****

**Comments on the Scottish Budget Scrutiny Consultation**

**Dr Jim Cuthbert,[[1]](#footnote-1) March 2017**

*Notes for oral evidence presented to the Budget Process Review Group of the Scottish Government*

**Introduction**

The Budget Process Review Group was established by the Finance and Constitution Committee of the Scottish Parliament and the Scottish Government’s Cabinet Secretary for Finance and the Constitution to carry out a fundamental review of budgetary scrutiny. The main driver for the review is the need to accommodate the Scottish Parliament’s new financial powers, as well as the operation of the Fiscal Framework, within the budget process. The Group, which includes Scottish Government and Scottish Parliament officials, produced an interim report on 10 March 2017, which included a number of questions for consultation. The note below sets out my response to this consultation, on behalf of the Jimmy Reid Foundation, and is the basis of the oral evidence I gave to the Budget Process Review Group on 30 March 2017.

**Structure**

What I want to lay out in response to the consultation does not fall neatly under the questions as structured. So, I have structured my responses along different lines: first of all, as a response to question 2, and then in three separate notes on specific topics prompted by my response to question 2.

Question 2 in the Budget Process Review Group consultation asked: ‘Should the Parliament pursue a full-year approach to budget scrutiny, and what are the challenges and opportunities of this approach? ‘

What seems clear is that, if the budget scrutiny process is going to be more than a hurried mechanical exercise then aspects of it will have to extend beyond the constrained timetable implied by an autumn Westminster budget. (The Block Grant component of the Scottish Budget will not be known until the Westminster Budget announcement. The Scottish Government then has until January 20th at the latest to present its Budget Bill to the Scottish Parliament: and the Bill must be passed within a further 30 days.) A distinction needs to be drawn between the complex logistics of the budget setting process itself: and the process of achieving an understanding of the wider context within which the budget setting process is operating. A proper understanding of that context would require having good information available on questions like:

1. Is the fiscal settlement currently operating in a stable or unstable fashion? If the system is becoming unstable, what are the factors driving this? (see Note 1 below);
2. Are there concealed threats which potentially threaten the ability to deliver budget plans? Are there, for example, potential threats arising from the possibility of a crisis in local authority finances? Or, from an undue reliance on ‘off balance sheet’ methods of funding capital expenditure? (see Note 2 below); and
3. Is adequate information available on the financial aspects of the general operation of devolution? (see Note 3 below)

I attach separate notes giving more detail on the issues involved in each of these questions.

The important point is, however, that unless there is an adequate grasp of issues like these when actual decisions come to be made in the budget setting process, then these decisions are likely to go badly wrong.

**Note 1: Monitoring and understanding the operation of the fiscal settlement**

Understanding how the fiscal settlement is operating, and the factors underlying its operation, will be a vital element in making sensible budget decisions. In particular, if the Scottish budget is threatened because the increase in the Block Grant Abatement (BGA) over a few years is greater than the buoyancy in Scotland’s devolved taxes, then a critical call will have to be made. The Scottish Government will have to decide whether this is likely to be just a temporary short term blip, which is likely to be self-correcting: or whether it represents the start of a secular trend.

The danger is that, if the Scottish Government makes the wrong call, it is likely to find itself on an accelerating path of relative economic decline, relative to rUK. The fiscal settlement is unstable, in the sense that, once Scotland finds itself in a position of relatively declining tax receipts as compared with rUK, the operation of the settlement will tend to re-inforce and accelerate these tendencies, rather than moderating them. Moreover, as noted in Bell et al, (2016), the current fiscal settlement is unusual in the extent to which it exposes Scotland to the risk of an asymmetric economic shock or adverse economic trends.

Precisely what risks Scotland will face will depend on which version of the fiscal settlement is in operation. At present, the BGA is adjusted effectively in line with the Indexed Per Capita, (IPC), method: with the possibility that, after 5 years, the Treasury will attempt to default to the Comparable Model, (CM), method, (depending on what interpretation is taken of the fiscal settlement agreement – see Cuthbert, (2016a)). Under the IPC method, Scotland is at risk, (of receiving less than it would have received under Barnett), if it fails to grow its per capita tax receipts as fast as rUK. Under the CM method, Scotland is in addition exposed to the risk of having a population which grows more slowly than rUK.

The algebra showing the relationship between the two approaches is set out in Cuthbert, (2016a), where (formula (1) in that paper), it is shown that the difference between the BGA and the CM and IPC methods grows cumulatively, with each term in the cumulative sum being an increasing function of the relative rate of population growth between rUK and Scotland. So the first step in understanding the potential difference between CM and IPC is to have available clearly displayed information on relative population growth, and how it is contributing to the evolution of this formula.

In many respects, however, the way in which the fiscal settlement negotiations came to fixate on relative population growth is something of a distraction. The big risk for Scotland, (particularly in the circumstances of secular decline in the North Sea), will be that per capita receipts on devolved taxes fail to grow as fast as in rUK. So it will be important for the budgetary process to be informed by clearly displayed information on what is happening to per capita devolved tax receipts in Scotland and in rUK: and also for information to be available on the factors which may be causing any divergences. Given that income tax is the main devolved tax, it will be particularly important to have relevant information available, and analysed, for income tax. In this respect, it will be important to have information on whether any divergence in income tax receipts per head is being driven by differences in the size of the tax base per head; and/or by differences in the tax richness of that base: (i.e., the amount which a standard tax policy would raise from a given base.)

A main factor which is likely to affect tax richness is likely to be any relative changes in the distribution of the tax base by income band.

What this points to is the need for a comprehensive report to be produced each year, giving, not just the full detail on the operation of the fiscal settlement, but also figures for Scotland and rUK on factors like population change, tax receipts, size of the income tax base per head, and tax base analysed by income band, together with an analysis of the impact of these factors on the operation of the fiscal settlement. Also relevant to what is happening, of course, will be economic information on relative GDP trends, etc.

Producing a report which pulls together all this information into a meaningful and accessible statement will be a non-trivial task. Such a report would require significant consideration and debate in its own right: this suggests it might better be handled outside the tight budget setting cycle between the Westminster Autumn budget, and the deadline for finalising the Scottish Budget.

**Note 2: Allowing for the impact of financial commitments which do not appear directly on the budget books.**

In the 2008 financial crisis, one of the nasty surprises was the impact on apparently well laid financial plans of various forms of commitment which had not originally been recognised. The most obvious form of this was when various assets, and their associated liabilities, which had been accounted for as ‘off the books’ of financial organisations, suddenly reverted to being ‘on book’ when the assets, (but not the liabilities), became worthless. But a similar, less formal, process also took place on a large scale when governments found that they could not escape underwriting the liabilities of various bodies – even though they had no formal accounting requirement to do so.

There are a variety of similar potential threats surrounding the Scottish Budget – both of the formal ‘off the book’ type, and the less formal type. It is argued here that budgetary decisions cannot safely be taken unless there is better recognition of such potential threats.

Probably the greatest such potential threat would be if there were to be a crisis in local authority finances. (As an interesting aside, the glossary to the BPRG Interim Report defines DEL plus AME as the ‘sum of current and capital expenditure of central and local government and public corporations.’ But the AME figures quoted in the Scottish Budget are departmental AME. This means that, as regards local authorities, DEL plus AME covers grants from the Scottish Government, and non-domestic rate income, but it does not cover expenditure by local authorities funded by council tax receipts, charges, or asset sales. The Interim Report itself thus in effect significantly overstates the extent to which local authority finances are covered in the budget documents.)

In both rUK and Scotland, central government has increasingly moved towards making local authorities themselves take responsibility for their long term financial planning and stability. This can be seen most clearly in the introduction, on both sides of the border, of the Prudential Code for Capital Finance. With the introduction of this code, central government abandoned the old system of controlling local authority capital expenditure through the issue of borrowing consents. Instead, local authorities were given the freedom to make their own decisions about borrowing for capital expenditure: each authority has, however, to set prudential indicators designed to endure that borrowing is affordable and sustainable, and has to produce an annual report showing that it is adhering to the prudential indicators that it has set.

It is quite clear, however, that if local authorities were to hit severe financial problems, then the Scottish Government would not be able to insulate its own budget from the resulting effects. If local authority services were being radically cut back, or council tax increasing too rapidly, then central government would face irresistible pressure to reconsider its own priorities, and to make additional resources available to authorities.

Given this, it is very important for the security of the Scottish budget that both of the following conditions hold: namely:

1. the Scottish Government has a good appreciation of the medium term prospects for local authority budgets; and
2. that mechanisms like the Prudential Code are operating safely and effectively.

At present, it appears that neither of these conditions is being met.

The Scottish Government appears to be remarkably poor at assessing even the fairly short term prospects for local authority budgets. In particular, it appears to be worse at doing this than some academic agencies. For example, it is instructive to compare the assessment of the prospects for local authority budgets in the Fraser of Allander Report, (FOA, 2016), which gives a careful, reasoned, and pessimistic, assessment for prospects up to 2020/21, with the Scottish Budget issued in December 2016. The budget only assessed prospects for local authority budgets up to 2017/18 – much too short a period.

Secondly, the Prudential Code is not operating satisfactorily. The operation of the code was the subject of a report from the Jimmy Reid Foundation, (Cuthbert, 2016b)), published last December. In that report, (a copy of which is submitted with this response), it was argued that the operation of the code had not adapted to the changed circumstances since its introduction. In particular, the planning horizons used by most local authorities in assessing their prudential indicators are too short. In addition, putting responsibility on each authority individually to assess its financial prospects gives no guarantee that authorities were sticking to nationally consistent assumptions.

The Jimmy Reid Foundation paper suggested a possible solution: namely, that there should be a central body, (but not central government), responsible for making an informed assessment of the medium term prospects for local authority finances: and that the financial planning projections of individual local authorities would both inform, and be informed by, this central assessment. Such an approach would do much to rectify both of the weaknesses identified at a) and b) above. Whether this is the appropriate approach to adopt or not, it seems clear that present practices need to be improved, if a potential funding crisis in local authorities is not to put the overall Scottish Budget at risk.

So far, I have concentrated on what, in the language of the opening paragraph of this note, is an informal ‘off the books’ threat to the Scottish Budget. But in addition, it is important not to lose sight of the extent to which the Scottish Government is using formal ‘off the books’ accounting in order to maximise capital expenditure. In particular, through the Hub initiative of the Scottish Futures Trust, more than £2 billion capital expenditure is being undertaken which is funded from revenue, and does not appear ‘on the books’ of the relevant commissioning public authorities: and about £3.5 billion of capital expenditure in total is being funded through various innovative approaches. The Scottish Government’s primary approach to ensuring that this does not cause future problems has been to set a limit (of 5%), as the maximum amount of the DEL to be taken up by the Scottish government’s contributions to funding such schemes. This seems to be an inadequate approach. If problems arise, they are likely to arise in the budgets of the commissioning bodies: and if the problems are serious, they are unlikely to be containable at this level. The Scottish Government should be more pro-active in modelling and assessing the wider implications of formal ‘off the books’ funding methods.

**Note 3: Background information on the operation of devolution across the UK**

Although not required as an essential input to the process of actually setting the Scottish Budget, it will still be important to have good background information available on how devolution is operating over the UK as a whole.

For example, one dataset which those setting and scrutinising the Scottish Budget will wish to have available to them is on the levels of per capita spend on the different ‘devolved’ services in the different parts of the UK. This is not to envisage, of course, that budget setting should simply reduce to matching spending levels elsewhere in the UK: the whole point of devolution is to let different political priorities be reflected in different spending priorities. But if accurate information is not available on what is being spent elsewhere on comparable services, then misleading claims are likely to be made: and this in itself could distort budgetary decisions.

The Treasury does publish a country and regional analysis of public expenditure in its annual Public Expenditure Statistical Analysis, (PESA). However, the Treasury figures are not ideal, because they take no account of the distinction between devolved and reserved services. Taking account of the devolved/reserved boundary will be even more important when aspects of social security are devolved to Scotland. Improving PESA is essentially a database issue, and ideally would require the alignment of the coding structures underpinning the Treasury Funding Statement, (which drives the Barnett formula), and the Public Expenditure Statistical Analysis. But once these databases are aligned, it should then be a relatively simple matter for the relevant analyses to be produced and published. (Note that different comparable expenditure figures will be required for different purposes: for example, the ‘comparable expenditure’ figure for London required for comparison with Scotland will differ from the London figure required for comparison with Wales, because of the different bundle of services devolved in Wales and Scotland.)

It would also be very useful to extend the existing GERS publication to bring out the different cross border funding flows. In essence, Scotland will be passing to Whitehall those tax revenues which are not devolved or hypothecated: and it will be ‘getting back’ the aggregate of the abated block grant, plus Scotland’s share of identifiable public expenditure spent for Scotland by Whitehall departments, plus Scotland’s share of non-identifiable public expenditure. The balance between these two aggregates will be very relevant to what the policy response should be to any funding squeeze in the Scottish Budget: and unless the Scottish government, or the Treasury, produce an authoritative estimate, unofficial, and less authoritative, estimates are likely to be quoted.

**Conclusion**

What has been argued here is that, if the Budget process is to operate successfully, there needs to be a thorough understanding of several different aspects of the wider context within which that process is operating. In particular, there needs to be a good grasp of the factors underlying the operation of the fiscal settlement: of any potential threats arising from formal or informal ‘off balance sheet’ debts: and of comparative information with the rest of the UK on the operation of devolution itself. Achieving such understanding implies a significant investment of resources: and a programme of work which should extend beyond the narrow budget setting process itself. However, the potential benefits are significant: in particular, successfully implementing such a programme would mark an important step in the maturing of devolved government in Scotland, away from the old days when the Scottish Government simply took and spent the block grant allocated to it from Westminster, towards a position where it thoroughly understood, and took responsibility for, its resources.

**References**

Cuthbert, J. R. (2016a) ‘Adjusting the Block Grant Abatement: the Algebra of CM and IPC’, *Fraser of Allander Economic Commentary*, 40/3, December.

Cuthbert, J. R. (2016b) ‘The Prudential Code: flimsy fig leaf in the coming storm’, Jimmy Reid Foundation policy paper, December.

Bell, D., Eiser, D. and Phillips, D. (2016) ‘Scotland’s Fiscal Framework: Assessing the Agreement’: IFS Working Paper W16/05; March.

FOA (2016) ‘Scotland’s Budget, 2016’, Fraser of Allander Institute, September.

1. Jim Cuthbert is an independent statistician who was formerly the Chief Statistician for the Scottish Office. [↑](#footnote-ref-1)