Overview

This paper analyses the scope to make different choices about the UK's public finances, within the fiscal targets set out in the Charter for Budget Responsibility. The key points are:

- The programme of fiscal consolidation since 2010, aimed at reducing public sector borrowing, has led to significant cuts in public spending, including to welfare. The spending plans set out in the March 2015 Budget suggest further spending reductions will continue during the current parliament.

- The Scottish Government advocates an alternative approach aimed at balancing deficit reduction with increasing investment in public services. The Scottish Government's proposal is to increase spending on public services by 0.5% a year in real terms between 2016-17 and 2019-20. This would release over £140 billion during this period for investment in UK public services compared to the March Budget plans - while ensuring that public sector debt and borrowing fall over the current UK parliament. Such an approach would provide up to £11 billion of additional investment for Scotland over the next four years.

- The Scottish Government continues to believe that a moderate increase in public spending, as outlined above, strikes the most appropriate balance between investing in public services and ensuring the sustainability of the public finances. The UK Government has advocated an alternative approach which will result in further spending cuts in the coming years to achieve the fiscal targets set out in the Charter for Budget Responsibility. However, the scale of the spending cuts set out in the March 2015 Budget significantly exceeds what is required to meet the UK Government's own fiscal targets.

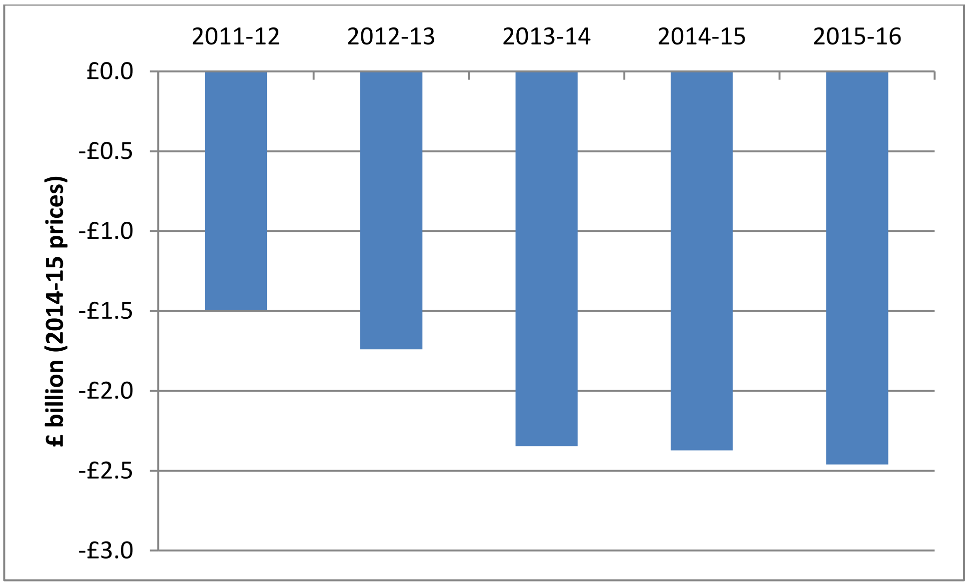
- There is therefore flexibility for the UK Government to meet its fiscal objectives without implementing in full the spending cuts that are currently planned for the coming years. For example, it could choose to increase investment in public services above March Budget levels – by £8 billion in 2016-17 and up to £36 billion in 2019-20, within the fiscal targets in the Charter for Budget Responsibility.

- In total, such a scenario would permit an additional cumulative £93 billion of investment in public services over the next four years compared to March Budget plans. This could provide up to £7 billion in additional investment in devolved public spending in Scotland over the same period.

Recent Trends in UK Public Spending

The programme of fiscal consolidation since 2010, aimed at reducing public sector borrowing, has led to significant cuts in public spending, including on welfare. For example, in the current financial year (2015-16) the Scottish Government's fiscal DEL budget is around £2.5 billion lower in real terms than it was in 2010-11 when the UK Government's fiscal consolidation programme commenced.

Reductions in Scottish Government Fiscal DEL budget compared to 2010-11 (real terms)



It has been argued that the UK Government's approach to deficit reduction has undermined the economic recovery in the UK, and in turn made it more challenging to achieve its fiscal targets.[1] For example, by depressing aggregate demand after 2010 at a time when private sector output had still not recovered from the recession, the speed and scale of the UK Government's austerity programme arguably contributed to the UK having a slower recovery than many of its international peers. Indeed, even by the end of 2014, five years after the end of the recession, UK GDP per head remained below the pre-crisis level. The subdued nature of the UK recovery has meant that growth in tax receipts has been slower than the UK Government anticipated when it set out its fiscal consolidation plans in 2010. As a result, over the six years to March 2016, the UK Government is due to overshoot the borrowing plans that it set out in June 2010 by over £150 billion.

Planned UK Public Spending

The Chancellor has signalled that treating public spending reductions as the focus of substantial further fiscal consolidation will continue during the current parliament. The March 2015 UK Budget set out aggregate spending plans for 2015-16 to 2019-20 which imply significant further real terms reduction in spending on public services, particularly in 2016-17 and 2017-18. The Office for Budget Responsibility reports that planned reductions in 2016-17 and 2017-18 will be larger than those implemented in any single year of the Coalition Government. The scale of these cuts means that, when complete, government consumption, a measure of spending on day to day public services, will have fallen to its lowest level since 1964 as a share of GDP.

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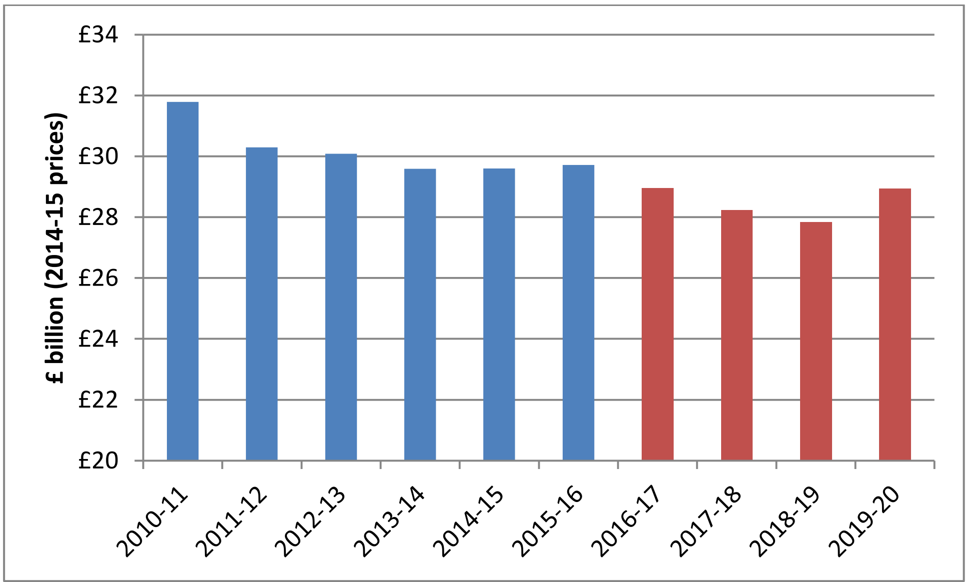
[1] See for example, Paul Krugman's article from 29th April:
http://www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion

The Institute for Fiscal Studies (IFS) published analysis in April of the spending plans contained in the March 2015 UK Budget and the fiscal proposals contained in the Conservative party manifesto to estimate the outlook for spending on public services (Departmental Expenditure Limits).[2] The IFS analysis suggested that in real terms spending on public services will fall by 2.6% in 2016-17, followed by cuts of 2.6% in 2017-18 and 1.5% in 2018-19. Spending is then projected to grow in real terms during 2019-20.

The impact of such cuts on the Scottish Government's budget will depend on how any spending cuts were allocated across UK Government departments and the subsequent application of the Barnett Formula. As an illustrative example, if the cut to the Scottish Government budget was in proportion to its share of overall UK departmental spending, it could expect to see its budget cut by up to £2 billion (6.2%) in real terms between 2015-16 and 2018-19.

The scale of planned cuts is expected to be confirmed at the supplementary UK Budget on the 8th July. The UK Government also announced, on the 4th June, changes to spending settlements in the current financial year. These will reduce Whitehall departments' budgets by £3 billion in 2015-16. Through the operation of the Barnet formula, these measures will impose further cuts on the Scottish Government's budget. The Scottish Government has already taken measures to minimise the impact of the UK Government's fiscal consolidation programme in the current financial year, including the use of capital borrowing powers of around £300 million and its programme of revenue-financed infrastructure investment, which will deliver estimated investment of around £950 million next year. Scottish Ministers have been clear that given the Scottish Government's budget for 2015-16 has been agreed by the Scottish Parliament, the proposed cuts should not go ahead and there must be no in year cuts to the Scottish budget this year.

Illustrative Outlook for Scottish Government Spending[3]



[2] IFS analysis is available from http://election2015.ifs.org.uk/uploads/publications/bns/BN170.pdf

[3] Figures to 2015-16 are consistent with Scottish Government budgets as of March 2015 Budget . Figures for subsequent years assume that 8% of the year on year change in the UK Government's total DEL budget is applied to the Scottish budget. Total UK DEL figures are taken from http://www.ifs.org.uk/uploads/publications/bns/BN170.pdf .

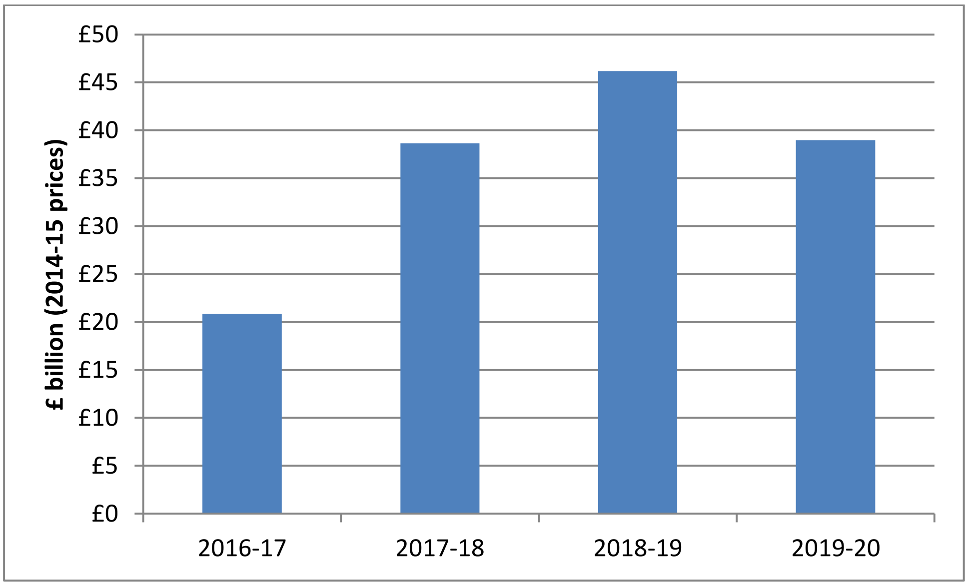
Scottish Government Proposals

The Scottish Government advocates an alternative approach to public spending which would balance the need to reduce the deficit with ensuring that there are no further cuts to spending on public services.

The Scottish Government's proposal is for an increase in spending on public services of 0.5% a year in real terms between 2016-17 and 2019-20. Such an approach would provide over £140 billion in cumulative additional investment in UK public services over this period, including up to £11 billion of additional spending on devolved public services in Scotland compared to the plans announced at the March UK Budget, whilst still ensuring that public sector debt and borrowing fall over the current UK parliament.

The Scottish Government continues to believe that this approach provides the best balance between ensuring the sustainability of the UK public finances, and investing in the public services which are vital to supporting households and long term economic growth.

Scottish Government's proposed increases in UK public spending compared to March Budget plans



The UK Government's Fiscal Targets

The UK Government's proposed approach for further reductions in public spending, as set out in the March 2015 Budget, significantly exceed what is required to meet the UK Government's own targets for reducing debt and the deficit set out in the Charter for Budget Responsibility. The UK Government therefore has flexibility, within these targets, to ease the scale of the spending cuts it has planned.

The Charter for Budget Responsibility sets out two key fiscal targets:

- **The Deficit Target** - "*to achieve cyclically adjusted current balance by the end of the third year of the rolling, 5 year forecast period*" and;

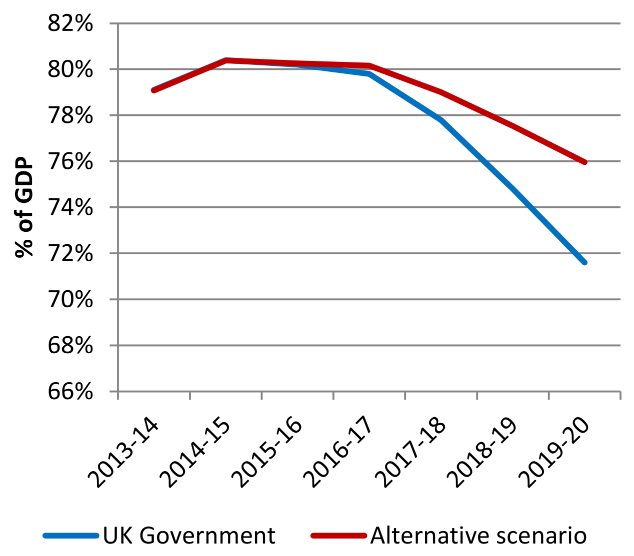
- **The Supplementary Target** – "*for public sector net debt as a percentage of GDP to be falling in 2016-17*".

To meet these targets when the next UK Budget is published on 8th July, the UK Government must set out plans consistent with achieving a cyclically adjusted current balance in 2018-19 (the third year of the forecast period) and having debt falling as a share of GDP in 2016-17. This will require further tax rises and / or spending cuts compared to 2015-16.

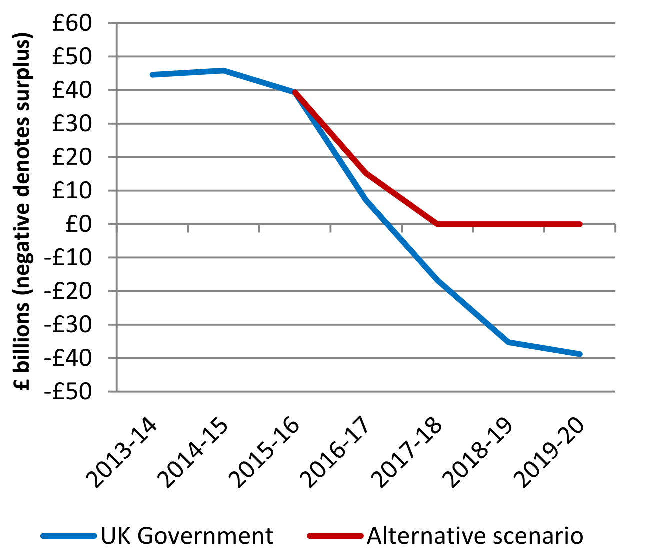
Based on plans set out in the March 2015 Budget, public sector net debt is projected to begin falling as a share of GDP in 2015-16 (one year earlier than the supplementary target requires) and a cyclically adjusted current budget surplus of £35 billion is projected by 2018-19, rather than returning the cyclically adjusted current budget to balance.

The UK Government therefore has the flexibility to cut spending by less than currently planned whilst still meeting its fiscal targets. This is demonstrated in the charts below. The blue lines indicate the path of public sector net debt and the cyclically adjusted current budget deficit based on the UK Government's Budget 2015 plans. The red lines set out an alternative fiscal path which would be compatible with meeting the UK Government's fiscal targets set out in the Charter for Budget Responsibility, while maximising resources available to public services.

UK Public Sector Net Debt



UK Cyclically-adjusted deficit on current budget



Source: OBR – Economic and Fiscal Outlook (March 2015) and Scottish Government analysis

Adopting the alternative approach implied by these charts would mitigate further reductions in public services while still meeting the UK Government's fiscal mandate. Additional investment could range from £8 billion in 2016-17 up to £36 billion in 2019-20, as summarised in the table below. With UK gilt yields remaining close to their historical lows, such an approach would allow investment in public services and infrastructure whilst minimising future repayment costs.

In total, such an approach would provide an additional £93 billion in investment in public services over the next four years as a whole compared to the March Budget plans. This could provide up to £7 billion in additional investment in devolved public spending in Scotland over the same period.

Potential additional spending on public services consistent with meeting the Charter for Budget Responsibility Targets (£bn)[4]

	2016-17	2017-18	2018-19	2019-20
Additional spending – UK	8	16	33	36
Additional spending – Scotland (Pro rata share)	0.6	1.3	2.6	2.9

Within this overall approach, the UK Government would be able to exercise choices about revised spending plans, for example investment in the economy and infrastructure, bringing forward increases in health spending, social security, supporting low incomes through tax changes and increases in the working allowance. These choices are important but are outside the scope of this paper.

Conclusion

The UK Government has set out plans for further reductions in public spending in the coming years.

The Scottish Government advocates an alternative approach aimed at balancing deficit reduction with increasing investment in public services. This would, release over £140 billion between 2016-17 and 2019-20 for investment in UK public services compared to the UK Government's March Budget plans – whilst safeguarding the sustainability of the UK public sector finances.

Even if the UK Government remains committed to meeting its fiscal targets for debt and the deficit, it has flexibility to ease the scale of planned spending cuts. The analysis presented in this paper demonstrates that it could choose to increase cumulative investment in public services by £93 billion over the next four years compared to March Budget plans whilst still meeting its fiscal targets

[4] Note – this table shows potential additional spending available for public services, after taking into account the impact on public sector debt interest