Scotland's fiscal position in the UK:accounting for the growth of the fiscal deficit in the post-devolution period

Professor Arthur Midwinter, Institute of Public Sector Accounting Research, University of Edinburgh

Introduction

The publication of the annual Government Expenditure and Revenues in Scotland (GERS) Report by the Scottish Executive is a continuing source of political dispute. This set piece confrontation, however, seldom generates any realistic assessment of its merits, because it results in claim and counter-claim over its validity in colourful language. It is not the "bogus" statistical exercise its critics suggest, although not without problems of interpretation.[1]

In the 2006 Report, the conclusion that the fiscal deficit had grown from £5.3 billions to £11.2 billions over five years, led one critic to describe it as "economic mismanagement of truly Zimbabwean proportions" by the Scottish Executive.[2] However, as the editor of this journal has succinctly stated – "regional budget deficits do not matter, there is no requirement to account for them and regional policy-makers do not need to seek directly to manage them".[3]

Scotland's fiscal deficit is not akin to those of sovereign states, but simply a measure of the fiscal balance between expenditure and revenues within the United Kingdom. That is, the Scottish fiscal deficit arises from the difference between the revenues raised and public money spent in Scotland as a part of the United Kingdom, as a reflection of UK fiscal and budgetary policy. Ashcroft rightly argues it would be more accurately described as a fiscal transfer, which reflects the pooling of resources within the UK. The question is, why has it grown so significantly in the post-devolution period?

GERS 2006

The 2006 Report was examined by the Parliament's Finance Committee earlier this year, and this paper draws on both my research paper prepared for the Committee, and the evidence provided to it by a number of leading Scottish economists.

GERS was first published in 1992, and sought to bring together, in convenient reference form, available facts and figures about government expenditure and revenues in Scotland.[4] It has since become "an important element in the debate about the size of Scotland's budget deficit or fiscal deficit and the implications for Scottish living standards under constitutional options open to the people of Scotland".[5]

This is because it is regarded by the Executive economists who produce it as providing a description of "the flows that would be inherited by a new administration, whatever the constitutional arrangements at that time".[6] It is the consistent conclusion of the GERS Report, over the fifteen year period since it was first published, that Scotland has a significant fiscal deficit that is the focus of the political dispute. But whilst there is disagreement between parties over this conclusion, the research literature contains a number of published papers which have accepted that GERS provides a broad, but realistic, assessment of Scotland's fiscal position within the UK, whilst querying specific aspects of the methodology.[7]

The **terminology** of GERS, however, in describing the excess of expenditure over revenue as a General Government Borrowing Requirement (GGBR), is misleading and inappropriate. Scotland is part of the United Kingdom, and only the UK fiscal deficit has to be met by government borrowing. Scotland's fiscal balance, like all other nations and regions of the UK, is met automatically by the operation of the uniform system of taxation and government borrowing where necessary. The British approach has no direct territorial link between tax and spending.

The pattern of fiscal flows result in fiscal transfers, through a process of equalisation. Areas can be equalised for expenditure needs and/or tax capacity. In Britain, equalisation for tax capacity only operates in local government, through grant to ensure authorities have the resources to meet their expenditure needs assessment. The financial arrangements for devolution reflect the expenditure basis of the UK system, which recognises the economic unity of the UK by considering allocations together, so Scotland benefits from higher spending on public services, reflective of higher expenditure need, and regional policy allocations intended to reduce inequalities in economic performance.[9] GERS records the outcome of the pattern of fiscal flows by providing estimates of expenditure and revenue, and an overall summary of the net fiscal balance. Estimates reflect plausible assumptions, and are necessary in the absence of regional budgetary accounts.

Scotland's relatively high levels of public expenditure have a long history, traceable back to 1928, and continuing consistently from then.[10] Post-devolution, questions as to whether Scotland's expenditure needs still justify such differentials are increasingly asked by researchers, in the light of the relative improvement of the Scottish economy in terms of incomes and employment.[11]

Pages 54-56

The growth of the fiscal deficit

If Scotland's economy has been improving, why has the fiscal deficit grown? This growth dates from 1999 – the first year of devolution – but in practice is a direct result of the fiscal and budgetary policy of the UK government, which embarked on a wholly exceptional period of spending growth. Spending has grown twice as fast as revenues since then. Aggregate spending in Scotland grew by 41%, from £33.8 billions in 1999-2000 to £47.7 billions in 2004-5; revenues only grew by 22%, from £29.8 billions to £36.4 billions over the same period. Whilst this is not a sustainable approach in the long term, there is evidence that this spending contributed positively to economic growth over this period.[12]

Table 1 below shows the growth in Scotland's fiscal deficit, and the trend from surplus to deficit in the UK budget. The existence of a structural deficit is evidenced by the Scottish figure being in deficit throughout the whole period, whereas the UK was in surplus in 1999 and 2000, and had only a modest deficit in 2001. This is a cyclical deficit. That is, the UK's move into deficit reflects a macroeconomic decision to increase government borrowing to maintain and enhance public spending at a rate faster than the growth of revenues from the economy.

Table 1: The Growth of the Fiscal Deficit (£billions)

	Scotland	UK
1999	**4.4**	**-13.1**
2000	**5.3**	**-15.8**
2001	**7.7**	**5.8**
2002	**9.8**	**29.4**
2003	**11.2**	**37.9**
2004	**11.2**	**43.6**

Source: GERS 2005, 2006

Table 2: Scottish Deficit including North Sea Revenues (£billions)

	£billion
1999	**1.9**
2000	**1.1**
2001	**2.8**
2002	**4.4**
2003	**6.9**
2004	**6.0**

Source: GERS 2005, 2006

The Scottish deficit should fall as UK government borrowing falls in subsequent years, but even when the UK is in balance, Scotland will still show a deficit, or more accurately, continue to benefit from a fiscal transfer. As one recent study showed, only three of the twelve regions of the UK make positive contributions to the public finances – Greater London; Eastern England; and South-West England; whilst the other nine are all in receipt of fiscal transfers.[13]

In the post-devolution period, total spending for Scotland grew much faster than revenues, from £30 billions in 1999 to £47.6 billions in 2004 – an increase of 40%. Revenues rose by only 15%, from £24.5 billions to £34 billions.

Over this period, Scotland's share of the UK budget remained broadly stable at around 9.9%, as did its revenue contributions at 8.2%. The GERS Report observes that the Scottish deficit has tended to mirror the changes that have taken place in the UK fiscal stance. As Scotland receives around 9.9% of spending, it is reasonable to assume it accounts for 9.9% of borrowing, or £3.9 billions. If this figure is subtracted from the net fiscal deficit of £11.2 billions, it leaves a net fiscal transfer of £7.3 billions in 2004-5.[14]

The impact of oil and gas revenues

One of the key issues in the political dispute is the omission of oil revenues from the calculation of the fiscal position. Oil and gas revenues are treated as **ex regio** – not attributed to particular regions. British governments have treated them as "windfall revenues" which are highly volatile and short term. This is an acceptable assumption if the purpose of the exercise is to monitor the pattern of fiscal flows **within** the United Kingdom under present accounting conventions.
It is the inferences drawn from the recurring deficits for an independent Scotland that is the central political issue. As with other revenues, it is impossible to make a precise assessment of the impact of such revenues on the fiscal position, so for illustrative purposes, this paper utilises the wholly unrealistic assumption that <u>all</u> such revenues would accrue to an independent Scotland.

In the years in question, these have been broadly stable at around £4 billions, which would **reduce** but not **eliminate** the fiscal deficit Scotland would inherit from the UK. As Table 2 shows, the deficit would remain, and these revised figures understate the size of the deficit. Whilst oil revenues have grown since then, an accurate picture of the impact of this trend awaits future GERS Reports, as spending has continued to grow in real terms since then.

The GERS assessment is consistent with the judgements of independent researchers. Peter Wood, for example, concluded that:

> *"A Scottish budget is in surplus only if almost all North Sea oil taxes are treated as Scottish, and only at times when oil prices are high. Take away either of these conditions and the Scottish budget is in heavy deficit".*[15]

Similarly, the Constitution Unit concluded that:

> *"Scotland has higher public spending and lower tax revenues per head than does the UK average, implying that when UK tax revenues and public expenditure are in balance, Scotland is in deficit. This excludes oil revenues which, when included, do not necessarily bring Scotland into balance. Relatively high oil prices and low US dollar values are required to bring present Scottish tax and spending patterns into balance".*[16]

Conclusion

In the period since devolution, Scotland's fiscal deficit has grown considerably, as a direct consequence of the fiscal and budgetary policies of the British Government.

The growth of the deficit reflects the major increase in public spending financed in part by higher borrowing. As the economic cycle turns, the deficit will begin to fall commensurately. The underlying structural deficit reflects Scotland's higher expenditure need and lower income levels. This is not a fiscal issue within the United Kingdom, but would become a major budgetary issue to address under a model of fiscal autonomy, or independence.

References

[1]For my own assessments of GERS, see A. Midwinter (1998) "Government Expenditure and Revenues in Scotland: Accounting for the Fiscal Deficit 1996-7", *Quarterly Economic Commentary*, Vol.24, No.1, pp.59-62.

[2]Hughes-Hallett A. (2001) "Why Scotland can do better on her own", *The Herald Newspaper*, 1st March.

[3]Ashcroft, B. (2007) "A Nation-State Would be Unsustainable", *The Herald Newspaper*, 30th April.

[4]Scottish Office (1992) "Government Expenditure and Revenues in Scotland 1991-2" (Report: Edinburgh).

[5]Scottish Office (1995) "Government Expenditure and Revenues in Scotland 1993-4" (Report: Edinburgh).

[6]Scottish Parliament Finance Committee Official Report, 22nd January 2001, col. 4-275.

[7]Heald, D., N. Geaughan and C. Robb (1995) "Financial Arrangements for UK Devolution", *Regional and Federal Studies*, Vol.18, pp.23-52;

McKay D. and P. Wood (1999) "The Economics of Devolution and Independence" (Edinburgh: DTZ Peida);

Bell D. and A. Christie (2002) "A New Fiscal Settlement for Scotland", *Scottish Affairs*, No.41, Autumn, pp.121-140; and

Muscatelli A. (2001) "Life after Barnett: Future Options for Fiscal Devolution in the UK", *Quarterly Economic Commentary*, Vol.26, No.3, pp.35-38

[8]Heald, D. (1994) "Territorial Public Expenditure in the United Kingdom", *Public Administration,* Vol.72, pp.147-175.

[9]MacKay, R. (2001) "The Search for Balance: Taxing and Spending Across the United Kingdom" (Cardiff: Institute for Welsh Affairs).

[10]See McCrone, G. (1994) "Scotland's Public Finances from Goshen to Barnett", *Quarterly Economic Commentary*, Vol.24, No.2, pp.30-46; and
Lee, C.H. (1995) *Scotland and the United Kingdom*, (Manchester: MUP).

[11]See for example Morgan, K. (2001) "The New Territorial Politics: Rivalry and Justice in Post-Devolution Britain", *Regional Studies*, Vol.35, Issue 4, pp.343-348; and

McLean I. and MacMillan A. (2003) "The Distribution of Public Expenditure Across the United Kingdom", *Fiscal Studies*, Vol.24, No.1, pp.45-71.

[12]Experian (2006) "Economic Impact of the Scottish Budget", report prepared for the Scottish Parliament's Finance Committee, October.

[13]Oxford Economics Group (2007) "Regional Contributions to UK Public Finances", *Economic Outlook*, January.

[14]Scottish Executive (2006) "Government Expenditure and Revenues in Scotland 2004-5".

[15]Wood, P. (2001) "Scotland's Budget: Deficit or Surplus?" in B. Jamieson (Ed) *Calling Scotland to Account: Policy Options for Spending and Taxation* (Edinburgh: The Policy Institute).

[16]Murkens, J., P. Jones and M. Keating (2002) *Scottish Independence: A Practical Guide* (Edinburgh: EUP).