Economic PERSPECTIVE

GOVERNMENT EXPENDITURE AND REVENUE IN SCOTLAND: ACCOUNTING FOR THE FISCAL DEFICIT IN 1996-7

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The annual publication of the Government Expenditure and Revenue in Scotland (GERS) Report is becoming a set-piece political confrontation between the Scottish National Party and the government of the day. This statistical exercise was dubbed 'Forsyth's fiddled figures' under the Conservatives, and as 'bogus' under Labour. This year, the SNP described the report as a 'thoroughly discredited exercise, that is political and subjective, but presented as factual and objective', and criticised 'the treatment of European funding, the underestimation of income tax receipts in Scotland, and substantial changes to the allocation of identifiable expenditure'. These criticisms shall be reviewed below, after setting out the fiscal arithmetic.

The GERS Report was first published in 1992, but has been published annually since 1995. As the 1996 report noted the government's expenditure and revenue flows in Scotland remain an important element in the debate about Scotland's future (Scottish Office 1996, p 3). These reports seek to make 'a strictly factual contribution to public understanding' of this issue, and note that Scotland's fiscal deficit 'in practice has no meaning under the existing constitutional arrangements'.

With the prospect of devolved government, it is in the public interest to generate information regarding fiscal flows within the UK. The GERS calculation, however, is not simply 'factual'. The methodology contains assumptions, and the data requires interpretation and judgement. It assessed total Scottish expenditure was £31.8 billion - giving a figure of 16% above the UK per capita average. Identifiable expenditure accounted for £24.7 billions; non-identifiable expenditure of £3.1 billion; and other expenditure £4.0 billions. Overall, this Government revenues accounted for £24.7 billion (8.7% of UK total) leaving a deficit of £7.1 billion. The figures exclude North Sea oil revenues and privatisation proceeds. If these were attributed to Scotland, the deficit would fall to £3.1 billion. The report acknowledges there is imprecision due to the need to make estimates for a number of elements, and should be regarded as indicative. The SNP challenge this interpretation, and assert that Scotland is in balance by contesting a number of the key accounting assumptions. These are:

- the government changed the accounting definitions to increase the amount of identifiable expenditure, to enhance the deficit.
- the approach to calculating Scottish income tax receipts underestimates the figure by around £500 millions.
- the calculation excludes EC receipts, for which Scotland is in surplus, which would reduce the deficit by £300 millions.
- the deficit excludes oil revenues and privatisation proceeds on their assumption would reduce the deficit by £3.6 billion.
- the figures exclude Scotland's share of the UK deficit which would reduce the deficit by a further £2.8 billions.

They argue that, when these matters are taken into account, Scotland's fiscal flows are broadly in balance.

To understand the issue better, we need to distinguish between the purpose of the GERS report - which is to measure the fiscal flows within the United Kingdom - from political arguments over Scotland's fiscal health in the event of independence. The latter would reflect both the inherited position from the UK, and the fiscal strategy adopted. The focus in this paper is on the accuracy of the calculation of the deficit within the UK, and its implications for the fiscal position Scotland would inherit on independence.

The assessment of fiscal flows published in GERS is reasonably accurate. Firstly, the evidence does not support the argument that the identifiable expenditure element had been enhanced to highlight Scotland's disadvantage. Scotland's share of identifiable expenditure actually fell after the change. In cash terms it grew by £900 millions, but most of this reflects normal spending changes - highlighted by the fact that Scottish non-identifiable spending fell by only £200 millions. This would have little impact on the deficit - which itself fell over the previous year.

Table 1 Scottish Share of Identifiable Expenditure

Year	%
1992-93	10.40
1993-94	10.43
1994-95	10.55
1995-96	10.49
1996-97	10.36

Source: HM Treasury, Public Expenditure Statistical Analysis 1998-9.

This criticism has little merit. The reality is that this change happened earlier in the year in the PESA Report, on the grounds that:

> . . . the coverage of the exercise has been significantly extended this year, in order to improve both the detail and the quantity of data collected. Expenditure was disaggregated in finer divisions than in previous exercises... (PESA 1998-9, p 83)

There is no visible disadvantage to Scotland's fiscal position from this change, and the relevant issue from a public interest perspective is simply that the new approach is more accurate - not who benefits from it. The new approach gives a more accurate measure of the deficits.

Secondly, the SNP challenge the calculation of income tax receipts in Scotland which is based on the Survey of Personal Incomes, and argue that using an estimate of 'liabilities' to calculate 'receipts' is unreliable because Scotland has a lower level of dividend income. They point out that, if population share were used rather than liability, the figure would be about £500 millions more. However, they too note that they can't be certain how big the underestimate actually is, but simply that some underestimate will occur (Private correspondence). The GERS study notes the problems, but defends the approach over basing it on share of income tax payers or population as it takes account of the different distribution of income, with Scotland having a higher share of low-earners than the UK norm. The liabilities will reflect that. Any attempt to quantify the 'underestimate' is therefore verging on guesswork without hard data. Hence we do not know if there is an underestimate, as there is no empirical basis to the SNP's figure.

Thirdly, we turn to EC expenditure. The treatment of EC flows (expenditure and contribution) is an appropriate one in the context of the UK's public finances. The Nationalists accept this for the UK as a whole, but not for Scotland, where they advocate treating European receipts as an "external flow" whereby the difference between Scottish receipts and Scottish contribution to the difference between gross and net UK contributions is applied to the deficit, reducing it by £300 millions. That is, they propose treating receipts as revenue rather than expenditure for the purpose of the calculation. This would not be defensible in a UK exercise seeking to identify flows of expenditure. The point is that the SNP see Scotland as being in surplus from EC flows, whereas the UK is in deficit. That would be a calculation to make in assessing fiscal health at independence, not fiscal flows within the UK.

Similar arguments pertain to the calculation of oil revenues and privatisation proceeds, which are excluded from the fiscal deficits. Excluding oil revenues and privatisation proceeds shows Scotland with a deficit of £7.1 billions or 11.25% of GDP (compared with £31.7 billions or 4.25% for the UK). When these flows are attributed to Scotland on the basis used by the SNP, then the deficit is reduced from £7.1 billions to £3.5 billions. Put simply, without oil, Scotland has a substantial deficit. With oil and privatisation proceeds it has a reduced deficit.

The SNP also argue for a Scottish share of the UK deficit to be discounted on the basis of the Scottish population. As the purpose is to measure relative fiscal flows, that makes little sense. It does not then put Scotland in 'surplus', as this £2.8 billions would still require to be met.

From the figures it is clear that Scotland's prospect of fiscal balance is heavily dependent on assumptions over oil revenues and privatisation proceeds, given our 16% spending advantage over the UK norm. Indeed, the parliamentary answer extracted by the SNP from the previous government reveals how fiscally precarious the Scottish position is without such flows. In the 15 years from 1979, Scotland had a fiscal deficit of £85.5 billions, which is converted into a £27 billions surplus when the oil and privatisation income is included. This 'surplus' was a central theme of the SNP 1997 election campaign.

However, it was mainly due to high oil income in the early 1980s. Using the SNP's own methodology, Scotland's deficit since then, including oil and privatisation income, is £11.76 billions. The decline of both oil and privatisation income has caused a rapid erosion of Scotland's fiscal health.

Table 2 Scotland's Fiscal Deficit since 1986-7 (inc. oil and privatisation income)

Year	£ billions
1986-7	+3.4
1987-8	+4.7
1998-9	+5.1
1989-0	+3.2
1990-1	+1.6
1991-2	-2.9
1992-3	-7.2
1993-4	-8.5
1994-5	-6.5
1995-6	-4.6
Total Scottish deficit since 1986-87	11.7

Source: SNP (1997) *It is Scots who pay*

These deficits matter as the SNP in its Programme for Government paper assumed Scotland would inherit a fiscal balance, which would move into surplus, and the estimates were 'expressed in terms of the additional revenue and expenditure compared to present tax and spending flows within the Union'. (p 1)

Would this assumption of fiscal balance hold at independence? The problem for the SNP is that the very areas they challenged in the GERS report are replete with the same uncertainty and imprecision when applied to an independence budget. Firstly, the £500 millions in greater income tax receipts has no empirical basis. It was achieved simply by assuming Scotland's share of receipts was the same as its population. Secondly, the calculation of a £300 million surplus from European flows assumes the same pattern continues after independence, whereas both could change. Scotland's contribution to the EC will have to be negotiated, and our eligibility for funds on the basis of per capita GDP (if this included substantial oil revenues) might well differ. Indeed, it is now clear that the Highlands and Islands no longer automatically qualify for Objective 1 funding on a GDP basis. Moreover, the official figures for European Union Receipts were £130 millions less than the £700 million used by the SNP (Scottish Office Finance Group, private correspondence). There is no sound basis for assuming that the flow of EU funding would reduce the Scottish fiscal deficit, and there is no empirical basis to the SNP's estimate of a Scottish surplus of £300 millions. Thirdly, proceeds from oil revenues are now in decline, having fallen from £3.5 billions in 1996-7, to £2.6 billions in the current year, and projected to fall below £2 billions per annum for the next four years, as shown below.

Table 3 Treasury Oil Revenue Forecasts, September 1998

	£ billion
1998-9	2.6
1999-0	1.3
2000-1	1.2
2001-2	1.4
2002-3	1.5
2003-4	1.9

Source: HM Treasury 1998

Privatisation proceeds - £400 millions for Scotland in 1996-7 - have now been eliminated. Further, the SNP have assumed Scotland will receive 90% oil revenues, which may not materialise. There will have to be proper negotiating over our share of oil revenues, debt interest etc.

CONCLUSIONS

The GERS report, whilst inevitably displaying imprecision, does reasonably quantify - in its own terms - 'the broad order of magnitude' of the gap between government expenditure and income in Scotland. This is not surprising. It is an established principle in British public finance that broadly expenditure should reflect need, and taxation should reflect ability to pay. With Scotland's relatively high levels of poverty, ill health and sparsity that is what we would expect. Scottish spending is 16% above the UK average. If Scotland was in fiscal balance that would indicate a failure of the UK polity, not the Scottish economy.

This review has shown that the GERS figures have not been fiddled, and that the judgements made are defensible. The SNP's criticisms over income tax receipts and EC funding are subject to the very imprecision they attributed to the report itself If Scotland were to become independent in the next few years, it would inherit a fiscal deficit from the UK government, because of our higher public expenditure levels, the decline of oil revenues, and the elimination of privatisation proceeds. The exact scale of the deficit would depend on the outcomes of negotiations over Scotland's share of oil revenues, debt interest etc. The issue would then be how to manage it.

The GERS report, therefore, makes an important contribution to our knowledge of the fiscal flows within the UK, and the uncertainties in the fiscal calculus if Scotland became independent. There is clearly imprecision, but the question mark is over the scale of the deficit, not its existence.

Annex 1

Government Expenditure and Revenue in Scotland 1996-7

Expenditure	*£ billions*
Identifiable Expenditure	24.7
Non-identifiable	3.1
Other	4.0
Total GGE	31.8
Privatisation Proceeds	0.4
Total GGE	**31.4**

Revenues	*£ billions*
Income Tax	5.5
Social Security	4.2
VAT	4.0
LA Revenues	2.2
Other	8.7
Total - identifiable	24.6
Oil Revenues	3.6
Total Revenue	**28.2**

Source: Scottish Office (1998) Government Expenditure and Revenue in Scotland, 1996-7 (Glasgow).

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