Scotland’s overspending problem

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Following the EU referendum result, the Scottish government announced that Scottish independence was once again “on the table”. However, most objective analysis shows that Scotland today couldn't afford independence, with the loss of English subsidies entailing a huge and unsustainable fiscal deficit. In short, the country is living beyond its means.

Part of the problem is the collapse in North Sea revenue. But more fundamentally, Scotland's public spending is excessive and beyond the capacity of its economy to support. The renewed call for independence has brought the issue into sharp focus, but overspending is a long-standing problem that needs to be tackled irrespective of the independence question.

This report examines the current state of Scotland's public finances and concludes:

- At £14.8bn Scotland's **fiscal deficit last year was 9.5 per cent of Scottish GDP**.
- That was over **twice the UK deficit,** and **higher than any other member of the EU**, including Greece.
- Despite sometimes record oil prices, **Scotland has run a deficit every single year since devolution in 1999.** The deficit has deteriorated over recent years, and is now running even higher than during the aftermath of the 2008 Crash.
- Scotland's **North Sea revenues have collapsed by £9.6bn since 2011-12**, equivalent to six percentage points of GDP. Falling production means that revenue loss will never be recovered even if oil prices return to previous highs.
- Despite this collapse in revenues, **Scotland's public spending remains far in excess of England's**. Spending per head is 20 per cent higher, equivalent to around 6 per cent of Scotland's GDP. This is sustained not by the Scottish economy, but by the continuing subsidy from English taxpayers via the Barnett Formula.
- To become and EU member, an independent Scotland would be forced to tackle its deficit. It would be subject to the rule that any deficit over 3 per cent of GDP is deemed excessive, requiring an agreed

programme of fiscal retrenchment.

- This could be achieved by tax increases:
    - The **basic rate of income tax could be increased from 20p to 39p**.
    - **VAT could be doubled to 40 per cent.**
- Such increases would almost certainly prove undeliverable politically, and would be deeply damaging to the Scottish economy.
- The country's excessive public spending would therefore have to be reduced, probably starting with those areas where provision is currently more generous than in England such as free university tuition, free personal care for the over-65s, and free prescriptions.
- The deficit could be reduced to 3 per cent of GDP by spending cuts. In 2015-16 this would have required:
    - Eliminating **all spending on defence** (£3bn), **public order and safety** (£2.8bn), **transport** (£3.2bn) and **agriculture, forestry and fisheries** (£0.8bn)
    - **Cutting health spending by 82 per cent**

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A chronic fiscal deficit

The latest official statistics[1] put Scotland's fiscal deficit at £14.8bn in 2015-16. Taking account of Scotland's geographical share of North Sea output, that's 9.5 per cent of GDP, which is well over twice the overall UK deficit at 4 per cent of GDP.

This is nothing new. Scotland has run a fiscal deficit every single year since devolved government was introduced in 1999. What's more, whereas the UK deficit has been on a slowly improving trend following the 2008 Crash, Scotland's has worsened. In the three years following the Crash, Scotland's deficit averaged 8 per cent of GDP, but it has now grown to 9.5 per cent. The figures are as follows:

Table 1: Net fiscal balance as percentage of GDP

	2011-12	2012-13	2013-14	2014-15	2015-16
Scotland	-5.7	-9.2	-8.2	-9.1	-9.5
UK	-7.1	-7.3	-5.9	-5.0	-4.0

Source: GERS 2016

As many commentators have pointed out, should Scotland become independent, a deficit approaching 10 per cent of GDP would almost certainly prove unsustainable. Scotland would be forced into a sharp bout of fiscal retrenchment, with one analysis suggesting it could become Greece without the sun[2].

We can see why that might happen by comparing Scotland's deficit with that of other European countries, especially those that have been forced to adopt stringent austerity programmes to tackle excessive deficits.

The standard international measure of a government's overall fiscal position is the General Government financial balance, published by the OECD and measuring the consolidated net deficit of central and local government, excluding public corporations. On that measure Scotland's 2015 deficit was £14.7bn, or 9.4 per cent of GDP – virtually the same as the numbers already quoted.

Here's how Scotland compares to other selected European economies in 2015 and four years earlier in 2011:

1 Government Expenditure and Revenue Scotland (GERS) 2016, The Scottish Government. Throughout this report we use the GERS figures allocating North Sea production and revenue on the basis of Scotland's geographical share.

2 Scotland: Could it become Greece without the sun? Centre for Policy Studies, July 2016

Table 2: General Government Financial Deficit as percentage of GDP

Country	2011	2015
Scotland	6.6	9.4
Greece	10.2	7.3
Ireland	12.6	2.3
Italy	3.5	2.6
Portugal	7.4	4.4
Spain	9.6	5.1
Euro area average	4.2	2.1

Sources: OECD World Economic Outlook June 2016; GERS 2016

As can be seen, Scotland's deficit is now higher even than Greece's, widely considered the archetypal fiscal basket case. In fact, Scotland's deficit is higher than that of any other member of the EU. Moreover, while deficits across the rest of Europe have been improving since the start of the decade, Scotland's has worsened.

An independent Scotland would need to convince markets that it could get on top of this chronic deteriorating deficit. Moreover, assuming it joined the EU, it would be governed by the EU's fiscal rules which define a deficit exceeding 3 per cent of GDP as excessive. On that test, Scotland's deficits have been excessive in 11 of the 17 years of devolved government. In 2015-16, the excess amounted to £10bn, and before accepting it as a member the European Commission would demand a plan to close that gap, either by boosting revenues or by cutting spending.

Of course, things could improve from here of their own accord, and at the time of the March Budget they were projected to do so: based on OBR forecasts the Institute for Fiscal Studies projected the deficit would fall to 6.2 per cent by 2020-21[3], still high but at least heading in the right direction. Unfortunately, since March, economic growth forecasts have been generally scaled back, and it seems likely that the fresh projections accompanying the Autumn Statement will show a worse picture.

3 Scotland's Fiscal Position: An Updated Assessment, IFS, March 2016

Revenue – higher oil prices are not the solution

As already noted, Scotland's fiscal deficit relative to GDP is currently over twice that of the UK. And as the following table shows, that reflects both higher spending and lower revenue.

Table 3: Scotland's fiscal position compared to UK (% of GDP; 2015-16)

Country	Scotland	UK
Public spending (% of GDP)	43.7	40.1
Revenue (% of GDP)	34.3	36.1
Deficit (% of GDP)	9.5	4.0

Source: GERS 2016

Now until a few years ago many of those in favour of Scottish independence argued that although Scotland's spending exceeded the UK average, Scotland could afford it because it owned most of the oil. And there are those who still maintain that Scotland's current deficit simply reflects temporary weakness in the oil price. They point out that the oil price has fallen from well over $100 per barrel just a few years ago to around $50 now. So of course Scottish revenue is down in the short-term, but at some stage it's bound to recover.

Sadly, that is a false hope.

For one thing, even in the years when the oil price was high, Scotland was still running fiscal deficits. Even in 2011-12, when the North Sea oil price peaked at $125 per barrel, Scotland's deficit was 5.7 per cent of GDP. In fact, Scotland has run a fiscal deficit every single year since devolution in 1999. Record high oil prices have never been enough to balance the books, let alone put away funds for a rainy day.

More fundamentally, the UK North Sea oil fields are depleting and production is on a sharply declining path. Since its peak in 1999 production has fallen by two-thirds, triggering a plunge in oil revenues. Between 2011-12 and 2015-16 revenues fell by over 99 per cent as industry profits declined and expenditures increased on marginal projects to squeeze out the final reserves.

Table 4: Scotland's North Sea Revenue (£m)

Country	2011-12	2012-13	2013-14	2014-15	2015-16
Revenue (£m)	9,633	5,306	3,999	1,802	60

Source: GERS 2016

Even given a higher oil price, with production falling and expenses rising, oil revenues will never reach anything like their previous levels. Oil is no longer the Golden Goose that can fund Scotland's higher public spending.

Of course, oil is not the only source of revenue, and an independent Scottish government could seek to raise revenue by increasing onshore tax rates. SNP rhetoric certainly suggests it would prefer that to cutting expenditure, and it's possible that Scotland might turn towards a Scandinavian high tax and spend model.

But closing Scotland's fiscal gap through onshore tax rises would entail some swingeing increases. Scotland's

two biggest tax revenue sources are income tax and VAT, and even they would require huge rate rises to stand any chance of closing the gap. On the basis of the latest HMRC tax ready reckoner[4], in order to bring its 2015-16 deficit down to the EU's 3 per cent limit using these taxes, Scotland's choice would be[5]:

a) Raise the basic rate of income tax from 20p to 39p; or
b) Raise the standard rate of VAT from 20 per cent to 40 per cent.

While such an approach might in principle be saleable to the Scottish people, in practice it seems highly unlikely. Although Scottish governments have had the authority ever since 1999 to raise income tax in order to fund additional public expenditure, it is telling that none has chosen to do so. They seem to have judged that the Scottish electorate are not receptive to the Scandinavian model, even to the extent of just a couple of pence on income tax.

And tax increases on the scale implied here would likely have a deeply damaging impact on the Scottish economy. An independent Scotland jacking up taxes substantially above those just over the border could expect to see a haemorrhage of GDP and jobs. Tax revenues could even fall.

Which means that the only option left to balance the books would be to cut spending.

Scotland's overspending problem

For as long as we have official statistics, Scotland's public spending has been considerably higher than England's. When we analysed the history in 2008[6], we found that Scotland's spending per head overtook England's sometime early in the last century, and despite various attempts to rein it in, remained higher right up to the present day. By the late noughties the Scottish premium was running in excess of 20 per cent, and that remains the case today.

According to Treasury figures[7], in 2014-15, identifiable spending per head in Scotland was £10,374, 20 per cent higher than England's £8,638. Identifiable spending makes up around 80 per cent of Total Managed Expenditure (TME) and comprises spending such as health, education, and welfare payments that can be related to beneficiaries in specific countries. Of the remaining 20 per cent, around half covers items such as defence and debt interest payments that are assumed to benefit people across the UK evenly. The other half comprises various accounting adjustments for non-cash items such as depreciation and pension liabilities that net off against matching revenue items and therefore don't impact the fiscal deficit.

4 Direct Effects of Illustrative Tax Changes, HMRC, March 2016
5 See Annex for calculations
6 Unequal Shares: The Definitive Guide to the Barnett Formula, Mike Denham, TPA, 2008
7 Public Expenditure Statistical Analysis (PESA) 2016, HM Treasury July 2016

The following table shows by how much Scotland's identifiable spending per head has exceeded that in England over the last few years, and what that excess implies in terms of Scotland's overall public spending, both in cash terms and as a percentage of GDP.

Table 5: Scotland's spending excess

Country	2011-12	2012-13	2013-14	2014-15
Spending excess per head (%)	19	20	19	20
Spending excess per head (£)	£1,573	£1,722	£1,608	£1,736
Scotland's excess spending (£bn)	£8.3	£9.2	£8.6	£9.3
Scotland's excess spending (% of GDP)	5.4	6.0	5.4	5.9

Source: PESA 2016, GERS 2016, and TPA calculations

The striking point here is that at around 6 per cent of GDP, Scotland's excess spending is virtually the same as the excess in its fiscal deficit compared to the EU's 3 per cent test. In other words, if Scotland's public spending was in line with the average for England, its chronic deficit problem would be largely eliminated.

Of course, higher Scottish spending does not necessarily mean it is excessive compared to England. It could be that Scotland's public spending is higher because it needs to be, perhaps because it has more poverty, or more old people, or it's less densely populated, or it scores higher on various other "needs indicators". Scotland could need more spending simply in order to achieve the same level of public service and welfare provision as England enjoys.

However, while studies have shown that differing needs may explain some degree of higher spending in some areas (e.g. schools), in other areas (e.g. health) the opposite is true[8]. There is no general pattern. Differing needs do not explain why Scotland spends more than England across every single one of the ten major categories of identifiable public expenditure, from education (+12 per cent), to health (+5 per cent), to social protection (+10 per cent), to economic affairs (+93 per cent)[9].

One very visible explanation for higher spending is that provision levels are higher in Scotland. Here are three well known examples:

- Scotland provides free personal care for all pensioners assessed as needing it; in England care is heavily means-tested.
- Scotland provides free university tuition for all its students; in England students are charged up to £9,000 pa.
- Scotland provides free prescriptions for all; in England there's a charge of £8.40p per item.

So in part, Scotland is spending more than England because of higher provision levels – something that increasingly grates with taxpayers elsewhere in the UK.

There's one further point to make about spending in an independent Scotland. As part of the UK, Scotland benefits from the EU contributions rebate originally negotiated by the Thatcher government. In 2015-16

8 See for example Government Spending on Public Services in Scotland: Current Patterns and Future Issues, IFS Briefing Note BN140, IFS, 2013

9 Source: PESA 2016, HM Treasury; figures relate to latest year, 2014-15

Scotland's estimated share of that rebate was £335m[10], just under a quarter of its gross contribution pre-rebate. It is highly unlikely that an independent Scotland joining the EU would be granted such a rebate, adding a further £335m to the country's spending excess.

The fundamental point is that whatever the explanation for its higher spending, with a fiscal deficit approaching 10 per cent of GDP, and no realistic way of raising sufficient tax revenues, an independent Scotland would have to make cuts. There's nothing magical about English levels of provision, and Scotland could chose a different set of priorities, but overall it would have to cut back to a level of provision its own economy could support.

And this highlights the fundamental issue here: whether or not Scotland eventually becomes independent, it is currently a country living well beyond its means.

A country living beyond its means

With a fiscal deficit approaching 10 per cent of GDP, Scotland's higher than average levels of public spending are made possible only by the continuing subsidy from English taxpayers via the Barnett Formula.

As we explained in a previous report[11], this subsidy has never been based on an analysis of need, but has developed almost by accident over the last 150 years. In essence it built up because for many years Scotland was allocated a more or less constant share of UK government spending even though its share of the overall population was falling. True, since the 1970s there have been half-hearted attempts to squeeze it (including the Barnett Formula itself), but given the rise of Scottish nationalism, Westminster politicians have always been wary of squeezing too hard.

After finally discovering what was going on, English and Welsh taxpayers have become increasingly agitated about the unfairness of this subsidy. They have been especially unhappy about the unfairness of paying for Scots to enjoy benefits unavailable to their English and Welsh counterparts, such as that free personal care for the over-65s, and free university tuition. Yet the subsidy also poses problems for Scotland, leaving it financially dependent on England at a time when many Scots want their country to follow a more independent course.

Nobody would start from here, but the long-term solution was identified in our previous report: fiscal decentralisation. Scotland should be given authority to raise more of its own taxes and freed from dependency on grant funding from Whitehall.

The UK currently has one of the most centralised fiscal systems in the developed world. The proportion of taxes raised centrally in the UK is over 95 per cent, compared to 87 per cent in France, 71 per cent in Germany, and an OECD average of 85 per cent[12]. Which means that both our local authorities and our devolved administrations are primarily dependent on central government grants for their funding rather than raising revenue from local people and businesses.

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10 GERS 2016

11 *Unequal Shares: The Definitive Guide to the Barnett Formula*, TPA 2008

12 OECD *Fiscal decentralisation database*; figures are for 2011

As we have discussed elsewhere[13], experience around the world shows that devolving tax raising power to the government level actually spending the money has several advantages. It makes for a greater focus on the efficient use of taxpayers' funds, it makes public provision more responsive to local priorities, and it puts direct democratic pressure on spending authorities to live within their means.

Thankfully, changes are now underway. Since April this year, Scotland has had its own 10p basic rate of income tax which it can vary and the revenue from which goes directly to Scotland, replacing a portion of the block grant. From next year, it will have further powers, including power to vary income tax rates and bands, Air Passenger Duty, and the Aggregates Levy. It will also receive half of Scottish VAT receipts, replacing another portion of the block grant.

These changes are welcomed but they need to go further. The long-term objective should be to allow Scotland to raise the bulk of its revenue from its own residents and businesses. Its government should have the authority and responsibility to strike its own balance between its desire for more public services, and the taxable capacity of its economy.

No country – independent or not – can expect to live beyond its means in perpetuity.

Annex: Revenue calculation

Our estimates of the tax increases needed to close Scotland's fiscal gap to 3 per cent of GDP are based on HMRC's tax ready reckoner (Direct Effects of Illustrative Tax Changes, March 2016). We have deliberately taken the largest annual impact figures they quote so as not to overstate the implied tax rises.

For Scotland's basic rate of income tax HMRC quote a revenue impact for each one penny change in the rate of £480m in 2016-17, rising to £530m in 2018-19. Taking the larger figure implies that to close the £10bn fiscal gap, the basic rate would need to increase by 18.9 pence (equals £10,000m/£530m), rounded to 19 pence.

For the standard rate of VAT, HMRC don't publish a separate figure for Scotland. However, for the UK as a whole, they quote a revenue impact for each one percentage point change in the rate rising from £5,500m in 2016-17 to £5,900m in 2018-19. To estimate the impact in Scotland, we take the government's estimate of Scotland's share in total VAT receipts (8.6 per cent)[14], and apply that to the UK impact figure. That gives us a Scotland impact figure of £507m, and implies that to close the £10bn fiscal gap, the standard rate of VAT would need to increase by 19.7 percentage points (equals £10,000m/£507m), rounded to 20 per cent.

It should be noted that like HMRC's ready reckoner, our estimates of the required tax rises take no account of the indirect effect of such tax increases on the broader economy. Rises on this scale would likely have a substantial and damaging impact on the economy. They would almost certainly erode the tax base, resulting in the additional revenues being much less than implied by the ready reckoner. To raise the desired revenue, the government might then need to raise rates by even more, although of course, at some point more, although of course, at some point counterproductive Laffer Curve effects would set in.

13 See for example *The Single Income Tax: Final report of the 2020 Tax Commission*; Chapter 8; TPA and IOD, 2012
14 Government Expenditure and Revenue Scotland (GERS) 2016, The Scottish Government.