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Impact of Recession on Scotland's Public Finances

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On 22 April 2009, the same day as the Chancellor presented the 2009 UK Budget to Parliament, official statistics confirmed that Scotland had officially entered recession. This paper considers some of the potential impacts of the recession on Scotland's public finances.

It begins by summarising the changes to the Scottish Government's spending plans since Spending Review 2007, before speculating on some of the scenarios for Scottish public spending in the coming years.



The Scottish Parliament
Pàrlamaid na h-Alba

CONTENTS

EXECUTIVE SUMMARY	3
SCOTTISH BUDGET CHANGES SINCE SPENDING REVIEW 2007	4
EFFECTS OF THE RECESSION ON SCOTTISH PUBLIC FINANCES	6
OTHER DEVELOPMENTS SINCE SPENDING REVIEW 2007	9
POTENTIAL LONGER TERM OUTLOOK FOR THE SCOTTISH BUDGET	9
POLICY RESPONSE TO RECESSION AND POTENTIAL LONGER TERM BUDGET REDUCTIONS.....	10
PROCESS RESPONSES TO BUDGET REDUCTIONS.....	11
SOURCES	13
RELATED BRIEFINGS	16



(SB 09/27)

EXECUTIVE SUMMARY

Impact of Recession on Scotland's Public Finances

Ross Burnside

The global economic crisis that hit in the latter part of 2008 forced the UK and Scottish Government to re-evaluate their spending intentions. This paper presents the latest Scottish Government expenditure plans, based on its Economic Recovery Programme and the recent UK budget.

The paper also summarises some possible implications of the recession for Scotland's public finances, before looking at some of the potential longer term policy responses that might have to be considered in the context of a tighter spending outlook.

The briefing concludes by raising the issue of the type of scrutiny structure and "challenge function" that might be required to handle tough budgetary choices.

SCOTTISH BUDGET CHANGES SINCE SPENDING REVIEW 2007

This section traces the changes to the Scottish Government's spending plans from the publication of its Spending Review in November 2007 through to the present.

When Spending Review 2007 was published in November 2007, the Scottish Government presented its intended plans for Scottish spending over the 3 years of the Spending Review period running from 2008-2011. The overall spending plans are presented in table 1 below. It is worth noting that in the original plans, the Scottish Government expected the increase in spending in year three of the Spending Review period (2010-11) to be the lowest in the three year period – a total percentage increase in the DEL of 3.7% in cash terms.

Table 1: Planned DEL spending in Spending Review 2007 (published November 2007)

	2008-09	2009-10	2010-11	2008-09 increase on 2007-08 %	2009-10 increase on 2008-09 %	2010-11 increase on 2009-10 %
	£m	£m	£m			
Cash terms						
DEL Resource	24,738.3	25,677.1	26,677.5	5.3	3.8	3.9
DEL Capital	3,263.4	3,578.8	3,661.9	-2.0	9.7	2.3
Total DEL	28,001.7	29,255.9	30,339.4	4.4	4.5	3.7

Source: Scottish Government 2007a

The following September (2008), the Scottish Government produced its Draft Budget 2009-10 which presented the Scottish Government's latest plans for 2009-2011, incorporating some relatively minor changes to the Government's previous spending plans. Table 2 presents the plans as outlined in Draft Budget 2009-10.

Table 2: Planned DEL spending in Draft Budget 2009-10 (published September 2008)

	2008-09	2009-10	2010-11	2009-10 increase on 2008-09 %	2010-11 increase on 2009-10 %
	£m	£m	£m		
Cash terms					
DEL Resource	24,818.4	25,775.0	26,860.8	3.9	4.2
DEL Capital	3,203.7	3,522.9	3,612.7	10.0	2.5
Total DEL	28,022.1	29,297.9	30,473.5	4.6	4.0

Source: Scottish Government 2008a

After the publication of Draft Budget 2009-10, the full effects of the "credit crunch" started to become clearer, and as a consequence the Scottish and UK governments re-evaluated their spending intentions for the remainder of the Spending Review period. Consequently, the intended Scottish spending plans for financial years 2008-09, 2009-10 and 2010-11 have been altered. These changes to spending plans are one of the reasons the Finance Committee has decided to undertake an inquiry into future Scottish Government spending (Scottish Parliament Finance Committee 2009a).

Table 3 presents the latest Scottish Government Draft Budget plans through to 2010-11 as presented in Draft Budget 2009-10 published in September 2008, and the latest information available for 2010-11 spending plans in Scotland (based on the UK Pre Budget Report published in November 2008 and the UK Budget 2009, published on 22 April 2009).

The Finance Committee discussed whether there is a real terms cut in the DEL in 2010-11 at its meeting on 28 April (Scottish Parliament Finance Committee 2009b). Some members argued

that because the re-profiling was a decision of the Scottish Government it does not alter the amount Scotland is spending over the course of the Spending Review period. The table below includes the Revised Scottish Budget with and without the re-profiling, but makes no comment on its effect for baselines for the next Spending Review. Note that the figures in the table work back from the Draft Budget 2009-10 and may differ from Government figures which include as yet unpublished in-year changes.

Table 3: Changes to the Draft Budget 2009-10 Scottish Government Budget proposals

£m	2008-09	2009-10	2010-11
Scottish Budget (DB09-10)¹	28,022.1	29,297.9	30,473.5
UK PBR Consequential (increases)	+0.4	+5.7	+5.2
UK PBR Consequential (decreases)			-128.6
UK Budget 2009 Consequential (increases)		+79.0	+24.7
UK Budget 2009 Consequential (decreases)			-391.7
Revised Scottish Budget (without re-profiling)	28,022.5	29,382.6	29,983.1
Difference with DB 09-10	+0.4	84.7	-490.4
Change on previous year (%) Cash Terms		4.9%	2.0%
Change on previous year (%) Real Terms**		3.9%	0.5%
Scottish Government Re-profiling* (capital)	+53.0	+294.0	-347.0
Revised Scottish budget (with re-profiling)	28,075.5	29,676.6	29,636.1
Difference with DB 09-10	+53.4	+378.7	-837.4
Change on previous year (%) Cash Terms		5.7%	-0.1%
Change on previous year (%) Real Terms**		4.7%	-1.6%

* In addition to the £347m which has been re-profiled from 2010-11, a re-profiling of +£30m in 2008-09, +£70m in 2009-10 and -£100m in 2010-11 was already factored into the 2010-11 Affordable Housing budget in the Scottish Government Draft Budget published in September 2008. This £100m had a zero net effect on the total Scottish Budget as it was "borrowed" from other budget lines.

** Based on a GDP deflator of 1% in 2009-10 and 1.5% in 2010-11 (Table C1, Treasury 2009a)

Source: Adapted from Scottish Government 2008a, UK Treasury 2008, UK Treasury 2009, Scottish Government 2009d.

The above tables present what is currently publicly known about the overall Scottish budget in 2009-10 and 2010-11. However, the Finance Committee inquiry is also interested in exploring some of the possible effects of the current economic climate on Scottish Government spending. The remainder of this briefing summarises some of the potential scenarios. As we still do not know the full extent of the recession and its economic impact, these scenarios are, by their nature, speculative.

¹ Based on the Departmental Expenditure Limit (DEL) in the Scottish Government's Draft Budget 2009-10. The DEL is the discretionary element of the Scottish Government's spending.

EFFECTS OF THE RECESSION ON SCOTTISH PUBLIC FINANCES

The change in economic circumstances since SR 2007 is likely to create the following pressures on the Scottish Budget in 2010-11.

Reduced funds due to:

- **Rescheduling of capital investment already announced by the Scottish Government.** The Scottish Government has rescheduled from the 2010-11 capital budget a total of £447m (+£83m in 2008-09 and +£364m in 2009-10). This was designed to offset the effects of the decline within the construction industry in the current financial year. However, the acceleration also means a reduction in the 2010-11 capital budget in addition to the UK Barnett based deductions summarised in Table 3.
- **Reduced revenue from taxes (Non Domestic Rate Income (NDRI), Council Tax), fees and charges and the sale of assets.** The Scottish Government has anticipated £2,014m in income in 2010-11 from NDRI and £1,856.6m in income from Council tax. The yield from these taxes next year is unknown, however, in a recession both these figures must be in doubt. Any shortfall in NDRI must be made up by central government. Any shortfall in Council tax must be made up by local government. The Scottish Government can also expect to see the value of public sector assets falling during the downturn. The sale of assets in recent years has been a valuable source of revenue for the public sector, but as new developments have slowed, the sale of surplus land will yield lower returns to public sector bodies. This may impact on the budgets of public bodies like Scottish Enterprise and Highlands and Islands Enterprise (HIE) which in the past have used asset sales to balance their budgets. It may also impact on Health Boards and Local Authorities who in the past have used asset sales to fund infrastructure projects.

The recession may also increase demand for or increase the priority given to services such as:

- **Social work and Health.** The recession may have an impact on demand for social work services. Health Scotland (2009) cite evidence that unemployment has a damaging effect on physical and psychological health, and can lead to increases in instances of alcohol and drug abuse. Therefore there is a possibility that a prolonged recession could increase demand on social workers in Scotland and the health service.
- **Housing.** Likewise, the recession may also impact on demand for housing, and the Government has responded by increasing financial support for schemes supporting low income household home ownership – for example, shared equity schemes. The recession may also result in an increase in homelessness applications as a result of rising numbers of repossessions. However, there are currently no accurate repossession statistics for Scotland. In an attempt to address the possibility of increasing difficulties for home owners, the Scottish Government has also increased funding for the Mortgage to Rent scheme and introduced the Mortgage to Shared Equity scheme (Scottish Government 2009a).
- **Justice.** Although the statistical evidence does not yet confirm a rise in crime due to the recession, there is speculation that crime may increase as a consequence of the economic downturn (Times 2008). Any increase in crime would place pressures on the Justice budget, increasing demands on police, courts and prisons.
- **Advice.** The recession may also result in an increased demand for practical advice for individuals facing redundancy and businesses facing difficulties. The Scottish Government has acknowledged that in its Economic Recovery Programme by allocating additional support to programmes like Partnership Action for Continuing Employment (PACE); Career Development Loans, Manufacturing Advisory Service; Finance Sector Jobs Taskforce and online resources like [Help through the downturn](#) and [Now's the time to ask](#). The Scottish Government has also allocated resources to personal debt advice services via Citizens Advice Scotland (Scottish Government 2009c). However,

unforeseen spending in these areas inevitably means less spending in other areas of Government activity.

- **Economic development.** Although the budgets allocated to Scottish Enterprise have declined over recent years, there may be renewed pressure for more economic development funding (via the enterprise networks and/or local authorities). The public/private gearing ratio to enable property and other economic development projects to be viable may shift, meaning that more public money will be required for each project. In relation to human capital, if fewer jobs are available there could be greater demand for training and for FE and HE places from school leavers.

More generally, the recession may have an impact on wider social inclusion targets – for example child poverty, health and homelessness targets may be more difficult to achieve.

The recession may also impact on some of the targets in [Scotland Performs](#), which, in the current economic climate, may be deemed less of a priority. For example, it is possible that targets relating to the environment or equalities will be given less emphasis as the Government attempts to boost economic growth.

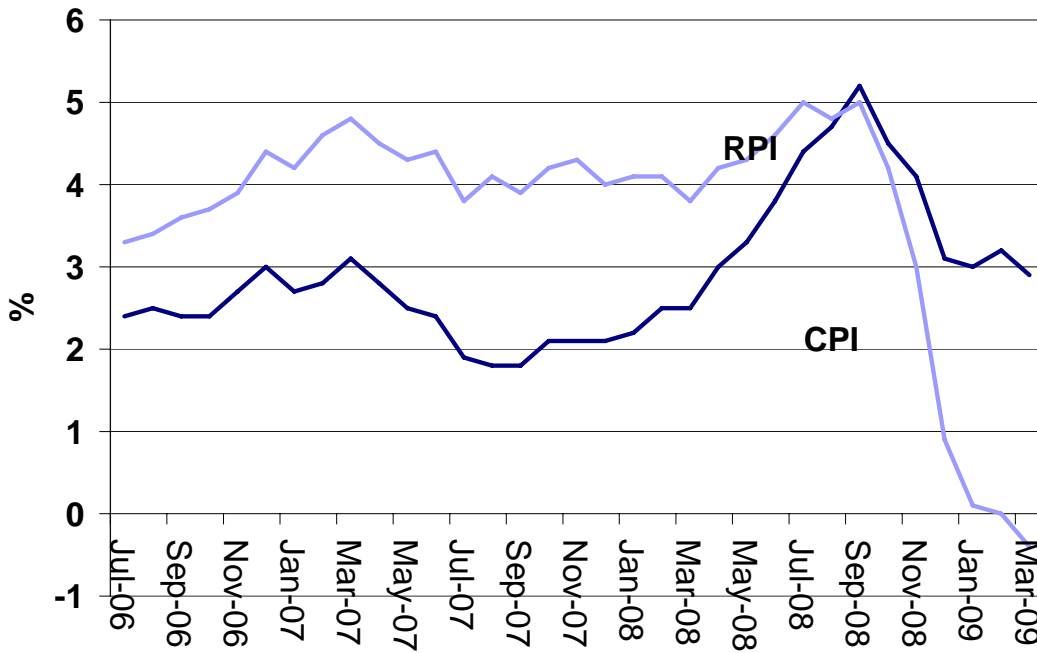
The recession may reduce demand for or lead to reduced priority being given to services such as

- **Development control – planning applications.** In an economic downturn, it might be expected that the number of planning applications is reduced. This may be exacerbated in this recession where access to credit has been more difficult due to the crisis in the banking sector. The latest planning statistics are not available to confirm the impact of the recession, but it seems likely that the recession and the “credit crunch” will have a downward effect on planning applications and development projects, with a consequential negative economic impact.
- **Road improvement schemes.** In an economic downturn, the rate of increase in road traffic may fall which could reduce the urgency of road improvement schemes.

It might also be expected that there are extra costs involved in managing changes as resources are reallocated from services where demand is reduced or priority is lower to areas where demand or priority is higher.

However, offsetting these downward pressures on budgets is the likelihood of a lower rate of general price inflation and the possibility of lower real costs for some inputs such as energy, raw materials and, possibly, labour. Figure 1 below presents the latest inflation indices.

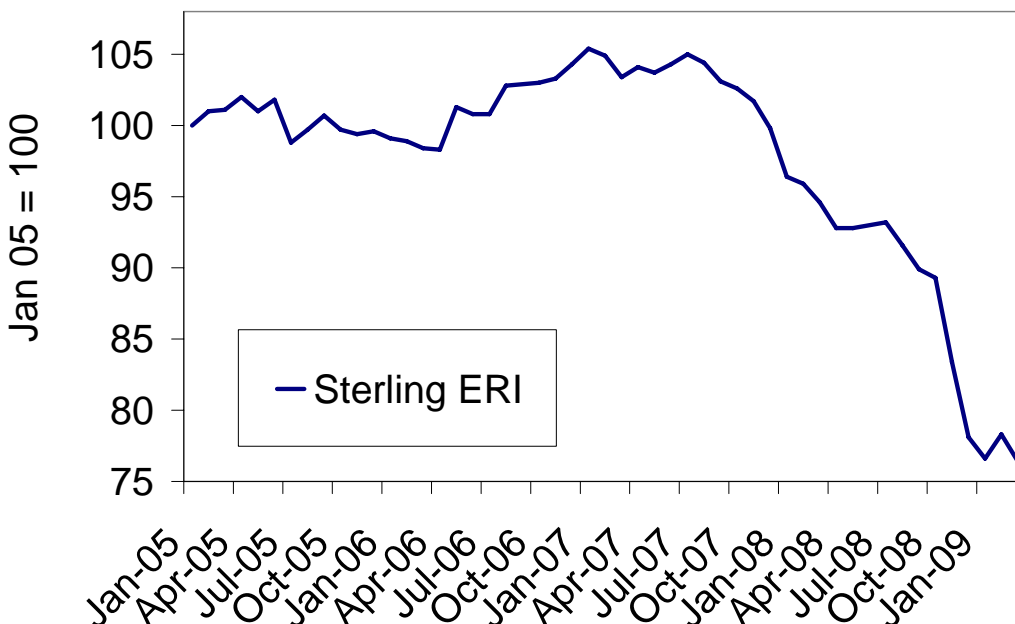
Figure 1: Consumer and Retail Price Indices



Source: National Statistics 2009a

The current Sterling-Euro exchange rate may also result in an increasing yield from EU funds (which are paid in Euros) and also an increase in tourism from Eurozone tourists. A decline in the Sterling-Euro exchange rate should also, in time, help Scottish and British exports.

Figure 2: Sterling Exchange Rate Index



Source: National Statistics 2009b

OTHER DEVELOPMENTS SINCE SPENDING REVIEW 2007

Other developments since SR 2007, which although not created by the recession, may have effects on Scottish Government discretionary spending are:

- **Single status/Equal pay.** Single status was developed to harmonise the terms and conditions of workers to ensure that they are non discriminatory. Currently, 26 out of 32 local authorities have implemented single status. According to the Tribunals Service there are currently 35,213 equal pay cases which have been lodged with the Employment Tribunal in Scotland. There is no definitive figure for the potential liabilities of single status and equal pay, but this could be a potential squeeze on local government budgets in the coming years.
- **Year of Homecoming = positive offsetter?** Although planned in advance of the economic difficulties, the Scottish Government hopes that the year of homecoming can serve as a positive economic offsetter to the difficulties that have been highlighted above. The Scottish Government has targeted an eightfold return on core investment into the event, and hope to create an additional £40m in tourism revenue (Scottish Government 2009a)

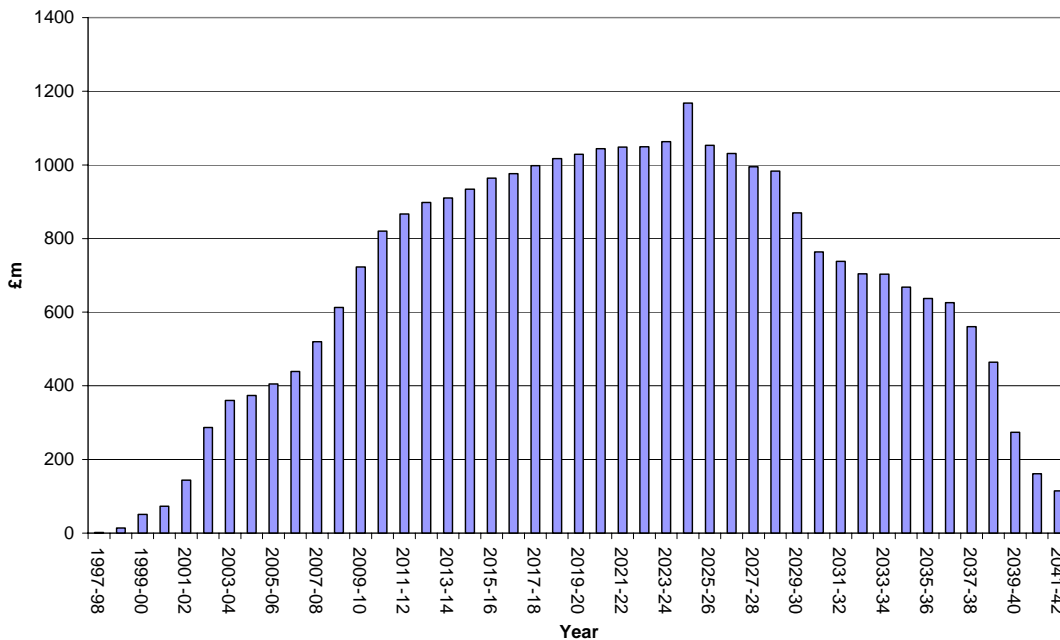
POTENTIAL LONGER TERM OUTLOOK FOR THE SCOTTISH BUDGET

The current Spending Review period runs to March 2011, but what about 2011 and beyond? What is the outlook for revenue, demand for services and costs in the longer term? Even if economic recovery begins in the next year or so, repaying the large levels of government borrowing is likely to limit government spending and increase the tax burden for a number of years to come (Institute for Fiscal Studies 2009a).

The remainder of this briefing looks at some of the potential funding pressures on the horizon. Factors to consider include:

- **Longer than expected recession.** The recession may last longer than expected, reducing the tax yields over time, and increasing social security payment liabilities, making it more difficult to pay off debts and more expensive, but necessary, for the UK Government to borrow. These factors will impact on the Scottish budget if the UK Government makes reductions in spending which have Barnett consequentials. Table 3 above presents what we know from the UK Budget 2009 for 2010-11 Scottish spending.
- **PFI + NPD Unitary payments.** Rising unitary charge commitments will squeeze the Scottish Government's discretionary spending. The figure below presents the latest projected unitary payments for all signed PFI and NPD projects, which combined equate to £30bn over the period 1997-2042.

Figure 3: Estimated unitary payments for all signed PFI and NPD projects



Source: Scottish Government 2009d

- **Capital Investment commitments.** The Scottish Government has a number of significant high profile capital spending projects on the horizon, such as the new Forth Bridge and the Commonwealth Games. The Government is in discussion with the Treasury to secure the funds to pay for the Bridge, and is on the record as saying that other projects would be at threat if a funding agreement is not reached. The infrastructure for the Commonwealth games is time critical and any overspends would inevitably squeeze other capital projects.
- **An ageing population.** With life expectancy increasing and fewer births, we are, like most of the industrialised world, experiencing an ageing population. This phenomenon has implications for the demand for health and social services.
- **Pension commitments.** Linked to an ageing population is the issue of public sector pensions. Increasing life expectancy is increasing the cost of pension provisions. When the pension age was set at 65 for men, it was envisaged that pensions would be paid for a comparatively short period. Latest estimates show that, despite the pension age remaining at 65, the average Scottish man can expect to live to 74.8 (GRO Scotland 2009).

POLICY RESPONSE TO RECESSION AND POTENTIAL LONGER TERM BUDGET REDUCTIONS

The Centre for Public Policy for Regions (CPPR) has said that impending reductions in the Scottish budget will require changes to the current Scottish Government spending plans. For example, the CPPR (2009, p8) suggest the following may be necessary with reduced public spending in Scotland:

- **Cut back and more clearly prioritise the intended capital projects.** The Scottish Government in its [Infrastructure Investment Plan](#) (Scottish Government 2008b) lists a number of infrastructure projects planned over the next ten years. The Strategic Transport Review announced in December 2008 lists 29 major transport investment priorities across Scotland. Given the future reductions in Scotland's budget, will these all be deliverable as planned?

- **Increase Council Tax and Non-domestic rates.** The Scottish Government has allocated £70m for the Council Tax freeze for each year of the Spending Review period. The Scottish Government has also introduced the Small Business Bonus Scheme during this Spending Review, at a cost of £73m in 2008-09, £126m in 2009-10 and £165m in 2010-11. However, the current economic difficulties may lead to a reduction in yield of both council tax and non-domestic rate income, which may raise questions about the sustainability of any freeze or cut.
- **Make deeper efficiency savings, outwith those imposed via Whitehall reductions.** The Scottish Government already has an efficiency programme targeting 2% cashable efficiencies per annum, worth £1.6bn in 2010-11 (Scottish Government 2009b).
- **Impose medium term public wage settlements at or below inflation.** Public sector pay settlements are usually negotiated for a 3 year period. With Retail Price Index (RPI) inflation having “gone negative” in March, there may be opportunities for savings in this area.
- **Move from universal public services to more targeted ones.** Scotland currently has a number of universally available public services, such as free care for the elderly², free bus passes for the over 60s, disabled and young people (estimated at costing £189.4m in 2010-11 (Rehfishch 2009)), free eye test (no figure for 2010-11, but costing £57.6m in 2007-08) and free tuition.
- **Increase or re-introduce charges for tolls, prescriptions, etc.** The Scottish Government scrapped bridge tolls on the Forth and Tay bridges at a cost of £16m per annum. Prescription charges are due to fall to £3 per prescription in 2010-11 at a cost of £32m and be free of charge in 2011-12 at an estimated cost of £57m (Wheeler 2008).
- **Increase private contributions to Higher Education.** The Scottish Government abolished the Graduate Endowment in 2008 foregoing £17m per annum. Universities in England and Wales can currently set tuition fees at up to £3500 per annum, and consequently require less of a subsidy per student from the Government.

PROCESS RESPONSES TO BUDGET REDUCTIONS

It seems likely that for the first time since devolution, real growth in the Scottish Budget will be low or non-existent in the coming years (IFS 2009b, CPPR 2009). This will present a new challenge for the Scottish Government and Parliament, which until recently had experienced real terms growth in budgets.

Although all budgets are changeable in the long term, there can be limits in the degree to which budgets can be altered in the short term, due to contractual and legal obligations. One suggestion in the CPPR study relates to there being some kind of “challenge function” performed within the Scottish Government, along the lines of the role performed by the UK Treasury. As budget decisions become tougher, it is argued that there should be a body within the Government which “spends little but has the greatest power amongst Departments. Such a body would tightly control spending in other departments and make the necessary, but possibly unpopular, spending decisions.” A similar proposal for some kind of internal “challenge function” looking at all spending across the range of Government activities was made in the Howat Report (Scottish Government 2007b). Within the Government structure at present, the Cabinet Secretary for Finance and Sustainable Growth has responsibility for Finance across the Government but also has a significant policy and spending portfolio, covering Local Government, Transport and Economic Development.

² Free care provision is now rolled up in the terms of the Concordat with local government so it is not possible to attain a figure for projected spend in this area. However, the latest figures for the cost of long term care (of which free care is an element) in Scotland assume a total cost of £2.3bn in 2006. This comprises over £1bn contributed from Local Authorities, £503m from the Department for Work and Pensions, £343m from NHS and £374m from private contributions. Based on 2006 population assumptions, the estimated cost of long term care in Scotland in 2011 is nearly £2.7bn (Sutherland 2008).

The Finance Committee is also currently considering the appropriate Parliamentary “challenge function” to the Scottish Government’s budget in its Budget Process Review (Scottish Parliament Finance Committee 2008).

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