costs Survey. Combining these estimates provides an estimate for the wage bill paid for by the Scottish Government of around £14.7 billion, which comprises about 60 per cent of Scottish DEL.

Table 5: Annual Wage Bill for Scottish Government

Annual Salary (£000)	£22.8
Add Labour Costs (National Insurance etc)	£28.9
Total Wage Bill (£m)	£14,655
Resource DEL (2008-09) (£m)	£24,814
Wage Bill Share	59.3%

This estimate omits the wage costs of those who are contracted to provide services to the public sector. For example, many voluntary organisations have contracts with local authorities to provide care services for older people. Nevertheless, even without these additional wage costs, it is clear that wage costs comprise a very substantial component of Scottish Government expenditure. In budgetary terms a 3 per cent reduction in public sector wage growth would be roughly equivalent to a one pence increase in the Scottish Variable Rate.

Public Sector Pensions

Public sector pensions are treated as Annually Managed Expenditure. Increased public sector pensions thus do not require cuts in other parts of the Scottish budget, as is the case with those costs that form part of DEL. Current costs amount to around £2.6 billion – around 7 per cent of Scotland's Total Managed Expenditure (TME).

Most public sector pensions are pay-as-you-go schemes where the pensions are paid for by the contributions of those currently at work. There is nothing inherently wrong with this system, but population ageing adds to the pressure on those contributing to the system.

However, public sector pensions are likely to come under pressure because private sector employers are increasingly less willing to contribute to pension schemes due to pressures on profitability. Public sector pensions seem increasingly generous by comparison with their private sector counterparts.

Most public sector pensions are defined benefit schemes where the recipient does not bear the risk associated with investing for a pension. Defined contribution schemes, where the individual bears the risk, are common in the private sector: much of this risk is associated with the cost of the annuities bought with the individual's contributions. At present, for example, it would cost at least £100,000 for a man aged 60 to buy an annuity that would pay a pension of £6300 for the remainder of his life.

If the Treasury were to decide that public sector pensions should form part of DEL rather than AME, this would become a pressing issue for the Scottish Government.

Configuration of the Public Sector

While it is obvious that reducing the wage bill will ease the pressure on the Scottish budget, there are clearly dangers that such action might harm the provision of services. One means of trying to protect service provision is to consider the structure of public service provision. This would involve considering whether the same levels of service could be provided with fewer bodies and whether the allocation of tasks and responsibilities might be more efficient if they were redistributed in some way. Local government, health boards, and a variety of NDPBs might be brought within the scope of such a review.

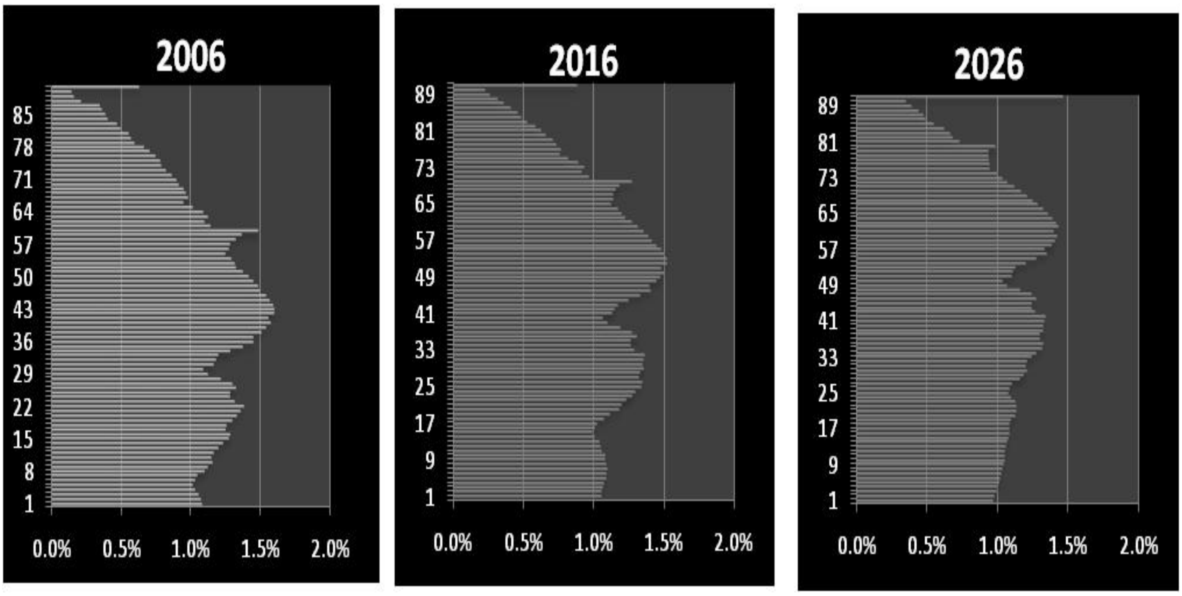
Demographic Change

One of the key strategic pressures on the Scottish budget in the next and succeeding decades will be population ageing. The dramatic change in the age structure is illustrated in Figure 3 which shows the proportion of the Scottish population by each single year of age up to 90.

In 2006, 15.4 percent of the Scottish population was aged 65 or over. In 2016, 18.1 percent of the population will be in this age group, while in 2026, 21.7 per cent of the population will be pensioners.

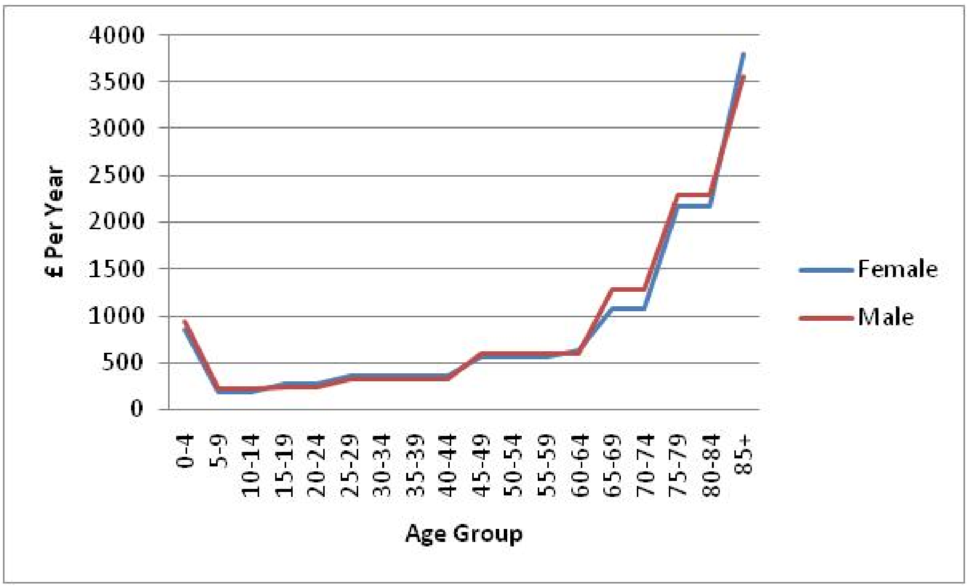
The implications for the Scottish budget of this change are quite profound. There will be fewer young people requiring education, but a substantial increase in demand for health care. Figure 2 shows how healthcare costs vary with age for males and females by 5 year age bands.

Figure 4: Scotland Population Age Structure 2006-2016-2026



Source: General Register Office Scotland

Figure 3: Health Expenditures Per Head in Scotland by 5-year Age Bands in 1996-97



Source: Scottish Executive: Fair Shares for All
(http://www.scotland.gov.uk/library2/doc01/fsag-00.htm)

These estimates are for 1996-97. Since then, there has been a very substantial rise in health care budgets. Hence, expenditure per head in 2009-10 will be very much greater for all age groups. But there is no reason to expect that the relative costs across age groups have changed significantly. There is still likely to be a steep rise in healthcare costs among those aged 65 and over. As population ageing progresses, aggregate health care costs will therefore rise. In addition a variety of other Scottish Government costs, including care costs are higher for this group. This will make it difficult to contain the health budget, which accounts for almost one third of spending by the Scottish Government, while maintaining health care standards.

Demographic change will clearly affect the demands that will be placed on the Scottish budget in future decades. The 2009 Budget implies that for the next decade, the resources available to the Scottish government will grow slowly, if at all. Strategic thinking is required to mitigate the effects of population ageing on these resources.

Section 5: Level 2 Budgets

In this Section, we consider how different elements of the Scottish Budget will have grown between 2002-03 and 2010-11. Table 6 below shows the compound growth rate of the funding associated with Level 1 and Level 2 budget headings in the Scottish Government's accounts. These growth rates include inflation as well as real growth. However, since there are no reliable deflators for different components of the Scottish Government budget, there is no basis on which to make real comparisons of growth rates and the nominal growth rates are the best approximations available.

Those that have grown very rapidly may have done so for reasons associated with promoting sustainable economic growth, which has been the primary objective of the last two Scottish administrations. However, the rapid real increase in funding that took place from the beginning of the decade may have resulted in the expansion of more populist schemes, which may have had little effect on economic performance. And, by definition, it will be difficult to contain costs on popular spending programmes. This is particularly the case with schemes where goods or services are being provided free. Examples include concessionary fares: its budget will have grown from zero to £195 million between 2002-03 and 2010-11.

The rate of growth of Scotland's cash budget over this period is 6.9 per cent. Some budgets have grown at a substantially greater rate; others much less rapidly. While there are technical reasons which affect growth patterns in particular budgets, these rates are the best evidence as to the choices that have been made by the Scottish Parliament over most of the last decade.

There is little to be achieved by detailed commentary on each budget. Level 1 totals have been coloured blue, while some that are perhaps surprisingly high or low are shaded mauve. In general, there is little evidence of what has been achieved by extra spending: there is even less information on the counterfactual – what would have happened if the money had not been spent. It is vital that a better understanding of these issues is gathered to inform the important strategic decisions that the Scottish Government will have to make in the near future.

Table 6: Comparison of 2002-03 Scottish Government Budget with 2010-11 Budget and Implied Growth Rate

	2002-03 Outturn £m	2008-09 Budget £m	2009-10 Plans £m	2010-11 Plans £m	Annual Growth Rate 2002-03 to 2010-11
Europe and External Affairs	0.4	15.2	15.2	18.2	61.2%
Culture and Gaelic	103.1	186.7	201.9	208.9	9.2%
Corporate and Central Budgets	1	15.3	15.4	15.9	41.3%
Historic Scotland	39.1	51.7	49.3	50.3	3.2%
National Archives of Scotland	10.1	10.3	10.3	10.5	0.5%
Total First Minister	**153.6**	**279.2**	**292.1**	**303.8**	8.9%
Scottish Public Pensions Agency	211	2,656.40	2,653.70	2,654.70	
Committees, commissions & other expenditure	2.2	14.1	18.3	40.6	44.0%
Rail Services in Scotland	115.3	689.2	672.9	667.1	24.5%
Concessionary Fares	0	187.5	189.5	191.5	
Other Transport Agency Programmes	-2	180.9	287.1	256.9	
Motorways and Trunk Roads	855	929.6	1,063.70	1,181.40	4.1%
Ferry Services in Scotland	32.5	91.4	106.4	112.3	16.8%
Air Services in Scotland	30.4	38.2	41.1	41	3.8%
Bus Services in Scotland	49.6	61.2	61.2	61.2	2.7%
Other Transport Directorate Programmes	12.6	76.6	65.6	54.4	20.1%
Planning	0	11.9	5.1	5.3	
Enterprise, Energy & Tourism	582.8	525.7	509.1	522.6	-1.4%
Scottish Water and Climate Change	170.9	331.8	351.8	371.8	10.2%
Third Sector and Social Economy	9.7	23.2	32.2	38.2	18.7%
General Register Office of Scotland	7.2	11.6	15.5	22.1	15.0%
Total Finance & Sustainable Growth	**2,177.30**	**5,829.30**	**6,073.20**	**6,221.10**	14.0%
Health	**6,785.40**	**10,642.00**	**11,058.20**	**11,540.90**	**6.9%**
Housing and Regeneration	510.1	478.6	611.7	461.2	-1.3%
Wellbeing	8	24.3	25.8	27.4	16.6%
Sport	17.2	47.4	53.9	54.9	15.6%
Food Standards Agency	4.6	10.6	11	11.4	12.0%
Total Health and Wellbeing	**7,325.40**	**11,202.90**	**11,760.60**	**12,095.80**	6.5%
Schools	117	132.7	135.6	140.3	2.3%
Children, Young People & Social Care	56.8	104.2	106.2	103.4	7.8%
Student Awards Agency for Scotland	346.8	506.1	504.7	530.8	5.5%
Scottish Higher Education Funding Council	733.8	0	0	0	
Scottish Further Education Funding Council	453.9	0	0	0	
Scottish Further & Higher Education Funding Council	0	1,677.50	1,742.10	1,840.00	5.6%
Other ELL (ELL)	40.3	276.1	263.9	262	26.4%
Total Education & Lifelong Learning	**1,748.60**	**2,696.60**	**2,752.50**	**2,876.50**	6.4%
Student Loans - net new lending (outsideTME)	214.6	4.5	4.5	4.5	-38.3%
Community Justice Services	60.8	21.1	23.2	23.2	-11.3%
Courts Group	25.1	44.3	46.3	48.1	8.5%
Criminal Injuries Compensation	30.9	28.5	28.5	28.5	-1.0%
Scottish Resilience	-	47.1	23.5	21.6	

Legal Aid	145.4	167.2	170.7	173	2.2%
Miscellaneous	25.8	28.5	29.2	29.6	1.7%
Police Central Government	76.5	148.5	175.6	182.2	11.5%
Drugs and Community Safety	0	32.3	34.8	35.6	
Accountant in Bankruptcy	3.1	6.9	7	7	10.7%
Scottish Court Service	74.7	81.3	92.9	95.3	3.1%
Scottish Prison Service	267.9	441.3	454.7	490.8	7.9%
Office of the Scottish Charity Regulator	0	3.6	3.7	3.7	
Total Justice	**716.6**	**1,050.60**	**1,090.10**	**1,138.60**	6.0%
EU **Support and Related Services**	510.7	166.2	165.9	165	-13.2%
Research, Analysis & Other Services	93.1	98.4	98.6	101.2	1.0%
Marine & Fisheries	60.4	66.9	72.3	72.1	2.2%
Natural Heritage & Rural Services	55.2	100.3	103.2	105.8	8.5%
Environment Protection, Sustainable Development & Climate Change	35.6	104.3	110.3	124.8	17.0%
Water Quality	11	9.3	8.6	8.6	-3.0%
Forestry Commission Scotland	38.5	64.3	67.6	70.3	7.8%
Forest Enterprise Scotland	70.6	26	26.2	26.3	-11.6%
Total Rural Affairs and the Environment	**875.1**	**635.7**	**652.7**	**674.1**	-3.2%
Total Administration	**206**	**265.9**	**273.1**	**278.8**	3.9%
Total Crown Office & Procurator Fiscal	**81.3**	**110.2**	**118.7**	**120.5**	5.0%
Total Local Government	**7,687.10**	**11,133.80**	**11,634.10**	**12,086.00**	5.8%
Total Scottish Government Budget	**20,970.90**	**33,204.20**	**34,647.10**	**35,795.20**	6.9%

Section 6: Conclusion

This paper has indicated that the public sector in Scotland faces an unprecedented period of austerity over the next decade. Many very difficult choices will have to be made. It is essential that the Parliament and the Finance Committee plays a leading role in articulating the issues associated with these choices.

Some public sector budgets are being directly affected by the recession, through reduced income capital values etc. However, the more profound effects on public services will arise due to the "overhang" of debt that has to be repaid by the UK government and the negative effect that will have on public spending throughout the UK including Scotland over at least the next decade. These will undoubtedly result in huge pressure being applied to the wage bill that the Scottish Government pays for and which accounts for the majority of its expenditure.

There are important societal pressures on the Scottish budget. This paper has illustrated the importance of demographic change, but other issues such as drug addiction, obesity and crime cannot be ignored. In addition, there are very significant economic issues such as the need to expand research & development and innovation in Scottish industry; the importance of having a highly skilled workforce that can help the economy perform better than its international competitors.

The evidence from the budgetary decisions that the Parliament has made is difficult to interpret. The lack of a narrative as to why particular budgets have grown substantially more rapidly than others makes the raw data problematic. But there is no very strong evidence that suggests that building up the economy has been given the particular focus of policy. The lack of linkage between budgets and outcomes is an issue that the Finance

Committee has worried about for some time. Perhaps, given the seriousness of the current situation, the Scottish Government may give it more detailed attention.