The Scottish Public Finances 2010-11 - Surplus or Deficit?

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The Fiscal Context

The annual publication of the Government Expenditure and Revenues in Scotland Report (known as GERS), which is compiled by professional economists in the Scottish Government, is a highly political event.

The stated aim of GERS is to enhance public understanding of fiscal issues in Scotland, by estimating a set of public sector accounts. It does so by both estimating total government revenue and expenditure in Scotland, then calculating a net fiscal balance. A fiscal deficit, however, is not a financial problem, as it is part of the UK public accounts and simply measures the gap between spending and revenues in Scotland (McCrone, 1999; Goudie, 2002).

GERS was first published in 1992, and then developed and expanded in 1995, since when it has been published annually. It was described as

> *"an important element in the debate about Scotland's future. This debate has generated a range of claims and counterclaims 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".*
>
> *(Scottish Office, 1995)*

It has always been subject to political spin by Scottish Ministers (Heald and McLeod, 2002), firstly to attack devolution, then independence, and now the SNP use the report to support their economic case for independence in the referendum process.

Scottish Finance Minister John Swinney claimed "that Scotland continues to contribute more to the UK Treasury than we receive in public spending" (Scottish Government, 2012a). This led to one respected economic analyst to describe this as "statistical massaging", arguing that political leaders must not be allowed to tailor findings in government expenditure reports (Young, 2012).

Arguments over GERS accuracy have generally been between the SNP and the other political parties, rather than between experts. Whilst GERS is based on estimating techniques and the UK's public expenditure statistics, researchers in the area have accepted that it maps out the broad magnitude of Scotland's fiscal position (Heald et al, 1998; MacKay and Wood, 1999; Bell and Christie, 2002), and therefore "the kind of fiscal position from which an independent Scotland would start" (Murkens, Jones and Keating, 2002).

Accounting for the Fiscal Deficit

The long-term fiscal deficit has resulted from a long established system of incremental budgeting, with allocations to departments and devolved administrations based on political judgements of expenditure need, irrespective of fiscal contributions. In a unified system, fiscal transfers occur automatically, and nine of the twelve regions of the UK have allocations which exceed their tax contributions (Midwinter, 2004).

What complicates the Scottish position is the treatment of North Sea revenues as ex regio (not attributed to any regions in the UK) in the public accounts. In this paper, a geographical share of North Sea revenues is attributed to Scotland. In a paper for the Scottish Parliament's Finance Committee, I showed that from 1996 Scottish shares of all other taxes fell from being broadly equivalent to our population share, to less than it each year, averaging 8.3% of tax yields, and 8.6% of the population (Midwinter, 2007). The GERS report regularly publishes fiscal balances on this basis, and with oil revenues attributed to Scotland on the basis of an estimated geographical share, the most relevant measure for an independent Scotland.

Since its victory in the 2011 Scottish parliamentary election, the SNP Administration has been undertaking a public consultation exercise prior to its independence referendum, and published two papers favouring independence. The first considers options for fiscal autonomy, and argues that:

> *"The current framework significantly constrains the ability of the Scottish Government to boost Scotland's long term competitiveness through, for example, introducing a simpler and more competitive regime. It also constrains the ability to take short-term measures to stabilise the economy, through, for example, tax cuts or significant increases in public investment"*
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> *(Scottish Government, 2009a).*

This is, however, wholly consistent with the reservation of macroeconomic responsibility with the central state as happens in most countries, and the devolution of microeconomic functions to support the economy. It does not mean action is not taken.

Similar arguments are set out in the consultation paper (Scottish Government, 2009b), identifying the creation of a "Sovereign Wealth Fund" based on Scotland's oil and gas reserves, and cutting corporation tax to enhance growth, as desirable initiatives.

The SNP has stated its view that "Scotland pays its way" (SNP 1997; 2001) for the past fifteen years, whilst acknowledging that surpluses in the 1980s were because of the high tax yields from oil and gas. In public accounting, this also reflected the attribution of privatisation proceeds as revenues (Midwinter, 2000).

The consensus among researchers, however, is of a recurring structural deficit and high levels of public spending over the 20th Century (Lee, 1995; Woods, 2001; Bell and Christie, 2002; Goudie, 2002; Midwinter, 2007; and Calmans Independent Expert Group, 2008).

By contrast, Hallwood and Macdonald (2006) who favour fiscal autonomy under devolution or independence, observe that "the Scottish budget deficit probably varies from negative to positive and back again", although they offer no financial evidence that this is indeed the case, data readily available in the GERS series.

So does the reported fiscal surplus stand up to scrutiny? In fact, GERS 2010-11 shows that in only two years out of five did Scotland record a current budget surplus of £552m in 2006-7, and £999.3m in 2009. But this is not a measure of the fiscal position Scotland would inherit on independence, as it excludes capital expenditure, which is funded as capital from current expenditure within the Block Grant. The actual net fiscal deficit, which the Finance Minister ignored, was £3 and £3.6 billions in these years.

Deficits have increased significantly in recent years as UK revenues fell and borrowing grew in response to the world financial and economic crisis. The net fiscal deficits reported in GERS 2010-11 are shown below.

Table 1: Scotland's Net Fiscal Deficits, 2006-7 to 2010-11

Year	North Sea Revenue (£bn)	Net Fiscal Deficit (£bn)
2006-07	7504	3034
2007-08	7115	3668
2008-09	11740	3734
2009-10	5930	14179
2010-11	7951	10679

Since 1992, GERS has reported fiscal deficits for Scotland, ranging from £2.9 billion to £14.2 billion, whilst North Sea revenues have ranged from £1 billion to £12 billion.

Similar findings were reached in a recent note on Scotland's fiscal position, applying a geographic share of North Sea revenues to Scotland (Ashcroft, 2012). This shows that Scotland had a theoretical surplus in the 1980s, when both oil revenues and privatisation income levels were high. Since 1990, there has been a recurring fiscal deficit, exacerbated since 2008 because of governmental responses to recession. Between 1990 and 2007 the deficit averaged above 3% of GDP, whilst the UK average was below this EU Stability Pact benchmark.

These figures highlight a major gap in the Scottish Government's argument; namely its failure to acknowledge that its high level of dependency on a highly volatile oil and gas revenue will be a recurring budget problem. Even when this yield is high, there would be no surplus to transfer on independence.

This dependency on oil and gas revenues is clear from data reported in GERS which I collated in a paper for the Scottish Parliament's Finance Committee. Since 1993-4, the Scottish public finances have been in a recurring deficit position, even when the North Sea yield was above the £3.2 billion average (see Table 2 below).

Table 2: Oil and Gas Revenues and Net Fiscal Deficit in Scotland's Public Finances 1993-2004

Year	Oil and Gas Revenues (£bn)	Fiscal Deficit (£bn)
1993	1.2	6.9
1994	1.6	6.6
1995	2.4	4.7
1996	3.5	3.6
1997	3.3	2.1
1998	2.6	1.3
1999	2.5	1.5
2000	4.3	1.1
2001	5.2	2.8
2002	4.9	4.4
2003	4.3	6.9
2004	5.2	6.0

Source: A. Midwinter (2007) Report prepared for The Scottish Parliament Finance Committee

The lack of feasibility of implementing their promises to create an oil fund or to cut corporation tax should be clear from the GERS data. Increased scrutiny of this in the news media has resulted in them being qualified by the Scottish Government as only happening when fiscal conditions permit, a key retreat from the claims in their earlier report (Scottish Government, 2009b). This is a belated recognition of fiscal reality.

Conclusion

The claims by the Finance Minister that Scotland is in fiscal surplus within the UK cannot be validated from his government's own data. As a stream of researchers have observed, Scotland has been, and remains, in a net fiscal deficit position since GERS reports began.

Moreover, this selective use of official data for partisan advantage is not new. In opposition, the SNP regularly varied the assumptions underpinning the GERS estimates in their own calculations to deliver a paper surplus (Midwinter, 2002), so this practice has been continued in government.

Similarly, the Scottish Government claims Scotland has been "underperforming" in relative economic growth, based wholly on a single indicator, GDP (Scottish Government, 2010). The Centre for Public Policy and the Regions has argued that GDP per capita is a better measure of changes in living standards (McLaren, 2012), and that Scottish growth has been broadly in line with the UK, and above the OECD average, since devolution. Indeed, the Scottish Government's own data records improved growth rates from 1.8% to 2.3%, but this is ignored. So, there has been no economic underperformance in recent years, nor would there be any fiscal surplus available on independence.

It should also be clear that the fiscal deficit is <u>not</u> a problem within the UK, as it simply reflects the fiscal flows within a unified fiscal system, which recognises higher needs in nine of the twelve nations and regions of the UK. The Finance Minister has presented a false prospectus in his assessment of the fiscal implications of independence.

The Scottish Government's assessment of the fiscal implications of independence contains fundamental errors of fact and judgement, and its claims must be subject to continuing rigorous scrutiny in the referendum process. The structural deficit remains a fundamental problem it is unwilling to address.

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