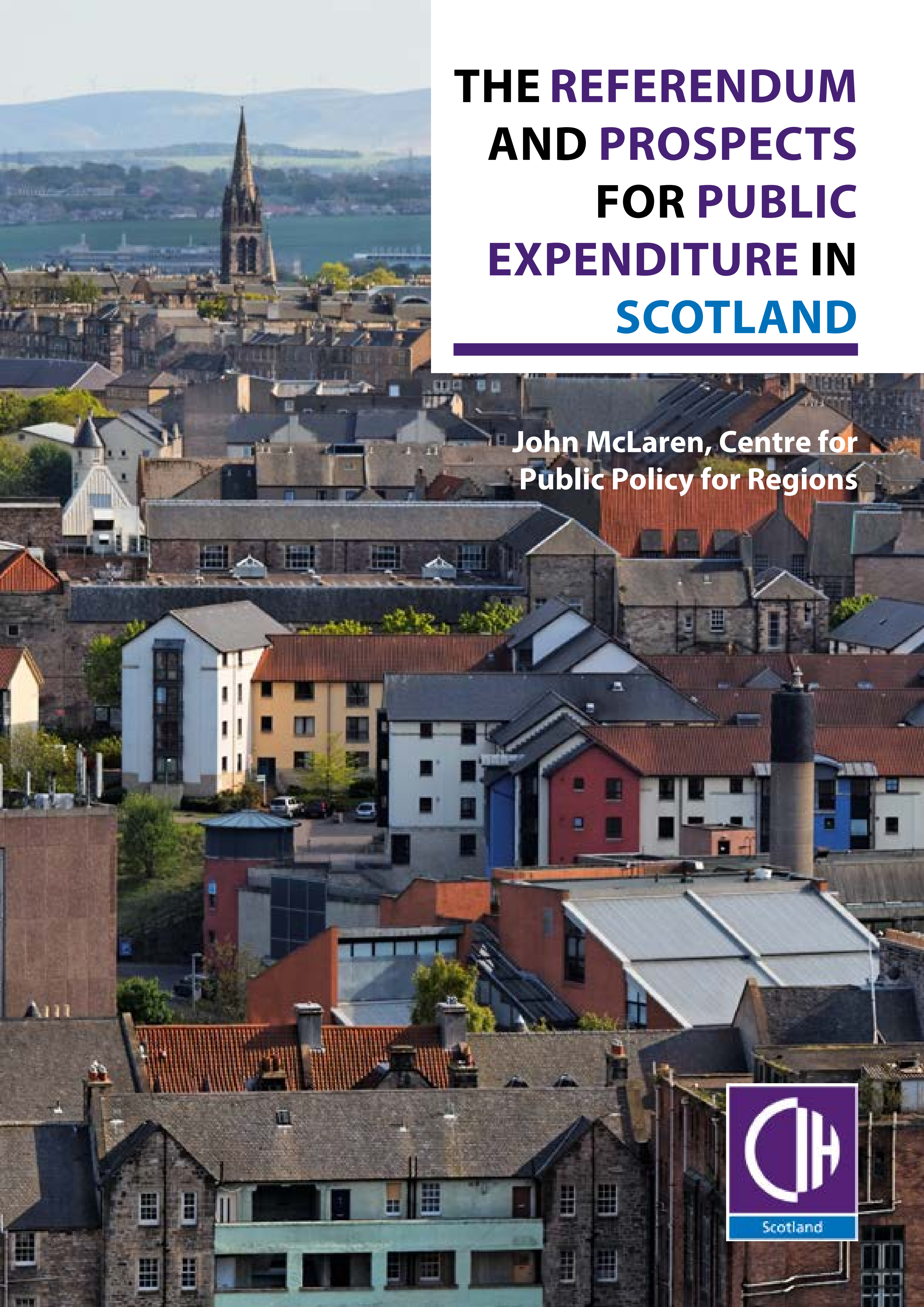

THE REFERENDUM AND PROSPECTS FOR PUBLIC EXPENDITURE IN SCOTLAND

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What issues should the Scottish housing sector consider in trying to assess the potential consequences of either outcome to the independence referendum on the prospects for public expenditure in Scotland?

The Scottish referendum on independence will take place at a time of continuing worldwide economic uncertainty and during a period of ongoing fiscal retrenchment in the UK.

These conditions will continue to apply regardless of the make-up of the UK Government in place and regardless of whether Scotland lies within or outwith the UK.

It is best to start by reiterating the current position of the UK, in terms of its fiscal balance, and then moving on to see how this might change as a result of independence.

The UK's net borrowing position peaked in 2009-10, at £168 billion (2012-13 prices), or 11% of Gross Domestic Product (GDP), i.e. as a share of the total economic output generated within the UK. This was higher than at any time over the past 40 years, and considerably higher than in the aftermath of previous recessions experienced in the mid 1970s, early 1980s and 1990s, when the peak borrowing figures were closer to 7-7.5% of GDP.

In 2009-10 UK Government revenues were at a relatively (historically) low level (36% of GDP) while UK Government expenditure was at a relatively (historically) high level (47% of GDP). The latter was not due solely to high spend levels but had more to do with the falling level of GDP.

Since 2009-10, the deficit has fallen and in 2012-13 the fiscal balance (net borrowing) amounted to £115 billion, equivalent to 7.3% of its GDP. The current UK coalition Government's aim is to achieve a fiscal surplus by 2018-19. This means that two thirds of the adjustment needed to achieve this, in terms of reducing borrowing as a % of GDP per capita, is still to come about.

While commentators talk of a period of austerity in recent years, in fact spending, in cash terms at least, has continued to rise, with the sole exception being in 2012-13. However, this rise has mainly taken place on the benefits side, due to the protection of pension payments and the rise in the number of citizens receiving working age benefits. The main cuts have come through departmental budgets, excluding the NHS.

This twin path scenario is likely to continue. The cuts to departmental spend are roughly halfway through at present, in terms of moving from peak to trough, but less so if the cuts are looked at in a cumulative sense. At present the UK Government has outlined further overall departmental budget cuts up to 2018-19, but has only broken those down, by department, up to 2015-16.

Moreover, due to the protection of the current (i.e. non-capital related) NHS spending, some education spending and the overseas aid budget, then the outcome for other, unprotected, budgets is even deeper cuts well above the average. This is likely to have some impact on the housing budget, even though much of this is capital expenditure. On top of this are revenue pressures – particularly on social landlords – from benefit cuts.

The Scottish Government's budget excludes benefits, and so, in line with UK departmental budgets, has seen a significant fall, in real terms, over recent years.

The Centre for Public Policy for Regions (CPPR) estimates that from a peak in 2009-10, the Scottish Budget will have fallen by over £3 billion by 2013-14, in real (inflation adjusted) terms, and is projected to fall by a similar amount again by 2018-19, in line with comparable UK departments.

As the NHS and schools budgets account for around half of the Scottish Government's budget, and are protected against the impact of inflation, this means that all other budgets receive around twice the real terms cuts than the average would imply.

Post 2015 budget scenarios

(i) Scotland stays within the UK, no further changes to fiscal powers

If Scotland were to stay within the UK then its finances would be dominated by the continued workings of the Barnett formula. This gives Scotland a population share of any increase to comparable English spending budgets. As discussed above this implies continuing, real terms, declines in the Scottish Government's budget until at least 2018-19.

It is possible that the Barnett formula may be reviewed at some point beyond 2015. If this were to happen any changes imposed are likely to reduce the rate of future increases in Scotland's budget. This is because Scotland is seen as having a high spend per capita on public services in relation to most other parts of the UK, not just in absolute terms but also in relative terms, i.e. in relation to any higher need caused by social or geographic circumstances. The degree to which any such slowing down in Scotland's budget would occur is open to conjecture, as it would be a highly political decision. Furthermore, any decision on what is a "fair" spend per head figure for Scotland (versus England) would probably be dependent on a 'needs assessment', which itself would be, to some degree, based on a subjective weighting of various factors.

Further reasons that the Barnett formula may be reformed, to Scotland's disadvantage, include:

- the fact that Wales believes, supported by some analysis, that it is underfunded, on a per head basis, relative to Scotland and England. [Note that within England such interregional comparisons are complicated by, for example, major cities acting as hubs of transport, health or higher education across regional boundaries.]
- Scotland's 'overfunding' could be implicitly defended in the past as being a reasonable trade-off for all North Sea revenues being collected centrally by HMRC. However, this implicit defence becomes weaker as the revenues fall over time, as they are currently doing.

(ii) Scotland stays within the UK, more fiscal powers transferred to Scotland

If Scotland were to stay within the UK but to receive full fiscal powers, then the position would be more akin to that under independence, as outlined below in sub-section (iv), as it would involve full freedom to vary the levels and rates of taxes or introduce new ones.

Any other degree of further fiscal devolution would lie somewhere in the spectrum ranging from the existing highly centralised system, to full fiscal autonomy/independence.

The current position under the Scotland Act (2012) falls into this spectrum, as it will see some more fiscal powers come to Scotland, principally control for up to 10p of income tax rates. However, the majority of fiscal (and taxation) powers will remain with the UK Government.

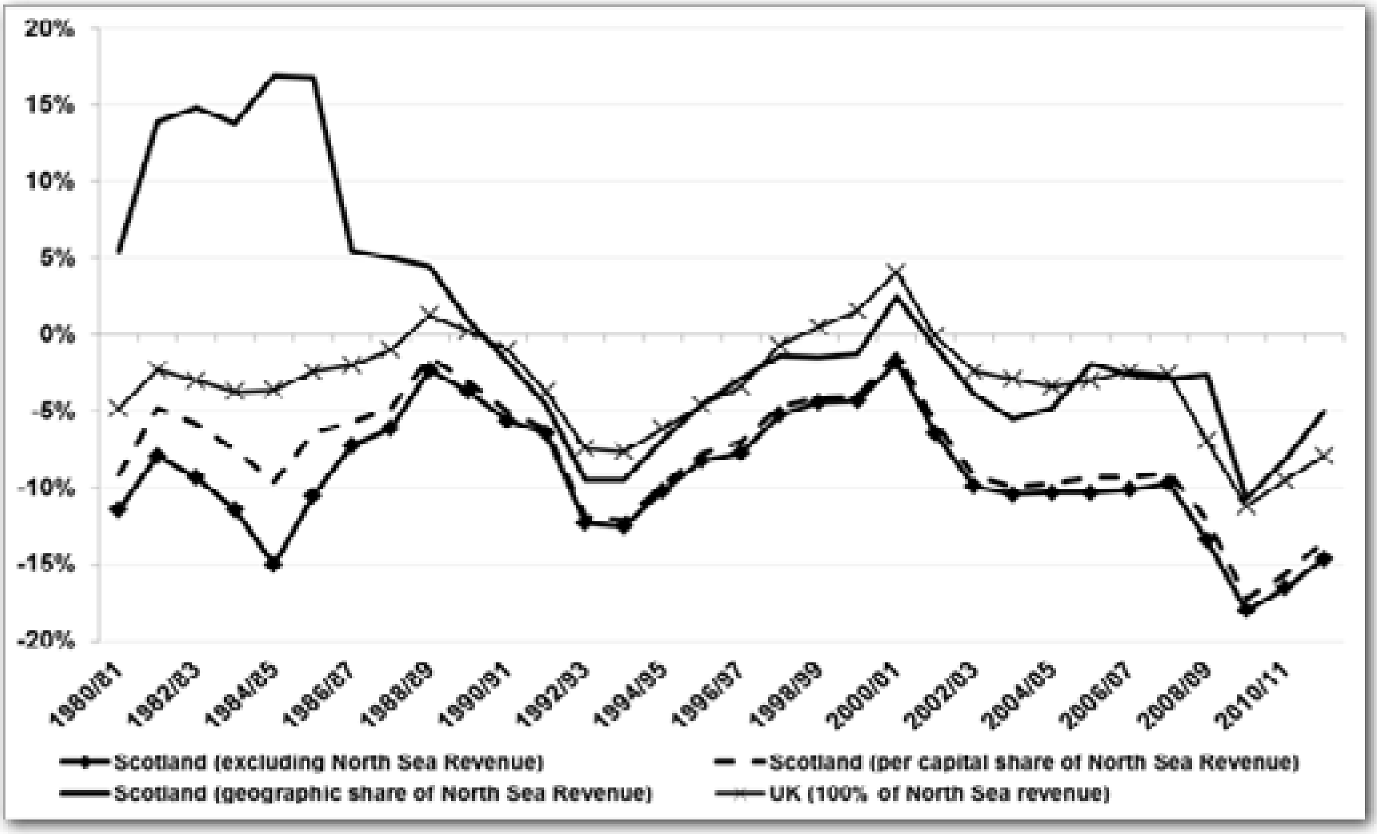
(iii) Independence, with similar tax and spending patterns

The key change in the funding of Scotland's public services post-independence would be that instead of Scotland's higher per head spending being funded in part by transfers from the rest of the UK, via the Barnett formula arrangement, it would now need to be supported by tax revenues flowing from the North Sea.

CPPR estimates the sum involved to be about £7 billion a year. In recent years the North Sea would have more than covered this, with some excess left over. Taking a longer term view, since 1980, North Sea revenues would have been higher than the Barnett related transfers, but this has not been a constant position, rather it has changed over time, with large relative surpluses seen in the 1980s and somewhat smaller relative deficits seen in the 1990s (see Chart 1 overleaf).

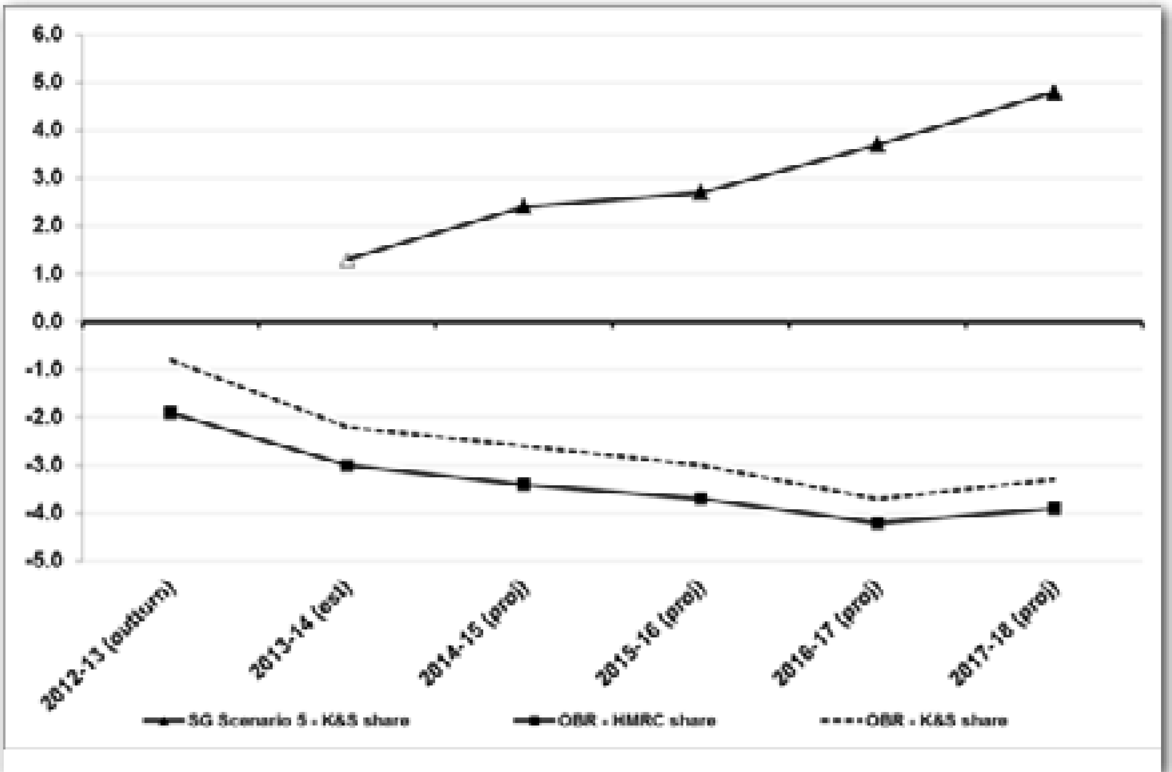
However, in this instance the past is no guide to the future. North Sea oil and gas production peaked around 2000 and has fallen to around a third of this peak level since. In the last three years alone, oil production has fallen by 38%.

Chart 1: Historic fiscal balances for the UK and Scotland, shown as a % of GDP



As a result, it seems likely that the current £7 billion net UK transfer via Barnett would not have been met from North Sea revenues in 2012-13 nor is it likely to be in 2013-14. In fact, CPPR estimates that North Sea revenues may only amount to around half this figure. The Office for Budget Responsibility's (OBR) forecasts for North Sea revenues suggest that, post 2013-14, such revenues will continue to fall well short of the £7 billion figure as, after a short period of flat revenues, OBR forecasts them to continue to decline (see Chart 2).

Chart 2: Relative net gain/loss for Scotland as a result of independence, based on similar tax and spending patterns, £ billion



Sources: CPPR, OBR, Scottish Government. Notes: the chart illustrates the net gain/loss to Scotland of replacing Barnett related UK onshore taxes transfer with Scotland's geographic share of North Sea revenues using December 2013 OBR forecasts and the most optimistic of the Scottish Government oil revenue forecasts from February 2013.

Clearly the price of oil is an important driver of future levels of North Sea revenues. Future oil prices are very difficult to forecast, due to both demand and supply uncertainties. There are a wide range of such oil price forecasts and they tend to vary depending on whether they are based on market futures prices, which tend to be lower, or on demand and supply models, which tend to predict higher prices. It may turn out that North Sea revenues surpass the £7 billion mark. For example, Chart 2 also shows the position based on a more optimistic Scottish Government scenario. However, to do so would require a very large increase above the current price.

Another North Sea revenues related issue is the higher degree of volatility it would introduce to Scotland's tax revenues post-independence. However, this could be largely dealt with by use of an 'oil stability fund' aimed at stabilising the impact of such fluctuations on annual budgets. [Note, this is different to the intergenerational Oil Fund discussed elsewhere.]

(iv) Independence, with different tax and spending patterns

Scotland's fiscal balance could be altered, based on tax and spend patterns different to those inherited from the UK.

On the tax side, the SNP-led Scottish Government has suggested that corporation tax might be cut in the future. This would initially reduce tax revenues but could be revenue neutral (or even raise revenues) in the medium to long term if it promoted enough additional taxable economic activity. It is impossible to tell, a priori, whether or not this would be the case.

The Scottish Government has also made positive noises with regards to the Mirrlees Review, which includes proposals relating to property and land taxes, although it has failed to update any such tax changes, already under its powers in the six years since coming to power.

On the expenditure side, areas of current spending determined by the UK Government could alter. For example, spend on defence could be reduced in relation to the current implied level. This has been proposed by the SNP but only to some degree (from £3.5 billion to £2.3 billion), whereas further savings could be made that would allow for a similar level of spend in this area as is seen in other small EU countries, e.g. Ireland.

Clearly then, much scope exists for things to change, but thus far little in the way of clearly different proposals have been put forward by proponents of independence.

(v) Potential for an Oil Fund?

The Scottish Government, and others, have supported the building up of an Oil Fund, similar to that seen in Norway. This would be based on saving most of the annual tax revenues from the North Sea and only using a relatively small proportion of revenues, along with the annual earnings from such a growing fund, to be spent in the annual budget round.

Such a fund has attractions. It allows for clear intergenerational benefits of a finite resource. It also helps avoid oil activity related inflationary pressures which can have negative knock on impacts on other parts of the economy.

However, under the fiscal circumstances outlined above, where all such North Sea revenues would be needed in order to match existing UK financed spending levels, the building up of an Oil Fund is a largely redundant issue.

If a high oil price were to lead to any 'excess' oil revenues they are unlikely to be of a scale akin to that seen in Norway. As a result, the accumulation of a large Oil Fund is highly unlikely, even under very optimistic scenarios.

If such high oil revenues were available, another option would be to pay down existing debt, rather than build up a dividend paying fund. Such early debt payback would also, effectively, benefit future generations. This could be a more attractive option depending on how the dividends from a fund compare with the interest payments on the debt. A final decision would depend on the relative rates of interest that would apply into the future.

Areas of uncertainty

This analysis is based on the best information available but it should be recognised that this information has serious flaws at present.

The issue of uncertainty over future North Sea revenues has been rehearsed above, due to uncertainty over future price, production and profitability levels. However, other uncertainties exist over questions such as what would Scotland's share of North Sea revenues be? Currently both HMRC and Prof Alex Kemp at Aberdeen University make estimates of this, but they can differ quite significantly.

Outside of the North Sea, there is also considerable uncertainty over how much corporation tax would come to Scotland, in particular in relation to UK-wide companies currently headquartered in England, e.g. supermarkets. This might also be affected by what post-independence tax rates apply in Scotland.

Another area of uncertainty exists around how wealthy Scotland actually is. Scottish Government estimates of GDP (i.e. what is produced in a country) per capita are well above those for the UK, as too is Gross National Income (GNI) – i.e. what remains in a country after international transfers – per capita. These are the figures used by the Yes campaign to claim that Scotland would move up the rankings of the world's richest countries post-independence.

However, such a higher Scottish GDP/GNI per person than the UK implies that revenues per capita should also be higher in Scotland than the UK average. This is not borne out by the official statistics contained in the Scottish Government's annual Government Expenditure and Revenues Statistics (GERS) publication. This apparent, and important, inconsistency has not been pursued by either the Scottish or UK Governments so far. This leaves us currently in a quandary as to what the true position might be.

In general terms, we can say that the figures currently being used to estimate Scotland's economic and fiscal position are proxies to what the true position might be. However, that true position is unlikely to be known prior to the referendum, or even independence.

Summary

In summary, it is fair to say that:

1. There is no certainty over future funding levels under either independence or the status quo in the medium to long term
2. In the short term there is likely to be a prolonged period of departmental spending constraint regardless of the constitutional position
3. The key variable is the role of North Sea revenues in ensuring the same, higher than the UK average spend on public services to be maintained
4. As oil prices are highly erratic and extremely difficult to forecast over the longer-term, this means that a high degree of uncertainty will continue as to whether Scotland would see a fiscal gain or loss as a result of independence
5. Latest data, for 2013, suggests there would be a fiscal loss versus the status quo. For this to change the price of oil would need to be considerably higher than it is now
6. There would most likely be a higher degree of volatility in Scotland's tax revenues post-independence, due to the influence of erratic North Sea revenues
7. The creation of a Norwegian style Oil Fund is unlikely, based on the current fiscal position and the likely size of future North Sea revenues
8. The ongoing, real terms, government budget cuts will continue to hit non-protected departments. This includes the housing budget, which is part of the capital spend total. Such budgets are likely to become even more pro-cyclical (i.e. to rise and fall in tandem with economic performance) than they already have been in the past
9. Hence the issues that are likely to dictate how much money will be available to the public purse revolve around (i) the future of North Sea tax revenues and (ii) the choices that will need to be made by any future independent Scottish Government. The latter choices will revolve around whether tax and spending levels need to differ from those that are inherently in place as a part of the UK.